

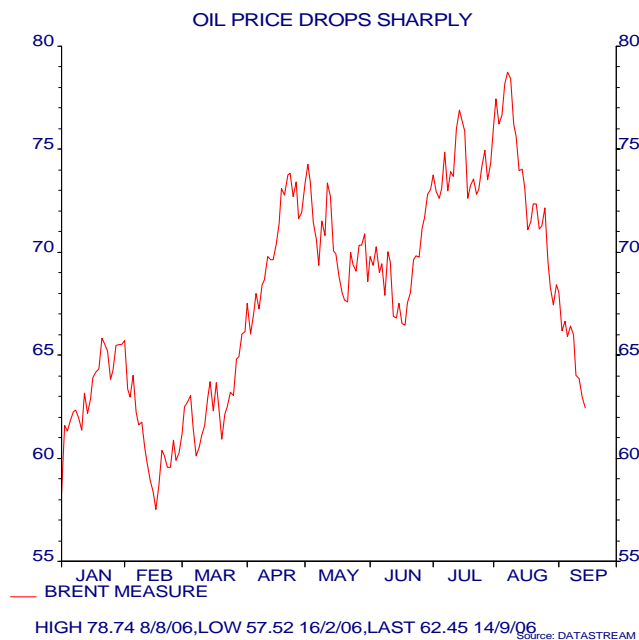
Strategy Matters: How do lower oil prices change the outlook?

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Oil prices have fallen around 20% from their peak in little over a month. Is this fall sustainable? And, if so, what does it mean for the economic outlook?

Recent developments in the oil price

Oil prices have fallen by around 20% since their peak in early August (the precise size of the fall depends on the measure chosen). The Brent measure peaked at almost \$79 a barrel on August 8th, and is now trading below \$63, a fall of almost exactly 20%.



OPEC agreed at its meeting last week to hold production quotas at their current level (though they did keep open the possibility of cutbacks later in the year, if there was further price weakness). To the extent that the fall in prices has been caused by an excess of supply over demand, this raises the possibility of some further weakness in coming months.

In fact, it is likely that the price fall reflects a range of factors. The easing of tensions in the Middle East due to the end of the conflict between Israel and Hezbollah and a noticeable lowering of the rhetoric in the dispute of Iran's nuclear ambitions will have reduced the risk premium in the market. So far, the hurricane season in the Gulf of Mexico has not hit oil production, and, after last year's problems following Hurricane Katrina, the market may have been priced for a worse outcome. And prices tend to fall at this time of year anyway. The peak in demand caused by the so-called "driving season" in the United States

has passed, while the step-up in demand associated with winter in the Northern Hemisphere has yet to occur.

More fundamentally, there are some signs of a slowing in the pace of global industrial growth, including evidence that the Chinese authorities may be succeeding in reining in their runaway economy. This may have led to slackening in the growth of demand for oil. With supply from non-OPEC producers growing moderately and OPEC still pumping out plentiful supply, inventories have built up. According to some reports they are 25% above normal levels in the United States.

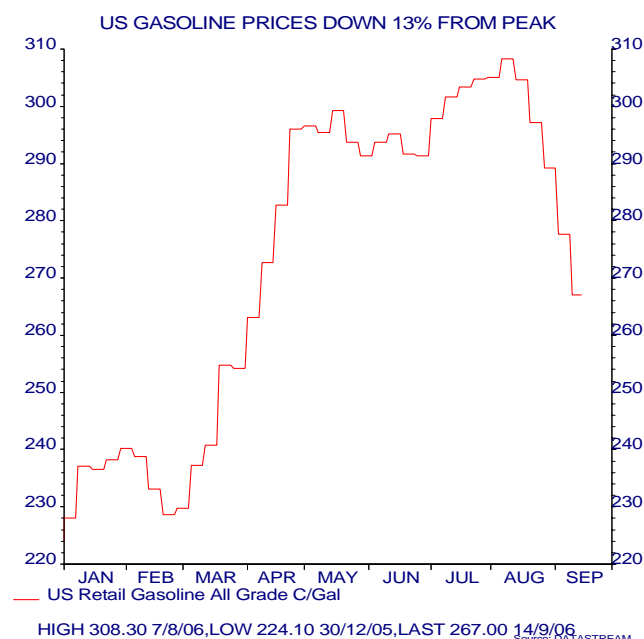
Economic impact of lower oil prices

The two most important effects of lower oil prices, if they are sustained, will be to boost spending power in non-oil producing countries and help lower inflation expectations.

A rise in oil prices causes a transfer of spending power from oil-importing countries to oil-exporting countries. If the rise is small, the impact on the global economy may be limited, as oil-exporters are no less likely to spend marginal shifts in their income than oil-importers. But when prices rise by a significant amount in a short space of time, the oil-exporters are unlikely to spend all their extra income immediately. The net result, therefore, is a reduction in global demand.

That is almost certainly what has happened in recent years (though other factors, principally easy monetary policies, have ensured that global growth remained strong anyway). This means that the recent fall in oil prices is now transferring spending power to oil-importers who are more likely to spend it. The net effect is, therefore, presumably positive for the global economy.

It is easy to understand this effect by looking at the impact of lower oil prices on US consumers. One direct effect is to lower the price of gasoline, which is already down 13% from its peak, and could fall another 5 to 10% in the next few weeks.

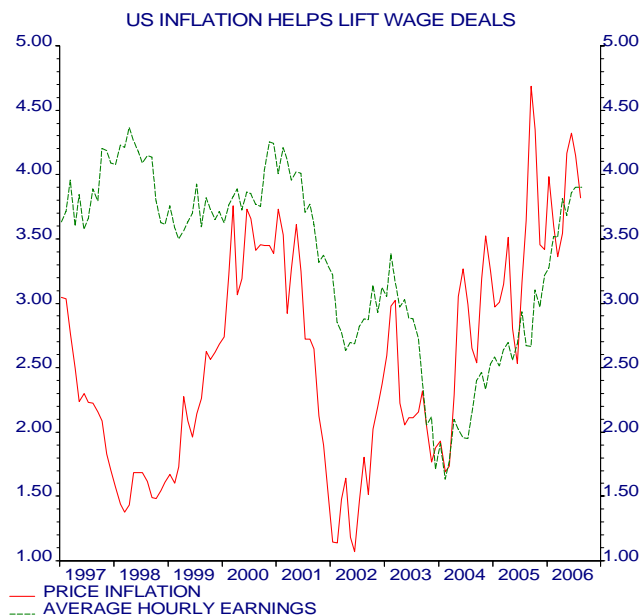


US households spend about 4% of their disposable incomes on gasoline. If the price falls by 20%, this would drop to 3.2%, freeing up 0.8% to be spent on other goods and services. In this respect, the drop in oil prices acts just like a tax cut, boosting spending power and, thus, supporting economic growth.

If this was the only effect the Federal Reserve in the US (and other central banks that believe their economies are already growing at too rapid a rate) could be expected to respond by raising interest rates. But it is not that simple.

Lower oil prices will also reduce inflation, which central banks care about too. More importantly, lower oil prices will help to lower inflation expectations. One of the main worries in recent years has been that wage bargainers would respond to the rise in headline inflation rates caused by higher energy prices by agreeing higher wage deals. This could lead to a rise in core inflation rates, thus permanently lifting inflation to undesirable levels. It would then be necessary for central banks to slow growth sufficiently to squeeze this inflation out of the system.

In most developed countries, there have been few signs that such an effect was at work, but in the United States, where the impact of higher oil prices on inflation was relatively large, wage growth has definitely increased over the last couple of years.



Lower gasoline prices, and lower prices of gas and electricity, could see headline inflation in the US fall back to 2½%, possibly even to 2%, over the next year or so. Wage inflation might be expected to follow it lower, so relieving worries of a permanent rise in inflation.

So, in the US, where there are worries that the collapsing housing market could cause growth to be very weak in 2007, the Federal Reserve might see lower oil prices as a welcome development, reducing the risk that it has to raise interest rates again to counter inflation pressures at a time of economic weakness.

Elsewhere, though, central banks are still hiking interest rates in the belief that their economies are already growing rapidly, and at a pace that threatens to lift inflation, irrespective of the level of oil prices. They probably would not welcome lower oil prices if they boost economic growth. If anything, lower oil prices make it a little more likely that the European Central Bank and the Bank of England raise rates in coming months.

Conclusion

The fall in oil prices seen in recent weeks is likely to be the result of a combination of factors, including rising inventories and a reduced risk premium.

Lower oil prices act like a tax cut in oil-importing countries and will boost spending and growth. But they will also lower headline inflation rates, which should help contain inflation expectations.

How central banks react may differ from country to country. If oil prices stay down, the Federal Reserve, which is worried about cost-push inflation, may be a little less likely to hike US interest rates again. But central banks in the UK and the euro-area, which are worried about demand-pull inflation, may see lower prices as a reason to push interest rates higher.

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