The Abnormality of Oil

Jim O'Neill | 21 November 2017

Writing about oil prices is always risky. In a January 2015, I suggested that oil prices would not continue to fall, and even predicted that they would "finish the year higher than they were when it began". I was wrong then – but I might not be wrong for much longer.

I recently spoke at the massive Abu Dhabi Petroleum Exhibition and Conference (ADIPEC), which is a kind of Davos for oil-market participants. While there, I caught the tail end of a discussion among senior oil executives who all agreed that at this time next year, crude oil will still be around $60 per barrel, as it is today.

I was about to be interviewed by the CNBC reporter Steve Sedgwick, to whom I said, "That would be a first. Oil prices hardly moving in a year?" Needless to say, Sedgwick began the interview by telling the audience what I had said, and quizzed me on why I disagreed with the others.

Before I get to my explanation, let me state the usual caveats. Forecasting oil prices is inevitably a fraught endeavor; in fact, it makes forecasting currency markets look easy. When I completed a doctorate on oil markets in the late 1970s and early 1980s, I had already concluded that trying to guess oil prices is a waste of time and energy. Later, when I was at Goldman Sachs, I was often amused to see commodity analysts in my research group struggling to cope with the usual chaos of oil-price developments.

While interviewing me, Sedgwick raised an interesting point. Given that the volatility of many other asset prices has declined sharply in recent years, it might just be a matter of time before oil and other commodity prices do the same. To be sure, that could very well happen. In principle, he is right.

But I would argue that the decline in volatility in currency, bond, and equity markets largely reflects low inflation in many parts of the world, and the lack of significant monetary-policy adjustments by major central banks in recent years. I'm not sure that these factors apply to oil in the same way, especially at a time when energy markets are on the cusp of big changes in supply and demand.

On the demand side, market commentators are finally waking up to something that has been pretty clear for most of 2017 – the world economy has gained momentum, and is now probably growing at a rate of 4% or higher. With the exception of India and the United Kingdom, eight of the 10 largest economies are expanding at the same time. And, even as many countries try to wean themselves off oil, that transition will not happen overnight. Accordingly, oil markets are adjusting to stronger demand.

On the supply side, the world's most important marginal supplier of oil, Saudi Arabia, has suddenly drawn a lot of wary eyes. The Saudi government has been implementing radical changes, both domestically and in its foreign policy, and its reasons for doing so are not entirely clear. Not surprisingly, market participants suddenly want to add a premium to the price of oil.

In my two speeches at ADIPEC, I shared a slide with trend lines for the Brent crude oil spot price and the five-year forward price. I have long defaulted to watching the five-year forward price for lack of a more fundamentals-based approach to thinking about the equilibrium price of oil. As I explained in January 2015, the Brent crude oil spot price is less subject to speculative fluctuations, and is thus a purer approximation of underlying commercial supply and demand factors.

The chart I prepared – which was made before the latest oil-price acceleration in early November – shows the five-year forward oil price picking up after a period of some stability. With the spot price having now moved above the five-year forward price, one could conclude that a trend change is underway. For my part, I'm unsure, but I wouldn't be surprised if it happened.

Let us return to Sedgwick's question. While oil prices could be around $60 per barrel in November 2018, my guess is that they will have risen to around $80 per barrel in the meantime.

Sedgwick also asked me how oil companies might be able to make their investment and operational decision-making less beholden to cyclical factors. Is it possible for oil companies to temper their excitement during periods of rising prices, and not to fall into a malaise when prices are low for lengthy periods?

It's a tough question. My answer is that oil companies need to complete the commodity-analysis quest that I started but never finished. They must come up with a credible method for estimating the underlying equilibrium price of oil. Then, as soon as the oil price exceeds two standard deviations of that equilibrium, they should start to ignore the fashionable advice of colleagues, analysts, and industry insiders.

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