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BI-WEEKLY OIL REPORT

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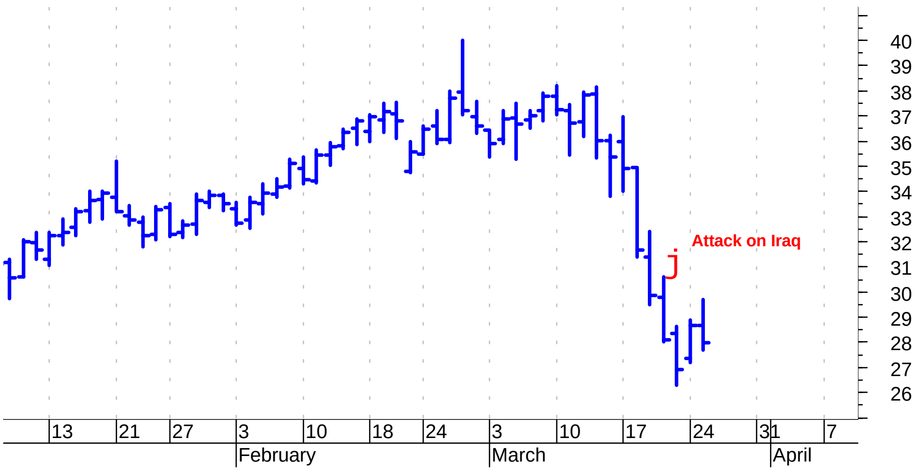
When a war starts against a major oil producing country sell crude oil! Especially if Iraq is the country involved then you should sell more! It may sound counter-intuitive, but this is exactly what we observed during the past few days. One could call the event a clear "buy the rumour, sell the fact" behaviour, but we could argue back that the trade did not even wait for the fact (ie the beginning of war). We will try to clear out recent price behaviour, which, if we take a closer look, could seem rather rational.

During the days that passed since our previous report, US despite failure to gain UN approval, led its forces against Iraq, in an attempt to overthrow Saddam Hussein. As we are writing these words, fierce fighting is taking place, as the US forces are approaching Baghdad. Iraqi resistance has proved stronger than expected and casualties are expected to rise significantly for both sides during the coming days. As far as the oil infrastructure is concerned, damages are not very high and US and UK forces seem to have more or less secured the oilfields in the South, as well as significant oil facilities. Basrah, however, the major city of the South is still under Iraqi control and few progress has been made in the North were the Kirkuk oilfields lie.

Figure 1. NYMEX crude oil futures prices ($/barrel)



Source: New York Merchantile Exchange

On Monday the 17th of March, US President Bush, in cooperation with UK and Spain refused to put to vote a new UN resolution and issued a 48 hour ultimatum for Saddam Hussein to leave Iraq. Saddam refused to adhere and the US led coalition forces started their offensive on the night of the 19th. If prices had followed the 1991 Gulf War pattern they should have risen as we were approaching the expiration of the ultimatum and fall with the first signs of easy US prevalence.

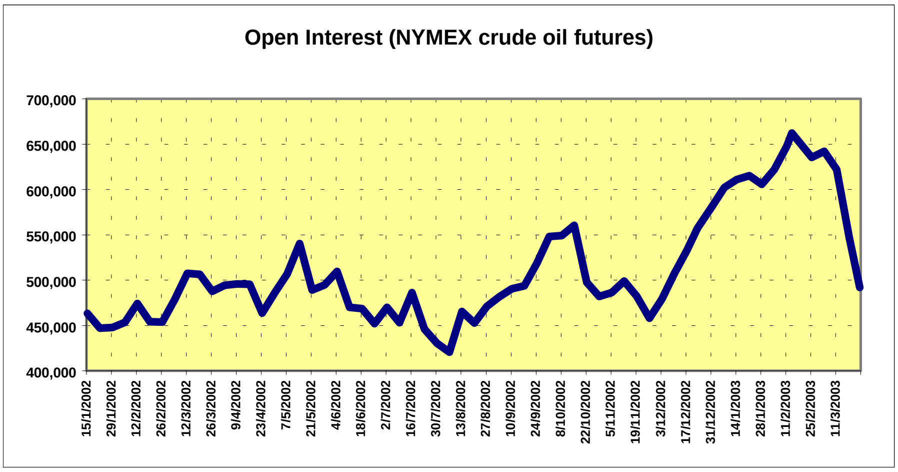
A typical buy the rumor sell the fact behavior would have called for a sell-off to take place as the offensive unfolded on the 19th, or maybe when Bush issued the ultimatum on the 17th.

In this case, however, prices had started falling since the 13th and did not stop until the 21st of March after hitting a low of $26.30. When the war began prices had already dropped from $37.85 to $29.88. The sell-off continued even as the expectations of an easy US victory started proving false.

Trying to explain such market behavior one should take into account several issues. Oil prices staged a strong rally after the beginning of the strike in Venezuela on Dec. 2nd. The virtual halt of Venezuelan production removed more than 50 million barrels from the markets and especially from the US, while at the same time uncertainty over Iraq was rising. Prices rallied from $26.90 on December 2nd to $39.99 on February 27th. At that time however the Venezuelan strike was over and oil operations had started returning back to normal, thus removing a major bullish consideration and quietly "pulling the carpet" under prices. Crude prices refused to give back at least some of the premium that they had build-in due to the Venezuelan crisis and collapsed only as the war against Iraq neared.

There were signs however that the market was losing its support well before the actual price collapse. Taking a look at the open interest of NYMEX crude oil futures one can make some interesting observations.

Figure 2.



Source: NYMEX

Open interest began to rise together with prices after December 2nd from almost 460,000 contracts to more than 660,000 contracts on February 14th. The addition of 200,000 new positions was the reason behind the strong rally. Most of the new positions were of short-term speculative nature, trying to benefit from what they saw as a major investment opportunity. It is clear, however, that traders had started to reduce their positions steadily since Feb. 14^{th}. The pull-out from crude accelerated further after March 13^{th}, bringing open interest down to 491,000 contracts by March the 24th. One could thus conclude that a number of traders had already reached their upside objectives a month before the declaration of war against Iraq and they were just seeking the right time to bail out of the market. The spectacular increase in open positions almost guaranteed a swift reversal and it was clear that the price of being late would have been too high. It should be of no surprise then that the selling did not stop even when there were some first signs that the military operations were not as successful as was initially expected. The price drop stopped only when it reached the pre-December levels of $26.30.

Figure 3. Price and Open interest comparison

	Dec. 2^{nd}	**Feb. 14^{th}**	**Mar. 19th**	**Mar. 24^{th}**
Price (WTI)	$26.90	$36.80	$29.88	$28.66
Open Interest	458,022	662,058	523,313	491,812

With the removal of most of the speculative positions, one would expect fundamentals to become once again the driving force in the oil markets. Uncertainty however continues to remain high, especially as in addition to the Iraqi situation came the unrest in Nigeria, which caused the shut-in of more than 800,000 bpd of production.

Nigeria produces 2.2 million barrels per day of crude oil and exports almost 600,000 bpd to the US. Most of Nigeria's exports to the US are directed to the East Coast and its sweet (low sulfur) crudes are ideal for the production of gasoline. A prolonged disruption could therefore cause concerns ahead of the US driving season and with US inventories at very low levels.

Usually disruptions in Nigeria are short-lived, but there are fears that this time the unrest that has already caused the death of more than 100 people will not easily be contained. Latest reports note that the Nigerian government launched a military operation against one of the ethnic groups involved in the unrest, which caused many deaths among villagers and has fueled angry reactions.

We would continue to expect volatility to persist, but it is unlikely that we will observe extreme price levels, unless speculative funds return aggressively in the market. Nevertheless, the speed of the sell-off, without waiting for the conclusion of military operations in Iraq could force many traders to reconsider their stance and readjust their positions.