left: American gas station sells out in first oil shock in 1973

Commodities

Oil, be damned

If countries are to survive in an age of increasingly unstable oil sources, they must reduce their exposure to the black stuff, writes Peter Whelan.

On October 6th 1973, Egyptian and Syrian jets attacked Israeli positions on the eastern bank of the Suez canal, the Sinai, and along Israel's northern border; on the ground, Arab gun and artillery fire barraged Israelis. The Israelis were caught off-guard and outgunned – no match for Egypt and Syria's array of Russian weapons and additional supplies from the Soviet Union. A few days after the attack, Israel sent word to President Nixon that the Jewish state verged on destruction.

The White House airlifted supplies to the Israelis, who managed to hold off the Egyptian offensive in the Sinai with successful counter offensives.

Ten days after the attack, the Organisation of Petroleum exporting Countries (OPEC) finally decided to use "the oil weapon" of threatened but never before employed, oil production cutbacks, and an embargo on exports to the US.

Gasoline prices soared 40%, cars lined up at petrol stations, some of which had apologetic signs up "Sorry No Petrol Today".

By December 1973, oil which had been selling for $2 a barrel in September , was going for $11.65. The economic effects were felt throughout Europe and Japan. Americans were stunned.

The 1973 -74 "oil crisis" still looms large in the American imagination. What most people did not know was that the OPEC oil embargo had little to do with the high prices. In the early 1970s, long before the war, oil supplies were already tighter than they had been for decades. The US oil fields had already begun to decline.

Oil producers no longer had the capacity to produce a surplus, while demand for oil was increasing.

In an attempt to prevent inflation, Nixon had put price controls on oil in 1971, discouraging oil production or exploration, while encouraging Americans to consume more oil.

In 2006, the price of a barrel of oil reached $70, eight years earlier in 1998 it was at $10. A very large price increase over the medium term.

The commodities investor must understand the basic economic theory and concept of supply and demand – which is the main mover of prices.

What is the future for oil prices ?

As I write, the price of Nymex Light sweet crude oil futures traded on the US markets is $105.50 and the Brent Crude oil contract is trading at $115.65. The price of oil has risen consistently since 2002 which was technically the start of the current bull market in oil and commodities.

The oil price actually hit an all-time high of $147 in July 2008 and fell back to $30 but increased again from $30 to $130 – a percentage increase of 435%.

You might ask "why has the price risen so sharply ?"

Firstly, there are structural factors that will take years to change.

Others are more transient factors that change almost daily. Structural factors include basic items such as weighted average production costs and transportation. But they also include supply chain factors such as inventories, limited refining capacity and thin spare production capacity.

These supply chain factors are not easily or quickly changed.

They have made the current era of pricing a departure from the previous 20 years when companies carried a lot of inventory and there was significant spare refining and production capacity.

Geopolitical concerns have a major impact on the price of oil, We have seen civil unrest in Egypt, Yemen, Bahrain, Tunisia and currently there is a civil war in Libya.

During times of civil unrest production is reduced dramatically and often oil production facilities completely shut down which reduces supply.

The Middle East is the largest producer of oil in the world.

Tensions may rise further in the near term, resulting in sky-high oil prices at a time when the global economy needs nurturing rather than a negative supply-side shock.

Apart from the oil price pressures, global food price inflation is also an ongoing concern.

Delivery of oil from Libya has been curtailed by the government's suppression of dissidents and the subsequent reprisals by allied forces, with analysts expecting a prolonged effect on supply. In this case, demand increases and supply is reduced. Hurricanes also destruct refining capabilities

There is not enough oil in the world to meet increased demand, so nobody knows for certain how high oil prices will go.

It will depend on the impact of rising oil prices on demand and the catastrophic risk of Israeli or US military confrontation with Iran which would block the strait of Hormuz and cut off Middle East oil

shipments, which account for 60% of world supply.

The Middle East countries have a monopoly over the world oil markets and dominate OPEC. Global oil demand is currently running at 85 million barrels of oil per day and this is estimated to increase to 120 million barrels per day by 2030.

Fundamentally, an increasingly short supply of oil in the world is the main cause of high oil prices. According to statistics from the British firm, BP, the world has been demanding more oil than can be produced since 1981; and the case is still the same today.

Currently, oil production in most countries has already or will soon, go down – leaving less of a surplus to use – but at the same time, demand keeps increasing.

The supply remains tight and prices keep soaring despite OPEC'S decision to increase crude oil production by 500,000 barrels per day as of November 1 2010.

With little price elasticity from both demand and supply, any trivial thing can/will send prices skyrocketing.

Secondly, short-term speculation on oil futures by large amounts of funding also drives prices up.

A Citi report in May 2006 said that US commodity markets hold an average speculation volume of over $120 billion each month, chiefly coming from natural gas ($30.3 billion) and crude oil ($30.1 billion).

The numerous speculation deals have a massive impact on oil futures prices considering the leverage effect of futures margin deals. With excessive liquidity, funds behind oil futures speculation will remain the same.

Thirdly, the US government's pursuit of a weak dollar policy in recent years has also contributed, to a certain degree, to the hike in oil prices. Almost all oil deals worldwide are priced in US dollars; and the dollar's devaluation puts on the pressure for higher oil prices.

To maintain an income and purchasing power, raising prices has become a major strategy of OPEC members. According to studies, when the dollar devalues by 1%, it causes an oil price hike of the same degree.

In addition, technical, meteorological and political elements also affect developed countries' use in particular – less than those in the emerging markets, ie China, India etc.

A review of the seven-year oil price trend shows that annual peaks usually appear in the summer and autumn, when demand runs high and hurricanes frequently occur; while spring is a period of adjustment.

Judging from current conditions, it is difficult for international oil prices to drop back heavily as long there is no fundamental change in the basic factors affecting price.

Oil was priced at $18 in 2002 and in July 2008 it reached $147 – a phenomenal increase of $129 in a six-year period. This can be evidenced and illustrated by looking at a long-term 10-year chart for oil.

Inflationary impact of high oil prices

Inflation has been rising since Q2 2010 globally even though all the central banks around the world and in particular the US and Europe are telling us that it is under control. I do not agree. It is already an issue in Asia, particularly in China, and the US and Europe are next.

It was only a matter of time before the Chinese central bank (People's bank of China – PBOC) increased interest rates.

They have increased rates a number of times over the last year in a prudent and aggressive manner as they do not want inflation to get out of control.

My opinion is that excessive money printing through quantitative easing has and can only lead to inflation and possible hyper (excessive) inflation in the medium term. Commodity prices have increased in price significantly and exponentially in 2010 and Q1 2011.

A recent OECD document stated that central banks may not need to react to recent jumps in energy prices with tighter monetary policy.

However, the report also highlighted the danger of inflation expectations becoming unstable.

The inflationary impact of oil price hikes depends on the ability of the monetary authorities to prevent inflation expectation from drifting away from implicit or explicit targets, the OECD said.

If inflationary expectations were to destabilise, the effect of recent oil price hikes, if sustained, could be stronger than expected.

Prevailing inflation is causing a huge impact not only oil consumers whose cost of living has increased significantly but on various other sectors of the world economy such as banking, trade, business, industry, education and food production.

The big question is, is economic growth as technically measured by GDP, sustainable in the current environment of high oil prices ?

Natural disasters are occurring as we saw recently in Japan. These calamities include earthquakes, hurricanes, storms, and floods. And then there is terrorism and famine.

Movements in oil prices have complicated the tasks of policymakers and business leaders over the past three decades. Increases in inflation during the 1970s have been blamed, in part, upon rapid increases in petroleum prices. The long decline in inflation during the 1980s and 1990s has in turn, been associated with declines in oil prices.

Hence, a clear understanding of the strength of the observed linkage between oil price changes and inflation is key to the proper conduct of monetary policy, to the extent that firms must alter their pricing policies according to the inflationary environment, managers of companies and firms also need to perceive the links accurately.

The proverbial thorn in Asia's side this year is deemed to be inflation – and there is no easy solution to it, with the political turmoil in the Middle East and North Africa. And inflation in Asia will certainly speed up if the crisis spreads to Bahrain and Saudi Arabia.

In such a scenario, oil prices are likely to reach as high as $150 per barrel.

Reactive monetary policy tightening is inevitable in Asia in the short to medium term.

So it is time to address these serious issues positively: the regimes of the world could play an important role in controlling inflation by enhancing more and more trade opportunities and utilisation of resources.

For example, Ireland needs to develop and market their natural resources of wave, tidal and wind energy.

We need to survive in the age of high oil prices, scarcity and high inflation. Investors need to adjust their portfolios and must have an exposure to oil, commodities and other asset classes that protect against inflation and a weak US dollar.

An oil crisis, food crisis, currency crisis, war, anarchy and possible sovereign debt defaults are serious issues that need to be addressed.

Higher oil prices are inevitable in the future.

Peter Whelan is a precious metals, commodity and currency specialist. ■