

MONTHLY OIL REPORT

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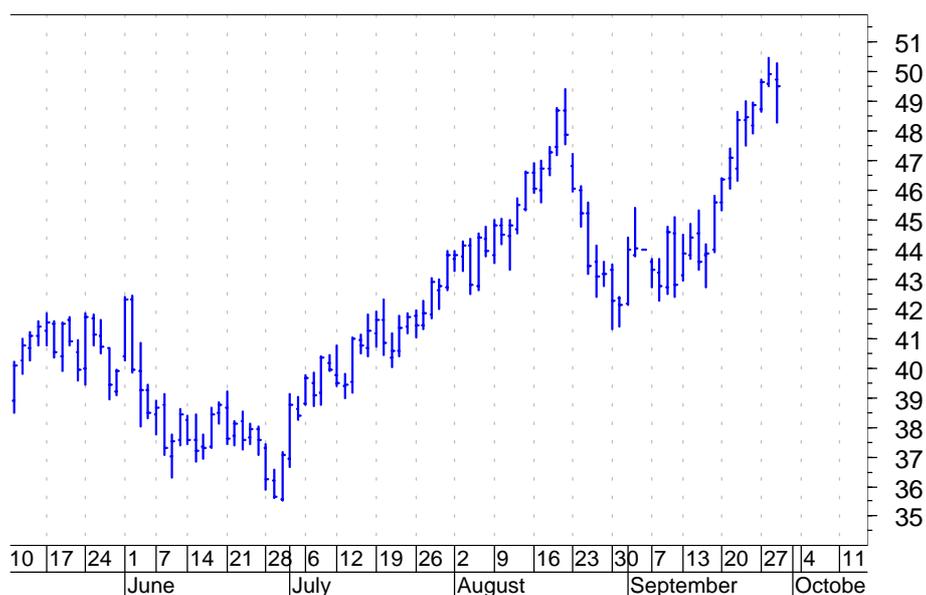
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“Something is rotten in the state of Denmark.”

The famous quote by Hamlet is not used to describe the situation in Denmark. It is used to discuss the recent geopolitical, as well as market conditions, which have caused – among other more dramatic things - oil prices to breach the \$50 level. What used to be considered a far-fetched disaster scenario is now a reality, but judging from the results the world is still turning, at least for the time being.

Crude oil staged a dramatic rally since hitting a local low on June 30th. It rose from \$35.52 to \$50.47 on September 28th, a rally of almost \$15 within 3 months. Since the beginning of the year prices are now 53.57% higher and are more than 70% higher than the same time last year. It is not percentages, however, that caused reactions among consumers, but rather the breach of a level that was for long discussed as a disaster scenario - \$50 crude!

Chart 1. WTI crude oil futures price (Daily in \$/barrel)



Source: NYMEX

There are a number of reasons that brought prices to such levels. During July and until mid-August the deterioration of the crisis in the Russian oil giant Yukos and the August 15th Venezuelan recall referendum led prices close to \$50. The fact that Venezuelans decided in favor of the incumbent President Chavez and the international community accepted the result (despite some minor objections) eased some of the concerns and led to a sell-off to \$41.80.

This was short-lived, however, as continuing tensions in Iraq and the Middle East in general, demand that refused to slow despite the high prices and a slew of hurricanes in the Gulf of Mexico reinvigorated the fears and led prices finally above \$50. Hurricane Ivan was the final blow to an already tense and volatile market. It made landfall on the coasts of Alabama on Sep 16th and has shut-in until today a cumulative 11.2 million barrels, while another 490,000 barrels per day remain shut-in 15 days later.



The appearance of \$50 on traders' screens caused quick reactions by many officials throughout the world, but no quick sell-off followed. Saudi Arabia stated that it will raise its capacity by 1.5 million within weeks to 11.5 million bpd, US Treasury Secretary Snow estimated that "...high energy prices are a short-term phenomenon", some blamed the dreaded "speculators" and "hedge funds" once again, but few failed to capture the real reasons for the situation we are now facing and this is why the "speculators" refused to close their long positions.

The real effect of speculators in this market as in all markets is that their aggressive tactics and lack of dedication expose the market's weaknesses and accelerate the coming of a crisis that was probably bound to happen later. The effect of their actions was exaggerated further because global geopolitics led more than the traditional energy funds to enter the petroleum markets. The world of trading recently discovered oil as the next vehicle for above average returns.

This was not done without reason. Rather it was a result of what was "...rotten in the state of Denmark". The world is faced with continuously deteriorating geopolitical conditions. The body count of worldwide violence is continuously increasing, safety conditions are worsening and as a result safety of supplies is also becoming questionable. At the same time no effective political initiative seems to be in place that will help ease the situation soon. Against this background we see worldwide demand for energy to grow substantially, led by China and the US, with no signs of slowing down despite rising prices.

What "speculators" did was to discard OPEC assurances and their ministers' fears for a price collapse, completely inaccurate IEA and EIA price and demand estimates, and consumer countries' beliefs that this is a short-term phenomenon and continue going "long" until they were proved wrong. US's reluctance to halt its SPR release program and its inability to solve the Iraqi riddle, Russia's decision to deal with Yukos now, rather than later, and the gods of hurricanes all conspired to make them richer and the oil consumers poorer.

The reason why prices refuse to drop despite OPEC's output rise, vocal interventions etc. is that this time in contrast with previous "oil crises" the situation we are facing is not caused by oil prices. It is not an unexpected shock (e.g. oil embargo, or a war as was the case with Iran-Iraq) that led prices to skyrocket and in effect hit global economies hard. Rather the rise in prices is the result of tense global conditions. We are also not facing a financial crisis; at least not yet. Current prices do not threaten developed economies with recessions and have not greatly affected consumers' wealth. This is more than clearly indicated by the fact that the behavior of consumers has hardly changed during the past year (demand has been growing strongly) and governments face neither high inflationary pressures nor major threats to their economic recovery efforts.

Oil therefore is not the reason behind the situation we are facing, it is the result, and what we are facing is not a financial crisis. It is a crisis of a different nature that cannot be dealt with the conventional economic tools. It is a crisis that has to do with the inability of countries to reach a common ground regarding energy sources distribution and energy consumption. This inability has led to isolated country policies for economic growth that call for continuously increasing energy consumption and elbowing in order to achieve strategic positioning to cover those energy needs.

The answer to the challenges the world is facing today is a more coordinated effort to curb energy consumption such as the one that took place in the 70's. It will also take a coordinated effort to start reducing world economic growth's dependency on oil. Investing more in drilling wells and in refining capacity and trying to secure supplies using military might, will not solve the problem and if it takes a true financial crisis for governments and consumers to become more responsible it seems that "speculators" are ready to help on that issue. In the time being, no one should feel comfortable in the state of Denmark.

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