

Why \$100 oil isn't economy-killer

Just how much should investors worry about high oil prices? Amid the ongoing Middle East conflict, it is not surprising that investors are focused on energy prices, given these remain the main channel to global financial markets. Many have been surprised, though, by the uneven impact across different markets. For example, many Asian equities have faced significant volatility, but the pullback in US equities has so far been relatively muted.

While we should not be complacent about downside risks, it is equally important to recognise that many asset classes now offer attractive opportunities and are likely to continue to do so if worst-case scenarios fail to play out.

The 1970s oil crises involved two major supply shocks – the 1973 Arab oil embargo and the 1979 Iranian Revolution – which nearly quadrupled oil prices, triggered global stagflation (a debilitating combination of sustained high inflation and stagnant economic growth) and created severe fuel shortages.

Given this historical precedent, one would have thought that the recent Brent crude oil price rise of about 75 percent since mid-February would have resulted in markets focusing entirely on an upcoming inflation shock, recession risk and a stagflationary world ahead. However, over the same period, US equities have fallen by less than five percent and the 10-year US government bond yield is below 4.5 percent – not exactly the growth or inflation shock one would have expected, given the staggering 75 percent rise in oil prices.

The clue sits in 'energy intensity' – the amount of oil or gas needed per unit of GDP growth. Since the 1970s, energy intensity has

Data suggests modern markets are far more resilient to oil price shocks than they used to be.



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Oil



fallen dramatically.

The World Bank, for instance, estimates that the amount of oil required to generate one unit of global GDP growth fell from 0.12 tonnes of oil equivalent (toe) in 1970 to 0.05 toe in 2022 – about a 58 percent reduction. Researchers at the Harvard Kennedy School found that the amount of oil required to generate \$1,000 (Shs3.6m) of global GDP fell by an average of 1.5 litres each year from 1984 onwards. S&P Global estimates that oil prices would have to rise to the \$150 (Shs553,596)-200 (Shs738,128) range to have a macroeconomic impact similar to historical energy shocks over the past 60 years.

The bottom line? Oil prices hovering around \$100/bbl are high, but not as high as they were for the global economy during historical energy price shocks.

The purpose of this perspective is not to foster complacency. Rather, it is to remind us that both risks and opportunities lie in front of us.

We certainly believe it is worthwhile to hedge against risks. Today's \$100/bbl oil prices

are expected to result in at least a moderate rise in inflation. However, a significant energy shock would involve either a rise towards levels that had an impact previously, such as \$150-200/bbl, or would result from prices staying above \$100/bbl for a prolonged period, pushing the average price higher for the year.

Our preferred hedges include inflation-protected bonds, which directly hedge yields against the US inflation index, and oil-correlated equities, such as energy sector stocks. Gold would also be an attractive hedge against a more stagflationary environment.

Downside risks notwithstanding, our baseline view continues to be that the current energy supply disruption is likely to be relatively short-lived. In this scenario, it would make sense first and foremost to stay invested in well-diversified portfolios, which in themselves offer an attractive entry point for long-term investors. More specifically, we would look for opportunities in asset classes that may post the strongest rebound if the high energy price threat recedes.

Top of our shopping list would be Asian equities, which have fallen significantly over the past month alongside higher oil prices and a stronger US dollar. This makes sense, given their relatively higher growth and balance-of-payment sensitivity to both oil prices and the USD.

Ultimately, the goal isn't just to survive the oil price spike, but to thrive beyond it. The current oil shock may very well prove to be a pivotal bargain-hunting opportunity this year.

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