Investment Strategy | India
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March: An "Eventful" Month but oil as important

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Focus on the 3 events ….

Over the next couple of weeks, 3 events will be important for markets. Given the sharp rally in markets, expectations are high and the market could be vulnerable to a correction on any disappointment. However, price of oil may be as important as these events in determining the market direction (and of course will affect two of these events).

1. **March 6 - Assembly election results:** A Congress strong performance with a kingmaker role in Uttar Pradesh positive for markets. See report.

2. **March 15th - Credit Policy:** Consensus and our expectations are for a rate cut but high oil prices persist, RBI may do a CRR cut only.

3. **March 16th – Budget:** The key to watch is the fiscal deficit estimate.

… but oil prices as important

While an increase in crude oil is clearly negative for India's macro-economy, the co-relation of Indian stock market and oil is strongly positive ie a rising crude oil prices lead to a rise in equity markets (co-relation is strong at 89%). However, this relationship turns negative at a tipping point (and we may be close to it) ie Indian markets fall even as crude continues to rally.

Sharp crude rallies break this co-relation: On 10 occasions over past 10 years we have seen a rally in crude prices by over 30% in 3 months. On 6 of these 10 occasions, markets gave a negative return over the next quarter. Similarly, India under-performed EMs on 8 of these occasions

Rising crude oil hurts the economy in 3 ways…

1. **Inflation:** A 5% increase in domestic oil prices increases inflation directly by app 75 bps (see Table 3)

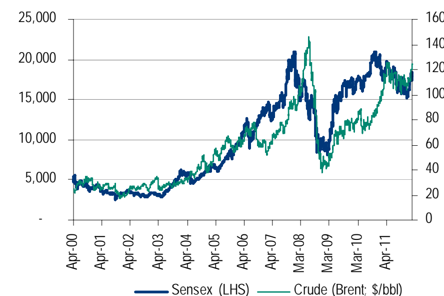
2. **Current account deficit:** Oil accounts for 30% of total imports. A $10/bbl increase in oil prices will increase current account deficit by $8bn (0.4% of GDP).

3. **Fiscal Deficit:** Every $15/bbl increase in oil price can lead to an increase in fiscal deficit by roughly 0.3% of GDP assuming a 10% increase in domestic oil prices (see table 5).

.. but the positive is that the tipping point has gone up

In a macro sense, oil, at US$110/bbl today, is like oil at US$70/bbl in 2007. For example, net oil imports remain around 4% of GDP and the oil subsidy around 0.8% of GDP similar to 2007 although oil prices are over 50% higher.

Chart 1: Crude on the move again



Source: Source: BofA Merrill Lynch Global Research

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Key Events, oil focus of markets

Over the next couple of weeks, 3 events will be important for markets:

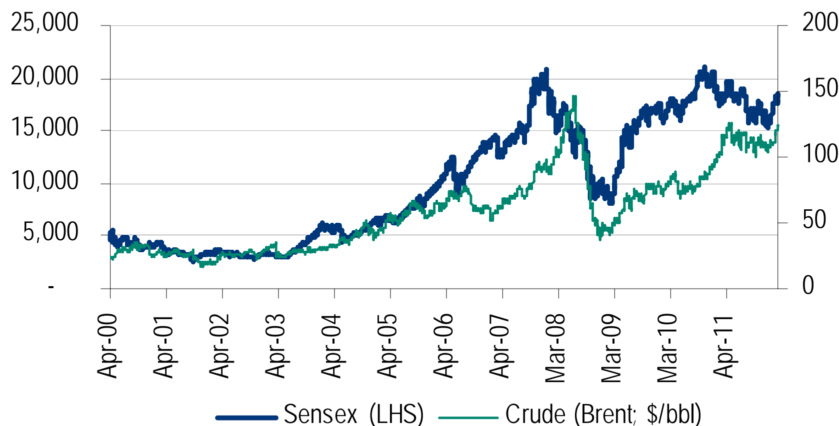
1. **March 6 - Assembly election results:** A Congress strong performance with a kingmaker role in Uttar Pradesh positive for markets.
2. **March 15th - Credit Policy:** Consensus and our expectations are for a rate cut but high oil prices persist, RBI may do a CRR cut only.
3. **March 16th – Budget:** The key to watch is the fiscal deficit estimate.

Following the sharp rally in markets YTD, expectations are high and near term the markets are vulnerable to any disappointment.

Oil prices have a positive co-relation with markets

The other factor to watch for is oil prices. As we have pointed many times in the past, markets are highly positively co-related to oil prices ie rising oil prices lead to a rally in the markets. The co-relation is a very strong (89% in last 10 years & 67% in last 3 years).

Chart 2: Crude on the move again



Source: BofA Merrill Lynch Global Research

…. But tipping point beyond which it gets a worry

The rally in oil prices as well as the Indian market is probably linked to a "risk-on" trade globally which both represent. However, if the risk on trade continues to play out, we may see this co-relation turn negative. Our guess is we are close to this tipping point.

In the past we have seen this relationship turn negative ie markets falling while crude rallies whenever crude has rallied sharply in a short period. On 10 occasions over past 10 years we have seen a rally in crude prices by over 30% in 3 months. On 6 of these 10 occasions, markets gave a negative return over the next quarter (with a lag of 2 months). Similarly, India under-performed EMs on 8 of these occasions.

Table 1: Relative Sensex performance (with MSCI EM) during sharp crude rallies

Start Date	Crude price ($/bbl)	Crude price 3m later ($/bbl)	% increase	2m Sensex Rel perf (lagged by 2m vs. MSCI EM)
11-Apr-00	21.9	29.2	33.0%	-10.0%
22-Jan-02	18.7	26.1	39.2%	-0.9%
17-Nov-02	22.9	33.1	44.2%	-0.9%
14-Jul-04	36.5	50.9	39.4%	-2.5%
15-Dec-04	37.4	53.8	43.8%	-1.9%
24-May-05	48.1	64.6	34.5%	2.7%
27-Aug-07	69.6	94.9	36.5%	1.0%
10-Feb-08	87.9	122	38.8%	-7.1%
13-Mar-09	43.0	71.5	66.6%	-3.9%
24-Nov-10	83.2	113.7	36.6%	-0.3%

Source: BofA Merrill Lynch Global Research

Table 2: Sensex performance during sharp crude rallies

Start Date	Crude price ($/bbl)	Crude price 3m later ($/bbl)	% increase	3m Sensex Performance (lagged by 2m)
11-Apr-00	21.9	29.2	33.0%	-0.7%
22-Jan-02	18.7	26.1	39.2%	-7.8%
17-Nov-02	22.9	33.1	44.2%	-11.4%
14-Jul-04	36.5	50.9	39.4%	17.9%
15-Dec-04	37.4	53.8	43.8%	-2.1%
24-May-05	48.1	64.6	34.5%	6.7%
27-Aug-07	69.6	94.9	36.5%	-4.6%
10-Feb-08	87.9	122.0	38.8%	-14.2%
13-Mar-09	43.0	71.5	66.6%	29.1%
24-Nov-10	83.2	113.7	36.6%	2.4%

Source: BofA Merrill Lynch Global Research

Rising crude is negative for economy

Rising crude oil prices are clearly negative for the economy and hurt the current as well as fiscal account deficit and worries of inflation would again surface.

Rising oil prices to delay RBI rate cuts; US$135/bbl flashpoint

We find rising oil prices a worry given that the RBI needs to cut rates to revive growth. In our base case of oil averaging US$-/bbl in June, we expect the RBI to cut policy rates by 25bp on March 15 and by 100bp by July. If oil persists at US$125/bbl, the RBI may temporize by cutting the cash reserve ratio (CRR) to signal support to growth but delay rate cuts to April. In our view, oil prices would strain the economy in terms of funding the twin deficits if it averages US$135/bbl for a year. Do find our last oil report here.

What if oil persists US$125/bbl?

In a sense, most of India's macro problems - inflation, twin deficits, high rates - have their source in high oil prices. These problems would obviously increase at US$125/bbl relative to our US$112/bbl base case.

1. Inflation worries would resurface: A 5% increase in domestic oil prices due to rising global oil prices increases inflation by 75 bps.

Table 3: 5% swing in fuel impacts inflation 75+bp

Item / inflation (%)	WPI weight	Approximate direct impact of 5% increase on WPI inflation (bp)
All commodities	100	
Crude petroleum	0.9	6
Fuel, power, light and lubricants	14.91	77
Mineral oils	**9.36**	**51**
Liquefied petroleum gas	0.91	5
Petrol	1.09	6
Kerosene	0.74	4
Aviation turbine fuel	0.26	1
High speed diesel oil	4.67	26
Light diesel oil	0.12	1
Naphtha	0.79	5
Bitumen	0.16	1
Furnace oil	0.47	3
Lubricants	0.17	1

Source: Ministry of Industry, BofA Merrill Lynch Global Research estimates.

2. Interest rate cuts may be delayed: We would expect the RBI to delay its rate cuts beyond March 15 if oil persists at US$125/bbl. Although oil prices are beyond the RBI's control, Gov Subbarao will not want to risk behind-the-curve chatter. The RBI will likely temporize by the cutting cash reserve ratio to support growth rather than rate cuts as the latter is perceived to be a 'softer' monetary signal.

… especially with higher fiscal deficits: Higher oil prices would also kindle fears of enlarging an already high fiscal deficit (5.9% of GDP at US$112/bbl). This would likely peg the 10y at 8.5% levels. That said, we would still expect banks to cut lending rates (150bp BofAMLe) from April onwards. After all, loan demands will likely slip to 15% by September robbing banks of their pricing power.

Table 4: Fiscal deficit swings on oil

	US$100/bbl		US$114/bbl		US$135/bbl	
USD-INR	**45**	**50**	**45**	**50**	**45**	**50**
10% hike in diesel, Kersosense and LPG	196	469	540	852	1057	1426
20% hike in diesel and 10% in kersosense and LPG	64	273	344	656	861	1230
Memo						
Fiscal deficit (10% diesel hike)	8.0	8.2	8.3	8.5	8.7	8.9
Fiscal deficit (20% diesel hike)	7.9	8.1	8.1	8.4	8.5	8.8

Source: BofA Merrill Lynch Global Research estimates.

3. Currency may come under pressure as inflation: Persistent US$125/bbl would peg the INR at Rs50/USD levels, especially once the seasonal support from higher exports ends in March. Note a US$10/bbl swings the trade deficit by US$8bn (0.4% of GDP). As it is, we expect the INR to rule weak as the RBI will need to recoup the US$50bn sold since 2008 at a time of a high 3% of GDP current account deficit (at US$112/bbl).

Table 5: Balance of payments risks overdone

Item	FY07	FY08	FY09	FY10 (US$69/bbl)	Q2FY11	Q2 FY12	FY11 (US$88/bbl)	FY12 (US$108/bbl)	FY13 (US$112/bbl)	FY13 (US$135/bbl)
Current Account	-9.0	-15.9	-28.8	-38.4	-16.9	-16.9	-44.2	-65.0	-64.5	-83.5
% of GDP	-0.9	-1.3	-2.3	-2.8			-2.6	-3.4	-3.1	-4.0
Trade balance	-61.2	-91.6	-118.7	-118.4	-37.0	-43.9	-130.4	-161.0	-166.5	-185.5
- Exports	128.9	166.2	189.0	182.2	52.0	76.6	250.5	296.0	328.0	336.1
- Imports	190.1	257.8	307.7	300.6	89.0	120.5	380.9	457.0	494.5	521.7
o/w Oil imports	57.3	79.7	93.7	87.1	23.3	32.4	106.1	136.0	147.0	176.5
Invisibles	52.2	75.7	89.9	80.0	20.1	27.0	86.2	96.0	102.0	102.0
o/w income from forex reserv.	8.0	11.0	10.9	5.9			7.0	7.0	9.0	9.0

Table 5: Balance of payments risks overdone

Item	FY07	FY08	FY09	FY10 (US$69/bbl)	Q2FY11	Q2 FY12	FY11 (US$88/bbl)	FY12 (US$108/bbl)	FY13 (US$112/bbl)	FY13 (US$135/bbl)
Capital Account	45.3	111.7	7.4	53.5	21.6	18.4	59.8	61.0	80.0	72.0
Foreign investment	14.8	45.5	3.5	51.2	22.8	3.2	37.4	24.0	30.0	18.0
- FDI	7.7	15.9	17.5	18.8	3.6	4.4	7.1	16.0	20.0	18.0
- FII+	7.1	29.6	-14.0	32.4	19.2	-1.2	30.3	8.0	10.0	0.0
Banking capital	1.9	11.7	-3.2	2.1	-3.2	6.7	5.0	11.0	10.0	10.0
- NRI deposits	4.3	0.2	4.3	2.9	1.0	2.8	3.2	8.0	10.0	8.0
Short term credit	6.6	17.2	-1.9	7.6	2.6	2.9	11.0	10.0	16.0	20.0
ECBs	16.1	22.6	7.9	2.8	3.4	7.0	11.9	12.0	18.0	18.0
External assistance	1.8	2.1	2.6	2.9	0.6	0.3	4.9	4.0	6.0	6.0
Others	4.2	12.6	-1.5	-13.0	-4.6	-1.6	-10.4	0.0	0.0	0.0
Overall balance	36.3	95.8	-21.4	15.1	4.7	1.5	15.6	-4.0	15.5	-11.5
Memo										
RBI's forex intervention	26.8	78.2	-34.9	-2.7			1.7	-15.0	0.5	-26.5

Source: RBI, BofA Merrill Lynch Global Research estimates.

4. Growth: Academic work shows that as a rough rule of thumb, a $10/bbl increase in oil prices cuts GDP growth by 0.1-0.5pp in oil consuming nations.

Table 6: Oil Impact on GDP & Inflation in Asia

	Impact of +10% in Oil Prices	
	GDP (bp)	CPI (bp)
Korea	-45	25
Thailand	-45	25
Philippines	-30	45
India*	-25 120 (WPI)	
Taiwan	-20	10
Hong Kong	-20	5
China	-15	25
Singapore	-15	10
Indonesia	-10	40

Source: BofA Merrill Lynch Global Research estimates; Note: *based on WPI for India and thus not comparable with other countries.

Here are some silver linings

1. India is relatively better off: One positive feature is that Delhi has been hiking oil prices steadily. As a result, oil subsidies, at 0.9% of GDP, are still lower than ASEAN levels. This, in turn, will mean that the cost of adjusting to higher oil prices will be relatively lower.

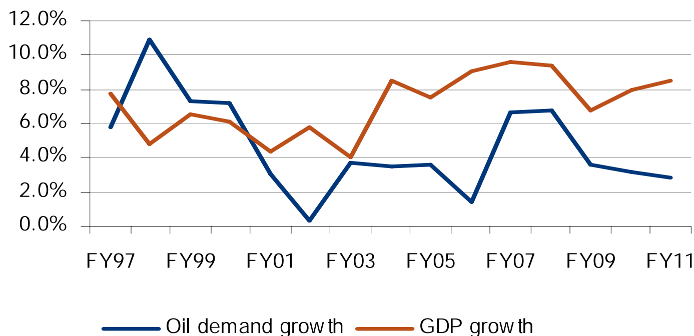
Table 7: Fuel Subsidies in Emerging Asia

			Size of Subsidy (2011e)		
	Fuel subsidy	Channel	Amount (US$bn)	% GDP	Fiscal balance (% GDP)
China	Yes	Oil fund	4.8	0.1	-0.9
Hong Kong	No				0.3
India	Yes	Budget	17	0.9	-8.6
Indonesia	Yes	Budget	18.2	2.2	-1.3
Korea	No				2.3
Malaysia	Yes	Budget	4.6	1.6	-5
Philippines	No				-1.6
Singapore	No				0.6
Taiwan	Yes	SOE	...	...	-2.1
Thailand	Yes	Oil fund/cut in excise tax	4	1.1	-1.1

Source: BofA Merrill Lynch Global Research estimates

2. Ability to absorb higher oil prices rising: Finally, the Indian economy's ability to absorb oil shocks has increased over the years. In a macro sense, oil, at US$110/bbl today, is like oil at US$70/bbl in 2007. Growth has outstripped oil demand growth partly because part of the higher growth comes from less oil intensive services sector

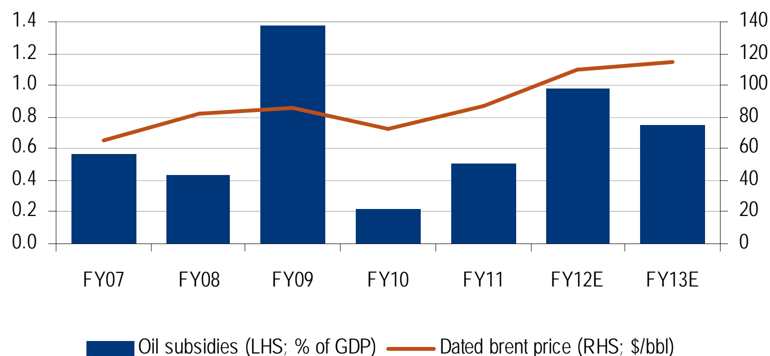
Chart 3: Oil demand lagging growth...



Source: Government of India, CSO, Bloomberg, BofA Merrill Lynch Global Research estimates.

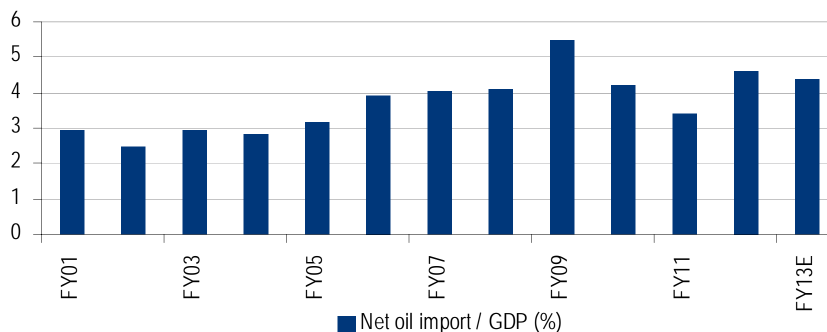
For example, net oil imports remain around 4% of GDP and the oil subsidy around 0.8% of GDP although oil prices are over 50% higher.

Chart 4: Oil subsidies stabilizing as % of GDP



Source: Government of India, CSO, Bloomberg, BofA Merrill Lynch Global Research estimates.

Chart 5: ...limiting oil import exposure



Source: RBI, CSO, BofA Merrill Lynch Global Research estimates.

Link to Definitions

Macro

Click here for definitions of commonly used terms.

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