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Investing in oil is a slippery slope

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Much of what you think you know about the market is complete nonsense

What next for the oil price? If the oil market was a normal market, finding the answer to that would be pretty easy. We would just have a look at the capital cycle. We would note that prices are always and everywhere a function of supply and demand. We would point out that at the beginning of the great commodities supercyle in around 2002, demand was rising fast and supply was limited. That meant fast rising prices and profits across the commodity sector. Those high profits stimulated a tsunami of capital into the sector as everyone (even post-2008) extrapolated Chinese growth at 10 per cent a year forever and expanded to meet the demand they expected that to create.

The demand never came. China started slowing in 2011 and that was that for the supercycle. In 2008, Goldman Sachs forecast that the oil price would hit $150-$200 by 2010. It is now knocking around $45 a barrel. It is textbook stuff — and anyone who looks at the capital cycle in any given industry before investing in it would have seen it as such and sold out of the obviously oversupplied sector long before Goldmans had its silly super cycle swoon.

But if the oil market was totally textbook we would now be seeing low prices and collapsing profitability leading to a pull back in supply. We'd also be seeing low prices lead to a rise in demand. We'd be on our way into the beginning of the next cycle — and I'd be telling you to get out there and buy.

But the oil market isn't totally textbook — and a large number of the things you think you know about it are complete nonsense. This week, Spencer Dale, who used to be chief economist at the Bank of England and now has the same job at BP, gave a talk in which he busted a few market myths.

The most important were these. First that oil is "an exhaustible resource which must eventually run out" given that demand for oil will always rise. Second, that Opec can (or wants to) control the price of oil and so will eventually slash supply to do so. The first is, to my mind anyway, the most interesting.

I once assumed that oil was finite as well — that we had reached some kind of peak oil, that we would find no more and that as a result it was 100 per cent inevitable that the price of oil would rise over time. Well, so much for that: we actually find new reserves all the time, so much so that total proved reserves of oil are almost two-and-a-half times greater now than they were in 1980.

And the idea that demand will always rise? It's beginning to look ridiculous. That's partly because an endless parade of anti-emissions regulations simply won't allow it to. The G7 has demanded an end to all fossil fuel use by the end of this century and China is just as keen to cut its demand (pollution is as much of a threat to its elite as corruption). That's why it is increasingly hard to get a licence plate for a new car in Beijing and why every new model in the US will be obliged to do 54 mpg by 2025.

Add to that the slowdown in China (which once accounted for some 45 per cent of growth in oil demand); the demographic changes in developed economies (old people drive less — which is why average vehicle miles per adult have been falling in the US for a decade); and a variety of social changes such as car sharing and diesel disapproval (only 40 per cent of Parisians now have cars, for example, down from 60 per cent in 2001).

Put all that together, Paul Hodges, chairman of International eChem says, and it is hard to see how today's levels of fossil fuels can ever be exhausted. The odds are that our fossil fuel reserves will last for ever. If that turns out to be the case, there is clearly no reason to continue to assume that oil prices will rise forever.

This takes us to shorter term supply. Normal capital cycle theory tells us that if demand is falling supply will too. Not so here. Opec might be able to affect the market when it comes to short-term shocks. But with long-term ones such as this, it just isn't in its interest to do so. It can't wage war on the western obsession with climate change or, for that matter, on hybrid Mitsubishi Outlanders or Uber. If the likes of Saudi Arabia can't stop prices falling (and they can't) why would they cut production? That would just mean less money for them (money they need rather more badly than they are letting on), more money for their rivals, and no compensating change to the market price.

You won't be surprised then to hear that Saudi production has not fallen during the oil price collapse, but risen. Add to that the fact that the supply coming out of the US isn't falling as much as you would think — rig productivity is exploding — and that Iran is returning to global markets after the nuclear deal and you will see that oil investors looking for their portfolios to be saved by drastic supply cuts have a nasty wait ahead of them.

Those who still aren't convinced might look to some charts put together by BCA Research. They suggest that to get anywhere close to their 400-year mean, commodity prices as a whole still have 40 per cent to fall (the Bank of England has price data for UK agriculture back to 1209). A rather shorter term price chart (no oil in 1209) suggests exactly the same for oil prices.

The key point to bear in mind is this: successful investing isn't about finding companies riding waves of rising demand, it's about finding those riding waves of limited supply, the kind of waves we saw at the beginning of the commodity supercycle. And are seeing no sign of now.

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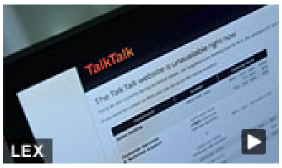

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