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# Will Falling Oil Prices Crash the Markets?

Shale Leads the Way

By Mike Whitney
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*Crude oil prices dipped lower on Wednesday pushing down yields on US Treasuries and sending stocks down sharply. The 30-year UST slipped to a Depression era 2.83 percent while all three major US indices plunged into the red. The Dow Jones Industrial Average (DJIA) led the retreat losing a hefty 268 points before the session ended. The proximate cause of Wednesday's bloodbath was news that OPEC had reduced its estimate of how much oil it would need to produce in 2015 to meet weakening global demand. According to USA Today:*

> "OPEC lowered its projection for 2015 production to 28.9 million barrels a day, or about 300,000 fewer than previously forecast, and a 12-year low…. That's about 1.15 million barrels a day less than the cartel pumped last month, when OPEC left unchanged its 30 million barrel daily production quota…
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> The steep decline in crude price raises fears that small exploration and production companies could go out of business if the prices fall too low. And that, in turn, could cause turmoil among those who are lending to them: Junk-bond purchasers and smaller banks." (USA Today)

Lower oil prices do not necessarily boost consumption or strengthen growth. Quite the contrary. Weaker demand is a sign that deflationary pressures are building and stagnation is becoming more entrenched. Also, the 42 percent price-drop in benchmark U.S. crude since its peak in June, is pushing highly-leveraged energy companies closer to the brink. If these companies cannot roll over their debts, (due to the lower prices) then many will default which will negatively impact the broader market. Here's a brief summary from analyst Wolf Richter:

> "The price of oil has plunged …and junk bonds in the US energy sector are getting hammered, after a phenomenal boom that peaked this year. Energy companies sold $50 billion in junk bonds through October, 14% of all junk bonds issued! But junk-rated energy companies trying to raise new money to service old debt or to fund costly fracking or off-shore drilling operations are suddenly hitting resistance.
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> And the erstwhile booming leveraged loans, the ugly sisters of junk bonds, are causing the Fed to have conniptions. Even Fed Chair Yellen singled them out because they involve banks and represent risks to the financial system. Regulators are investigating them and are trying to curtail them through "macroprudential" means, such as cracking down on banks, rather than through monetary means, such as raising rates. And what the Fed has been worrying about is already happening in the energy sector: leveraged loans are

> getting mauled. And it's just the beginning…
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> "If oil can stabilize, the scope for contagion is limited," Edward Marrinan, macro credit strategist at RBS Securities, told Bloomberg. "But if we see a further fall in prices, there will have to be a reaction in the broader market as problems will spill out and more segments of the high-yield space will feel the pain."…Unless a miracle happens that will goose the price of oil pronto, there will be defaults, and they will reverberate beyond the oil patch." (Oil and Gas Bloodbath Spreads to Junk Bonds, Leveraged Loans. Defaults Next, Wolf Ricter, Wolf Street)

The Fed's low rates and QE pushed down yields on corporate debt as investors gorged on junk thinking the Fed "had their back". That made it easier for fly-by-night energy companies to borrow tons of money at historic low rates even though their business model might have been pretty shaky. Now that oil is cratering, investors are getting skittish which has pushed up rates making it harder for companies to refinance their debtload. That means a number of these companies going to go bust, which will create losses for the investors and pension funds that bought their debt in the form of financially-engineered products. The question is, is there enough of this financially-engineered gunk piled up on bank balance sheets to start the dominoes tumbling through the system like they did in 2008?

That question was partially answered on Wednesday following OPEC's dismal forecast which roiled stocks and send yields on risk-free US Treasuries into a nosedive. Investors ditched their stocks in a mad dash for the exits thinking that the worst is yet to come. USTs provide a haven for nervous investors looking for a safe place to hunker down while the storm passes.

Economist Jack Rasmus has an excellent piece at Counterpunch which explains why investors are so jittery. Here's a clip from his article titled "The Economic Consequences of Global Oil Deflation":

> "Oil deflation may lead to widespread bankruptcies and defaults for various non-financial companies, which will in turn precipitate financial instability events in banks tied to those companies. The collapse of financial assets associated with oil could also have a further 'chain effect' on other forms of financial assets, thus spreading the financial instability to other credit markets." (The Economic Consequences of Global Oil Deflation, Jack Rasmus, CounterPunch)

Falling oil prices typically drag other commodities prices down with them. This, in turn, hurts emerging markets that depend heavily on the sale of raw materials. Already these fragile economies are showing signs of stress from rising inflation and capital flight. In a country like Japan, however, one might think the effect would be positive since the lower yen has made imported oil more expensive. But that's not the case. Falling oil prices increase deflationary pressures forcing the Bank of Japan to implement more extreme measures to reverse the trend and try to stimulate growth. What new and destabilizing policy will Japan's Central Bank employ in its effort to dig its way out of recession? And the same question can be asked of Europe too, which has already endured three bouts of recession in the last five years. Here's Rasmus again on oil deflation and global financial instability:

> "Oil is not only a physical commodity bought, sold and traded on global

> markets; it has also become an important financial asset since the USA and the world began liberalized trading of oil commodity futures…
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> Just as declines in oil spills over to declines of other physical commodities…price deflation can also 'spill over' to other financial assets, causing their decline as well, in a 'chain like' effect.
>
> That chain like effect is not dissimilar to what happened with the housing crash in 2006-08. At that time the deep contraction in the global housing sector ( a physical asset) not only 'spilled over' to other sectors of the real economy, but to mortgage bonds…and derivatives based upon those bonds, also crashed. The effect was to 'spill over' to other forms of financial assets that set off a chain reaction of financial asset deflation.
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> The same 'financial asset chain effect' could arise if oil prices continued to decline below USD$60 a barrel. That would represent a nearly 50 percent deflation in oil prices that could potentially set in motion a more generalized global financial instability event, possibly associated with a collapse of the corporate junk bond market in the USA that has fueled much of USA shale production." (CounterPunch)

This is precisely the scenario we think will unfold in the months ahead. What Rasmus is talking about is "contagion", the lethal spill-over from one asset class to another due to deteriorating conditions in the financial markets and too much leverage. When debts can no longer be serviced, defaults follow sucking liquidity from the system which leads to a sudden (and excruciating) repricing event. Rasmus believes that a sharp cutback in Shale gas and oil production could ignite a crash in junk bonds that will pave the way for more bank closures. Here's what he says:

> "The shake out in Shale that is coming will not occur smoothly. It will mean widespread business defaults in the sector. And since much of the drilling has been financed with risky high yield corporate 'junk' bonds, the shale shake out could translate into a financial crash of the US corporate junk bond market, which is now very over-extended, leading to regional bank busts in turn." (CP)

The financial markets are a big bubble just waiting to burst. If Shale doesn't do the trick, then something else will. It's just a matter of time.

Rasmus also believes that the current oil-glut is politically motivated. Washington's powerbrokers persuaded the Saudis to flood the market with petroleum to push down prices and crush oil-dependent Moscow. The US wants a weak and divided Russia that will comply with US plans to increase its military bases in Central Asia and allow NATO to be deployed to its western borders. Here's Rasmus again:

"Saudi Arabia and its neocon friends in the USA are targeting both Iran and Russia with their new policy of driving down the price of oil. The impact of oil deflation is already severely affecting the Russian and Iranian economies. In other words, this policy of promoting global oil price deflation finds favor with significant political interests in the USA, who want to generate a deeper disruption of Russian and Iranian economies for reasons of global political objectives. It will not be the first time that oil is used as a global political weapon, nor the last." (CP)

Washington's strategy is seriously risky. There's a good chance the plan could backfire and send stocks into freefall wiping out trillions in a flash. Then all the Fed's work would amount to nothing.

Karma's a bitch.

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