(Contribution for UpDate no.1, 2016)

PERSONAL FINANCE

ARE YOU A WINNER OR A LOSER IN THE OIL GAME?

Economists are always experts when it comes to explaining why events have occurred in the financial markets. But few, if any, accurately predict what will happen in the near future. No-one ever dreamed eighteen months ago that the price of oil would fall by some 70% to levels not seen since 2004. This inability to predict events is why we should be prepared for a wide range of outcomes when making financial plans. The first principle to follow being if you are likely to need cash in the short term stay in cash. Investing in assets such as stocks, commodities and property is strictly for the medium (minimum five years) and preferably the long term (ten years plus).

Investing in oil is certainly a long term matter. The major oil companies have to plan years ahead when they make investments. At the same time they have to watch their quarterly results and dividends to keep their shareholders happy. In normal times they have been very successful in maintaining this balance but the shock fall in oil price has hit their bottom lines hard with some of the majors reporting a quarterly loss for the first time in decades.

So who are the losers in the oil game?

- The big oil companies whose profits and cash flows have been slashed.
- The smaller oil companies and the service companies that serve the oil industry, some of whom have already gone out of business with others facing insolvency if the price of oil remains for long at current levels.
- Thousands of employees worldwide whose livelihoods depend on the oil industry directly or indirectly and have lost their jobs.
- Oil exporting countries including those in the Middle East who now have to drastically cut their national budgets and countries like Russia whose economies and currencies have been severely hit due to their high dependence on oil.

- Investors in oil and energy shares and funds which have fallen by up to 50% in value since the price of oil started falling.
- All stock market investors around the globe as the shock in the energy industry has impacted a wide range of non-related stocks and brought all indexes down, particularly at the start of the year.
- Pension funds and institutional funds. No escape for them either. Many of them count on dividends for their cash flow but these are also under threat. According to a Sky report, Shell accounts for £1 in every £6 received by UK pension funds.
- The environment. Cheap oil is going to slow down moves to develop alternative energy solutions. 'Gas guzzlers' will come back into favour in the US. Sales of fuel-efficient and electric cars have slumped.
- Alternative energy industries. In the UK a major airline has shelved a £340 million project to produce aviation fuel from household waste.

But there are winners too! Who are they?

- Countries that rely on imported oil.
- Motorists. Prices of petroleum products are falling.
- Airlines. We may even see those 'fuel surcharges' disappearing.
- Industry as a whole. Cheaper energy means lower costs and more efficiency.
- Companies and in turn their share prices which will benefit from lower costs. Some airlines are now reporting significant profits thanks to lower fuel costs.
- Small businesses with reduced energy bills.
- The tourism industry. Lower costs should mean cheaper air fares and more tourists, coupled with lower fuel bills for hotels.
- Investors in non-oil related industries, as reduced costs improve profits, dividends and share prices.

- Investors with regular savings plans as they are buying in right now at very low unit prices and are therefore buying more units than they were a year ago for the same monthly contribution. The benefit will come in future years when prices rise again (as they always do after a crash).

Is Indonesia a winner or a loser?

In fact it is both. Now that half of the oil the country consumes is imported the impact on the country's budget and also foreign trade balance is significant. The crippling fuel subsidy before President Jokowi took office has disappeared and fuel prices may be reduced further at the next review in April.

On the downside however the country, as elsewhere, is seeing a major shrinkage of the oil industry and related investment. Several thousand jobs have gone or will go before a balance is restored. Large numbers of expatriates in the industry have been forced to leave. This in turn adds to job losses among the people who provide services to them such as drivers, domestic staff and so on.

Cheaper petrol has only made Jakarta's traffic jams worse. This would be an ideal time to tax petrol as in Europe. It would discourage non-essential motoring and produce a useful income to the country. But it's not going to happen.

Perhaps more serious is the long-term impact of a smaller oil industry and lower production. Not such a problem while cheap imported oil is available but the crunch will come in the future when the oil price rises again (as it will) at which point the reduced local production and the cost of importing most of the oil to satisfy a growing economy could become a serious issue. It will mean either further subsidies again or the risk of labour unrest. Either way there will be further pressures on the economy.

Where will the price of oil go from here?

Predictions vary wildly. Movements can alternate up or down on almost a daily basis. Several major banks have suggested the price of oil could fall to as low as £10 and £20 a barrel before recovering. On the other hand, there is a wide consensus among analysts that a forced reduction in production levels could cause the price to rise to between £45 and $50 a barrel by year end. There are those however who believe that the addition of Iranian oil into the equation will hold prices down. The fact is, no-one really knows for sure and any one of many factors could cause a major surge in price, such as an agreement between several major producing countries to reduce production or a serious spat between arch rivals Iran and Saudi Arabia.

Are there investment opportunities for small investors?

Human nature is such that people flock to invest when prices are high but are reluctant to invest while prices are low like today. This applies to any asset. The usual rationale for not investing is that prices may fall even further. Indeed they may, but in due course they will rise again but people will not be convinced at the first signs and when they finally take the plunge prices will have already made half their gains. Sales of any given asset are almost always at their highest when prices are close to their peak. This is why people rarely make money when investing!

The key is to look long term. There is a good chance that the oil price will reach $40 to $50 a barrel by year end, compared to the current price of around $30 a barrel. Of course the price could also fall to $20 a barrel. But at that price, and even at today's price, more production facilities would be shut down and this in turn will diminish supply to a point when it is in balance with demand. Then we could see a significant rise. But as it could take longer than is currently predicted patience is essential.

Just looking at the history of energy funds I would be very surprised if today's energy fund prices have not trebled in five years. The International Energy Agency in a report dated 22 February said that due to a rapid fall in output oil prices will start recovering in 2017 and there could be a spike in oil prices by 2021. This really makes investing in oil and energy today a non-brainer if you can hold on through near-term volatility.

Cautious investors can hedge against a delayed rise in prices by investing each month into an energy fund via a long term savings or pension plan. This will avoid any sudden short term shocks and will reap benefits in later years. As many expatriates have long term savings plans with life companies a simple switch costs nothing. Similarly, a portfolio switch would cost little compared with the potential gain over five years.

And while you are at it, don't overlook gold. But that's another story!

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