The Telegraph

Fear grips market as oil leads commodity crash

Oil prices have buckled following the breakdown of Opec talks last week, but Chinese commodity demand is actually picking up

Oil states face an ordeal by fire after Opec paralysis causes price crash Photo: Alamy

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154 Comments

Brent crude prices have crashed below $40 a barrel for the first time since the depths of the global financial crisis as **Opec** floods the market to drive out rivals, with a parallel drama unfolding across the gamut of industrial metals.

The **Bloomberg commodity index** has fallen to within a whisker of lows last seen in 1998 and has now dropped by two-thirds from its peak, wiping out the entire gains of the resource supercycle. What China giveth, China taketh away.

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While plummeting commodity prices can be a warning sign that the world economy is heading into recession, the latest sell-off has a different character.

The slump is chiefly due to excess production, and amounts to a “positive supply shock” that should boost global recovery. Bank of America said oil demand has risen by 1.8m barrels a day (b/d) over the past year, the second strongest in a decade.

“The oil market is driven by fear,” said Ole Hansen, from Saxo Bank. The spectacle of a neutered Opec unable to act in a clear crisis – or even issue a coherent statement – has rattled investors.

“We have a ‘dump and pump’ war between Saudi Arabia and Iran. It’s possible the Saudis will try to match the Iranians with an extra 500,000 b/d in an exhaustion game. Anything could happen,” he said.

“US inventories are already at record highs, yet we are going into a seasonal period when they normally rise further."

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Brent futures for January touched $39.88 before rebounding slightly, while spot US crude fell to $36.63.

Sabine Schels, from Bank of America, said the Opec meeting last Friday had degenerated into a battle for market share within the cartel itself. There is a risk that the Saudis will succumb to “completely irrational behaviour” and try to drive prices even lower, despite their own fiscal crisis and the danger that this could blow apart the country’s riyal peg to the dollar.

Yet the evidence so far – despite the bluster from Riyadh – is that they have are already trimmed output by 250,000 b/d and are wary of letting the glut build so much that the world runs out of storage, an inflection point that could set off a further crash. “We think they will continue to take barrels off the market quietly until they have pushed Brent back to $50,” she said.

Short positions on the crude market have been rising to fresh highs for the past three weeks, reaching a record 360m barrels. This prepares the ground for an explosive short squeeze if anything goes wrong in the geostrategic cauldron of the Middle East. Despite the market gloom, the **CPB world trade monitor** showed that global trade grew 1.1pc in the third quarter after contracting for two quarters in a row.

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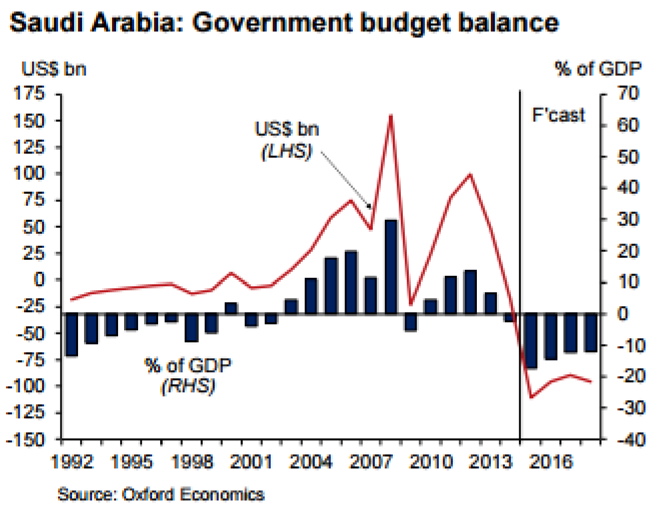
The latest import data from China were relatively strong as the country takes advantage of cheap crude to fill up its strategic petroleum reserve. Chi Zhang, from Barclays, said Chinese oil demand rose by 500,000 to 6.7m b/d in October. Demand rose 9pc for iron ore and 37pc for copper from a month earlier, dovetailing with signs that the property market is stabilizing.

Capital Economics said Chinese imports of commodities – in volume terms – rose at the strongest pace since early 2014. Yet investor angst has switched to the supply glut across the gamut of oil, gas and metals.

Iron ore is moving in lockstep with oil. Prices for delivery at Qingdao Port in China have broken through $40 a tonne, dropping to a 10-year low of $38.65 as investors wait to see which of the mining giants blinks first.

An Opec-style fight is unfolding among base metals. The low-cost Chilean producer Codelco – the Saudi Arabia of copper with 10pc of global share – is refusing to cut output, betting that it can outlast its rivals and win market share.

The open question is how long the oil states can withstand the political effects of crumbling income and forced austerity. Opec revenues are heading for $400bn from a peak of $1.2 trillion in 2012. Indonesia said there may have to be an emergency meeting if prices fall to $30.



Fitch Ratings has downgraded Bahrain to BBB-, warning that the fiscal break-even cost needed to balance the budget is $122 a barrel. It is running a budget deficit of 12.5pc of GDP with no plausible policies to stem the crisis. Its debt will jump to 65pc next year from 46pc in 2014.

Bahrain is a litmus of what can go wrong for several states in the Gulf region, not to mention Iraq, which is already in dire straits. It is far from clear whether Bahrain can endure another year of low prices, and the island is a political powder keg, with a Sunni elite trying to control a restless Shia majority. Saudi Arabia had to send in tanks to prop up the regime in 2011.

Opec is now in the awkward position of pleading for allies to prop up prices, admitting that it no longer controls enough of the global oil market to act alone. Russia has rebuffed the call. The cartel may have to choose between limited influence or none at all.