Oil price fall brings global market turbulence

Nick Beams
15 December 2014

US stock markets last week experienced their largest decline in three years amid fears that the rapid fall in oil prices is having an impact on debt markets and is a symptom of deepening recessionary pressures in the world economy.

In the past, a drop in oil prices often saw a rise in market sentiment because of the belief that it provides a boost to consumers and economic growth more generally. But not on this occasion. The Dow Jones index fell 316 points, or 1.8 percent, on Friday, bringing its total loss for the week to 3.7 percent. It was the worst weekly result since November 2011.

The sell-off on Wall Street was reflected around the world, with more than $1.2 trillion sliced from equity markets. The so-called VIX index, which measures market volatility, spent most of the year at around 25 percent. It jumped to 78 percent last week, indicating growing nervousness.

A contributing factor to the continuing slide was that the International Energy Agency cut its forecasts for oil consumption in 2015. Crude oil prices dropped to their lowest point in five and a half years, falling 10 percent over the week. Trading at around $60 per barrel, the price of the benchmark, Brent crude, is now down by 51 percent from its highest point following the financial crisis of 2008, with most of that fall since June.

One financial analyst told *Bloomberg*: “Clearly the oil situation is driving things. At first it was just oversupply of oil. But now it’s that, plus fear of a world economy that’s growing too slowly.”

The oil price drop is only the sharpest expression of the downturn in commodity prices amid lower growth and stagnation, especially in the euro zone, where output has yet to reach the levels attained in 2007.

The price of iron ore, another key indicator of the level of industrial activity, has fallen by two-thirds since its peak of $180 per tonne in 2011 to under $70 per tonne, with 30 percent of that decline since May.

Indicating the rapidity of the commodity price decline, Australian Treasurer Joe Hockey said on Sunday that the terms of trade for the commodity-dependent Australian economy will decline by 13.5 percent this year, instead of falling by 6.75 percent, as predicted last May.

In another expression of the worsening global economic outlook, figures prepared for an Australian government budget update downgraded the forecast for Chinese economic growth for 2015 from 7.25 percent to 6.75 percent and for 2016 from 7 percent to 6.5 percent. This is below the Chinese official target of around 7.5 percent, and a far cry from the growth rates of almost 10 percent achieved as recently as three years ago.

The oil price fall is particularly significant because of its connection to financial markets. “Oil is a hugely traded financial asset. It links through the financial system and as it breaks down it becomes a huge tipping point,” Robert Sluymer, a technical analyst at RBC Capital Markets told the *Financial Times* .

The falling price is also impacting on junk bond markets because of the large-scale fund raisings undertaken over the past four years, using cheap credit made available through the quantitative easing program of the US Federal Reserve, which has held real interest rates close to zero.

According to Deutsche Bank, energy producers have raised $550 billion since 2010 by issuing new bonds. With the price of oil plunging, however, questions are being raised about the ability of some to meet their debt obligations. Energy companies now account for about 16 percent of the junk bond market, compared to just 4 percent a decade ago.

There are also signs that stability concerns are extending beyond the energy companies. According to a report published in the *Financial Times* at the weekend: “Investors are fleeing the US junk debt

market as a sell-off that started in low-rated energy bonds last month has now spread to the broad corporate debt market amid fears of a spike in default rates."

Last week, the average rate of interest on junk bonds spiked to 7 percent, its highest level since June last year. At the same time, finance is seeking a safe haven, with the yield on 10-year treasury notes falling to 2.08 percent. This is below the level reached at the close of trading on October 15 when a "flash crash" during the day recalled market conditions in the immediate aftermath of the Lehman Brothers bankruptcy.

While it is impossible to make short-term predictions about market movements, there are growing signs that financial instability is increasing and the financial bubble inflated by the ultra-cheap cash flowing from the US Federal Reserve and other major central banks may be about to burst.