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Global investment event

Winners and losers from the recent oil price rally

- Since mid-2017, oil prices have been on an upward trend. Strong oil demand growth, OPEC-led production cuts, and collapsing production in Venezuela have contributed to this
- Despite significant uncertainty around the oil price outlook, it is likely that oil prices will remain significantly higher than in the recent past. This will create economic winners and losers
- In an environment of still robust global activity, higher oil prices will add to near-term inflationary pressures. This reinforces our underweight positioning in developed market government bonds
- But the response by global central banks to higher oil prices should be limited by below-target inflation in many economies. There are downside risks to corporate margins amid higher input costs, but the aggregate economic hit is likely to be limited and we remain overweight in global equities
- Higher oil prices will affect emerging market (EM) economies with a large degree of variation. This highlights the importance of being selective in the EM asset universe

HSBC

What's happened?

Since mid-2017, oil prices have been on an upward trend. Brent crude is now trading close to USD80 per barrel (bbl) (Figure 1).

Figure 1: Brent crude oil prices

Source: Bloomberg, as at 22 May 2018

A number of factors have contributed to the rally:

Strong oil demand growth. Global economic activity has accelerated over the past two years (notwithstanding a recent moderation), which has driven strong oil demand growth.

OPEC-led production controls. In November 2016, OPEC and Russia agreed to cut production in order to help support oil prices and reduce high levels of global oil stocks. In April, stocks in the OECD economies fell below the five-year average (i.e. the average level for that month in the preceding five years) for the first time since August 2014.

Collapsing production in Venezuela. Amid economic disruptions and sanctions, output has fallen by around 850k bbl/day since early 2016 (nearly 1% of global production).

Iranian nuclear deal. Recent developments with regard to Iran's nuclear deal are expected to hinder the ability of countries to purchase Iranian oil.

What next for oil prices?

There is very high uncertainty over the future trajectory of oil prices. The prospect of continued OPEC restraint amid robust global economic activity supports a bullish outlook. But there are downside risks too. For example, Iranian exports may be propped up by continued buying from China, India and Turkey.

Crucially, US oil production has increased sharply over the past 18 months to reach an all-time high. This has translated into higher US exports of oil (also at record levels) and should help keep a lid on prices. The oil 'futures' market expects prices to edge lower in the coming months.

Who is vulnerable?

Despite the high uncertainty, it is likely that oil prices will remain significantly higher than in the recent past. This will create economic winners and losers.

Most major **developed markets (DMs)** are large net importers of oil, and therefore will be hit by higher import costs, and by inflationary pressures acting as a drag on household consumption. The good news is that inflation remains below target in most DMs (Figure 2), which should limit the extent to which central banks respond by raising interest rates.

In any case, most central banks typically "look through" energy and exchange-rate-related inflationary pressures, and tend to focus on domestically-generated inflation.

For emerging markets (EMs) the picture is more nuanced. The winners will be large net oil exporters (**Saudi Arabia, Russia, Mexico, Nigeria**). On the other hand, major net importers are vulnerable. Figure 2 shows EM economies with the lowest self-sufficiency in oil, highlighting **India, South Korea, the Philippines, South Africa, and Turkey** as vulnerable.

The inflation context is also important. Both **Turkey and Argentina** have elevated levels of inflation, limiting their central banks' ability to look through higher oil prices. Also, economies with a high weight attached to transport costs in their CPI inflation basket are likely to see a larger response of inflation to oil price movements. **Thailand** looks vulnerable in this respect.

Figure 2: Oil vulnerability heatmap

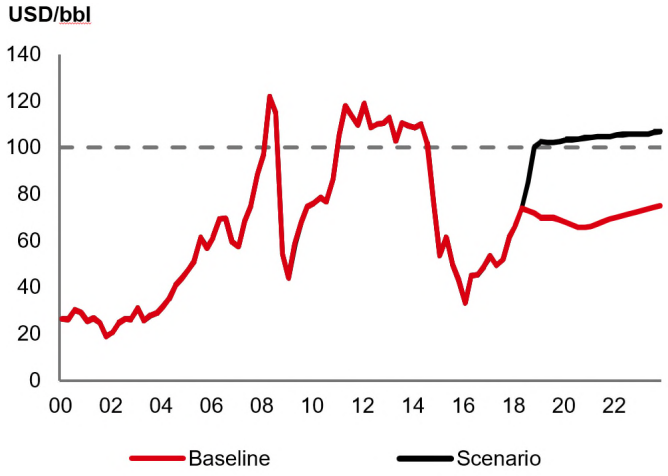
	Developed Markets (DM)							Emerging Markets (EM)														
	Canada	France	Germany	Italy	Japan	United Kingdom	United States	Argentina	Brazil	China	India	Indonesia	Korea, South	Malaysia	Mexico	Nigeria	Philippines	Russia	South Africa	Thailand	Turkey	
Oil self sufficiency index[1]	0.9	-1.0	-1.0	-0.9	1.0	-0.4	-0.3	-0.2	-0.1	-0.6	-0.8	-0.5	-1.0	0.0	0.4	6.7	-0.9	2.3	-1.0	-0.6	-0.9	Least self sufficient
Transport weight in CPI basket (%)	21	15	13	14	8	16	13	17	17	11	9	19	14	14	13	7	8	3	14	27	16	Highest CPI weight
Inflation versus target (%)	0.2	-0.2	-0.6	-1.4	-1.6	0.5	-0.1	10.5	-1.7	-1.2	0.6	-0.6	-0.4	-1.7	1.6	5.0	1.5	-0.4	-0.7	-1.4	5.9	Furthest above average

Source: HSBC Global Asset Management, EIA, Bloomberg, BP. 1 The oil self-sufficiency index is oil production less consumption, divided by consumption. Data as at 22 May 2018

The impact of a return to USD100 oil

Using the Oxford Economics global economic model, we can assess the impact of a return of oil prices to USD100/bbl by the end of the year (Figure 3).

Figure 3: A scenario of a return to USD100 oil



Source: HSBC Global Asset Management, Oxford Economics, as at 22 May 2018

Figure 4 highlights the impact of this scenario on GDP growth in the years 2018-23.

Figure 4: GDP growth impact of scenario versus baseline forecast (basis points)

	2018	2019	2020	2021	2022	2023	Cumulative GDP growth (2018-23)
World	-1	-20	-53	-18	12	28	-52
DM	-3	-18	-55	-28	18	30	-55
Eurozone	-2	-34	-63	-9	25	21	-62
Japan	-2	-22	-61	-53	9	54	-75
UK	-1	-22	-32	-5	14	14	-32
US	-5	-18	-52	-44	13	27	-79
EM	4	-29	-53	-2	4	21	-55
Brazil	1	-47	-48	-49	-9	34	-119
China	-6	-80	-83	43	8	29	-89
India	-4	-88	-71	-44	8	31	-167
Indonesia	3	-33	-160	-87	90	102	-85
South Korea	4	16	-86	-44	15	92	-5
Malaysia	2	7	-44	-108	-34	30	-147
Mexico	6	17	-2	48	23	4	95
Philippines	-8	-125	-120	-138	-21	52	-360
Russia	-2	49	16	-15	-25	-29	-6
Saudi Arabia	60	141	33	2	-23	-15	199
South Africa	-2	-28	-65	-52	-7	33	-121
Taiwan	-2	4	-55	-39	28	68	5
Thailand	-1	-38	-53	-100	-22	10	-204
Turkey	-1	-59	-95	-52	20	40	-147

Source: HSBC Global Asset Management, Oxford Economics, as at 22 May 2018

In DMs, the oil-intensive US economy and oil import-dependent Japan would be the hardest hit. Meanwhile in EMs, large net importers such as the Philippines, India, South Africa, and Turkey would be among the most adversely affected. Elsewhere, Argentina, Brazil and Thailand would lose out due to their high transport CPI weights and oil-intensive economies. Finally, Malaysia would also be hit hard, but export powerhouses South Korea and Taiwan would be supported by the global cyclical rebound by 2022.

Market considerations

In an environment of still robust global activity, higher oil prices will add to near-term inflationary pressures. In a multi-asset portfolio context, this reinforces our **underweight positioning in developed market government bonds** where prospective returns look low relative to competing asset classes.

As discussed earlier, the response by global central banks to higher oil prices should be limited by below-target inflation in many economies, whilst the oil price typically has a transitory effect on prices which central banks can “look through”. This means that rather than tighter monetary policy, the economic hit should be limited to (i) a temporary squeeze on household consumption via lower real-wage growth, and (ii) higher costs of production leading firms to lay off workers in order to protect profit margins. Indeed, in our scenario of USD100 oil during 2018-23, the cumulative deterioration in world GDP growth would be very limited in magnitude (approx. 50-60bp).

Overall, we expect policy normalisation by DM central banks to remain gradual and predictable. Since our measure of the global equity risk premium (excess return over cash) is still reasonable given where we are in the profits cycle, and as global economic growth remains solid, **we retain an overweight stance in global equities**. But with US Treasury yields edging higher, we are approaching the critical level where equity risk premiums are eroded to more neutral levels. Corporate profit margins are also at risk as oil price rises feed into higher costs of production.

Higher oil prices will affect EM economies with a large degree of variation. As can be expected, major net exporters will benefit (although this may be a curse in disguise as it potentially delays much needed structural reforms and economic diversification). Meanwhile, large net importers are vulnerable (e.g. India, Turkey, Philippines), along with those economies with already high inflation levels (Turkey, Argentina) and a greater sensitivity to oil price moves (Thailand).

Overall, this highlights the importance of being selective in the **EM asset universe**, among other vulnerabilities (for example to a stronger US dollar and capital outflows). But at the aggregate level, this asset class remains attractively valued and one of the best ways to benefit from the still robust growth backdrop, in our view.

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