COMMENTARY

Oil prices and US$: do not expect the usual linkage

By Thierry Apoteker

THE April 18 failure of Opec (Organization of the Petroleum Exporting Countries) and non-Opec countries to reach a deal in Doha on a freeze or a decline in oil production quotas led to an immediate sell-off in the oil market, which quickly reverted towards a confirmation of the earlier trend change seen in February 2016. As a matter of fact, the mere occurrence of such a meeting attended by Russia as well as all Opec members to discuss oil supply control is of far more (medium-term) significance than the inability to reach a deal at "first sight".

In terms of actual supply and demand, US output is starting to effectively contract on a year-on-year basis, and other non-Opec production also declines or stabilises. Over the very short run, the recent fires in Alberta are likely to subtract a significant amount from Canada's oil output.

Even the past increase in Opec production (read: Saudi Arabia, Iraq, Iran) is now heading south. US and non-Opec production is moving into larger contraction, and total supply is thus going towards an overall year-on-year decline over the next few months. On the demand side, we note that a very mild winter has dampened demand in OECD (Organisation for Economic Co-operation and Development) countries in the early months of 2016, but we do not expect the y-o-y decline to continue; with China and most emerging markets (EMs) stabilising, this would translate into a 1-1.5 million barrels/day y-o-y increase. The rebalancing is therefore taking place.

From another angle, the Doha meetings are likely to be followed by more discrete and more numerous dialogues between the major producers.

Saudi Arabia, Iran and Russia are (willingly or not) sharing a similar objective of raising the oil price: notwithstanding Saudi authorities' plans for "structural changes" and their efficient communication exercise, the cost of security and defence and the social protection are not readily adjustable, and the credit rating of the kingdom has already been downgraded by one agency (Fitch); in Iran, President Hassan Rouhani has put a lot of political stake on the expected benefits from the lifting of sanctions: achieving this is very unlikely in the current price environment, even with an increase in output; finally Russia has its own budget/strategy/social constraints and is clearly in need of an easier environment. Overall, the likelihood of an agreement among major producers is increasing by the day; the "signal" would be a political advancement on Iran and Saudi Arabia's respective zones of influence in Iraq, Syria and Yemen.

Markets are already starting to adjust to the progressive rebalancing in demand and supply. As always, speculative positioning is going to accelerate and possibly amplify the fundamental trend: net long positions on Brent contracts have increased by 58 per cent between the end of 2015 and the end of April 2016, and +152 per cent for WTO contracts.

Higher oil prices will not lead a further depreciation of the US dollar this time!

TAC Economics' own quantitative models suggest a medium-term neutral level slightly above US$60/barrel for the Brent price that would be reached either in the second half of this year or early 2017, even though the timing may once again be disrupted by Saudi Arabia's uncertain strategy and volatile regional political environment.

CYCLICAL CONDITIONS

Observed on a long period of time, a strong correlation is noted between oil prices and the US dollar exchange rate: when oil prices go up, the dollar depreciates, while it appreciates when oil prices decline. Indeed, the US dollar has depreciated against mature and most emerging market currencies since the early part of 2016, coinciding with the upward trend in oil prices.

The rationale behind such a link is a complex combination of relative inflation and monetary policy impact in the US versus the eurozone or Japan (the movement from higher oil prices to higher inflation and higher interest rates is stronger in the eurozone, for instance, providing support to the euro against the US dollar), and purchasing power and structure of imports for large oil-exporting countries (which are buying goods and financial assets in euros while their exports are exclusively in dollar).

Specific cyclical conditions suggest that the correlation will not work further this year.

Indeed, the post-global and post-debt crises situation in the eurozone precludes any transmission from higher oil prices to substantial inflation and to any reaction in terms of monetary policy, at least up to the first quarter of 2017.

Conversely, if we are right on the increase in oil prices, inflation will surprise on the upside very soon in the US, as the core CPI (ie, consumer price index, excluding volatile food and energy components) is already at +2.3 per cent y-o-y while headline CPI is close to one per cent only because of the y-o-y decline in the energy component. The core CPI is likely to accelerate further, given wage pressures (more clearly evidenced in the latest labour report from the US in early May), the impact of relative housing scarcity on rent costs and the trend acceleration in healthcare costs. In such a background, the expected swing in energy price would move from subtracting one point to adding one point: headline inflation could jump towards or even above 3 per cent very rapidly.

When I try to inject this scenario into the current discussion about the next move by the US Federal Reserve in June, and as I believe that the Fed policy is primarily dictated by market expectations and the systemic risks associated with "contradicting the markets", I come rapidly to the conclusion that a larger or more rapid increase in US Fed fund rates is unavoidable between now and the end of the year.

When this happens or gets expected by market participants, the US dollar will register another bout of appreciation. Our models suggest a move back towards 1.05 against the euro and possibly as low as 1.0 vis-à-vis EM currencies, the differentiation is likely to be large between oil producers (indeed with exchange rates supported by the price improvement) and commodity importers and manufacturing EMs that would be more sensitive – especially if the Chinese yuan depreciates again.

The writer is chairman of TAC Economics.

COMMENTARY

Another year of capex cuts will set oil market up for serious supply crunch

By Nick Cunningham

TOTAL global oil production could decline for the next several years in a row as scarce new sources of supply come online.

According to data from Rystad Energy, overall global oil output will fall this year as natural depletion overwhelms all new sources of supply. But the deficit will only widen in the years ahead due to the dramatic scaling back in spending on new exploration and development.

Statoil says that global capital expenditure is set to fall for two years in a row, and is on track to fall for a third year in 2017 as more spending cuts are likely. "For the first time in history, we've seen cutting of capex two years in a row and potentially we risk a third year as well for 2017," Statoil's chief financial officer (CFO) Hans Jakob Hegge told Bloomberg in a recent interview. "It might be that we see quite a dramatic reduction in replacing the capacity and of course that will have an impact, eventually, on price."

Oil companies are making painful cuts to spending, which will translate into much lower production than expected in the years ahead.

Although markets have dealt with the supply overhang for the better part of two years, the surplus could flip to a deficit as early as this year, as declines exceed new sources of production by a few hundred thousand barrels per day. That widens to more than a million barrels per day in both 2017 and 2018. To be sure, there are extremely large volumes of oil sitting in storage, which will take a few years to work through. That will prevent any short-term price spike even if depletion surpasses new production. But Statoil's CFO said that the world could start to see supply problems by 2020.

According to a separate report from SAFE, a Washington-based think tank, the oil industry has cut somewhere around US$225 billion in capex in 2015 and 2016, which will lead to a fall in global supplies by four million barrels per day in 2018-2020, compared to what market analysts expected as at 2014.

Of course, these figures are not inevitable. A sharp rise in oil prices would spur new investment and new drilling. In other words, deficits create profit opportunities for drillers, ushering in new supplies. The price acts as a self-correcting mechanism.

DELAYED RESPONSE

The problem is that, unlike many other industries, resource extraction is extremely volatile, with supply responses very delayed. Many oil projects, after all, take years to develop. When supply overshoots demand, prices crash, and in response, supplies will undershoot demand in the next few years. The industry has always suffered from booms and busts, and there is little reason to think that it will change, at least in the short run.

But we tend to have a myopic view on what to expect. When oil prices go up, people buy fuel-efficient cars. When prices go down, SUVs (sport utility vehicles) are back in style. When the world is dealing with too much supply, market watchers predict oil prices will stay low for years to come. If spot oil prices suddenly rise, forecasts are revised sharply upwards.

Here's another example: *The Wall Street Journal* (WSJ) reports that oil prices are entering a "sweet spot", a range between US$50 and US$60 per barrel that could finally be good for the global economy – low enough to provide consumers with a bit of a stimulus, but high enough to keep the industry and capital spending afloat. Also, crude at US$50, as opposed to US$30, can provide a bit of inflation to the deflation-beset economies in Europe and Japan. "Crude between US$50 and US$60 would be the absolute sweet spot," Mark Watkins, regional investment manager at US Bank Wealth Management, told the WSJ. "Everybody wins there."

That is all well and good, but who expects oil to trade between US$50 and US$60 for any lengthy period of time? If there is one thing that we have learned over the past two years, it is that nobody has a crystal ball on prices. And if the industry indeed cuts capex for three consecutive years, at a time when demand continues to rise, the one thing we can be sure of is more volatility. OILPRICE.COM

Free trade agreements, like any other treaty, may contain provisions for the settlement of disputes between states in their capacity as states. The TPP and Acia are no exception. PHOTO: REUTERS

Enforcing investors' rights in FTAs

A look at how investors are protected under FTAs, using the Asean Comprehensive Investment Agreement and Trans-Pacific Partnership deal as illustrations. **BY CHAN LENG SUN AND THUY NGUYEN**

FREE trade agreements (FTAs) have been receiving considerable attention recently. Even as investors explore opportunities ushered in by the new trade pacts, it is essential that they understand what provisions exist in these agreements to protect their investments, and the potential recourse they have in the event of a breach to such protection.

We look here at how investors are protected under FTAs, using the Asean Comprehensive Investment Agreement (Acia) and the Trans-Pacific Partnership (TPP) agreement as illustrations. The Acia is a key part of the Asean Economic Community blueprint, and took effect on March 29, 2012. It offers protection to eligible investors and investments in all business sectors. The TPP is a comprehensive trade agreement among 12 Pacific-Rim countries and protects investors of one TPP state in another TPP state.

Investor Protection

Companies investing abroad will look first to their contracts with their counterparts in the host country. Contract law typically provides for private remedies in the event of breach or non-performance by one party.

Sometimes, things happen within the host country that undermine the investment. Disruptive changes can be in the form of a sudden imposition of exorbitant tax, a change of law restricting certain industries, preferential treatment given to local competitors, or outright seizure of assets. The private contract might be of no avail because the investor will not be able to point to any particular breach of the contract.

FTAs often seek to protect the investor from such contingencies. Those protections that are commonly stipulated in treaties include:

■ Compensation against expropriation

Expropriation can be direct, such as the forcible seizure of property or the nationalisation of an industry. It can also be indirect, for example, laws that substantially deprive the investor of the benefit of its investment. Measures restricting or revoking licences can amount to indirect expropriation. Both the TPP and Acia set conditions for expropriation and require the payment of adequate compensation.

■ Fair and equitable treatment

Broadly speaking, the host state must not act unreasonably, arbitrarily, or contrary to the legitimate expectations of the investor. Both the TPP and Acia require due process in any legal or administrative proceedings.

■ Full protection and security

This protection requires the exercise of police power to protect the investment from unlawful damage, whether by rogue officials or private persons. Both the TPP and Acia include this concept, albeit not in exactly the same language.

■ Non-discrimination

Many treaties provide against discrimination of foreign investors. National treatment requires the host state to grant foreign investors, at the minimum, the same treatment that is given to its own investors. Most-favoured national treatment gives investors the right to treatment that is, at the minimum, as favourable as any given to investors of any third countries in like circumstances. The TPP and Acia have provisions for both national treatment and most-favoured nation treatment.

These are just common examples and there are numerous other provisions in the Acia and TPP inserted for the protection of covered investments and investors.

Investor-state dispute settlement (ISDS)

Historically, public international law developed to regulate relations between states. FTAs, like any other treaty, may contain provisions for the settlement of disputes between states in their capacity as states. The TPP and Acia are no exception. In addition to that, modern FTAs will generally also permit investors to bring claims directly against the host state.

When an investor's rights are violated, it can seek redress in the normal way under its contract if it can identify a breach of a contractual duty by its counterpart. If the violation is inflicted at the governmental level, the investor may also have to look beyond the contract for remedies under an FTA

Under a private contract, the dispute is normally referred for determination by either a domestic court or to arbitration. In most international transactions, the contract will provide for arbitration under a set of institutional rules, such as the ICC (International Chamber of Commerce), the SIAC (Singapore International Arbitration Centre) or the SCC (Stockholm Chamber of Commerce).

Investor-state disputes can also be referred to commercial arbitration like any other commercial dispute, if both parties have agreed to do so. Many investment contracts and trade agreements also provide for arbitration under the UNCITRAL Arbitration Rules. On May 27, 2016, SIAC launched its investment arbitration rules, and became the first commercial arbitral institution to have a set of rules designed for investment arbitration.

Apart from the options just mentioned, many investor-state disputes are determined in accordance with the dedicated ISDS regime of the ICSID Convention. The full name of the Convention is actually International Convention on the Settlement of Investment Disputes between States and Nationals of Other States. This Convention established the ICSID, which stands for International Centre for Settlement of Investment Disputes. The ICSID is part of the World Bank and is headquartered in Washington DC. An award administered by the ICSID is directly enforceable in any of its 161 member states.

The Acia and TPP demonstrate how trade agreements give a range of options for the settlement of investor-state disputes. Under the Acia, the parties should first try to settle an investment dispute by consultation and negotiation. If these fail, the investor has several options on where it might want to bring its claim. Its options include the courts of the host state, ICSID arbitration, arbitration under the UNCITRAL Arbitration Rules or arbitration in the Regional Centre for Arbitration in Kuala Lumpur (KLRCA) or, if both parties agree, to any other arbitral institution.

The TPP also requires the parties to attempt settlement through a process of consultation and negotiation. Similar to the Acia, if the dispute is not settled amicably, the claimant has options which include bringing a claim under the ICSID Convention, the UNCITRAL Arbitration Rules or, if both parties agree, any other arbitral institution.

Occasionally, an event can give rise to both a private contractual claim as well as a claim against the host state under an FTA. In such cases, the investor has rights under the private contract which co-exist with its rights under an FTA. Invariably, there are commercial and practical considerations in coming to a decision on whether to proceed under the private contract or elevate the dispute to one against the state. A dispute with the host state is a multifaceted problem because it is linked to the legal, economic and political environment in which an investor operates. It often requires a multi-pronged approach to resolve the problem.

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