Oil price drop could fuel crisis

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Like the man parading up and down the high street with a sandwich board, for most of 2014 I've been harping on about us coming to the end of the financial world as we know it. We may now have stumbled upon the catalyst of this great change.

I've never really understood why someone who genuinely thought the world's days were numbered, would choose to spend their last days being jostled about on a busy street full of shoppers and tourists. Surely it'd be better to do something you truly love before the earth imploded. Of course, you could see the situation as a win-win; if the world comes to an end, you were right; if it doesn't, then all the better!

The end of the financial world is rather different, however. I see it as an opportunity as well as a threat. It may actually make economists and people in finance realize that we need a complete re-think of how to structure the global economy.

The global financial crisis (GFC) of 2008 is, in my view, a precursor to a far bigger and far more durable slump. If you don't think that can happen, take a look at how Japan's 'lost decade' has become a 'lost generation'.[1] The latest Japanese government employment statistics (July-September 2014) show that nearly 35% of those in jobs work on a part-time or temporary basis.

Central banks have been seemingly oblivious at best, or burying their heads in the sand at worst, persisting with austerity measures (ECB), which will only cause stagnation; or expensive and ineffectual quantitative easing as with the Bank of Japan; and back door stimulus, as with the Fed[2].

Meanwhile, the economies of Japan, the US and the Eurozone have been stuttering along helplessly awaiting the trigger of the next financial crisis – and the latest 'shot heard around the world' could have already happened in late November, with the plunge in crude oil prices.

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[1] http://www.japantimes.co.jp/news/2014/01/25/national/media-national/age-brings-no-respite-from-hard-times-for-the-lost-generation/#.VIfC6TGUeSo

[2] See my comments on CNBC http://video.cnbc.com/gallery/?video=3000335426

Some analysts believe that the oil price will bottom out as people start to use the fuel more, because of lower prices and the oncoming winter months in the US[3]; others see lower crude oil prices as a catalyst to make the booming US shale oil industry more efficient.[4]

ETFS WTI Crude Oil prices
Last 5 years

Source: Bloomberg

ETFS WTI Crude Oil prices
11th Nov-9th Dec 2014

Source: Bloomberg

However, these commentaries are missing an important point: this rise in the shale oil industry has been financed by junk bonds.[5]

Junk bonds. Remember those? High-yield bonds with a high risk of default. In 2008, illiquidity of junk bonds – repackaged and backed by overvalued subprime mortgages – led to the GFC. A J.P. Morgan analyst estimates that, should prices for crude oil remain at the relatively low level of around US$65 a barrel for the next three years or so, up to 40% of all energy junk bonds could default.[6] He added that even if default rates hovered at 20% to 25%, the consequences would be "dire".

While 40%, even 20%, default rates may seem high, 2008 shows us that such disaster can happen – default rates on global speculative-grade financial products was at 38% by 2009.[7] In fact it doesn't necessarily take actual default to trigger a crisis. Merely the threat of default can make bonds illiquid: if everyone is trying to get out of them at the same time, no-one wants to buy them.

Of course, it's easy to say "Don't panic" if you don't hold junk bonds. But if you are sat on them, what else would you do? Seemingly, the only way to avert a personal financial crisis is not to buy high-yield bonds in the first place. After all, if they're high yield, chances are they'll be high risk.

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[3] http://www.cnbc.com/id/102246693

[4] http://fortune.com/2014/12/08/oil-prices-drop-impact/

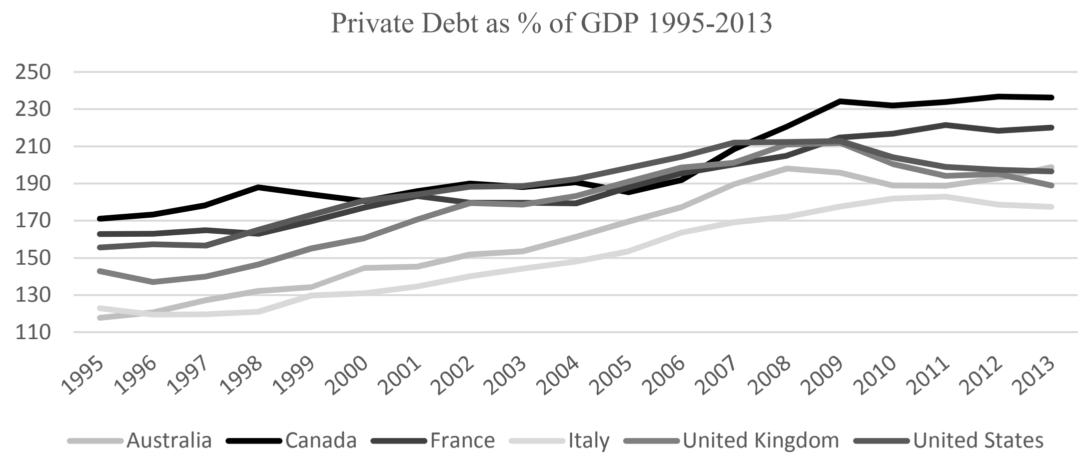
[5] http://blogs.wsj.com/moneybeat/2014/12/01/falling-oil-prices-could-lead-to-massive-junk-bond-defaults/

[6] *ibid*

[7] http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245331158575

On a global level, I'm not sure there's any way we can avoid the looming crisis. If it's not oil prices that light the blue-touch paper, it'll be something else. While government and central bank economists continue to ignore an important part of the whole picture, there is little chance of avoiding another shock.

Steve Keen, chief economist for IDEA (where I'm an advisory board member) and head of Economics, History and Politics at Kingston University London, has long expressed dismay that, when analyzing economic performance, economists completely ignore private debt levels.



Source: OECD

It is a sad irony of today's global economy that something as remote as the mere threat of some junk bonds defaulting in America can cause consternation, and large-scale government intervention in many developed economies; yet few people even look at more direct threats such as private debt, which has soared in the last 20 years or so.

Surely tackling debt issues closer to home will generate longer-term recovery; help give people gain more control over their wallets; or failing all that, at least give us a rounded perspective of what is actually happening, so we can try to do something about it.

For further information contact us by e-mail on info@mbmg-investment.com or call +66 2 665 2536.

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