

How oil prices became the 2014 X-factor

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THIRTY-TWO years ago, I succumbed to a serious addiction. Starting then, I've felt a compulsive need each December to compile a list of the main X-factors for the preceding 12 months — and to record the X-factor for that year.

An X-factor is a largely unexpected influence that comes from left field and seriously impacts the economy, investments or finance in general. Its key characteristic is the element of surprise: an X-factor cannot have been generally predicted or anticipated, or already built into market pricing.

The X-files, listed below, show my selections of the X-factor, year by year. The X-factor can be negative, as with the terrorist attacks in the US in 2001, the near-meltdown in global banking in 2008, and the sovereign debt problems in Europe in 2010 and 2011. Or it can be positive, as in 1983 with the float of the Australian dollar, in 1991 when trend inflation collapsed, and in 1998 when the Australian economy was little affected by the Asian financial crises.

To be a fan of the X-factor, as I am, does not mean opting out of taking a view on the outlook for the economy, shares, interest rates, the exchange rate, or property. Instead, it's a reminder that much of what happens to investments and the economy is not, and cannot be, predicted.

Diversification, awareness of uncertainty, and good management of risk are always important principles of investing — and so is having a core holding of safe assets.

The list of contenders for the X-factor of 2014 is long and varied.

It includes, in no particular order: the 49 record high closings for US shares since the start of the year; the complex geopolitical problems of the year including Islamic State, Russia's incursions into Ukraine and pro-democracy rallies in Hong Kong; the extreme lows recorded in bond yields in many countries; the collapse of oil prices towards year-end; the mess the Australian government and Senate made of the 2014-15 budget; Japan's much-increased commitment to print money; the low volatility in most investment markets through to mid-October; the smooth ending of quantitative easing in the US; the US economy shrinking at an annual rate of about 3 per cent in the March quarter, mainly because of a cold weather snap, but the strength of the rebound in the June and September quarters; and the Australian government signing free trade agreements with South Korea, Japan and China.

In my view, the X-factor this year is the combination — unprecedented in my experience — of much-increased stress and instability in the Middle East and of sharply lower oil prices.

Of course, investors must allow for another plethora of X-factors in the year coming up. To all readers of this column, best wishes for successful investing, much happiness and good health in 2015.

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THE X-FILES 1982 - 2014:

2014 Collapse in oil prices during severe tensions in middle east

2013 Confusion on US central bank “taper” of bond purchases

2012 The extent of investors’ hunt for yield

2011 Continuing problems with European government debt

2010 European government debt crisis

2009 The resilience of our economy despite the GFC

2008 The near-meltdown in banking systems

2007 RBA raises interest rates 17 days before the election

2006 Big changes to superannuation

2005 Modest impact on economies from high oil prices

2004 Sustained hike in oil prices

2003 Marked fall in US dollar

2002 Extent of US corporate fraud in Enron, etc

2001 September 11 terrorist attacks

2000 Overshooting of exchange rates

1999 *Powerful cyclical recovery across Asia*

1998 *Resilience of our economy despite Asian crisis*

1997 *Asian financial crisis*

1996 *Global liquidity boom created in Japan*

1995 *Powerful rally in US markets*

1994 *Sharp rise in bond yields*

1993 *Big improvement in Australian competitiveness*

1992 *Souring of the vision of "Europe 1992"*

1991 *Sustainable collapse of inflation in Australia*

1990 *Iraq invasion of Kuwait*

1989 *Collapse of communism*

1988 *Boom in world economy despite Black Monday*

1987 *Black Monday collapse in shares*

1986 *"Banana Republic" comment by Paul Keating*

1985 *Collapse of \$A after MX missile crisis*

1984 *Measured inflation falls sharply*

1983 *Free float of Australian dollar*

1982 *Substantial Japanese buying of Australian bonds*