Group Economics

Ulster Bank

Milk sheikhs & oil sheikhs rattled at the price of black & white

Contact: Richard Ramsey
Chief Economist, Northern Ireland
02890 276354 or 07881 930955

Richard.ramsey@ulsterbankcm.com
www.ulsterbank.com/economics
Twitter @UB_Economics

This is an extended version of an article that appears in Belfast Telegraph Business Month published 2nd February 2015

Arguably the biggest surprise of 2014 was the collapse in the oil price. Few economists if any predicted the price of a barrel of Brent crude to fall by almost 60% in just 7 months. Having peaked at $115pb last June, the European oil price benchmark hit $45pb last month. This represented the lowest level since March 2009 which coincided with the depths of the global recession. Since then, the oil price has largely fluctuated between $48-50pb.

The sharp fall in the price of oil provides a welcomed boost to consumers' disposable income the world over as it feeds through into lower energy and petrol / diesel prices. UK petrol prices have already fallen by 17% y/y at the time of writing. Falling oil and food prices helped the UK consumer price index fall to its joint-lowest level in December since records began in 1989.

Whilst falling commodity prices are viewed as a positive from a consumer viewpoint, they are seen as a negative for producers. The mismatch between supply and demand is largely, but not solely, due to a glut in supply. It is noted that US crude oil inventories in December surged to their highest level for the month since 1930 as production climbed. Meanwhile the US shale boom, which was in response to high oil prices, propelled crude oil production to its highest December figure since 1972.

Traditionally, when oil prices fall, OPEC, the oil cartel's policy was to cut production to prop up the price. However, OPEC's most significant oil producer, Saudi Arabia has recently stated that it will not cut production even if the oil price falls to $20pb. In essence, Saudi Arabia is playing a game of chicken with other, higher cost producers, to cut output instead as it seeks to maintain market share. This would include the US shale oil producers. Other high cost oil producers such as Venezuela and Russia will suffer too. A number of US and UK oil producers have already announced significant job losses as they adjust production levels to the new reality.

Will we see a rebound in the oil price soon? Back in the mid-1980s the oil price plunged by 69% between November 1985 and April 1986. It took four years for prices to return to their pre-downturn high. Again this was due to the build up in oil supply from the North Sea and Alaska oilfields. Development of these oilfields followed the oil price boom in the 1970s. Meanwhile an influential Saudi oil investor, Prince Alwaleed Bin Talal, has said that the world will never see $100pb again. "There's an oversupply and demand is not so high" he added. According to the Saudi Prince the road back to the $60-$70pb range will be "not that easy, not that quick" and markets still may not have found the bottom yet.

The fall in the oil price has been part of a wider story; namely, a collapse in global commodity prices. The closely watched Bloomberg Commodity index, which tracks the prices of a range of commodities *(e.g. industrial metals, agricultural commodities, precious metals, oil and gas)* has fallen by over a quarter since June but is currently at its lowest level since December 2002. Oversupply and weakening demand has been evident across a range of commodities. Iron ore, which is used for steel, is at a 5-year low as an economic slowdown in China, the world's biggest user, is giving rise to a surplus in the metal. The price of copper is also on the slide for the same reason with the metal at its lowest level since July 2009.

The falling cost of metals will be welcomed by those in the construction industry. On the precious metal front, the gold price is less than 5% below its recent high 6 months ago. The European Central Bank's (ECB) it will launch a Quantitative Easing (QE) programme next month has boosted the gold price as it is viewed as an inflation hedge. Nevertheless, with disinflation and deflation more of a concern than inflation, the price of gold remains almost one third below its 2011 peak when the Federal Reserve, the Bank of England and the

ECB were all overshooting their respective inflation targets. Furthermore, both the Fed and BoE were both engaged in quantitative easing programmes at this time whereas now they are not.

Given that oil is a key input cost for fertilizer and feedstuffs, agricultural inflation tends to track the oil price. It is therefore not surprising that agricultural commodity prices have been falling too. For example, wheat prices have fallen by 30% since the middle of last year. More significantly from a Northern Ireland-perspective though is something else that has been happening on the farm.

Financial markets have been focused on the price of the black stuff; however, our dairy farmers have become increasingly concerned about the price of the white stuff – milk. There are some similarities between the two markets. Prices received by dairy farmers are down approximately 40% relative to last year and recently hit a seven-year low. The global milk market, like that of oil, is suffering from a glut in supply. Producers responded to high prices by increasing production, particularly in the US and New Zealand, with the UK set to produce its highest output in 20 years. Rising yields have been boosted by super-intensive farming which in turn has been aided by cheap grain. Weather conditions have also been favourable. However, demand for milk has been waning, particularly from China. The world's largest economy bought heavily in H1 2014 but has yet to return to the market.

Meanwhile Russia's ban on EU food imports has closed the door on one significant market for milk products. The demand and supply dynamic has pushed the price of milk below the cost of production. A supermarket price war is compounding the problem. Indeed, the price of some four-pint bottles of milk has fallen below the price of bottled water. Unlike oil, milk cannot be stored offshore in supertankers waiting for the price to rise. It is a case of use it or lose it. Turning it into cheese is one option. However, demand for this product has fallen too with Russia's ban on EU imports. We may hear more about EU 'cheese mountains' in the months ahead.

Barring a major weather event, to curb production, 2015 will be a very challenging year. Most local farmers will be producing milk at below the cost of production. Meanwhile the EU, like OPEC, is not going to reduce output. Instead, the EU is set to do quite the opposite by ending 31 years of restraining milk production through its policy of milk quotas. In the meantime, political pressure is mounting for the EU to raise its minimum purchase price for unsold milk from around the 15-16 pence per litre mark. In common with the oil production industry, the lower the price the louder the cries will become for market intervention. Outside of these difficulties the ongoing slide in the Euro/Sterling exchange rate will continue to make a difficult situation worse.

Milks sheiks and oil sheikhs have been rattled by the plunge in the price of black and white. Supply and demand in both markets are out of synch. Balance will eventually be restored with inefficient oil producers being knocked-out of the market at current prices in an international game of oil price limbo. Efficient producers, notably Saudi Arabia, will remain to take advantage of rising prices when they return. Despite some short-term pain, Northern Ireland's relatively efficient milk producers, like their oil producing equivalents in Saudi Arabia, should prosper once more when the price of milk eventually rises.

Richard Ramsey
2nd February 2015

This document is issued for information purposes only for clients of Ulster Bank Group who are eligible counterparties or professional customers, and does not constitute an offer or invitation to purchase or sell any instrument or to provide any service in any jurisdiction where the required authorisation is not held. Ulster Bank and/or its associates and/or its employees may have a position or engage in transactions in any of the instruments mentioned.
The information including any opinions expressed and the pricing given, is indicative, and constitute our judgement at time of publication and are subject to change without notice. The information contained herein should not be construed as advice, and is not intended to be construed as such. This publication provides only a brief review of the complex issues discussed and readers should not rely on information contained here without seeking specific advice on matters that concern them. Ulster Bank make no representations or warranties with respect to the information and disclaim all liability for use the recipient or their advisors make of the information. Over-the-counter (OTC) derivatives can involve a number of significant and complex risks which are dependent on the terms of the particular transaction and your circumstances. In the event the market has moved against the transaction you have undertaken, you may incur substantial costs if you wish to close out your position.

Ulster Bank Limited Registered Number: R733 Northern Ireland. Registered Office: 11-16 Donegall Square East, Belfast BT1 5UB.

Authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. Member of The Royal Bank of Scotland Group.

Ulster Bank Ireland Limited . A private company limited by shares , trading as Ulster Bank , Ulster Bank Group and Bank Uladh. Registered in Republic of Ireland. Registered No. 25766. Registered Office: Ulster Bank Group Centre, George's Quay, Dublin 2. Member of the Royal Bank of Scotland Group. Ulster Bank Ireland Limited is regulated by the Central Bank of Ireland.

Calls may be recorded.

Ulster Bank Limited accepts no liability for the outcome of any actions taken arising from the use of this article