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Oil Price Crashes, Who Really Wins?

By Bill Holter

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I'd like to address the outright crash of the oil market this past week. The hope was the Saudis would cut back on production to stabilize prices somewhere in the $80+ range. This was not to be as Saudi Arabia announced no cutback whatsoever …oil then fell over 10% in one day on Friday and actually traded to a $65 handle. First and most importantly, oil is THE biggest and most widely used commodity on the planet. For a market of this importance to outright crash or rise over 10% in one day, unintended consequences not seen or anticipated can be expected at some point.

I guess the initial question that should be asked is "why has oil been so weak in the first place"?

There are several answers to this but the two main drivers are "supply and demand". Demand has definitely dropped as the global economy has slowed. There is no getting around this, less oil is being used now than say two or three years ago. On the supply side, the U.S. shale industry which has been in an outright boom has actually made the U.S. a larger producer than Saudi Arabia. I can remember two-three years back when the stories arose, "the U.S. was going to become energy independent". What the stories forgot to include is the fact that shale production has a very high cost to breakeven. The current estimates for breakeven are $75 per barrel or higher. Just as I wrote earlier regarding gold and silver, I believe "low prices will cure low prices" for oil. I will get to this thought shortly.

When looking at the new, low oil prices, one must ask the questions "who, what and why"? Why would Saudi Arabia not want to cut back on production to stabilize the price of their product? If Saudi Arabia has budgeted a price of $95 for their own production, why would they allow the price to drop unabated (or in Friday's case "helped")? What's in it for them? Before digging any deeper, I want to remind you how the U.S. broke the Soviet Union in the late 1980's. The U.S. baited the USSR into an arms race and then with the help of the Saudis, broke the price of oil down to $10 per barrel …the rest is history as the USSR bankrupted from the starvation of oil revenues.

Fast forward to current day, are we seeing the same sort of operation? Some say that the target is Iran who is a religious enemy of Saudi Arabia and also happens to have the highest cost of production in the Middle East, I'm not buying this theory. I would rather look at Saudi Arabia's latest business deals and go from there. They just a few months ago signed long term energy contracts with non other than China

http://www.theaustralian.com.au/business/mining-energy/china-saudi-arabia-sign-new--energy-agreement/story-e6frg9df-1227025276198?nk=d5fc75cee3fcc71d3ce5ef9ce4f38a-c3 .

Taking this one step further, "who" would benefit the very most from cheap oil prices?

The answer of course is China as they are THE biggest importer of oil in the world!

http://www.theglobeandmail.com/report-on-business/industry-news/energy--and-resources/why-the-collapse-in-oil-prices-is-such-a-huge-win-for-china/article21824558/

Can you see where this exercise may be going? Most everyone in the West believes Saudi Arabia was engaged with the U.S. to hurt Russia's energy revenues, what if this is not the case …or maybe our leaders believe this to be the case? What if Saudi Arabia, who has definitely been in serious talks with China is obliging them while wiping out one their most recent competitors?

Who is this new competitor you ask?

Why the shale industry in the U.S. which was supposed to make us energy independent and a bigger producer than even Saudi Arabia? The cost of production for shale is estimated at $75 per barrel. $100's of billions have been borrowed (and lent) in order to get this production up and running. As of this past Friday there may be a little, previously unforeseen problem. You see, the debt issued is almost entirely "high yield" (understand "risky") and makes up somewhere near 20% of this entire market. Also please understand many of these bonds are used as collateral and then re hypothecated for further borrowings. This is not yet a disaster but a "margin call" to such a leveraged industry could turn the lights out VERY QUICKLY.

Of course, you can add the rest of the financial system to this as leverage has never ever been higher systemically than it is right now.

I would also like to add the comment "someone, somewhere, got hurt and hurt very badly this past Friday". I am talking about speculators, OTC derivatives between banks and financial institutions, institutions which issue CDS, etc.. We don't know who, what, how much or even "if" this 10% drop in one day has caused a chain reaction but the odds are pretty good this will not pass without someone important being financially killed.

Before putting this all together, mention must be made of Russia. Yes, Russia is being hurt financially and economically. Their currency the ruble has been hammered as well as their sovereign bond market but …it is important to understand they only carry $200 billion worth of debt. Will these low oil prices bust Russia? No, it will however make life very hard as the economy slows and their social programs do not get fully funded. In my opinion this is a huge blow to Russia but not a fatal one.

Putting this all together I will ask some questions, however, there are no firm answers yet.

Who is really behind this?

Would the U.S. cut the legs out from under their own shale industry or is it more likely the Chinese wooed Saudi Arabia into aiding them in filling their reserves?

If it is China rather than the U.S., what does this say about Saudi Arabia?

Are they in the process of switching allegiances? Is this a case where they are abandoning the petrodollar? I obviously do not have the answer but I will ask another question or two. Is it possible China has swayed Saudi Arabia by promising to pay them with something real?

Like gold? Could this even be possible? It is already rumored that Russia is trading oil for gold, maybe the Saudis have seen this and a light bulb went on for them?

Financially, yes I believe it is possible but not probable. Much more likely would be payment in yuan. Would Saudi Arabia accept the paper of another sovereign in the place of dollars? In my opinion they would …if they are able to see the writing on the wall. Has China let the Saudis in on their future plans for their currency? Maybe a gold backed yuan? A gold backed yuan which is backed by or one that is ratio pegged to gold? Does China have enough gold to do this? Let me say this, China very probably has as much gold (or much more) as the U.S. "claims to have". Would this be enough gold? The answer of course depends entirely on what "price" they value or peg gold at. At "some price", China can go to a 100% gold backed yuan, any country can …if they have gold and the international price is high enough.

This is much speculation on my part but it does make common sense. The U.S. may believe we can bankrupt Russia with low oil prices …and this is "our" plan, I don't believe it is "the" plan. In fact, the argument can be made that not only does this hurt (destroy) our shale industry, crashing oil prices actually endangers our financial system. After six years of trying to reflate the system via outright monetization, would we really risk a wildfire of deflation? I don't think so. I believe it is much more likely this is a Chinese/Saudi partnership play where they both "win" and the U.S. is left out in the cold. This would also be a terminal event for the U.S. petrodollar and a "polite" way for the Chinese to move center stage. If this is so, we will be watching the formation of a "new world order", just not the one the Rockefellers had in mind!

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Bill Holter writes and is partnered with Jim Sinclair at the newly formed Holter/Sinclair collaboration. Prior, he wrote for Miles Franklin from 2012-15. Bill worked as a retail stockbroker for 23 years, including 12 as a branch manager at A.G. Edwards. He left Wall Street in late 2006 to avoid potential liabilities related to management of paper assets. In retirement he and his family moved to Costa Rica where he lived until 2011 when he moved back to the United States. Bill was a well-known contributor to the Gold Anti-Trust Action

Committee (GATA) commentaries from 2007-present.