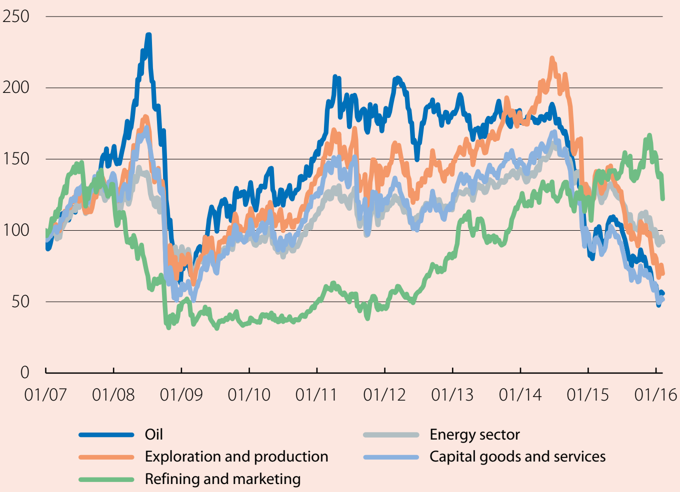
Financial stability and cheap oil: a blessing or a curse?

In just over a year and a half the price of a barrel of oil has gone from 115 dollars to around 30 and this rapid and sharp slump has acted as a significant source of tension in international financial markets. Investors and regulators fear the potential consequences for global financial stability of a scenario of persistently low oil prices. Certainly there are more reasons for caution than for complacence.

The bad performance by risky assets in the last few months can actually be put down largely to three factors: one common factor that affects the energy industry but also all the other sectors (related to global growth prospects), a second factor that has a specific impact on the energy industry (oil prices) and, lastly, a factor related to possible contagion from this sector towards the rest. The high correlation between the trend in crude oil prices and stock markets is mostly due to the aforementioned common factor: the fear of a sharp slowdown in world economic growth which, in view of the activity indicators as a whole, seems exaggerated. To a large extent this fear arises from evidence of a slowdown in China's economy, the recession in important emerging economies such as Brazil and Russia and, more recently, the weaker tone shown by the US economy. All this has helped to intensify the downward pressure on oil prices, whose origin can be found in supply factors (in particular related to the emergence of shale oil, to Iran rejoining the international market and the strategy adopted by Saudi Arabia).

US: oil and stock market indices for the energy sector

Index (100 = January 2007)



Source: *CaixaBank Research, based on Bloomberg data.*

A considerable proportion of this drop in share prices is due to the severe correction in assets with a higher exposure to the energy industry. In stock exchange terms, energy sectors have been at the epicentre of the poor performance by stock markets over the last few quarters. Since the price of crude oil started to plummet in June 2014, the MSCI global index for energy has fallen by 45% while, in the US, the sector's stock market decline has reached 40% and, in Europe, the correction has been 30%. In the US the oil exploration and production sector (known as its upstream business) has been particularly hard hit, reflected in a cumulative drop of more than 70%. The equipment and engineering services industry for gas and oil has also recorded strong stock market losses due to the close relationship between the cycle of investment in the industry and the price of crude oil and especially because of investment cuts in shale oil in the US. On a more positive note, the oil refining and marketing industry (downstream business) has performed relatively well compared with the rest of the sub-sectors during the oil sell-off. It therefore comes as no surprise that the more diversified oil companies are the ones that have best weathered the storm. Ultimately, in cases such as the US, euro area and Japan, the positive effects of cheaper energy costs, which benefit the majority of the companies whose shares are quoted on their respective stock markets, should probably outweigh the negative effects. However, the accuracy of this last point depends very much on the detail, as we will explain below.

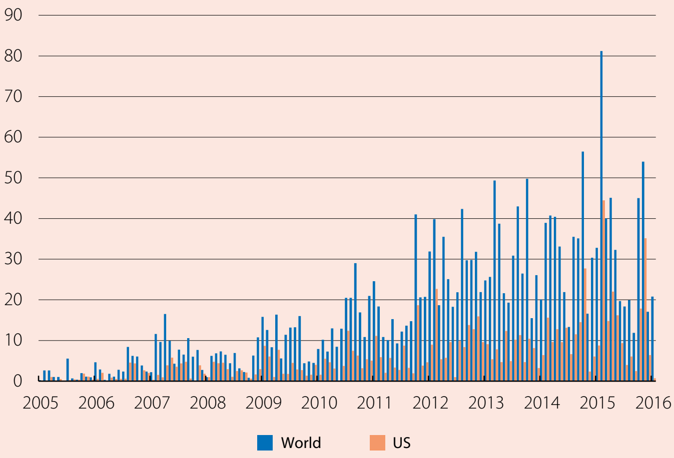
Equity is not the only source of turbulence. The corporate bond market was among the first to show signs of weakness just a few months after oil prices started to plummet. The risk premia for energy sector corporate bonds exemplify the difficult situation faced by the industry, especially in the US. In this country the yield on energy bonds in the high-yield segment rose sharply last year and reached 19%, in comparison with the 10% yield for the high-yield bond market as a whole, a spread that is at an all-time high. This trend can be explained by the worse outlook for earnings, the decline in variables related to corporate balance sheets and particularly by the size of debt held by energy companies, a phenomenon that had not been present, at least not on the scale seen today, in previous oil crises. According to data from the BIS, the outstanding debt for oil and gas companies grew at an annual rate of 15% between 2008 and 2014, more than for the rest of the sectors, reaching 1.4 trillion dollars in 2014 compared with 455 billion in 2008.[1] Although the most worrying scenario is related to low quality debt, problems have begun to spread towards the investment-grade segment, in principle considered to be very safe. In the first two months of the year, the ratings agency Standard & Poor's downgraded its rating of 13 energy companies in this segment, a considerable figure when compared with the 18 downgrades throughout the whole of 2015 or the 10 carried out in 2014. In the US alone, a wave of downgrades in credit ratings has led to five energy firms losing their investment grade status, a trend that could deepen over the coming months.

The leveraging of the energy sector, which has gradually come about thanks to extraordinarily accommodative global monetary conditions, represents a risk whose effects could be transferred from the energy sector to other markets and the whole of the real economy. One particularly sensitive aspect relates to the harmful effects of excess debt on capital investment (capex), not only in the energy sector but also in other interconnected business segments.[2] On the other hand, concentration in geographical and sector terms is an additional aspect that needs to be monitored. The fact that a large number of emerging countries depend on crude oil exports introduces a considerable element of fragility. Russia and Venezuela are cases in point. The slump in oil prices has particularly harmed tax revenue and thereby the sustainability of sovereign debt in these and other countries. Given the current situation of oil neither can we rule out episodes of contagion in the corporate bond or sovereign debt markets.

Lastly, banks' exposure to the energy sector could also represent an additional source of risk. According to data from Bloomberg, internationally this accounts for between 1% and 5% of all total loans for most banks, a size that nevertheless appears to be sufficiently modest so as not to cause any great upset. For instance, it is far from the figure of 44% reached by mortgage loans in the US in 2007. However, the global financial crisis that followed the implosion of subprime mortgages highlighted just how harmful the materialisation of such tail risks can be when not calculated accurately. Although it is true that hindsight is always 20/20, we can still learn valuable lessons from that period.

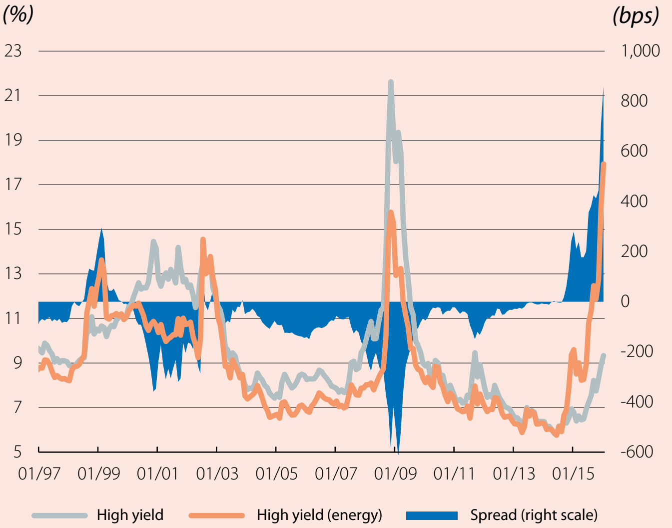
Energy sector: bond issuances

(In billions of dollars)



Source: *CaixaBank Research, based on data from Bloomberg.*

Energy sector: yields in the US high yield market



Source: *CaixaBank Research, based on data from Bloomberg and Bank of America Merrill Lynch.*

1. For an interesting presentation of the dynamics in oil prices and debt, see Domanski, D., Kearns, J. et al. (2015). «Oil and Debt», BIS Quarterly Review, March 2015.
2. According to the arguments presented in Banerjee, R., Kearns, J. and Lombardi, M. (2015), «(Why) Is investment growth weak?» BIS Quarterly Review, March 2015.

From all of this we can see that plunging oil prices on the one hand and leveraging on the other have created vulnerabilities that could mutually reinforce and feed each other. Nevertheless it seems unlikely that systemic contagion in bond and equity markets would end up having a considerable impact on the real economy. However, the premise that oil's collapse is a zero sum game between some countries and others is highly questionable. At least in the short term.

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