

Opinion

FROM THE CAPITAL

Oil shock threatens metals recovery

Complexity of price-freefall impact for metals and mining makes future less clear

John Robertson

Tumbling oil prices are tainting the investment outcome for mining stocks as markets largely ignore the favourable growth impact of cheaper fuel.

Last Friday, the International Energy Agency (IEA) cut its 2015 demand estimate by 230,000bbl/d. This was after OPEC cut its expected 2014 and 2015 use by 120,000bbl/d and 70,000bbl/d, respectively.

Such spuriously precise numbers offer little reason for a radical re-pricing of oil. The IEA change that seemed to influence markets so much was equivalent to just 0.2% of its expected 2014 consumption rate, well within the bounds of forecast error.

The IEA attributed its demand cut to changed expectations for what it refers to as the former Soviet Union and other oil exporting countries, in the statement accompanying its December oil market report.

Doubtlessly, oil exporters will suffer an income loss, but the IEA appears to be playing down second- and third-round effects from price falls, including the announcement effects of its own forecast changes.

The annualised value of oil exports has been cut by over US\$600 billion since 2013. This is a loss for the exporters but a gain for the importers of crude oil in Japan, Europe and the United States – where consumers and businesses will have to spend less on fuel purchases and have more to spend on other goods and services.

Strangely, the IEA commentary has questioned whether consumers in importing countries will see much of the price decline. Its scepticism is despite average retail prices in the USA having already dropped from \$3.70/gallon at the end of June to \$2.55 in mid-December with more to come. Shopping around will garner better prices. Sub-\$2 prices are already appearing at the pump in some places.

With falls in excess of 30%, forecasting models designed to calculate the impact of only modest marginal changes will likely miss the full effect of the actual real income and relative price effects being felt. Consequently, the forecasts being embraced by markets at the moment do not take full account of the beneficial impact on output growth and even the possibility of more oil being consumed in the year ahead rather than less in response to lower prices.

Many of the oil exporting nations have accumulated capital that will help sustain



spending, at least in the short term. Some, like Russia, will face relatively stiff challenges, but the gains for the oil importing countries will be unambiguous.

There is another reason to discount a single link between recent price movements and global growth. The most significant weakness in demand for oil is coming from one of the most strongly growing parts of the world.

Petroleum consumption in the USA in the first seven months of 2014 was 5.2% lower than over the equivalent period of 2009, according to data from the US Department of Energy, despite the US economic recovery and ongoing expansion in output now being several years old. At 18.8Mbbbl/d, usage so far this year has been the same as in 2013.

Critically, efficiency gains in US motor vehicles are offsetting population growth. The number of litres of gasoline per 100km travelled has fallen from approximately 8.8 in 2008 to an estimated 6.3 in 2014. The IEA expects this to fall to 5.1L by 2019. Behavioural changes peculiar to the oil market are a work.

The rush to conclude that oil price movements have messages for other raw material markets lacks rigour. Unfortunately, sentiment surrounding the oil sector is pulling the rug from under the sometimes delicate cyclical improvements which had been evident in some of the base metal markets such as zinc and nickel and, more recently, in uranium.

One aspect of the oil price weakness does have broader adverse macroeconomic implications. A combination of new technology and cheap money has helped transform the US oil industry and tilt the balance to lower prices. Some of today's anxiety about growth rests on

the experiences of 2008 and 2009, when unravelling collateralised debt obligations threatened to sink the global economy. Today, there is uncertainty about who holds the bonds financing the lift in US crude production from 7.5Mbbbl/d in 2007 to 14.2Mbbbl/d currently.

Fears that specialist lenders to the US oil industry may fail as borrowers lose income are propelling a wider deterioration in equity and financial market sentiment. More than that, the Dodd-Frank rules introduced to regulate lending practices in the aftermath of the experiences with collateralised debt have caused banks to dismantle proprietary trading desks. Liquidity in the markets for higher yield bonds has been cut.

Now, bonds used to fund oil production are harder to sell. Fund managers may be forced to liquidate non-oil related bonds to replenish cash. That's contagion. And that would affect a broader range of industries and the outlook for the resources sector. As in 2008, however, the extent of this problem remains veiled.

The re-pricing of mining equities may yet prove to be an overreaction. Lower oil prices could just have easily been seen as beneficial for metal consumption, helping to rebalance metal markets more quickly than might have otherwise been the case.

These markets may yet shrug off the oil price effect to reassert their better and more advanced cyclical positioning. This could be something that becomes more evident after the Christmas shopping season, for example, when consumers' preparedness to spend will have been on display. A robust display of spending could quickly overturn current interpretations of what is happening. ▼

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