

Beyond the oil bust: Are markets right to worry?

Be careful what you wish for. Since the price for West Texas Intermediate (WTI), the benchmark in North America, last peaked at \$107/per barrel (b) in June 2014, crude oil has lost more than 70% of its value. On January 20, it fell to \$26.3/b, to levels last seen 13 years ago. Not so long ago, you might have expected such a collapse to mostly cause cheers. We all consume oil in one form or the other, but comparatively few people, companies and countries produce it.



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Instead, major equity markets have been rattled. The S&P 500 Index, the Euro Stoxx 50 Index, and the Nikkei 225 were down about 9%, 12% and 14%, respectively, since the start of the year (as of January 20). The German DAX, which does not include a single major oil producer, was down almost 13%.

On the fixed-income side, spreads on U.S. high-yield bonds over U.S. Treasuries have been widening for months. This is more understandable: during the shale boom, energy became the single largest sector in the U.S. high-yield market, accounting for 15.5% of the face value of bonds issued. When the oil price fell below \$80/b in October 2014, spreads of energy issuers began to widen and energy bond prices plummeted. At current market values, however, that share is already down to about 11%. Exploration and production only accounts for less than half of energy high yield, or 3.5% to 4% of the total – hardly enough to cause financial turbulence around the world.

This triggers three questions:

1. What is happening in the oil market?
2. Are markets right to fear that, this time around, a lower oil price is bad rather than good news for much of the world economy?
3. What are the implications for high-yield bonds and other asset classes?

At the end of this report, we also consider four hypothetical scenarios that would lead to lower oil prices for longer than we are expecting.

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