Investment Note

Manulife Asset Management

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Oil prices and Asia: Who wins and who loses?

With the price of oil having fallen to its lowest point since 2008, Manulife Asset Management's team of Asia equity specialists takes a closer look at what cheap crude means for Asian economies and markets. They find that the implications go well beyond the economic winners and losers, with low oil prices also having potentially significant implications for government policy in parts of the region.

One thing that cannot be debated regarding the recent plunge in the price of oil is that it has been a boon for consumers in much of the world. As lower manufacturing and transportation costs flow through to lower retail prices, restrained inflation and fatter consumer wallets, many economies around the globe are benefiting from an unexpected jolt of economic stimulus via lower prices at the pump.

At the national level, however, things are more nuanced. It is hardly a surprise that oil exporters such as Saudi Arabia, Russia and Venezuela are being hurt as their oil earnings plummet. On the other hand, while the net effect on Asia is positive, a closer look reveals that this is not necessarily for the obvious reasons. Indeed, the impact is being felt at many levels in Asia, with the low cost of crude having implications for consumers and corporations, but also for government policy and the associated pace of social and economic reforms underway in some markets across the region.

China balances economic growth and reform

As the second largest oil importer in the world, **China** is a clear winner from lower oil prices – the current about-US$50-per-barrel level could boost its 2015 GDP growth by 0.2-0.3%[1]. This would mainly be driven by the positive effect of lower commodity input costs for manufacturers and lower packaging costs for consumer staples companies – we are positive on both of these sectors. That being said, the benefits are likely to show up more on corporate income statements than in consumer wallets, as companies in China are often less quick to pass cost savings on to consumers than their peers in the US market, for example. The main losers in China will be oil producers and the oil production supply chain. Despite being a large importer, China is also a major oil producer.

At the policy level, we have just seen the announcement of 2014 GDP growth of 7.3% year-on-year, partly due to economic stimulus in the form of an interest rate cut, direct liquidity injections and targeted spending. We see the potential for additional rate cuts and even further targeted stimulus in 2015, but believe that low oil prices will have sufficient stimulus effect to lessen the need for direct government action.

Moderate positive to Hong Kong and Taiwan

As oil importers, **Hong Kong** and **Taiwan** are also benefitting from low crude prices, just not to the same degree as China. Hong Kong has a relatively low concentration of manufacturers, but will see some policy effect as lower inflationary pressure makes an interest rate hike less likely in the near term. This allows the central bank to save its monetary policy ammunition.

[1] UBS, *How will lower Oil Price Benefit China?* January 2015.

Meanwhile, although Taiwan is a manufacturing powerhouse, resident manufacturers will see less benefit than their Chinese counterparts as Taiwanese manufacturers are generally high-tech companies that are further up the value chain. This translates into higher margins and a lower percentage profitability gain for any given decrease in the price of crude. That being said, Taiwanese semiconductor manufacturers are enjoying a surge in demand as newly flush US consumers step up their spending on technology gadgets which require ever more silicon content as their capabilities and complexity evolve. We are positive on Taiwanese tech manufacturers and auto parts manufacturers, which are benefitting from strong automobile demand in the US.

South East Asia benefits to varying degrees

In South East Asia, **Indonesia** may be the biggest beneficiary of cheap crude from both an economic and political perspective. The country is a net importer of oil and historically heavily subsidised gasoline. President Joko "Jokowi" Widodo swept into power last year with a platform of aggressive policy reform and took immediate aim at the wasteful subsidies, with falling oil prices allowing him to move much more quickly than would otherwise have been possible and significantly offsetting the potential impact on inflation. This is expected to free up to US$8 billion for other uses by the end of 2015, primarily much needed infrastructure investment to support continued economic growth[2]. Against this backdrop, we are positive on manufacturers in Indonesia, which are benefitting from reduced commodity prices, and on sectors geared to domestic consumption and the construction, infrastructure and property markets.

Thailand is also a net importer of oil, and is benefitting as low crude prices feed through supply chains and show up in enhanced margins and earnings growth. Like in Indonesia, the low price of oil has reduced inflationary pressure in Thailand and allowed government oil fund subsidies to be cut with minimal effect on consumers already burdened by high levels of household debt. Key beneficiaries include manufacturers and sectors geared to domestic consumption and the construction and infrastructure markets.

Also a net importer of oil, the **Philippines** is in a similar position to Thailand, though the net effect is less apparent as the Philippines has not historically provided fuel subsidies. That being said, higher-than-average inflation in 2014 had set the stage for an interest rate hike that is now not likely to go ahead. We are positive on sectors exposed to domestic consumption and on utilities, which are enjoying lower input costs. However, few Philippine construction or manufacturing companies are listed, so while these companies are benefitting, they are not accessible to most investors. We are more interested in the gaming sector at the moment, as the Philippines' first integrated gambling resort will open in February 2015 and is expected to draw significant tourist traffic.

Malaysia is in a rather different position vis-à-vis oil prices than its ASEAN peers, as it is a significant oil producer – though still a net importer if liquefied natural gas (LNG) is stripped out of its export numbers. Regardless, the Malaysian government depends on dividends from Petronas, the state-owned oil giant, for a large part of its funding. It is estimated that oil at the previous US$100 per barrel would have resulted in a 2015 budget deficit not exceeding 3.0% for Malaysia, while oil at US$55 per barrel is likely to translate into a 3.2% deficit[3]. There are obviously significant policy ramifications to this situation, with the government having already revised its budget to cut operating expenses, cancelled lower-priority capital projects and launched a campaign to boost local sourcing by government agencies and corporations in a bid to minimise the impact on its already thin current account surplus. The oil and gas sector has obviously been the hardest hit, while we are constructive on Malaysian manufacturers and sectors geared to domestic consumption.

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[2] http://blogs.wsj.com/moneybeat/2014/11/18/markets-rally-as-indonesia-cuts-fuel-subsidy/
[3] http://www.thestar.com.my/Business/Business-News/2015/01/20/New-fiscal-deficit-for-2015/?style=biz

Finally, **Singapore** is the odd country out in South East Asia. While its relatively large oil and gas support services sector has been negatively impacted, the nation is not host to a large manufacturing industry, so the benefits accrue mostly to the transport sector – ranging from taxis to shippers – which will benefit from lower fuel costs. Singapore meanwhile continues to struggle with wage inflation, and low oil prices will do little to ease this pressure.

Figure 1. Impact on trade balance for every 10% decrease in crude oil prices

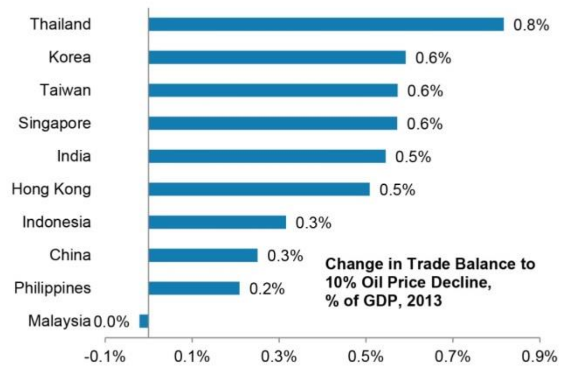
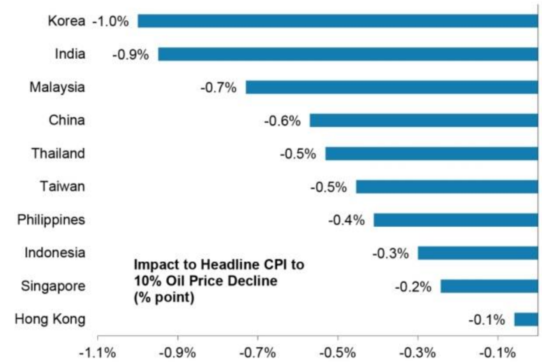


Figure 2. Impact on inflation for every 10% decrease in domestic fuel prices



Source: Bloomberg, CEIC, Morgan Stanley Research, October 2014.

Conclusion

Overall, Asia is a net beneficiary from low oil prices from an economic perspective. What should not be underestimated, however, is the policy impact of crude prices. Low oil prices are raising challenges for the Malaysian government. However, in much of the rest of Asia cheap crude is spurring economic growth and is putting the wind in the sails of government reform in China and Indonesia and, to a lesser extent, Thailand – it is always easier to make changes when economic time are good, after all. These changes could have ramifications that live well beyond the current economic cycle and should continue to pay dividends for many years to come.