Should We Worry About Higher Oil Prices?

By Stephen Slifer *Thu, Jul 26, 2018*

'Faster global growth contributed to the earlier increase in oil prices. Slower growth triggered by reduced trade flows will do the opposite,' writes our guest columnist.

In the middle of last year oil prices were $45 per barrel. A year later at $74 they are higher than anyone anticipated. What is behind this 65% increase in oil prices? What should we expect going forward? Could they be the catalyst for the Fed to accelerate the pace of rate hikes?

Oil prices began their ascent in the second half of last year as it became apparent that global GDP growth was accelerating. In April the IMF officially raised its estimate of global growth by 0.2% to 3.9% as the United States, European, and Japanese economies all gathered momentum. The prospect of faster growth began to push oil prices higher.

Since that time supply factors have come into play. The Venezuelan economy has plunged into a deep economic crisis. The IMF estimates that GDP growth will fall 15% in 2018, which would be the fifth consecutive year of contraction. Inflation is expected to skyrocket to 14,000%. The oil sector is in shambles as the result of chronic mismanagement and inadequate investment. At the beginning of 2016 Venezuela produced 2.6 million barrels of oil per day. That has fallen steadily to 1.5 million barrels per day currently — a multi-decade low — and analysts expect a further drop to 0.8 million barrels per day by the end of this year. This dramatic drop in production from a previously top-10 oil producing country has been a major factor behind the recent rise in oil prices.

In May President Trump announced that he was withdrawing from the Iran nuclear deal and intended to re-instate sanctions against Iranian oil exports. The idea is to slash Iranian oil exports from 1.3 million barrels per day currently to almost nothing. That announcement caused oil prices to jump by an additional $6 per barrel.

With the prospect of losing perhaps another 2.0 million barrels of oil output per day between now and the end of next year, can other oil producers pick up the slack? Perhaps. Last month OPEC ministers and non-OPEC producers agreed to step up production by about 1.0 million barrels per day with Saudi Arabia and Russia leading the way. However, there may not be enough unused capacity in those two countries to achieve the agreed-upon increase in production.

At the same time U.S. shale oil producers continue to boost output. Since the end of last year oil production in the U.S. has climbed from 9.8 million barrels per day to 11.0 million barrels currently, and the Energy Department expects production to climb further to 11.8 million barrels per day in 2019.

Between the announced increase in production by OPEC and the likely pickup in U.S. production, global output should counter most of the reduced oil supply from Venezuela and Iran.

At the same time the demand for oil could be reduced if countries that rely primarily on trade see some slippage in GDP growth caused by the newly imposed tariffs. China is a prime candidate for slower growth from reduced trade flows. As the world's second largest economy slower GDP growth in China matters. In its recent revision the IMF did not soften its growth outlook for China, which it expects to slip from 6.9% last year to 6.6% this year and to 6.4% in 2019. However, those projections do not incorporate any impact from the broader trade actions announced by the U.S. in early July, which are bound to further curtail GDP growth.

Elsewhere, growth in most European countries and Japan will be negatively impacted by reduced trade flows. The IMF recently chopped GDP growth for Germany, France, Italy, Britain, and Japan this year by 0.3% apiece. The imposition of additional tariffs will further stifle growth in these countries.

The oil market is trying to digest unprecedented changes with output largely disappearing in a previously major oil-producing country, a potential significant drop-off in exports from another country as the result of sanctions, combined with a dramatic increase in output in yet another country. At the same time the demand side outlook is murky as the trade war between the U.S. and its trading partners escalates. Faster global growth contributed to the earlier increase in oil prices. Slower growth triggered by reduced trade flows will do the opposite.

For now, the impact from this combination of events appears to have produced a temporary run-up in oil prices, which are expected to decline over time. For example, the December 2018 futures contract for West Texas Intermediate crude oil is about $65 per barrel; the December 2020 contract expects a further drop to about $58.

The real concern will be if, at some point, business leaders become sufficiently uncertain about the economic environment that they are unwilling to invest in which case the global growth slowdown will become more pronounced. For now, the economic outlook is solid. Second quarter GDP growth in the U.S. should be solid at about 4.0%. Business confidence as measured by the ISM index is at a 14-year high despite all the trade talk.

Consumer confidence by any measure is equally buoyant.

The Fed will be concerned only if higher oil prices significantly boost inflation expectations. But, thus far, that has not happened. Survey-based measures of inflation expectations have been relatively stable. One such survey produced by the University of Michigan has been at about 2.75% since the end of 2016.

One market-based measure of inflationary expectations, the difference between the yield on the nominal 10-year note and its inflation-adjusted equivalent, has risen in the past year or so but remains subdued at 2.1%.

So, while the oil market has been struggling to adjust to some dramatic changes in production and possible changes in demand, thus far the recent increase in oil prices appears likely to be a largely temporary event with little negative impact on the U.S. economy or inflation expectations. If business and consumer confidence hold up and inflation expectations remain subdued the Fed will not be alarmed.