

Weekly Perspectives

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A Weekly View of Global Economies

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North America

Last year, as oil prices trended higher, there was a reasonable expectation that a downward adjustment was due in 2005 based on the forecast of a slowdown in economic growth. Well, prices did fall substantially in the final two months of 2004, but resumed their climb in January.

Cold weather in North America has been a precipitating factor but the main reason is that tight global capacity has left the oil market vulnerable to marginal changes in demand. At the same time, the underlying appetite for oil remains strong and China's rapid growth rate is an important variable in the overall equation.

On a long-term view, there has been a re-rating of oil and of commodities in general. The consensus outlook has shifted from a sanguine to a more uncertain view about supply/demand tightness. Last year, the broad expectation was that, longer term, oil supply will increase readily to meet demand, easing upward pressure on prices.

However, the growth momentum in emerging countries and, in particular, China has convinced observers that relatively high oil prices are here to stay for a good number of years. On the supply side, it appears that investment to expand capacity has been lacking in many of the major oil producers in the Middle East - - and these countries are among the lowest-cost producers in the world.

So, from a longer-run structural point of view, it is likely that the floor price for oil has been raised and the era of very cheap energy is behind us. Asian demand is growing rapidly, exemplified by the fact that Indonesia, which is an OPEC member, is now a net importer of oil. As for other commodities, China's presence also looms large.

It is no surprise that Chinese companies and officials are scrambling to ensure secure sources of energy supply in the Middle East and elsewhere. This is a strategic resource with geopolitical implications, and explains much of the increased interest in the Middle East and Russia shown by Western countries.

As for price forecasts, even though the multi-year structural argument appears to be plausible, it does not negate a cyclical pattern of upswing and downswing mapped over the long-run upward trend. We should expect corrections related to the business cycle, marginal changes in demand, as well as fluctuations due to event risk.

As a swing factor in the oil market, the Chinese economy is still growing at a robust pace. For now, the authorities are comfortable with the policy measures in place. However, if inflationary pressures develop, along with bottlenecks caused by imbalances, then there may be a need for stronger medicine to avoid overheating. A growth deceleration in the second half of the year may be a consequence.

So, in cyclical terms, there is the distinct possibility of a downward adjustment in oil prices even though the longer-term theme of tight spare capacity remains in place. Meanwhile, money-flows into commodity funds have been strong, which explains part of the reason for the rise in commodity and oil stocks, as well as activity in related derivatives. It also appears that hedge funds are still positioned with an overall long stance on commodity plays. The risk is that a price correction may be exacerbated as short-term investors rush for the door.

The market for forward oil, and oil swaps, is pricing in fairly high prices over the next few years. This indicates that participants are betting on the sustainability of relatively elevated oil prices over a longer-term horizon, based on issues such as tight capacity and political instability.

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Rising oil prices, because of the role they play in widening the trade deficit, are generally associated with a poor outlook for the US dollar. There is also an impact on inflationary pressures. And, both of these factors tend to support gold prices. Meanwhile, because oil is priced in US dollars, OPEC members have taken a hit in their overall revenues, when translated into other reserve currencies. This provides an incentive for producers to seek ways of pricing oil in terms of a basket of currencies.

Barring the Gulf War spike, the real price of oil is now higher than it has been for almost twenty years - - since it plunged in 1986. The effect is to reduce disposable income in consuming countries. This is worrisome, but unless there is a further rise from current levels, it is unlikely to cause a recessionary outcome for the global economy.

Europe

Eurozone growth remains fairly anaemic. It's the same old story of weak domestic demand, along with the export side propping up the economy. Of course, there is the usual discrepancy between better performances from peripheral countries compared with the core. Unfortunately, the average is pulled down by the core heavyweights. Given the differences in economic momentum, monetary policy is somewhat loose for the strong-growth countries and tight for the weak-growth economies.

Asia/Pacific

Japan's fourth-quarter GDP growth has been revised up. It was a surprise upward revision to a 0.5% annual rate, from a previously estimated -0.5% pace of advance. Actually, the market was expecting a downward revision. There has always been a degree of scepticism about Japanese GDP data among analysts, and the latest revision confirms that view. The cheerful aspect of the new estimate is that Japan, which was previously thought to have experienced a recession - - defined as three consecutive quarters of negative growth - - can now claim to have escaped that fate. Meanwhile, another positive bit of data release was the upward revision in January industrial production, which indicates that the Japanese economy is holding up.

Bonds

High commodity prices and inflation fears, along with concerns about foreign funding of US deficits, have been supporting Treasury yields. At this point in time, any indication of foreign official entities diversifying out of American assets is likely to be negative for Treasury bond prices.

Currencies

After experiencing a weekly losing streak, the US dollar staged a rally from oversold conditions, particularly against the euro. This week, trading sentiment will be dominated by data releases on the current account deficit and foreign purchases of US securities. Longer run, if Asian central banks engage in diversifying their reserve currency holdings, the euro, being a major alternative, may find some support.

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