

# Junk bond crisis brings “stress” warning

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The mounting crisis in the high-yielding or “junk” corporate bond market is starting to impact on some of the largest banks.

The *Financial Times* reported on Tuesday that the head of corporate banking at Wells Fargo, which is described as the “biggest bank in the world by market capitalisation,” had warned of “stresses” in its energy portfolio as a result of the plummeting price of oil and natural gas.

Kyle Hranicky, who became Wells Fargo corporate banking head in May, said the bank had been in discussion with clients for several months about preserving cash and cutting borrowing limits.

“Some have liquidity to survive the cycle but others will be under significant stress and may be forced to sell assets or recapitalise,” he said. “We’ve been in the energy business for 30 years, so we’re comfortable with cycles. But this one feels deeper and broader and could last longer.”

This latter comment points to the fear that the present situation, in which oil and the prices of other major industrial commodities have plunged to levels not seen since the global financial crisis, may be something more than a “cycle” from which a “recovery” can be expected.

The *Financial Times* reported that the fall in stocks and bonds related to oil had been causing a “lot of problems for fund managers over the past year” but the damage was only now beginning to be felt in banks’ loan books “where oil services companies, in particular, have been bearing the impact of cuts in the industry.”

The price of oil hit a seven-year low on Monday amid concerns that oversupply in the industry is becoming a permanent feature. Since the start of the month, when ministers of the Opec cartel decided they would not cut back production, the prices of two crucial benchmarks, Brent and West Texas Intermediate have fallen by 17

percent and 16 percent respectively.

“The year is ending on an uncomfortable note. The smell of fear is back in the air,” David Hufton from the London-based broker PVM told the *Financial Times*.

The decision at the Opec meeting not to reduce supply had removed the last hopes for a reprieve in oil and had increased downside sentiment for the commodities in general, he said. “The dam has collapsed as prices are in freefall, with devastating consequences.”

As oil continues to plunge, the price of natural gas has also fallen rapidly losing 6 percent on Monday to reach its lowest level since 2002.

“It cannot get any more bearish for gas,” market analyst Stephen Schork told the American business TV channel CNBC on Monday. “Hence, it would still go lower.”

Pointing to the underlying causes of the slump, he said that because of weakness in the industrial sector there was “no demand” for natural gas right now. The gas price was down to \$1.862 per million British thermal units with predictions that it may go as low as \$1.50.

Chris Verrone from Strategas told CNBC that natural gas had now become an “epic bear market,” one that would take years to correct.

Since the eruption of the global financial crisis, the financial system has been sustained by the supply of trillions of dollars from the world’s central banks. The cheap credit has fuelled a rise in share prices and speculation in bond markets, even as the underlying real economy has stagnated amid the ever-growing threat of global recession.

Amid this frenzy of speculation, oil and gas companies, including those with a shaky credit status, were able to issue corporate debt which was eagerly snapped up while oil was trading at \$100 per barrel. But over the past 18 months, as the world economy has

continued to slow, the price of oil has fallen by two-thirds, creating the conditions for a wave of defaults. Financial speculation in the oil and gas sector has been particularly vulnerable because it has such a direct connection with the industrial economy.

Last month, US bank regulators reported that aggregate loans in danger of default in the oil and gas sector had risen to \$34 billion, five times higher than a year ago. The report blamed “aggressive acquisition and exploration strategies” which had made many borrowers vulnerable to a protracted fall in commodity prices.

Last Friday Michael Contopoulos, head of high-yielding strategy at Bank of America Merrill Lynch, told CNBC that despite what he said was a “widespread feeling” that the economy was OK and therefore that high-yielding bonds were OK, the present situation was “not just a commodity story.” Leverage in non-commodity high yield was at a record high and “high-yield companies’ balance sheets are not that healthy—even outside commodities.”

There are growing fears that, like the emerging mortgage-backed securities crisis of 2007, dismissed by the then chairman of the US Federal Reserve Ben Bernanke as having no great significance for US financial markets let alone the economy as a whole, today’s situation in the junk bond market is a harbinger of something much bigger to come.



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