

Rising oil prices – what is the tipping point for growth?

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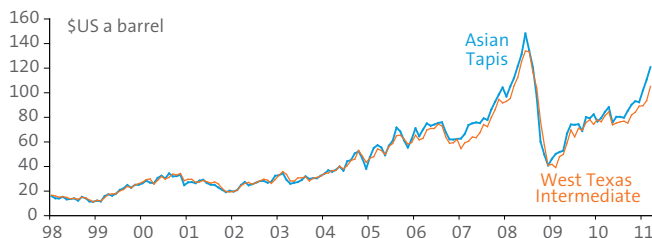
Key points

- Global oil prices remain under upward pressure from turmoil in the Middle East and North Africa. This will dampen global growth and add to the financial pressure on Australian households.
- The global and Australian economies and share markets can probably live with current oil price levels but a sustained sharp rise in the oil price to US\$140 would make life a lot more difficult.

Oil prices are surging again

After a dip last week, on the back of the tragedy in Japan, the US West Texas Intermediate oil price is back above US\$105 a barrel and Asian Tapis oil prices are around US\$120 a barrel.

World oil prices still on a rise



Source: Thomson Financial, AMP Capital Investors

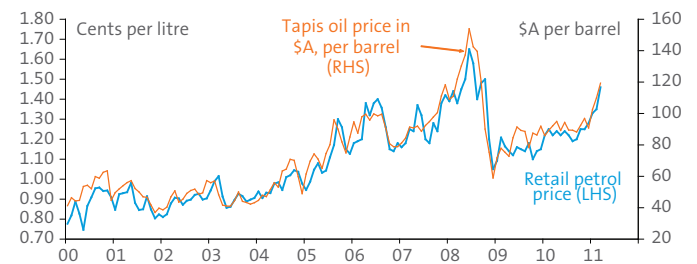
Increasing tensions in the Middle East and North Africa (MENA) have been the primary driver, with the US and various European countries now intervening militarily in Libya to enforce a no fly zone, along with escalating tensions in Bahrain, Yemen and Saudi Arabia. The tensions between Sunni rulers and Shiites in Bahrain risk a further escalation, possibly drawing in Shiite dominated areas in Saudi Arabia and Shiite dominated Iran.

In addition, the lessening of the risk of a full-blown nuclear meltdown in Japan has shifted the focus back to increased oil demand from Japan in order to make up for reduced nuclear power production and as part of rebuilding demand following the earthquake. This is all occurring at a time when global demand for oil is rising on the back of the global economic recovery and a long-term deterioration in the pace of new oil discoveries.

The rise in oil prices is pushing up energy costs worldwide. Australia is no exception, and the rise to date has pushed up local petrol prices to an average of around \$1.45 a litre. As can be seen in the next chart there is a pretty close relationship between the local petrol price and the world oil price in Australian dollars. Roughly each US\$10 a barrel rise in the world oil price translates to around an 8 cents a litre increase in Australian petrol prices. If world oil

prices stay at current levels expect petrol prices to rise another 3 to 5 cents over the next few weeks.

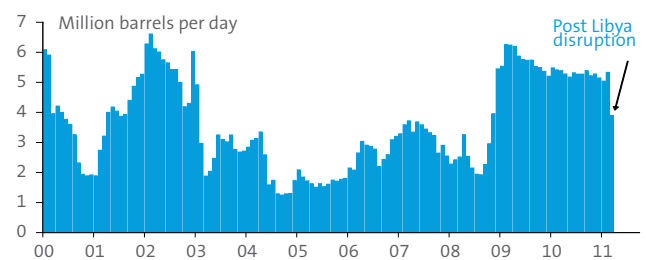
Australian oil prices have moved up with the oil prices



Source: Thomson Financial, AMP Capital Investors

The war in Libya has affected most of its normal 1.8 million barrels per day of oil production. Prior to the unrest in the Middle East, OPEC had 5 million barrels a day of spare oil capacity and so Saudi Arabia and other gulf states have been able to make up for lost Libyan production.

OPEC spare capacity



Source: Bloomberg, AMP Capital Investors

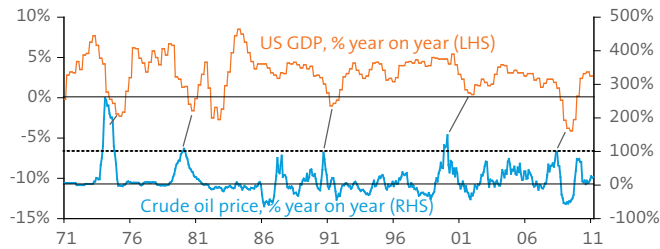
However, Libyan crude oil is light and cheaper to refine compared to the heavy Saudi oil grades, so this has added to the price of light oil grades such as Brent and Tapis. Secondly, while OPEC can make up for lost Libyan production, it would only take a spreading of unrest and production disruptions to say Kuwait, Iran or part of Saudi Arabia to wipe out all of the spare capacity. Finally, some suspect Saudi Arabia may be exaggerating its spare capacity. So it's little wonder the oil price contains a risk premium, estimated to be around US\$10-15 a barrel. If the unrest spreads, a further increase in oil prices is likely.

Our sense, while not being experts on the Middle East, is that although the turmoil will continue to bubble on for a while, further significant oil supply disruption will be avoided. As such the issue will become background noise for global investment markets but as the risks are skewed towards more disruption and higher oil prices, it's worth considering at what level the surge in the oil price would create a problem for the economic outlook.

At what level will the oil price become a problem?

It's true that past surges in world oil prices have preceded US recessions and sharp global downturns. See next chart.

Oil prices and US economic growth



Source: Thomson Financial, AMP Capital Investors

Previously however, other factors have also been involved – notably significant monetary tightening, and we are not seeing that now. Much of the rise over the last two years has also been due to stronger demand with supply concerns only adding US\$10-15 a barrel this year. It's also the change in the oil price that matters, not its level, as businesses and consumers gradually get used to higher oil prices. Trouble normally ensues if the oil price doubles over 12 months. We are not quite there yet. Our assessment is that the world can probably live with oil around US\$100 a barrel, and we expected it to reach that level this year anyway.

The following table estimates the impact on gross domestic product (GDP) growth of a US\$10 rise in the price of oil for the year ahead in the second column and then applying that to the impact of oil at US\$110 a barrel and US\$140 a barrel.

Impact on GDP growth of rising oil prices, % points

Country	Impact of \$10 rise in oil price	Impact of oil at \$1.10 *	Impact of oil at \$1.40 *
US	-0.3	-0.3	-1.2
Europe	-0.5	-0.5	-2.0
Japan	-0.3	-0.3	-1.2
Asia	-0.8	-0.8	-3.2
World	-0.4	-0.4	-1.6
Australia	-0.25	-0.25	-1.0

* Relative to a base case of \$US100. Source: IEA, IMF, OECD, AMP Capital Investors

Global growth this year is currently forecast to be around 4.3% by the IMF so if the world oil price settles around US\$110 a barrel then global growth would be reduced by around 0.4% but would still be solid at around 3.9%.

However, a sustained spike to US\$140 a barrel would be much more worrying as it would slice around 1.6% off world growth, 1.2% off US growth and 1% off Australian growth. Asia is the most vulnerable, reflecting its heavy reliance on imported oil and its more intensive oil use. Australia is less vulnerable as it is a net energy exporter.

The rise in the oil price will also boost inflation with roughly a US\$10 a barrel rise adding 0.5% to inflation in the US and Australia and 0.7% to inflation in Asia.

What would central banks focus on – inflation or growth? The European Central Bank is more likely to focus on headline inflation

and so raise interest rates as it is threatening to do. However, the US Federal Reserve is likely to see a fuel-inspired boost to inflation as temporary and would probably give more weight to weaker growth.

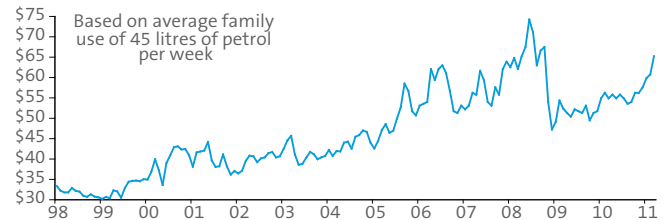
At this stage it's too early to get overly worried given that it's quite possible that significant tensions in the Middle East and North Africa will be confined to current countries. Just as the much-feared nuclear meltdown didn't happen a week ago, a worst case oil price surge may be avoided. **The bottom line is that current oil price levels are probably not enough to derail the global recovery. However, if oil prices rise to US\$140 a barrel the threat would be significant** – both via the direct hit to growth and the indirect hit if central banks in some countries respond to higher inflation via interest rate hikes.

What about Australia?

For Australia, the strong Australian dollar is acting as a buffer against the rising oil price. Australia is also a net energy exporter so the rise in the oil price is providing a boost to national income via higher gas and steaming coal prices. We also see the Reserve Bank of Australia giving more weight to the growth-reducing impact of higher oil prices, rather than the boost to headline inflation and so don't see it responding with a rate hike, providing underlying inflation stays benign.

The real problem for Australia is that the rise in oil and petrol prices will add to consumer caution. While higher energy prices boost national income, and hence resource sector investment, the rise in petrol prices over the last month has already added another \$5 to the weekly petrol bill for a typical Australian family. It is now just \$10 a week below the 2008 high. Coming on the back of solid increases in costs for electricity, insurance, fresh food and education this will only cut further into consumer discretionary spending power - more bad news for retailers.

Weekly petrol bill for a typical Australian household



Source: AMP Capital Investors

Implications for shares

The surge in oil prices is great news for energy shares, but not so good for the rest of the share market. However, shares can probably still perform well with current oil price levels, helped by the improvement in valuations after the recent correction. However, a sustained sharp rise in the oil price to around US\$140 would make life a lot more difficult.

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