NBP Fullerton Asset Management Ltd.
A Subsidiary of National Bank of Pakistan

Dr. Amjad Waheed, CFA
Chief Executive Officer

The Impact Of Declining Oil Prices On Capital Markets

Over the past three years ending June 2014, oil prices remained relatively stable. Brent crude oil prices averaged USD110 per barrel. However, during the last few months, global crude oil prices have been in a precipitous decline. The price of Brent has fallen by about 40% from USD115 per barrel in June to under USD70 per barrel at present. The aforesaid drop is ascribed to both economic and geopolitical factors.

The USD3.5 trillion oil market has become a political weapon and a strategic asset. On pure economic reasoning, today's plunging prices are undoubtedly caused by shifts in both supply and demand dynamics. A slowing global economy, as reflected in sluggish European and Japanese economies, decelerating Chinese economic growth, and a general slowdown in other countries, is restricting demand growth for oil. Conversely, supply growth has been very robust as new production capacities initiated when oil prices were at elevated levels are coming on line now. For example, US oil production, a key beneficiary of shale revolution, has increased to 13 million barrel per day at present from 9 million barrel per day in 2011.

Some political analysts add a geopolitical dimension to plummeting oil prices. According to them, US and Saudi Arabia are trying to drive down the oil price by flooding an already weak market with more crude. The purpose is to put pressures on Russia and Iran, which are most vulnerable to falling oil prices, to better deal with them politically on Ukraine, Syria and nuclear proliferation issues. The recent OPEC decision to keep its production unchanged despite steep decline in oil prices corroborates this view. An alternative view is that OPEC decision to keep output unchanged is meant to hurt American shale producers.

With global economy likely to remain in the doldrums and new supplies firmly baked in, crude oil prices are forecasted to remain weak over the next few years. More specifically, according to leading research houses and industry experts, oil is likely to trade in the USD65-85 per barrel band in 2015 and 2016.

For Pakistan's economy, cheaper oil provides manifold benefits. First, oil makes up about 35% of Pakistan's imports. Based on FY14 trade figures, every USD10 per barrel drop in oil price saves Pakistan an annual USD1.4 billion in imports. The recent decline, if sustained, could lower country's import bill by USD4.5-5.0 billion over a 12- month period. The above would significantly strengthen Pakistan's external account position. Second, lower oil prices would keep inflationary pressures at bay. Due to lower commodity prices, including oil, and restricted money supply growth, inflation has already fallen to a multi-year low of 4.0% in November. After the latest oil price reduction, we expect overall FY15 inflation to remain well below 7.0%. This is expected to lead to another 50-100bp cut in the discount rate in the upcoming monetary policy review in January. Third, cheaper oil narrows Pakistan's budget deficit by reducing energy subsidies. Last, but not the least, lower oil prices enhances the competitiveness of local manufacturers.

Debt markets have already started responding to falling inflation expectations and improving macroeconomic outlook as yields on long-term bonds (10 years) have declined by around 2% in the last two months and may drop further. In the forex market, rupee has appreciated by 1% against the USD in November, after losing 4% of its value in the first four months of the fiscal year. In view of the expected improvement in foreign exchange reserves and external account, exchange rate is likely to remain largely stable in the coming months.

At current valuation of 8.5x forward earnings, the stock market is trading at a 47% discount to regional market average despite relatively higher earnings growth and handsome dividend yield. We see strong possibility of the stock market earnings multiple rerating due to improving macroeconomic fundamentals going forward. In view of falling inflation and lower oil prices, companies with high dividend yield and energy consumption are likely to outperform. On the other hand, Oil & Gas Exploration and Production companies, which have a significant (17%) weight in the KSE-100 Index, would continue to lag the market due to further expected decline in oil prices. Nonetheless, after the recent sell-off, valuations of even E&P companies have become attractive and have adjusted to a possible drop in oil prices to USD60 per barrel.