

MONTHLY OIL REPORT

Herodotus Antonopoulos &
Filimon Antonopoulos
Oil Market Analysts

lnx@otenet.gr ; info@iraj.gr

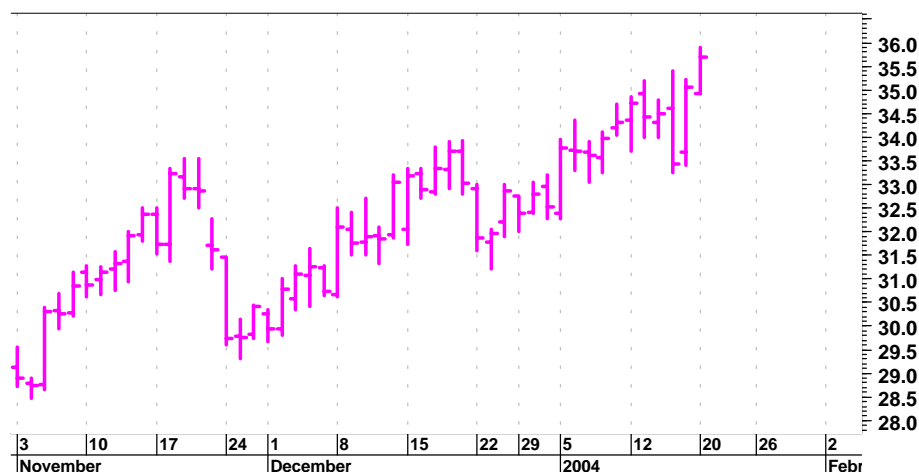
Taking a look into the crystal ball of petroleum.

As usual, in the beginning of every year most market participants are taking a closer look into their crystal balls trying to predict price direction and identify the factors that will play the leading roles in this year's price roller coaster. Current price conditions provide an early indication that 2004 promises lot of excitement and that petroleum will most likely continue to hold center-stage in world geopolitics.



After rising by \$5 in 2003 to an average of \$31.08 basis WTI, crude oil prices moved even higher at the beginning of 2004 breaking above the \$36.15 today. The rise is spectacular, given that conditions today seem much milder compared to the same time last year when Venezuela was facing a general strike and expectations about the war against Iraq were building up. One, however, cannot ignore the fact that US crude oil inventories are now at a 30-year low and that economic recovery mainly in the US and China has been boosting petroleum demand.

Figure 1. NYMEX WTI futures prices (daily chart)

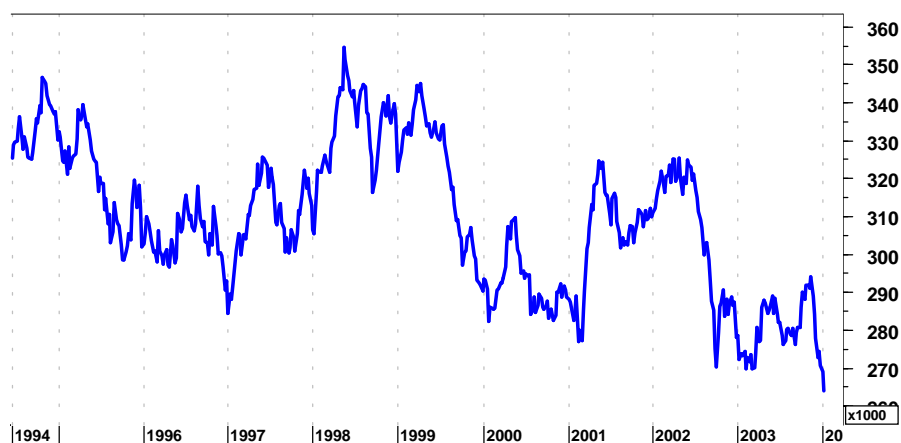


Source: NYMEX

What then to expect from the coming year? Looking into some reports of major institutions that released their estimates in January could put things into perspective.

The Energy Information Administration (EIA) released its monthly report on January 7th, expressing its concerns regarding the low crude oil stocks in the US, which have fallen below the Department of Energy’s Lower Operational Level. Its officials stated however that they do not foresee crude oil shortages in the US, but rather that current conditions make the country vulnerable to future supply shocks. EIA predicts that prices will decline in 2004 reaching the \$28-\$30 range and will continue to decline even further in 2005. Non-OPEC supply will be the main reason behind the price moderation. EIA also predicted that crude oil prices will average \$31.35 during the winter season. This is very interesting because it implies an average price of \$29.66 for the remaining days of the winter season, which, if true, would represent a drop of more than \$5 from current levels.

Figure 2. Commercial US crude oil inventories (million barrels)



Source: EIA

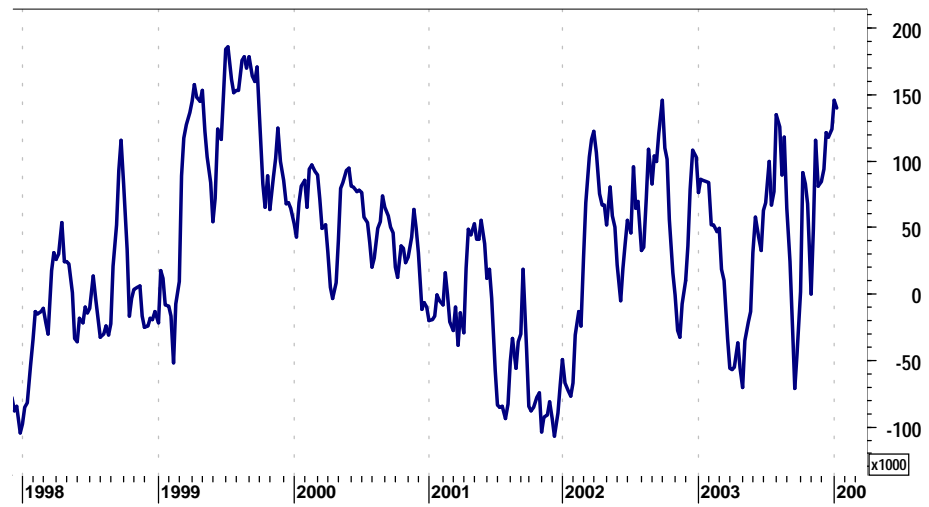
The International Energy Agency (IEA) also expressed its concern regarding low petroleum inventories, urging OPEC to raise supplies in order for stocks to be replenished. On the other hand IEA has put the call-on-OPEC (the amount of oil OPEC should supply for the market to remain balanced) to 25.8 million bpd during Q1 and 23.3 million bpd for the dreaded Q2. Given that total OPEC production now stands at 27.9 million bpd and Iraqi output will gradually increase OPEC-10 will have to reduce output by more than 4 million barrels in March in order to balance the market. Current high prices and low stocks make such a decision on their February 10th meeting extremely difficult. Unless prices correct lower and inventories start building up, any decision to restrict output will face angry reactions by consumer countries. If, on the other hand IEA's predictions are accurate, any OPEC hesitation to reduce output would lead to major surpluses and trigger a price collapse.

It is therefore interesting to note that while both organizations express concerns regarding current inventory levels, EIA predicts lower prices and IEA describes a situation that will create wild fluctuations unless prices ease in the near-term.

What can reverse their expectations is an unexpected supply shock. IEA puts OPEC's spare capacity at 1.32 million bpd, while non-OPEC countries are all producing at maximum levels. Any major supply disruption, such as the one that occurred in Venezuela last year could cause a major shift in supply/demand balances and create bottlenecks that could send prices surging higher. The example of Venezuela is not accidental. The country's electoral council will decide on February 11th whether or not a recall referendum against President Chavez will take place. This is one day after the OPEC meeting and any outcome will most likely draw angry reactions by any side that is not vindicated by the decision. Another round of political turmoil in an oil-producing country so close to the US can easily put-off any estimates of supply/demand balances for the year.

Given the above-mentioned conditions it is likely that the period until mid-February will provide a lot of excitement for traders. If fund positioning is also added to the equation, the situation may become even more exciting. According to CFTC funds and small speculators in NYMEX have accumulated a net long position very close to their historical highs. The size of their open position creates clear expectations that any unwinding will lead to a significant price drop. It is nevertheless obvious that as they represent the most aggressive part of the market, their moves cannot easily be predicted and the traps set before the actual final move could be numerous. During the war in Iraq, major unwinding took place before the announcement of the invasion and without any clear sign of the consequences. It is often the case that unwinding takes place against fundamental developments that point to the contrary.

Figure 3. Net position of NYMEX non-commercial and non-reportable traders (thousand contracts)



Source: CFTC

It seems that our crystal ball is on average pointing to lower prices in the medium term. However, existing political turmoil in most oil producing countries cloud our view and we cannot help but note that spec-fund activity usually proves much more powerful than magic itself.

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