AMG Market Commentary

March 2011

Geo-political tension fuels the rally in oil prices

The “Jasmine revolution” continues to roil North Africa and Middle East. Anti-government movement in Libya rapidly turned into armed conflict, and now the nation is practically in a civil war. As the struggle turned nasty, crude oil prices jumped. WTI crude oil topped USD 100/barrel, and Brent crude oil climbed to USD 116.

The turmoil in the region was started in Tunisia longer than 1 month ago, but international crude oil price has hardly moved until Libya became a mess. The reason is that war in Libya has lead to disruption to oil production and supply, which is not the case for Tunisia and Egypt. According to the estimated figure of International Energy Agency (IEA), Libyan oil production has dropped by 850,000-1,000,000 barrel a day. And several OPEC members have promised to make up the lost in oil output with its spare capacity. Given that the OPEC members has total spare capacity of 4 million barrels a day, they should be able to shield the international oil market from a severe shortage of supply even if all 1.6 million barrels daily output from Libya is lost.

So now, the biggest risk for international oil market and global financial markets is that oil production of major exporters such as Saudi Arabia, Iran, Iraq and Kuwait became affected. Fortunately, the anti-government protest in the major oil exporting countries is not as popular as in Tunisia, Egypt or Libya. The protestors in Saudi Arabia are mainly Shiites, which is religious minorities in the country. And for Kuwait, it is mainly the non-permanent citizens fighting for their civil rights. Moreover, the protest in the major oil exporters has not turned into large scale violent clashes and does not have any meaningful impact on oil production and output.

Given that lost production is met with utilization of spare capacity, the immediate impact on international oil market is contained and the rise in oil prices seems to be reflecting the worries about further impact on oil supply as anti-government protests continues. So, we would say the risk is priced in now. Unless the worry about disruption to oil production becomes reality, we would expect crude oil to trade in the range USD 100-120. And at this level, global economic recovery shall not be de-railed.

US : Positive

Non-farm payroll is reported for Feb 2011. Last month, total payroll rose by 192,000 while employers in private sector added more than 220,000 jobs. Strong payroll figures showed that U.S. job market is still on track of mild recovery and the poor figures reported for January was just due to poor weather conditions.
Higher commodities prices and perceived risk of rising inflation started speculations about policy directions in U.S. We would suggest investors to listen to the Fed as it is the Fed who determine the policy. In the latest FOMC statement, the Fed has explicitly stated that they are now paying more attention of inflation and change in inflation expectation. But, they believe the inflation pressure resulted from rising commodities prices should be temporary.

Core inflation and inflation expectation remain subdued. And they also confirm that the Fed will complete the asset purchase program by end of June according to the schedule. So, we do not expect any change to the monetary policy of U.S. any time soon. And the Fed will probably observe the change in job and inflation figures in coming months before they decide the next step.

Europe : Neutral
Consumption price index, the indicator for inflation rose to 2.4% for Eurozone. It has topped the 2% policy target for the last 12 months. The ECB refrained from lifting the interest rate last month. Yet, top officials are obviously talking in a more hawkish manner against rising inflation. In the press conference after the policy meeting, President Trichet stressed that “strong vigilance is warranted with a view to containing upside risks to price stability”. Very obviously, the ECB is sending signals to prepare the market for a rate hike while it does not necessarily means that they will act next month. Take last interest rate cycle as example, there was a 13 month time lag between the first rate hike and the appearance of the wording “strong vigilance” in the press conference statement. So, now the ECB has just started to signal an interest rate hike to the market, it could still be some time till the interest rate is lifted. And we would expect it to move in 4Q 2011, subject to the rise of higher than expected inflation.

China : Positive
Economic data reported for February showed that inflation pressure and new bank lending declined in China, it was in line with the policy target to bring inflation and liquidity under control. Some cheered on those figures. But, we think that seasonal effect due to Chinese New Year has a significant impact and it is doubtful if the policy goals have been accomplished. We still expect more tightening to come for China.

Emerging Markets : Indonesia : Positive
CPI growth dipped as food price inflation declined last month. Year on year change in CPI in Feb 2011 was 6.86%, 0.16% lower than Jan 2011. It was mainly due to lower food price inflation which declined from 16.2% to 14.85. And in the next 3 months, Indonesia will move into harvest season for rice. According to the statistics department, rice crop is expected to reach 63 million tonnes this year and a surplus of 4 million tones is expected for this year. Ample supply of rice, the main food crop for Indonesia shall help to ease inflation pressure.

Commodities : Positive
Oil prices rose as political tensions continue to grow in Middle East. WTI crude oil tops USD 100/barrel and Brent crude oil stays above USD 110 a barrel. But, according to Oil Market Report of the International Energy Agency, there is no severe shortage of supply in international oil market despite the disruption to Libyan oil exports. We think that crude oil will likely stay at around USD 100-120 and not breaching USD 150 unless oil production in major exporters e.g. Saudi Arabia, Iran, Iraq or Kuwait becomes interrupted.
Gold benefited again from chaotic situations as investors fled for safety, gold prices topped USD 1,400 an ounce again.

Hedge Fund : Neutral
Barclay Hedge Fund Index went up by 1.19% in Feb 2011, while Barclay CTA Index gained 0.94%.

Government Bonds : Negative
Negative rating is maintained for government bonds of U.S. and Germany. As we said last month, rising inflation pressure has hurt the Treasuries and Bunds. And lately, the Fed and ECB explicitly expressed their concerns about rising inflation. Clearly, higher inflation shall take it tolls on their bonds.

Things to Look Forward :
For the financial markets, the biggest risk with the political turmoil in Middle East is the impact on oil output and therefore oil price. Thus far, oil production in the region is largely unaffected with the exception of Libya. The impact on global oil market is still contained. If the lost of oil output does not escalate, we would expect oil price to be contained below USD 120.

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The loose monetary policy introduced by U.S. and Europe has been a major driver for the recovery of global economy and financial markets. Now, it seems that ECB is turning hawkish and the next move by the Fed unclear. The chance for interest rate hike in U.S. and Europe is getting higher and expect it to cause volatility in financial markets.

* All figures and information are collected from International Energy Agency (IEA), Bloomberg.com & Barclay Hedge.

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