Economics & Strategy

DBS Flash

Saudi drone attacks: Implication for assets

Economics/Strategy/Rates/FX/Credit/Equities

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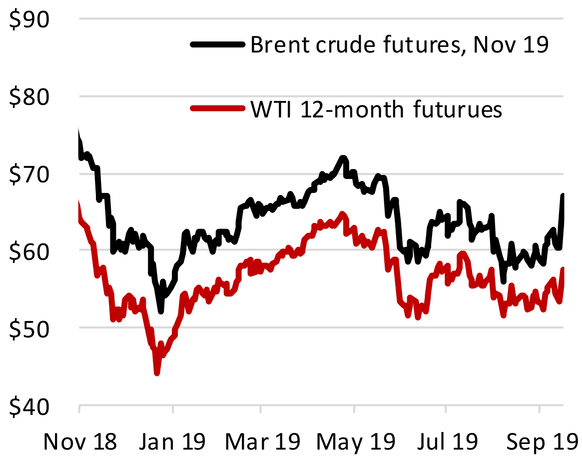
Crude oil futures jump



Source: Bloomberg, DBS

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- *This weekend's drone attacks on Saudi oil facilities mark a major setback to the global geopolitical landscape.*
- *Breakdown of peace talks between the US and the Afghan Taliban, continued uncertainty over North Korea, and the chance of a major military conflict involving Iran are adding gloom to the outlook.*
- *Drone attacks may affect 50% of Saudi production, but repairs and stock drawdown would prevent an immediate supply crunch.*
- *Activation of US strategic reserves and other OPEC economies stepping in to raise production would also help the supply conditions.*
- *However, strikes on Iran by Israel, Saudi Arabia, and/or the US would cause major spikes in global oil prices*
- *EMFX would be the immediate casualty, in our view, especially those affected by large oil import bills.*
- *Flight to safety is to be expected, supporting gold and government bonds*
- *The most vulnerable asset class could be EM credit. Already, in the past month, spreads have widened around CNY depreciation.*
- *Military conflict would tighten dollar funding conditions and reduce risk appetite, challenging debt service.*

Wake-up call

This weekend's drone attacks on Saudi oil facilities ((Abqaiq refinery and Khurais oilfield) mark a major setback to the global geopolitical landscape. Just as conditions were falling in place for US-Iran talks, the weekend's events push risks in the opposite direction.

The attacks crippled Saudi Arabia's oil output by about 5.7mmbpd, or around 5% of global supply. Half of the production disruption is expected to be restored by Monday, while full recovery would likely take a few weeks. In the meantime, Saudi Arabia will tap into its crude oil stockpile, which should be adequate to cover the temporary supply outage by 35-40 days. In addition, US President Trump has authorised the release of emergency inventory from the US strategic petroleum reserves. If Saudi Arabia takes longer than expected to mend the affected production and tensions in the Persian Gulf remain elevated, there could be upside risks to our USD65/bbl oil price forecast in the coming quarters. Futures markets this morning are reflecting similar concerns.

Breakdown of peace talks between the US and the Afghan Taliban, continued uncertainty over North Korea, and the chance of a major military conflict involving Iran are adding gloom to the outlook. In particular, strikes on Iran by Israel, Saudi Arabia, and/or the US would cause major spikes in global energy prices.

Implication for asset classes

Currencies. We think that given the ongoing developments, EMFX would be the immediate casualty. especially those affected by large oil import bills. In this regard, IDR, INR, KRW, and THB would top the vulnerability list. The MYR will be the most resilient, given that Malaysia is the only net oil exporter in EM Asia. The region is vulnerable to prolonged high prices weighing on the global economy. Recent hopes for an easing in China-US trade tensions could be displaced by the fears of an escalation in US-Iranian tensions. China is not only Iran's top trading partner but has also extended USD10bn in loans to Chinese companies to build infrastructure in the country.

Rates. In the short term, risk aversion is inevitable, and US Treasuries are likely to retrace some of their recent selloff. On balance, this marginally raises the probability of a Fed cut at this week's meeting. Some premium is likely to linger in oil prices, but this should not be sizable enough to warrant a re-pricing in inflation expectations. Moreover, the supply disruption is not expected to last beyond a few weeks. In any case, we think that DM rates may have traced a bottom in early September as excessive pessimism on the global economy and China-US trade war gets faded.

Credit. The most vulnerable asset class could be EM credit. Already, in the past month, spreads have widened around CNY depreciation. The impact of higher oil prices for India and Indonesia could cascade from a deterioration in the terms of trade to a tightening of external financial conditions. Higher oil import prices and the resultant compression in margins could impair the willingness of lenders to rollover or extend USD loans in these two economies.

Our analysis of BIS's consolidated banking statistics shows that Indonesia is more vulnerable to India in terms of external liquidity risks. For one, foreign banks' international claims on Indonesian entities remain somewhat high at 11% of GDP, despite having eased from its 2014 peak of 13%. Furthermore, these external claims are almost as large as Indonesia's reserves. The state will be constrained in terms of the USD liquidity it could provide, without impairing confidence in the IDR. India's case is more benign compared to Indonesia, as USD loans have always been restricted by regulations on ECB (external commercial borrowings). Foreign banks' international claims on Indian entities, as a proportion of GDP, are only half of Indonesia's. Furthermore, these claims can be adequately covered by India's FX reserves, which are over two times the amount of international liabilities to the banks.

Equities. Other than helping some oil exporting companies, the overall impact of heightened risk is negative for global equities in the near-term. Clearly, the planned mega IPO of Saudi Aramco IPO will be affected by ongoing developments.

Implication for regional economies

China. Higher oil prices could lead to an increase in motor-fuel surcharges under "transportation" in the CPI basket and contribute to higher tourism spending due to increases in aviation surcharges. Specifically, we estimate that a 20% increase in oil prices could push up headline CPI inflation by roughly 0.4pp.

Upstream industries will be hit relatively harder than the consumers. Policymakers will unlikely withstand rising cost-push inflation on the back of weakening domestic demand and a worsening trade war with the US.

Higher oil prices will boost China's import bill. Given that oil accounts for 10% of total imports, a 20% rise in oil prices will boost imports by about USD43bn. The current account balance as a share of GDP currently standing at 1.34% of GDP will likely decrease to 1% in H2 2019 and 0.5% in 2020. As a result, growth of foreign reserve will likely shrink, exerting downward pressure on the CNY exchange rate.

India. High reliance on imported crude to meet 83% of its domestic oil demand leaves India vulnerable to movements in global oil prices. Saudi Arabia is India's second largest supplier of crude and cooking gas. For every dollar move in the Brent prices adds around USD2bn to India's oil imports bill. A 10% rise in crude prices, widens India's current account deficit by 0.4-0.5% of GDP.

Indonesia. The impact of higher oil price to fiscal balance is net positive, as additional non-tax revenue is usually larger than the possible increase in fuel subsidy. A USD1/bbl increase in oil price is associated with increase in government revenues by IDR3tn. As the oil price assumption is USD63 in the 2020 budget, there will be an additional tax revenue of IDR51tn or 0.25% of GDP, resulting in fiscal deficit of around -1.5% of GDP in 2020.

Singapore. Although Singapore is a net oil importer, with a deficit of SGD15.4bn (3.1% of nominal GDP), its oil and gas sector (accounting for 5-6% of GDP), together with other supporting services, are expected to benefit from the higher oil price. Singapore has one of the highest current account positions in the region (+17.9% of GDP) and the impact will also be offset by increase in refined petroleum exports. Impact on the economy will be mostly felt in terms of inflation. Every 10% increase in oil prices will likely add about 0.3ppt to the headline CPI inflation. Yet, the impact could be partially offset by lower electricity tariffs as a result of the introduction of the Open Electricity Market (OEM) scheme since Nov18.

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).