

REPORT WRITTEN JUNE 12, 2003

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

Oil Moves Higher Despite Iraq

Regardless of my prognostications about the flow of Iraqi oil, prices have been rising and I am, once again, on the wrong side of this market. Having decided to enter crude instead of heating oil, I can be grateful that my enthusiasm did not carry to the complete energy complex. Amid signs of an increasing natural gas shortage and word that Iraq's pumps will not reestablish production until August, current OPEC quotas appear sufficient to force prices upward.

Interestingly, the front page of *Investor's Business Daily* (IBD) carried an energy article, "OPEC Still Has Muscle, But Grip Is Loosening As Market Share Falls." Essentially, the article reflects all that I have been saying since troubles with Iraq began. Was the war about oil? You bet. Now that we have unsuccessfully uncovered weapons of mass destruction (WMD), it is clear that our intelligence could not have been "that wrong!" Thus, real motives come to the surface. Surely, the debate between Democrats and Republicans for the 2004 presidential race will dwell upon the lack of WMD and the "unnecessary war" that cost American taxpayers billions. Why did we put American lives at risk if not for WMDs?

The answer is political as much as it is economic. As the IBD article accurately points out, Iraq has the capacity to rival Saudi output. With this American

controlled potential, OPEC's grip on oil supplies is substantially diminished. In fact, Saudi swing production could easily be rendered irrelevant if Iraq's fields are fully developed.

In short, the attack upon Iraq was an economic strategy against Saudi Arabia. But, I have been saying this all along. However, the situation is far more complex than the Saudi/Iraq dynamic. The United States faces a critical turning point in Middle East policy. The only way to defeat terrorism and Islamic fundamentalism is to offer better alternatives. This means modernizing repressed societies and literally steering them into Westernization. It is a daunting task with a relatively small window of opportunity.

My view is simple. Pump as much oil out of Iraq as possible while pumping as much money into restructuring Iraq as possible. If Iraq becomes the jewel of the Middle East, other societies will come under substantial pressure to follow. Believe it or not, even Israel has expressed interest in partaking of the opportunity. An aerial overview of the region shows an incredible delineation between Israel and her neighbors. Where Israel's borders begin, there is green. Beyond the borders are dust and neglect.

Everyone is keenly aware that Iraq possess more than oil. The Tigris and Euphrates rivers have the potential to

make Iraq bloom again... as in Biblical days. Cultivating Iraq as the breadbasket of the Middle East permits development beyond oil which is vitally important when evaluating energy production trends.

Longer term subscribers may recall my occasional reviews of the global oil situation. In particular, I cited studies done by the Deutsche Bank that showed remarkable progress in the development of Caspian Sea reserves. These are controlled by members of The Commonwealth of Independent States. In particular, Kazakhstan has the capacity to dwarf Iraq and Saudi Arabia. Although Saudi Arabian and Iraqi reserves are officially rated #1 and #2 respectively, Kazakhstan is unofficially sitting on top of the largest single pool of oil in the world. Combine this with untapped resources in the China Sea and we are suddenly awash in crude.

Given the economics of these regions, I have seen estimates for production costs below \$4/bbl. This means a selling price of \$10 yields a substantial profit on high volume. This is why we will see an evolutionary change in energy production. With this metamorphosis, eco-political structures in the Middle East must change. Quoting the late Israeli Prime Minister, Golda Meir, "Moses dragged us for forty years through the desert to bring us to the one place in the Middle East where there was no oil." Even with this handicap, Israel has the most diversified and vital economy in the region. This demonstrates that anything is possible with or without natural resources.

But for repression, Arab neighbors could have surpassed Israel decades ago. In

fact, had Arab nations followed Israel's example, there would be no Middle East conflict because borders would have dissolved... in my opinion.

Coming back to the present, I remain shocked and in awe of the strength oil has exhibited in the face of OPEC's deterioration. Iraq is not a wildcard. The intent is clear. We will use plenty of oil to rebuild Iraq while supporting a U.S. recovery with lower energy prices. That's the plan... short-term and long-term. Hence, \$32-plus crude should not be sustainable... particularly beyond June! Viewing today's action I suspect traders are looking over my shoulder!



After breaking out above 2960, crude quickly climbed to 3240 resistance which was encountered today. I suspected this could be achieved and set our August crude oil stop at 3125, just in case. Prices came within 10 ticks of this measurement before retreating. WHEW! However, we are not out of the woods, yet.

July crude must close below 3160 to provide any measure of relief. Even then, the possibility of a spike is significant. A bust below 3080 should be sufficient to invoke a test of 2960 support. Numbers for the August contract are different, but August is taking its lead from July until expiration.

Of course, my preferred position was our former short heating oil. Who thought? July heating oil traded close to 80¢! Think about that. It's supposed to get hot outside and July heating oil is above 7900! I can't see a reason to squeeze the July contract. Even if you strongly believe we will see a shortage in the late fall, there is ample time to allow prices to settle down.

I am inclined to believe heating oil will trade below 6700 in July and lower through August. Unless some unforeseen event or events impact crude production, there is no way to keep a prop under heating oil. This means that the late summer and fall telephone hucksters who tell unsuspecting investors to buy heating oil calls may be placing their would-be clients in front of a freight train. Cold won't matter if the pumps are turned up to capacity.

For the brave and financially capable, I am considering adding shorts to the current August crude oil position. Further, it may be time to sell heating oil for my long-awaited market decline. August encountered powerful 7950 resistance and a more pronounced reaction today.



We are testing 7700 support and I believe this should fail. This brings us to a potential retracement to 7125. This happens to be where the 20-day and 40-

day moving averages converge. Many traders express pessimism when entering a market that has already retreated by 6¢ or \$2,500 per position. The rule is, "Buy strength – sell weakness." If, in fact, we have seen the interim top, there is no reason to wait for further deterioration.

Where Europe Stands

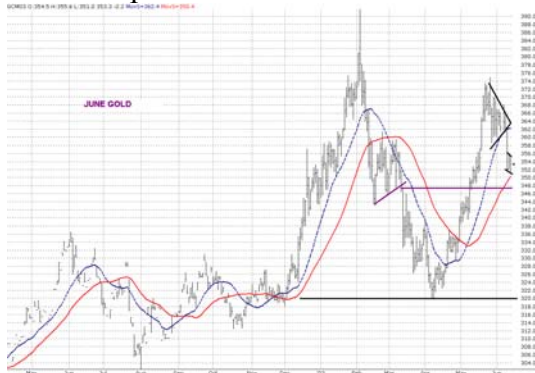
A great deal of news has centered around Europe's relative economic position to the United States. Europe has maintained higher interest rates under an assumption of better economic conditions or prospects. With a 17% decline in French tourism and rapidly rising German unemployment, this assumption may prove false. Europe is in trouble and the weaker U.S. Dollar is not helping.

Iraqi Freedom has left a bitter taste in the U.S. Our alleged allies appeared to turn on us and attitudes towards French and German goods have gone decisively negative. One car is not a market study, however, a doctor friend who had been a diehard Mercedes buyer since he earned his first fees just traded for a Cadillac CTS. *Amazing!* His reason, "I'm not buying German anymore." He also pointed out that Mercedes has fallen on the quality scale. Another acquaintance who owns a BMW dealership has reported a drop in enthusiasm. When Woody Allen is called upon to convert us back from Freedom Kissing to French Kissing, you know the EC is in deep trouble!

Europe may be forced into the same monetary policy as the U.S. Most importantly, this will be the first challenge of the Euro Currency's

stabilization under interest rate adjustments. This is not to say we have not seen rate changes. It is to say that the Euro has not been subjected to the same monetary adjustments as the U.S. Dollar. We simply don't know how a unified currency will react to non uniform national economies. France's woes are not the same as Germany.

This could rekindle interest in Dollars or even gold. When all else fails, where do we flee? There has been an expectation for \$320 gold and lower. Yet, the yellow metal stabilized this week above 35200 in June futures. Consider the technical picture.



June gold rocketed from 32000 to 37400; \$54. After forming a broad pennant, gold busted below 36200 and dipped to approximately 35200 support where it has remained for three days. Divide 54 by 2 and you have 27. Subtract \$27 from 37400 to get a 34700 50% retracement objective. This is in line with the February/March consolidation.

After taking \$4,010.00 out each June gold last week, I approached the formation with warranted caution because the broad triangle represented a dual potential. A breakout above 37200 signaled a continuation while a bust below 36000 reflected a reversal. I was opting for the push above 37200 and

recommended accordingly. While we did not participate in the downdraft, it did not catch us either. It's better to be out, wishing you were in.

Against gold's backdrop, consider the Euro's performance.



After breaking out above 11000 at the end of April, the steep upward channel has finally stalled just after 11900. The 12000 remains elusive. With the EC contemplating further rate reductions, the Euro can fall back to test 11000 support... a huge correction. At the least, we could see a 5¢ drop as a 50% retracement.

In the meantime, gold may find its footing at 35400. This points to a realignment with gold as a "safe" haven. You and I may not be skittish. Then again, you and I don't have billions riding in foreign exchange transactions every day. Look at the parity fluctuations! Somewhere there must be stability.

Admittedly, the gold chart doesn't look any better right now. However, a range of 35000 to 37500 is not bad when you look at relative U.S. Dollar parities. Despite gold's dip, I am still favoring the metal. We need a rally above 35650 to get mildly excited. 😊

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