FINANCIAL MARKETS

LOOKING AT OIL PRICES

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We believe that sound investment and trading decisions begin with a strong grounding in financial education. Our goal is to make this available to everyone - and this free eBook is part of that commitment.

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ALL CHANGE IN 2018?

FOREWORD

There was some surprise at the beginning of 2018 when oil prices rocketed.

After a four-year low, many investors took pleasure not only at the choices of OPEC - but also the performance of the US dollar.

In this eBook, we take a look at why there has been a boom in oil prices this year - and what has been keeping them low in recent times.

Patrick Latchford
CEO, Blackwell Global Investments (UK) Limited

WHAT DROVE LOW PRICES?

OPEC & THE US DOLLAR

Before the price boom at the start of 2018, oil prices had remained relatively low for around four years.

This was largely down to the increase in the value of the US dollar in 2014 and 2015.

Remember, the price of oil heavily depends on the performance of the US dollar. This is because most oil transactions are paid in US dollars.

It's why in 2014 and 2015, a strong US dollar was partially responsible for the 70% decline in the price of petroleum.

As well as this, in 2014, Saudi Arabia lowered its oil prices for its largest customers. The reason behind this was to avoid losing its market share to Iran; its regional rival. This had a huge impact as Saudi Arabia is the Organization of the Petroleum Exporting

Countries' (OPEC) largest contributor.

To raise oil prices in the past, Saudi Arabia has also reduced its output. However, in 2015, it refused to do so. It is suggested that this was to persuade Russia and other large producers to share out the costs of limiting production.

As well as a strong US dollar, the US played other parts in keeping oil prices low.

According to the US Energy Information Administration, US oil production increased by around 45% between 2010-2014.

Canada also produced roughly 25% more than the previous four years. By the end of 2014, it was producing five million more barrels of oil per day than in 2010.

New techniques - such as a fracking - helped North Amercian companies access reserves that were previously inaccessible.

By this point (2014), the rate of production in North America had grown faster than the entire global demand. This caused a huge shift in the supply and demand balance. The increased supply meant that in 2015, the demand for OPEC fell to 29 million B/D (barrels per day) from 30 million B/D. By 2016, low prices meant that US oil production fell to 8.9 million B/D.

WHAT IS HAPPENING IN 2018?

There are two main contributors to the spike in oil prices at the start of 2018.

The first is the decision making from OPEC.

On 30th November 2016, OPEC decided to cut production by 1.2 million B/D by January 2017. Exactly one year later, they decided to continue the cut. In doing so, oil prices spiked as traders began to respond.

Shortly after OPEC's initial announcement, the US dollar began to decline. Between 11th December 2016 and 11th April 2018, the USDX dropped from 102.95 to 89.53.

By January 2018, the US dollar had lost 3.2% against the other major currencies in the world. At the same time, investment and crude futures had reached a record high.

In January, we saw oil prices hit $70 a barrel. That is almost triple the 13-year low that came on 20th January 2016 at $26.55 a barrel.

IMPACT ON THE MARKETS

MARKET RISKS

For traders, it is important to look at the impact higher oil prices can have on the global economy.

Though high oil prices are generally beneficial, there are some related risks. For instance, high oil prices have the ability to cause inflation. Keep in mind that most developed economies are heavily reliant on oil - so expenditure on this commodity is high.

Let's consider the following scenario. If the price of oil rises to the point where it becomes too expensive, national wages will need to increase to compensate.

As most traders know, one effect of increased wages is faster inflation (the increase in the cost of goods and services). Higher commodity prices could also squeeze the profits of companies that rely on oil (such as airlines). Downward pressure on company profits can weaken stock market indexes.

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WHAT CAN WE EXPECT FOR THE REST OF 2018?

For now, it seems as though the price of oil is likely to remain high for the foreseeable future.

It is important to remember that the price of oil does not depend on supply and demand alone. Recent history demonstrates that OPEC also plays an important role.

By choosing to cut production, the price of oil will increase, as the supply will be less. If they choose to increase production, more will be sold but at a lower price.

According to their own monthly report, OPEC believes that the world's oil demand will increase by 1.3 million barrels every day in 2018. By this logic, we should predict that oil prices are likely to either continue to rise (or stay at a similar level seen in early 2018) throughout the year.

The US is likely to continue to play a big role in both the production and the price of oil.

As we've seen already, continued US dollar weakness will drag on oil prices. US production looks set to increase too - with experts predicting that it will break its record for the most barrels produced per day in 2018.

As there was such a rapid start to the year, it is hard to predict exactly what could happen in regards to the price of oil.

So far, OPEC has shown no signs of making any significant changes. With this in mind, it's reasonable to suggest that prices are likely to stay in the range we've seen over the first quarter of 2018.

In addition, we could see OPEC come under pressure to lower the price of oil. We've already seen evidence of this from President Trump - who criticised OPEC for creating 'artificially high' oil prices.


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