

INVESTMENT NOTE

March 2011

Oil Shocks & Inflation

Will higher oil prices force the hand of Central Banks?

With growing international support for rebel opposition in Libya, including the sending of arms, trade sanctions and embargos, and the seizure of billions of dollars claimed to belong to Gaddafi in Switzerland and the UK, one can only expect tensions in the country, and indeed the region to continue for now. Against this unsettled backdrop in one of the world's more significant oil producing areas, we discuss the probable effects on both the oil price and the knock on effect for commodity price driven inflation – a key issue for investors this year!

Momentous events continue to unfold in North Africa and the Middle East initiated by an uprising of the people that has ended thirty years of Mubarak rule in Egypt. Subsequent protests in Bahrain have been dealt with violently and now we witness a uprising in Libya where protestors and 'rebels' have even faced attacks from their own military (at least two air force pilots to defect with their war planes to Malta rather than bomb their own people!). It is now almost certain that in the face of overwhelming international support for the rebels and sanctions against the incumbent rulers and Colonel Gaddafi personally, that time has effectively run out for the Libyan leader. Whilst these events do not directly affect the security of most western countries any increase in geopolitical risk has an unstable effect on global stock markets and eventually the economic outlook. Of particular concern is whether the supply of crude oil will diminish should production within these mostly oil producing nations fall. Although Egypt and Libya account for less than 3.0% of global oil production there is concern that we may witness a contagion to nearby countries such as Saudi Arabia, which alone accounts for nearly 12% of total global production and a quarter of global reserves. Despite assurances from Saudi rulers one must remain concerned about stability in the country; apart from sending tanks towards the Bahrain border last week, the Saudi government has banned its citizens from going ahead with the "day of rage" rally planned this week and even blocked access to websites used in its organisation. Such concerns have sent Brent crude oil prices above \$115 US dollars a barrel (two year highs) and WTI Crude to \$104 (see "Brent or WTI" below).



However, let us not forget that oil prices were already on the rise prior to these potential supply disruptions coming to the fore. As in 2008, when oil prices hit \$147 a barrel, an increase in global demand and the unavoidable effect of financial speculators pushed up prices – a situation we are facing now as the world emerges from recession. This effect can not only be seen in energy but also metal and agricultural commodities which are making similar new highs. **What we face today, therefore, is a long-term demand led price rise being exaggerated in the short-term by supply disruption fears; higher oil prices may be here to stay.**

Despite renewed calls for the adoption of 'greener' technologies (and energy production) we remain firmly reliant on crude oil, and as such, any sustained higher prices will undoubtedly feed through to higher inflation as production and transportation costs increase. Higher costs to households (as petrol and heating costs rise) will additionally curtail both retail spending and threaten economic growth possibly derailing the current economic recovery.

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There can be no doubt that higher energy costs will pass through to core inflation (which excludes energy and food costs) which is already running in the UK at twice the Bank of England's target rate. The Bank's monetary policy committee is already split as to whether interest rates should rise now or remain at their historically low level (unchanged for two years) but it is doubtful they will remain inactive should inflationary pressures persist. Policy makers are therefore in a quandary as to which route to take. On the one hand, many reassuringly claim that heightened inflation will be a short-term phenomenon, interest rate rises are not warranted and that any such monetary tightening will be detrimental to economic growth. Whilst on the other hand, others warn that inflation will not fall without some form of intervention and inactivity will be far more damaging to long term growth prospects. **We believe that the central bank will not be able to stand idly by and modest interest rates will be required to ensure price stability.** The timing of these rate rises looks increasingly imminent as energy and other commodity prices continue to rise. Pressure for the UK to act may further increase as the more 'hawkish' European Central Bank signal possible rate hikes as a necessity given their concerns over inflation and higher growth forecasts across the stronger elements of the Euro zone.

How does this expectation affect our Asset Allocation Policy?

Higher inflation and higher interest rates, against a backdrop of improving economic fundamentals has been our forecast for 2011 and does not detract from our current asset allocation positioning but rather, supports it further. Indeed since 2010 we have been reducing our fixed income exposure, particularly towards government debt, believing that the low yields available are scant compensation for the capital loss we expect many bond holders to experience as interest rate expectations, and finally rates, rise. **Only our more cautious portfolios have any Gilt exposure, and even those are exposed to the very short-end of the market which is typically the least effected by interest rate moves.** As a substitute for our reduced fixed income exposure we have again focused on the absolute return sector which we believe will produce attractive returns but with a far lower volatility than directional equity investment given the current investment environment.

Brent or WTI Crude?

We have been often asked what is the difference between the 'Brent' and 'WTI' crude oil prices. Typically the answer is not as straightforward as one would expect. There are actually four popular benchmarks for crude oil prices; Brent crude, West Texas Intermediate (WTI), OPEC Reference Basket and Dubai Crude. The WTI crude oil, refined in the US, and priced in US Dollars, was originally chosen to underpin crude oil futures when the NYMEX exchange launched in 1983, has been the most popular benchmark, and often the price quoted when we discuss the global oil price. Brent the second most popular benchmark price consists of oil sources from the North Sea and was named after the Brent Goose oil field. Brent crude, also quoted in US dollars was originally traded on the International Petroleum Exchange in London and is actually used to price two thirds of the world's crude oil supplies.

Historically the price of WTI and Brent crude have been within a few dollars of each other, however since last year the price of Brent has moved away from that of WTI to the \$14 dollar difference we see today. There are many reasons for this dislocation but the most prominent are the rising supplies is the land-locked delivery point in the US subduing the price of WTI, whilst Brent (which long term actually faces supply issues as oil field reserves dwindle) more accurately reflects the violent upheavals in Libya and other key oil-producing countries in the Middle East and North Africa. In the medium term one would expect the spread between the two prices to narrow to more normalised levels. Until then we must be conscience of which we are talking about given the near 15% difference between the two.

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