Oil prices and bond yields continue their decline

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The price of oil continues to fall as further signs emerge of the recessionary trends in the global economy, including the lowest inflation figures in Britain in 15 years and a sharp decline in yields on government bonds around the world.

Brent and West Texas Intermediate, two key oil benchmarks, both fell to around $45 per barrel yesterday, continuing the decline of last week, when prices dropped by more than 11 percent. Oil prices are now only about $10 per barrel above the lows they reached in 2009, following the eruption of the global financial crisis.

Market analysts are unable to say when the bottom might be reached. Harry Tchilinguirian of PNB Paribas told the *Financial Times* the lack of a price floor was discouraging buying interest. "The difficulty currently is to identify a fundamental anchor to shore up oil prices in the short term," he said. There was no obvious answer as to whether there was a threshold price that might halt the market slide.

One of the factors promoting this week's renewed fall was a report by Goldman Sachs downgrading its forecast for oil prices over the next year. It predicted Brent would average around $50 per barrel, compared to its previous forecast of almost $84.

"We expect that the global market imbalance will be larger [in the first half of 2015] than we had previously expected," the report said. It warned that prices could fall into the $30-$40 per barrel range. Prices would have to stay lower for longer before the market "rebalanced."

A note issued by Citi analysts said the market was concerned that oil would stay lower for longer and that "crude will stay close to $40 a barrel for the first half of 2015."

Jeff Sica, the head of an investment advisory firm, told Bloomberg it had been expected that oil prices would stabilise, but this was not happening. "My contention has been that we're beginning to see some very severe structural damage to the economy as oil prices continue to fall."

That damage could include the scaling back of investments in US shale oil as well as problems in financial markets, where oil-based investments constitute about 18 percent of junk bonds. Investments made on the assumption that oil prices would remain at between $80 and $100 a barrel may become unviable at the new price level. Charles Peabody, a banking specialist at Portales Partners, told the *New York Times*: "We do believe that you will start to see some defaults."

Yesterday the oil minister of the United Arab Emirates, Suhail bin Mohammed al-Mazroui, said the oil cartel, OPEC, would not change its strategy and any sudden increase in prices was unlikely.

Faced with increased production of shale oil in the US, the Saudi-led cartel has refused to cut production in order to force higher-cost US shale oil producers out of the market.

While this price war is a particular factor, the sharp fall in oil is indicative of the downward pressure on industrial commodity prices across the board.

The Bloomberg Commodity Index has fallen to its lowest level since 2002. The index, which tracks 22 industrial commodities, has fallen 26.5 percent since its peak last April.

The price of iron ore, a key indicator of the level of industrial production, has dropped by more than 50 percent, with large-scale producers, such as BHP Billiton and Rio, pursuing the same strategy as their Saudi counterparts in the oil industry by maintaining or even increasing production in order to drive their higher-cost rivals out of the market.

The sharp downward movement in oil and other commodities and what it indicates about the state of the world economy are producing sharp swings in equity markets. Yesterday, the Dow wiped out a 282 point increase and a 143 point decline to finish the day lower.

According to Bloomberg, the more broadly-based S&P 500 index has moved by an average of 0.95 percent per day so far in 2015, compared to an average of 0.53 percent per day in 2014, which was the calmest year for markets since 2006. The so-called Vix index, which measures volatility, was up by 4.9 percent for the day.

Another indication of recessionary trends was the fall in UK inflation to just 0.5 percent last month, the lowest level in 15 years, prompting warnings about "mounting disinflation pressures" in the British economy. This led to a sharp decline in the yield on the UK 10-year bond during the day.

Even more significant was the news that the yield on Japanese government bonds hit zero for the first time ever, as bond yields continued to fall internationally. The yield on Swiss five-year bonds has been in negative territory since mid-December, and that on German five-year bonds went below zero earlier this month.

The fall in yields reflects the move by financial investors to buy government debt—the yield on a bond bears an inverse relationship to its price—in the absence of investment opportunities elsewhere.

The situation in Japanese financial markets borders on the bizarre. Under its quantitative easing program, the Bank of Japan is committed to buying massive amounts of government bonds in order to try to boost inflation.

From April 2013, when the BoJ announced its "new era" monetary policy, to September 2014, the central bank's share of outstanding government bonds has risen from 10 percent to 23 percent, with its share set to rise to 44 percent in 2017.

This has led to a situation where private investors, having no other profitable outlets, are willing to bid up bond prices, thereby lowering yields, in the expectation that they will then be able to sell them at an even higher price to the Bank of Japan and realise a profit.

While short-term profits are to be made in this fashion, the whole process, in which profits come from a series of round-robin trades in government debt, indicates the growing level of financial parasitism and is inherently unviable in the longer-term.

Moreover, it is only the sharpest expression of trends throughout the global financial system, where bond yields are falling in 21 out of 24 developed markets and yields in what are considered to be "safe havens," such as German bonds, are turning negative.