How the Looming End of "CHEAP MONEY" Will Impact Texas Oil and Gas

By Alan Lammey

For years now, local, national, and global economies and financial markets have been caught in the vice-grip of deflation. With the Lone Star State being such a large, energy-based economy, Texas businesses know all too well how lower oil and natural gas prices have taken a bite out of commerce and cash flow. However, it appears the era of exceptionally low interest rates may finally be coming to a close while inflation begins to set in. This means more economic charges are afoot for Texas businesses and consumers.

For years, global central banks have pushed back with extraordinarily easy-money policies, delivering ultra-low and even negative interest rates worldwide. And for years, financial commentators have been predicting this will end very badly one day when the spell of omnipotent central banks is forever broken and investors reject government debt of any kind. It appears that this scenario may be on pace to finally arrive, probably sooner than most realize. In fact, as 2016 draws to a close, it may go down in the financial history books as a real game-changing year: the end of the great bull market bubble in bonds.

What is a bond, and why should you care?

A bond is a debt security, similar to an "IOU." In order to raise money, governments, cities, counties, municipalities, and corporations borrow capital from investors willing to lend them money for a certain period of time at an agreed, fixed interest rate. When a person buys a bond, he or she is lending money to the issuer of the bond.

After years of the U.S. Federal Reserve (the Fed) and foreign governments around the world doing everything possible to suppress interest rates, the great bull market in bonds has persisted for 35 years. From a peak above 15 percent in 1981, yields on the 30-year U.S. Treasury Bond steadily declined to a low of just 2.1 percent earlier in 2016.

The era of cheap money, particularly from 2009 to 2016, was indeed one of the chief reasons that the oil and gas industry all over the U.S. was able to expand at such a mind-boggling pace. Moving forward, hugely expensive oil and gas production projects that were only doable because of ultra-low interest rates may not be economically feasible. Once these projects are completed, the break-even price for oil and gas will increase.

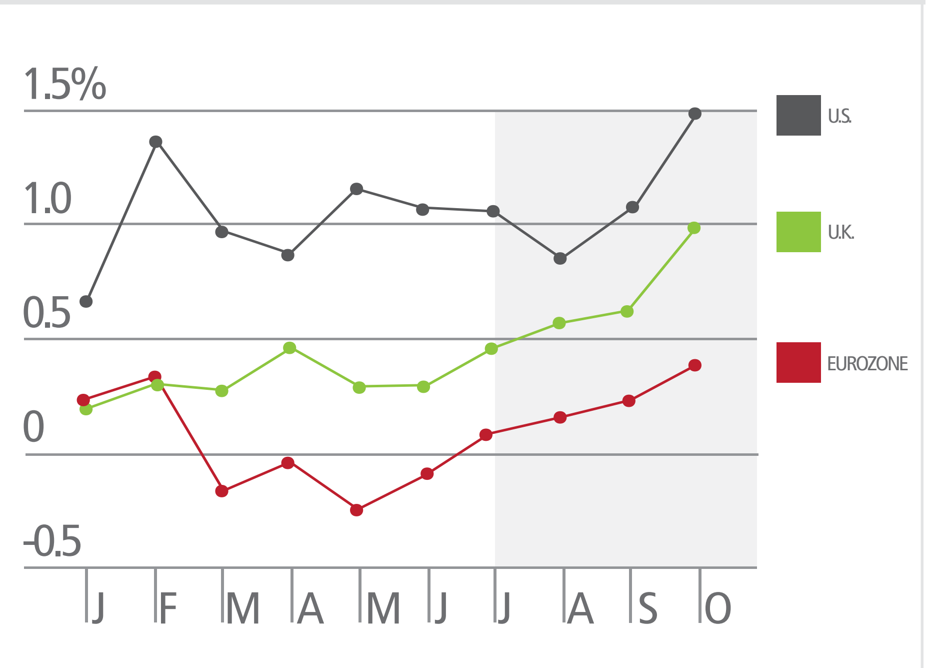
Since bond prices move in the opposite direction of yields, this means windfall profits for bond investors for several decades. But now the game has changed, and a major shift is already underway across financial markets.

In fact, yields on the benchmark 10-year Treasury note were at a low of 1.3 percent as recently as July but have lately spiked. Now it appears that there's real potential for yields to ascend even higher in the weeks and months to come.

What's different this time?

What's different is that, previously, bond yields consistently declined whenever uncertainty and stock-market volatility were on the rise, but not this time. This time, yields are rising as investors unload bonds and prices tumble. A move in bond yields from 1.3 percent to almost 2 percent may not sound like such a big deal, but consider

Consumer Price Indexes | Change From a Year Earlier



this: a paltry one percentage point rise in yields translates into a roughly 7 percent loss in the principle value of global government and corporate bonds. That's equivalent to a $3.4 trillion hit to the global bond market, a loss large enough to erase several years' worth of interest payments!

Why *are* bond yields suddenly selling off worldwide? The shortsighted seers on financial television programs might tell you it's due to fears about an impending interest-rate hike from the Federal Reserve, but that doesn't exactly appear to be the case. The Fed's desire to "normalize" monetary policy and to begin raising rates has been the worst kept secret on Wall Street.

After all, the Fed ended its quantitative-easing program when it bought government bonds to suppress interest rates a little over two years ago in November 2014. Then, this past December, the Fed made its first move in over a decade to raise short-term interest rates. Yet 10-year Treasury prices were higher back then than they are right now. Thus, you can't pin the blame for recent bond market losses on fears of rising rates alone.

What is really happening?

The rising fear of inflation is the real game-changer. Here's a fact that hasn't been widely reported by the financial news media: on Halloween 2016, the Fed's preferred measure of inflation, something called the Personal Consumption Expenditures (PCE) deflator, was reported to have risen 1.2 percent in September from a year ago. This time last year, though, PCE "inflation" was up only 0.2 percent for the year ending September 2015. In other words, inflation is accelerating.

In fact, prices have been rising at a 2.1 percent annual clip over the past six months alone, a rate that surpasses the Fed's publicly stated 2 percent inflation target. It's no surprise when you consider that American wages are finally starting to rise, various commodities are rebounding, and healthcare and tuition costs continue to soar at double-digit rates.

It's not just here in Texas and the U.S. either. Measures of inflation are also on the rise in Europe and the United Kingdom, as you can plainly see in the chart on the preceding page.

Bonds are selling off due to fears that the Fed, and many other central banks, are already behind the curve on inflation, which should be defined as the *real* cost-of-living, not the contrived government data. Mind you, this is not suggesting the economy is in store for the 1970s-style inflation with soaring prices for everything from food to fuel. However, investors have gotten so accustomed to years of low inflation—and have grown so complacent that it will continue—that even a mild acceleration in prices, with interest rates at record lows, can be a major game-changer for financial markets.

How will this impact the market in Texas and elsewhere?

Stocks that benefit from rising prices, including energy and financials, have been outperforming the stock market. Financials, the second-best performing sector behind technology, are up 6.6 percent since the end of June. This is another sector that typically performs well amid rising inflation. Energy stocks have been up nicely since the 3rd quarter of 2016 but will see notable volatility. In particular, oil companies will increase as interest rates begin to climb in the months to come.

When interest rates climb higher, they typically strengthen the U.S. dollar. It's important to note that there is an inverse relationship between the value of the dollar and commodity prices, namely West Texas Intermediate (WTI) oil. When the dollar strengthens against other major currencies, the prices of commodities tend to drop. When the value of the dollar weakens against other major currencies, the prices of commodities generally move higher. That is because the U.S. is the strongest and most stable economy in the world.

Therefore, the dollar is the reserve currency of the world and the pricing mechanism for commodities. When the dollar strengthens, it means that commodities become more expensive in other non-dollar currencies. This tends to have a negative influence on demand. Conversely, when the dollar weakens, commodity prices in other currencies move lower, which increases demand. Meanwhile, the most interest rate sensitive stocks, including utility and telecom shares, are getting thrashed; both sectors have declined 6 percent since July 1, 2016, and may be on pace to see even deeper losses.

At this juncture, more than any other time in many years, there is more solid evidence that interest rates are likely headed even higher so long as inflation remains on the rise. This means the long-anticipated bond market bust may finally be unfolding now, right before our eyes. The U.S. stock market and Exchange Traded Funds (ETFs) with bond-like qualities are vulnerable to get dragged down along with bond prices.

Oil and gas production projects may slow amid higher interest rates, and oil prices may tend to remain suppressed for a while longer due to a stronger U.S. dollar until supply becomes smaller and tightens the supply-demand balance. In a nutshell, it would be wise for investors, both small and large, to adjust their own portfolio holdings in preparation for some big volatility in the markets going into 2017 and over the next few years. N

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