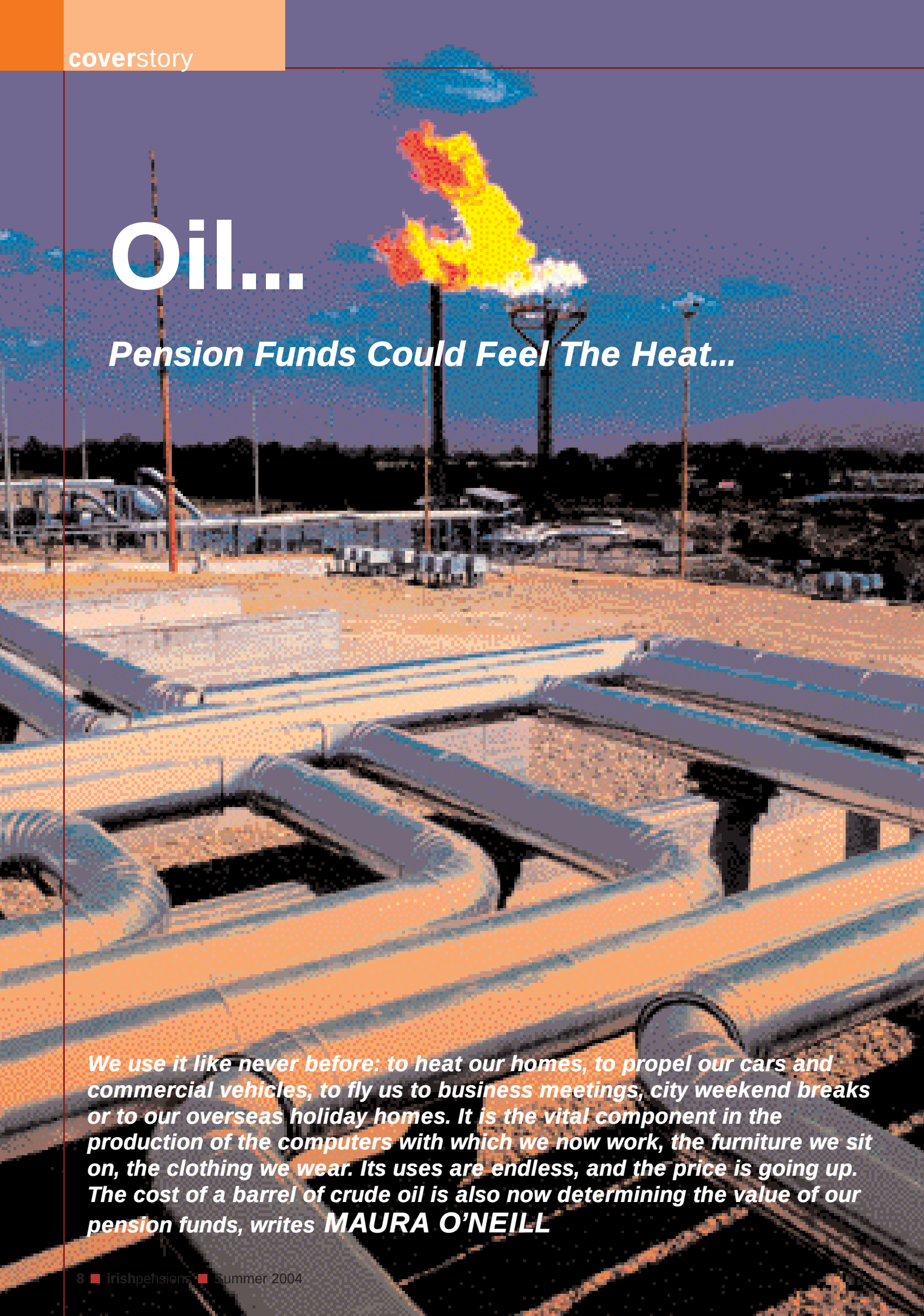


Oil...

Pension Funds Could Feel The Heat...

We use it like never before: to heat our homes, to propel our cars and commercial vehicles, to fly us to business meetings, city weekend breaks or to our overseas holiday homes. It is the vital component in the production of the computers with which we now work, the furniture we sit on, the clothing we wear. Its uses are endless, and the price is going up. The cost of a barrel of crude oil is also now determining the value of our pension funds, writes MAURA O'NEILL

World oil demand in 2004 will rise to its highest level since 1980, according to the International Energy Agency, as stronger economic growth leads to higher consumption in India, China and the US. The price of a barrel of crude oil is up 16% this year because of rising demand, refining bottlenecks that limit petrol supplies and growing concern that Middle East supplies will be disrupted.

Yet higher oil prices have not led to reduced demand for the black stuff. Demand in China, the second largest oil consumer after the US will rise by 14 percent this year. By 2025 it is estimated that China could be consuming 10 billion barrels a day, five times its 2002 consumption.

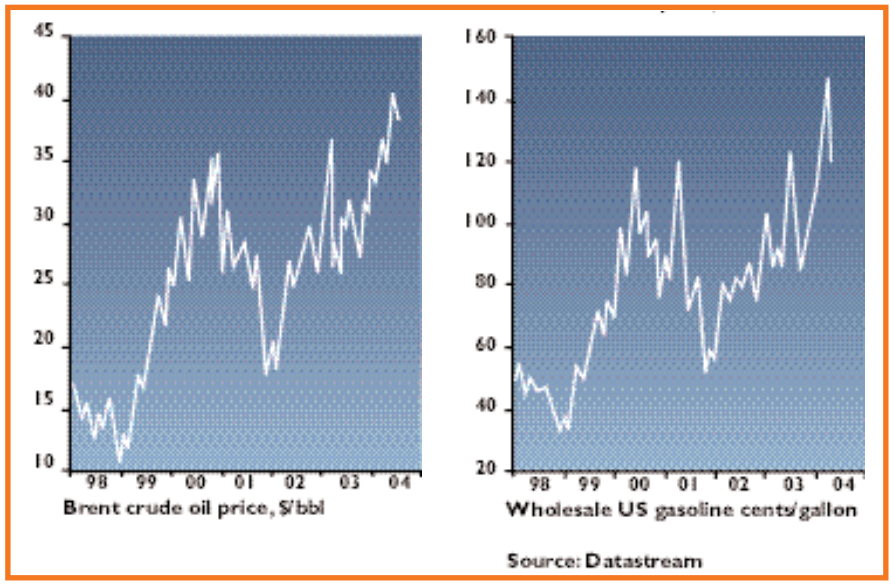
ENERGY PRICES HAVE RISEN SHARPLY

Global oil production has soared in 2003 and is now at 95% of capacity. If demand continues to grow at the current pace then spare capacity could be used up within a year. With demand expected to remain strong, and no gush of new oil predicted in the foreseeable future, the current high prices are unlikely to be a short term phenomenon.

Not everyone agrees. The chief economist at BP says, "There is no global resource or reserve shortage, and oil reserves in Russia may rise significantly in the coming years. In 1980 the oil reserve-to-production ratio was only 29 years. The world has produced 80% of the proved reserves of 1980 and we are still left with 70% more reserves than when we started as a result of exploration successes and new technologies". The company's annual review of energy trends stated that it would take 41 years to deplete the amount of oil left in the world.

STOCK MARKET IMPLICATIONS

There have been eight periods since 1970 which have seen a 35% increase or more in the price of crude oil. The most serious and damaging of these was the Arab oil embargo in 1974 which triggered a 235% increase in oil prices in a three month period and which resulted in a 25% fall in the S&P 500.



Interestingly, when you exclude the 1974 oil shock, the S&P has actually performed above average in the six months after a rapid oil increase. Since 1979, the S&P recorded an average return of 8% in the six month period after a 35% or greater increase in the oil price.

Companies, which in the past may have been able to pass increases on, are more sensitive to higher oil prices because in this competitive landscape, margins may already be low. Lower profits, higher unemployment and reduced economic growth are possibilities if the oil price continues rising for whatever reason.

Losers will include airlines like British Airways who have admitted that they only hedged 30% of their fuel needs for first half of 2004. A fuel shock is the last thing needed by the airline sector just when it is recovering from the after effects of September 11. Needless to say, individual consumers too will have less to spend on other goods if energy prices stay high or continue rising. The winners in this scenario are, of course, the oil and gas companies i.e. B.P. and Shell or any company that discovers oil. One example would be Cairn Energy whose share price has more than doubled since January after major finds in India.

While there is often a cyclical correlation between oil and equity prices because of their link to underlying economic activity, the longer-term relationship is inverse. The implication is that a sustained rise in oil prices from current levels will jeopardize the cyclical equity bull market.

The impact of rising oil prices on equity markets is a function of the oil intensity of economic activity and the composition of market capitalisation. In aggregate, oil stocks (encompassing oil and gas stocks) represent only 7% of global market capitalisation, indicating that a relatively small proportion of the market will benefit from higher prices. Conversely, about 15% of market capitalisation is in relatively oil-intensive sectors such as automotive stocks, basic industries and general industrials. The latter two include chemicals and machinery, two industry groups whose earnings move inversely with oil prices.

Emerging markets have the largest weight in oil stocks as a share of market capitalization, particularly Russia. Among industrial economies, the Netherlands has the largest weight in oil stocks, with Royal Dutch Shell accounting for 20% of total market cap. Oil stocks account for 12% of UK equity capitalisation. Japan has negligible market cap in oil stocks, but has by far the largest weight in equities that are comparatively oil-

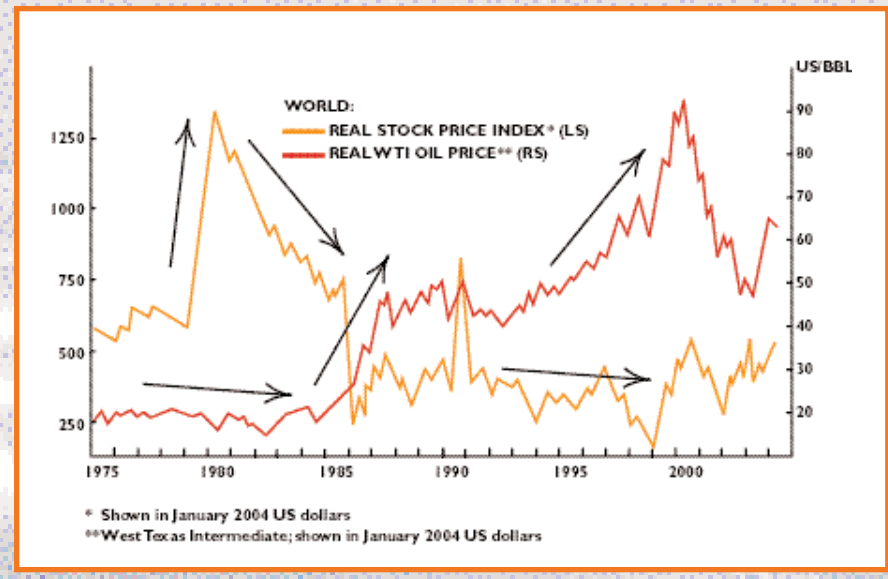
intensive. About 35% of Japanese market cap is in auto stocks, basic industries and general industrials, indicating that overall market earnings could be severely damaged. Asian equities also have a low weight in oil stocks and a high weight in oil-intensive industries. Combined with the generally high oil-expenditure to GDP ratio, Asian stocks will be among the most adversely affected by a rise in oil prices.

The UK is the biggest net beneficiary among developed markets; it has about twice as much market cap in oil stocks as in oil-using industries. Combined with the UK's overall lower reliance on oil relative to its GDP, it is clearly the least affected by rising oil prices. The US and Eurozone equity markets will suffer more modest impacts. The US suffers a slightly larger macro shock to its economy from higher oil prices, but it has a somewhat lower net oil-intensity within its equity market.

BOND MARKETS

The impact of rising oil prices on bond yields depends critically on inflation expectations and consequent monetary policy. History indicates that rising oil prices are bearish for government bonds in the short-term. Back in the 1970s, yields rose steadily following the first oil crisis. Bond yields rose sharply, albeit only temporarily, ahead of the Gulf War.

High oil prices are bearish for the US dollar since America's current account position would deteriorate more than other major economies.



With headline inflation likely to rise in the short-term at least as a result of higher oil prices (an increase in oil prices from $30 a barrel in 2003 to $40 a barrel in 2004 would boost inflation across the G7 region by around one percentage point), it is fair to assume that the world's major central banks, including the European Central Bank, will raise interest rates to counter higher inflation if the high oil price trend continues indefinitely.

The supply/demand situation suggests oil prices will remain in the $35 - $45 a barrel range over the next 12-18 months. Given that oil accounts for only some 3% of global GDP, investment markets could probably cope with this, but trustees need to plan for future rises in the oil price.

Pension funds are vulnerable to high oil prices, given the large weighting in equities, with Japan and the US to a lesser extent, the main losers of the major stock markets.

So what should the pension trustee take into account?

Asset Classes

- Reduce exposure to government bonds in favour of cash as higher inflation caused by spiking oil prices will result in lower bond prices.
- Add index-linked bonds.
- Reduce equities in favour of alternative investments such as commodities.

OIL FACTS

- **Ireland consumes an estimated 174,400 barrels of oil a day, and ranks 59th in world consumption, according to 2001 statistics.**
- **Petrol duty consumes 65% of the cost of a typical litre of petrol in Ireland compared to 73% in England and France and and just 27% in the US.**
- **The top three consumers of oil are the United States, using c20,000,000 barrels a day, Japan, c5,300,000 barrels and China, 4,570,000 (2001 estimate) although it is now believed that China's 2004 consumption exceeds that of Japan. World consumption is now c.80 million barrels a day.**
- **US oil production peaked in 1970. Estimates differ, but world oil production is expected to peak between 2016 and 2040.**