Cheap Oil: The Slump That Could Energize The World Economy

KEY TAKEAWAYS

The steep fall in the Brent crude oil benchmark from above $100 a barrel in early September to nearly $60 recently has surprised everyone. But the reasons for the decline are mundane supply and demand imbalances. While the near recessionary conditions in the Euro-zone and Japan have restrained global oil consumption, demand is muted even in the healthier economies such as the U.S.

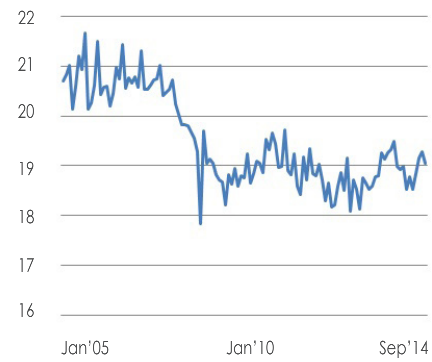
The sharp oil price plunge is undoubtedly the most dramatic, least anticipated, and by far the most consequential economic trend of 2014. From above $100 a barrel in early September to nearly $60 recently, the fall in the Brent crude oil benchmark is so steep it would likely have been triggered by a highly unusual and abrupt event, like the 2008 global financial crisis. Only this time, the reasons are more mundane supply and demand imbalances that somehow surprised everyone.

Oil prices are now at a five-year low

Data source: U.S. Energy Information Administration

The steady growth in U.S. domestic oil output, boosted by the surge in shale energy production, is now a well-known story. This increase has more than offset the partial loss of production in the Middle East due to rising violence and terrorist threats. What surprised the oil traders more was probably the softness in demand growth. While the near recessionary conditions in the Euro-zone and Japan have restrained global oil consumption, demand is muted even in the healthier economies such as the U.S. For instance, the current average daily U.S. oil consumption is nearly two million barrels below the 2007 peak of around 21 million barrels. Advances in engine technology and conservation efforts have helped make the world less reliant on fossil fuels for economic growth. For a well-supplied oil market, this was a negative demand surprise that was large enough to force prices down.

U.S. oil consumption is below the pre-crisis peak...



Average daily crude oil and products supplied, in million barrels

...While U.S. domestic production has surged

Total U.S. domestic crude oil production, in million barrels per day

Data source: U.S. Energy Information Administration

While consumers all over the world would gain from lower pump prices, the positive effect of the savings on consumer sentiment is likely to be most evident in the U.S. Any gain in U.S. consumer demand is good news not only for domestic businesses, but also for exporters in Europe, China, Japan, Mexico, Korea and several other countries. What's more, as lower fuel prices gradually filter through the industrial production and supply chain, most businesses should see lower input costs.

For consumers around the world, cheap oil is almost like an early Holiday gift, spreading cheer far and wide. If prices remain low for a few years, as they look increasingly likely to do, this could even be a gift that keeps on giving. If Brent prices for 2015 are $30 per barrel below this year's average, the world's oil consumers could save more than $1 trillion through the year. True, the oil producing nations may be hurt and some of them could slip into deep recession and face political unrest. Yet, for a world economy that has seen several false dawns since the global financial crisis, the boost to consumption from lower energy prices could be the much needed succor. The International Monetary Fund has said lower energy prices would help the world economy grow more rapidly in 2015.

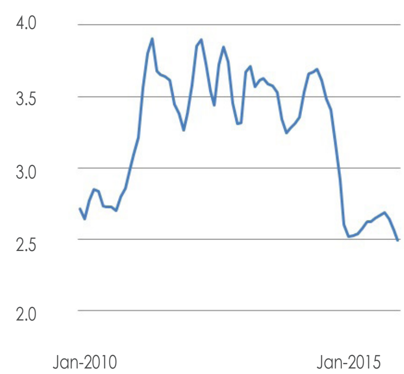
It is not too difficult to see why.

1. **Big boost to consumer sentiment**: While consumers all over the world would gain from lower pump prices, the positive effect of the savings on consumer sentiment is likely to be most evident in the U.S. At the current fuel efficiency level, the average American who drives close to 13,500 miles a year would save $560 for a $1 per gallon price drop. As most families have more than one car, savings for an average household could top $1,000 a year. That is more than the 2008 payroll tax cut, a major component of the fiscal stimulus program announced after the financial crisis, which saved the average household $934 a year. That is not all. Though natural gas prices have moved higher recently, cheaper heating oil and propane should lower the heating costs for the average household this winter. Most likely, consumers would spend these savings on other goods and services. Any gain in U.S. consumer demand is good news not only for domestic businesses, but for exporters in Europe, China, Japan, Mexico, Korea and several other countries as well.

2. **Wider margins for industrial users and service businesses**: As lower fuel prices gradually filter through the industrial production and supply chain, most businesses should see lower input costs. Even businesses that do not use much fuel directly in their production process could save from lower costs for transportation and other activities. A substantial part of these savings are likely to be passed on to end consumers in the form of lower prices. Nevertheless, in an environment when demand is expanding, businesses would have increased pricing power and be in a better position to boost profit margins by retaining some of the savings resulting from lower costs. Higher profits could encourage businesses to invest more in capacity additions and increase hiring, providing a further lift to consumer spending.

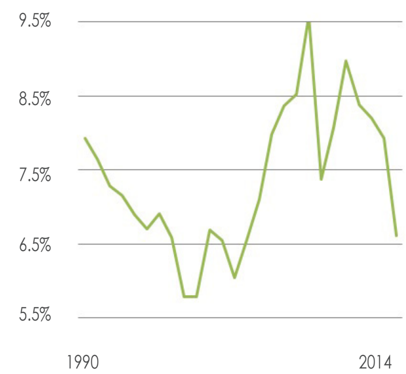
If the slump in oil prices persists, India and Indonesia would likely see their current account gaps narrow further. South Korea, which imports almost all of its energy requirements, as well as China should also make substantial gains. Among the developed economies, Japan and Germany stand to benefit the most.

U.S. retail fuel prices are expected to remain low



Average U.S. gasoline prices in $ per gallon

U.S. energy expenses are likely to see an appreciable decline



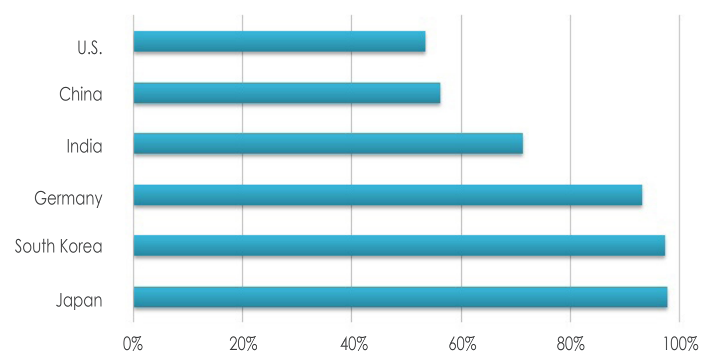
U.S. energy expenditure as a % of GDP

Data source: U.S. Energy Information Administration

3. **Improved current account balances for oil importing countries**: Widening current account deficits caused heightened equity and currency market volatility in several emerging markets last year. Among the victims, large oil importers such as India and Indonesia would likely see their current account gaps narrow further. South Korea, which imports almost all of its energy requirements, as well as China should also make substantial gains. Among the developed economies, Japan and Germany stand to benefit the most.

4. **Lower fiscal deficits for countries that subsidize fuel**: Several countries offer subsidies on fuel prices to consumers, and the costs have been a heavy fiscal burden. For instance, Indonesia currently spends more than 13% of its government budget on fuel subsidies. In India, total fuel subsidies for the fiscal year ended March 2014 were nearly 1% of GDP. Subsidy costs for these countries are likely to be substantially lower in the coming year, and the savings should allow governments to increase outlays for more productive purposes. What's more, lower inflation risks would possibly allow central banks in these countries to cut interest rates further.

The biggest oil importers are likely to gain the most



Data source: U.S. Energy Information Administration

Percentage share of imports in total crude oil consumption

Tracing the Gains to Sectors and Companies

Sectors such as transportation where fuel is a large component of total costs are the most obvious beneficiaries of the oil price decline. The global airline industry is likely to see windfall gains as the International Air Transport Association (IATA) expects 2015 profits for the industry to be 25% higher. While airlines the world over should see sharp margin gains, U.S. airline companies such as **American Airlines** stand to gain the most as industry consolidation and capacity rationalization have improved their pricing power. Express delivery firms such as **FedEx Corp.** that operate very large fleets of vehicles and airplanes are also likely to benefit significantly.

Similarly, if oil prices remain affordable for an extended period, automobile manufacturers are likely to benefit from higher demand as more people may opt for personal transport. Also, less concerned about fuel efficiency, buyers are likely to prefer larger vehicles that earn higher profit margins for manufacturers. Automakers such as German manufacturer **BMW AG** and **Tata Motors**, which owns the British car brands Land Rover and Jaguar, are likely to benefit from this trend. Automobile tire manufacturers such as **Continental AG** and **Michelin SCA** should also enjoy stronger demand as well as lower costs of inputs such as synthetic rubber, which is made from petroleum feedstock.

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In Japan, where energy costs have increased after the nuclear plants were shut down in 2011, most industrial manufacturers are likely to benefit from reduced oil prices. Japanese utilities like **Tokyo Electric Power**, auto manufacturers such as **Nissan Motor Co.**, heavy machinery manufacturers like **Komatsu Ltd.**, and steel companies including **JFE Holdings, Inc.** stand to gain as their costs come down. As consumers begin to realize fuel cost savings, sectors such as consumer staples, retail, consumer electronics, and luxury goods should see improvement.

Korea Electric Power (KEPCO), the largest Korean electric utility, is likely to see a substantial decline in costs as imported liquefied natural gas (LNG) and coal have become cheaper. European utility **E.ON SE**, one of the world's largest electricity generators, is likely to be another major beneficiary as coal and natural gas cover nearly 75% of the company's fuel mix.

Nevertheless, amazed by the extent and speed of the oil price decline, investors appear unsure about whether cheap oil is good for equities or not. What started as a selloff in stocks of oil producers, equipment suppliers and oilfield services providers has gradually spread to other areas that are considered relatively more risky or vulnerable. Emerging markets corrected in early December as the steep decline in equity prices and currencies of oil producers such as Russia have made investors more cautious about other countries as well. We believe these apprehensions will gradually fade, as the positive impact of lower oil prices on global growth becomes more apparent.

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— Thomas S. White, Jr., Portfolio Manager

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