

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

Does Iraq Belong to OPEC?

Over the past week, news commentators have been dwelling upon the exile of the former Iraqi ambassador to the UN. As he prepared to depart from New York for Damascus he stated, "I have no country." This simple statement has been echoing through the media and think tanks as though it is a sudden surprise. It is part philosophical and part political. With the government removed, who is in charge? The seemingly obvious answer is the coalition military. However, the secondary question is more complex. What are they in charge of?

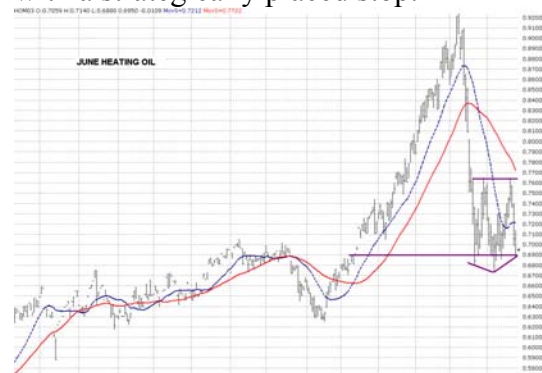
This brings up the point, "What constitutes a country?" While a commodity newsletter is not necessarily the forum for highbrow debate, this perplexing issue will be the focus of Iraq's entire "rebuilding process." I add that it is a process precipitated by the U.S. and U.K. Enter the "Radical Westernists" ... a label I just recently heard that refers to a growing group of Westerners (as in citizens of the "industrialized western nations") who claim that Iraq is no longer a nation. Absent a government, absent social services, absent a military, absent a charter or constitution, absent a governmental consensus among the population, Iraq is just a territory.

An examination of the prior structure reveals that the "people of Iraq" had no

proprietary interest in their territory. Where are the land deeds? Who owns resources like water, oil, minerals, and farmland? How will the country be apportioned?

From our perspective as commodity traders, the question is more appropriately narrowed to oil. Without an oil minister, no central oil company, no energy policy and no regulation, where does Iraq stand? While in coalition control, I believe it is highly unlikely Iraq will continue as an OPEC member. Thus, the dynamic I have touched upon in previous REPORTS has become a reality *this week* as coalition representatives of the Army Corp of Engineers proudly announced that Iraq's wells were already in production.

To me, this eventuality was crystal clear. *Yet, I was (once again) unable to establish a properly timed short in heating oil.* We sold Thursday's open with a strategically placed stop.



With the benefit of today's chart, we see the more strategically correct protection was above 7650. The wild and volatile

formation presented by heating oil is a fiction, despite its painful reality. The actual equilibrium price is in decline as are all energy contracts. Absent any rebellious reaction from remaining OPEC members, the crude price should be destined for \$22/bbl., at which time OPEC ministers will grumble that that is their acceptable low within the 2200 – 2800 range.

But, the West will say it is not the final low. There is rebuilding to be done. Iraq needs the volume of sales and the West needs price relief. Under this scenario, OPEC may opt for a free-for-all that could easily sink crude to the single digits. “Preposterous!” you may say. However, a glance from October 1985 through April 1986 shows just how potent opening spigots can be. While not as dramatic, the post 1991 Gulf War displayed a similar dramatic price slide.

The logic behind the strategy rests with two principles; 1) volume X price = revenue, and 2) better man (producer) wins. Saudi Arabia knows it can earn more revenue with greater volume... even with price declines. Further, there is an incentive to allow Iraq to deplete reserves on declining values to prolong any recovery. Saudi Arabia would like to see a global recovery that can carry its foreign investments higher. They are also concerned that the energy price focus has begun a techno backlash represented by developments like the Toyota Prius hybrid (gas/electric) car that achieves 55 miles per gallon *in the city* and an impressive 48 on the highway. OUCH!

Honda has a similar vehicle and both Japanese auto giants plan to release SUV hybrids in the very near future... like

next year! This is exceptionally disturbing news that can only be combated using extreme measures. *Lower oil fast!*

Of course, that’s just my view. As Dennis Miller says, “I could be wrong.” But, put yourself in OPEC’s position. If the auto industry embraces hybrid technology with an eventual move to fuel cells, we could see a 15% to 20% reduction in overall fuel consumption within the fleet half-life; estimated to be 3.5 years. Within a decade, this number could climb to 50%, effectively putting OPEC out of business. However, if gasoline is lowered to the “break point,” Americans will continue to enjoy the roar of their V-8 engines under hoods of ever more massive conventional SUVs.

OPEC may have already pushed the West to the point of no return. As of today, you can still get a \$2,000 cash tax credit for buying a hybrid. The fuel cell Toyota Highlander is already being road tested. General Motors has prototype household fuel cells that convert methane (cooking gas) into electricity. The technology trend is in. Just as CDs took over from vinyl records and digital cameras are displacing film, so will fuel cells encroach upon conventional fossil fuel burning.

Thus, I am inclined to sell energy contracts regardless of previous wounds and the missed portion of the current decline. The liquids all possess similar technical patterns. However, natural gas has only recently shown weakness coming into the summer. This is considered contra-seasonal because natural gas supplies can come under pressure as electricity demand rises with summer temperatures. So far, the

Eastern Corridor has been spared a spring heat wave. In fact, temperatures have been far below seasonal norms. Consumption patterns show more demand likely from the Midwest and West. Still, consider the chart.



After spiking to 6600, June natural gas plunged to 5000. Half this 1600 points is the 800-point rally to 5800 resistance. Although the prices tested 100 point higher, this is well within the 50% retracement rule. From the 4000 top of last summer's consolidation range, we see two nearly symmetrical advances that represent downside objectives should the 40-day average be breached. These are lofty profit potentials.

Unlike the liquids, gas shows a more pronounced and even pattern. Still, this has been a treacherous market and represents considerable exposure and risk. As I have experienced... correct logic and slightly flawed timing lead to ruin.

Wherefore Art The Dollar?

Just when it seemed safe to go back into the Greenback, the plunge resumed to paint an exceptionally volatile picture as we move through the second quarter. It is fair to say that 9925 support, that some believed would pave the way for a bounce back above 10000, was breached. The chart no longer appears

“constructive,” and the Dollar may easily come under the same pressure as the Euro just two short years ago.



The nasty trading range established since February flattened the moving averages while blasting within a 9925 – 10250 envelope. This is a trend follower's nightmare. However, a bust below this pattern suggests a new interim trend. The “M” double top found support at the March gap above 9900. That gap was filled and we are probing March lows.

The U.S. has rapidly turned its political attention to domestic issues and Democrats are desperate to dilute any Presidential war popularity with new emphasis upon tax cuts and the recession. The Democrat front-runner wants to repeal tax credits in favor of healthcare. His reason? Polls show healthcare as #2 behind security in the minds of voters. But, it's a big gamble for Democrat strategy to pit a slogan of less taxes against government sponsored healthcare... Ugh!

Currency traders see the battle lines being drawn and conclude the Dollar is in for softening over the next several months. The “Bush economy” lacks sufficient strength to raise interest rates. This compromises the Dollar's ability to lift on the heels of Federal Reserve policy. The fact the Bush expressed confidence in Federal Reserve Chairman

Alan Greenspan hints that the current interest rate environment is okay with the Prez... for the moment.

Gold rallied in contra-Dollar fashion, creating a suspicious flag. We bought gold with a wide stop based upon the belief Dollar/gold parity would erode. Regardless of anti-gold sentiment, this metal is playing an increasing role in cross-parity comparisons. For example, as the Euro climbed against the Dollar, it simultaneously lost ground to gold... a seeming contradiction. So, gold's price went rapidly higher in Dollars and less rapidly up in Euros. This means gold as assumed a more substantial place as a monetary indicator. Wake up *The Wall Street Journal* and *The New York Times*. It might be time to put gold on the front page of the Business Sections... where it once was.



Undoubtedly, June gold has a considerable technical hurdle at 33800 resistance. If held, the rally is doomed. But, the 40-day average is under attack. If a breakout above the 40-day average generates sufficient follow through, 33800 should be an easy target.

What could sustain gold thereafter? Certainly, a sell-off in energy is not inflation producing nor gold stimulating... on the surface. Investors find gold attractive because it remains resilient and has not met the skeptics'

objective of \$300 before the end of March. If the Dollar collapses, I assume gold will respond positively.

Since my triple appearance on CNBC and subsequent radio spots, people have been interested in tracking Middle East accumulations. The revelation that Saddam did not have an opportunity to convert over \$1 billion in U.S. cash into gold movement out of Iraq did not tarnish the metal. To the contrary, gold supported through this news to imply that the plan may still be implemented.

Seeing \$600 million in neat \$4 million canisters is a remarkable sight. In fact, it was so tempting, some GIs allegedly tried to pocket \$12 million worth of those cute little "Franklins." But, the \$600 million found along with \$100 million here and there is indicative of several billion that may still be stashed in gold. The questions, "Isn't that bearish because the price will come down when Saddam and/or friends and relatives liquidate?" Opposing this logic is the possibility that there is nobody left to lay claim to these secret deposits and, thus, they are off the market.

The flow into gold has actually picked up over the past 14 days as indicated by some of the storage statistics I have reviewed. This is not the same as certified receipts for delivery. I am astonished by the amount of gold moving into private hoards after the price faltered. Are these the smart people, or are we seeing the blind following the lame?

Hmmm. Perhaps the cash is being moved into the yellow metal. A breakout above 33800 in the June will tell! ☺