Crude oil has proven to be one of the worst possible investments of 2014. In **June prices stood at $115** per barrel after a five-year period of relative stability, with many oil producing countries factoring these prices into their budgets for 2015. However since June the oil price has been in freefall, **descending over 45% to just below $60 per barrel** at the time of writing. This month we examine the major factors behind the fall and consider the implications for exporters, importers and markets if prices fall further.

History tells us that **we could be a long way from the bottom**. In December **1998 oil prices plunged to around $16 per barrel** (the lowest level for decades) at the height of the Asian crisis as global investment in oil and gas production fell by 20%. Also in **February 2009**, when the financial crisis was in full swing, prices tumbled to around **$43 per barrel**. Clearly there is room for prices to push further south if demand weakens and if supply stays plentiful.

When it comes to supply, **OPEC's** (Organisation of the Petroleum Exporting Countries) **twelve members** (including Iran, Iraq, Saudi Arabia, Kuwait and Qatar and the UAE) **control about 30% of global crude oil production**. Perhaps one of the most noticeable shifts in position within OPEC recently was the news that **Saudi Arabia and their Gulf allies decided not to sacrifice their own market share** to restore the price of oil. They have done so in the past, notably in the 1980s, when they cut output by almost 75% to sustain prices. Other countries cashed-in but the Saudis suffered large losses of revenue as a result. **They see little reason to make such a sacrifice again**. When they failed to reach an agreement on production curbs on 27th November this sent oil prices tumbling further and there is no sign that they are in any rush to limit supply, as highlighted by Saudi oil minister Ali al-Naimi's quote **"Why should I cut production?…this is a market and I'm selling in a market. Why should I cut?"**

So what are the catalysts for this dramatic price move? Firstly, the **US shale boom has revolutionised the energy market in the US**. The world's largest economy has **opened 20,000 new oil wells since 2010, more than ten times that of Saudi Arabia over the same period**. This has been driven by a combination of horizontal drilling and hydraulic fracturing, which has unlocked huge supplies from onshore shale formations. For **example Eagle Ford well in Texas produced 77,000 barrels in 2010 but has produced over 1,600,000 barrels so far this year**. Bakken Oil Production in **North Dakota is a similar story - 320,000 barrels in 2010 compared with over 1,200,000 in 2014**.

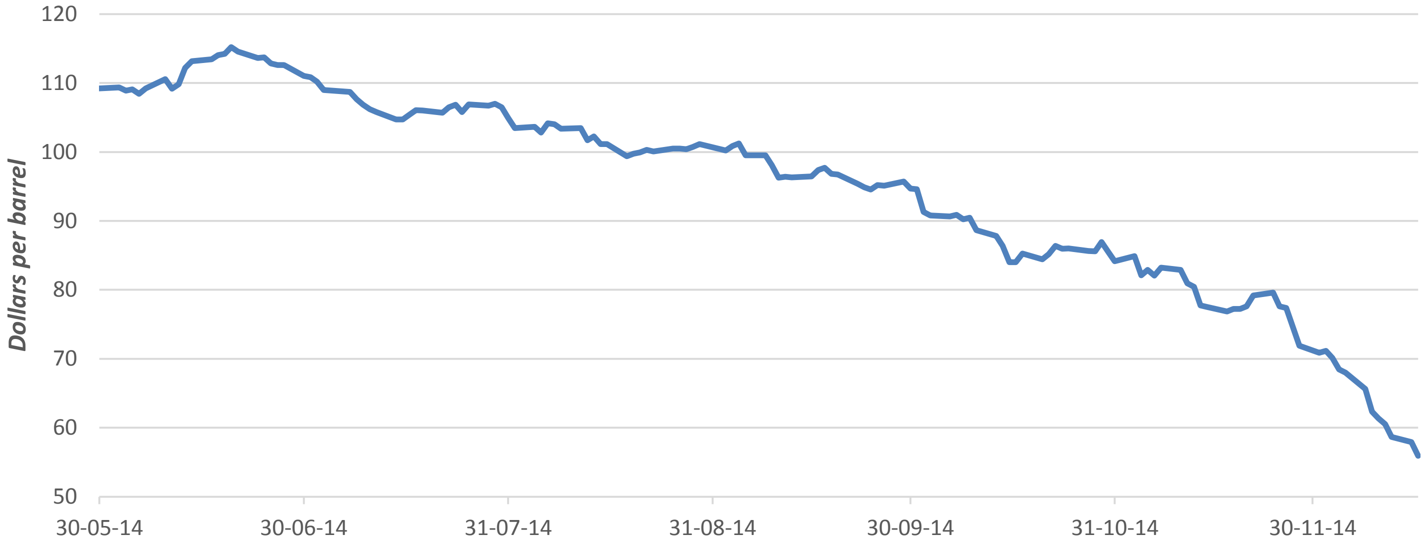
US production now comfortably surpasses Saudi Arabia's (14m vs 12m barrels per day**), putting it on course to be the largest oil exporter in the world**. The bad news for Middle Eastern oil producers is that the US shows no signs of slowing production. **With the US producing more and more oil and countries in the Middle East increasing supply this has created a large surplus**.

Furthermore **geopolitical events must also be taken into account**. Global markets anticipated the **turmoil in Iraq and Libya** throughout the year and expected that this would lead to a cut in production, leading to a potential deficit in the market. However the two economies have **together produced a steady 4m barrels per day (their normal functioning rate) and this has added further to the surplus**.

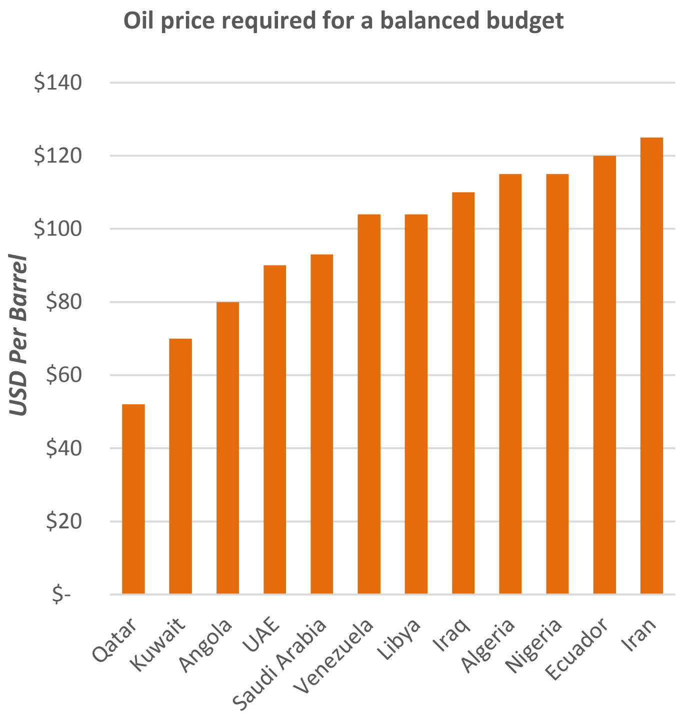
Meanwhile slower economic growth has affected demand, with **stalling economies such as Japan and Europe purchasing less than producers anticipated at the start of 2014**.

So there are many reasons why oil prices have tumbled over the last 12 months but what are the implications? At the very highest level, **oil price declines shift resources from producers to consumers of oil as capital is sucked out of oil producers**. To combat this **Saudi Arabia has shifted focus to selling their supplies to China**, the world's second largest oil consumer in an attempt to ride out short-term losses. **Iran is experiencing extreme budgetary pressure** leading into 2015 and needs oil to be at $140 a barrel to balance a budget padded with the extravagant spending schemes of former president Mahmoud Ahmedinejad. Sanctions designed to curb its nuclear programme give it further vulnerability. Other countries, such as Nigeria, whose oil exports support 75% of government revenue and 95% of all exports, will also be starting to feel the squeeze**. It may take a smaller player to default, among other influences, for oil surpluses to subside.**

Oil prices have plummeted since June 2014



The chart below shows the break-even rates for governments in oil-producing countries for 2014.



As you can see there is a huge difference between countries who budgeted over $120 per barrel (Iran, Ecuador) and those who have budgeted below $70 per barrel (Oman, Kuwait)**. The price has declined a further $15 per barrel since these figures were published, well into the surplus territory and causing serious concern to most OPEC members**.

The **impact will also be felt in Russia**, currently under sanction from western nations and this has affected their market share of oil sales. The **rouble has weakened 51% vs the dollar this year** (roughly in-line with oil prices) and therefore net income from exports hasn't been that badly affected in local currency terms. However **investors from Europe are trying to distance themselves from Mr Putin's regime** to cut dependence on the nation, adding further trouble to Russia's woes. **Cynics might argue that oil prices have been manipulated in an attempt to squeeze Russia** and whilst this view is uncorroborated, lower prices are certainly starting to damage growth prospects in 2015. The **Russian economy has plentiful reserves (in the region of $450bn) which will last them around 18 months at current prices**, however every passing month will add further angst.

The **impact on net consumers, for the most part, is positive**. China, one of the largest oil consumers by nation, imported over 25 million tons of crude oil in November, up 9% from a month earlier. **Every $1 drop in the oil price per barrel saves the Chinese economy approximately $2.1bn annually. Since this saving is likely to be spent (rather than saved) this should lead to a boost in GDP**.

Net importers of oil have experienced falling inflation as the cost of importing oil has dropped (oil accounts for 9% of the impact of global inflation). This is good news because **"cost-push" inflation is the enemy of growing economies and reducing it takes pressure off central banks to increase interest rates, which in turn encourages investment within the economy and a boost to lending.**

The **main market sectors to benefit from falling prices include machinery intensive agriculture with countries such as India being prime beneficiaries** (oil accounts for a third of imports into the economy). In addition airlines have also performed well as their fuel bills plummet. **US airline stocks have increased on average by 70% in 2014.**

This should be of **benefit to consumers who could see travel and food prices falling, if indeed producers cut prices**. If they don't then at least these lower input costs will be of benefit to companies, which will see margins increase.

So in general, for most of the world economy, low oil prices are good news and the **International Monetary Fund (IMF) estimates that each $10 a barrel fall in oil prices increases world growth by 0.2%.** The oil price drop could very well boost equity markets going into 2015, for reasons highlighted above, and we remain positive on developed market equities for the medium to long-term.

On the back of this significant move, how does this affect our views and how are we positioned for next year? At the time of writing the **markets have weakened significantly because investors fear that weak demand for oil is a bigger factor than excess supply and that this weak demand stems from slow global growth prospects.** However there are **significant long-term economic benefits that come with dramatically cheaper oil** and consider also that the sell-off has taken place in thin markets in the run up to Christmas therefore major market moves are likely to be exacerbated. **We believe that markets have overreacted (again) and that there is now, once investors pause for breath, another buying opportunity for long-term holders of equities.**

We wrote in our last couple of issues how **we remain positive about the developed markets, notably the US**, and this view has not changed. The US looks to be in a strong position and the **future potential for oil production and energy self-sufficiency should be a major catalyst for future growth.** Not only is it positioned well from a domestic standpoint, but there is a huge amount of foreign investment flowing from energy giants looking to exploit the shale revolution. **We've had great employment data coming from the States** and our view about the market there hasn't changed. What has become more interesting in the very short term is the underperformance of the FTSE 100 (-6.54%) vs S&P (-4.14%). Admittedly the FTSE has c.14% oil majors as compared to the S&P which has only c.8% but this means that when we do see a stabilisation in oil prices that the FTSE should bounce back further and we still favour both markets.