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# ALL ABOUT OIL?

**With the possibility of a reduction in the price of oil now on the cards, global equity markets could be in for a much needed boost.**

*By Eoin Fahy*

**W**e have now passed the half-way point of 2008, a year which certainly seems set to be one to forget for most investors – and one that many politicians or central bankers will want wipe from their memory also. Both markets and policy-makers have been grappling with damaged banking systems, high and rising inflation, low and falling economic growth and a credit crunch.

Of course, the credit crunch, damaged banking systems, and falling economic growth are clearly connected. The huge hit to bank profits that started when sub-prime mortgage loans in the US began to deteriorate quickly led to higher market interest rates, as banks became increasingly wary of lending to each other due to the fact that they could not judge how badly affected each bank was by the sub-prime loan fiasco.

Banks also became increasingly anxious to conserve capital and liquidity, to forestall the kind of liquidity crisis that eventually led to the downfall of Northern Rock in the UK and Bear Stearns in the US. As a result, they were far less willing to give out loans, even, in some cases, to good quality borrowers. So economies were hit with higher market interest rates, hard-to-obtain credit and a daily drip-feed of negative news stories about banks and economic growth. It is therefore no surprise that economic growth did slow markedly in most regions and that the US, for example, may even have moved into recession.

However, the inflation problem was quite different and was in no way linked to the other issues. In every major economy around the world, food and energy prices rose sharply over the last few months. Energy prices rose, seemingly inexorably, as still-strong demand

from Asia, in particular, simply could not be matched by increased supply as the world's oil producers were essentially producing flat out.

Also, world food prices rose due to a combination of factors. Rising demand for some grain crops for use as ethanol or bio-diesel was a factor, as were bad weather conditions in several food-producing parts of the world and the increasing demand for some foods as a result of the 'consumerisation' of millions of people in the developing world.

Of most concern to central banks, however, was the fact that higher food and energy inflation were causing inflation expectations, in general, to ratchet higher. Several surveys of consumers across different economies showed that consumers expected inflation to stay significantly higher for longer than previously. This – even more than a rise in actual inflation – is what particularly worries central banks, as it can very quickly become a self-fulfilling prophecy. If people expect inflation to rise, they will seek higher wage increases and thus ultimately cause that higher inflation.

It came as no particular surprise, then, when central banks took action to forestall a further

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rise in inflation. The European Central Bank made it clear in June that it would raise its key interest rate in July, while the Bank of England appeared to abandon plans for rate cuts, and the US Federal Reserve brought its rate cuts to an end, signalling that inflation was a serious concern and interest rates might have to rise as a result.

With all this going on, equity markets unsurprisingly reacted to this poor set of circumstances by falling – a lot. Since the end of July of last year, which is roughly when the current downturn got under way, the Irish equity market fell a savage 40 per cent, while Europe and Asia were down about 20 per cent and the US a little more than 10 per cent (in dollar terms, but the dollar fell sharply so the return to a euro-based investor was down 24 per cent). Bonds, on the other hand, rose slightly and of course commodities performed very well, with the best known commodity index up 45 per cent.

So much for the year so far. What can we expect in the remainder of the year?

At the time of writing, most equity markets have fallen through the low that they hit in mid-March in the immediate aftermath of the Fed's rescue operation for Bear Stearns. Interestingly, while the concerns in March were about the stability of the banking system, it seems that current concerns centre on energy prices, inflation and the steps that central banks will take to damp down inflation (with the risk that this will cause a severe economic slowdown).

In our view, the markets are quite correct to be concerned about energy prices, and inflation more generally. In Europe in particular, the central bank has made it fairly clear that if it takes a recession to get inflation down, so be it. It simply will not tolerate a 'permanently' higher rate of inflation brought about by high energy prices leaking through into general inflation. And while the rhetoric of the central banks in the US, UK and Japan has not been quite as strident as that of the European Central Bank, nonetheless the message is clear: central banks stand ready to prevent inflation taking hold.

That risk of higher interest rates (and actual higher rates in Europe and several Asian economies) has certainly been a factor in the most recent weakness of equity markets, and it may be hard for equity markets to make much progress while central banks take this stance.

But what could change the outlook, for the better, would

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be a decline in energy prices. While forecasters of the price of oil have certainly not had a good track record in recent years, nonetheless there is some reason for optimism that perhaps the oil price will not continue to rise inexorably. The most important change in recent months has been that several Asian countries have reduced, or even eliminated, the very large subsidies that they had had in place for oil and other energy products.

This is important because basic principles of economics (and common sense – though economics and common sense don't always agree) tell us that as the price of something rises, there is less demand for it. But in many countries in Asia, consumers have not begun to use less energy for the simple reason that their government subsidised prices so much that the price they paid did not rise. Now, however, large price rises are being implemented and this is likely to lead to a reduction in demand for oil. Put that together with reduced demand for gasoline from the US, where high prices are really beginning to bite and for the first time, there is a realistic prospect of the growth in demand for oil falling below the growth in supply of oil. That could mean a fall in oil prices, or at the least it may mean the oil prices cease their upwards march.

Of course, if oil prices stabilise or even fall, the inflation problem that is worrying central banks so much will recede and there will be less need for central banks to tighten policy. That should lead to a much better tone to equity markets. The markets will still have to deal with slower economic growth and ongoing problems in the banking system, but after all, markets have had substantial falls already so a good part of these worries must be priced in.

The bottom line? Instead of interest rates, or economic activity indicators, the one thing we should be watching most closely for the next few months is in fact the oil price.