Back to the future?

# Initial Reactions to the Collapsing Oil Price from CBRE

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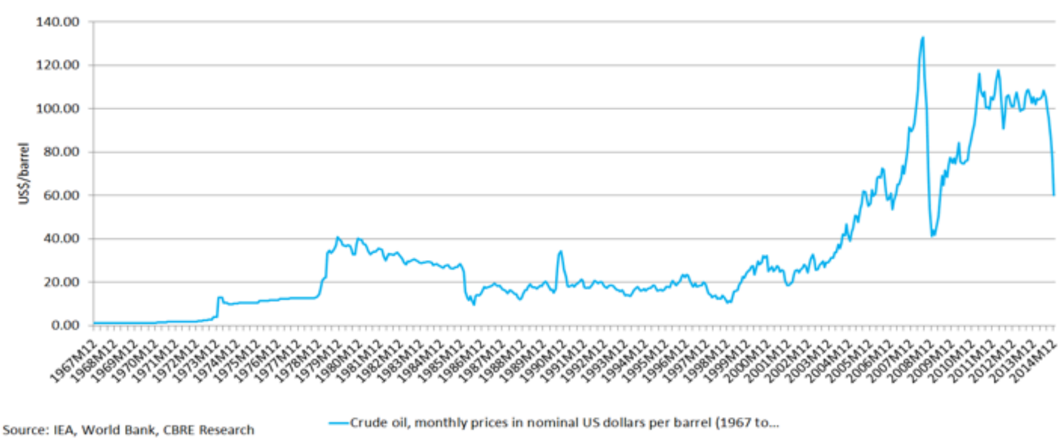
**In the last six months, oil prices have dropped from US$115 to US$61 per barrel (Figure 1). The initial hope that this would provide a shot in the arm to the West's debt-laden consumers has given way to unease about the prospects for certain oil based economies- Russia in particular. The purpose of this note is to provide an overview of the causes and consequences of the current situation in advance of a more substantive piece of work that will consider in detail the implications for real estate markets in the New Year. Further swings in the demand and supply side of the oil market are possible and it will be a while before sensible price forecasts can be made. Our view is that it is a little early to call a 'new era' in oil pricing but that there are some striking parallels with the 'oil glut' of the mid-1980s which had dramatic real estate consequences.**

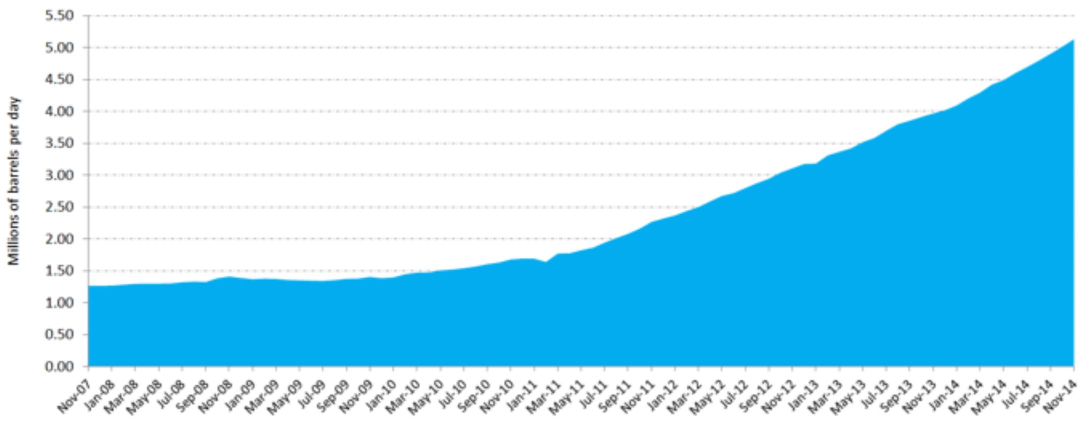
Figure 1. Crude oil, average monthly prices in nominal US$/bbl (1967 to Nov 2014)



## WHY HAS THE OIL PRICE FALLEN?

Most people will be aware of the 'fracking' or 'shale oil' revolution that has taken place in the U.S. Since 2007, the production of 'tight oil'- oil that is difficult and costly to extract- has expanded from just over 1 million barrels per day to around 5 million barrels per day Figure 2. To put that in context, world consumption and production of oil totalled 93 million barrels per day as at the end of 2014. So 5 million barrels a day represents a material boost to world oil supply.

Figure 2. US tight oil production



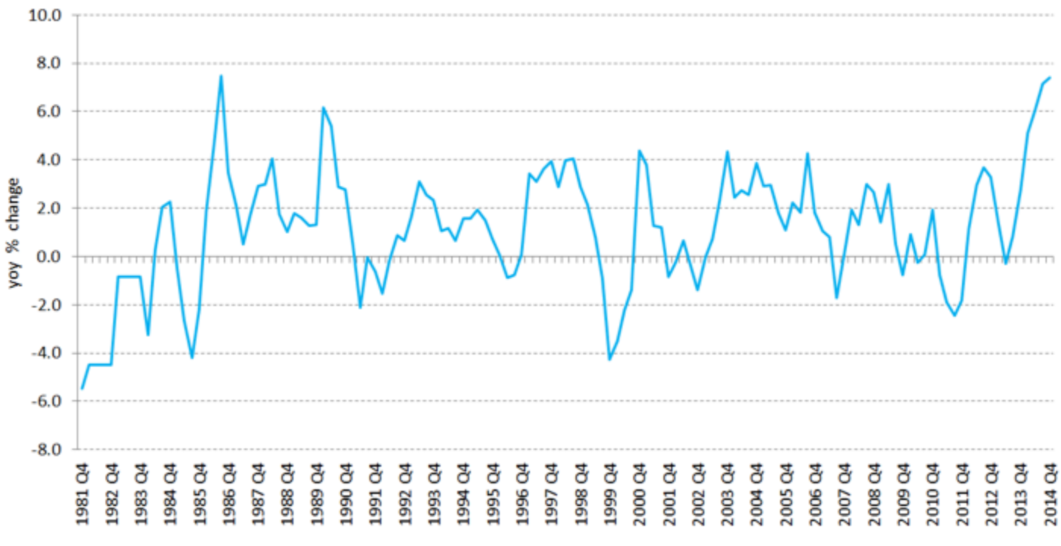

Source: EIA, CBRE Research

Against a backdrop of robust growth in the emerging markets, the expansion of production in the US was a welcome addition, easing price growth and facilitating economic development. However, that period of emerging market pre-eminence, driven by China, is now over. China's growth between 2001 and 2012 averaged 10% per annum, since 2012 according to official estimates it has fallen to 7% per annum and some unofficial estimates put it considerable lower. A number of forecasters are suggesting that it will drop to 5% per annum in the next five years. The causes of the slowdown in China need not detain us, but relate to an unbalanced economy, namely over-investment in industrial capacity and real estate and the build-up of problematic debt. Whilst the Chinese government has a clear and plausible plan to move the economy away from dependence on investment and exports towards consumption, it will take some time, and there will by some disruption on the way. In the meantime, the slowdown in China, and its knock on impact on the other emerging markets, has caused a slowdown in the growth of the global demand for oil. Economic weakness in the Eurozone is also a factor, as is greater energy efficiency ushered in during the period of high oil prices.

Keeping track of movements in the oil market aggregates of demand and supply is difficult in real time. It is not easy to be sure what is being pumped in the areas of the

Middle-East that are in conflict. However, if we look at recorded stocks of pumped but un-consumed oil, or inventories, we get a clear sense of the balance of demand and supply.

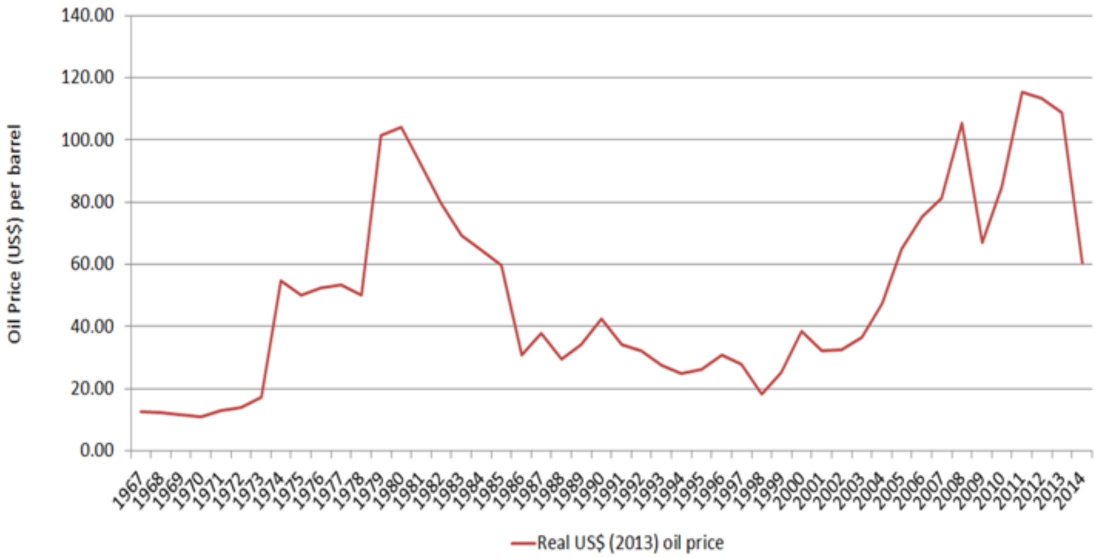
Figure 3. Year on year change in world oil inventories




Source: IEA, Oxford Economics, CBRE

Figure 3 shows that the growth in oil inventories has been stronger in the last six months than at any time since the mid-1980s. Not many will remember the oil market of the 1980s, but there was a similar price collapse in first quarter of 1986 after oil inventories spiked (Figure 4). In fact, real prices had been falling from 1980 onward, partly in response the recession of 1979 to 1981, including the double dip recession in the US and partly because the oil price hikes of 1974 and 1979 had brought about an increase in supply from non-OPEC sources, Russia in particular, and a material degree of demand destruction due to improvements in energy efficiency. A situation not unlike the present.

Figure 4 Long-run real oil price (real US$ 2013 oil price)

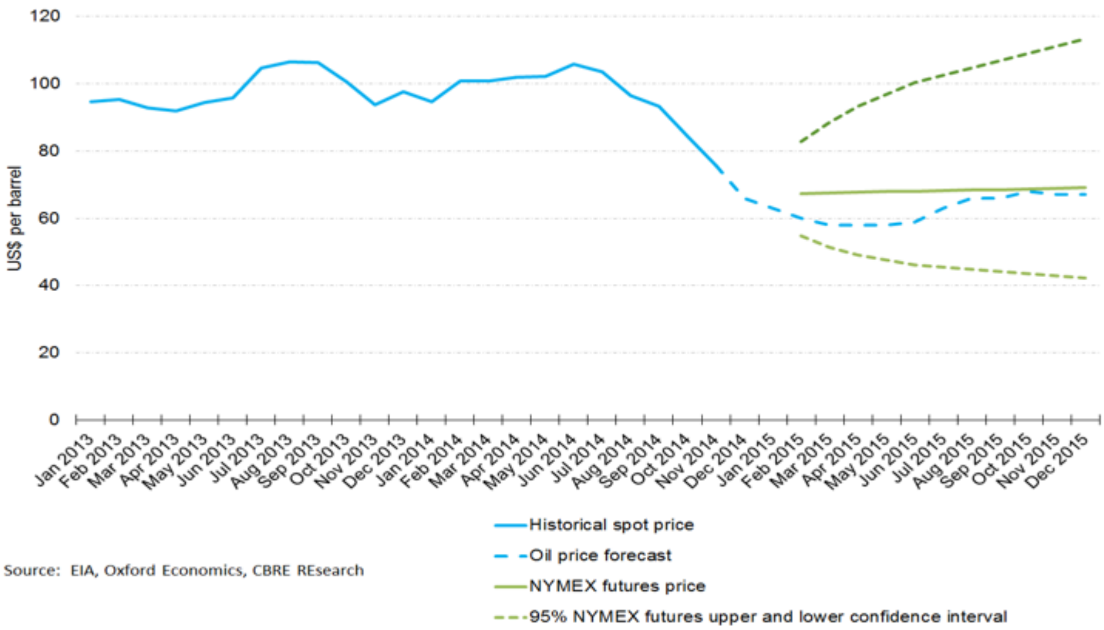



The initial OPEC response in the 1980's was to cut back on production in order to support the price with Saudi Arabia becoming, due to OPEC indiscipline, the global swing producer. Eventually, in 1986 Saudi Arabia tired of being the only main OPEC member that stuck to agreed quotas and ramped up production in order to regain market share. As now, the oil price slumped.

Now we appear to be back to 1986: OPEC leading member is pumping oil to preserve market share irrespective of price. Its calculation is quite clear: a weak oil price will, in the medium term, take high cost production out of the market and, in the long term, create demand by reducing energy efficiency and undermining the development of alternative energy sources. Opinions within OPEC differ but Saudi Arabia has the reserves and financial strength to make good its aims.

So, where do we go from here? Figure 5 shows the oil price futures curve from the New York Mercantile Exchange (NYMEX). The central projection is that prices will remain at around $65 per barrel for at least another year. So the markets are not expecting a sudden turn-around.

Figure 5 Crude oil futures price (West Texas Intermediate – WTI)




Source: EIA, Oxford Economics, CBRE REsearch

This seems plausible, given the current demand and supply conditions, but the wide confidence bounds around these forward projections and the general inadequacy of forwards markets in anticipating events, are worth keeping in mind. For instance, there are rumours that the Chinese government will use the current period of price weakness to increase its strategic oil reserve from nine day's consumption to 90 days. In all likelihood, China is not the only government entertaining such thoughts. A move of this magnitude would be a substantive demand-side boost. This is why we have delayed a more substantive real estate outlook.

Our working hypothesis is that prices have probably hit bottom now. They will stay at this level for about one year, as predicted in the forward curve, and then drift slowly back to between $90 and $100 per barrel by around 2020.

## WHAT ARE THE CONSEQUENCES?

The economic consequences of falling oil prices are unequivocally good, for the economy and for real estate fundamentals of western countries. Already the IMF has stated that the fall in oil prices could boost global growth by up to 0.7% in 2015 and up to 0.6% in 2016. The boost to growth would occur across the OECD, but also in non-oil producing emerging markets such as China.

The majority of the boost to growth would come through stronger consumption but companies would also benefit from lower input costs. With a lag of 18 months or so we would expect to see higher rents than previously forecast across the board and particularly in retail. The residential sector will also receive a boost, as households gain the ability to service slightly higher mortgages. In addition, as housing market activity picks up there will be a knock-on effect on bulky good sales.

There is a reasonable argument that, weaker oil prices will extend the length of the current US economic cycle. We need to be cautious here, the labour market in the US, as in the UK, is much tighter than elsewhere in the OECD, particularly the Eurozone. The oil glut of the mid-1980s contributed to the unsustainable consumer boom of 1987 to 1989. Something similar could easily develop in the Anglo-Saxon countries over the next two years. However, at thepresent time much stronger consumption growth is exactly what the Eurozone needs.

Of course, this being economics, it is not all good. A number of economies, particularly those heavily dependent on oil production, face a very sharp contraction. Russia has the biggest problem due to its export dependence on oil.

- If, as we expect, the oil price settles at around $65 per barrel, then Russia faces a balance of payments deficit of $90billion, in 2015. This is equivalent to 25% of its foreign currency reserves.
- This looming balance of payments crisis, exacerbated by capital flight has caused a collapse in the value of the Rouble, vis-à-vis the U.S. dollar of around 40%. With inflation the most likely result, the central bank has hiked interest rates to 17.5%. This is a crushing burden for the economy and will lead to a fall in output of around 3% to 5% in 2015.
- Russian imports will inevitably fall as a result of the joint oil price/rouble crisis. Russia is not a big trading partner for many western countries but there are exceptions – Finland, Poland and the Baltics in particular.
- There is a small, but non-trivial, chance of loan default by Russia or a Russian domiciled entity or at least some form of moratorium on external debt repayments. Whilst the global financial sector is much more robust than it was seven years ago, such an event would hit equity markets and lead to a short livedbut damaging decline in confidence and investment. Western banks are not generally very exposed, but loans to Russia account for 1.2% of Austrian banks' assets.
- There are net oil producers outside of Russia and OPEC. Canada, Mexico and, especially Norway, are oil exporters and they could see investment, public finances and government spending suffer as a result of the price fall.
- There is no sign of it at present, but the longer that oil prices remain weak, the greater likelihood that some of the oil revenues of Middle Eastern states will be diverted from overseas investment, including into real estate, to maintaining public spending at home.
- Inflation, particularly headline inflation is very low, or negative, in a number of European countries and lower oil prices will exacerbate this. This has created a fear that dis-inflationary expectations will set in which will lock European countries into a deflationary spiral. Given that lower oil prices will provide a boost to economic activity and, potential to core inflation, we believe that this concern is probably over-done.

Although we have focussed on Russia in this short note, it is far from the only possible source of negative capital markets event. Under our noses almost, there has been a boom in lending to the oil industry in the US that might even be described as a bubble. Since 2010 some $550 billion has been raised by the energy sector in the form of loans and bonds. We should expect a rise in loan default from this source as well, which might cloud the first half of 2015 in uncertainty, despite the boost to consumer incomes.

## CAN WE HAVE TOO MUCH OF A GOOD THING?

There are many parallels between now and 1986. Then, an abrupt fall in oil prices ushered in a period of low inflation, low interest rates and higher economic growth. The result was a full-scale boom in international real estate markets driven by a combination of a buoyant occupier market and credit expansion. This ended in tears when the bubble burst and economies and real estate markets crashed in the late-eighties and early nineties.

Such a scenario might sound fanciful this time around given the weakness of many of the world's economies – the Eurozone and China in particular- but we know from past experience that big movements in the oil price is a game changer. There are already signs that credit availability is picking up and real estate values are being buoyed by capital inflows from the Far East and long-term interest rates are very low.

If the oil price fall does have a major positive impact on economic growth, preventing a bubble from developing will depend substantially on the actions of central banks. There are already a number of measures in place to control lending from the quantitative side but central banks might also be tempted to target core rather than headline inflation and this might not suggest quite as benign an outlook for interest rates as many expect.

For general assistance on the real estate consequences of the decline in oil prices, please contact:

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