Mizuho Brief: Oil

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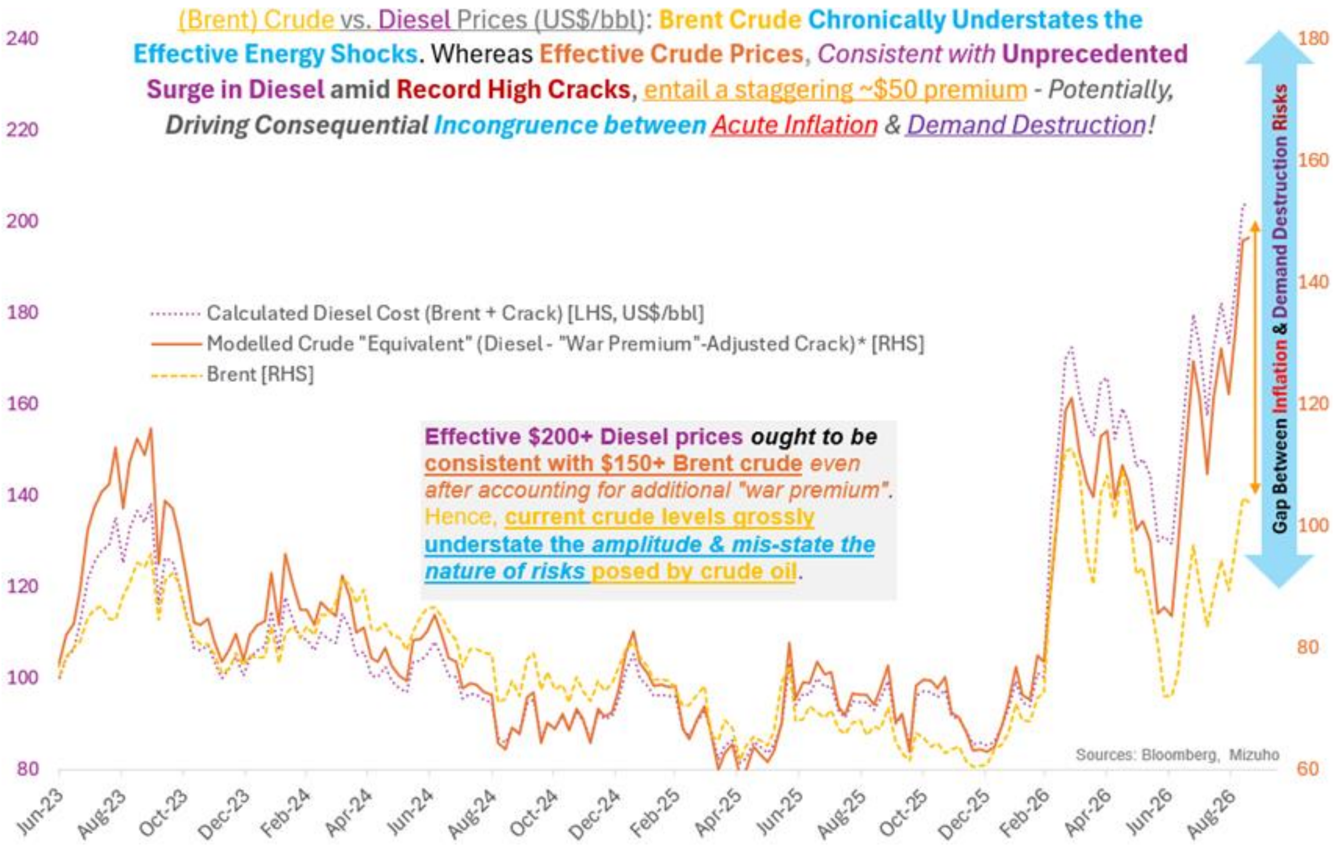
Vishnu Varathan | Head Macro Research, Asia ex-Japan

Second-Order Oil-Crack Risks

"Your eyes can deceive you. Do not trust them." **Obi-Wan Kenobi, Star Wars**

In a Nutshell: The **unprecedented surge in cracks** disproportionately **driving diesel** (and other end-use fuel) **prices sharply higher simultaneously**; i) **understates adverse impact from energy shocks** and; ii) **unevenly re-distributes wider growth-stability threats,** *further exacerbated by asymmetric AI dynamics,* to the disadvantage of EM Asia economies,. The **first order problem** is that the **prevailing $100 crude**, *typically associated with $120-125 diesel,* **understates the "oil shock" risks** as it **is conservatively consistent with $150+ crude**; *even after accounting for additional "war premium".* Crucially, ***as Major central banks fixate on inflation risks from $100 crude***, ***demand destruction threat of $200+ diesel*** (effectively $150+ crude) ***may overwhelm EM Asia central banks***. Consequently, **unwelcome headwinds from rising global rates/yields** threaten to exacerbate *adverse industrial, fiscal, consumption growth dampeners* for EM Asia. In turn, **sharpening growth-stability trade-offs** *to the detriment of "twin deficit" AXJ (and AXJ-denominated assets)*.



- The **unrelenting surge in cracks** has arguably **unleashed far greater-order**, and **under-the-radar**, **risks than commonly tracked crude price alone might otherwise suggest**.
- The obvious **first-order problem** is that the **amplitude of energy shock** is **chronically and misleadingly understated by Brent crude**.

- And especially problematic for past comparisons is the *highly uneven shifts in* the *known correlations" between crude* and *end-use energy.*
- Fact is, **diesel now at >$200 per barrel** (as *diesel cracks soar to match crude at ~$100*), **is dramatically above what $100 Brent has been typically associated with**.
- In fact, **$200+ diesel** may be suggesting economic stress/price shocks as high as ~$180 crude (*based on simplistically backing out$20-25 pre-Iran war, diesel crack*).
- And ***even after accounting for "additional war premium"***, the record diesel is **at the very least, consistent with $150+ Brent** (and ***not*** the ***$100 crude*** quote).
- Crucially, it is **not just that** the **amplitude of adverse impact**, ***but*** the ***asymmetric nature of shock transmission***, that is **grossly under-estimated**.
- More acutely as the **delayed** and **dampened shock transmission** from ***inventory buffer*** is **further obfuscated by** the ***cover of*** (more than?) offsetting ***AI-related demand**.*
- Which **leads into** the **second order risk** of **policy incongruence** (and resulting policy tensions) ***between Majors*** and ***EM*** – *especially for EM Asia.*
- **Major economies**, led by a hawkish Fed, are now **responding to inflation risks** *associated with $100-120 crude.*
- Especially given the **growth cover**, and **attendant inflation risks**, **of disproportionate AI-related gains** (both in profits and capital).
- *Whereas* **demand destruction risks overwhelm** for **EM Asia**, which suffers **adverse economic dynamics** *from the effective impact of effectively $150+ crude*).
- Especially *given how disproportionately reliant EM Asia is on refined products* for industrial energy, downstream production, and fiscal-social sustainability.
- **And ascendant global rates/yields from Fed-led hikes** by Major central banks inevitably accentuate pain from adverse fiscal-risk re-pricing-inflation feedback loops.
- All said, this ***unprecedented tear-away in (diesel) cracks*** **disproportionately subjects EM Asia to adverse growth multiplier dampeners** via *industrial, fiscal, consumption* and *risk channels.*
- Consequently, EM Asia's **growth-stability policy trade-offs sharpen acutely amid Fed hikes** – *accentuating FX and bond/asset market vulnerabilities.*