

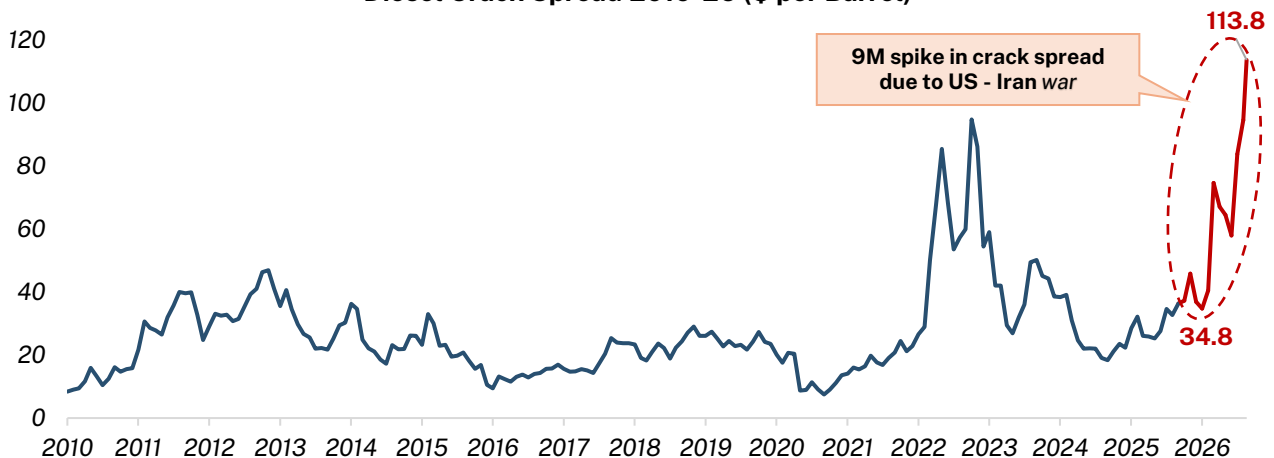


Island of Calm

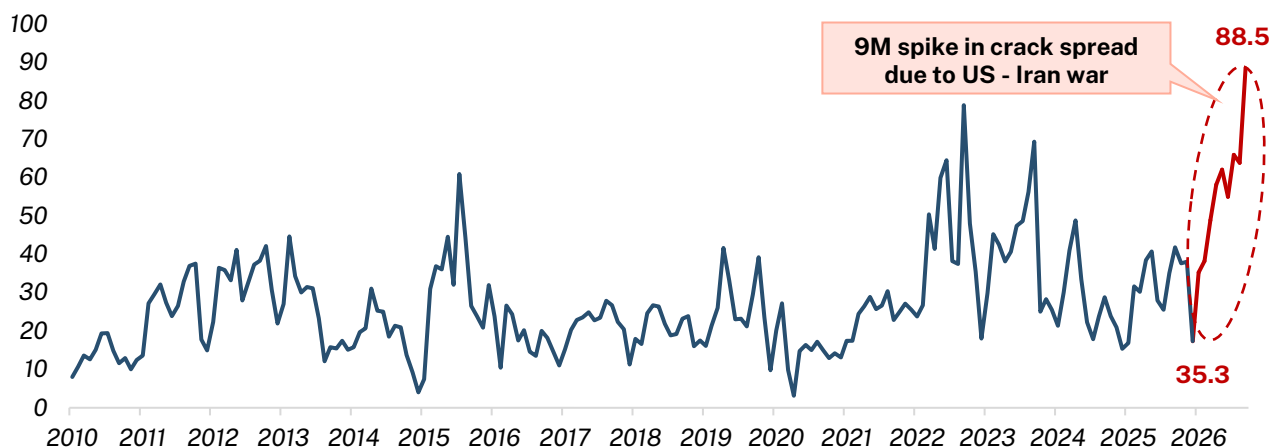
The oil shock of 2026 has morphed. It is not about just crude anymore. It is about products with diesel emerging as the shock multiplier. This is how the transmission is winding its way through the global economy.

1. Refineries in the middle east and in Russia have been put out of action due to two different wars. Two very different conflicts. This had a severe impact on this crucial industrial commodity. Perhaps the most important one as a transmission mechanism for supply-led CPI anywhere. Trucks run on diesel and you need trucks to get anything that you consume to your door. As simple as that.
2. Diesel is one of the products that come out of crude. Diesel crack spread represents the measure of the conversion mark-up. Here is how crack spread of diesel and that of gasoline have moved.

Diesel Crack Spread 2010-26 (\$ per Barrel)



Gasoline Crack Spread 2010-26 (\$ per Barrel)



Note: Gasoline Crack is calculated by subtracting the cost of crude oil from wholesale value of gasoline produced from a barrel of oil; Diesel crack is calculated by subtracting the cost of crude oil from wholesale value of diesel produced from a barrel of oil.

Source: U.S. Energy Information Administration, Spark Fund Research.

The crack spread is out of whack. At current crack spreads, diesel is pricing in an oil price of over \$200 per barrel and petrol corresponds to over \$170 per barrel.

3. The story does not end here. It is evident from the above that refineries were caught short particularly on diesel. Refineries can ratchet up the production of diesel to a certain extent but then, they need to trade off the output in other petro-derivatives such as gasoline, aviation fuel, naphtha etc. And even this is practical for only the refineries which are relatively modern – how ‘complex’ a



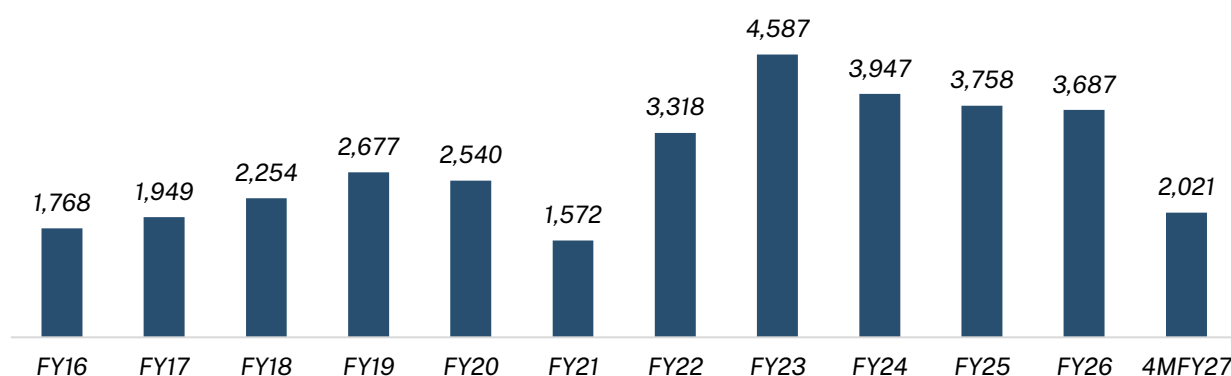
refinery is would determine that. In real life, you cannot toggle between products on a daily basis. Refineries around the world may be trying to increase the diesel output as that is more profitable now but that puts pressure on availability of gasoline, aviation fuel and other critical petro-inputs used in areas such as fertilizer production.

4. This is all about how linkages can unravel a global economic system that came to take for granted responsible economic behaviour from the key actors on the global stage. When the most important of them indulged in what is widely believed to be an uncalled-for adventurism, the world pays. We are at that juncture right now.
5. It is one thing for prices to go up. Higher prices will work their way through the market mechanism which is designed to lead to demand destruction in response to the price signals. Substitution would be the result where possible and eventually, prices self-correct. Physical stock outs are a different matter altogether. This is what is happening in countries like Thailand, Philippines, Sri Lanka, Pakistan and Bangladesh. The contagion is now reaching France, and a lot of Europe is not far behind. This can produce economic discontinuity or sudden stops which are disastrous. The world is closer to this scenario than many realize.

India stands out as an island of calm in this messy progression of the conflicts, particularly involving Iran. Why?

India has a refining capacity of about 267 MT and consumes about 259 MT.

Export of Crude Oil and Petroleum Products (Rs. bn)



Source: Petroleum Planning & Analysis Cell – Ministry of Petroleum and Natural Gas, Spark Fund Research

India exports refined products, largely due to the giant capacity put up by Reliance and even by Russian (Rosneft) owned Nayara Energy. This is why we in India have not seen headlines of fuel shortages and have not heard the news about fuel riots. The mechanism for India works something like this.

India has been importing crude from wherever it can possibly get the same – notably, the source has been Russia in the last few months. It pays a higher cost than before at a USD/INR conversion rate that is significantly more adverse than before. Indian refiners (state owned refiners who are for most part oil marketing companies – IOC, HPCL and BPCL) process the crude and enjoy high refining margins – consistent with the huge crack spreads. India then prices the end products way lower than the international prices. There is an opportunity cost for the refining/marketing companies, but the cash loss is limited to the adverse crude dynamics. This has avoided shortages. This has also shielded Indian consumers from supply shock led CPI tremors. The cascading effect of inflation produced by sky-high diesel prices would have crippled the economy. Hence, it is fair to say that India remains an island of relative calm in this storm that is yet to pass.

After many months of cautionary vibes from us, we view this as a macro-positive of sorts which deserves to be called out. However, the good story has to end there. The world has gone past the Goldilocks moment.

Distortion has a cost

There is no such thing as a free lunch.

1. Aviation Fuel – ATF is priced internationally and Indian airlines are not immune from this. The June quarterly financials revealed a sea of red and that was probably just a trailer. Aviation fuel will also impact cargo movement and push up costs across the spectrum. Once airlines start to pass on the full burden as they have to, travel demand is going to be hit.



2. Petrochemical feedstocks – LPG is being heavily subsidized and as I have said before, every rope has an end. Other petro-derivatives do not have such shock absorbers. Plastics, packaging, synthetic fibres, chemicals, paints, tyres, solvents, industrial inputs etc. have all seen humungous input cost pressure. This is feeding into inflation, and we are afraid the impact has not been factored into earnings and growth estimates.
3. Fertilizer and food – Sulphur availability has been highlighted for a while now and ammonia is another key input that is in squeeze. The shipping rates and elongating delivery times (more distances, more risk, more insurance cost) are affecting fertilizer production. This crashes right into an El Nino year. We cautioned in June that it is dangerous to pronounce monsoon as normal looking out of the window from offices in Mumbai. We are ending up with a terrible monsoon season, particularly for spatial and temporal distribution. The food economy is at a clear risk. Yes, the immediate response will talk up our buffer stocks. It may be useful to bear in mind that post-Covid, the free food program has taken a toll on the food buffers. Buffers are good for a mayday. They do not take you to the other side of a mayhem lasting many months.
4. Market distortion – The effect of this is going to be under-appreciated in an environment where the discourse is dominated by the need for ending everything on a positive note. India has denied itself the discipline of its large population base going through a price-driven demand adjustment. Fuel price has been kept artificially suppressed in India.

Country	Diesel price (Rs. /L)	Diesel price change* (%)	Gasoline price (Rs. /L)	Gasoline price change* (%)
USA	162	76.4	113	68.3
Pakistan	135	53.6	130	58.0
Norway	283	49.3	194	3.1
UK	250	47.4	220	38.9
France	240	35.8	258	40.7
Sri Lanka	111	35.1	116	16.6
Japan	96	13.7	103	12.1
India	95	8.6	102	7.8
Thailand	144	7.1	141	-2.8

*Changes in gasoline and diesel prices following the onset of the Middle East crisis, from Feb'26 to Sep'26.

Note: Price for Gasoline and Diesel for above countries is as on Sep'26.

Source: Bloomberg, Media Articles, Spark Fund Research

Look at Norway. They sit on a US 2 trillion-dollar petroleum fund but would not subsidize fuel. The reason is the prudent self-restraint based on the logic of the eventual high cost that society pays when prices of economic necessities are distorted. Norway will no doubt be dismissed as a wrong example as the country is tiny and wealthy. But the lesson holds. The distortion cannot be sustained beyond a point. Something has to give. And when it does, a higher price may be the result.

5. Inflation looms

Inflation is not just a number. The market narrative has tended to make light of the 4.8% CPI print in August by arguing that it is not far above the 4% red line of RBI.

Month – 2026	WPI (YoY%)	CPI (YoY%)
January	1.2	2.7
February	2.2	3.2
March	4.0	3.4
April	8.4	3.5
May	9.9	3.9
June	10.0	4.4
July	9.8	4.5
August	9.9	4.8

Source: Office of Economic Advisor, MoSPI, Spark Fund Research

For four months in a row, WPI is close to double digits. This represents input costs for all the producers (for many of whom the market is happy to boost the market cap almost every day these days). The time has now come for the producers to take a hit on the margins or pass the bad news on to the end consumer. Q2 results may start to reflect that. Q3 outlook cannot escape this at all.



We are staring at generalized price increases across the economy including wage inflation. This is where the CPI print becomes more than just a number. This is when the central bank will squirm.

Of course, the war can end as abruptly as it started and that would give the whole world some wiggle room to crawl out of the hole into which things have descended. At this point, that is slowly becoming a hope and not a plan.

India still an island of relative calm

All things considered, India is still in a relatively better position as compared to most of the emerging world (other than China – who sits on strategic oil reserves, a game plan on AI and what not) and much of Europe. Even the middle east is hemmed in now because of obvious reasons. The fact that India can refine the black gold puts it in a position of relative strength. I need to reiterate that. This will mean that India may well be a sought-after market once everyone bites the dust. We simply do not know the trajectory of how this will play out.

We highlighted the humungous challenge posed by the rising cost of global capital just a month back (we have been sounding the drumbeat of caution on this all the way from 2022). Things have taken a material turn for the worse since then. The US 10-year yield went beyond 5.2% and the Japanese yield surged way past 3% at 3.08%. These are epochal numbers which a capital starved economy like India cannot just wish away. Foreign capital is not in the business of giving awards to countries who claim podium finish in a race where the others did not manage to run. Besides, India is quite vulnerable on its external front, the current feeling of calm notwithstanding. Foreign capital will flow in when valuations give it margin of safety and when the fundamentals of the country beckon strongly. India can get there. The path is likely to be more painful than Indian investors have come to accept.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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