



## Inflation, stagflation and deflation...all the rage for Oil?

Price action to date remains frustrating as the commodity continues to oscillate around US\$83.00 and US\$78.50. Market rhetoric continues to be divided however, we are getting a little lift in discussions concerning the effects of inflation in our economies and as a result debate on the future direction of primary inputs. As a result we feel it is fitting to have a discussion on inflation and how it could affect the future price for oil.

As it stands we continue to experience benign inflation in Europe, the UK and the US where it is trading well below central banks (CB) bands, yet across the world in Asia, in particular, India and China we have opposite experiences. Here the CBs have been hard at work tightening monetary policy by lifting interest rates in India and bank reserves in China. Prospects and forecasts remain positive that the CBs will continue as long as price pressures to the upside remain strong.

Generally speaking we experience three types of pricing pressures in economies;

1. Inflation, which is a general rise in the level of prices of goods and services in an economy over a period of time. Here inflation can be further grouped into a demand pull, cost push and built in inflation environments.
2. Deflation; which is a fall in the price level of goods and services.
3. Stagflation which is a combination of inflation, slow economic growth and high unemployment.

At the present we feel that global economies can be divided into two camps, those experiencing inflation such as the emerging economies of India and China and those economies, mainly G7 where they are experiencing benign inflation with high unemployment. At a time when oil inventories continue to build it is important that we understand how these varying economics, in particular conditions in India and China, the current engine rooms for growth, can affect the demand for oil. How can these economic occurrences affect the demand for oil?

India at the moment has a major inflationary concern. The stock market is currently extending last years rally which was the largest in 18 years and domestic spending remains robust. India is the number three economy in Asia expanding at an annual rate of 8.2%, it's industrial production gained 16.7% in January when compared to the same period the year before. The RBI only last week raised interest rates and we expect further tightening to continue for the foreseeable future as they look to combat inflation and the risk of an asset bubble. The current inflation rate is 9.7% well above the RBI targeted band so the need to rain in monetary growth is essential.

In China, we continue to read news that the PBoC continues to increase the reserve requirements of Banks which can be viewed as an effective tool to manage price pressures. The current inflation rate in China is about 2.7% which is again outside the targeted band set by the PBoC. Industrial production for February came in strong at 12.8%, although slightly weaker than forecast it is still extremely strong. The key for both these economies is for them to maintain the expansion process on both a domestic/international level whilst controlling local spending and manufacturing. If this is achieved then the demand for Oil will remain strong, if not grow as well.

As it stands consumption out of Asia (China, Japan, India and Korea) accounts for over 20% of global consumption which is just below that consumed in the US which stands at 24.3%. So if growth continues at the current rate we feel that demand for the commodity is justifiable and prices should break the US\$83.00 levels however, efforts to slow emerging market growth may see investors adopt a knee jerk reaction and adopt a bearish stance whilst this tightening occurs. This is a concern in particular as we see G7 economies in the process of withdrawing stimulus packages. At present there are neither price pressures nor other inflationary pressures in G7 economies and at a time when inventories remain stubbornly high any negative sentiment in Asia could just start the ball rolling and help prices trading lower. This would also confirm that we are in fact still in the wide trading range of US\$83.50 to US\$70.25.

Technically, the price action has been neutral pretty much since the end of February and traders have been jostling for a direction. We expect a break out soon and remain vigilant to this. Keep focused on US 83.00 and US\$78.50 as a break either way could see a trend develop. Our preferred positions at the moment is still bullish as we believe that Asian demand will remain robust however, I would not be surprised if the bears take hold in anticipation that economic growth in Asia will slow as a result of the tightening in monetary supply. In doing so I would trade the break on the downside through US\$79.50.



Happy trading..... JB