

Rising oil prices and Japan - should investors be concerned?



Events in Libya and Japan have gripped markets and stopped a nine month upward trend in global share prices in its tracks. Matt Sherwood, Perpetual's Head of Investment Market Research examines these developments and concludes the Japanese earthquakes will be the most expensive natural disaster in history and that global oil prices are likely to remain elevated due to the strong global economic recovery, which will place more pressure on household budgets.

Key takeouts:

- The Japanese earthquake is likely to be the most expensive natural disaster in history.
- Concerns about nuclear power may increase the construction of coal-based facilities.
- The relationship between rising oil prices and economic growth has changed radically
- Australian consumers have to date been protected from higher oil prices by the higher Australian dollar and higher disposable income, but this won't last.

Introduction

For the land of the rising sun, these are dark days indeed. Not only did Japan experience the fourth largest earthquake in recorded history, but then a tsunami invaded its' east coast and this, in turn sparked a partial meltdown in the Fukushima nuclear power plant. The earthquake that started this chain of events reached 9.0 on the Richter scale and while Japan sits on a fault line and earthquakes are regular events, the combination of back-to-back disasters is most likely unique and has prompted a sharp market reaction.

Japanese earthquakes – some perspective

The economic history of Japan is one of the most studied, but the country has also been studied in depth by seismologists. Japan is situated in a zone called the 'Ring of Fire'. This region is home to over 75% of the world's active and dormant volcanoes and starts as far south as New Zealand and rises to include Indonesia, the Philippines, Japan, Russia, Canada, the USA, Mexico and Chile. The region experiences about 90% of the world's earthquakes and 80% of the world's largest earthquakes.

Indeed over the past 16 years, Japan has experienced 14 earthquakes in excess of 6.5 on the Richter scale. The worst of these (in terms of damage) was in 1995 in Kobe, which has the distinction of being the most expensive natural disaster in history (according to the Guinness Book of World Records) with an estimated USD103 billion in damage (or around 3% of Japanese economic output). Nonetheless, while Kobe recovered with manufacturing activity in the city back to normal levels within 15 months, the recent earthquake is likely to attract a higher reconstruction cost and a longer duration for reconstruction.

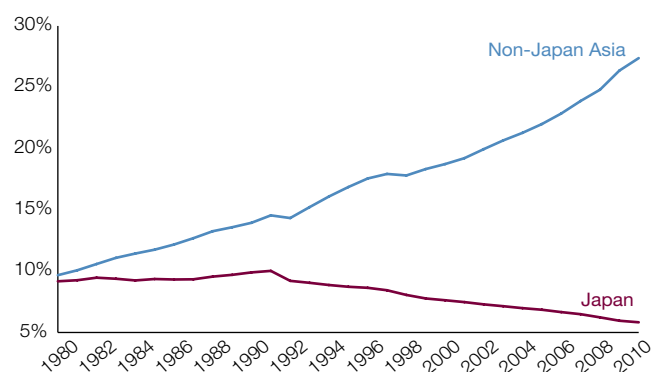
The best case scenario

Putting the human cost (which is enormous) to one side, the economic damage is still being assessed and at present there are only small amounts of information. The potential meltdown of the Fukushima facilities is the biggest difference between the 1995 and 2011 disasters. The worst case scenario doesn't bear mentioning and the best case scenario keeps getting worse. Was there to be only minimal radioactive leaks and lives lost, there will still be sizable short-term and long-term costs to the Japanese economy. Under this scenario, there would be an immediate shock to industrial production which would be likely to decline in the March and June quarters. However, the eventual rebuilding of the economy's capital stock (such as housing, commercial buildings and infrastructure) should increase economic activity in the second half of 2011 and beyond.

As such, the impact of any economic 'loss' from the earthquake on global GDP is likely to be modest, as Japan's contribution to global economic production has halved over the past 20 years (as their economy has stagnated, while the global economy surged) and is now dwarfed by the total productive capacity of non-Japan Asia (see Chart 1). Given the cost of the Kobe earthquake (in terms of GDP) was 3%, Japan is unlikely to experience any trouble raising the funding for their reconstruction as interest on their entire debt is only 4% of government revenue (representing an interest cover of 25 times). Japan is carrying a debt burden equivalent to roughly 200% of its economic output, which is the worst among any industrialised country (by a long way), but this disaster will add only marginally to this mounting number and its domestic savings pool is very large. More economic damage would be sustained if the radiation spread south west and led to an evacuation of Tokyo or if it spread west over the Sea of Japan and into North or South Korea and China.

Chart 1: Japan's share of the global economy is dwarfed by the rest of Asia

Share of Global Economic Output: Japan and Non-Japan Asia (%)



Source: Macquarie Equities and the International Monetary Fund as at 28 February 2011.

The long-term affect could lead to more oil and coal-facility investment

There are likely to be significant power shutdowns in many nuclear facilities over the medium to long term, in the wake of repairs and safety checks, which could significantly impact growth. In the 1995 quake, some of the associated nuclear facilities were shut down for several years, but growth remained positive. There is also the growing risk that safety concerns of nuclear power, in general, will prompt a decline in global construction of these facilities and accelerate the usage and development of more coal-based facilities (which produce cheaper energy, but with higher carbon dioxide emissions, than nuclear power). Accordingly, the long-term impact on commodities could be mixed, with Japan's need for more oil and thermal coal to produce electricity (to replace its damaged nuclear plants), possibly offsetting reductions in other commodity markets. This may add more pressure on some global energy prices through time.

The oil price is rising notably

Between 2004 and 2008 investors witnessed oil prices rise by 330%, even though daily oil demand rose by just 2%. Part of the price rise reflected the high inelasticity of oil in the wake of rising demand from the emerging economies and increased speculation in global derivatives markets. Although the oil price declined in the wake of the GFC, the relationship between oil consumption and prices since 1995 indicates that the trough of 2008 was well below the level justified by global demand (see Chart 2), and that gap has now closed, with prices rising in the wake of the strong global economic recovery since early 2009. During this period the oil price has risen (220%) from its GFC trough of USD33 per barrel in January 2009, as global demand has risen by 4%.

Some investors are scarred by rising oil prices

The thought of rising oil prices can put shivers up an investor's spine. Oil is considered by most to be the engine of global economic growth as nearly all manufactured goods (from car tyres to toys to shampoo) have oil as an input to their production. It logically follows that changing oil prices will negatively affect economic growth, which is probably the rationale for why some people are concerned about the theory of 'peak oil'.

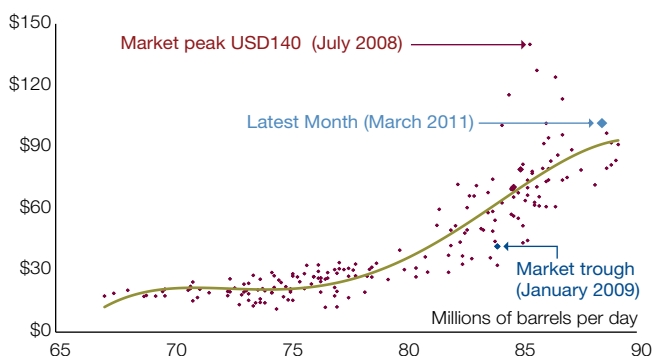
... and rising geopolitical tensions aren't helping prices

While the rise in oil prices of the past year has mainly been driven by rising global demand, several 'people's revolutions' around the Middle East has seen global prices spike. There are only two catalysts needed for governments in undemocratic countries to be removed from power – general economic hardship (which causes a people's revolt) and the army to side with the people.

Consequently, the widening of the democratisation wave in the Middle East that started in Tunisia and Egypt, and that has more recently resulted in oil supply disruptions in Libya, will likely keep crude oil prices at elevated levels over the coming period. Given that Libya contributes only 2% of global oil production, the key question for investors is will the geopolitical risks spread West to larger producers such as Algeria (2% of global oil production) or East to producers such as Kuwait (3%), United Arab Emirates (3%), Iran (5%) and Saudi Arabia (12%). In the case of the latter two, Iran put down a significant people's revolt with the help of the army late last year. Meanwhile, the army in Saudi Arabia is owned and paid by the King and he just gave the population USD33 billion of 'gifts' to the people, without an election in sight. Accordingly, these large sources seem secure for the time being.

Chart 2: The rise in oil prices has primarily been driven by demand

Global Oil Demand and Price per Barrel (monthly data, post-1994)



Source: Morgan Stanley as at 10 March 2011.

The price of increased democratisation

The recent elevation in geopolitical risk in the Middle East has prompted oil prices to rise above the 15-year trend line between consumption and price, which suggests that they're about 9% above where they should be. Most investors are mindful of the destructive impact that global oil prices had in the 1970s in the wake of the two oil shocks, which produced both severe recessions and rampant inflation. However, the relationship between oil and economic growth is more entwined nowadays as oil prices both affect and are affected by economic activity.

The changing nature of oil and economic growth

While it is true that higher oil prices can act like a tax on discretionary spending and lead to lower economic growth, it is also true that rising oil prices and higher economic growth have co-existed for the vast majority of the past 12 years (see Chart 3). While in the 1970s and 1980s, the oil price was negatively correlated with global economic output, by the end of the 1990s

the relationship had totally changed, as the strength of demand led to higher oil prices.

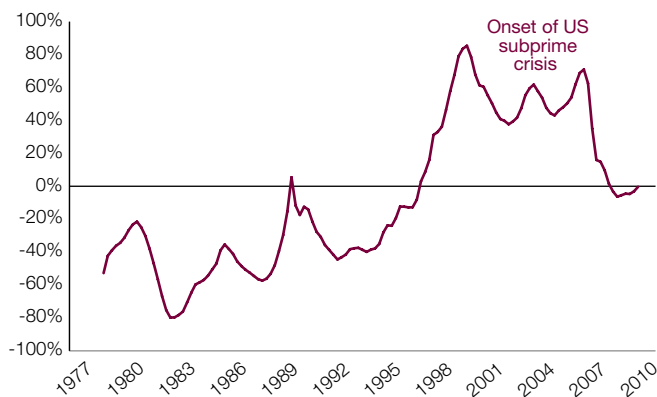
This change in relationship was sparked by emerging Asia's industrialisation, which are primarily manufacturing based economies. As these economies grew, their total energy demand also rose and this meant that the relationship between oil prices became positive until the onset of the US subprime crisis in 2007. However, the downtrend in the correlation has ended over the past year and if this is the case, investors need not necessarily fear rising oil prices.

Australian consumers are being partially protected

Importantly, if Middle East tensions escalate, then it is possible that oil prices could continue their ascent and be more of a dampener on growth and place upward pressure on inflation (which is the last thing Australia needs given the higher fruit and vegetable prices in the wake of the recent floods). While most households cringe at the thought of rising global oil prices, Australian consumers are being partially protected by two factors. Firstly the rise in the Australian dollar is cushioning the price increase. However, this shield may prove temporary as any further rise in oil prices would require a higher Australian Dollar, but the currency has struggled to break through USD1.02. Australian petrol prices have already risen to AUD1.35 a litre in February 2011, but this is being offset by higher income (see Chart 4).

Chart 3: Oil prices and economic growth - positively correlated for over ten years

Oil Prices and Real Global Economic Growth: 7-year Rolling Correlation (%)

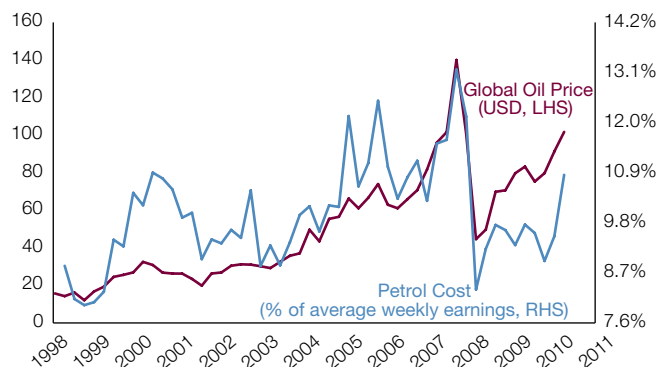


Source: UBS Australia Limited as at 28 February 2011. Data includes a forecast for March 2011.

The relationship between global oil prices and the share of petrol costs from disposable income is fairly consistent. However, despite the rise in global prices, the share that petrol costs represent of average weekly earnings is around its lowest level in around 10 years. However, if prices rose to AUD1.50 a litre, the ratio would rise to just under 11% of disposable

income, which could increase pressure on household budgets. Given this price increase is occurring at a time when insurance premiums, food, utility price are rising, the outlook for discretionary spending remains rather bleak.

Chart 4: Australian consumers have been protected
Oil Prices and Petrol Costs as a Share of Average Weekly Earnings (USD, %)



Source: Australian Automobile Association and Reserve Bank of Australia as at 31 March 2011. Assumes family consumes 60 litres of petrol at average Australian price. Estimate for March 2011 is an estimate, based on February data.

Implications for investors

Events in Japan appear increasingly serious and not just because of the wide-scale loss of life, but also because of the risks posed by damaged nuclear facilities. The best we all can hope for is minimal radioactive damage in a localised area. Markets are expecting something worse and have marked uranium stocks down and coal stocks up. Meanwhile, oil stocks are continuing to perform well on the back of higher global prices, whereas it appears that most stocks exposed to discretionary spending are likely to struggle to rise as revenue growth remains low and cost pressures remain high. This is likely to continue until events in the Middle East calm down, but this should only provide consumers with short-term relief and there is likely to be a rising trend in global oil prices in the next few years. From a stock perspective, the two keys in this sort of environment are to identify companies that can control costs and are able to grow revenue in tough market conditions. Stocks with these characteristics, a strong balance sheet and that are shareholder-focused in their payout strategy are likely to find favour with investors.

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