Low oil is here to stay

Oil prices had been artificially propped up by financial investors and government stimulus programmes. Now prices are returning to their historical averages, and are likely to stay that way

PAUL HODGES INTERNATIONAL ECHEM

At long last, oil prices are returning to reality. There was never any real reason for them to temporarily trade at multiples of their energy value relative to natural gas. Thankfully, the looking-glass world of $100/bbl prices has finally begun to shatter over the past nine months. And we can expect prices to resume their historical level, averaging less than $50/bbl.

This, of course, is excellent news for downstream companies. High oil prices destroy consumer demand, as they increase fuel and heating bills and leave people with less cash to spend in other areas. But it is also good news for the global economy, as it marks the start of the Great Unwinding of central bank stimulus policies, which have destroyed the proper functioning of the price discovery mechanism in oil and other critical markets.

SHORT TERM LITTERED WITH LOSERS

But it's not all good news. In the short-term, there are many losers as the process of adjustment takes place. This is most obvious in the area of inventories, where many companies have found themselves holding product which has halved in value compared to their original raw material costs. There is no way around this problem, as buyers down the value chain simply disappear when prices start falling.

This has been seen before when prices have fallen, as in 1986 and 2008. It is the opposite of the false boom that develops when oil prices rise, and buyers rush to buy today before prices go higher tomorrow. But it represents a bigger threat today, as so many companies have been fooled by the result of central bank policies into thinking that oil prices would inevitably stay at $100/bbl forever.

Nobel Prize winner Daniel Kahneman provides the answer for this mystery with his theory of "anchoring". This suggests that we often fail to realise how much we can be influenced by recent events. The fact that oil prices rose to $100/bbl in 2011 and seemed able to stay there, led this to appear to have become their 'natural level'. Yet as the lower chart makes clear, it was positively unnatural in terms of the history of the past 150 years.

This "anchoring" meant that some companies made a bad situation worse by trying "to catch a falling knife" as oil prices fell in Q4. Their decision to actively build inventory has cost them dearly, as the price failed to increase back to $100/bbl as they expected. And another aspect of the "anchoring" effect can be seen in the US, where companies have developed highly ambitious expansion plans for ethylene and derivative expansion.

The problem, as discussed here and in my ICIS Chemicals & the Economy blog, is that these expansion projects are based on two unlikely assumptions:

- They required oil to somehow be able to command a long-term premium versus natural gas in terms of its relative energy value
- They also required a complete reversal of the historical decline seen in US ethylene production since 2004, and in net exports of key derivatives such as polyethylene since 2009.

But we should not blame the companies involved. They are simply the victims of the stimulus policies established by policymakers and central banks in early 2009, which had the aim of creating a 'wealth effect' by boosting the prices of financial assets.

'STORE OF VALUE' CLOSED

There have never been any shortages to justify $100/bbl prices. Instead, prices were driven higher by pension funds' search for a 'store of value' to counter-balance the US Federal Reserve's perceived aim of devaluing the US dollar. They found this in oil as it was (unlike natural gas), a major international market, and easy to enter as a financial investor due to its deep and liquid futures market.

Rex Features

Oil supply is plentiful so high prices cannot be justified

Thus by 2011, as the top chart shows, they and other financial investors such as hedge funds had boosted futures market volume to an almost unbelievable 616m bbl/day, some seven times physical production. And of course, they were buy-and-hold investors, happy to buy contracts that would only mature in three to five years' time. In turn, their purchases caused prices to rocket. The Fed can print electronic money in milliseconds. But it takes years to find new oil supplies and bring them to market.

Nor was the situation helped by the Chinese government's panic in late 2008. It worried that the loss of factory jobs tied to exports to the West might lead to major social unrest. So it introduced the biggest stimulus package in history, far larger than the Fed's own efforts. Lending rose from $1 trillion to $10 trillion, creating a property bubble in major cities such as Beijing and Shanghai that made the US subprime bubble seem almost tame by contrast.

The aim was the same as in the West – to create a 'wealth effect' that would stimulate domestic consumption. Thus car sales suddenly trebled from around 550,000/month in 2008 to 1.5m/month by 2013. And in turn, this led many people outside China to assume that the country had somehow overnight become middle class by Western standards.

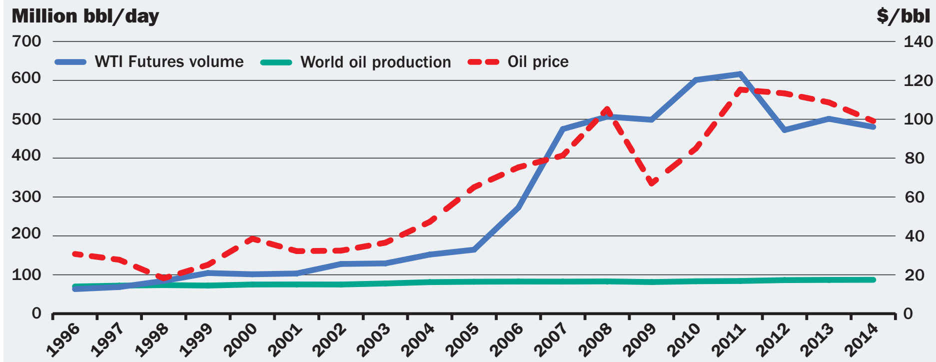
CHINA POLICY IMPACT

Nothing could be further from the truth. Latest data from China's National Bureau of Statistics shows that average disposable income was just $3294 per capita in 2014. Far from being middle class, most Chinese incomes are in fact below the poverty line by Western standards. But it wasn't until the change of government in March 2013 that new President Xi Jinping began to reverse course and implement wholly new economic policies.

Months of planning in conjunction with the World Bank took place, to prepare detailed proposals for approval by China's main economic policy-making body in November 2013. And President Xi left no doubt about his views when opening the Conference with the words, "The good meat is all gone; all that is left are hard bones to chew". In his mind, and that of his advisers, China had no choice but to strike out in a new direction. The aim was no longer to try and create 'wealth effects', but instead to boost incomes for the majority of the population.

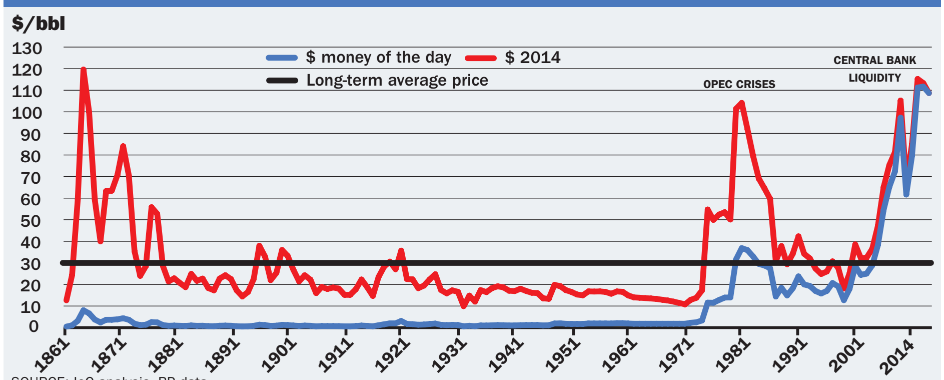
This was the moment when the Great Unwinding became inevitable. And by last summer it was clear that commodity and currency markets were beginning to feel the first impact of China's "New Normal" policies. Thus by August, I felt able to forecast in the blog that we were about to see a major collapse in oil prices and a strong move upwards in the value of the US dollar. These moves proved mutually reinforcing, as pension funds no longer needed to buy oil once the value of the dollar began to rise. Instead they could happily start to unwind their positions.

WORLD OIL PRODUCTION vs WTI FUTURES AND PRICE MILLION BARRELS/DAY, $/BBL 1996-2014



SOURCE: Analysis, International eChem; Data, Bloomberg, BP Energy review

CRUDE OIL PRICES 1861–2014



SOURCE: IeC analysis, BP data

> **"The good meat is all gone; all that is left are hard bones to chew"**
>
> **XI JINPING**
> President of China

MORE UNWINDING TO FOLLOW

Of course, we are still only at the start of the Great Unwinding. Outside China, most policymakers still dispute the common sense argument of our 'Boom, Gloom and the New Normal' eBook (co-authored with ICIS journalist John Richardson) that demographics drive demand. But just as you can't print oil, so you can't print babies. Global fertility rates have halved since 1950 to just 2.5 babies per woman, and there is no sign of this trend being reversed at present. Equally important is that global life expectancy has increased by 50% over the same period to average 70 years.

This means that the post-War BabyBoomers are no longer likely to die in their late 60s or early 70s, as their parents and grandparents would have done. Instead, they can look forward to an additional decade or more of active life. But this good news for individuals is also bad news for economic growth, as people's needs and incomes reduce as they enter retirement.

In effect, the main impact of the stimulus policies has simply been to provide a temporary fig-leaf behind which policymakers could hide. It enabled them to pretend that the inevitable decline in spending power associated with an ageing population could somehow be replaced by a sustained 'wealth effect' based on elevated valuations for financial markets.

Yet in reality, as consumer spending is around two-thirds of the economy in most Western nations, the world is moving into a New Normal. In turn, this demands major change to take place in business models. As the subtitle of our book highlights, "The Ageing of the Western Baby Boomers is Changing Demand Patterns, Again". ■

Paul Hodges is chairman of International eChem, trusted advisers to the chemical industry and its investment community. With John Richardson, he authored 'Boom, Gloom and the New Normal', published by ICIS. To download the book visit http://www.new-normal.com/book/ The pH Report aims to guide companies and investors through the Great Unwinding of central bank and government stimulus policy now underway. www.iec.eu.com/the-ph-report