United-ICAP
the technical advisory service
walter j. zimmermann jr. walterz@united-icap.com

Financialization
17 Nov 11

The Financialization of Energy Price Trends: Review and Update - 17 Nov 11

Contents

Intro - p. 1 - 2
Part I - Interest Rates
WTI - p. 3
Copper - p. 4
CRB Index - p. 5
Part II - Stock Indices
Crude Oil - p. 6 - 11
Real Estate - p. 12
RBOB - p. 13 - 14
Distillate - p. 15 - 16
Natgas - p. 17
CRB Index - p. 18
Gold - p. 19
Part III - US Dollar
SPX - p. 20
WTI - p. 21
RBOB - p.22
Euro-fxs - p. 23 - 24

Introduction

By the end of 1999 it had become obvious that something new was happening in energy prices. By year 2000 WTI prices had spent almost an entire year moving in tandem with trends in the S&P 500 Index. There were always occasional period of correlation on a monthly closing basis. But this was a week by week tracking. And as the years unfolded from 2000 this week by week relationship spread to RBOB, and 2Oil, and Brent, and even to the shape of forward curves. And over the years the relationship between price trends in the S&P 500 Index and price trends in energy evolved from a week by week correlation, to a day by day link, then to hour by hour, and now almost minute by minute. Economic expectations, as embodied by price trends in broad based stock indices like the SPX, now exert absolute dictatorial power over energy prices. Of course the other dictator are price trends in the US Dollar. In this report we explore how this came to be, and what it portends for the future of energy prices.

A Culture of Speculation

There may be no field where the law of unintended consequences rules so thoroughly as the field of economics. There should be no surprise here. Economists are renowned for sticking blindly to failed theories and broken models. The theories and models of traditional economics are failed and broken precisely because they do not produced the desired effects. One of the most egregious examples is the area of interest rate policy.

In traditional economic theory lower interest rates are supposed to stimulate economic activity through increased lending, borrowing, spending. And this is generally the case during a bull market. However this has been shown to not be the case during the deleveraging that follows the collapse of an easy-credit driven speculative bubble. When interest rates are driven low enough during an economic contraction the end result is increased financial speculation, not an economic stimulation.

walter j. zimmermann jr. walterz@united-icap.com

The Federal Reserve of Unintended Consequences

Under Alan Greenspan the sole focus of the Fed became perpetuating the bull market in stocks. As the speculative bubble in equities began to inflate more and more rate cuts were required to ensure that the bubble continued to inflate. Despite his one protestation of irrational exhuberance Greenspan's actions revealed another motive altogether. During his reign as Fed chief Greenspan cut the Fed Fund rate from 9.625 % in 1989 to 1.00% in June of 2003. Then Bernanke came on board and lowered the Fed Fund rate from 5.25% in 2006 to the current 0.00 to .25 % range.

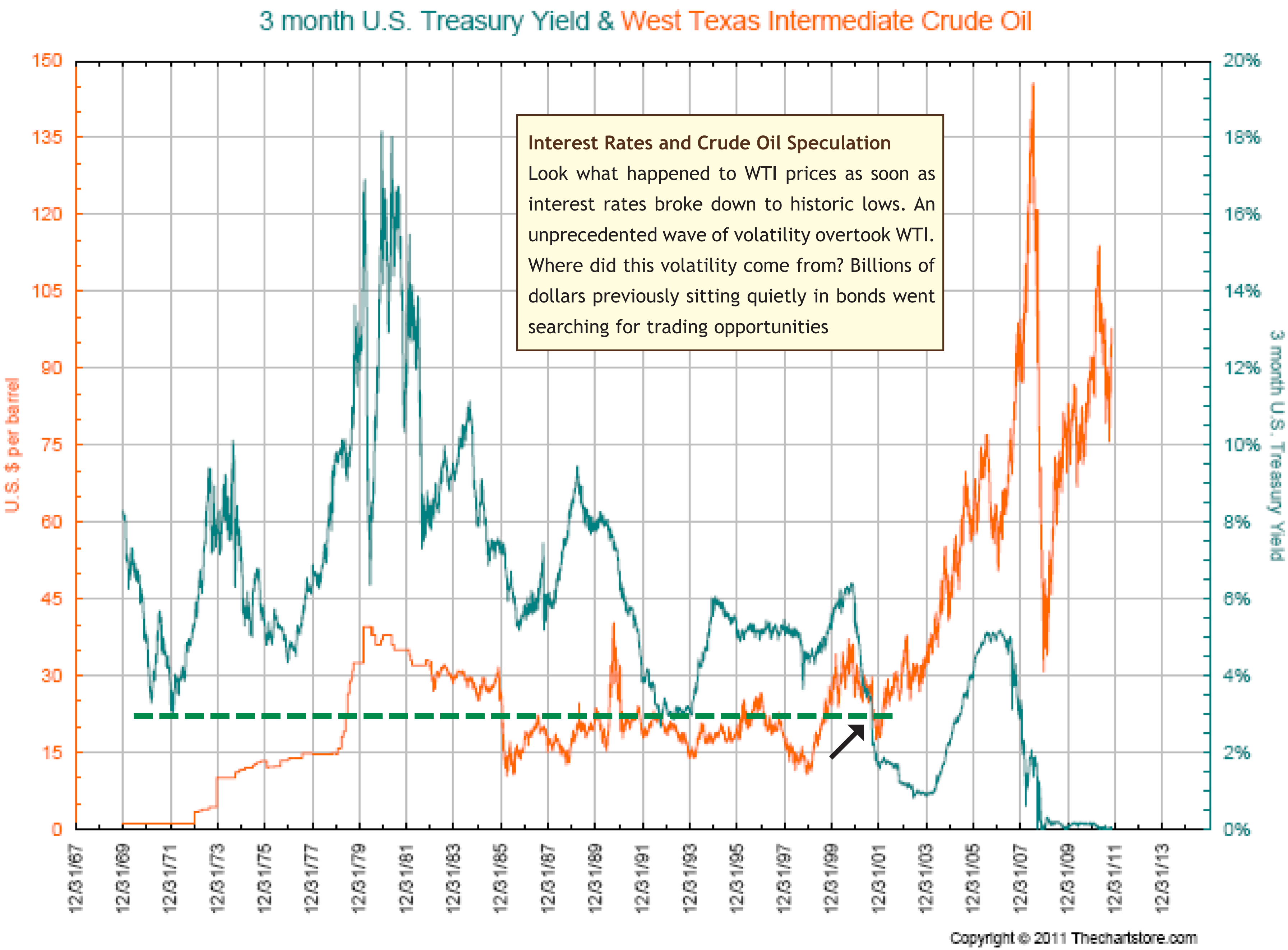
Under Bernanke the stated goal of a zero Fed Fund rate was to stimulate the economy through increased borrowing, lending, and spending. However the largest credit bubble in the history of the world burst from 2007. The foundation of our economy, the consumer, faced an immediate an on-going need to reduce the debt load in order to avoid bankruptcy. In fact consumer sentiment has been declining along with the Fed Fund Rate. So were did all this new Fed credit go to if consumers were not taking it on? The pages 3 to 5 charts give quite a dramatic answer.

When the Fed drove interest rates to zero to spur the economy the unintended consequence was a massive flow of funds out of bonds and into speculative trading. As treasuries were no longer yielding an income, speculative trading was going to have to make up the shortfall. The commodity sector became a favorite destination of this new wave of speculation, and as I just noted, the charts tell the story.

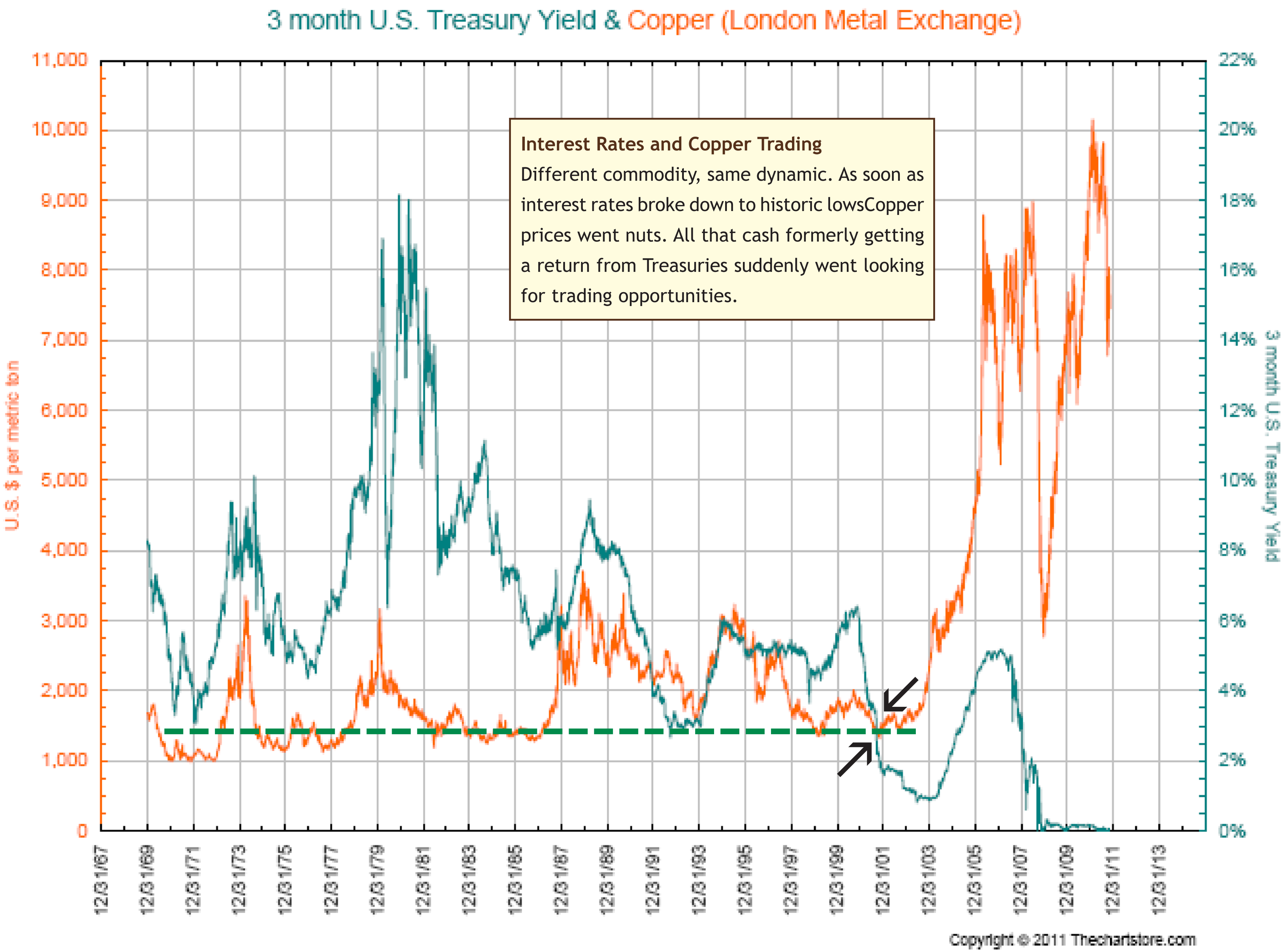
Energy Prices as Economic Expectations

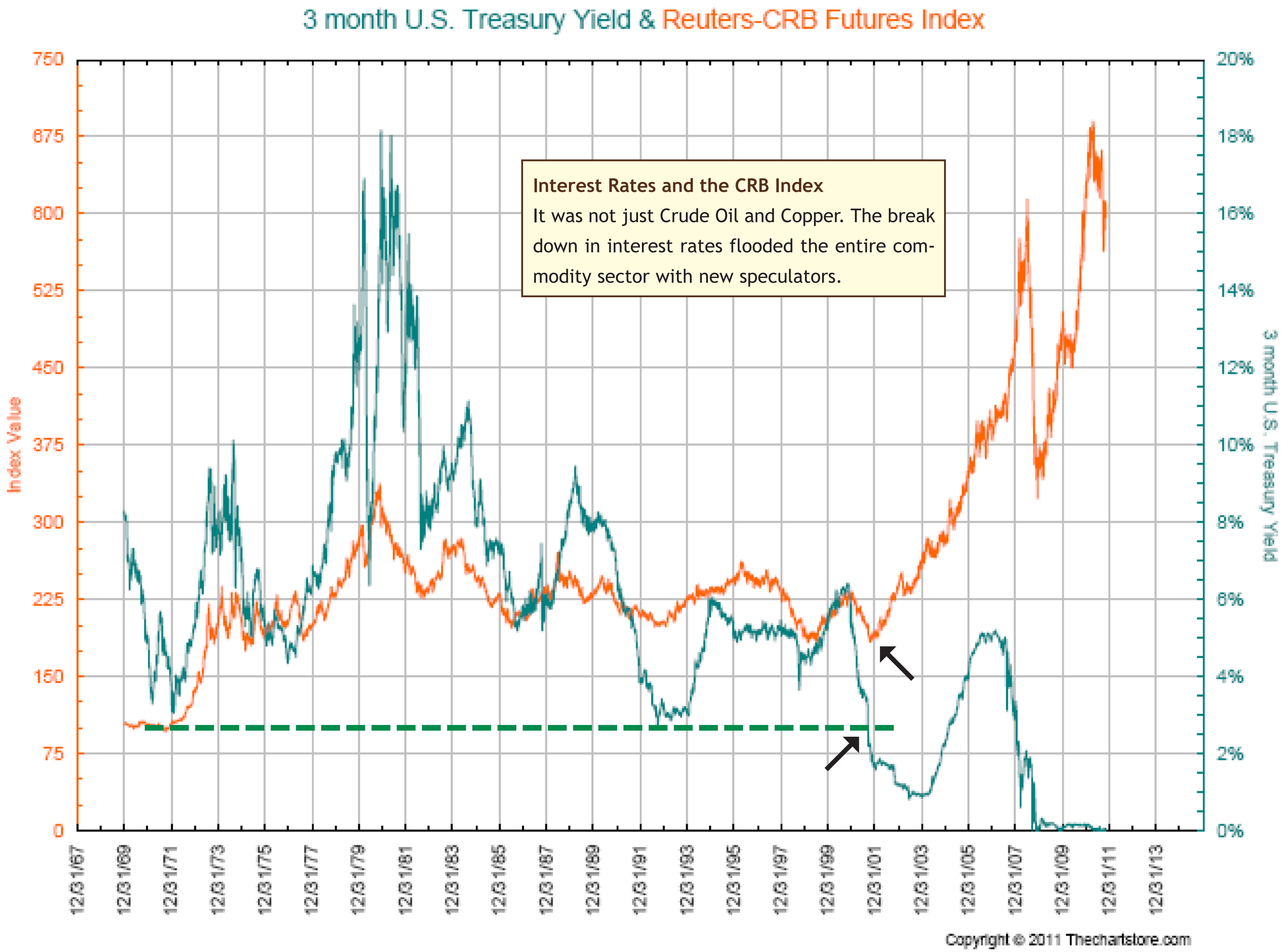
In a world where the Federal Reserve thinks that zero interest rates are needed to prevent another financial collapse one can only conclude that the Fed sees a very high risk of deflation. It has been our contention all along that the risk is deflation, not inflation. Our working definition of deflation is still the same - too much debt and not enough revenue to support the debt. That is clearly the problem for cities, states, and countries everywhere. It is also the problem for the average American family. And it is clearly the engine driving the continuing down trend in real estate values. What happens during deflation? As fears rise everyone is compelled to sell assets to remain solvent. So prices for everything fall. Real estate loses value, and commodity prices drop along with stock market values. During inflation the opposite occurs. Too much money and high consumer confidence drive the prices of good and services higher. Deflation is falling prices and an economic contraction. Inflation is rising prices and an economic boom.

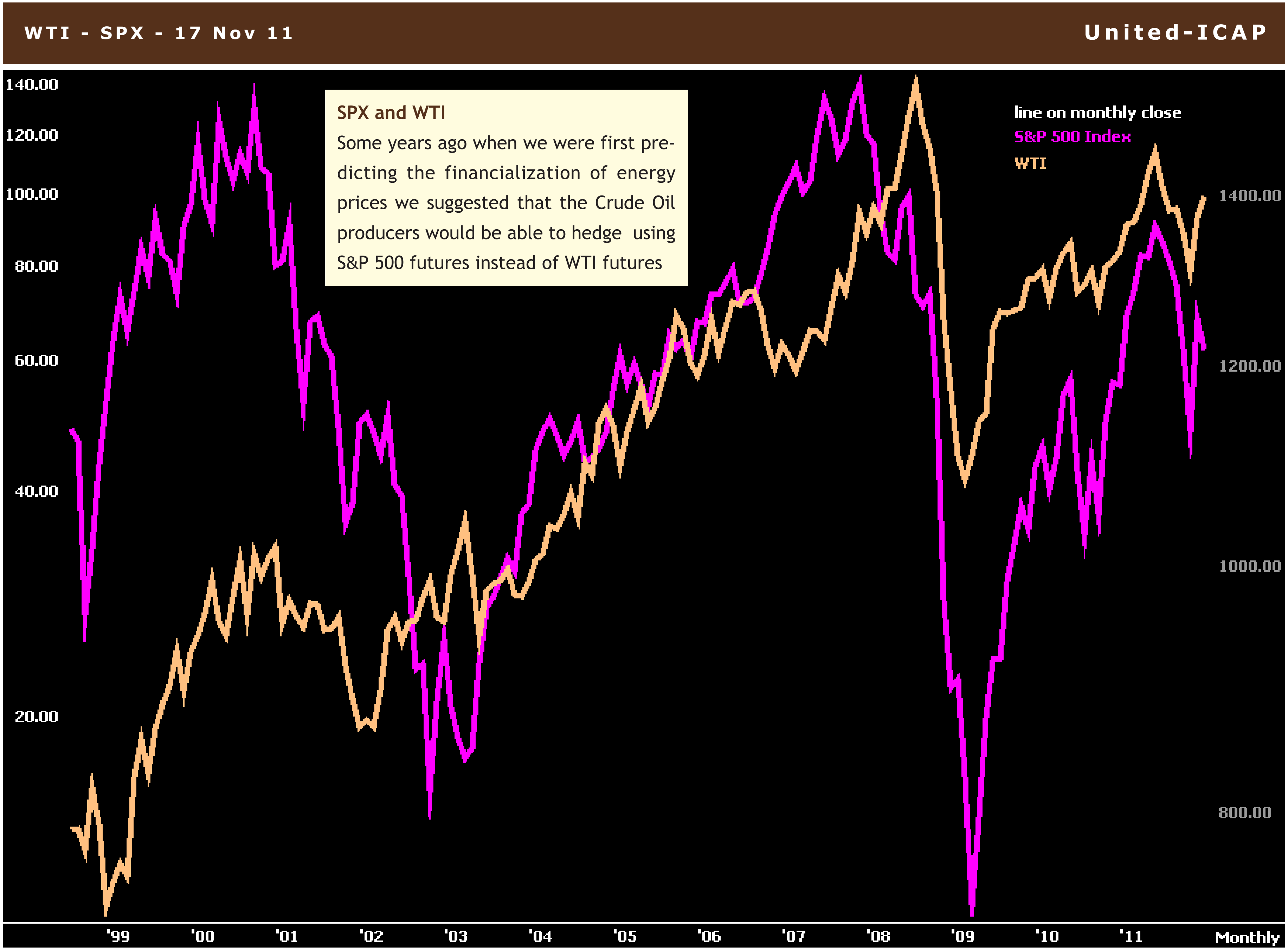
So in today's global market, whenever a whiff of hope for reflation and economic recovery waft through the market, stock market values and commodity prices rise as one. Whenever fears of deflation and a further economic contraction spread through the market, equity prices and energy prices fall as one. As we have summarized before, one big market, one big mess. If we get inflation then there is no way energy prices can fall. And if we get deflation then there is no way energy prices can rise. So energy prices have become 'financialized.'

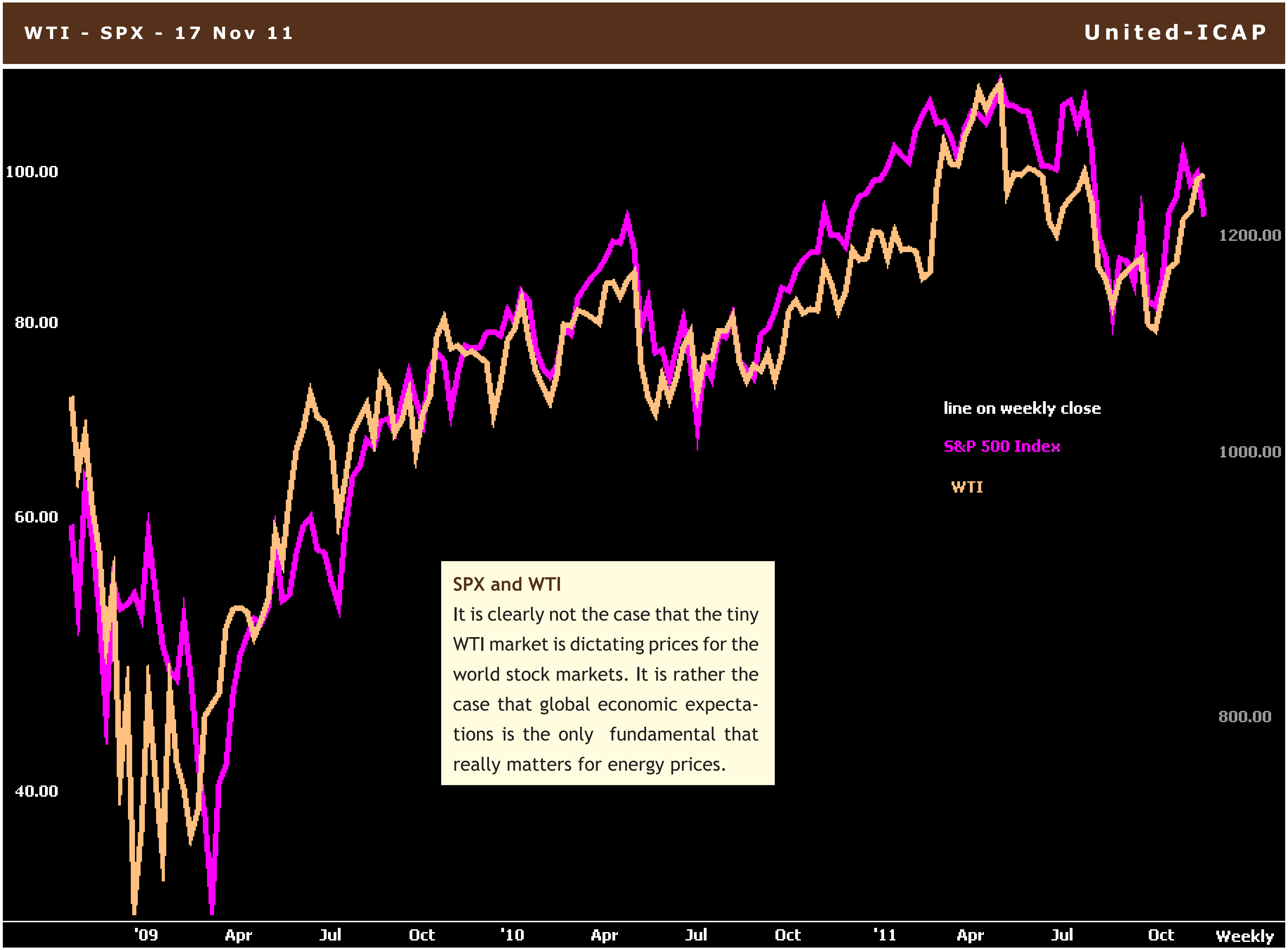


3 month U.S. Treasury Yield & West Texas Intermediate Crude Oil
Interest Rates and Crude Oil Speculation
Look what happened to WTI prices as soon as interest rates broke down to historic lows. An unprecedented wave of volatility overtook WTI. Where did this volatility come from? Billions of dollars previously sitting quietly in bonds went searching for trading opportunities
U.S. $ per barrel
3 month U.S. Treasury Yield
150
135
120
105
90
75
60
45
30
15
0
20%
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
12/31/67
12/31/69
12/31/71
12/31/73
12/31/75
12/31/77
12/31/79
12/31/81
12/31/83
12/31/85
12/31/87
12/31/89
12/31/91
12/31/93
12/31/95
12/31/97
12/31/99
12/31/01
12/31/03
12/31/05
12/31/07
12/31/09
12/31/11
12/31/13
Copyright © 2011 Thechartstore.com


3 month U.S. Treasury Yield & Copper (London Metal Exchange)
Interest Rates and Copper Trading
Different commodity, same dynamic. As soon as interest rates broke down to historic lowsCopper prices went nuts. All that cash formerly getting a return from Treasuries suddenly went looking for trading opportunities.
U.S. $ per metric ton
3 month U.S. Treasury Yield
11,000
10,000
9,000
8,000
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0
22%
20%
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
12/31/67
12/31/69
12/31/71
12/31/73
12/31/75
12/31/77
12/31/79
12/31/81
12/31/83
12/31/85
12/31/87
12/31/89
12/31/91
12/31/93
12/31/95
12/31/97
12/31/99
12/31/01
12/31/03
12/31/05
12/31/07
12/31/09
12/31/11
12/31/13
Copyright © 2011 Thechartstore.com

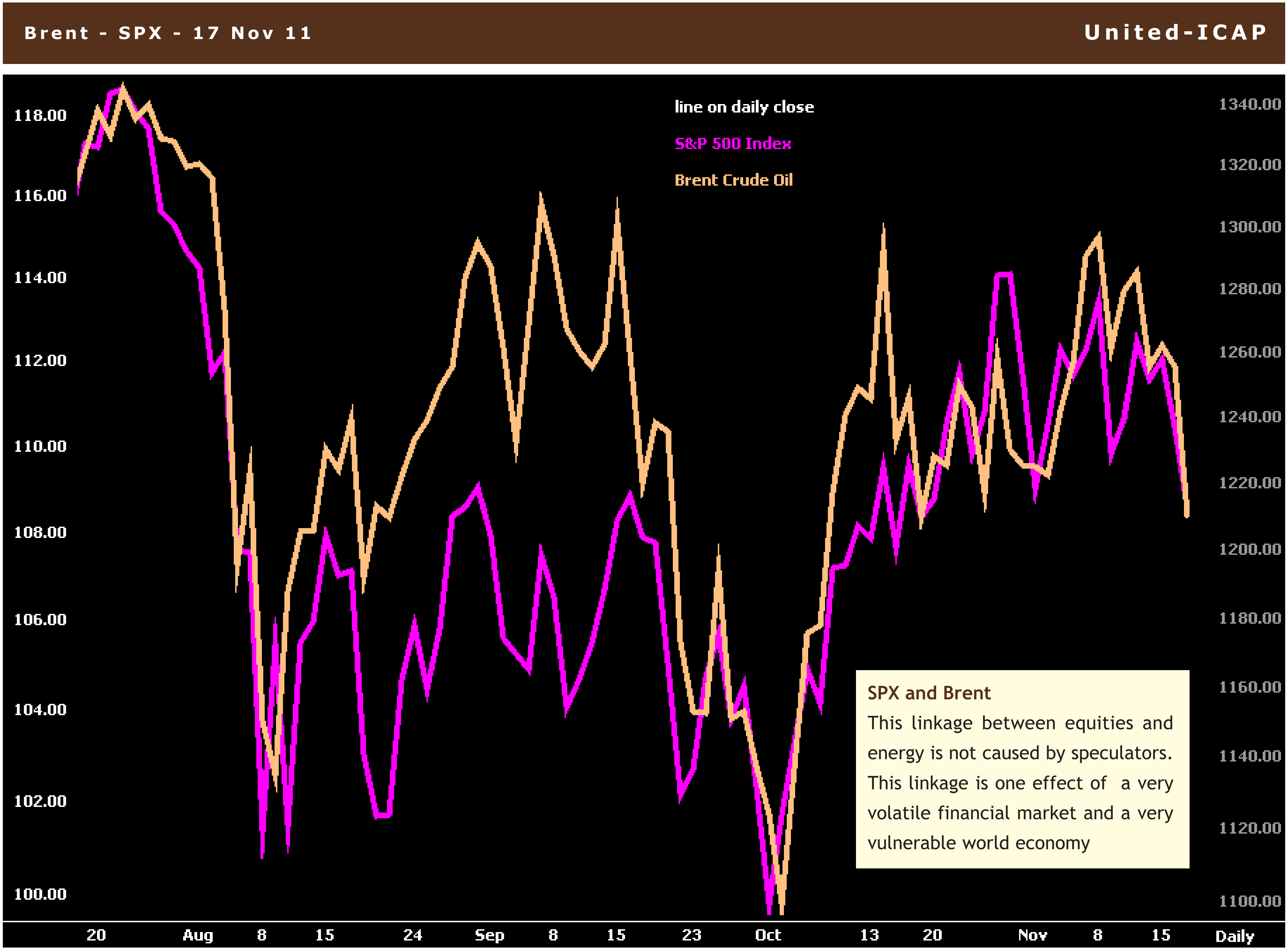

3 month U.S. Treasury Yield & Reuters-CRB Futures Index
Interest Rates and the CRB Index
It was not just Crude Oil and Copper. The break down in interest rates flooded the entire commodity sector with new speculators.
Index Value
3 month U.S. Treasury Yield
750
675
600
525
450
375
300
225
150
75
0
20%
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
12/31/67
12/31/69
12/31/71
12/31/73
12/31/75
12/31/77
12/31/79
12/31/81
12/31/83
12/31/85
12/31/87
12/31/89
12/31/91
12/31/93
12/31/95
12/31/97
12/31/99
12/31/01
12/31/03
12/31/05
12/31/07
12/31/09
12/31/11
12/31/13
Copyright © 2011 Thechartstore.com


WTI - SPX - 17 Nov 11
United-ICAP
SPX and WTI
Some years ago when we were first predicting the financialization of energy prices we suggested that the Crude Oil producers would be able to hedge using S&P 500 futures instead of WTI futures
line on monthly close
S&P 500 Index
WTI
140.00
120.00
100.00
80.00
60.00
40.00
20.00
1400.00
1200.00
1000.00
800.00
'99
'00
'01
'02
'03
'04
'05
'06
'07
'08
'09
'10
'11
Monthly

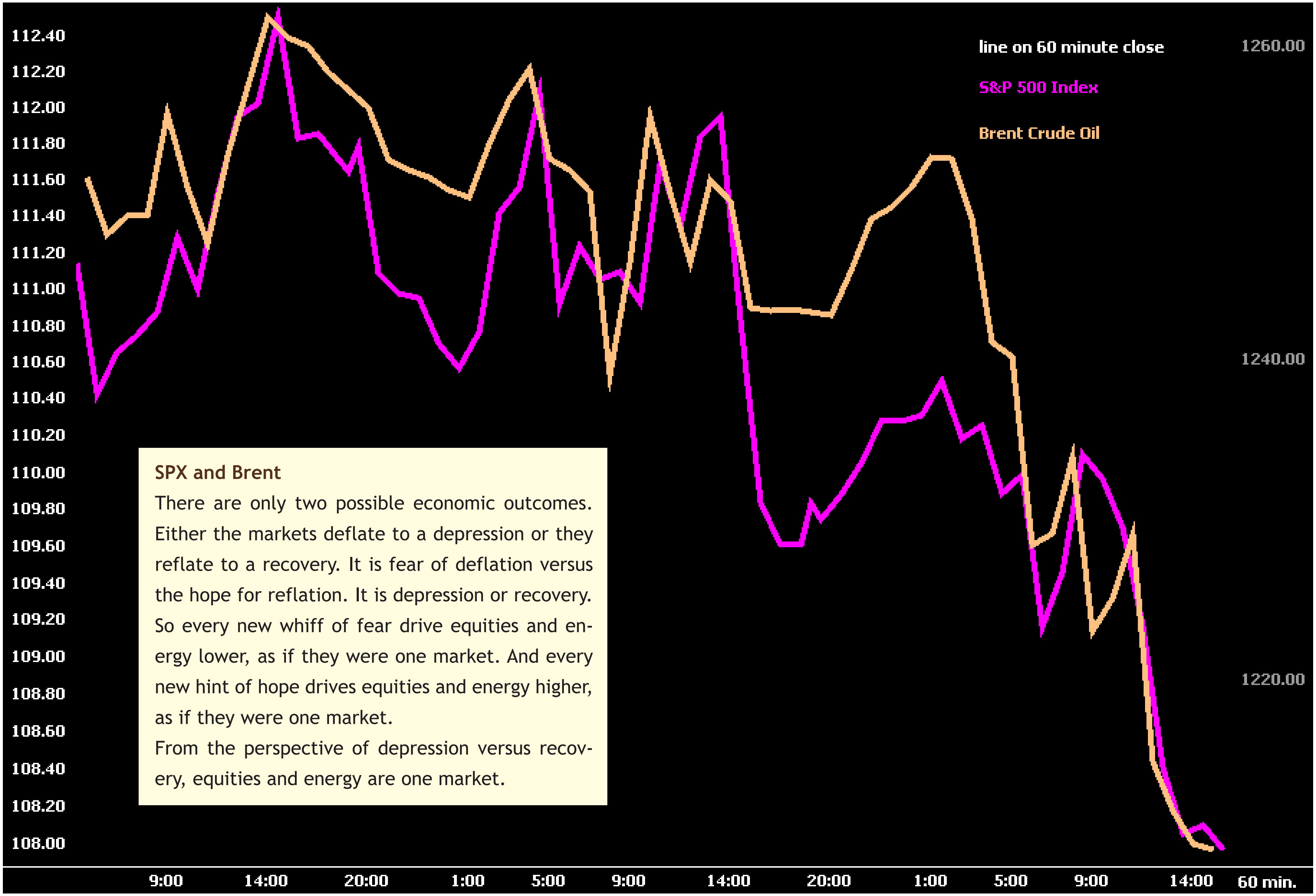


SPX and WTI

It is clearly not the case that the tiny WTI market is dictating prices for the world stock markets. It is rather the case that global economic expectations is the only fundamental that really matters for energy prices.


Brent - SPX - 17 Nov 11
United-ICAP
line on daily close
S&P 500 Index
Brent Crude Oil
118.00
116.00
114.00
112.00
110.00
108.00
106.00
104.00
102.00
100.00
1340.00
1320.00
1300.00
1280.00
1260.00
1240.00
1220.00
1200.00
1180.00
1160.00
1140.00
1120.00
1100.00
20
Aug
8
15
24
Sep
8
15
23
Oct
13
20
Nov
8
15
Daily
SPX and Brent
This linkage between equities and energy is not caused by speculators. This linkage is one effect of a very volatile financial market and a very vulnerable world economy

Brent - SPX - 17 Nov 11 **United-ICAP**



SPX and Brent

There are only two possible economic outcomes. Either the markets deflate to a depression or they reflate to a recovery. It is fear of deflation versus the hope for reflation. It is depression or recovery. So every new whiff of fear drive equities and energy lower, as if they were one market. And every new hint of hope drives equities and energy higher, as if they were one market.

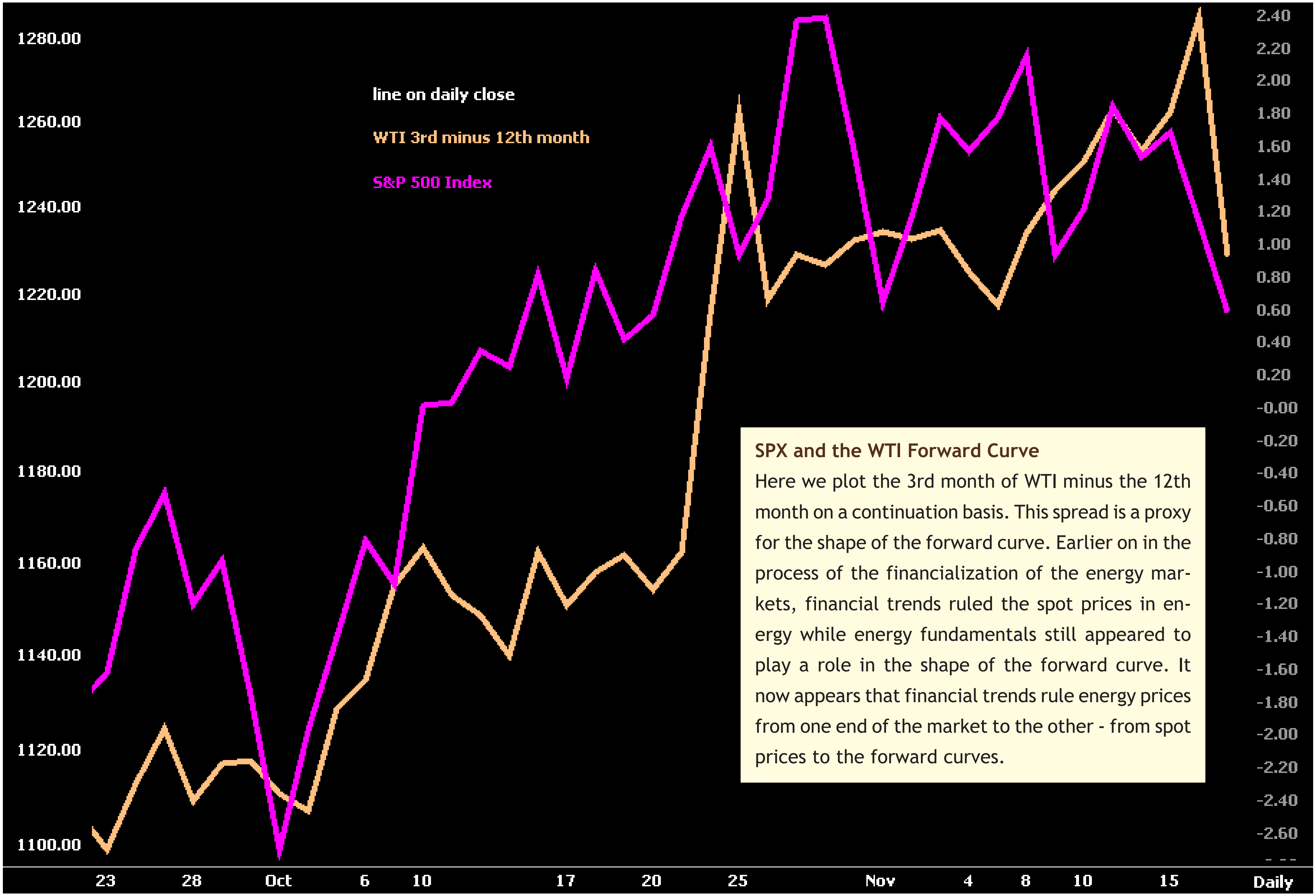
From the perspective of depression versus recovery, equities and energy are one market.

WTI - SPX - 17 Nov 11 **United-ICAP**

SPX and WTI

Price trends in the financial markets reflect swings in the mood of the collective consciousness whether the trends lasts for five years or five minutes. There are only two primary moods: hope and fear. The good news is that, through the tools of technical analysis, this collective behavior is predictable. These mood swings can be translated into price targets and time cycles.

WTI forward curve - SPX - 17 Nov 11 United-ICAP



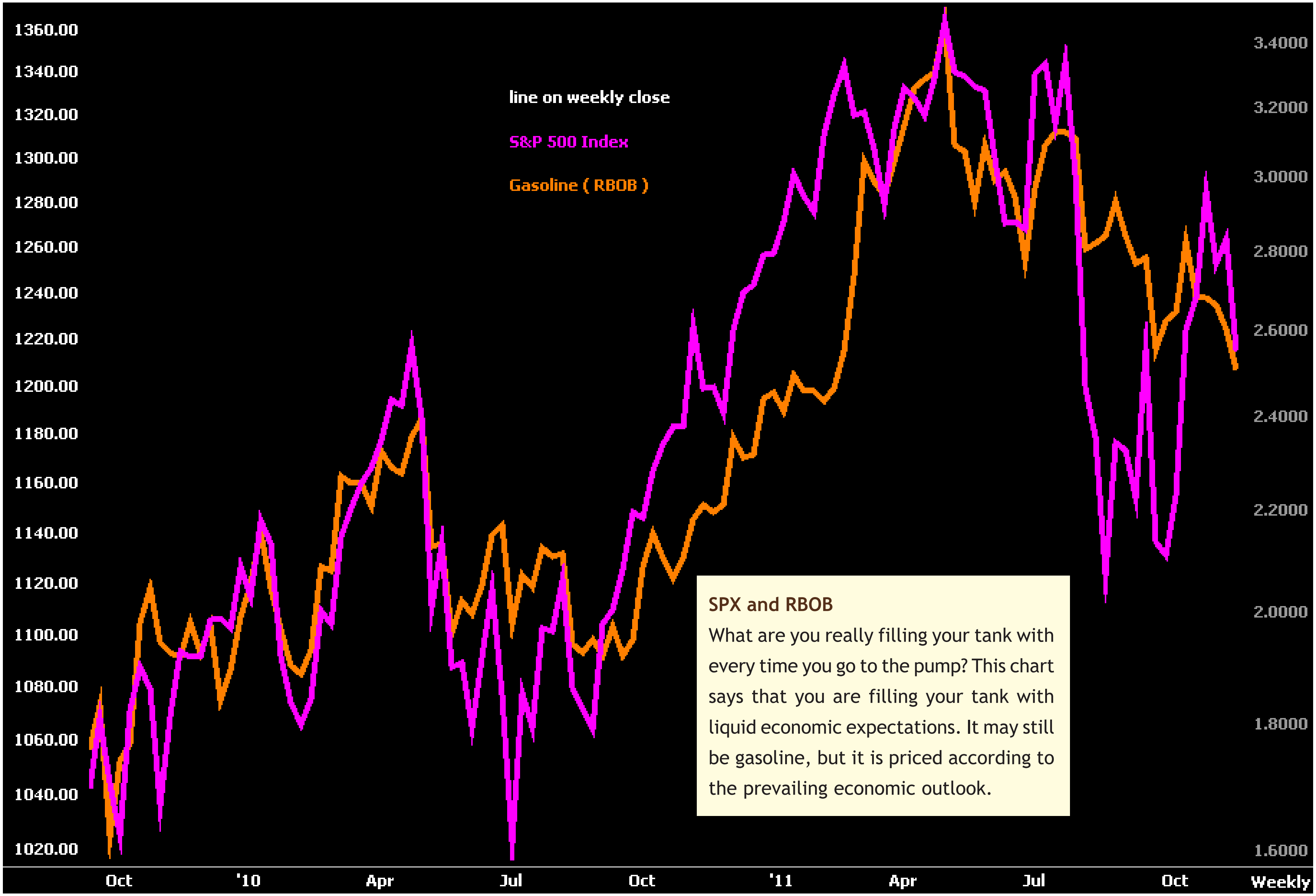
SPX and the WTI Forward Curve

Here we plot the 3rd month of WTI minus the 12th month on a continuation basis. This spread is a proxy for the shape of the forward curve. Earlier on in the process of the financialization of the energy markets, financial trends ruled the spot prices in energy while energy fundamentals still appeared to play a role in the shape of the forward curve. It now appears that financial trends rule energy prices from one end of the market to the other - from spot prices to the forward curves.

Home Construction Index - WTI - 17 Nov 11 United-ICAP

This chart was

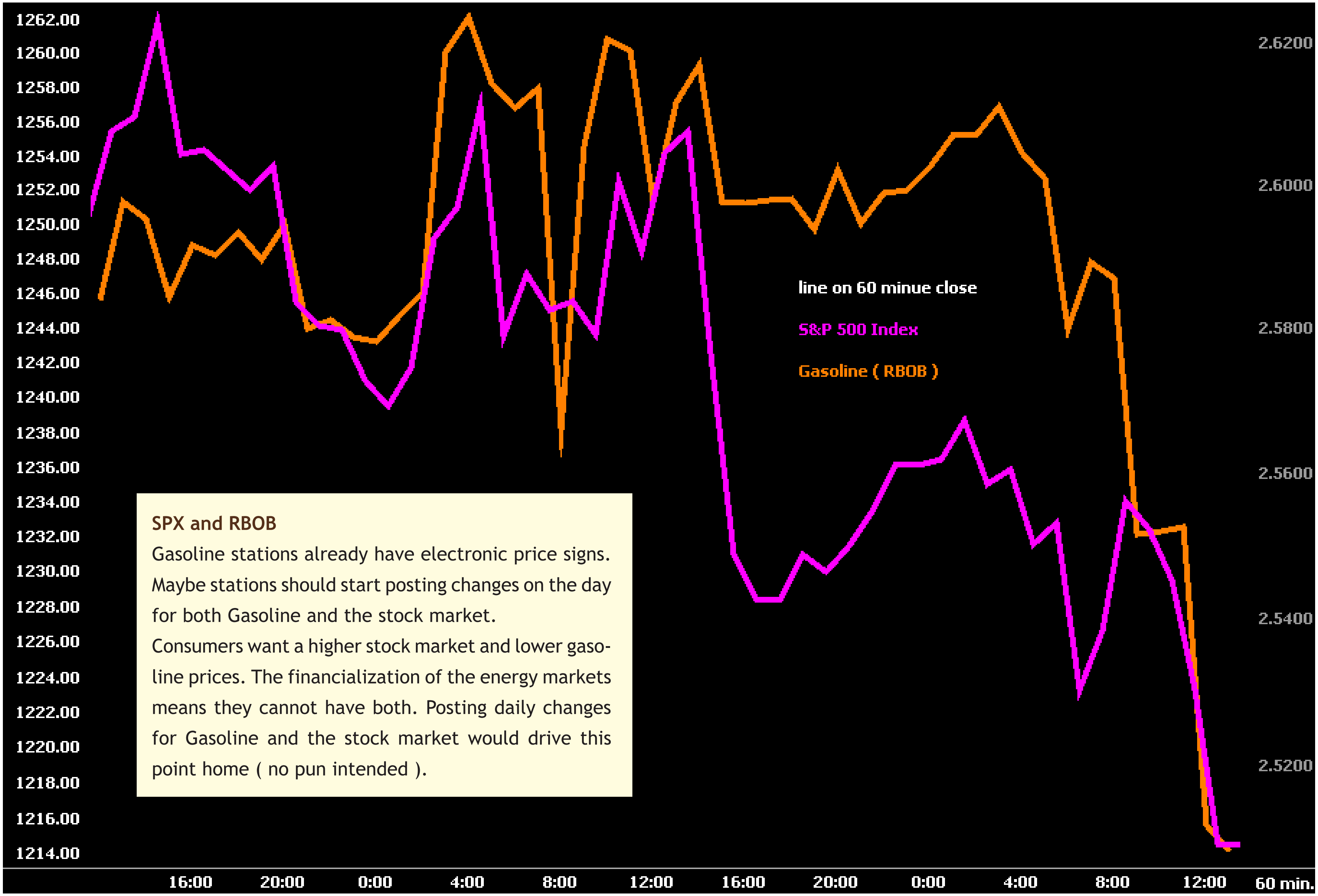
RBOB - SPX - 17 Nov 11 **United-ICAP**



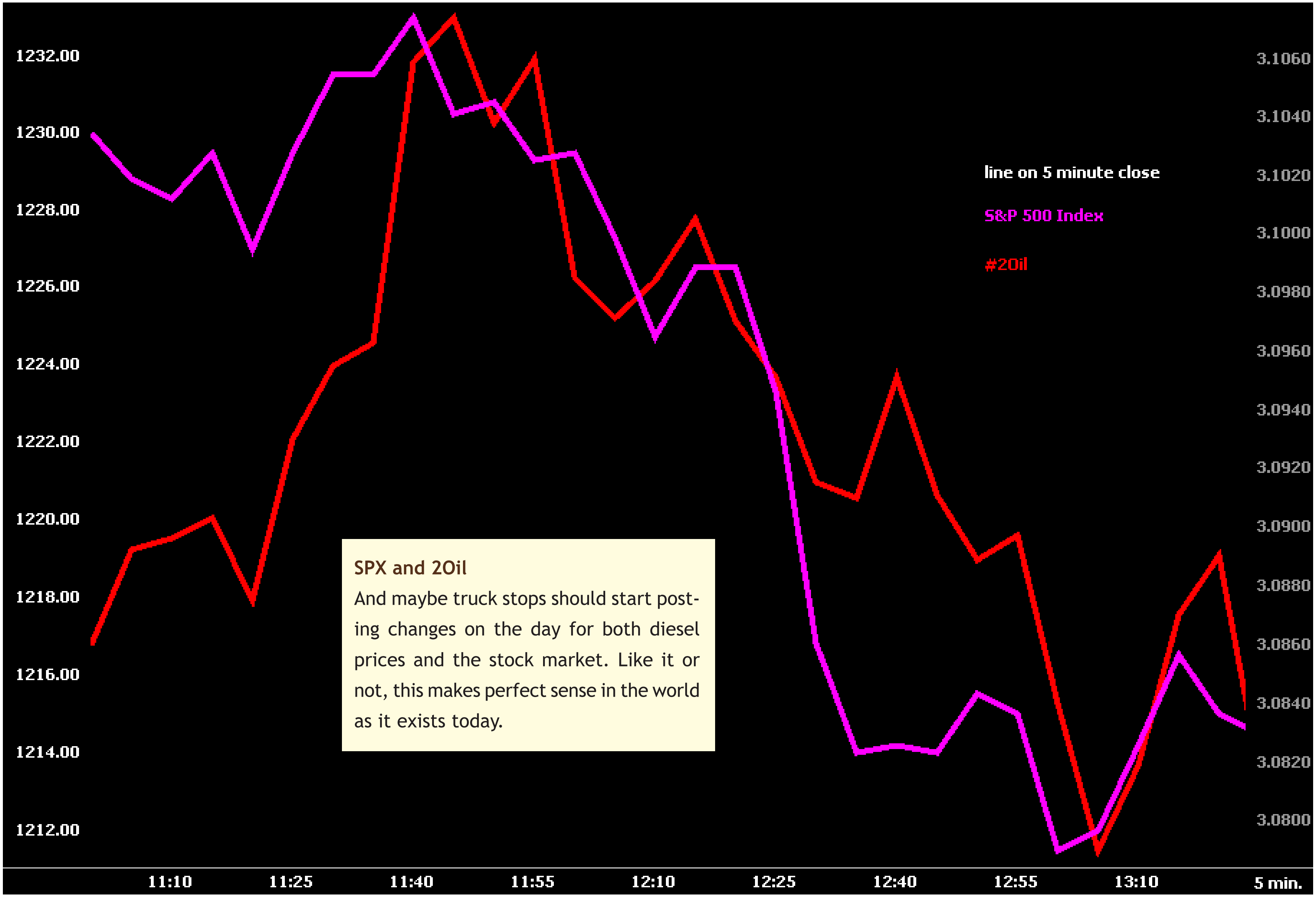
SPX and RBOB

What are you really filling your tank with every time you go to the pump? This chart says that you are filling your tank with liquid economic expectations. It may still be gasoline, but it is priced according to the prevailing economic outlook.

RBOB - SPX - 17 Nov 11 **United-ICAP**



2Oil - SPX - 17 Nov 11 United-ICAP

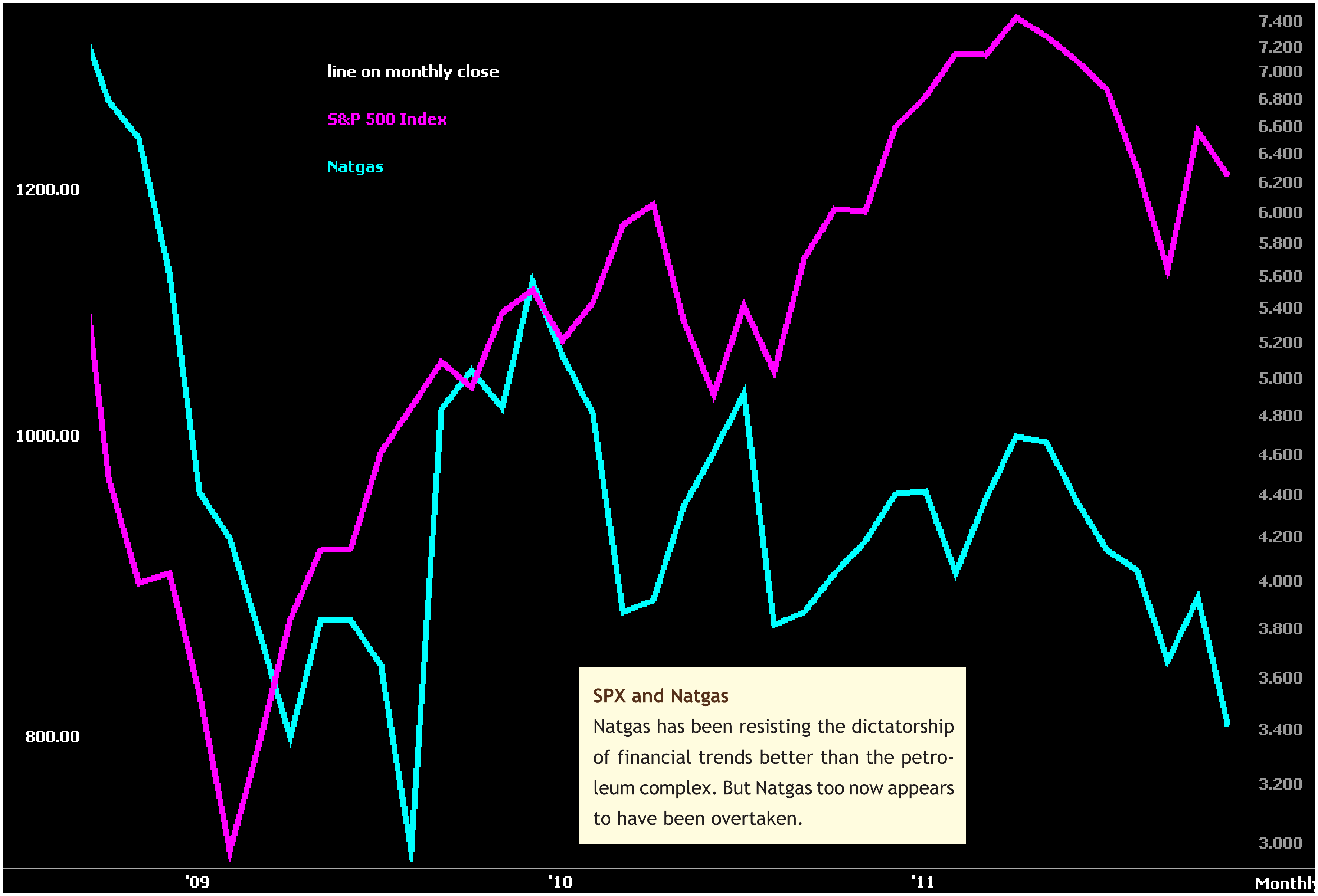


SPX and 2Oil

And maybe truck stops should start posting changes on the day for both diesel prices and the stock market. Like it or not, this makes perfect sense in the world as it exists today.

GasOil - SPX - 17 Nov 11 United-ICAP

Natgas - SPX - 17 Nov 11 **United-ICAP**

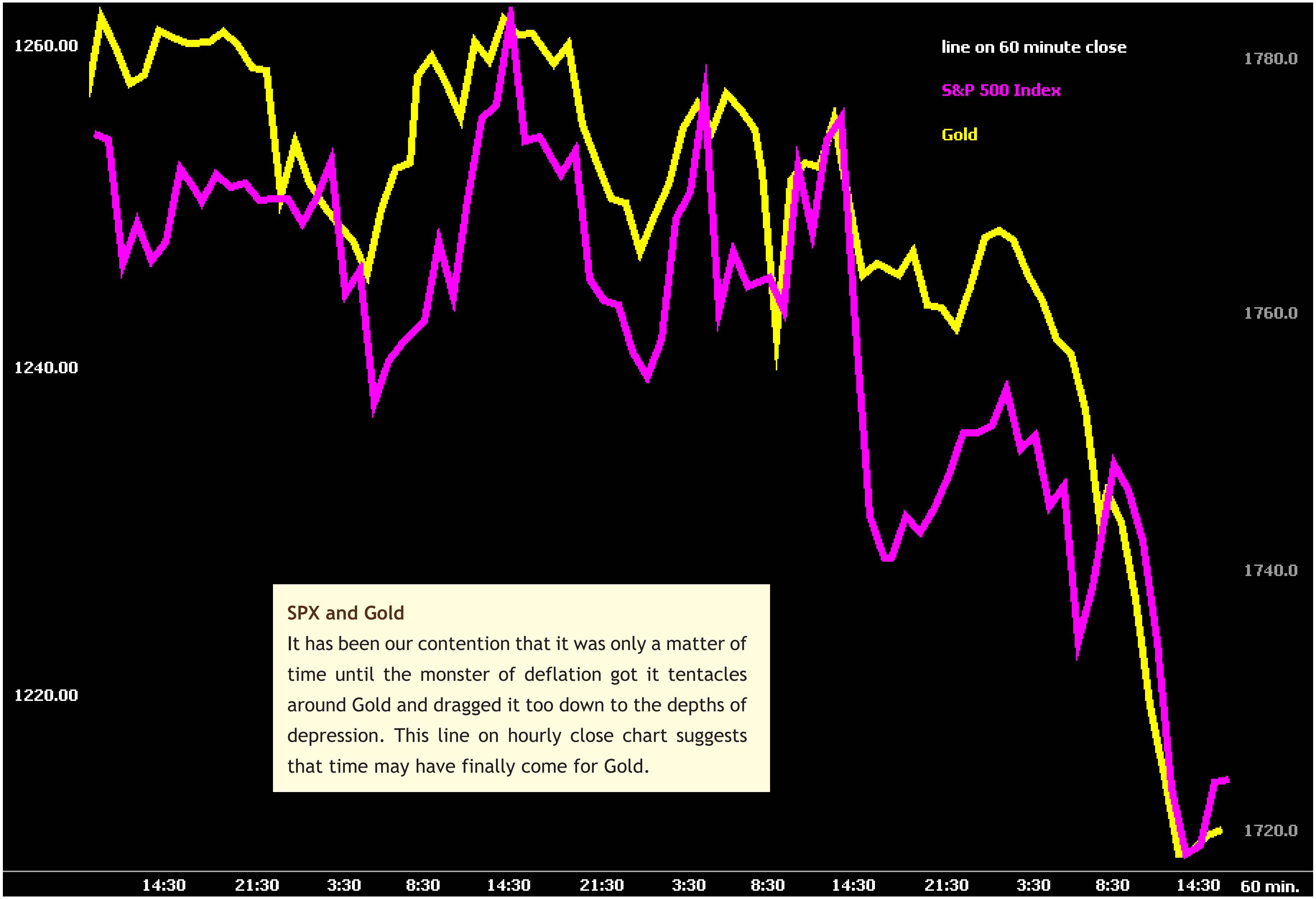


SPX and Natgas
Natgas has been resisting the dictatorship of financial trends better than the petroleum complex. But Natgas too now appears to have been overtaken.

CRB Index - SPX - 17 Nov 11 **United-ICAP**

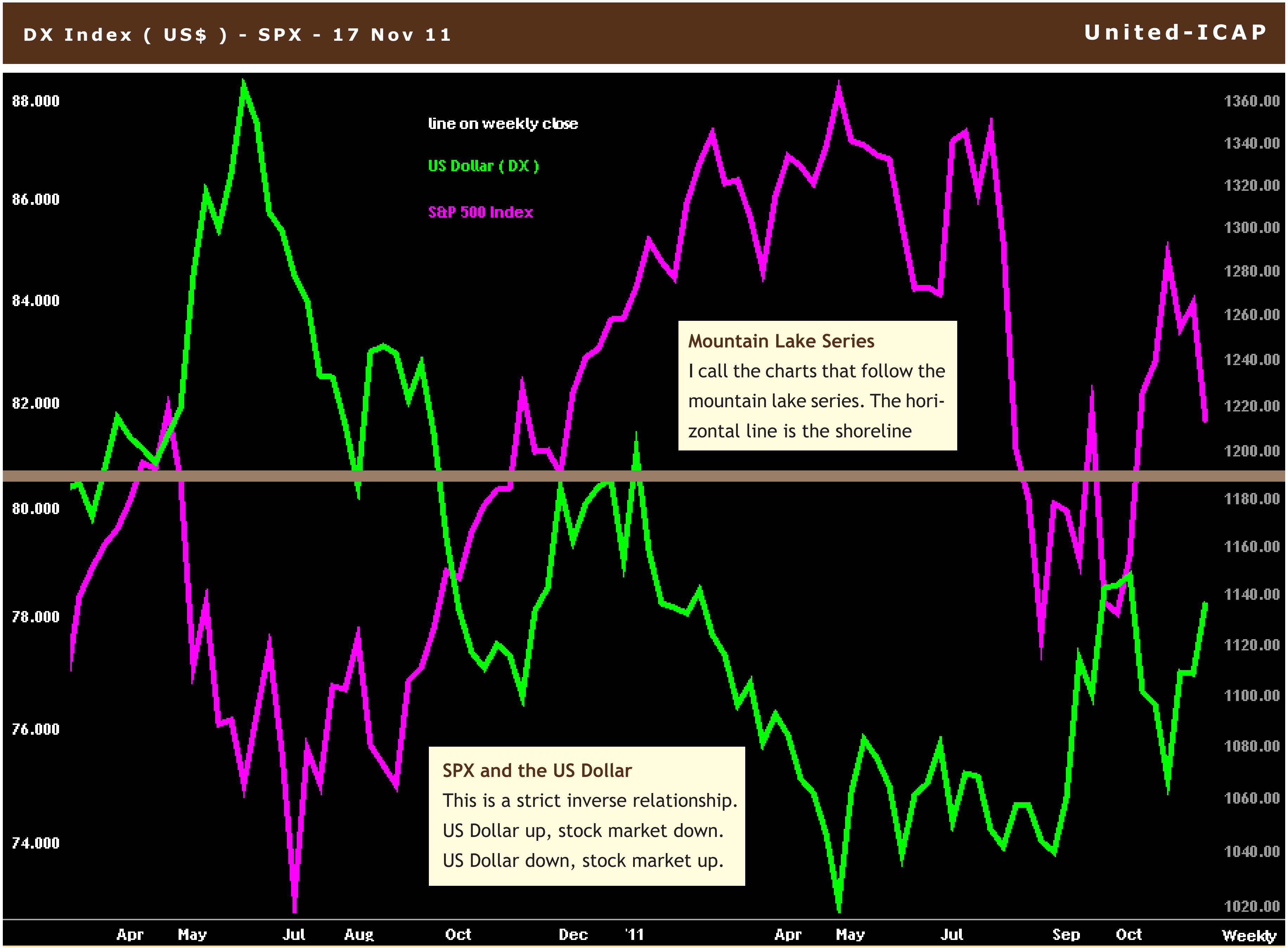
Gold - SPX - 17 Nov 11

United-ICAP

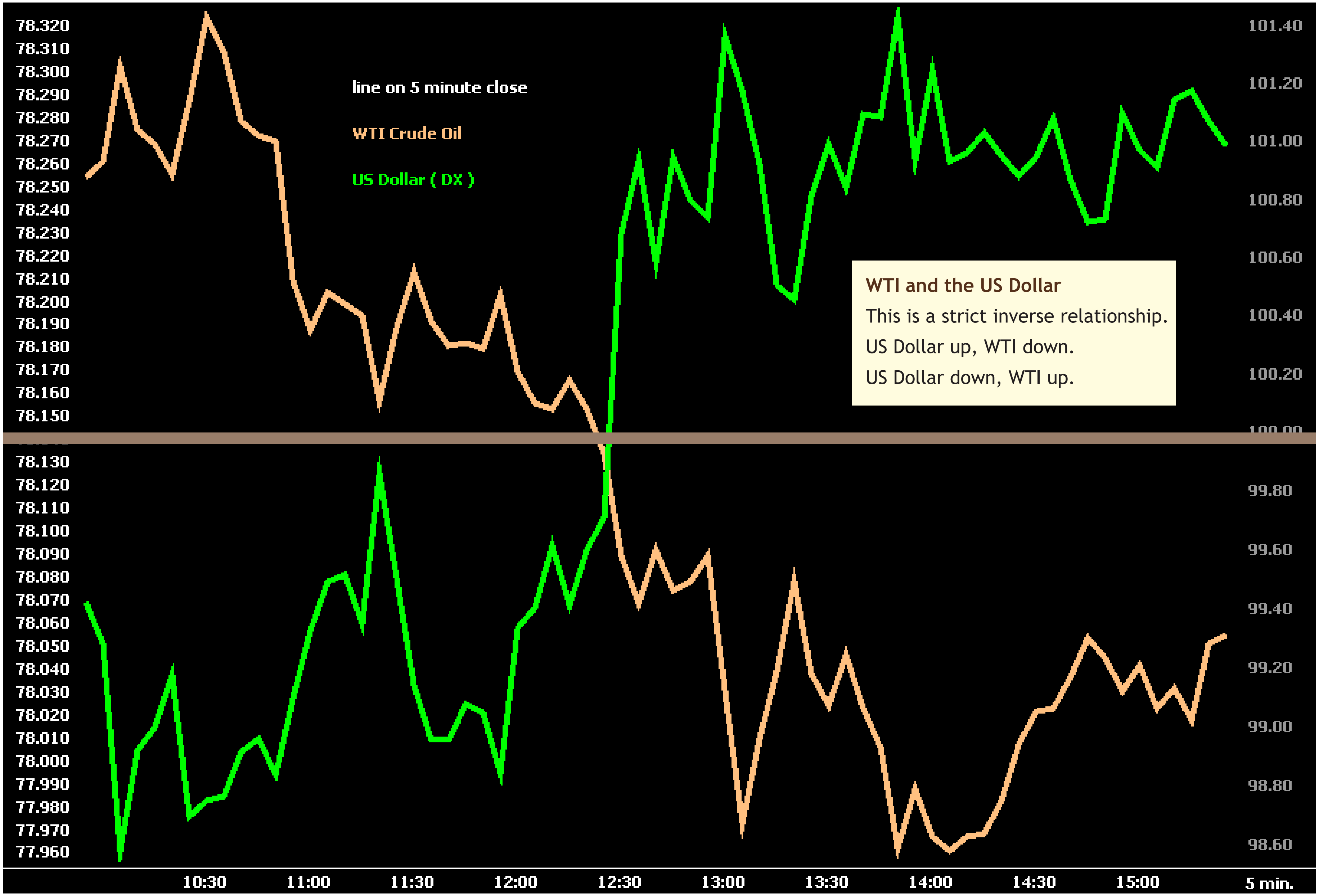


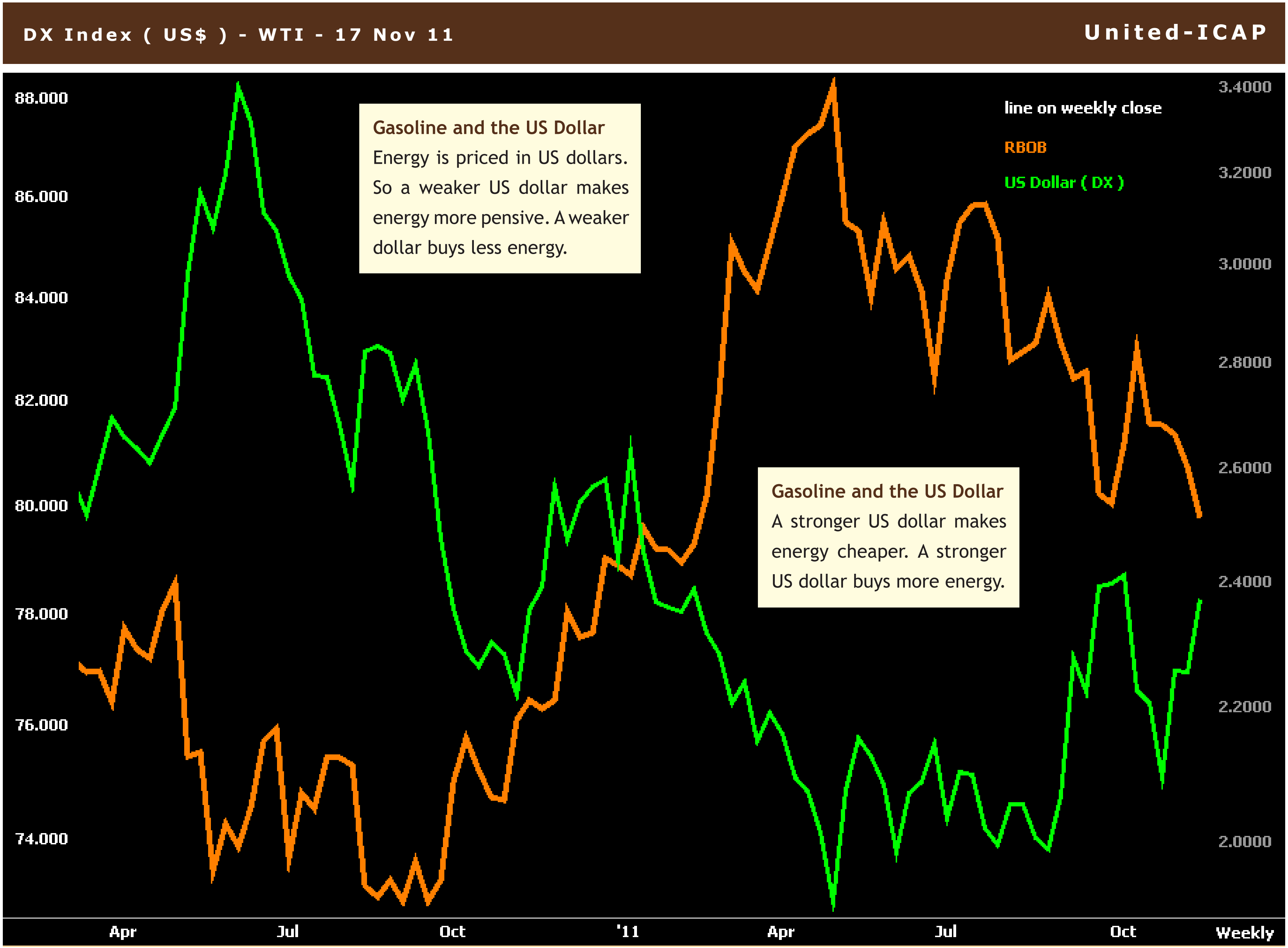
SPX and Gold

It has been our contention that it was only a matter of time until the monster of deflation got it tentacles around Gold and dragged it too down to the depths of depression. This line on hourly close chart suggests that time may have finally come for Gold.

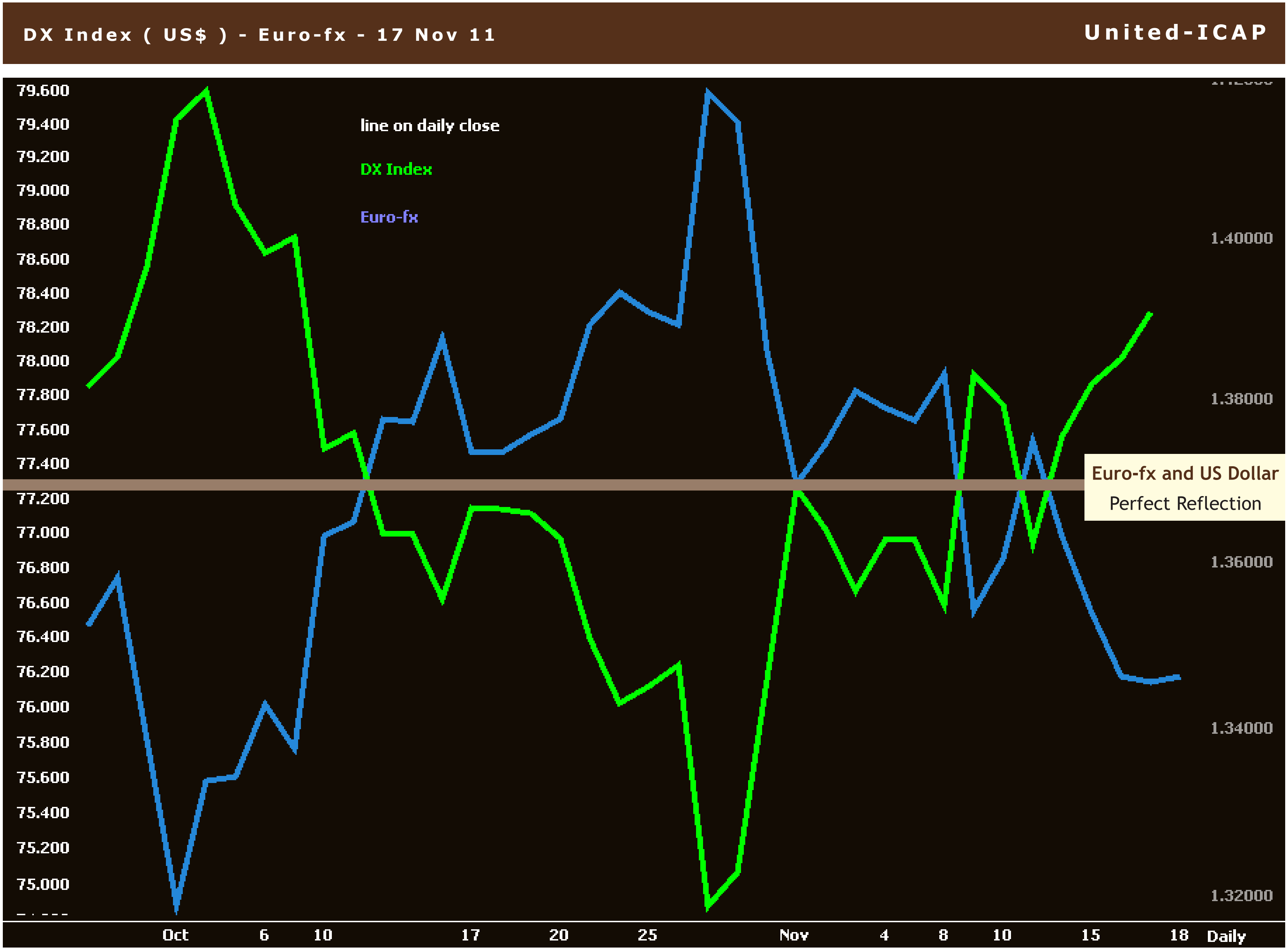

DX Index (US$) - SPX - 17 Nov 11
United-ICAP
line on weekly close
US Dollar (DX)
S&P 500 Index
Mountain Lake Series
I call the charts that follow the mountain lake series. The horizontal line is the shoreline
SPX and the US Dollar
This is a strict inverse relationship.
US Dollar up, stock market down.
US Dollar down, stock market up.
88.000
86.000
84.000
82.000
80.000
78.000
76.000
74.000
1360.00
1340.00
1320.00
1300.00
1280.00
1260.00
1240.00
1220.00
1200.00
1180.00
1160.00
1140.00
1120.00
1100.00
1080.00
1060.00
1040.00
1020.00
Apr
May
Jul
Aug
Oct
Dec
'11
Apr
May
Jul
Sep
Oct
Weekly

DX Index (US$) - WTI - 17 Nov 11 United-ICAP




DX Index (US$) - WTI - 17 Nov 11
United-ICAP
88.000
86.000
84.000
82.000
80.000
78.000
76.000
74.000
3.4000
3.2000
3.0000
2.8000
2.6000
2.4000
2.2000
2.0000
line on weekly close
RBOB
US Dollar (DX)
Gasoline and the US Dollar
Energy is priced in US dollars. So a weaker US dollar makes energy more pensive. A weaker dollar buys less energy.
Gasoline and the US Dollar
A stronger US dollar makes energy cheaper. A stronger US dollar buys more energy.
Apr
Jul
Oct
'11
Apr
Jul
Oct
Weekly

DX Index (US$) - Euro-fx - 17 Nov 11 **United-ICAP**


DX Index (US$) - Euro-fx - 17 Nov 11
United-ICAP
line on daily close
DX Index
Euro-fx
Euro-fx and US Dollar
Perfect Reflection
79.600
79.400
79.200
79.000
78.800
78.600
78.400
78.200
78.000
77.800
77.600
77.400
77.200
77.000
76.800
76.600
76.400
76.200
76.000
75.800
75.600
75.400
75.200
75.000
1.40000
1.38000
1.36000
1.34000
1.32000
Oct
6
10
17
20
25
Nov
4
8
10
15
18
Daily