

## ***SPECIAL REPORT*** **FROM THE DESK OF PHILIP GOTTHELF**

### **Operation “Free Oil”**

The image of a victory spread throughout the world yesterday as statues of Saddam Hussein were toppled and selective cheers of joy were strategically filmed for Western media. Although a “constructive” conclusion was supposed to be drawn by investors, the recent stock market rally stalled (again) and May crude oil staged a contra-logical rally in response to rumors OPEC would significantly cut production to counter any renewed Iraqi production.

Oil politics are about to move to the front burner. Already, the U.S. rhetoric has shifted towards U.N. Security Council member Syria with a powerful warning that harboring Iraq’s former regime is an invitation for U.S. intervention. Who else should take notice? Iran and North Korea... to name a few. But, the focus is on new distribution rights for the second largest Middle Eastern oil producer and how it will impact OPEC. Conspicuously missing from the conversation is Iraq’s status as an OPEC member. Simply put, is Iraq free from OPEC as well as Saddam?

If so, the U.S. has hammered the first nail in the oil oligopoly coffin. Within nine months, OPEC policy could fade into insignificance. Still, crude has yet to respond. After touching 2650 and bouncing all the way to 3130, May

futures retraced to test 2700. Technicians warn that the bottoms are rising and a push to 3150 will confirm a new upward thrust. Fundamentally, they point out that the Kurds have taken control of some northern production fields and a turf war could easily develop between the U.S. and indigenous forces.



On the flip side is the interpretation of a “W” formation with resistance between 2900 and 2950. A bust below 2700 signals crude in the teens by June. This presumes a rapid ramping up of oil production and no extraordinary complications.

Already, the U.S. military has detailed plans for protecting tanker traffic from terrorist interference. Escorts will provide protection and ships are being equipped with sophisticated surveillance technology that warns of any approaching danger. So, it is about oil after all. However, the Bush Administration is determined to use oil revenue to rebuild Iraq. Is anyone familiar with the “transference principle?”

There are economists who believe economic “transference” is a form of hidden tax. For example, when Brazil owes the U.S. money, a hike in coffee prices increases export revenues and raises Brazil’s creditworthiness. However, it is the U.S. coffee consumer who pays the price. Thus, our purchase of post war Iraqi oil transfers our energy payments into rebuilding Iraq.

After the first Gulf war, crude oil prices plunged. Saudi Arabia sought to punish Iraq by dropping oil values when Iraq needed the revenue the most. This form of economic warfare is not unusual. Companies do it all the time to thwart new entries into their domains. The question is, “Does the U.S. want a high or low price?” It may seem obvious that a low price is desirable to help kick start the U.S. economy. On the other hand, Global energy consumption has become highly balanced. The market structure is “on demand” which is likened to a “hand-to-mouth” strategy. Regardless of the strategic reserves, refineries buy crude as needed with very little forward purchasing. This makes oil extremely sensitive to immediate supply disruptions or gluts.



Notice the May 1991 post Gulf War pattern. While less symmetrical, the “W” pattern appeared shortly after victory was realized and oil gapped from

2160 to 1950 followed by another \$1 plunge before shorts became cautious and covered. After that war, Saudi Arabia wanted to lower oil prices to prevent Iraq from rebuilding on rapid oil revenue growth. As it played out, Kuwait’s oil fields came back into production much faster than “experts” predicted. Saudis achieved their objective of economically punishing Iraq, but the plan gained too much momentum. This war is different.

With tough talk against those nations who would harbor terrorists or build weapons of mass destruction, the U.S. is claiming a de facto proxy for military intervention. The candidate Bush who pledged against nation building is becoming the quintessential builder of nations. The candidate Bush who declared we had enough problems at home that foreclosed global policing actions by the U.S. has requested more than \$70 billion to finance his nation building campaign... so far.

### April is the Cruellest Month

Are there any T.S. Eliot fans out there? Like his poem *The Wasteland*, April has surprised us with extraordinary weather in the Midwest, Northeast, and South central regions. A deep trough dipped arctic air from the Dakotas through Chicago. The track moved east, spreading sleet and snow from Philadelphia to Maine. The cold snap sucked down heating oil inventory just as we jumped into the short side of June at 7075 on Friday’s open. Prices popped to 7320 today. Obviously, volatility forced us to select a wide stop.

As warmth resumes this weekend, the instantaneous need for heating oil will

abate. I believe we can see 6000 before May expires. This assumes normal spring weather will emerge. In general, seasonal anomalies like a prolonged winter are brief. Yes, up to 10 inches of snow accumulated along the Northeastern Corridor. Temperatures were ten to fifteen degrees below average, but the snow was gone within two days and we can hardly say there was a genuine freeze. Were heating oil inventories drawn down? Generally, companies top off customer's tanks before the summer to collect those last few dollars before the lull. That process was already well underway.

Like crude, heating oil displays a "W" formation with support at 6700 in the June expiration. A bust below 6700 implies a test as low as 60¢ based upon volatility and the length and strength of this support.



Don't discount collapse potential simply because of the dramatic decline from March highs. The current advance must overcome 7500 resistance before the bulls will be in technical control.

### Speaking Of Weather

The early spring storm that swept across the upper and central Midwest blanketed emerging winter wheat with abundant snow. While the moisture was welcome, temperatures did dip into the deep freeze

for some producing areas. Unfortunately for bulls, Kansas City hard red winter wheat didn't respond. The weather was insufficient to definitively turn the tide, but an upward channel has been forming in the May Chicago contract.



I was tempted to buy KC and sell Chicago in anticipation of a dip in winter production and quality. A lack of interest in KC may be to blame for lackluster KC performance. The chart shows May Chicago wheat challenging 2.90 resistance. A breakout above 2.90 can cause a stepwise progression to 2.97, 3.05, and 3.17, moving above the 20-day and 40-day average.

Many traders argue that there is no reason for wheat to exceed \$3 at this time. After all, what has changed since March? We continue to expect the same harvest as before, despite recent weather. With the strengthening of the U.S. Dollar, U.S. grain has become more expensive on the world market. The rally from 2.75 to 2.90 is even considered unjustified.

This ignores a possible acceleration in U.S. humanitarian exports that can be paid for with Iraqi oil. Price won't matter as much as feeding the civilian population. The volatile upward channel appears suspicious. The bias is up even with the price below the moving averages... for now.

In the meantime, bull spreads have worked well in grains and I am disappointed we were bounced out of our July/November soybeans before meeting the full potential. Again, I emphasize the need to feed. The greatest impetus for a failed Iraqi Freedom campaign would be empty stomachs. A population can live without TV and sporadic electricity. After all, it happened in California! But, hunger rapidly breeds discontentment. The Iraqi people will ask the U.S. political question, "Am I better off today than I was when Saddam was ruling?" The answer had better be, "Yes."

The surprise was the breakout from the upward drifting soybean channel. I avoided beans because they were gyrating around converged moving averages. Excessive volatility demanded \$750 to \$1,200 stops. Even with such protection, interim channel swings were capable of taking out positions. With the thrust above the channel at 5.85, July soared another 15¢ and is shaping a new consolidation. Latecomers must ask whether the slope of this consolidation (if it comes) will point to a continuation or a retracement back to 5.85 *for another buying opportunity*.

Farmers have been waiting for \$6 beans for a long time. If July can test above \$6 now, there could be some real potential for the summer. To be sure, Southern Hemisphere supplies will not expand global inventories to any extent and the world must rely upon this summer for a good crop and moderate prices. Like 1988, this year can go either way, but the upside exposure is considerably greater as we move through the planting season.

Farmers can afford to plant more. Price parity shows soybeans gaining on corn. Using extraordinary yields of 200 bushels per acre for corn and 100 for beans, corn provides \$480 while beans yield \$600. Add in the difference in inputs and beans come out ahead. This implies farmers will be more favorable to planting \$6.00 to \$6.50 beans in lieu of \$2.30 to \$2.60 corn... for the moment. Seed orders confirm this bias, but it is still early and weather dependent.

We opted to take the 240/220 July corn option strangle for 11¢ which keeps us safe down to 2.09 or up to 2.51. Corn immediately blasted above 2.46, but has declined back to the 2.40 strike. There is still time and premium. We may have an opportunity to add to this strategy and/or cover our downside exposure.



I was counting on 2.48 resistance to hold, and it did. Recall that I was concerned that the upward consolidation might have been a continuation pattern pointing to a test of the 2.20 reference low. Obviously, it wasn't! The gap from the channel breakout looms as a correction target. If achieved, we should have taken about 50% of our premium in time deterioration. If weather continues to be strange, I may be happy with that and cover the positions. 😊