

Strategy Matters

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How high can oil (and petrol) prices go?

The price of Brent crude oil is up 13% since the beginning of the year and recently hit a record \$79.64 per barrel before easing again. The price of petrol has had a similar run. The velocity of the recent run-up was mostly due to large speculative inflows and was quick to unwind in the most recent market rout; however, the fundamental backdrop for both crude oil and petrol prices remains supportive.

Structural backdrop favours a firm oil price.

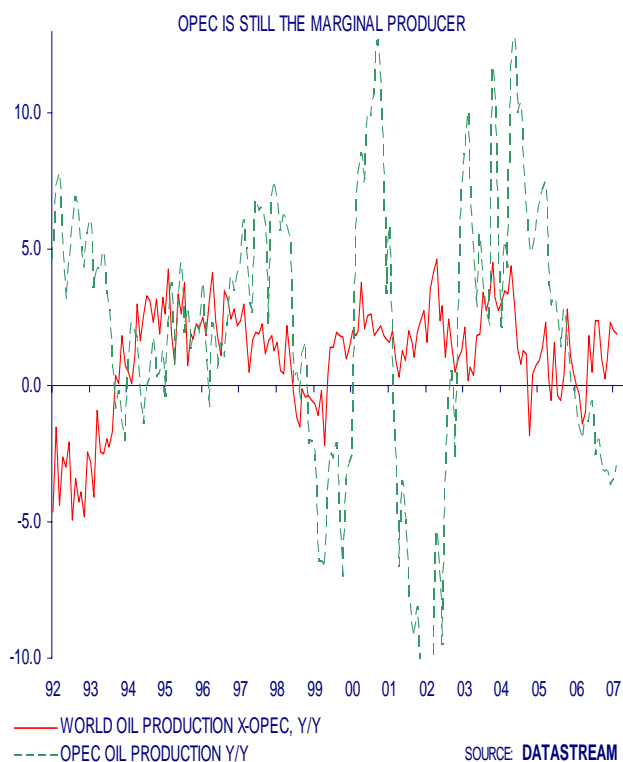
In 1956 M. King Hubbert postulated that global oil discoveries would peak in and around 1970 and decline progressively. The ‘Hubbert’s peak’ theory, or ‘peak theory’ as it is widely known, has in large part been proved correct as global oil (and condensate) discoveries peaked at about 50 billion barrels/year in 1970 and fell to a current rate of 10 billion barrels per year. The current rate of discovery stands at about one third the current rate of consumption, an imbalance which is not sustainable in the long run. Thus far, a higher price for oil has acted as a release valve to the imbalance and looks set to continue to do so in the medium term.

Demographic trends argue that oil consumption is poised to continue rising on the back of higher demand from emerging economies. China, which currently accounts for 8.5% of global demand, has already become the most important marginal consumer of world energy, and this trend looks set to accelerate. One particular study on the correlation between automobile ownership and the number of individuals with incomes greater than \$10,000 per year, a demographic which is growing rapidly in China, supports this view. Adding further to the impetus for car purchases is a reported over-supply and ensuing price wars

which have further raised affordability. China is not alone. Automobile producers have targeted other emerging economies for growth with one major car company marketing a \$3000 car in India. The automobile demand effect on oil, along with demand generated by the countries’ industrialization, will gain momentum as their income per capita continues to rise.

Cyclical supply dynamics are tight...

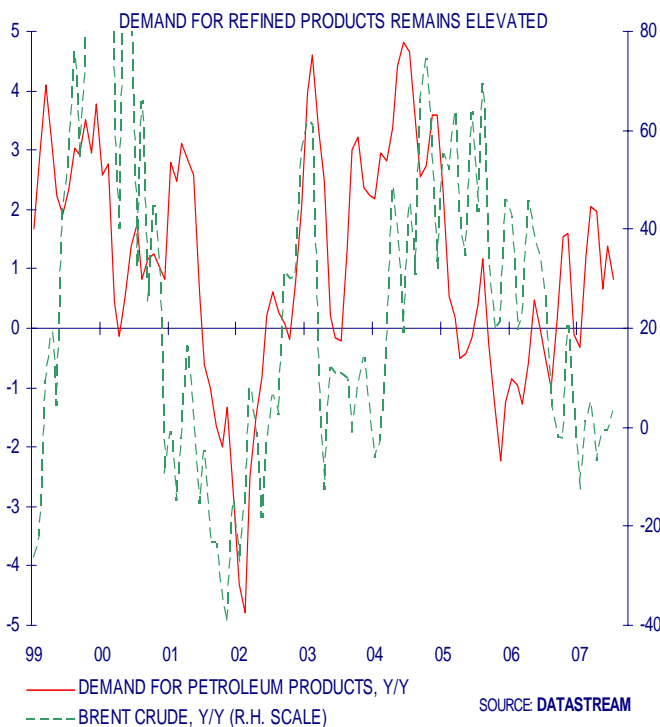
Whilst global oil production excluding the OPEC cartel of countries has grown close to its historic average in recent months, the cartel’s production has been falling in year-on-year terms. The net effect has been a tightening of global supply as OPEC still accounts for around 40% of global production.



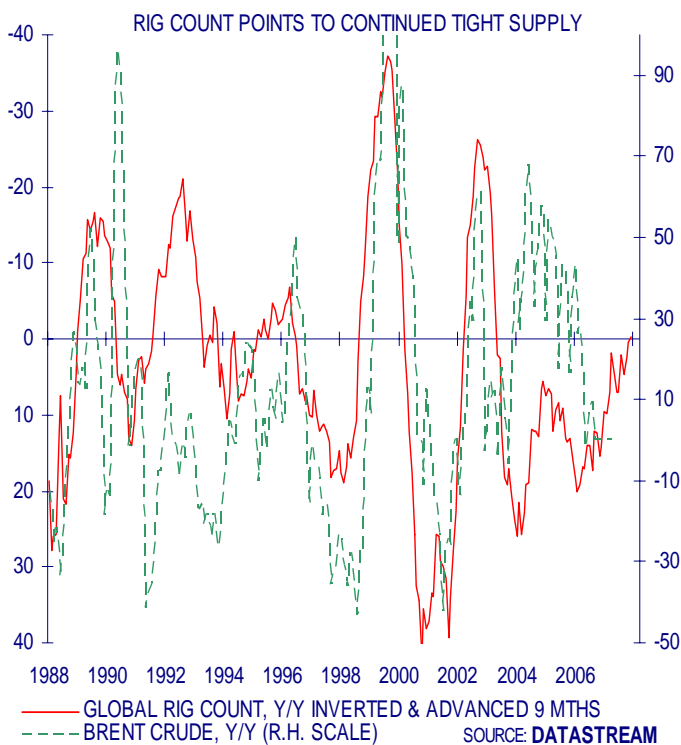
In early August, OPEC Secretary-General Abullah al-Badri instigated what appears to be a concerted effort by the cartel to dampen oil prices if they break out to new highs. The reasoning behind this is said to be that spikes in the price of oil spur economic and political incentives to develop alternative sources of energy which is negative for the cartel in the long term. Notwithstanding this recent development, data as of May shows that OPEC production continues to fall at around 3.0% year-on-year. At the same time Saudi Arabia, the Cartel's swing producer, appears to be building a reserve cushion as evidenced by a surge in its rig count in 2006 combined with a contemporaneous fall in its production. Taken in the context of OPEC's conservative estimate for global oil demand growth for 2008, which stands at some 850,000 barrels per day less than the International Energy Agency's, it is difficult to envision an increase in OPEC production which would drive the price of crude significantly lower.

OPEC. As well, continuing maintenance in North America means that the amount of rigs coming online globally will remain depressed. In fact, year-on-year global rig count growth was -0.34% in July, the first time the number of rigs in operation globally fell since November of 2002. A falling rig count has traditionally been bullish for the price of oil.

...while demand remains robust

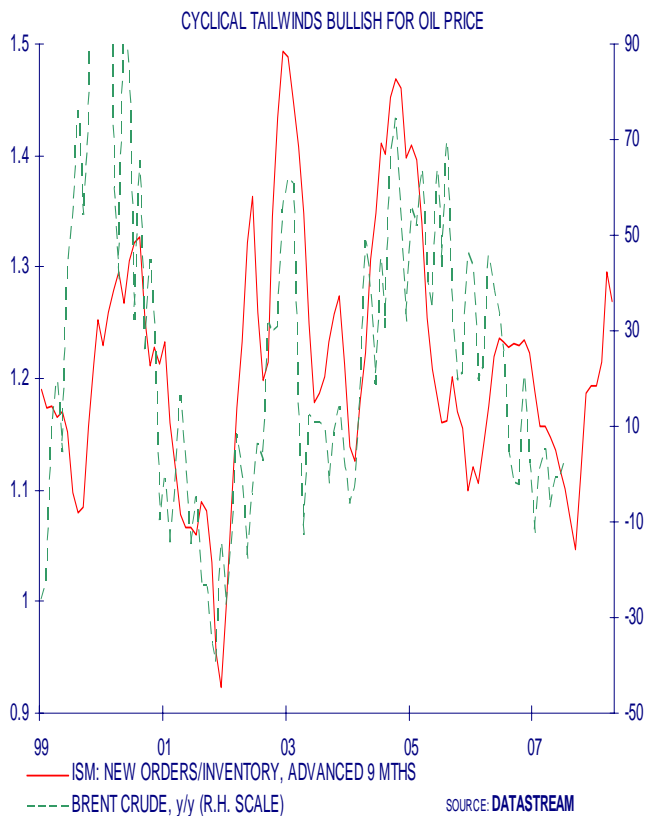


Whilst global oil supply continues to tighten, the cyclical demand backdrop is also constructive for prices. Growth in demand for petroleum products has risen from negative territory in 2006 to around 1% currently despite the fact that the end of the U.S. (Western) driving season has driven consumption growth for petrol to near 0% y/y. Notwithstanding recent financial market turmoil and questions as to the sustainability of the fleeting recovery in the U.S. manufacturing sector, forward indicators remain elevated and continue to signal an expansion in both the manufacturing and service sectors. A sustained expansion would further bolster demand for refined products such as petrochemicals used directly in the manufacturing process, and fuel for transportation purposes. These dynamics are all playing out against the backdrop of an already robust global economy (the IMF recently



While the willingness of OPEC to significantly increase oil output remains questionable, projections for non-OPEC supply have been pared down for 2008. Non-OPEC oil production growth has averaged around 1% over the last 15 years and each individual country's ability to affect global supply is limited in relation to that of

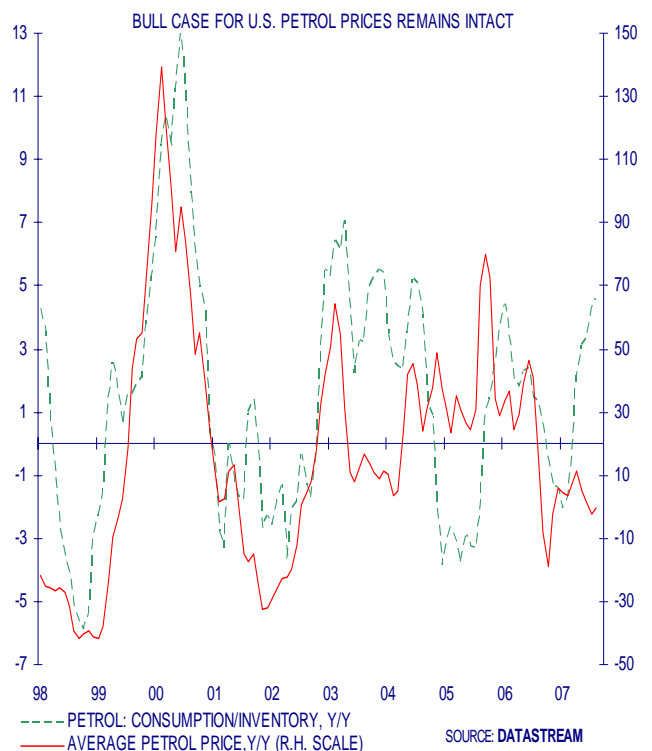
raised its 2007 and 2008 global growth forecasts from 4.9% to 5.2% for both years). The recent easing in global monetary conditions should provide a further tailwind for global growth as long as equities manage to avoid sustained losses.



Petrol supply is tight but demand is easing

The run-up in the oil price into late July coincided with a rise in the price for petrol. This relationship has held for many decades, however, fundamentals argue that, notwithstanding the short-term direction of oil, petrol prices should remain supported. Petrol is in the midst of its own supply-demand imbalance. Refinery capacity growth has fallen below demand growth for refined products which has caused a rundown of refined product inventories. Much like with the supply/demand imbalance for oil, the petrol price has acted as the release valve having risen as much as 43.8% this year. Currently, the price of petrol is 16.4% higher than at the beginning of the year. This scenario should continue to underpin the price of petrol in the long run. In the medium run, the petrol price will likely be dictated by the opposing forces of a cyclical decline in demand due to the end of the driving season and the threat of hurricanes to both oil rigs and

refineries, with the later already struggling to lift capacity and increase throughput.



Implications for the broader economy?

When it comes to interpreting the impact of higher oil/petrol prices on the broader economy, market participants tend to focus on two effects: the impact a higher oil/petrol price has on inflation, both headline and second round effects on core, and the impact a higher oil/petrol price has on personal consumption, especially in the petrol-intensive U.S.. In recent years, higher global productivity and rising import penetration from emerging economies has led to a sustained period of disinflation which allowed, and in most cases forced, firms to absorb higher costs related to oil in order to keep their pricing competitive. As a result, second round inflationary pressures from higher oil prices have not been prevalent. The effect of higher prices on personal consumption has been more observable and the two have correlated negatively. The most recent rise in consumer expenditure on energy signals that they may be set to pull back on their core consumption going forward.



Conclusion

Fundamentals remain supportive for the price of oil and petrol. Given the current supply-demand balance, a sustained fall below \$60 per barrel in Brent crude seems unlikely. Whilst the medium-term fundamentals argue for a strong petrol price, the cyclical demand drop off into autumn should see prices ease. The threat of hurricanes should also contribute upward pressure on energy prices, but the strength of its influence is highly unpredictable. So far, oil and petrol prices have had a limited effect on inflation and output growth in aggregate, but while consumers' expenditure on energy as a percentage of their disposable income remains elevated, non-energy spending will be under pressure.

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