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CLIENT BULLETIN

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- ***Oil and the Economy***

Recent tensions in the Middle East have caused crude oil prices to move as much as 30% higher in recent weeks, from roughly $80 at the beginning of the year to over $100 currently. With the topic of oil hitting the headlines with such intensity, it is a good idea to be well grounded in the realities of oil prices and the effect they may have on you. The following discussion will examine drivers of oil prices and next month we'll take a look at the price of oil's inflationary role and its' effect on the U.S. economy.

- ***Supply and Demand***

Like any commodity, the forces of supply and demand play a central role in price movements of oil over time. As exemplified by the 1973-1974 OPEC oil embargo (and to a lesser extent the aftermath of Hurricane Katrina), any disruption in the supply-demand dynamic, however temporary, can send prices sharply higher. Even ***anticipation*** of a future supply disruption can cause futures prices to climb, having serious implications for the global economy. Conversely, a decline in demand for oil during the global recession in 2008 and 2009 resulted in an abundance of additional supply and a collapse in oil prices from $146 in July 2008 to $30 in December of that year.

- ***Oil Price Protection***

In order to insulate themselves from swings in the price of oil, many countries and organizations have built large strategic reserves as protection. The Organization of Petroleum Exporting Countries (OPEC) is currently holding spare capacity of crude oil far above its' average level and China, which has one of the largest oil reserves in the world, has also continued to build its strategic stock of oil. Back at home, the U.S. Strategic Oil Reserve, according the U.S. Department of Energy, is the world's largest emergency oil supply, and is filled to capacity at 727 million barrels. While the President can make a decision to draw on this supply if deemed necessary, this has only happened twice, once during Operation Desert Storm (1991) and once during Hurricane Katrina (2005).

- ***Oil Reserves – So What?***

Given the magnitude of oil reserves, investors should not underestimate the ability of certain authorities to drive the price of oil down by increasing production or releasing additional supply into the marketplace if they deem it appropriate. When considering the supply and demand dynamics of the global marketplace for crude oil, the Middle East is the elephant in the room. Five of the top 10 oil exporting nations are located in the Middle East.

- ***Saudi Arabia***

Saudi Arabia, in particular, is in a tricky situation. While they have not yet been faced with civilian protests, recent turmoil in surrounding nations has pushed the price of oil higher. While on the surface this seems like a “positive” for the #1 oil exporting nation, high oil prices may eventually begin to threaten their market share if consumers decide to pursue alternative sources of energy. Given that the Saudi Arabian economy primarily relies on oil as a driver of growth, a move away from oil consumption could threaten the economic stability of the country. As anecdotal evidence of this, Deutsche Bank noted that by next year, more than 130 different hybrid and electric vehicles will be on the market, up from just 12 in 2008. Developments like this should be cause for concern for large oil producing nations, as higher oil prices can lead to demand destruction, and act as a catalyst for innovation in alternative energy solutions. In short, it may be counter to Saudi Arabia’s interests to see oil prices rise too high or stay there for too long, and we shouldn’t underestimate the propensity or ability of the Saudis or OPEC to push prices down.

- ***Middle East Unrest***

At the root of oil’s surge has been unrest in the Middle East-North Africa region, as buyers have bid up oil contracts on fears over even greater supply disruptions resulting from spreading protests. Understanding the basic geopolitical dynamics at play in the region is important. Stated simply, the failure of “oil richness” to trickle down to the citizenry in the form of jobs, wealth and opportunity has led to massive income inequality and a groundswell of anger towards the respective governments in the affected countries. The breaking point came in mid-December, when a Tunisian street vendor set himself ablaze in protest of the confiscation of his merchandise, enraging the public and inciting protests in Tunisia that have since spread to Egypt, Bahrain, Libya, Algeria, Jordan, Sudan, Yemen and Oman.

- ***Who’s Next?***

While thus far the result has been only a modest oil shock from a supply/demand perspective, the key message here should be simple: if the type of unrest we’ve seen in the smaller oil producing nations were to spill over into some of the larger oil producing nations (Saudi Arabia or Iran are of particular concern), the impact on oil markets could put a serious dent in the global economic recovery.