Point of view

Mark Dutton, Chief Investment Officer – Australia & NZ, AXA

Middle East, North Africa tensions concern markets

In the space of a few weeks, political upheavals in the Middle East and North Africa have pushed oil prices up by 25 per cent. In this Point of View, AXA's Chief Investment Officer Mark Dutton looks at the impact of rapidly rising oil prices on the global economy and investment markets.

Key points

- Oil prices have jumped as recent uprisings in Tunisia, Egypt and Libya have raised fears that disruption could spread to other major oil producers in the region.
- History shows that oil shocks can lead to recessions. This is because major world economies depend on oil being a relatively cheap source of energy.
- Financial markets, still recovering from the GFC, are again reacting to changes in 'risk' by pushing commodity and bond prices higher, and prices on risky assets lower.

What's going on?

2011 began with positive prospects for ongoing recovery and future growth. But with running repairs from the GFC still underway, financial markets remain more jumpy than usual when a new risk emerges.

In a matter of weeks, waves of demonstrations and protests have swept across the Middle East and North Africa, triggering dramatic change in some of the region's longest standing regimes.

These upheavals have already caused the price of oil to rise by 25 per cent and markets remain nervous of further disruptions in world oil supplies.

But the recent jump in oil prices isn't directly linked to an interruption of supply.

According to OPEC – a cartel that influences the supply of oil to help stabilise oil prices – the Middle East and Africa account for 66 per cent of world oil reserves and 42 per cent of world oil production.

Tunisia and Egypt, two countries that have successfully overthrown their respective governments, account for less than 1 per cent of global oil production.

The outcome in Libya still remains uncertain and while its oil production has been reduced, it only accounts for around 3 to 4 per cent of global oil production.

Saudi Arabia, the regions' largest supplier of oil, which accounts for a significant 30 per cent of global oil production, has already pledged to make up the shortfall.

A big fear is that demonstrations and protests in other parts of the region escalate further, including Iran and Iraq which are among the top five oil producers.

The worst case scenario would be for unrest to spread to Saudi Arabia, as their ability to turn up the volume has for some time been a key aspect of maintaining stability in oil markets. So far there is little sign of this occurring.

Why is the price of oil so important?

Rapidly rising oil prices have far ranging knock-on effects because global demand is increasing and the world has not yet made enough inroads towards replacing oil with alternative sources of energy.

According to the International Energy Agency, world demand for oil grew by an extraordinary 2.7m barrels per day over 2010.

The worlds' largest global economies, the US and China, are both the biggest oil consumers. The US imports just over 50 per cent of its oil consumption, while China's imports grew by a massive 33 per cent over the past year.

Interestingly, both the US and China are also among the world's top five oil producing countries.

According to Consumer Energy Alliance, crude oil is predominantly used in manufacturing and transportation.

History shows that consumers tend to absorb the brunt of rising oil prices, which translates relatively quickly to lower global domestic demand. Inflation also tends to rise, especially in relation to rising food costs because of higher transportation costs.

The US has very low inflation. It's the developing economies that would feel the heat. Many of these economies are already operating at capacity and facing inflation constraints.

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Do rising oil prices lead to recessions?

Over the past 40 years, there have been five occasions where oil prices have doubled in the space of a few months and global recessions followed.

This happened in 1973, 1979, 1990, 1999 and 2008.

The 1973 oil crisis and 1979 oil crisis were a direct result of supply interruptions and a lengthy recession ensued until the early 1980s.

But in the case of the 1990s, early 2000s and our most recent global recession, the rapid increase in the price of oil was more due to demand side factors. (Sudam Hussein's invasion of Kuwait in 1990 didn't lead to a supply side shock as other OPEC member countries increased their oil supplies.)

Consequently escalating oil prices are seen as one of many factors contributing to recessionary conditions, rather than the root cause itself.

This suggests that rapid rises in oil prices makes the global economy more vulnerable to other shocks and that supply side disruptions have the biggest direct impact.

What does this mean for markets?

The threat of a potential oil supply shock has already resulted in the price of oil jumping above $US100 a barrel for the first time since mid 2008.

This spike in oil prices has once again reignited increased risk aversion in financial markets and swamped market fundamentals.

In the case of oil prices, the fundamentals of supply and demand haven't changed much, but the perceived level of risk has.

Consequently, market volatility has increased and equity markets have been weak. Commodity prices have increased sharply, especially gold, and US Treasury Yields have fallen further.

So far the Australian dollar, which is perceived as a currency geared to growth has held up well and remains above parity with the US dollar, but is now facing headwinds.

There is no doubt that if the current turmoil resulted in a long-term disruption to oil supplies, the impact would be negative for global economic growth prospects.

In the near term we can expect markets to remain jumpy. A key feature of the post-GFC world is that the global economy is still fragile and markets will react strongly in the short term to any new risks on the horizon.

This shouldn't cause investors to overreact.

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