

MONTHLY OIL REPORT

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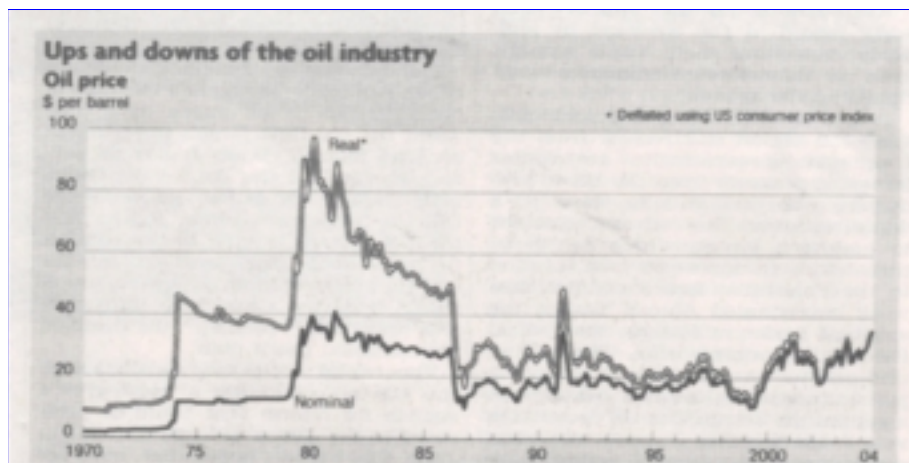
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The 7th post war oil crisis and a little romance...



How about a romantic walk on the beach, or maybe a bicycle ride? What about leaving those car-keys on the table and hold the hand of our significant other while strolling down the street to the nearby movie theatre? For those less romantic that feel secure only behind the wheel of their SUV or limo, maybe taking a good look at the price of retail gasoline will help them revise their ideas... and if they don't revise them today they can take a look at the gasoline price again in a couple of days and maybe the price then will finally make them a little more romantic...

The question however remains: How high is high enough for crude oil? What is the right price for oil today taking into consideration inflation, growth, dollar strength etc... The following chart will shed some light since it shows the nominal price of oil compared to its real price since 1970:



Financial Times - EIA

What can one observe by looking at the chart at first glance, is that on real terms crude oil has gone up to almost \$100 per barrel in early 80's which was a result of the panic in the oil industry due to the Iraq-Iran war that was declared in 1980 following a seizure of power in Iran from Ayatollah Khomeini in 1979. That was the **5th post war oil crisis**.

Before that another great increase in oil prices happened in 1973 at the Arab Oil Embargo when prices rose from \$2.90 in September 1973 to \$11.65 in December of the same year. That was the **4th post war oil crisis**.

(Just for the readers' interest the previous first 3 post war oil crisis were:

1st - In 1951 when Iran nationalized the Anglo-Iranian oil industry.

2nd – In 1956 at the Suez crisis.

3d – In 1967 at the Suez canal closure due to the Six Day War).

Since 1981 prices had been deteriorating at a fast pace and in 1986 they fell by more than 50% when OPEC failed to agree upon production quotas.

Since then for almost 20 years prices had been fluctuating between \$15 - \$30 per barrel with the exception of the invasion of Iraq into Kuwait in 1990 that led to the Gulf War in 1991 and the sabotage of the Kuwaiti oil fields by the Iraqi army that kept burning for more than a year. That was the **6th post war oil crisis** that drove prices at \$40 (something less than \$50 in 2004 real prices).

In 1990 it was a major oil crisis since two major OPEC producers (Iraq, Kuwait) were at war, which led to the sabotage of the huge Kuwaiti oil fields. Nevertheless in January 1991 prices had dropped to \$18 basis WTI (nominal).



Price of WTI – NYMEX

From the above observations one can conclude that oil has been trading at an average price of low 20s since 1986 but has a tendency to appreciate fast when an oil crisis occurs. It can also be observed that when a crisis is resolved then prices drop to initial levels.

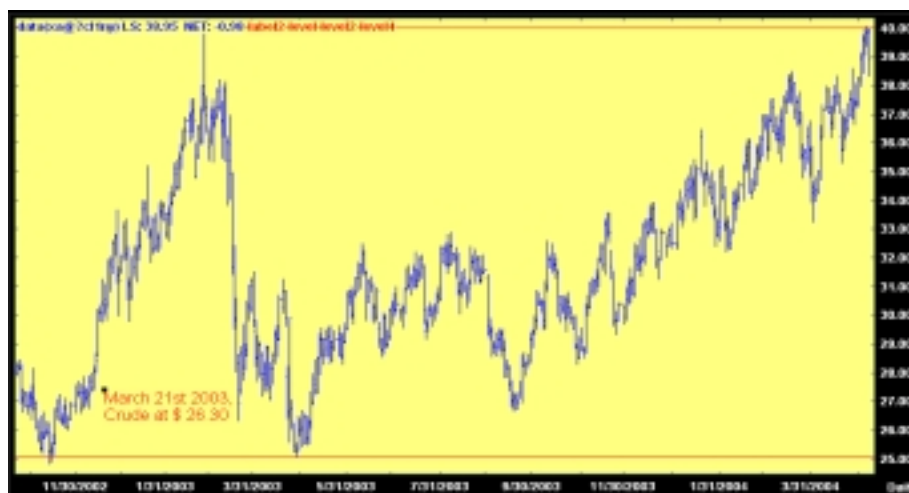
What can trigger an oil crisis?

From the past 6 oil crises since 1951, five of them included **a war and/or an embargo**, and all of them were driven from fears of a sudden loss of significant oil supply – **(major supply shock)**.

Last Year

The trigger-factors of the past six oil crisis show that the US led invasion in Iraq **last year** could have caused the 7th post war oil crisis. The invasion immediately caused the loss of Iraqi oil supply of 2.4 million barrels per day, and it could lead to the destruction of the Iraqi oil fields for several months. Meanwhile when war preparations were taking place another major OPEC producer Venezuela was on a general strike that had paralyzed its oil industry for two months which at the time was **3 million barrels per day**.

Amid such a bullish price environment, last year prices reached \$38 basis WTI in late February made an intra-day high of \$39.99 in early March and collapsed to \$26 in Mid March, one day before the expiration of the US ultimatum to Saddam Hussein and the beginning of the war.



Price of WTI – NYMEX

Last year's additional supportive factors also were:

- The Euro had appreciated against the Dollar from EUR/USD 0.87 to EUR/USD 1.08.
- US was experiencing one of the coldest winters of the past years.
- Commercial petroleum inventories were at all times lows due to the effect of all the above.

This Year

Comparing this year with last year we have to observe the following:

On the bearish side ↓:

1. United States is not currently at war against any major oil producer.
2. Iraqi oil reserves are controlled and guarded by US coalition forces.
3. United States experienced a much milder winter than last year which has led to distillate inventories (Heating Oil and Diesel) being 10.1 million barrels higher than last year (+10.4%).
4. Due to milder weather US Natural Gas Inventories are 391 bcf (Billion Cubic Feet) or 46.7% higher than last year.
5. Due to higher imports US crude inventories are 9.1 million barrels or 3.1% higher than last year and total US commercial inventories are 32.2 million barrels or 3.6% higher than last year.
6. Gasoline Inventories are only 3.3 million barrels below last year's level.
7. The Strategic Petroleum Reserve which can release crude oil for commercial use at a rate of 4.0 million barrels per day in case of any severe oil shortage, has added a huge 58 million barrels this year and is up 9.7% on year.
8. OPEC and non-OPEC countries supply oil at a very high rate to benefit from such a high oil price environment.

On the bullish side ↑:

1. The high GDP growth of key oil consumers such as United States, Japan and China has led to an unexpected increase of global demand.
2. US gasoline demand is 3.8% above last year's 4-week average.
3. Euro has appreciated against the dollar from EUR/USD 1.08 to EUR/USD 1.20+ the past year. (Oil is globally priced in dollars and producers tend to increase oil prices when dollar depreciates to make up for lost revenue.)
4. New gasoline standards in key consuming states in the US such as New York, created fears that new specs would not be met easily from local and foreign refiners triggering a prolonged squeeze of the gasoline market that is trading at all time high prices.

5. Terrorism has targeted oil facilities in key oil exporters such as Iraq and Saudi Arabia and has created a fear that exports could be disrupted anytime.

Comparison 2003 vs 2004.

Last year's war against Iraq had at risk 2.5 million barrels per day for several weeks that could have become months. This year terrorism can cause significant damage but will affect a maximum of 1 million barrels at worst for several weeks. This has not happened yet, the everyday sabotage actions affect a couple of hundred of thousand barrels for a few days.

- Last year's euro appreciation against the dollar was similar to this year's.
- This year's unexpected demand surge is estimated at an extra +500,000 bpd. OPEC is overproducing more than 2 million barrels per day to meet demand.
- US Energy Information Administration reported last week that the transition to new gasoline specs has been very smooth.
- United States is not currently at war against any major oil producer.
- Global inventories are well above last year's levels.
- Total US petroleum inventories are 90.2 million barrels higher than last year.
- OPEC has another 1.5 - 2 million barrels per day of spare capacity in hand.
- Any "Terror Premium" should be lower to last year's "War Premium".

So why is price at \$40?

Most of analysts in the energy sector believe that oil is very overvalued. A report from an influential market participant underlined that oil price has "**detached from fundamentals**" at such high levels.

Since all the major fundamental factors point to significantly lower prices current price strength can be attributed to Spec Funds that squeeze the paper market taking advantage of the increased sensitivity due to the fragile environment in the Middle East.

The paper petroleum market is very powerful since it is more than 3 times larger than the physical market. Usually such squeezes create bubbles that burst in a spectacular way like last year when crude dropped more than \$10 in 5 days.

Prices at current price level do not seem sustainable. If the right price of oil was above \$40 that would mean that the past 18 years oil was kept undervalued.

Romantic walks should prevail upon flamboyant “limo-rides” because of other reasons not due to gasoline prices.

Don’t rush to park you limo or sell your SUV... the 7th post war oil crisis does not seem to be here yet.



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