Dispelling Popular Misconception...That Rising Crude Pulls Equity Markets Down

Tarun Dang

Historical data shows otherwise. In fact, a positive correlation exists between crude prices and equities!

Iraq is on a boil with sectarian violence gripping the northern part of the country. Supply disruption fears have caused Brent crude to rise to its 9 month high at $115/bl. Rupee along with most other currencies, weakened against the USD and that has dented the sentiment in the equity markets. There is growing apprehension. However, history tells us that equity markets love knee jerk reactions, generally blown out of proportion (remember the sharp plunge of Aug 2013 on QE taper fears).

Historical perspective

This 25 year long chart with CNX Nifty and Brent crude plot dispels popular misconception that a rising crude oil will bring equity markets down or disrupt their long term trend uptrend. In fact the above chart shows a healthy and positive correlation between them. Closer inspection of a major equity index like the S&P 500 against crude shows that it followed equities across bull and bear trends over many decades in the past.

This trend can be explained in two parts; typically, but not always, rallies in commodities have been accompanied by rallies in equities. Sustained rising commodity prices are a sign of demand and economic activity which will eventually translate to corporate earnings, reflected in equity prices. Secondly, oil shocks (abnormal escalation of prices) have been temporary in nature. They did not have a material impact on the larger trend in equities.

Technical outlook for the next quarter

It's always challenging to analyze any long term, sustainable trends in a commodity like crude oil which does not merely react to laws of demand and supply but that of fear as well. Our technical studies show that crude oil prices are in a multi decade uptrend. The bottom in 2009 was the first leg of a larger corrective cycle which touched $44/bl. The rather choppy rise since then is the second leg of this corrective cycle. There is a technical case for this rise to extend to $125-$130 in the medium term and even $140 if the tension in the middle-east comes to a boil.

The dependency on crude imports

Iraq is India's 2nd largest supplier of crude oil after Saudi Arabia, in the wake of sanctions against Iran. We import 80% of our crude requirement. And so a sustained price escalation of this nature over a long period, coupled with an already weak currency will lead to a double blow to where it hurts the Indian economy the most! The current account deficit.

A lot depends on how the government with the help of RBI builds its import cover to tide over the spike in crude prices. The RBI has built FX reserves to $313.5 billion, allowing for 8 months of import cover. A import cover more than 8 months is essential for a stable INR. RBI has already been buying dollars since it slipped to near 58 levels to strengthen the import cover and also to support exports.

If crude prices spike by another $10-15/bl, our current FX reserves could potentially cover the losses. A continuous rise would be detrimental to the currency, markets and the economy. In the meantime, a short term correction in the markets led by these fears will not derail the long term bull run.

Investors have put faith in the new government based on its decisive leadership and pro-business history. This government is expected to take many unpopular decisions to straighten our deficit given the utter state of despair the previous UPA 2 government left the economy in. The serious investor is less likely to get dissuaded easily without giving time to the new government. Or by geopolitical events that are outside its control.

The author is Managing Partner, Trend-Wise Capital Management. Views and recommendations expressed in this section are the analyst's own. Twitter: @iTarunDang