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Countdown to $100 Oil - Deja Vu?

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The general and simplified theory to be tested in this series of posts is that OECD economies cannot grow with average annual oil price over $100 / barrel. As of 16 August 2011, the annual average for Brent stood at $100.04 per barrel! Are there any signs that the global economy is buckling under this strain?

Disclaimer: the author does not **currently** hold any energy related investments that may be affected by the content of this post. Any forward-looking observations and comments should not be viewed as forecasts. I will return to this subject with updated charts as the story unfolds.

Data for Brent from the EIA, 1 year moving average roughly equals 5 trading days per week divided by 7 days per week = 261 days. FTSE 100 data from Yahoo.

The FTSE 100 stock index provides valuation for the UK's 100 largest companies. Whilst now top heavy in commodities stocks, it still provides a broad market measure similar to the US S&P 500 index. Back in 2007 – 09, the top of the London FTSE 100 index was 6731 on 12th October 2007 (1). The top of the oil price spike was $143.95 on 3rd July 2008, 8 months after the market top(2). Both oil price and markets had declined substantially by the time the Lehman induced crash came in October 2008.

The stage appears to be set for a rerun of these events. The recent high in the FTSE 100 was 6091 on 8th February 2011 (3). The top of the recent oil price spike was $126.64 on 2nd May 2011,3 months after the market top (4). And the European banking sector seems to be in desperate trouble. For example, Royal Bank of Scotland (RBS) formerly one of the UK's largest banks, now owned 83% by the UK government, has seen its share price fall from 50p earlier this year to 20p. Reduced to penny status, this and other European banking stocks appear to be heading towards zero. Shares in Uni Credit, Italy's largest bank were suspended from stock market trading on 23rd August.

The links between the health of the banking sector and high oil price is complex but can be reduced to a very simple argument constructed around economic growth. Over indebted sovereign governments require strong economic growth (3 to 5% per annum) to generate the tax revenues required for them to service their debts and to remain solvent. High oil and energy prices, caused by economic growth, have contributed to snuffing out the fragile recovery from the 2008/09 recession and growth has stalled across the major OECD economies. European High Street banks that own large amounts of European sovereign debt are therefore at risk of insolvency themselves should any government default.

Gavyn Davies, writing in the Financial Times last week, had this to say on: What went wrong with the global recovery?

> The oil price increases, if permanent, would reduce consumer purchasing power in the developed economies by around 1 per cent this year. But the impact on GDP growth, through a complicated mix of supply and demand side effects, may be greater than this. One model, estimated by James Hamilton at the University of California in San Diego (who is probably the leading academic economist in this field), suggests that the oil shock may have reduced US real GDP growth by 1.1 per cent in the first half of 2011.

It is easier to identify these links than it is to prescribe a cure. The stage seems set for a major price reset of markets, energy prices, currencies and property that brings with it the prospect of a major socio-economic upheaval. John Kinhart's comic strip from October 2009 remains a fine summary of the peak oil predicament.