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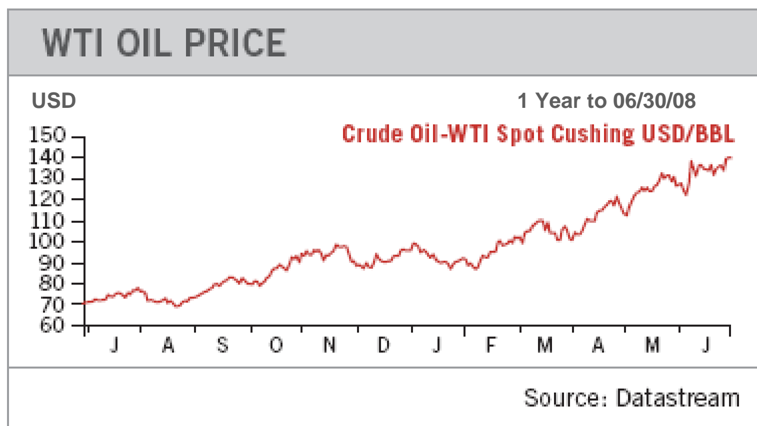
Pictet Asset Management

Oil—an Old-Fashioned Bubble or Secular Trend?

Since the beginning of the year, the oil price has risen by some 45% from around U.S. $96 to over U.S. $140/barrel by the end of June. In a phenomenon often seen in the late stages of a bubble, analysts now seem intent on trying to outbid each other with ever-higher forecasts for the eventual peak. Rising prices in other commodities, notably food, have lifted inflationary risks, causing central banks to focus on price pressures and limiting their freedom to ease the credit crisis through rate cuts. The continuing escalation in energy prices, even as economic growth slows in developed economies, has provoked an acrimonious debate as to whether the oil price is driven more by financial speculation than by fundamental forces of supply and demand. Either way, at some point before long, we expect a violent reversal in price, which would be likely to trigger a sharp rally in equity markets from currently depressed levels.

The Oil Price Rise Looks Firmly Based on Fundamentals…

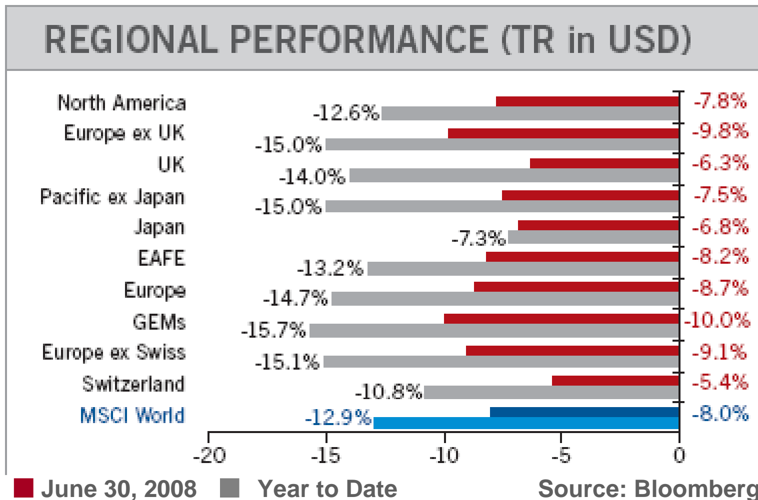
The argument that oil prices reflect a fundamental imbalance between supply and demand generally rests on the observation that the world has enjoyed a synchronized and extended expansion cycle, accompanied by surging demand from China and other emerging markets. Here, government subsidies in domestic fuel markets have distorted the normal effect of energy prices on supply and demand. The disruption in supply from non-OPEC countries such as Mexico and Nigeria has also been significant, as has the slow recovery in output from Iraq. Nevertheless, while the fundamentals have been broadly supportive, supply and demand for the underlying commodity alone would not appear to justify the very sharp run-up in the oil price over 2008.

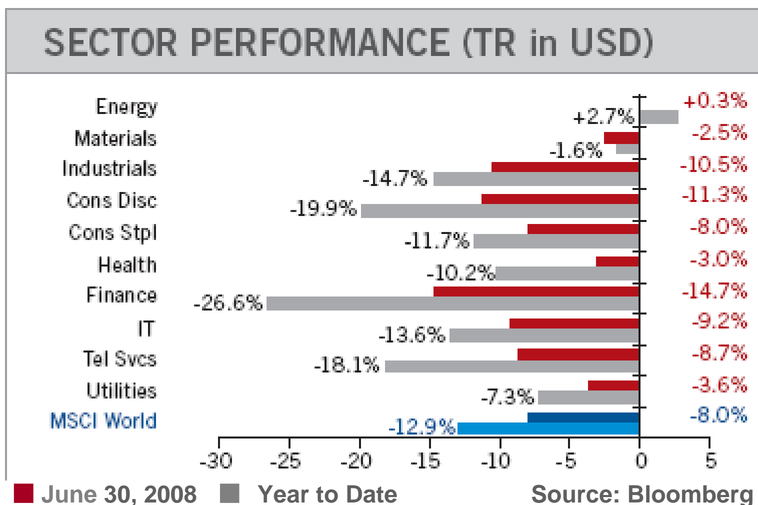


…Amplified by a Long Period of Excess Liquidity

On the impact of speculative activity, there is certainly evidence of an unprecedented jump in long-side interest in commodity markets from passive investors looking for asset class exposure. At the same time, the coincidence of a weak U.S. dollar and a strong oil price suggests that trading activity is driven both financially and fundamentally. The fact that the oil price has yet to react to strong evidence of falling demand in the developed world—still the primary consumer of oil products—suggests that financial investors are inflating an oil price bubble as they did with the so-called TMT (technology, media, telecoms) bubble at the turn of the millennium. The role of excess liquidity in fuelling commodity inflation has been highlighted by David Roche of the consultancy firm Independent Strategy. In a recent Financial Times article, he noted that cheap funds had been readily available for speculative investments—in this case commodities—for too long, so contributing to higher prices. The liquidity bubble stemming from this low interest rate period drove up asset prices and created an illusion of prosperity that buoyed real economic activity to unsustainable levels. Thus, Roche argues, it is a global boom based on leverage, rather than on productivity gains, that lies behind the rise in the energy price. Just as the liquidity bubble has been followed by a credit crunch, so we believe that the oil price will deflate in due course. While the timing is uncertain, the larger the bubble grows, the greater will be the eventual fallout as commodity

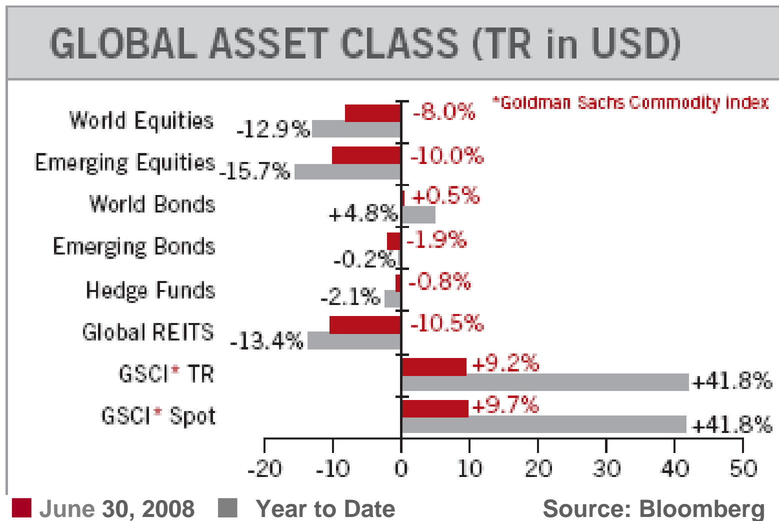
prices come to reflect economic fundamentals and momentum investors, always game for a speculation, move on to the next incipient bubble.





Worst Market Falls in over Five Years

During June, equities suffered one of the largest single monthly declines in five years. The MSCI World Index fell by 7.9% (TR in USD) over the month, while the fall of 7% of the North American S&P 500 Index represented the worst monthly return since September 2002. Markets have been caught in a pincer movement between rising inflationary pressures and fears that the banking sector—despite aggressive moves to recapitalize—faces the risk of substantial further credit crisis related write-offs. As the decline in property prices spread to the most vulnerable areas of Europe, notably the U.K. and Spain, the financial sector retested the lows reached in February/March at the time of the Bear Stearns rescue and bail-out of Northern Rock. The U.S. Fed kept interest rates at 2% as Chairman Bernanke noted that although downside risks to growth remained, they had receded somewhat, while risks associated with inflation had grown.

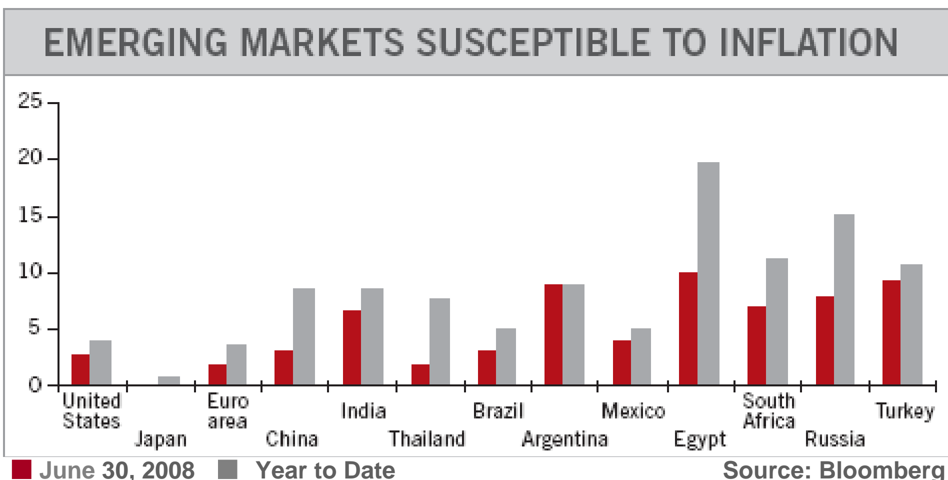


Commodity-Induced Inflation Ties Central Banks' Hands Even in the Face of Slowdown

With bearish sentiment completely dominant, investors have become obsessed with the notion that rising inflation would restrict central banks' willingness to provide continuing liquidity to the banking sector. Therefore, the bears argue, any economic improvement is threatened by rising inflation that will force central banks to raise interest rates. This gloomy scenario suggests a protracted housing and consumer slowdown as the debt excesses of the last cycle are slowly unwound. Inside the Eurozone, rising energy prices have pushed the inflation rate to 4.0% in June, a 16-year high, causing the ECB to raise rates by 0.25% to 4.25% in July. Consumer confidence in Germany has been declining and the market expects a spending retrenchment throughout the region. In this context, it is no surprise that the MSCI Europe ex-U.K. Index fell by 9.8% over the month.

Acute Price Pressures in Emerging Markets Even as Government Subsidies Come under Threat

Emerging equity markets fared worse than developed markets, with the MSCI EM Index falling by 10.0% in June. India fell by 19.6% and in China, the locally traded index has now fallen by around 50% from its high reached towards the end of last year. Price pressures are most acute in emerging markets as rising food and energy costs have pushed inflation to 25% in Vietnam, 8.5% in China and 11% in India. Although central banks have begun to raise interest rates, negative real rates are generally still the norm. Investors now fear that further aggressive action will lead to economic and social turmoil. While government subsidies have insulated consumers from rising energy prices, the growing budget burden is forcing a move towards market prices, leaving domestic economies more sensitive to rising costs.



Evident Value in Equities, Especially Japan and U.S.; Unusual Long-Term Value in 'Global Franchises'
Given the tsunami of negative news, it would be futile to expect a rapid reversal in the downward draught in equity markets. However, the current degree of pessimism should not obscure the evident value, particularly in some developed equity markets such as Japan and the U.S. In the longer term, valuations against bonds remain extremely cheap. Despite some risk of rising commodity prices fuelling inflation, we believe that the credit crisis is a deflationary event, and that the commodity price boom is a one-off shock, which means that the recent pick-up in bond yields provides opportunity for investors in the short to medium term. More significantly, we believe that long-term investors are being presented with an unusual opportunity to buy into sustainable global franchises at historically cheap valuations. In the short term, however, we believe the oil price will continue to dominate sentiment and, until the upward trend is broken, markets will continue to be vulnerable.

Investing in foreign securities, especially emerging markets, will involve additional risks including exchange rate fluctuations, social and political instability, liquidity, greater volatility and less regulation.

The Morgan Stanley Capital International World (MSCI World) Index is an unmanaged index composed of more than 1,400 stocks listed on exchanges in the U.S., Europe, Canada, Australia, New Zealand and the Far East.

The S&P 500 Index is a capitalization-weighted index of 500 stocks traded on the NYSE, AMEX and OTC exchanges, and is comprised of industrial, financial, transportation and utility companies.

The MSCI Europe ex-U.K. Index is a free float-adjusted market capitalization index designed to measure developed market equity performance in Europe excluding the U.K.

The MSCI Emerging Markets (MSCI EM) Index is a free float-adjusted market capitalization index designed to measure equity market performance in the global emerging markets.

It is not possible to invest directly in an index.

The European Central Bank (ECB) is one of the world's most important central banks, responsible for monetary policy covering the fifteen member countries of the Eurozone. The ECB, established by the European Union (EU) in 1998, is headquartered in Frankfurt, Germany.

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