Why the Fracking Bubble is Set to Blow

The Trigger of the Next Debt Crisis

— Harry Dent, Editor

One of the major consequences of the Fed’s monstrous, six-year quantitative easing experiment is the unbelievable mispricing of high-risk, high-yield junk bonds — and its impact on the U.S. fracking boom. Now, it seems, this mispricing has come home to roost.

Cratering oil prices have pushed up yields on these junk bonds — but, unfortunately for investors, when yields move up, prices move down.

And not only does it mean that the junk-bond market is getting trashed, it also means that the fracking boom is about to turn into a devastating bust.

But more than that, I believe the fracking bust will likely be the trigger for the next debt crisis.

Let’s first take a closer look at what is happening in the junk-bond market these days...

To be sure, investors have flocked into the junk-bond market in recent years, because the rate of return on higher-quality investments has been so poor.

At the top of the previous boom in late 2007/early 2008, junk bonds were yielding 10% with $710 billion outstanding — a significant jump from the 7.5% yield they were getting just a few months before in early 2007. I would argue 7.5% to 10% is a more appropriate yield for investors, who opt to take such risks in what back then still looked like a good economy.

Then, in late 2008, those yields skyrocketed to 23.5% as the global financial crisis and subprime mortgage crisis took hold. When the riskier sectors of debt begin to go bad, the bond markets start worrying about other sectors.

The upshot was that investors lost almost 50% on a basket of high-yield bonds — almost as much as the stock crash. Junk-bond prices are more closely correlated
to the stock market than other areas of the bond market.

But mark my words: It’s about to get worse. High-yield bondholders are likely to see 60%-plus losses next time around.

Thanks to the Fed’s massive dosages of QE, junk bonds have jumped in value to $1.6 trillion, but yields fell to unprecedented low levels of 5% between early 2013 and mid-2014. That was just three percentage points higher than the risk-free 10-year Treasury bond!

Not only did that mean companies could borrow money to buy back their own shares, it also meant that risky ventures now became financially feasible — things like fracking.

As it happens, the energy sector — and largely frackers — is estimated to account for up to 20% of the total junk-bond market. That is around $250 billion. And during 2014, some 61% of the junk bonds issued were in the energy sector.

Frackers have also borrowed some $300 billion through leveraged loans. That makes a total of $500 billion-plus in risky energy debt in this sector — easily enough to trigger a debt crisis.

I’d say that’s the sound of a bubble about to burst!

And what is the real trigger? Obviously, rapidly falling oil prices have played a major role. Recall that the greatest bubble burst in modern history was the oil crash from $147 to $32 in just over four months during the second half of 2008. Oil is highly volatile and traded with high leverage.

With consistently slowing global growth rates, frackers have created more than three million additional barrels a day in the recent fracking bubble — thanks both to extended levels of high fracking bubble — thanks both to extended levels of high oil prices and cheap debt. That’s how the world got into a position of oversupply.

At the same time, Saudi Arabia is not cutting back production, because it wants the frackers and marginal oil producers to go under. That would only strengthen its market share and ultimately drive prices back up where the Saudis want them.

Why the Oil Price Will Keep Falling

To understand the real connection between frackers and junk bonds, it’s important to understand the financial dynamics of the industry.

Most frackers break even between $55 and $85 per barrel. Hence, there will be little or no new drilling or junk-bond issuance after the recent drop. But the variable costs of extracting the oil from the ground after great upfront expense are only $10 to $25. This means that operating wells will keep the oil flowing and the bubble in production that took off in 2011 will continue until between late-2015 and mid-2016 when the wells tap out.

Oil supply therefore will continue to expand for at least a year while global growth decelerates. So the oil price will likely fall further in 2015.

By the time production is cut, we will probably be in a global depression and that will suppress demand even further toward at least $32. It could be 2017, before oil prices finally bounce significantly. But they could ultimately fall to as low as $10 to $20 by the early 2020s.

After breaking the key $75 to $80 a barrel level in early November, the only support is at the late 2008 lows of $32. I expect oil to rally a bit into early 2015 back to $64 to $75 and then to crash and then to crash again, likely back to around $32.

This next crash is likely to start by late March, if not earlier. It will make it much clearer that many frackers will be defaulting, even while continuing
production for short-term cash flow. They will not be able to cover their debt service increasingly.

Once we hit a spike for high-yield energy bonds, they will begin spiking for other sectors. The increasing slowdown in fracking will also hurt jobs down the road. That will add insult to the injury of next year’s slow growth, thanks to demographic trends here, in Europe and in China.

While the Fed helped create the fracking bubble with their “free” money policies, it can’t do anything about falling oil prices. If oil keeps falling — as I believe it will — more frackers (as well as a number of foreign countries, including Venezuela, Iran to Russia) will go bust.

Falling oil prices now look most likely to be the trigger that starts the next debt crisis, which will spread as global growth continues to slow.

Meanwhile, markets see little or no risk and continue to rally as if they were on crack. Although the latest I see this stock rally continuing is mid-March. The Dow is likely to hit 19,000. But I also see the lesser possibility of it peaking near 18,000 on the back of brief, sharp Santa Claus rally.

The key sign of a final peak would be a rebound in oil and a final “risk-on” rally in commodities, gold and stocks. If oil does bounce back to $64 to $75, that would be the time to start selling stocks and all risk-on financial assets.

### The Fricking Fracking Bubble

Fracking stock prices have fallen 40% in just over five months. To me, that’s another sign of a bubble bursting.

Falling oil and commodity prices are not good for the economy, despite obvious benefits to consumers and businesses. Why? Because it will burst the great fracking bubble and because falling commodity prices just add to the deflationary environment that central banks are fighting so hard to counter in the first winter season since the Great Depression.

Fracking, which has been around since 1949, is a very interesting technology. However, it really took off from 2005 onward and accelerated from 2009 onward as a result of QE and cheap money. Today, 65% of oil rigs are horizontal and almost all of them need some degree of fracking stimulation to work.

Free or very cheap money will always cause excess and ill-advised investments. The chart above shows the parallels between the subprime mortgage bubble that peaked in 2005/2006 and the high-yield debt bubble that seems to be peaking on a similar trajectory in 2013 to 2014.

There are other bubbles, such as student loans at $1 trillion and rising subprime auto loans, that make the overall subprime picture even worse this time around.

There is also a bubble in emerging market corporate debt in U.S. dollars that now totals $5.7 trillion.

As oil and commodity prices continue to fall, these loans will go bad. And as the dollar continues to rise, these loans will cost more to pay back. So I expect a much larger round of defaults.

The key insight is that you can see that, like all bubbles, they accelerate for about five years before they burst. That’s where we are now with the fracking bubble.

Most people don’t realize these frackers are a significant part of the high-yield bubble, and it now looks like these energy companies are ones that will cause it to burst. In 2005 energy companies were...
4.4% of high-yield (junk) bonds; now some estimates suggest they represent as much as 18% to 20% of the junk-bond market.

Since 2012, fracking companies have seen an average $120 billion a year of expenditure, most of which is funded by cheap junk-bond debt. It takes a lot of money to fund a rig and it has an average production life of just two years. You can see how super cheap money causes an industry like this to bubble and grow faster than would be otherwise warranted.

FRAK, the only fracking ETF, started up in early 2012. Its price went from $19.50 in June 2012 to $35 in June 2014, before it fell 40% to $21. That plunge wiped out 90% of the gains. Meanwhile, Continental Resources, the North Dakota company owned by Harold Hamm, is down 60%. It had $140 million in debt in 2005; it now owes around $6 trillion!

The fracking crisis is already here and will accelerate when oil prices drop again. That may be a few months out as oil prices look to be bottoming here in the low $50s range — or they could continue to crash toward $32 at any time.

I have been predicting for years that oil prices will hit $10 to $20 by 2020 to 2023. I think $32 is likely just in the next year, most likely by September of 2015. That will mean the end of fracking and the million-plus jobs that have come with it!

The Real Impact of Falling Oil and Commodities Prices

There are three trends creating a deflationary environment that central banks have been fighting with their fire hose of quantitative easing. The first is the deleveraging of the greatest debt bubble in history. The second is aging populations in the developed world. The third is falling commodity prices.

If governments and central banks are intent on fighting deflation, as they clearly are, they can’t be happy about commodity prices and things like oil continuing to fall.

I have been arguing for years now that one of the least recognized leading indicators of the next global financial crisis is simply falling commodity prices, which create a vicious cycle of slowing exports for emerging countries. This slows China’s export bubble, which slows commodity prices, because China is the biggest importer of industrial commodities and energy to feed its giant manufacturing export machine.

EEM, the ETF which tracks emerging markets, is 29% below its late 2007/mid-2008 highs. CRB, the commodity price index, is 47% below its mid-2008 highs. The first crash hit sharply in 2008. The next one looks like it is emerging progressively into 2015 to 2016.

I have been commenting on how the CRB, oil, gold and copper have been trading in a sideways pattern for the last three years, and at some point these would break down.

That breakdown just happened. Oil broke below support at $75 to $80, copper broke below $2.90 to $3, gold broke below $1,180 and the CRB broke below $270.

These commodities are now holding and they look like they may have bottomed for now. Gold got extremely oversold, the most in years, and now looks likely to rally back toward $1,300 to $1,380 in the months ahead.

This is what a trader-dominated bubble looks like. Traders drive prices higher than anyone might imagine. Prices are then taken below support before they rally again. This trader-dominated world makes this the trickiest of markets to call in the short term.

Oil has been the most dramatic recently, as it was in the crash of 2008 when it plunged from $147 to $32. Now it has fallen from $106 down to $54 in just six months! It could fall a bit lower just ahead.

If oil does rally in the coming weeks or months to $64 to $75 and then turns around and starts to collapse again, breaking below $50 to $54, my advice is to watch out for the next global stock crash.

Yours,