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If only oil was more expensive...

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- **Low and falling oil prices are positive for energy importers, such as the eurozone**
- **But they are also negative as they seem to affect economic and financial stability and risky assets**
- **There is a risk of a vicious circle with low oil prices leading to lower economic growth through various channels and growth then pushing oil prices lower yet and so on**
- **But given the behaviour of the economies in the eurozone and the US and considering recent falls in oil prices an overshoot, we think oil will bounce later this year and the vicious circle will be averted**

I never thought I would wish, let alone pray, for higher oil prices, but I am. While low oil prices are good for net energy importers, which is the case for the eurozone, the depressed state of the oil market seems to have a huge and negative influence on global economic stability, global financial stability and on risky assets.

Low oil prices: good or bad?

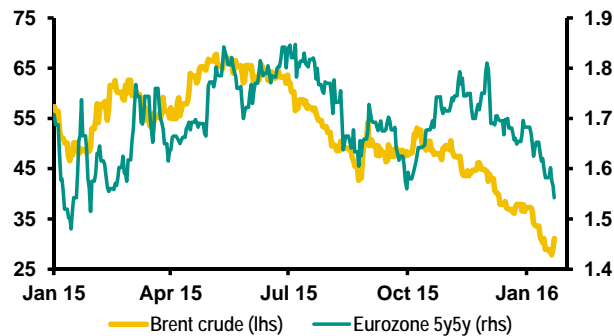
In the past, a drop in oil prices, particularly a drop caused by the supply side of the market, was good for our sort of economies. In economic jargon, a significant drop in oil prices constitutes a positive supply shock. But this time around, it seems to be all bad. Perhaps it is more a matter of degree. Lower oil prices are generally welcome, but if they fall to extreme levels, they cause stress that may be a bigger negative than the benefits.

Oil pushing down inflation expectations

There are several channels through which low oil prices are currently bad, despite the positive supply shock they provide. First, low oil prices have pushed inflation down to levels central banks feel uncomfortable with. In fact, the drop in oil prices have taken inflation expectations down with them. In the economists' jargon, inflation expectations have become 'unhinged'. This worries, for example, the ECB as they feel that inflation expectations affect people's behaviour and the current low level of inflation expectations is bringing deflation closer. I am not sure if I can really follow that logic. Isn't it reasonable for people to lower their inflation expectations if oil falls to such lows? But my doubts on the issue are not relevant. The ECB seems to have decided that it needs to act if things do not change. At his last press conference, ECB president Draghi signalled the central bank would act. Having seen the markets'

verdict in December when Draghi under delivered, my guess is that the ECB will want to avoid repeating that debacle.

Oil vs eurozone inflation expectations



Source: Bloomberg

So how is the ECB going to push inflation expectations up? Well, they cannot determine or affect the oil price, so they must try to push actual inflation higher and hope that expectations at least partly follow that move. The way to go then is to try and push the currency lower (which means push the dollar higher).

There are two problems with this. First, a higher dollar risks pushing commodity prices lower, making the problems of very low oil prices worse. Second, many other countries are facing similar challenges and we cannot all depreciate our currencies at the same time. If all countries depreciate against the US dollar (which is effectively what has happened since mid-2014) this puts a huge strain on the US, which is going to cause problems at some stage.

Credit events

Another channel through which low oil prices are troublesome is that the longer they are sustained, the bigger the risks of significant credit events in the energy sector (jargon for companies going belly-up) and it is unclear how well the financial system will be able to cope with that. So this threat is making people nervous. Understandably.

Sovereign wealth funds

A third problem with low oil prices is that they imply significant financial problems for oil-exporting countries. These have seen their public finances move deeply in the red and their balance of payments deteriorate significantly. Their response consists of two main elements. First, as one can imagine, they must tighten their belts, which is bad for global trade etc. Second, they have little choice but to dip into their financial reserves. And that seems to be exactly what has occurred. Sovereign wealth funds have been selling assets in recent months, or even longer, which is probably one of

the drivers of the fall in equity prices in recent weeks despite the fact that important economic indicators have actually not been that bad recently.

Vicious circle

The risk is that continued weakness or a further slide in oil prices feeds a vicious circle. It leads to deflationary pressures to which many central banks respond by efforts to depreciate their currencies. This will either not work at all, as we cannot all have a depreciating currency, or lead to a currency war, or lead to further dollar strength which may exacerbate the fall in commodity prices and will add to capital flight from emerging economies. All this will be bad for growth and may weaken commodity prices further.

In addition, weak and falling oil prices lead to further belt tightening in oil producing countries and leads them to liquidate investments which pushes down risky assets. If this persists, it will affect economic growth in many countries. Last, the low oil prices raise the risk of credit events, which would also be unfavourable for global growth.

TGIF

We are still on the cautiously optimistic side of the argument, though we are aware of the risks. It seems to me that oil markets have overshot and that markets for risky assets are not giving the economy the credit it deserves. In other words, markets for risky assets appear to be overshooting (or have overshot) on the downside. The rally in the oil market on Thursday and Friday is very welcome and I, for one, hope it can be sustained. Bears will point out that the oil market is still struggling with excess supply and that prices will inevitably fall again as a result. Perhaps they will, but this analysis fails to take account of the extreme short positions in oil futures. When they are unwound, oil prices can bounce strongly despite production of oil exceeding consumption.

On balance, we feel that the global economy is in better shape than markets appear to be giving it credit for. But there is a risk of a vicious circle in which oil prices play an important role. While I do not want to put undue pressure on our analysis of the oil market, we continue to forecast higher oil prices later this year as excess supply is shrinking and excessive short positions are unwound. I am convinced that the world badly needs higher oil prices.

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Main economic/financial forecasts

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GDP growth (%)	2014	2015e	2016e	2017e	3M interbank rate	14/01/2016	21/01/2016	+3M	+12M	2016e	2017e
United States	2.4	2.4	2.0	2.1	United States	0.62	0.62	0.7	1.3	1.3	2.4
Eurozone	0.9	1.5	1.6	1.9	Eurozone	-0.14	-0.14	-0.25	-0.35	-0.35	-0.35
Japan	-0.1	0.7	1.0	0.6	Japan	0.17	0.17	0.2	0.2	0.2	0.2
United Kingdom	2.9	2.4	2.2	2.6	United Kingdom	0.59	0.59	0.6	0.9	0.9	2.0
China	7.3	6.9	6.5	6.0							
World	3.4	3.1	3.3	3.6							
Inflation (%)	2014	2015e	2016e	2017e	10Y interest rate	14/01/2016	21/01/2016	+3M	+12M	2016e	2017e
United States	1.6	0.1	1.6	1.8	US Treasury	2.10	2.02	2.1	2.5	2.5	2.8
Eurozone	0.4	0.0	0.2	1.7	German Bund	0.51	0.45	0.4	0.8	0.8	1.5
Japan	2.8	0.6	1.0	1.9	Euro sw ap rate	0.88	0.77	0.7	1.0	1.0	1.7
United Kingdom	1.5	0.0	0.6	2.0	Japanese gov. bonds	0.23	0.23	0.7	0.7	0.7	0.9
China	2.0	1.4	2.0	2.5	UK gilts	1.74	1.67	2.0	2.0	2.0	3.0
World	3.8	3.6	3.9	3.7							
Key policy rate	21/01/2016	+3M	2016e	2017e	Currencies	14/01/2016	21/01/2016	+3M	+12M	2016e	2017e
Federal Reserve	0.50	0.50	1.25	2.25	EUR/USD	1.08	1.08	1.05	1.00	1.00	1.10
European Central Bank	0.05	0.05	0.05	0.05	USD/JPY	118.1	116.9	120	130	130	120
Bank of Japan	0.10	0.10	0.10	0.10	GBP/USD	1.44	1.41	1.40	1.33	1.33	1.57
Bank of England	0.50	0.50	0.75	1.75	EUR/GBP	0.75	0.77	0.75	0.75	0.75	0.70
People's Bank of China	4.35	4.10	3.85	3.85	USD/CNY	6.59	6.58	6.55	6.70	6.70	6.60

Source: Thomson Reuters Datastream, ABN AMRO Group Economics.

Key Global Macro Events

Day	Date	Time	Country	Key Economic Indicators and Events	Period	Latest outcome	Consensus	ABN AMRO
Monday	18/01/2016	05:30:00	JP	Industrial production - % mom	Nov F	-1.0		
Tuesday	19/01/2016	03:00:00	CN	Fixed investments - % yoy	Dec	10.2	10.2	
Tuesday	19/01/2016	03:00:00	CN	Retail sales - % yoy	Dec	11.2	11.3	
Tuesday	19/01/2016	03:00:00	CN	Industrial production - % yoy	Dec	6.2	6.0	
Tuesday	19/01/2016	03:00:00	CN	GDP - % yoy	4Q	6.9	6.9	6.9
Tuesday	19/01/2016	08:00:00	DE	CPI - % yoy	Dec F	0.3	0.3	
Tuesday	19/01/2016	10:30:00	GB	CPI - % yoy	Dec	0.1		
Tuesday	19/01/2016	11:00:00	DE	ZEW index (expectation economic growth)	Jan	16.1	8	3
Tuesday	19/01/2016	13:00:00	TR	Repo rate - %	Jan 19	7.5	7.5	7.5
Tuesday	19/01/2016	16:00:00	US	NAHB home builders' confidence index	Jan	61.0	61.0	61
Wednesday	20/01/2016	10:30:00	GB	Claimant count unemployment rate - %	Dec	2.3		
Wednesday	20/01/2016	10:30:00	GB	Change in claimant count - thousands	Dec	3.9	3.3	
Wednesday	20/01/2016	14:30:00	US	Inflation excl food and energy - % mom	Dec	0.2	0.2	0.1
Wednesday	20/01/2016	14:30:00	US	Inflation excl food and energy - % yoy	Dec	2.0	2.1	2.1
Wednesday	20/01/2016		US	Inflation (CPI) - % mom	Dec	0.0	0.0	0.0
Wednesday	20/01/2016	14:30:00	US	Inflation (CPI) - % yoy	Dec	0.5	0.8	0.8
Wednesday	20/01/2016	14:30:00	US	Housing starts - % mom	Dec	10.5	2.7	3.5
Wednesday	20/01/2016	16:00:00	CA	Policy rate - %	Jan 20	0.5	0.4	
Wednesday	20/01/2016		BR	Policy rate - %	Jan 20	14.3	14.8	
Thursday	21/01/2016	06:30:00	NL	Consumer confidence - index	Jan	6		7
Thursday	21/01/2016	07:30:00	NL	Unemployment rate - %	Dec	6.8		6.8
Thursday	21/01/2016	08:45:00	FR	Business confidence manuf. - index	Jan	103		
Thursday	21/01/2016	11:00:00	EC	Core inflation - % yoy	Dec F	0.9	0.9	0.9
Thursday	21/01/2016	13:45:00	EC	Refi rate - %	Jan	0.05	0.05	0.05
Thursday	21/01/2016	13:45:00	EC	ECB Deposit rate - %	Jan	-0.30	-0.30	-0.30
Thursday	21/01/2017	14:30:00	EC	ECB QE (EUR bn per month)	Jan	60.00	60.00	60.00
Thursday	21/01/2018	14:30:00	EC	ECB Press Conference	Jan			
Thursday	21/01/2016	14:30:00	US	Philadelphia Fed - business confidence - index	Jan	-5.90	-1.14	
Friday	22/01/2016	10:00:00	EC	PMI manufacturing - index	Jan P	53.20	53.00	52.50
Friday	22/01/2016	10:00:00	EC	PMI services - index	Jan P	54.20	54.20	53.80
Friday	22/01/2016	10:00:00	EC	Composite PMI output	Jan P	54.30	54.20	53.80
Friday	22/01/2016	10:30:00	GB	Retail sales - % mom	Dec	1.70		
Friday	22/01/2016	15:45:00	US	Markit - Flash PMI	Jan P	51.20		
Friday	22/01/2016	16:00:00	US	Existing home sales - % mom	Dec	-10.53	7.96	8.00

Source: Bloomberg, Reuters, ABN AMRO Group Economics (we provide own forecasts only for selected key variables and events)