Philequity Corner (May 14, 2018)
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Rising oil prices – Culprit behind high inflation & current account deficit

The surge in inflation which rose to a 5-year high of 4.5% in April 2018 has been blamed on the TRAIN Law, the weak peso and many other factors. But one of the main culprits why inflation is surging is the sharply higher oil prices - already up by 50% year-on-year.

Effect on inflation

The sharp surge in crude oil prices the past year had a huge effect on the country's inflation rate, especially since the Philippines is a net oil importer. High oil prices directly affect the prices of crude oil and petroleum products we import. In addition, it indirectly adds to inflation through higher transportation and manufacturing costs.

Impact on the trade balance

The effect of high oil prices on the domestic economy is also evident when we look at the latest trade data from the Philippine Statistics Authority (PSA). While imports are basically flat (up 0.1% year-to-date) in the month of March 2018, the value of petroleum crude imports surged by 63.9% mainly primarily due to higher oil prices, in addition to a weak peso. According to the PSA, the trade deficit expanded to $2.61 billion in March 2018 from $2.1 billion in March 2017.

Why are oil prices going up?

Crude oil prices have been on an upward trajectory the past year primarily due to the OPEC output cuts, heightened geopolitical risks and strong global oil demand. In recent weeks, rising geopolitical risks coming from Iran and Venezuela have pushed crude oil prices above $70 per barrel. WTI Crude closed at $70.51 per barrel while Brent Crude closed at $77.12 per barrel last Friday– both registering their highest weekly close in nearly 4 years.

US backs out of Iran deal

Last week, US President Trump announced that the US is backing out of its 2015 Iran nuclear agreement and re-imposing oil sanctions to OPEC's 3rd largest oil producer. Iran produces an estimated 3.8 million barrels of oil per day, and exports between 2 million to 2.5 million barrels of oil per day. While other parties to the 2015 agreement, namely China, France, UK, Germany and Russia, have not reneged the pact, analysts expect a reduction of around 0.2 to 0.5 million barrels per day over the next six months.

Venezuela's dwindling oil output

Besides Iran, another major issue is the protracted collapse of Venezuela's oil industry. Decades of mismanagement and underinvestment have resulted in huge cuts to Venezuelan oil output. According to EIA, oil production declined 30% from 2.3 million barrels per day in January 2016 to 1.6 million barrels per day by January 2018. Missed debt payments have affected joint ventures and have led to a seizure of its oil assets. The recent arbitration case which was ruled in favor of Conoco Philipps may start a wave that will further cripple Venezuela's oil industry.

OPEC/Russia output cuts extended to end-2018

The developments in Iran and Venezuela further tightens global oil supplies at a time when the supply of crude is already falling short of demand. Note that OPEC, Russia and several other non-OPEC producers began to cut their output in January 2017 in order to address a supply glut. In later meetings, these countries agreed to extend those cuts up until end-2018 even after the glut appears to have been wiped out. Recent estimates from EIA show that global oil inventories fell an average of nearly 0.6 million barrels per day in each of the past five quarters from January 2017 through March 2018.

Strong global oil demand

In contrast, global oil demand growth has been robust. EIA estimates that global oil consumption in 1Q2018 was 1.9 million barrels per day or 2% higher than in 1Q2017. Stronger global economic growth is driving greater demand for oil. IMF expects global growth to remain strong for the next couple of years and has revised its global growth forecast for 2018 and 2019 to 3.7% and 3.9%, respectively.

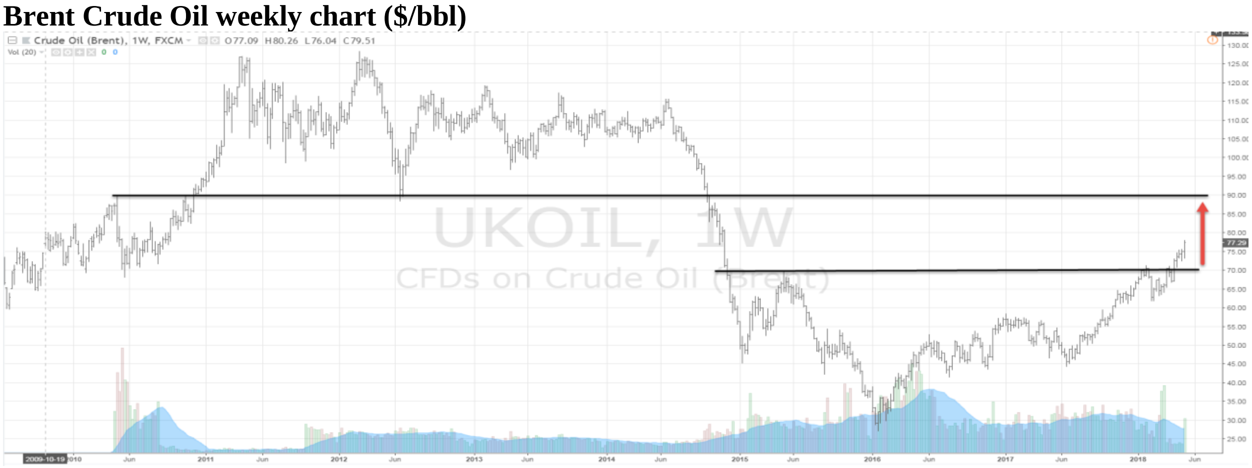
Saudi Aramco IPO

There is also news that Saudi Arabia is targeting oil prices at $80 per barrel to boost the valuation of Saudi Aramco IPO. Saudi officials are looking to raise $100 billion by selling 5% of the state giant which they believe to be worth $2 trillion. Saudi Arabia’s motivation for higher oil prices is certainly driving price expectations higher.

Technical breakout targets $90 per barrel

The technical picture is very bullish for oil prices. The major resistance level of $70 per barrel was tested a couple of times this year and was successfully broken last April. The break above $70 to a new 3-year high of $77.12 confirms a possible price move towards the next resistance level at $90 per barrel.

Brent Crude Oil weekly chart ($/bbl)



BSP raises rates, signals further action if necessary

As we expected, the BSP rates interest rates last Thursday to address the buildup of inflation pressures as mentioned in last week’s article (see *Philippine Peso recovers across the board*, May 7, 2018). The BSP raised its reverse repo rate by 25 basis points to 3.25% - its first hike since September 2014. It also revised the inflation forecast for 2018 to 4.6% from 3.8%. But more importantly, the BSP Gov. Nestor Espenilla, Jr. signaled that the BSP is ready to take further action if necessary *“to ensure the achievement of its price and financial stability objectives.”*

Philippine stocks rally

This move by the BSP to raise its key rates and signal further action if necessary was well received by the market. Investors also cheered 1Q2018 GDP growth of 6.8% as growth in government spending kicked-in at a 15-year high of 17.2% As a result, the PSE index rallied by 2.39% last Friday to close strongly at 7,752.11.

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