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The Recession Caused by Low Oil Prices

Misery for oil incumbents from the fracking boom is spilling into the global economy. But there is cause for optimism.

By Donald L. Luskin

The global economy is slipping into recession. The evidence is showing up in all the usual ways: slowing output growth, slumping purchasing-manager indexes, widening credit spreads, declining corporate earnings, falling inflation expectations, receding capital investment and rising inventories. But this is a most unusual recession—the first one ever caused by falling oil prices.

We've had plenty of recessions caused by rising oil prices: 1973-75, 1980-81, and 1990-91. In these recessions, the oil price ultimately fell as demand collapsed.

But this time oil prices have fallen more than 70% since mid-2014, while demand has been rising. The drop is entirely the result of America's supply-side technology breakthrough with horizontal drilling and hydraulic fracturing—"fracking." This has given consumers world-wide what amounts to a tax cut of $7.8 billion every day, or about $2.9 trillion over a full year.

So shouldn't there be an economic boom, rather than a bust? Yes, eventually. But first, because of its magnitude and speed, the technology revolution that drove down oil prices has also threatened the important institutions that benefited from high prices. Collectively, these institutions are down $2.9 trillion.

For a century and a half, the largest global corporations and cartels of oil-producing nations have controlled the oil market. The years of "secular stagnation" after the Great Recession were mostly good times for them, with fears of "peak oil" making inflation-adjusted prices the highest in history.

Now thanks to the U.S.-led revolution in fracking, oil is abundant. It will be for decades, if not centuries, because there is shale everywhere in the world. And unlike the megaprojects that have dominated the oil industry over the past several decades, shale can be tapped by smaller companies with less capital. The oil market, as OPEC has learned to its sorrow, is now much more difficult to control.

This is capitalist creative destruction. But nowadays it happens on Internet-time, so it's also "disruptive innovation." Fracking is to the global oil industry what Uber is to taxi medallion owners: great for consumers who enjoy the sudden abundance, deadly for incumbents whose business models were built on exploiting scarcity.

In the short term, the misery visited on oil incumbents is spilling over into the economy generally. The U.S. non-investment-grade bond market is in tatters, with energy companies making up 15% of its aggregate face value. Energy defaults are increasing, and spreads have widened to distress levels. It's infectious; even outside the energy sector, junk-bond spreads have widened by 240 basis points over the past year and a half, the equivalent of almost 10 Federal Reserve rate increases on this key market for entrepreneurial funding.

According to bank regulators, U.S. banks have syndicated leveraged loans for the oil and gas industry of $276 billion, 15% of which are now regarded as distressed, up from less than 4% a year ago. And in our hyper-cautious, Dodd Frank-saddled world, such distress drives a tightening of lending conditions system-wide. And that drives recession.

Energy company earnings have collapsed. In the U.S., earnings of the energy sector of the S&P 500 have fallen by 76%. The same is happening in energy around the world. And over the past quarter, earnings for companies in all sectors have started to slump, too. Every recession in a generation has been preceded by such an earnings rollover.

The public finances of oil-producing nations—from Russia to Venezuela to Saudi Arabia—are also collapsing. When petrodollars dry up at the source, they dry up downstream as well, across the whole global economy.

U.S. capital investment—which never really recovered from the housing bust—has been hit particularly hard by cutbacks in oil-field capital expenditures. That took 44 basis points off real U.S. output in the first quarter of 2015, 88 basis points in the second, and 33 basis points in the third. There are more cutbacks to come.

China—an economy with rapidly increasing oil consumption—ought to be a beneficiary of low prices, but instead it is a victim, and potentially a globally systemic one. That's because the foreign-exchange value of the U.S. dollar has surged, as it always does when oil prices fall. After substantially revaluing the yuan over a decade in response to protectionist threats, China now finds the strong dollar has left its currency grossly uncompetitive with the euro, the yen and all the rest. The alarming recent devaluation of the yuan, while a sensible response for China, is creating strains throughout emerging economies and deep uncertainty through all global supply chains.

Maybe no single one of these oil-driven stresses would be enough to trigger a global recession. But a recession is often a death by a thousand cuts, not a single blow. Today's reverse oil-shock has made a lot of cuts. And it's not as though the world economy was all that robust to begin with.

There has never been a recession caused by low oil prices, so there is no playbook for how this one might evolve. It is critically dependent on how the global consumer responds. If the rigors of recession reduce demand for oil—as happens in a typical recession—then we'd have a vicious cycle in which further oil price declines would make the recession worse.

But there is also cause for optimism. Low oil prices make the global consumer very resilient, which buffers the recession's severity and duration. The best news is that, thanks to fracking, recessions caused by high oil prices are a thing of the past.

Mr. Luskin is chief investment officer at Trend Macrolytics LLC.