Oil, stocks and our lives

Stocks worse off due to soaring oil prices

Mark Story - July 17, 2008

Over the last year the rise in oil prices has added around $20 to the average Australian household's weekly petrol bill, and if consensus forecasts are right, it's going to get worse. Shane Oliver chief economist with AMP Capital Investors expects shares to rally sharply in the December quarter as oil prices fall back in line with supply and demand fundamentals.

But over the longer-term an expectant jump from current levels (US$145) to around US$200 a barrel would see petrol prices in Australia hit A$2.30 a litre. And given that the single biggest driver of CPI increases is imported from offshore in the form of oil, Australia's inflation rate could conceivably hit 6%.

Supply dynamics aside, oil prices are also being impacted by underlying weakness in the US$. According to Opec president Chakib Khelil, each time the dollar falls 1%, the price of the barrel rises by a corresponding $4, and vice versa.

Closer to home, rising fuel costs may act as a restraint on further central bank activity. But there's growing speculation that the corresponding impact oil is having on food costs will force the Reserve Bank of Australia (RBA) to nudge interest rates up (from 7.25%) one more time to ease inflationary pressure.

Spiraling energy costs and high interest rates will put downward pressure on all stocks. And the more directly wired shares are to both higher oil prices, and a direct by-product - the lowest consumer and business confidence levels since the recession of the 1990s – the more they'll be affected.

So how are higher oil prices and inflation affecting our spending habits? Well, for starters, our lifestyles are changing, with higher petrol prices cutting into household budgets. Surprise, surprise we're driving less, per capita consumption of oil has fallen to 12.93 litres a week. According to Access Economics, higher interest rates and costly petrol will suck an estimated A$12.5 billion out of the economy in 2008.

These numbers are also responsible for a 17 year low in housing credit in the May, a 5.3% fall in new home sales, a 6.5 per cent drop in building approvals and an 18.1% fall in year-to-date home loans (ex refinancing).

Unsurprisingly, shares within the housing, building services and lending sectors are feeling the heat from soaring oil prices. This in part, explains why UBS strategist David Cassidy puts banking sector 2007-08 earnings growth at close to nil, with insurance projections down 20 per cent.

Higher funding costs and a stagnant housing markets are also keeping the pressure on listed property trusts with the Australian REIT index falling to its lowest level since 2001. Mirvac Group has downgraded its fiscal 2008 earnings guidance and cut the carrying value of its assets amid a slowing global economy.

Admittedly, all shares are (in varying degrees) hostage to short and long-term oil prices. But if statistical research going back 15 years by Citigroup Global Markets found anything meaningful, it's that bank share prices typically go down when oil prices go up.

Citi's research confirms that the share prices of stocks directly exposed to housing, transport and consumer discretionary spending are highly vulnerable to oil price increases. According to Citi's research, every 1% drop in the price of oil led to a -3.26%, -3.24%, -3.13% and -2.33% share price drop in Boral, Cabcharge, David Jones and Qantas respectively.

ABN Amro expects record fuel prices, plus declining load factors and yield to cut Qantas's net profit in 2010 by 17.7%, while UBS only expects Virgin Blue to break even in the second half of 2008. Ironically, retail sales were marginally higher in May, yet this may have been an abberation of savvy shoppers scooping end of (financial) year bargains. Interestingly, food staples such as Woolworths, typically regarded as defensive had a higher than expected exposure to oil - with every 1% price drop having a -2.40% impact on the share price.While not on the Citi list, retailer Harvey Norman's share price has halved since early January. But major share price losses by Harvey Norman and other retailers probably has more to do with the oil shock coming immediately on top of the credit crunch.

Gerry Harvey executive chairman attributes Harvey Norman's recent warning of a sales slump in June, plus announced new building delays to both oil and a 20% jump in steel prices. Meantime, other retailers have signaled slower conditions with fashion retailer Just Group and electrical chain Clive Peeters warning of 14% and 25% earnings downgrades respectively.

Clearly, industrials stocks, like materials group, Boral that uses energy in manufacturing are also in the eye in oil price hikes with Cassidy forecasting low single digits for most of the sector. Using 160 million litres of diesel a year, Boral, warned that unexpected increases in energy and transportation costs will put pressure on its forecasted earnings.

Stocks with a negative sensitivity to oil prices
(Citigroup Global Markets)