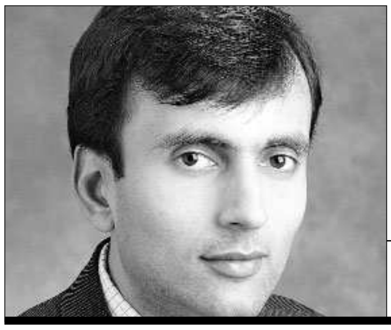
Oil and the seven myths

While it's hard to say when the uptrend will reverse, it must be noted that it is psychology, rather than fundamentals, that is spurring oil prices



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> **Myth often transcends reality at the late stages of a powerful trend. While the oil price surge over the past decade is largely rooted in fundamentals, the blow-off this year is driven more by hype than any changed demand-supply dynamic**

IT IS one of the most powerful momentum markets in history. Across the globe, almost all stocks that have outperformed the benchmarks over the past year belong to the just one group. Six out of the world's 10 largest companies by market value are drawn from this sector. Pension plans and hedge funds have been pouring record sums of money into the space. Conversations around office water coolers and living rooms revolve around the same financial topic. It is fashionable to throw about forecasts of much higher prices, which are already up 100% over the past year and are pasted on every other magazine cover.

So is this early 2000 or mid-2008? The parallels are indeed striking between the late stages of the tech mania and the current oil boom. Both mega trends were rooted in a powerful economic shift; while the tech boom was associated with several technological breakthroughs and new 'killer applications' for mass use, the oil-led commodity boom is attributed to the rapid industrialisation of emerging markets.

At some point, however, investor imagination begins to overstate reality. With oil prices doubling since mid-2007, without any major corresponding change in the supply-demand dynamic, there are now widespread signs that the myth has again transcended the truth. While it's hard to predict exactly when the deeply entrenched uptrend will reverse, it's important to be fully aware that psychology rather than fundamentals is currently spurring oil prices. Here are some of the most popular misconceptions that come through in any discussion about oil.

Myth 1: The oil price surge is due to a drop in output growth. While there is some reason to be genuinely concerned about long-term supply constraints in oil, growth in production has not hit a wall as yet. Global oil supplies have been increasing 2% annually over the past five years and supply of crude is more than adequate to meet demand this year as well.

Still, the market is worried that the dependence on OPEC supply has recently been growing as estimates for North Sea and Russian crude production have been steadily declining. In addition, global spare capacity has fallen to 2% of production from a historical average of 3% to 5%. But this hardly justifies the doubling in oil prices over the past year. The last time prices rose at such a meteoric pace was in the 1970s when there were actual supply disruptions.

Myth 2: Emerging market demand is main determinant of oil prices. Unlike most other commodities, where China is indeed the price-setter, OECD demand is still the most relevant factor when it comes to oil. The US consumes 25% of global oil compared to 9% for China. US oil demand has contracted by 5% so far this year, as demand destruction is in the works. While it is hard to get a fix on latest Chinese demand, growth in oil demand is unlikely to be as high as the 5% annual run-rate of the past five years, given the marginal slowdown in China's economy.

Myth 3: Emerging market demand is price inelastic. For every commodity, demand destruction sets in at some point. In the 1960s and '70s, the re-industrialisation of Japan and Europe propelled commodity prices higher, but at a certain juncture, the demand for commodities recoiled. Copper consumption peaked at 0.45% of global economy in the mid-1960s while the demand for nickel started to fall in the 1970s after reaching 0.2% of global GDP. For the previous oil price boom, the breaking point was in late 1979 when the total spend on that commodity exceeded 7% of global GDP.

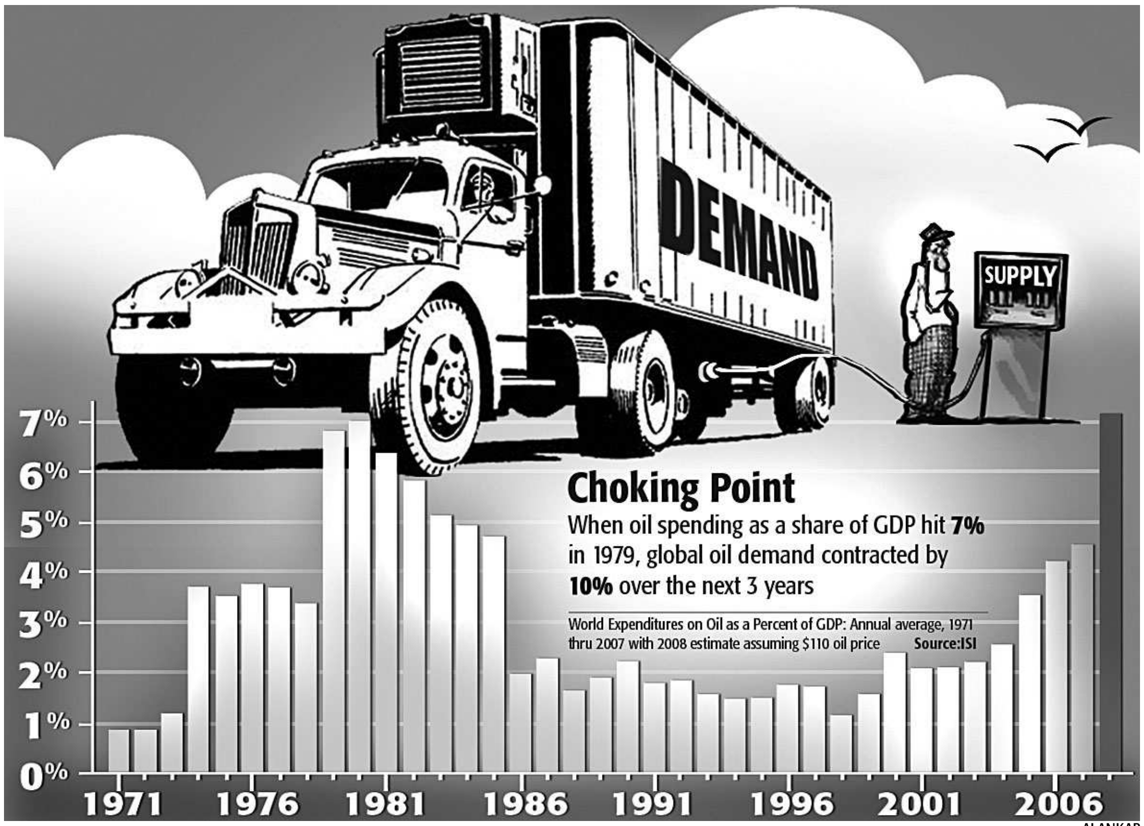
Over just the past ten years, the weight of oil in the global economy has moved from a low of 1.5% of GDP to over 7% of GDP again. The experience of the 1980s could be instructive in the current context as well. Even as Japan and Europe continued to grow strongly in the 1980s, oil consumption remained essentially flat through that decade as both the regions strived to achieve better fuel efficiency and switched to alternative sources of energy, such as nuclear power. With governments in many emerging markets finally raising oil prices at the retail level this year, oil demand is bound to decrease. As a case in point, the Indonesian government is budgeting a 10% decline in volume growth for 2008 on the back of a 30% adjustment in oil prices.

Myth 4: Better standards of living in developing countries will only increase oil consumption. As the demand patterns of the 1980s show, when oil gets too expensive consumers look for different sources of energy and succeed in finding them. A similar move has been underway with nearly 90% of the growth since 2004 in new 'oil' capacity coming from bio-fuels, synthetic oil and natural gas liquids. Furthermore, higher per capita incomes are often associated with greater energy efficiency and the increased urbanisation projected for emerging markets could even translate into lower per capita oil consumption with the greater use of mass transportation.

Myth 5: The tidal fund flow into oil and other commodity products will keep raising their prices in financial markets. Asset allocation into commodity funds has risen dramatically over the past year, with the total influx in the first quarter of 2008 exceeding the total inflow of 2007. Many commentators argue that this trend has a long way to go as total allocation to commodity-related assets is still below 5% of total financial assets. Late last year, during the heady months of the emerging market boom, similar arguments were bandied about with regard to a potential re-rating of emerging markets stocks. Yet, the reality is that while momentum can drive markets for a while, flows can quickly reverse once it becomes apparent that the underlying fundamentals are deteriorating; indeed this is the case with the Indian and Chinese equity markets this year. Even if pension plans keep increasing their strategic allocation to commodities, the process is likely to be gradual and spread over time.

Myth 6: Retail gasoline and diesel prices in emerging markets such as India are too low by global standards. The retail prices of petrol and diesel vary greatly across the world, reflecting the very different tax structures implemented by each country. Venezuela reportedly sells gasoline at a mere 3 cents per litre while Turkey charges $2.80 for a litre. India's latest price for petrol is in line with the global average, although it is lower by 30% for diesel. Still, at $0.85 per litre, India is selling diesel at a more expensive price than China.

The key difference between China and India is that the latter cannot afford to keep subsiding oil prices or further cutting taxes on oil products due to the large fiscal deficit. China doesn't face the same compulsion to raise prices as it is running a fiscal surplus amounting to nearly 1% of GDP. If the incumbent government had been more sensible in spending the revenue windfall from the runaway growth of the past four years, then it would be in a much better shape to absorb the global oil price shock.



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Myth 7: A 1970s-style decade lies ahead for the global economy. Until late 2007, the rise in oil prices did not pose a problem for the global economy. In contrast to the 1970s when the oil price increase largely represented a supply shock, in this decade it is mainly a reflection of booming economic demand in the developing world and till last year any major inflationary impact was offset by high productivity growth in the global economy. Over the past six months, the price of oil has risen at its fastest pace in recent history even as global economic demand has slowed due to fears of supply shortages, which is why it is now leading to fears of a 1970s redux.

But the situation today is more analogous to late 1979 — the oil price shock has already happened with prices again rising by 900% over the past decade. The global economy is at a point similar to 1979 when demand and the price of oil started to decline.

Over the past 30 years, every major oil price setback has been demand-, not supply-led. Now with evidence mounting to suggest that demand is eroding — from the collapse in SUV sales in the US to a change in the subsidy regime in many developing countries — it's only a matter of time before the psychology of ever-rising oil prices breaks on the marketplace.

(The author is head of emerging markets at Morgan Stanley Investment Management)