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Low oil price and concern over China sink markets;
Investors fear sharp drop in crude could begin to do more harm than good

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ABSTRACT

As oil dipped below the symbolically significant price of $30 a barrel on Friday, stock prices fell sharply and the outlook for 2016 grew darker.

FULL TEXT

Oil dipped below the symbolically significant price of $30 a barrel on Friday, and stocks fell sharply around the world, as concerns about China's economy and the plummeting price of petroleum continued to create a vicious circle in global financial markets.

The turmoil, which is playing out in stocks, bonds, commodities and currencies, reflects investors' growing anxiety about global growth - particularly the slowdown in China. And the plunge in oil prices could have geopolitical repercussions as it impinges on the economies of big suppliers involved in global crisis zones, like Saudi Arabia and Russia. If the broad sell-off signals deeper economic and market turmoil to come, 2016 could be shaping up as the rockiest year since the global financial crisis of 2008.

Few markets escaped the mess on Friday. China's stock market is now in bear territory - a decline of at least 20 percent from recent highs. Major European stock indexes all ended the day down more than 2 percent, and American stocks were down almost 3 percent in afternoon trading in New York.

Whether the market upheaval persists will depend largely on the direction of the global economy - and how it affects demand for oil. While cheap oil in theory is a boon to buyers and consumers, the extent to which the plunging price is now causing economic harm for producers and generating big losses in financial markets could offset those benefits.

In China, the second-largest economy after the United States, the government is expected to report in the coming week that economic growth cooled last year to 6.9 percent. That rate would be the envy of many countries but would be China's slowest pace in a quarter century.

China and other growing Asian economies have become important customers for oil exporters like Saudi Arabia and Iran, particularly as rising production of oil in the United States has meant a sharp decline in American imports. If the economic weakness in China continues to sap demand, the big oil producers would most likely cut prices even more aggressively to attract buyers.

The price of oil, which until this past week had not been below $30 in more than a decade, has now fallen by more than 70 percent over the past 18 months. Many traders are betting on still-lower prices, perhaps even heading toward the $20-a-barrel range.

Adding to the downward pressure on oil prices is the easing of international sanctions on Iran that could come in the next few days. Sanctions have crimped Iran's production and sales in recent years. If they are removed, Iran could start to ramp up production and rekindle sales to former customers in Europe and elsewhere. In the coming months, that could add as much as 500,000 barrels a day to an already oversupplied market, analysts estimate.

New supplies and weak demand have shifted the oil market away from a dynamic in which producers like Saudi Arabia and Venezuela could formerly extract ever higher prices from buyers like the United States and other industrialized countries. Now it is a buyers' market, and "producers themselves need to fight for market share" said Seth Kleinman, an analyst at Citigroup in London.

To be sure, as oil prices have dropped and some drillers have curtailed activity, the amount of excess production has been cut in half over the past six months. Even so, about one million barrels of extra oil is now getting dumped on the global markets each day.

The glut, in other words, is continuing to grow, and it could take years to work through all the crude that is being stored in warehouses, poured into depots and loaded onto supertankers that sail figure eights for lack of buyers at port.

The shake-out could will be painful, taking an even bigger toll on companies, countries and investors.

"What was once viewed as a gift is now viewed similarly to the gift of the monkey's paw," said Tom Kloza, global head of energy analysis for Oil Price Information Service. "Under $30 a barrel oil means the trillion-dollar oil business in the United States is threatened and the losses in investment dollars have exceeded the benefits of more consumer disposable income thanks to cheap gasoline."

The United States - where the advent of shale-rock oil extraction via "fracking" and other means has been a big contributor to the glut - is slowly cutting production, with major oil companies dropping their rig count and dozens of small businesses going bankrupt. But the industry cannot simply flip the switch on big projects, like deepwater production projects in the Gulf of Mexico, that require companies to keep pumping to cover their costs. Smaller companies have to keep producing from shale fields, even at a loss, to keep paying their lenders.

"Sheiks and shale caused this," said Scott Tinker, director of the **Bureau of Economic Geology** at the University of Texas at Austin. "They are both producing more oil. That is the fundamental driver."

One million to two million barrels a day of excess production may not seem like much in a world market that requires 94 million barrels. But the amount of daily oversupply in recent months is the largest since oil prices collapsed in the late 1990s.

Back then, the price dropped below $10 a barrel, on an inflation-adjusted basis. The market was flooded with oil from new fields just as the Asian financial crisis was roiling emerging markets.

In the past when markets got out of kilter, Saudi Arabia and its partners in the Organization of Petroleum Exporting Countries slashed production to support prices. But this time, the Saudis and other big producers have increased output in an effort to preserve market share and undercut higher priced producers like those drilling in the shale fields of Texas and North Dakota.

Even as prices slipped through 2015, global production climbed. The Energy Department projects that global inventories will rise by an additional 700,000 barrels a day in 2016.

The balance of oil supply and demand can swing abruptly, along with price, as they did in the early 2000s. At the time, the Chinese and other emerging market economies went into overdrive just as production in several countries, such as the United States and Mexico, was declining and big producers like Venezuela and Nigeria faced political turbulence.

By mid 2008, the price of oil had risen to nearly $150 a barrel. When the financial crisis gripped the global economy later that year, the price collapsed. But with China and other emerging markets surging ahead, oil rebounded, with unrest across the Middle East and North Africa threatening output.

It is the type of scenario that many analysts are now contemplating. An unexpected drop in supply or a rise in demand could quickly create a floor for prices and ease the glut, and eventually lead to a slow price recovery.

On the supply side, if tensions erupting between Saudi Arabia and Iran lead to armed conflict or an insurrection, the excess production could quickly disappear.

The boom in Iraqi oil production faces multiple threats, including Islamic State terrorism. The financially strapped government is falling behind in its payments to international oil companies, water is running low for pumping to revive aging oil fields, and northern Kurdish fields are short on pipelines.

Low oil prices have already constrained exploration and production investment around the world.

American oil producers are in retreat, with companies decommissioning more than 60 percent of their rigs in the last year or so. Since domestic oil production peaked at 9.7 million barrels a day early last year, it has fallen by more than half a million barrels. Rosneft, Lukoil and Western companies are also dropping big projects in Russia.

"Increased demand can certainly help, but the growing supply glut is what ultimately got us below $30-a-barrel oil," said Michael Tran, an RBC commodity strategist. "Significant supply cuts are what will ultimately have to dig us out."

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