Correlation Between Oil & Equities

One of the most troubling and confusing aspects of recent market volatility is the close connection between the oil market and the stock market. Why have lower oil prices led to lower equity prices in 2016?

Falling oil prices are typically seen as beneficial to global consumers, and equity prices outside the energy sector historically tend to be immune to or even benefit from cheap oil. Maybe one possible explanation for this can be found by looking at the impact sovereign wealth fund of oil producing nations can have on the equity markets.

The Linkage between Oil and Equities: Relatively high oil prices over the past decade allowed oil-producing nations to accumulate funds in sovereign wealth and other types of reserve funds. Sovereign wealth funds bought hundreds of billions in equity, corporate bond and real estate investments with the surplus revenue made possible by high oil prices. According to Bloomberg, these funds currently account for between 5 to 10% of total global investment dollars. Low oil prices are turning budget surpluses into deficits, and these funds are having to sell assets to make up for the budget shortfall.

Sovereign wealth fund liquidations have trapped the markets in a self-reinforcing cycle – low oil prices force oil producers to pump more oil to fund their budget deficits. That makes oil prices go down, so they sell stocks to fund the budget gap. Selling pressure from the sovereign wealth funds make stock prices go down, which means the funds have to sell even more to meet their fundraising targets, causing additional downward pressure on stocks. The process repeats with the next drop in oil. Ultimately, valuations correct sufficiently to where buyers are attracted to the valuations they can buy stocks at and the supply / demand curve for stocks begins to find a point of equilibrium. We think that we are getting close to this point in the current market environment.