Slippery slope

Economist Insights

Should lower oil prices be considered bad news for equity markets and the economy? If the drop in the oil price is a symptom of weak global economic activity, then it is indeed bad news. But if it reflects an increase in supply, then it should be good news for everyone except oil producers. However, a severe and persistent oil price drop could be bad for equity markets if it forces sovereign wealth funds, mostly owned by oil producer countries, to liquidate assets to cover deteriorating public finances in those countries.

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Remember the old days when rising oil prices were considered bad news? Nowadays, it seems, falling oil prices are bad news. Plummeting stock markets are going hand-in-hand with collapsing oil prices (the correlation with world equity indices is almost one since the Fed hiked rates in December). If you do not live in an oil-exporting country, this looks a bit odd. Surely cheaper gasoline and energy bills are good news?

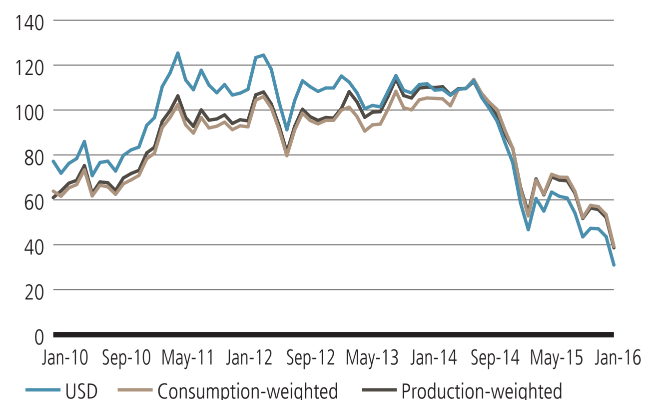
It is a good question, but first take a step back and ask what we mean by the oil price. Like almost all commodities, the price of oil is quoted in USD. Yet the USA accounts for only a quarter of global oil consumption and about a fifth of production. And over the last year and a half the USD has strengthened by about a quarter against other currencies, which makes oil prices more expensive in those countries when you convert back to the local currency. The drop in oil prices far outweighs the currency move, but it is a mitigating circumstance.

If we want to know what the oil price looks like for consumers around the world, we can create a price index that weights the local currency price of oil by the share of global consumption of oil. This consumption-weighted oil price has fallen by 64% since June 2014, as compared to a 70% drop in the USD price (chart 1). We can do the same to see how producers are faring, by using production weights. This price for producers is surprisingly close to the consumption price, despite many producers being pegged to the USD. There are exceptions: thanks to the drop in the RUB, the local oil price in Russia has fallen by less than a third.

This currency differential swung the other way in preceding years. As the Fed embarked on quantitative easing the USD fell relative to other currencies, pushing the local currency price down in other countries relative to the US. Or to put it another way, the weighted oil price indices rose sharply in early 2014, so for them some of the decline was simply reversing the recent spike.

Chart 1: Foreign currency not accepted

Oil price in USD and adjusted oil price in local currency weighted by global consumption or production (2015t weights), rebased to equal the USD oil price in June 2014



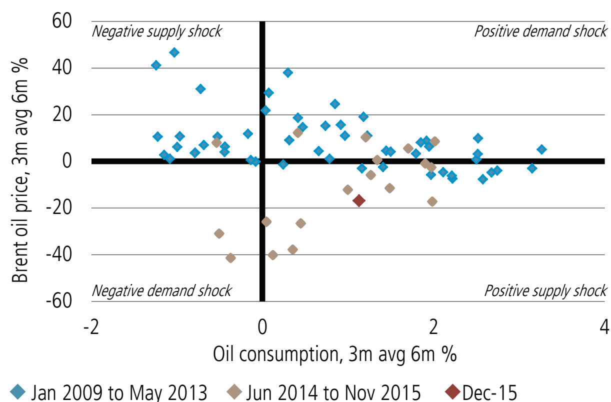
Source: DOE/EIA, Thomson Reuters DataStream, UBS Asset Management

Now that we have a better measure of the global oil price, we can ask again why lower oil prices should be considered bad news for equity markets. If the drop in the oil price is a symptom of falling global economic activity, then it is indeed bad news. But it could also reflect an increase in supply, which would be good news for everyone except oil producers. Unfortunately we cannot observe demand and supply directly, only where demand equals supply. When demand is falling, both prices and quantities fall. When supply is rising, prices fall but quantities rise.

It becomes pretty clear that by this measure we should be enjoying a positive supply shock. Comparing six-month changes in quantities and oil prices shows that since June 2014 there has been a huge positive oil shock (chart 2). Saudi Arabia has increased production to maintain market share (see *Show and cartel,* 14 December 2015) and other countries have followed suit. This is not to say that there may not have been a negative demand shock, but the positive supply shock clearly dominates.

Chart 2: Good news?

Global oil price index (consumption and production average weighted) and quantities of oil consumed, 6m% change



Source: DOE/EIA, Thomson Reuters DataStream, UBS Asset Management.

So is there still the puzzle of why falling oil prices are bad news? Yes there is weaker economic activity in China, but that was hardly new news in January. Whenever market prices move sharply around the start of the year, the first suspect has to be investor behaviour. As investment committees meet and discuss their performance over the last year, they may take big decisions.

The biggest single decisions are by the sovereign wealth funds (SWFs). And many of those SWFs are from oil exporters, who are facing the biggest squeeze on their budgets in living memory. When governments back home need their cash, they take money out of their sovereign wealth funds. That often means liquidating the most risky parts of the portfolio: equity and credit. These flows could go a long way to explaining why the market move has been so large. And once there are big moves, they can often take on a life of their own.

This makes the equity link to oil prices a financial phenomenon, rather than an economic one. There are certainly economic factors as well, such as the inventory cycle in the US (see *Schism*, 11 January 2016). And we should not take too much comfort from this being a financial markets wobble. Gyrations in the financial markets can feed through to the real economy through confidence, wealth effects and business investment. Nonetheless, there have been many occasions when equity markets have taken a nosedive and the economy has sailed on, or suffered a slight wobble at most. Hopefully the drop in oil prices is just such a temporary slip up, rather than the start of a slippery slope.

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