Northern Trust

DAILY ECONOMIC COMMENTARY

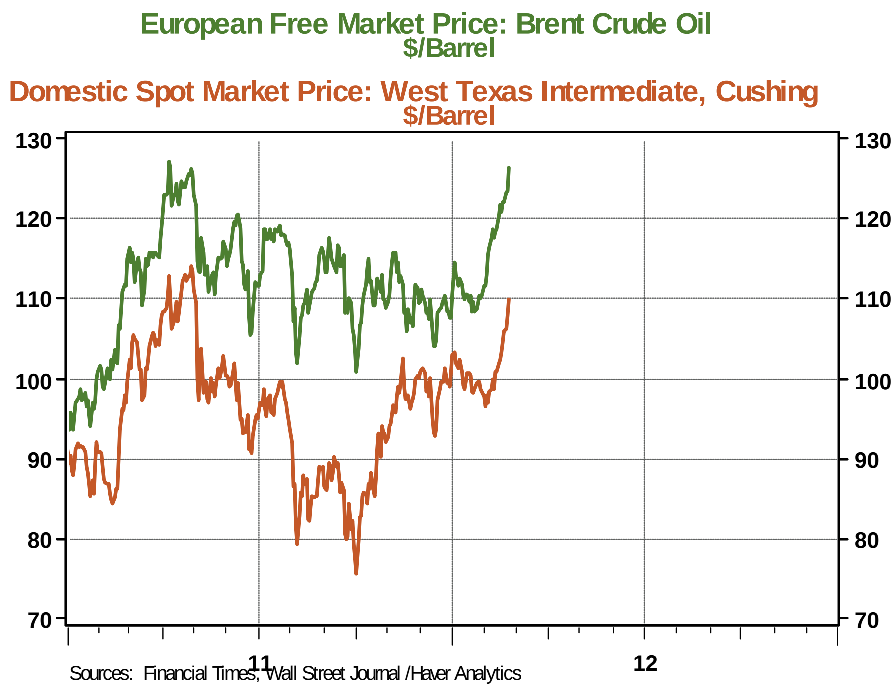
Oil Prices – One More Perspective for 2012

February 27, 2012

Asha G. Bangalore
agb3@ntrs.com

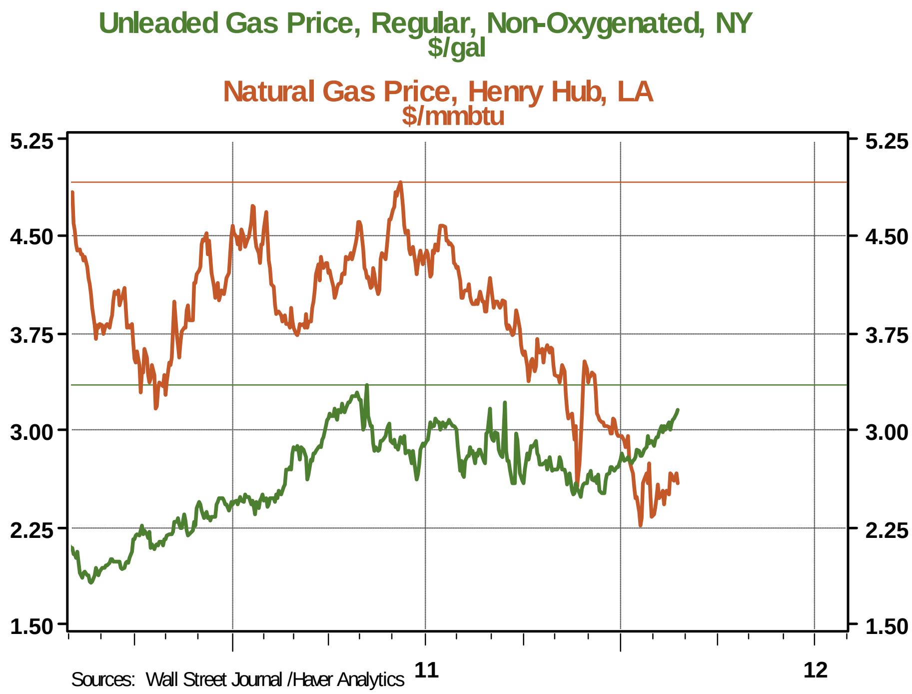
Crude oil prices lost ground in today's trading (down around $1.31 for Brent crude and decline of $1.21 for U.S crude oil, data points stop at quotes for February 24 in Chart 1.) Needless to say, the impact of rising oil prices is one of the pressing economic issues in the past few days. Here is one more perspective.

Chart 1



A good place to start is gasoline prices in the United States. Gasoline prices (excluding taxes) closed at $3.16 on February 24, which is higher than readings seen a year ago and it is close to the peak ($3.22) registered in 2011 (see Chart 2). At the same time, natural gas prices show a significant decline in the past year. Natural gas prices stood at $2.60 on February 24 vs. a peak of $4.91 in 2011 (see Chart 2). Here is an important partial offset that should soften the blow from higher gasoline prices to consumers.

Chart 2



In addition, employment conditions show an improvement in the last few months vs. early 2011. The unemployment rate in January 2012 was 8.3% vs. 9.1% in January 2011 (see Chart 3) and initial jobless claims show a noticeable downward trend (see Chart 4). Putting these pieces of information from the demand side, purchase of gasoline in the United States is not likely to show a rapid decline in the near term. At the same time, the higher price of gasoline should translate into a jump in profits of oil producing companies. At the margin, if higher oil prices reduce discretionary consumer spending, profits of oil companies could make their way into economy through other conduits – increased investment expenditures of oil companies, larger dividends to shareholders of oil firms, and buying back of equities.

Chart 3

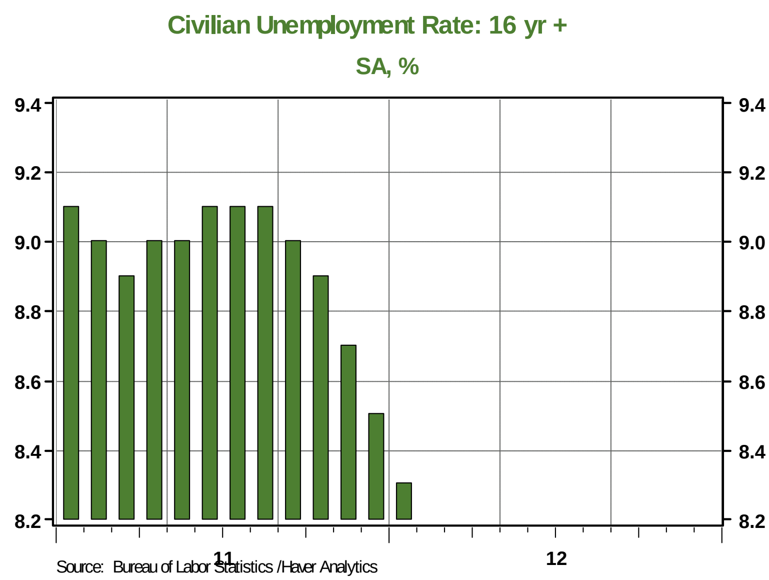
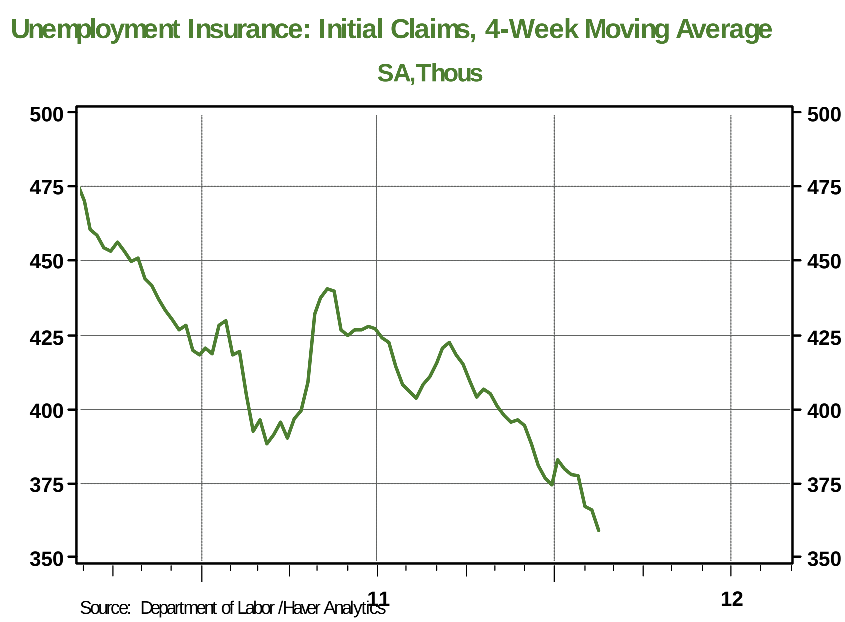


Chart 4



From a global standpoint, the eurozone is most likely to experience a recession in 2012. The IMF/World Bank projections show advanced nations growing at a 1.2% pace in 2012 vs. 1.6% in 2011, while emerging economies are predicted to grow 5.4% in 2012 compared with a 6.3% increase in 2011. China, an economic juggernaut, is likely to advance 8.2% in 2012 vs. 9.2% in 2011. These forecasts imply near term demand pressures on oil prices are likely to be more benign in the months ahead compared with the first-half of 2011

Moving on to the supply side of the equation, the 2011 Arab Spring led to higher oil prices temporarily in 2011. This time around, the Iran situation is the not the only source of supply pressures. The Economist (Oil markets: High drama | The Economist) notes that supply disruptions of oil are occurring from a pipeline dispute in Sudan, striking workers in Yemen, and repairs in the North Sea; all of which are transitory setbacks that have led to recent gains in oil prices. The bottom line is that demand and supply both determine the price of oil. The recent shortage of oil is a passing event in 2012 which is likely to be overshadowed by soft economic conditions in 2012, particularly in Europe, until world GDP growth gains momentum. That said, a sustained increase in oil prices due to geopolitical tensions is a legitimate risk to bear in mind for the economic outlook of 2012.