

We are all oil traders now

Oil is the only differentiating factor in the performance of various equity markets this year. For now, it's a waste of time focusing on all other fundamental factors, says Ruchir Sharma.

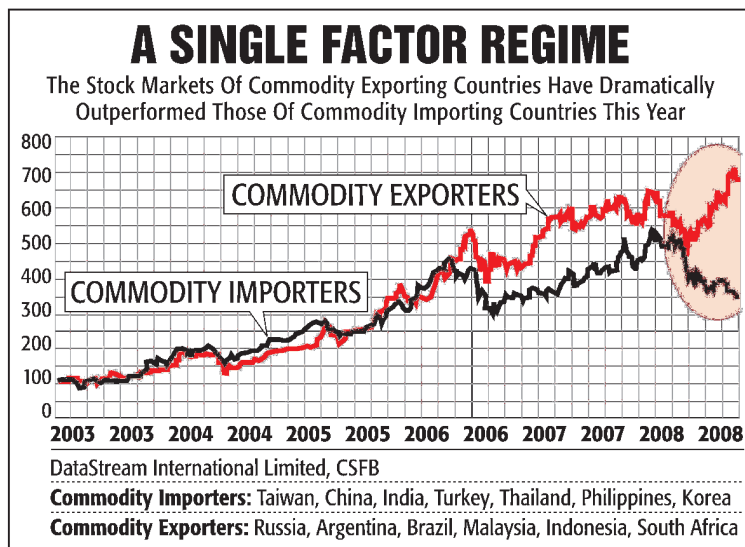
WITH India's equity market registering one of its worst ever first-half performances, harried financial analysts are rushing to "round up the usual suspects," to borrow a line from the inspector in the classic movie *Casablanca*. The cast of characters includes surging inflation, high valuations, political uncertainty, falling global risk appetite and, of course, soaring commodity prices.

But the archfiend is oil. Nothing else explains the Indian market's kamikaze dive this year. While the blow-off in the oil-led commodity complex has contributed in a major way to the near 15% decline in global equity markets, India's further 20% relative underperformance is entirely due to its high exposure to oil imports. Indeed, oil is the only major distinguishing factor in the equity market performance of various countries.

Reasons put forth for the disproportionate fall in the local market, such as high valuations at the peak in January 2008 or persistently rising inflation just do not stand up to cross-examination. For one, the Turkish stock market has dropped by the same magnitude as India's this year even though it never had a valuation issue; it was trading at a discount to most other emerging markets at the start of 2008.

India and Turkey rank near the bottom of the global stock market league tables this year as both the countries have extremely large oil import bills, running at nearly 5% of GDP. They have no other major commodity exports to offset the oil price shock and also have few listed companies that are commodity plays. Furthermore, if inflation was a crucial factor in differentiating performance, stocks in commodity exporting economies such as Russia and Nigeria, which have witnessed the most pronounced increase in inflation, could not have held up as well on a relative basis.

The current scenario is analogous to the 1999-2000 period, when equity market trends were driven solely by which countries had a high exposure towards the technology sector. India benefited from the tech-driven regime but now



finds itself at the wrong end of the lopsided wealth transfer centred on the oil boom. In the current context, it's all about rewarding economies that are net exporters of commodities. The principal driver of relative stock market performance is the share of commodities in each country's total market capitalisation.

A case in point is South Africa, where the economic fundamentals are terrible right now. The growth rate is slowing precipitously and is estimated to come in below 2% in the second half of 2008. Consumer price inflation is in double-digit territory and the central bank has been aggressively hiking interest rates. But the Johannesburg stock exchange, where commodities comprise half the index, has retreated less than the global averages.

Once again, local fundamental factors have played a marginal role in determining market trends. Argentina possibly has the worst track record as far as reforms go in the developing world while Turkey's current government has done a great job in changing the fundamental structure of the economy by undertaking some path-breaking reforms. But there is a 70% per-

formance spread between the stock markets of the two countries this year, with the Argentine market rallying strongly as it is dominated by large oil services companies.

STOCK market investors in India are then wasting their time waiting around for weekly inflation data or the monthly industrial production numbers to figure out which way the market is headed. All that's relevant is the price of oil — a fact apparent in the market's reaction function. Last Wednesday, the stock market managed to shrug off news of the RBI's larger than anticipated monetary tightening, focusing instead on the easing in oil prices in New York overnight. Conversely, the market fell sharply on Friday as oil prices took out the \$140 barrier.

It is critical to get a fix on the overall regime at work in any period to understand the rules of engagement. The prevailing regime is uni-dimensional as it revolves only around the price of oil, rendering stock selection and local analysis irrelevant.

Even within countries, there has been a massive performance gap between the commodity and domestic sectors. In Brazil

—arguably the biggest star among emerging markets due to its high commodity orientation — oil and metal stocks are up 20% year-to-date while other domestic companies are down 10%. Although Brazilian domestic demand related stocks have still outperformed similar companies in oil-importing countries, for the Brazilian investor too it's been a tale of two different worlds. It's a sign of the times that the very divergent performance trends among various sectors have resulted in commodity-related companies presently forming nearly 40% of emerging market capitalisation while consumer stocks account for less than a 10% share.

What all this suggests is that if and when oil prices turn, the sectors and broader markets most afflicted by the oil price shock will rally the hardest. So regardless of inflation or economic growth data, the catalyst for a turnaround in the fortunes of Indian equities is a reversal in the price of oil. Once oil settles down and the market stops obsessing about its daily price gyrations, a new investment regime in which more fundamental factors such as core inflation and long-term growth prospects drive returns can gain ascendancy.

Until then we are all effectively oil traders. Taking a directional view on black gold is what matters. Unfortunately for equity investors, the news on the oil front has been increasingly disheartening. Despite widespread signs of demand destruction, the price of oil remains stubbornly high. It is almost as if the message from the marketplace is that oil prices need to get to such an egregious level that global economic demand cracks decisively.

As was the case with the tech boom in the 1990s, price action tends to get very violent towards the final stages of a bull-run and leads to all sorts of extrapolative forecasts involving ever higher price targets. It's hard to forecast when such psychology will break. History suggests regimes in which a single factor overwhelms market behaviour are eventually unsustainable. However, till the parabolic move in oil is over, market participants need care about just that variable in making all decisions.