Oil Plunge Can Trigger 'Subprime' Debt Crash

by Paul Gallagher

Dec. 10—What began as a British-Saudi financial warfare weapon against Russia and Iran—the so-called "oil sanction"—is turning into an unpredictably bouncing hand grenade which may blow out a large debt bubble over the bankrupt U.S. economy.

Warnings are now starting to proliferate, as the price of West Texas Intermediate crude oil has fallen to the low $60s/barrel, that a wave of defaults of "high-yield," or junk, energy debt, could trigger a broader mass default in the high-yield debt markets as a whole, which represent a couple of trillion dollars in very leveraged debt. High-yield energy debt is variously reported to constitute 20-30% of that bubble.

One of Two Results Possible

During the last decade's "shale oil boom" which has propelled the United States toward the world lead in oil production, oil companies here and in Europe have taken on record levels of debt. This is true both of the independent shale oil producers and of the long-established oil majors, although for different purposes. The repayment of that debt requires prices for a barrel of (Brent crude) oil which range from $80-85 to $120.

Therefore, the Saudi-triggered plunge in oil prices from $110-115/barrel this past Summer, to $60-65 now, will have one of two results: Either the price will shoot abruptly back up in 2015, or the collapse of energy debt can trigger a financial crash in the U.S., as it already has in Norway.

This point was made by economics columnist Liam Halligan in the *Telegraph* Dec. 1. His colleague Ambrose Evans-Pritchard had written several data-loaded columns since July, comparing the petrochemical sector currently to the mortgage sector in 2006-07 and the role of "subprime" debt in the 2007-08 crash. The petroleum sector is overloaded with debt whose basis is an appreciating oil price. This, despite persistently depressed demand since the 2008 financial collapse.

The International Energy Agency (IEA), in a report of July 29, 2014, made clear that since 2008, the oil industry has been borrowing about 20% of the cash it needs, or about $100 billion a year, net new debt. Its total debt has rocketed to about $1.6 trillion, with revenues of under $600 billion a year *at $110/barrel average*. If the oil price remains in the $60-70 range, that would become $1.6 trillion in debt *based on less than $400 billion in revenues*—a ratio perilously close to the definition of "unsecured leveraged lending" in banking terms.

And Evans-Pritchard wrote in September, when the oil price was in the $90s, that "The world's leading oil and gas companies are taking on debt and selling assets on an unprecedented scale to cover a shortfall in cash, calling into question the long-term viability of large parts of the industry. . . . Companies appear to have been borrowing heavily both to keep dividends steady and to buy back their own shares, spending an average of $39 billion on repurchases since 2011."

Financial columnist Andrew Critchlow found, in the *Telegraph* on Nov. 14, that oil shale drillers had come to be nearly one-third of all "high-yield, sub-investment grade" (sub-prime) borrowers in the United States. And that if the oil price stayed in the $60s, 30% of high-yield B- and CCC-grade [energy] borrowers would default: "A shock of that magnitude could be sufficient to trigger a broader high-yield market default cycle."

'Mini'-Financial Crash?

Debt defaults have already begun to hit in the North American shale oil/gas industry, due to the collapsed oil price and the relatively great inefficiency of the hydraulic fracking technology. More significantly, credit has quickly frozen up in this sector in the past two months, and the effects are spreading to the "high-yield" bond and loan markets as a whole.

The Dec. 5 *Dallas Morning News* carried one such warning on its front page: "As Prices Fall, Fears Rise About Massive Debts Taken On in Boom." "Already trouble is emerging in the usually steady bond markets," the paper reported. "Among the nation's largest energy companies, the ratio of debt to earnings, a key measure in determining a company's leverage, has almost doubled since 2011. And now that forecasts of even lower oil prices are emerging, the value of high-yield bonds in the energy sector has plummeted."

For reasons presented in the article following, namely the great economic inefficiency of the "shale oil and gas revolution" since 2009, it has consumed a great deal of capital investment to keep new holes constantly drilling while prior holes gave out—an estimated 35% of all U.S. capital investment since 2009. It has accounted for one-third of all net employment creation in the U.S. economy since the the end of 2007: roughly 400,000 jobs. That investment has been heavily leveraged with debt of the "high-yield" variety, which can be analogized to "subprime" debt in the mortgage bubble.

What is the relation of this high-yield energy debt to the entire high-yield debt market (leveraged debt and junk bonds)?

Former Reagan budget chief David Stockman, on his "ContraCorner" website Dec. 9, estimated that the now-shaking high-yield debt bubble in energy is $500 billion—$300 billion in leveraged loans and $200 billion in junk bonds. *EIR* had also estimated, Dec. 7, that high-yield energy debt is close to one-quarter of the more-than-$2 trillion high-yield market.

In that junk energy debt market, interest rates have suddenly leaped, in the past 45 days, from about 4% higher than "investment grade" bonds, to 10% higher; i.e., credit in that sector has effectively disappeared, triggering a sudden 40% drop in oil drilling permits, and the start of defaults of the highly leveraged shale companies and their big-oil sponsors.

Bloomberg News reported Dec. 8 that Southern Pacific has hired Royal Bank of Canada to advise on quarterly interest payments it can't make on C$432 million of bonds. Conacher, with C$977 million in debt, hired Bank of Montreal to advise on a similar default.

In the larger, $2 trillion high-yield debt market as a whole, interest rates have also risen sharply, so far by 2-2.5%: i.e., contagion.

Whether this bubble, which is only about one-fifth the size of the mortgage debt which melted down in 2007, could detonate a broader "reverse leverage" blowout, is now the subject of analyses that claim it is "contained." The term is familiar. *Business Insider*, for example, published a chart estimating the big U.S. banks' exposure to oil/gas debt at 2.5% of their total assets, with Citibank an outlier at 7% (about $65 billion).

But according to a Brown Brothers Harriman analysis published Dec. 6, the energy sector has just suffered its own "Minsky moment." That term refers to the point in time when a commodity which must, to sustain the debt leveraging it, go up indefinitely—takes a sudden turn lower and starts a debt crisis. "A lot of things were leveraged based on oil prices that can only go up," states the analysis.

Whether the debt collapse will be mini or maxi, may be determined in the markets for $20 trillion in commodity derivatives exposure. About $4 trillion of that exposure is energy commodity derivatives exposure of the half-dozen largest U.S.-based banks. And because the shale energy producers have bought derivatives contracts from these banks to protect themselves against a plunge in oil prices, there is good reason to believe that the big banks' $4 trillion energy derivatives exposure consists largely of bets in the wrong direction now.

Is it a coincidence that Republican leaders in Congress are in a strong push, with Wall Street, to pass legislation to allow commodity derivatives, among other types of these financial weapons of mass destruction, to be put under FDIC insurance?

This, on the path to another financial blowout.