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Higher oil prices could dent any rally in stock markets

David O'Shea, investment manager with Quintas, examines how oil could have knock-on effects on other sectors

OIL has risen more than 50% over the last six months. While volatility in the Middle East has been making headlines, more than 80% of this increase is down to the strength in the global recovery. This is borne out by the fact that nearly 50% is produced by a combination of Russia, Saudi Arabia, US, Iran, China, Canada, and Mexico. Libya produces 2% of global oil.

One of the other factors driving oil price, at least in the short term, has been increased speculative activity. Speculative positioning and trading volumes are at all-time highs. There has been a significant increase in buying of deep out-of-the money call options, which bet on more price surges. While this suggests the market is positioning for a move higher in oil prices it also warns of potential excessive moves lower should these positions be liquidated.

Higher oil will impact a variety of asset classes both directly and through its affect on global growth and the subsequent policy repose from governments and central bankers.

While oil-price increases generally have to be persistent to impact growth, there is no doubt that higher oil price against a backdrop of a fragile global economy and higher commodity price inflation will only result in a drag on global growth. The persistence of oil prices above $110 per barrel could shave up to 0.5%-1% off current estimates of global growth. Oil at a persistent $150 per barrel could impact global growth as much as 2%.

There are differences between the potential impact of higher oil prices on developed versus developing world, with the former likely to suffer more than the latter.

The global recovery has lead the surge in oil prices in recent months.

While monetary policy is broadly accommodative across the globe it is significantly more accommodative in the developing world. With accommodative monetary policy offering a cushion against rising oil price, emerging markets are more likely to absorb any future oil-price shock. Historically the impact of rising oil prices on the developed world has been about twice the impact on emerging markets.

Over the past 30 years there has been little pass-through from higher oil prices to core inflation (inflation excluding food and energy) but the current economic fragility points to a more complex relationship. The extent of food and energy price increases over the past year points to a potential breakdown of this historical relationship, with the inflation-growth dynamic complicating policy reaction for central bankers.

What this means is that there could be some reversal in the current trend towards tighter monetary policy. Specifically, there could be divergence in the approach of countries.

The US Federal Reserve is likely to keep monetary policy more accommodative, erring on the side of growth over inflation, whereas the ECB is likely to continue to focus on inflation over growth. Resulting interest rate differentials could see the euro outperform the US dollar. The dollar is also likely to suffer from the overdependence of the US relative to Europe on oil. When oil spiked to $140 per barrel in 2007 the euro gained more than 10% again the dollar.

Europe is potentially more at risk from the rising price of natural gas, which it heavily imports and relies on for energy production. Natural gas prices have lagged oil-price increases over the past six months but we could witness a catch up if oil remains at current levels.

While gold has a strong correlation to oil prices around times of geopolitical risk, industrial metals perhaps offer a more interesting trading opportunity. Aluminium production in particular has a strong relationship with oil prices as more than 30% of its production costs are energy-related. Persistent oil prices above $100 per barrel will put upward pressure on aluminium and other energy-intensive metals.

Equity markets are likely to suffer in the face of higher oil prices. One of the more interesting trends since 2008 has been the positive correlation of equity markets to oil prices.

Equity investors became more sanguine about oil prices as global equity rallied in line with rising oil prices. This persistence positive correlation has been striking. Historically, however, this relationship does not last. And in the past month this correlation has broken down and become negative for the first time in two years suggesting high oil prices will cause the recent stock market rally to falter.