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FOR WHOM THE BELL TOLLS

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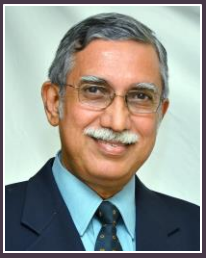

As a strategy consultant, Raj has helped companies across diverse industries in India, USA, Europe, and the Middle East to develop strategies, align strategy to vision, grow in competitive markets, restructure to make companies more customer focused etc.

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FOR WHOM THE BELL TOLLS

By **Mr. Raj Nair,** Chairman of Avalon Consulting

No man is an island,
Entire of itself.
Each is a piece of the continent,
A part of the main.
If a clod be washed away by the sea,
Europe is the less.
As well as if a promontory were
As well as if a manor of thine own
Or of thine friend's were.
Each man's death diminishes me
For I am involved in mankind.
Therefore, send not to know
For whom the bell tolls,
It tolls for thee.

The likely events of 2015 due to oil price fall and volatility can be seen through the lens offered by John Donne in this famous lines from Devotions Upon Emergent Occasions (1624 Meditation 17).

The global economy is going to benefit from the oil price drop but it is going to hurt those who were benefiting from high oil prices, right from oil producers to prospectors and speculators besides those dependent on the prosperity of oil producers. They are the ones who are squealing and giving the impression that the world is about to collapse. It will be instructive to look at the oil prices from 2002 to 2007 to understand this ***(See Chart 1)***. The world was chugging along fine at sub $50 oil prices before rapid growth in BRICs (China and India) propelled oil demand and the hunger of speculators. Oil producers benefited but the world adjusted to the rising prices. Now that it is back to where it used to be, the global economy is not on the verge of collapse. There will be a period of adjustment again. It is the turn of the oil producers to reconcile, not just producing countries but also regions within them. In the US and Canada, there are examples of oil producing regions losing while oil consuming regions gaining.

CHART 1: Crude Oil
US$/BBL

SOURCE: WWW.TRADINGECONOMICS.COM | NYMEX

No Man Is An Island

No country is an island and every one of us is going to be impacted by the strange twists and turns of remote events which will determine the course that our intertwined future is going to take. That sounds a bit fatalistic but mankind is actually digging furrows, deep ruts and chasms in which will flow our future. One such chasm is our insatiable hunger for energy. On the one hand the world's energy needs have risen and will spiral further given that emerging economies are heading down the energy guzzling path created by Western economies, while on the other hand, precious little has been done to create bold new large scale sources of energy which can feed the yawning gap that is developing. Instead, all seemingly 'path-breaking' efforts (shale oil included) tend to only marginally increase supply. It will not solve the world's problems in the long run but even this marginal development can shift the balance between consumers and producers of oil. Politics and social behaviour built around essential commodities react to even small surpluses or shortfalls. Instead of aiming to solve the world's energy problems for next half a century or more, technology has hitherto looked at the world through myopic economic lenses. What the world needs is radically new solution to save it from itself but it will cause a tectonic shift if new suppliers of energy replace the incumbents. Since oil will be the main force for economics and politics in 2015, it will be the central theme of this note.

Bloody Fracking Oil

Many oil supplying countries will curse thus, but what is happening in the Bakken formation in USA, will bring good tidings to oil importers like India and several countries in Asia and Europe. 2015 will be witness to economic upheavals in the global oil market without the overall demand rising or falling very significantly. The play will be on the supply side, which can only invite attendant forces like political expediency, strife, selfishness, bigotry, violence, etc. to the centre stage. Since these consequences will rule our lives in the coming year or longer, let us look at how these will impact us as peoples of the world and businesses that transcend boundaries of nations. It is useful to remind the reader of two facts:

- That MNCs are powerful. A third of all international trade is between different arms of individual multi-national corporations (MNC) and another third is between various MNCs.
- 62% of the oil produced is traded internationally.

Hence oil price movements and regional shifts in oil demand and supply will impact cross-border trade, exchange rates and money flows will be willy-nilly connected.

In my previous annual paper *(for 2014 - The Five Go to Delhi Amidst Optimism in a Fragile World*), I had referred to shale oil's impact on the US because it would be an important topic for 2015 given the pace at which fracking technology was evolving in 2013. Back then there were others who also thought so. For instance, the Saudi Government had prepared their 2014 national budget assuming oil price to be $75 per barrel despite the ruling price at that time being around $100. The Saudis wanted oil prices down to probably render investments in shale oil development unattractive. This is a defensive tactic that has worked well for decades to curb the march of solar energy and other non-conventional energy technologies. The ME dreads the thought of a self-sufficient US losing interest in the ME oil. The delicate Arab – Israeli equation could tilt adversely against the Arabs. Right now it so happens that the US too would like oil prices to be low for a while so as to bleed Russia which has, under Putin, become difficult for the US and Europe to deal with. The Western economic sanctions have bombed the Russian economy which is now in negative territory. The same could be said of Iran which has invested seriously in nuclear energy and is facing knuckle breaking sanctions. 2015 could see further deep decline in the Russian economy because oil & gas feed 50% of Russia's economic budget. The Rouble has already tumbled 38.2% in 11 months by Christmas day. The Russians who are not blind to the import of this, now need more volume throughput to offset the price drop. With the economic needle shifting from the West to the East, where else would it look than China and India? They topped up the successful $400 billion gas supply deal signed with China in May 2014 with another $280 billion, in November just before the APEC Summit 2014 in Beijing. The gas will flow only from 2018 but till then Russia's cup of woes is full. The West knows that Russia needs a short term solution like lifting of economic sanctions by the West and will hope for a toothless Putin or a Putin-less Russia in return. China, the new banker to the world, may still oblige Russia financially unless they can wrench some concessions for themselves from the US. Will China fund Russian Banks like VTB, OAO Gazprom bank, Russian Agricultural Bank, etc. which are badly in need of fresh capital? Possible, but it is too early to take that call.

Xi Jinping's comment at the APEC Summit was telling. *"Now fall has set in, it's harvest time. It's time to gather fruit".* Fruit indeed, since the gas deals could potentially mean that China has secured 20% of its growing gas requirements in 2020! This will put it in a stronger position to negotiate arrangements with Australia, the other big energy exporter in the region. This deal with Russia, which may be partially done in Yuan, can have grave portends for the US $ because it could embolden China to challenge the reign of the US $ as the sole global reserve currency. The US is aware that this can happen and that the BRIC Bank being set up a rival to the US controlled IMF, can over a period of time take the shine off the dollar.

Decisions taken on creating a BRIC Bank in Fortaleza in 2014 will not, in the near future, kill the decisions taken under US supervision at Bretton Woods in 1944, but it is something that could eventually result in a basket of reserve currencies. China will periodically make the US aware of this eventuality and this would be an undercurrent in the Sino US relationship even in the short term. Yet, 2015 will be the year of the Dollar; companies with uncovered exposure to the US $ must beware! The long term future of the Euro is still rocky because the EU constituents never seem to be able to act on measures required to keep it healthy. Chronic patients like Greece, Portugal, Italy and Spain may show short bursts of wellness but untreated patients and their families are known to suffer.

If A Clod Be Washed Away By The Sea, The World Is The Less...

When the price drops below $60 a barrel, (already $53 on Dec 31, 2014 and could drop below $50 in January), there are unhappy consequences for all OPEC member countries which together are home to 440 million people whose lives will be impacted to various degrees. Countries like Venezuela, Nigeria and Iran could get unstuck if oil prices remain low for a year. They need oil to be above $120 per barrel for their national budgets to break even. No tears will be shed by the Big Powers for Venezuela, Russia and Iran but as Donne said in his poem, "if a clod is washed away, Europe is less". The world cannot afford to ignore the consequences of misery, unrest, violence, etc. in Venezuela, Iran, Iraq, Algeria, Libya and even Russia. The Saudis can manage with slight belt tightening as also Kuwait, UAE and Qatar but the rest including many other OPEC members will face serious consequences. Even with oil accounting for hardly 13% of its exports and just a third of the Government's revenue, Mexico would be close to OK only if oil is at $75 in 2015.The exodus of expat workers from the GCC countries could become an issue for India, Philippines, Bangladesh, Sri Lanka, etc. if construction and infrastructure activities are cut because oil does not settle quickly at about $ 70 to 75 before the year is out. The price rise could happen if oil supply is cut in oil producing countries due to social turmoil or war, etc. That price would ease the problem somewhat in the GCC, and will leave existing shale oil extractors in the US, largely safe in the short term because many of them are today able to start generating positive cash flows at $42 to $48 oil prices. But it will discourage new shale investments by Hedge Funds and junk bond investors in 2015 because the heavily indebted existing shale wells will not generate much money to pay back old debt and to reinvest in new wells, when the existing wells run dry (average life about 3 years). Oil at $80 per barrel will however, encourage further development of fracking technology and will encourage prospectors, even in other countries to have a go at shale oil. Brazil is one of them. That would pose a serious barrier against oil prices crossing $100 per barrel in a hurry unless social strife or war causes very serious supply dislocations. But such events cannot be ruled out given the rise of ISIS and other social problems which low oil prices can lead to. This is why predicting oil prices is difficult but understanding its impact is still possible.

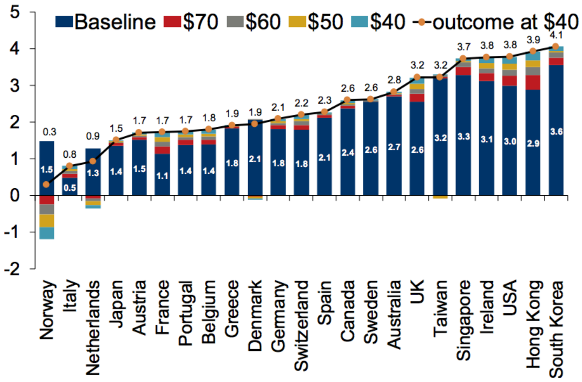
It would be safe to conclude that oil polemics will leave the US where it wants to be, its adversaries like Russia, Venezuela and Iran chastened, its allies (Saudi Arabia and some OPEC countries) somewhat poorer but not down and out. However, it will inflict collateral damage on some countries like Egypt, Nigeria, Iraq, Algeria, Angola, Ecuador, etc. Since the US wants to be the undisputed global leader, it can conveniently heed John Donne and win influence in the suffering countries by helping them out of the crisis (in some cases, after getting them to accept some international demands). It is a game that China would also like to play.

Where Does All This Leave Growth In The G7 And Oil Importing Counties?

The US, the largest oil producer and importer, will on balance, be a bit better off than before. In fact, in 2015 the world will depend more on the US than on China to lift it out of the problems that it has been since 2008. The import intensity of US growth is likely to be much higher (above 2.5 times GDP growth) than that of Emerging Markets like China, India, etc. (less than half the US ratio). India's role will be minor but will become increasingly relevant in the years to come. China under Xi, is at the threshold of significant macro-economic reforms that will rebalance the power between private enterprise and SOE (State Owned Enterprises). The role of the SOEs in creating capacities ahead of time without regard to principles of financial prudence, and in general, contributing to investment led growth, is going to diminish. So also is the dependence on labour intensive and polluting industries, so that China's long term future is protected. China will be a major beneficiary of low energy prices. In 2015, USA and China are expected to register a growth of about 3 to 3.1% and 7 to 7.3% respectively. Given that the EU consumes 14.8% of the global oil while producing only 1.8%, it is obvious that low oil prices will be good for the EU. There is an analysis by Oxford Economics **(See Chart 2)** that quantifies the view that low oil prices will be good for Europe despite the fact that inflation will fall below the ECB target of 2% in 2015 and could be in the negative territory for some EU countries. Not a bad thing considering the consumption led GDP growth is ultimately what it seeks. There are some alarmists who suggest that it will create a serious deflationary environment in Europe.

CHART 2: GDP Growth Under Baseline & Oil Scenarios

Baseline and impact on average growth 2015-16



Source: Oxford Economics, Haver Analytics

The EU as a whole will have sluggish growth of around 1 to 1.3% but within that France, Italy and Belgium are expected to pull the average down. Greece, Portugal, Germany, and Netherlands would be relatively better off, whilst the star growers could be Ireland, Lithuania and UK.

Will lower inflation embolden Central Banks in the EU and the UK to raise interest rates? Will they be a bit more cautious about dosing the economy with some QE? Such questions remain unanswered because of the track record of the EU in allowing political expediency to score over economic logic. Greece remains a major worry leading to uncertainty across the EU.

Canada will get impacted at sub $ 50 oil prices. But oil importers like India, China, Japan, S Korea, Germany, Italy, France, UK, etc. could not have asked for a better gift from Santa. In fact, some ME OPEC countries are offering special discounts to Asian countries. It is believed that a $10 drop in oil prices could improve the GDP by about 0.2%. Add to that a reduction in inflation. Oil importing Emerging Markets could not have asked for more.

Financial Markets And Flows

The oil price contagion is already spreading into the financial markets. In the midst of all this, the world will continue to remain awash with liquidity, what with Japan infusing liquidity in the market with its version of QE and with the EU facing the same unanswered questions, about how to deal with the problems that have been on their table since the end of 2013. One major concern that should be tracked through 2015 is the divergence between US equity market s and the Bond markets, the former being optimistic and the latter expecting a recession. Particularly interesting could be the flattening yield curve in the bond market. If the flattening is due to higher yield expectations in the 2 year paper, it is understandable given the impending interest rate hike, but if flattening is because investors are not demanding higher yields for 10 year papers, it could be that they don't expect significant inflation and/or growth to happen in the foreseeable long term. Extended stagnation or even worse, recession? Lead indicators suggest the potential for a surprising flattening of the yield curve in 2015-16. The markets seem to be cognisant of the fact that USA's long term problems (explained in my previous annual papers) will not just go away easily. The short term looks encouraging for the markets. Funds flow from Emerging Markets to the US was significant in 2014 (2.6% drop) and will increase in 2015 when the US interest rate is hiked. Global equity markets can expect to be buoyant on the back of higher GDP growth but in Europe, the performance of equities could depend upon Draghi's ability to introduce QE to lift the EU economy and on Greece's post-election stand on austerity. Indian equities would see a bullish trend but volatility is expected to be the norm in India and globally.

Implications Of Oil Price Drop And Volatility For Business In General

The answers will vary by industry and can be the subject of another paper but they are not difficult to seek if you pose the right questions. For example:

RM or RM substitute:

- If you consume oil downstream products as raw materials 2015 could be good, but what will your strategy be to keep some of that benefit for yourself instead of having to let it pass through to your customers? How will you deal with price volatility?
- If you use a raw material that has an oil derived substitute, how soon can you negotiate a price reduction given that oil prices will not hit $90 in a hurry?
- If you supply such a raw material, what should you be doing to you protect your margins? What is your hedging strategy?

Finished product

- If you supply raw materials or intermediate products to large oil prospectors, refineries, or petrochemicals companies, your volumes may not be under immediate threat but what about your strategy to protect margins?
- If you are in a cyclical business that benefits from low oil prices, what is your strategy to build muscle and capital for the next cycle?

US Dollar

It seems like a one-way bet on the dollar rising. What should companies with open exposure to the dollar on raw materials or on finished products do? What about companies that have un-hedged US $ debt exposure? Hedge or diversify markets to offset currency exposure? What if your country has a deliberate policy to weaken her currency like the Yen?

Government spending or subsidy

If your margins depend on Government subsidy or the demand for your product depends upon Government spending, and you operate in countries where the Government will not be able to spend much (eg. Many oil exporting countries)

- How will you protect your margins?
- Where will growth come from?
- Will your key suppler or customer go broke?

Energy guzzlers

If you are a producer of metals from ores, or caustic soda/ chorine from salt or any other energy guzzler, that use fossil fuels including coal (and not electricity from the grid), the chances are that you are in for a windfall in 2015. One key question is:

- Should you be hedging the energy for the medium term given that oil prices may not shoot to $90 per barrel in a hurry or should you be buying periodically following the ups and downs?

Brands (pricing stability, price positioning)

If you are a branded supplier of products that use a lot of oil downstream materials like plastics whose prices will be volatile in 2015, you will no doubt, demand lower raw materials prices (given that supply volumes are unlikely to get dislocated) but

- If you are a B2B player,
  - To what extent can you retain most of the extra margin without losing volumes?
  - How can you protect yourself from customers demanding a price reduction before your suppliers drop their prices? Often, it is difficult to make even back-to-back contracts with price pass, coincide.
- If you are a B2C player,
  - A strong consumer brand that uses oil downstream for packaging does not have to worry except about the overall demand for their products due to country specific economic conditions but even if the product itself is linked with oil downstream,
  - Like lubricants, the question is really how to exploit the rise in demand due to more usage of vehicles than about cutting prices in line with lower costs
  - Like plastic spectacle frames, cell phone covers, footwear, laptop bags and covers, pens, etc. or even some types of cars and two wheelers, branding should provide stable pricing even while the raw materials are volatile. You will probably see upsides because of higher consumer spending in the world in general and some countries like the US, China, India, the UK, etc. in specific.

Implications for India

After 3 really lost years, the Indian economy is going to look up in FY 2015-16. To get a measure of how bad things have been at 5% growth, you have to understand that it is lower than the average growth of 5.8% for the last six decades. It takes at least a year to steer economy out of the mess it had been in. Before getting into what will happen to the Indian economy in 2015, it is instructive to recognise what killed in the last 3 years and why things could be different now.

- A spineless Prime Minister has got replaced by a strong leader
- In place of an indecisive Government which virtually brought infrastructure sector investments to a halt, there is a Government that is willing to take bold and clear decisions be it on governance or defence or the economy or foreign policy.
- Irresponsible governance that made it difficult for bureaucrats and senior bankers to take decisions without fear of future reprisals is slowly being remedied
- Incomprehensible actions by the Government that drove MNCs away from India are being visibly reversed
- The coal and iron mining sector which was in a coma due to corruption in the highest quarters followed by the Court's activism, could be woken up in another 6 months
- High interest rates necessitated by the previous Government's inability to curb fiscal and current account deficits, could see a drop before June 2015 largely due to fortuitous drop in oil and commodity prices, although economic risks would still persist. India stands to gain because of the drop in prices of the two major imported goods, oil and gold (due to a strong dollar) whilst the well diversified export basket is not going to be cheaper.
- Inadequacy of long term financial resources has been a problem but that could change because of interest shown in India by Japan and China, besides global MNCs.
- Lack of confidence of the Indian private sector in the economy under the UPA's governance, leading to new investments heading overseas has started reversing, starting with mere hope and little else in June 2014. That hope will get strong legs from March after the presentation of the Budget 2015.

Some commentators wrongly say that drop in oil prices, has weakened the Rupee. It happened at about the same time, but actually the Rupee has weakened because the dollar strengthening due to the impending US interest rate hike and a surge in demand for dollars. Oil price could drop further and a probably rise later. Even an average price of $65 to $75 per barrel for the full year and interest rate reduction with inflation dropping, will favour growth. Petrol, diesel and cooking gas subsidies could drop, thereby reducing the budget deficit. This will all add up to a lucky bonus of about 1% real GDP increase for the Modi government. Normal monsoons along with restarting of coal and iron ore mining besides getting stranded infrastructural projects moving could add another 0.5 % taking the overall GDP in FY 2015-16 to around 7 +/- 0.3%. A better estimate can be obtained in March after the annual Budget. Business friendly policies implemented through bills in the Parliament or ordnances will encourage FDI and foreign portfolio investment in India despite Emerging Markets seeing a slowdown in foreign fund flows, given the increased attractiveness of the US markets. This is a far more optimistic estimate than most commentators have predicted. The Indian capital market is likely to expect too much from the Annual Budget and could rise in anticipation and even fall temporarily immediately after, but clearly the bull-run will continue.

- Automotive (passenger and CVs) will see a boost in demand as will plastics and downstream petrochemicals due to lower oil prices. This will, in turn help a wide range of suppliers of products that are linked with automotive demand like lubes, etc. like Castrol, etc. and several downstream processors of plastic, especially those with strong brands, like Sintex, etc.
- Oil upstream companies like Reliance, Cairn, etc. will get hurt. Indian companies which have heavy reliance on infrastructure and engineering contracts in the ME could get hurt too.
- Real Estate would firm up as will cement and other construction materials. Steel and steel downstream demand which is intimately linked with GDP will witness a revival as will non-ferrous and mining industries. Paint companies, especially Asian Paints, will gain on the demand side as well as on the cost side because many of

its raw materials are oil derived. Suppliers of fillers and other materials to the polymer and coatings businesses will also gain from increased demand.

- Lower inflation and more money in the consumers' pockets augur well for the FMCG companies in 2015.
- While the Rupee at 63+/ 2 to a US $ in FY 2015-16, would help export competitiveness, there is concern that demand from the UAE which is India's largest trading partner may be dampened by low oil prices. Demand from the EU is unlikely to rise much in the near future, leaving exports to the US and Asia as the bright spots. Our study in 2014 on Sino-Indian trade strategies clearly identified specific areas in which India's exports to China could be increased substantially and the actions needed at the Government level. A small beginning in the coming year leading to a substantial jump in the medium term could surprise many observers who have taken a defeatist position on India's negative balance of trade position vis a vis China.
- Flow of investments to international destinations from the Indian private sector would reverse in favour of India, leading to a boost investment in manufacturing and services businesses in India which suffered enormously in the last 3 years. Capital goods industries could see a turn around by the year-end.
- Inflow of FDI, especially from Japan, China, US and the ME will part support the capital required for 7% growth in FY 15-16 and help sustain high growth thereafter.
- Across business sectors, India incorporated will face some wage inflation without commensurate productivity increase and significant job hopping now that growth will return. The march of technology continues. 2015 looks good for smart phones and consumer apps. Ecommerce will dance in concert with that. Last mile logistics businesses could see immense growth opportunities in India

IT TOLLS FOR THEE

On balance, 2015 will be a better year globally but the bell tolls for speculators and those who do not rethink their game plan.

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