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MONTHLY OIL REPORT

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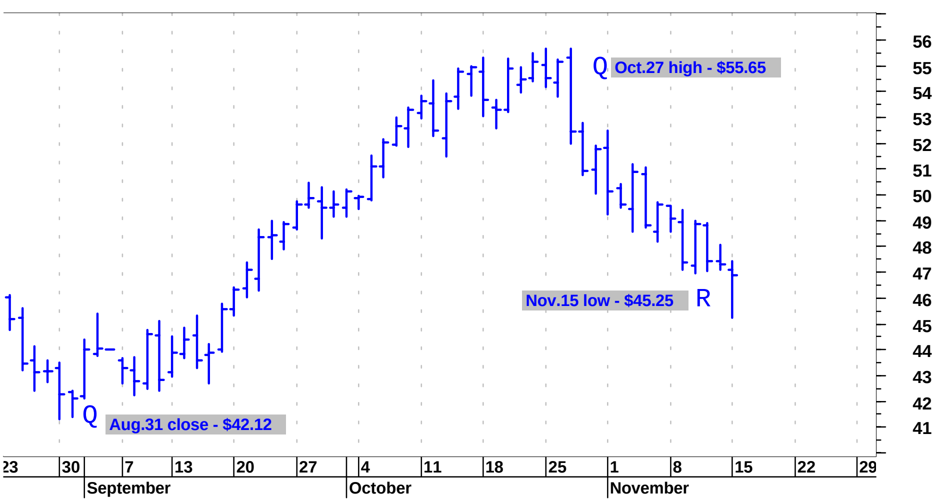
“When fear and greed prevail.”

The time between our previous report and today has been filled with extreme price movements and major developments in many fronts. Starting with US President Bush’s triumphant reelection to the death of Palestinian leader Arafat. World energy markets are now ready to enter the winter season with few of the global issues resolved, but at the same time a feeling that we have probably already put the worst behind us.

Crude oil prices staged another spectacular rally in October reaching a high of $55.65 on October 27th, only to lose more than $10 in the days to follow until mid-November. In the weeks that past the most important bearish developments were the significant reduction of the diverse effects of Hurricane Ivan to US oil operations and the Chinese interest rate rise. Production shut-in due to Ivan has been reduced to almost 200,000 bpd from the initial 900,000 bpd, while crude oil inventories managed to rise by 22 million barrels during the past 7 weeks assisted by a steady high level of imports.

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

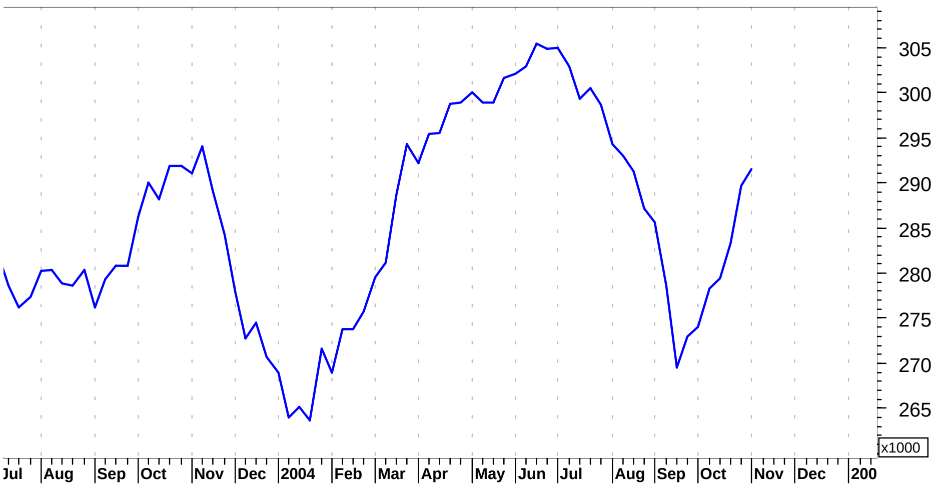


Source: NYMEX

At the same time Chinese authorities unexpectedly announced an interest rate hike for the first time in 9 years, raising most key rates by 27 basis points on October 26th. It is probably no coincidence that prices collapsed the next day. While the rate rise is not huge, it clearly shows that the Chinese government is worried about the economy overheating and is willing to take measures. Given the fact that Chinese demand was the main reason behind this year's crude oil rally, it should be of no surprise that funds decided to call an end to the rally just then. The actual effect of the measures on Chinese energy demand remain to be seen, but this is probably the first time that analysts are considering revising down their estimates for the coming year after continuously revising them up during the previous months.

The above bearish developments neither mean that all issues haunting the energy markers have been resolved nor that all of events occurring during the last one and a half-month were bearish. The reelection of President Bush, with a stronger majority and the subsequent replacement of Secretary of State Powell by Condoleezza Rice were considered as bullish. Crude oil lost almost $3 when the first exit polls indicated that Kerry would be the winner, and reversed the losses when the next day it became clear that Bush had won reelection. The Bush Administration controlling both Houses is expected to push its international agenda with even more determination. The resignation of Colin Powell, considered a moderate, and his replacement by Condoleeza Rice, a close aide of the President and National Security Advisor, is a clear indication of the Administration's intentions.

Figure 2. US crude oil inventories



Source: EIA

US forces staged a major offensive against the city of Fallujah, a stronghold of Iraqi insurgents, a few days after the elections and it is very likely that such operations will be repeated until January, when elections are due to take place in Iraq. While, theoretically, pursuing the insurgents will limit their sabotage operations, as they will be continuously on the defensive, it could also lead them to bolder and more destructive courses of action in order to show they are still dominant. As these lines were written the Kirkuk pipeline system and some oil wells were repeatedly hit and exports had been halted while at the same time relatives of Prime Minister Allawi had been kidnapped.

The death of Palestinian President Arafat is seen as complicating the situation in the Middle East even further as it is unclear whether his gap will be quickly filled, or infighting between the different factions will create chaos in the region. In a world that is highly polarized even if a new Palestinian leader is quickly elected and is willing to negotiate he will have an extremely hard time convincing both the US as well as his countrymen for his sincere intentions. The assassination attempt against Mahmoud Abbas, a possible successor of Yasser Arafat, the day of the funeral that resulted to the killing of two of his bodyguards indicates exactly how complicated the situation is.

Nevertheless, the overall impression during the past weeks is that we have already priced in most of the bullish developments and that we are entering a period were supplies will be adequate and relatively stable, while demand may start slowing as high prices are taking their toll on world's economies. The International Energy Agency in its November report revised down its Q3 and Q4 estimates and predicted a counter-seasonal Q4 stock build. With OPEC producing at almost maximum pace and non-OPEC production steadily rising supplies seem to be adequate for the winter as IEA officials suggested.

What remains to be seen is what the reaction of producers is going to be to this recently acquired sense of comfort. OPEC is meeting on December 10th to discuss output levels and already unnamed sources have indicated that if the price slide continues they will consider tightening output to avoid "…a supply glut". It was this same fear a glut that led them to cut output early this year, triggering the spectacular price rally. If such rhetoric begins it could cause jitters to energy markets, which feel a little bit more comfortable, but are weary that any serious supply disruption cannot be easily countered unless inventories have been replenished.

To all the abovementioned parameters we would also add the fact that the euro has reached record levels against the dollar, breaching the €1.30 level, while the US Administration does not seem eager to stop its currency's decline. US Treasury Secretary Snow when faced with complaints from his European counterparts responded that Europeans "…cannot devalue their way to prosperity." The dollar weakness is mentioned here because it had been one of the major reasons cited by OPEC to justify rising prices this spring. It has not been mentioned during the last 4-5 months since crude oil rose even further, but it is likely that if the oil price decline continues and it is coupled with a falling US$ producers will use it as an excuse to restrict output.

The situation oil markets are facing is, as always, complicated. It seems, however, that we have probably seen this year's highs. Whether prices will collapse amid a supply glut as producers fear, or tight spare capacity and geopolitical turmoil will lead us higher will hinge on all of the above parameters, but mostly on the accuracy of demand estimates for the coming year. The major downside target that will indicate the conclusion of the spectacular price move is the breach of the uptrend that started from the September 19th 2003 low of $26.65 and has now reached $40 rising at a pace of 4.6 cents per day. This 14-month trend characterizes the market after the toppling of Saddam Hussein and its breach could signal a significant shift in overall market sentiment.

The winter season ahead of us will probably be one of the most challenging for the energy markets, as it will test the tolerances of a system that is already running at full pace. Last year market participants moved from being overly bearish to becoming overly bullish, leading to wild price swings. One could only hope that during the months ahead the same people will try to use more accurate prediction methods and reign on their sentiment. In a market where fear and greed prevailed last year in their ongoing war against sense and prudence, we hope that in the months to come the result will be reversed.