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Slide in oil prices is simple reality restaking its market place

A COUPLE of months ago, when crude oil was threatening to barge its way through the $150 level, I was among a growing band of sceptics looking for a very marked correction. It was hardly rocket science but, with economies grinding to a halt and the papers filled with unrealistic remedies to soaring energy prices such as hydrogen-powered cars and wood burning stoves, it wasn't difficult to call it right and to test Alan Greenspan's law of asset price bubbles, which he used to say you don't know you've got until it burst. We did and it did.

This week, the oil price fell below the $100 mark representing a 32 per cent drop from its $147 high. Opec responded with a 2 per cent cut in production and crude climbed back into triple digit territory again. But during these gyrations, the relative prices of oil and gas shares have dropped substantially and are now at a level appropriate to a crude price of about $70. It would therefore seem that oil shares have been oversold and must at present represent a sure-fire opportunity for day-traders and investment managers alike.

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Or, taking an alternative stance, could it be that the oil price is too high?

It is also true to say that most producers will be working on drilling production cost assumptions probably closer to $60 a barrel. The fact is the sector is in great shape and could take a further $40 drop in the crude price without drastically damaging the corporate arithmetic. But this isn't going to happen, even though I have to confess that along with other market observers I had felt that the astonishing appreciation of the oil price from $70 in autumn 2007 could very easily be matched on the downside. And there are plenty of analysts who believe that the present price is still much too high, having risen at 15 per cent a year with barely an interruption since 2003.

From our vantage point in Charlotte Square, where prosperous Edinburgh appears little moved by economic horror stories, we take the view that equity markets will recover sooner rather than later. That may very easily be prompted by a further fall in the oil price as production and inflation begin to slide together, perhaps even temporarily allowing a quarter or two of real live recession. But with the US leading the recovery – and those green sprouts may already be in evidence – a lower oil price will be the fillip that the UK and other European economies need to move off the bottom, albeit cautiously to begin with. The declining gold price is also a key indicator suggesting calmer economic times ahead.

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So, a deepening state of further domestic upset isn't going happen if the oil price continues its decline. Mark my words, this is the most likely outcome. Inflation will also decline as it will lack any sort of economic traction to maintain it present momentum. Under these circumstances, there will be no wage inflation. A job is going to be a valuable asset and union bosses will ignore this at their peril.

The truth is that oil price has been the cause of all this turmoil. Extraordinarily, the Mid-East sheikhs, who have held the world to ransom, will probably not even notice that their revenues are down by a few hundred million dollars a day.

Encouragingly, the product of all this will be an almost imperceptible trend-change in the equity markets. At the same time with the mortgage markets in the US and Europe being underwritten by governments, house prices will stabilise and values will start to rise meaningfully at the top end, with benefit slowly filtering down to the new homes sector. In addition, consumer prices will level off and there will be a return to a feeling of wellbeing compared to the current apprehension.

And when will all this happen? Probably in 12 months from now, we will see the roots of recovery. In a year's time, I'll be able to say, "I told you so".

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