The Connection Between Financial Markets and Energy - Open Thread

Posted by Gail the Actuary on September 15, 2008 - 10:25am
Topic: Economics/Finance
Tags: finance, lehman brothers, original, peak oil [list all tags]

Today, the financial markets are struggling with Lehman Brothers' Chapter 11 bankruptcy, AIG's problems, and the sale of Merrill Lynch to Bank of America. There is also the problem of the unwind of the credit-default swaps tied to hundreds of billions of dollars of Fannie and Freddie debt. This thread is intended for folks who want to discuss what is now happening.

Some may be asking how all of this is tied to oil and energy. There are quite a number of relationships:

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(1) Some of the organizations with problems were no doubt speculating in oil futures. Once the prices started to drop, the balance sheets of the organizations were affected, and they suddenly needed more capital.

(2) As the companies who speculated in the oil market (all of them, not just the particular ones having problems today) try to unwind their positions because of margin calls, they drive down the price of oil in the futures market. That is likely why we are seeing declining oil prices, at a time when fundamentals would say they should be rising.

(3) As the price of oil and food rises, people have less money to pay debt of all kinds. This has contributed to the rising mortgages defaults, and is helping to drive down home prices. This is very closely tied to problems of banks and other financial institutions.

(4) Structured securities based on sliced and diced mortgages and other debt depend on assumptions regarding "independence of defaults". Once a shortage of oil and higher food and energy prices start causing mortgage defaults, the defaults are no longer independent (as they would be if they were caused by an illness of a particular homeowner, for example). Instead, there is a systematic bias in the pricing the risk, and the structuring doesn't work as planned.

(5) Energy companies need well-functioning credit markets to expand their exploration and production, and to pursue alternative energy approaches. For example, expanding the use of wind energy, or electric-powered vehicles, is likely to need a huge amount of debt financing.

I have warned in the past about the possibility of a debt implosion. There is a significant possibility that what we are seeing now is beginning of such an implosion. There are a number of institutions that have problems. Systemic risk (caused in part by counter-party failures) can cause these problems to spread to other institutions.

Here are some links to some earlier articles that may be of interest:

Peak Oil and the Financial Markets: A Forecast for 2008 by Gail the Actuary (Gail Tverberg)

The Failure of Networked Systems by aeldric.

The Expected Economic Impact of an Energy Downturn by Gail the Actuary (Gail Tverberg)

Peak Oil and the Financial Markets: A Forecast for 2008--July 31 Update by Gail the Actuary (Gail Tverberg)

This is the front illustration from that post:

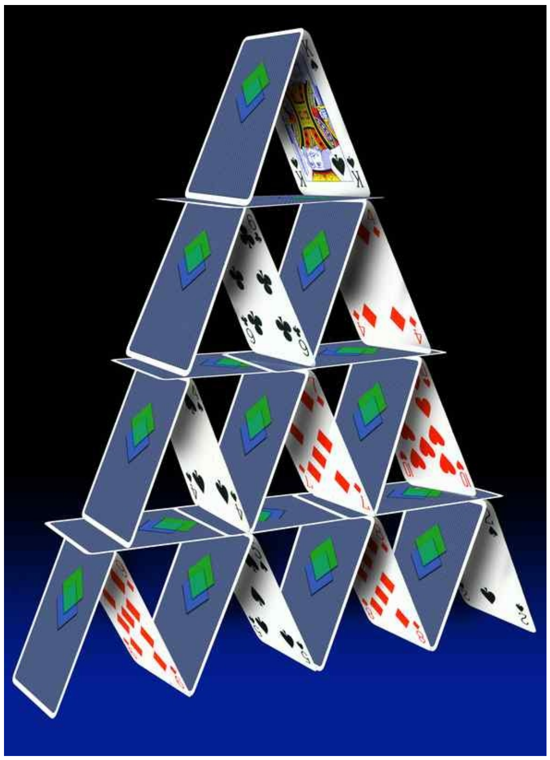

Figure 1. An example of a system with systemic risk (Photo from homebuyerphoenix.com)

In that article, I say:

> **15. There is a chance that some type of discontinuity will make financial conditions suddenly take a turn for the worse.**

With the events of last weekend and this weekend, there is a significant chance we are hitting such a point. In that article, I say:

> As we go forward, I expect that there will be more and more individuals, businesses and governments that will be unable to repay their debt, because of indirect impacts of higher oil prices flowing through the economy. Eventually, the US government will have to make a decision as to what to do about all these defaults. The most obvious options

> would seem to be:
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> (1) Prop up as many as possible
> (2) Let the chips fall where they may

We are now getting to see what happens when the US government lets the chips fall where they may.

Another article that is of interest is an article by Jerome a Paris (Jerome Guillet):

Lehman: more socialising the losses of the rich

While Jerome guessed wrong on which way the Lehman situation would turn out, his analysis is helpful for understanding some of the problems that could be ahead. Also, the discussion thread from yesterday has many links to recent articles on what is happening in financial markets.

Finally, Energy, Hurricanes, and Hedge Funds explains why short term financial movements have the ability to overpower the energy supply/demand fundamentals - especially their impact on energy prices.