Government Actuary's Department

Investment News

Monthly Bulletin from the Investment & Risk Team

December 2014

Last Month in Brief

In November, oil prices reached a 4 year low (see reverse) as a result of stagnating factory output in China and Europe and OPEC's decision against decreasing its output ceiling. The plunging oil prices mean Russia's rouble has continued to fall (as much as 6% against the dollar) to a new record low.

In the UK the lower oil prices have reduced inflationary pressures and led to the continued push back of expectations for the timing of a BoE interest rate rise.

UK manufacturing activity increased in November and the Purchasing Managers' Index (PMI) stands at a four-month high of 53.5 (with a score of over 50 indicating growth), as solid domestic orders offset the decline in new export orders and job creation accelerates.

Japan's credit rating has been downgraded to A1 (from Aa3) by Moody's as doubts increase about its ability to reduce debt levels. The A1 rating is one level lower than China and South Korea, and four lower than the US and Germany, which both have the highest Aaa rating.

U.S. Stocks began to fall at the end of November despite manufacturing growing faster than expected. At the month-end US PMI stood at 58.7 (down 0.3% on previous month), the fall is attributed to China's PMI dropping to 50.3 and fewer Black Friday sales than expected.

Chart 1: Equity Indices

Equity markets rallied during November.

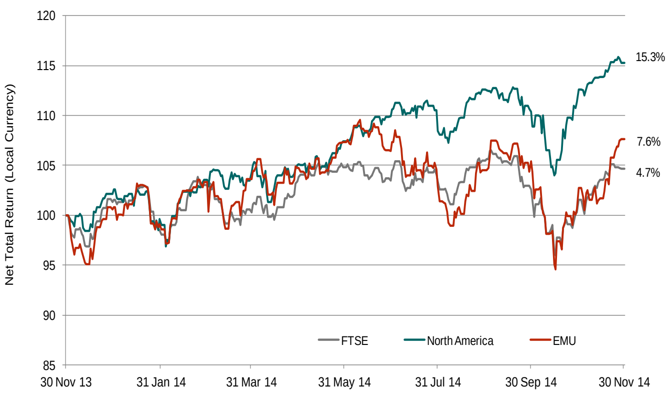


Chart 2: Sterling Credit Spreads

Spreads ended November slightly higher

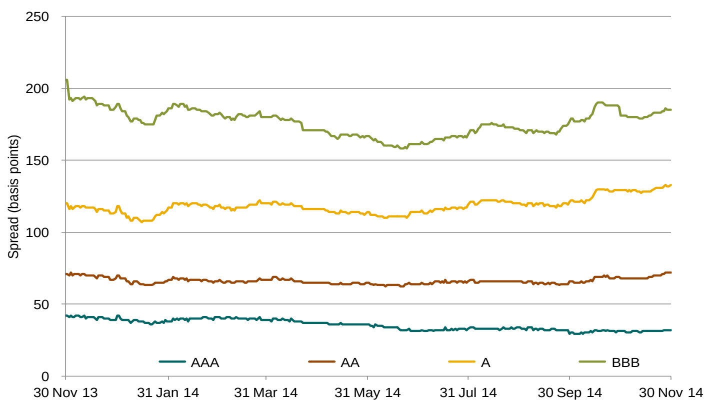


Chart 3: Gilt Yields

Gilt yields ended November slightly lower

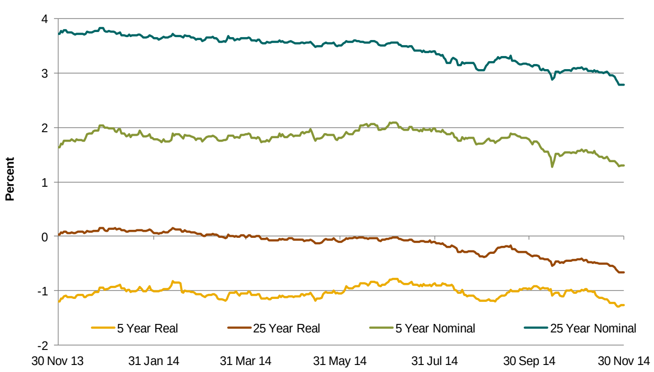
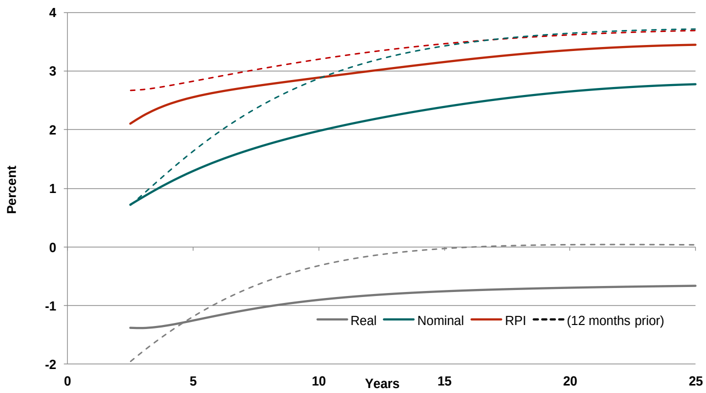


Chart 4: Gilt Spot Curves



Source: Financial Times, MSCI, Merrill Lynch Bank of America, & Bank of England

	Latest	Previous		Latest	Previous
CPI increase (annual change)	1.3%	1.2%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	87.9%	89.2%	**QE Level**	£375bn	£375bn
Halifax house prices (monthly change)	-0.4%	0.6%	**VIX (volatility) index**	13.33	14.03
IPD TR property index (monthly change)	1.5%	1.7%	**$/£ exchange rate**	1.57	1.60

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

Falling oil prices and the impact on the economy

Oil prices are seen as a key indicator of the state of the global economy. In November 2014, oil prices reached a 4 year low, falling to below $80 a barrel (see box 1).

What has caused the recent fall in prices?

Put simply, falling oil prices have been driven by global over-supply and falling demand.

In the last few years, US production has increased significantly. Technological advances have allowed access to previously unreachable reserves meaning that production levels of oil in the US have nearly doubled since 2010, reaching almost 9 million barrels a day. Along with this, US oil consumption has generally fallen and subsequently improved the net export/import position of the country.

Conflicts and political unrest in various oil producing countries such as Libya, Iraq and Russia led to fears of disruption in the supply of oil and consequently prices maintained high levels at over $100 at the beginning of the year. However, production was maintained at steady levels with minimum interruption in the supply which subsequently caused the prices to fall from the high levels analysts and investors had become accustomed to.

Box 1: Brent Crude Index ($US/bbl)

Oil prices have fallen dramatically since the summer

On the demand side, a slowdown in global economic growth has also contributed to falling oil prices. China's economic growth in the third quarter of 2014 was at its weakest since 2008 and low domestic demand, alongside reduced construction and mining activities, have translated into a reduction in consumption and demand for oil.

In Europe, concerns about economic growth, with the IMF lowering the Eurozone growth forecast to 0.8% in 2014 and 1.3% in 2015, have caused uncertainty amongst investors. The International Energy Agency cut its world oil consumption growth forecast in October 2014 for the fourth time since June and forecast oil consumption levels to expand at the slowest pace since 2009.

How has OPEC responded?

The Organisation of the Petroleum Exporting Countries (OPEC) is an intergovernmental organisation of oil-producing countries. It's mission is to coordinate policies amongst member countries with the aim of stabilising prices and ensuring regular supply.

Despite investor expectations that OPEC might decide to reduce the output ceiling in an attempt to stabilise prices, it decided at a meeting in November to maintain production at current levels. The OPEC secretary general stated that oil producing nations would not be rushed into action in light of the price drop, instead taking the view that the market will stabilise itself.

Saudi Arabia, the world's largest exporter of oil, seems unwilling to decrease supply just to alleviate the downward pressure on prices. Instead, it wishes to maintain production at current levels in an attempt to maintain market share and compete against US shale oil.

Whilst Saudi Arabia was a key driver of OPEC's decision to maintain the output ceiling at current levels, the decision was far from unanimous amongst OPEC ministers. Some OPEC members rely on high oil prices to balance budgets and hence had pushed for a cut in production to boost oil prices.

What is the impact of falling oil prices?

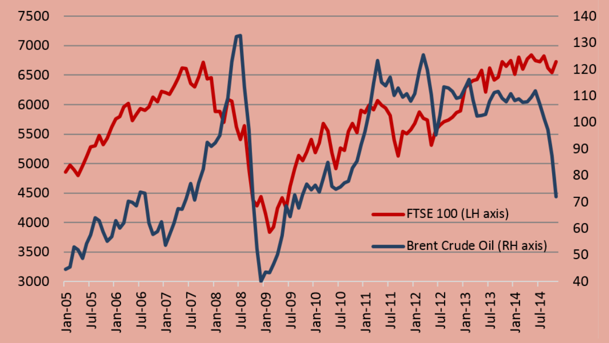
As oil is a major input in the economy, low oil prices are likely to translate to lower inflation. In the UK, this might ease pressure on the Bank of England to increase interest rates and hence encourage economic growth. However, lower inflation might not be welcome in areas such as the Eurozone which is already suffering from deflationary pressure.

Shares in energy companies are heavily linked to oil prices and as a result, energy stocks fell as investors reacted to OPEC's decision not to impose cuts in production. These companies make up 16.3% of the FTSE100, with the Oil and Gas producers making up two of the top five constituents of index.

Also, companies who have large expenditure on fuel and oil-based products such as airlines, plastics and chemical companies may benefit from the decline through a decrease in costs. As a result, shares in these stocks might be expected to increase from the falling oil price. In addition, a reduction in costs might be passed on to the consumer, and act as a stimulus for economic growth.

The correlation between oil prices and equity markets as a whole is not clear cut. Although traditionally it was thought that equities and oil prices were inversely correlated (as falling oil prices reduce production costs), that relationship has been relatively weak and can invert during different time periods (see box 2).

Box 2: Oil prices and equity markets



In recent years oil prices and equity markets have tended to move in tandem - perhaps reflecting the significant market cap of energy companies in the FTSE 100. However, the recent oil price fall has seen this relationship break down.

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