M&G Emerging Markets Equities

Lower oil prices: a boost for emerging markets?

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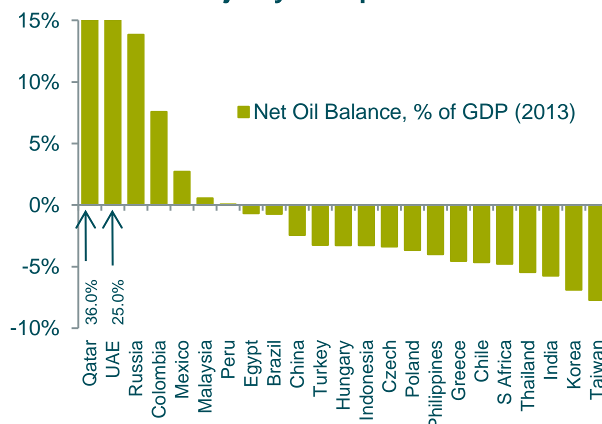
Fund manager – Matthew Vaight

Amid concerns about abundant supplies of crude, stemming in part from rising US shale oil production, and weaker global demand, oil prices have fallen nearly 50% since mid-2014. While recognising that there will be winners and losers from this development, Matthew Vaight, manager of the M&G Asian Fund and the M&G Global Emerging Markets Fund, believes, on balance, lower oil prices are positive for emerging markets. In his view, the impact of the collapse in oil prices on emerging markets will be varied, but also offers potential investment opportunities.

The debate about the recent decline in the oil price has tended to focus on the challenge for producers, in particular US onshore oil companies. There has also been some discussion about the potential benefit to consumers. However, in our view, this disguises the real winners of lower oil – specifically net importers.

Contrary to what many believe, emerging markets overall are net importers of energy (on a population-weighted basis). However, this headline figure disguises the intricacies, variability and consequences that a lower oil price has on different emerging market economies. So what are the impacts and opportunities on different emerging market economies as a result of the dramatic fall in oil prices; what does this mean on a country-specific basis? What effect does a drop in oil prices have at an index level? And finally, how can investors capture these opportunities?

Figure 1. Oil production in emerging markets: a majority of importers



Source: EIA, BP Statistical Review of World Energy, Haver, UBS.

Economic impact

The oil price has nearly halved since mid-2014, presenting a real budgetary challenge for oil-dependent countries. Figure 1 shows how important oil is for emerging market economies. What is evident is that most emerging market countries are actually oil importers and therefore beneficiaries of a lower price environment. In the short term, the immediate harmful effects of lower oil prices can be seen in countries such as Russia where oil & gas accounts for 16% of gross domestic product (GDP), provides about half of federal budget revenues and the breakeven price is in the region of US$100 a barrel[1]. Oil weakness has compounded the effect of economic sanctions imposed in relation to the crisis in Ukraine.

The low cost oil-producing nations in the Middle East, where the cost per barrel of oil extraction is considerably lower than other emerging market countries, are better placed, albeit the low oil price remains a headwind given that oil exports are such a large component of GDP. However, we can divide the large emerging market oil producers into two groups: the first comprises low-cost producers with huge external surpluses that can cushion the impact of lower oil prices on both the economy and government spending (Qatar and UAE, primarily). The countries in the second group have higher extraction costs and negligible external balances; consequently, they suffer greater gearing towards the oil price (Russia, Colombia and Malaysia).

The biggest beneficiaries from a softening oil price are those nations that heavily subsidise the cost of oil. Indonesia, Thailand, Vietnam, Malaysia and India all provide energy subsidies that drain 2–3% of GDP every year and therefore have the opportunity to dramatically reduce these costs. The benefits of a lower oil price can be evidenced by Indonesia, which is expected to reduce fuel subsidies from an estimated 2.4% of GDP in 2014 to 0.5% in 2015[2]. As these subsidies can be cut back, or completely removed, it improves a government's fiscal position enabling it to commit capital to other parts of the economy, such as infrastructure projects that are needed to support longer-term economic transformation.

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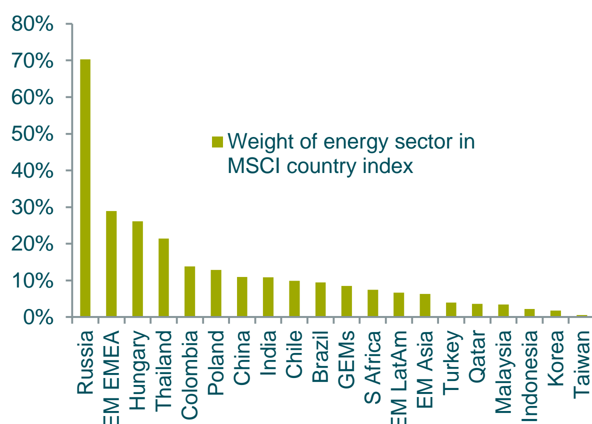
Market impact

From an aggregate country level perspective, net oil importers account for 73% of emerging market GDP. From an index viewpoint, net oil importing countries account for 86% of the MSCI Emerging Markets Index, by market cap. Figure 2 shows the energy weighting within each respective emerging market country index.

Figure 2. MSCI Emerging Markets Index: energy weight (%)



Source: MSCI, UBS. Data as at 23 February 2015.

Russia has by far and away the biggest exposure to energy within its index. Several equity markets, including some major oil producers such as UAE and Mexico, have zero market weights in energy. In most cases, the oil & gas operations are publicly owned, removing potential index headwinds. While energy stocks obviously suffer from falling oil prices, there is a flip side: consumers, and therefore consumer-related companies, will be notable beneficiaries as fuel prices drop.

Fund impact

To assess how the funds are affected by lower oil prices, it is worth looking at it in two ways: direct and indirect exposure.

From a direct perspective, the M&G Global Emerging Markets Fund has 9.2% invested in the energy sector, slightly above the index weighting of 7.8% (as at 31 January 2015). The M&G Asian Fund has 2.3%, compared with 4.8% in the MSCI Asia Pacific ex Japan Index (as at 31 January 2015). As contrarian, value-oriented investors, we are attracted to out-of-favour areas. Given the collapse in the share prices of energy-related companies, it is an area of the market that we are actively looking at and would be inclined to increase our exposure to. However, in this environment of lower oil prices and reduced capital expenditure across the sector, it is essential to be selective and have confidence in the strength of a company's balance sheet to withstand a potentially sustained period of low oil prices.

In terms of indirect exposure, the M&G Global Emerging Markets Fund's exposure to Russia proved how 'external' factors can affect a company's share price. Our Russian holdings struggled in the second half of 2014, even though most of them have no connection to the oil industry. The plunging oil price drove down the ruble, which affected the performance of Russian shares for us as international investors. From a local-currency perspective, though, the downturn in share prices was much more muted. The fund holds one Russian oil company, Lukoil, which has actually proved quite defensive. Lukoil's revenues are in US dollars as oil is traded in dollars while its operating costs are in rubles. In Lukoil's case, the collapse in the oil price has therefore been softened by the depreciation of the ruble against the dollar.

Lower oil prices: a boost for EM

Historically, there has been a strong correlation between oil prices and emerging market equities. The traditional argument is that lower oil prices are caused by slowing global growth. However, there are reasons to believe we are now experiencing something different as the current oil price weakness arguably stems from over-supply. Lower oil prices should boost emerging market equities by helping the bottom line for energy-intensive companies and helping the top line for consumer companies via higher real income growth. From an economic perspective, lower oil prices should help ease inflationary pressures and allow emerging market central banks to cut rates (or at least not raise them). For long-term equity investors, the sharp fall in the share prices of oil-related companies is presenting opportunities.

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1. Fitch Ratings, Oil: Fiscal Breakevens are a Key Guide to Exporter's Sovereign Credit Risk, 24 November 2014.

2. Credit Suisse, 'The Impact of Falling Oil Prices in Emerging Markets', The Financialist, 29 January 2015.

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