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Energy Risk
Management Services

HIGHLY CONFIDENTIAL

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Good Morning

Overview

- Hydrocarbon prices fell overnight. **Crude oil down $0.78 to $50.27 per barrel; natural gas down $0.046 to $3.686 per mmBtu.**

News/Views

- The petroleum gods are playing with us again. In response to our suggestion yesterday morning that we were mentally preparing for a correction in crude oil prices as we experienced in late March since prompt WTI was trading even above *our* outlier outlook thus far in April, they served it up to us. We also suggested that instead of a $48.00 per barrel trough something around $50.00 might have greater odds this time around, and thus far this has been a reasonable perspective, although obviously equity market moves and the weekly stats could prove otherwise. Crude oil responded somewhat to weaker equities yesterday, and some rationale given for the decline in the S&P 500 was a bank analyst's negative rating on his universe, but this was probably overplayed by the press. In any event, other factors were at work in terms of energy specifically.

- Our friends at Goldman Sachs issued a note also suggesting that crude oil prices were getting ahead of themselves and, we are paraphrasing somewhat, believe prices will remain weak until the second half of the year when more stable demand and the need to restock "will help push the oil market into a sustained deficit later in the year". We have to admit this latter phrase is alien to petroleum industry phraseology, but we assume they mean that inventories will move below the prior year. A true deficit rarely, if ever, exits in the oil market, but it does not mean that prices cannot move higher. We would also take exception with what we assume to be their argument that "restocking" in the second half of the year will help firm prices. First of all, even if demand stabilizes as we expect, we see no need for net restocking of any magnitude once inventories are reduced as we anticipate. Second, restocking will in no small part be a function of the term structure, which we expect will flatten once supplies decline, thus reducing the incentive to store. Third, we have not found any evidence that "stocking demand" has a net positive influence on price, be it oil or natural gas. Granted, buying for inventories *is* a form of physical demand, but the stocking impact once materialized in the data tends to have a net negative price impact as non-commercials observe the pattern. In any event, our Base Case has consistently anticipated an improving balance in the second half of the year, but it appears GS, for whatever reason, is not yet prepared to move the market up.

- Another reason for energy equity and commodity weakness yesterday could have been related to word that Saudi Aramco had reduced crude oil prices for May lifting almost across the board. The cuts were apparently the largest ever for crude sold into the United States. To quantify the new prices for U.S. destination, Arab Light, for example, was slashed by $4.15 per barrel to WTI minus $2.25 per barrel. Our point in all this would be that the adjustments were made to move somewhat closer to the current state of refining margins and to approach the relative values of other sour grades in the U.S. Gulf Coast such as Mars. Some may view the cuts as possible evidence that Saudi Arabia has "had it" in terms of lack of full compliance by other OPEC members and is therefore willing to increase sales a bit by providing some

incentive for refiners. We do not believe this is the case, however, since as we have previously discussed Saudi pricing is, by and large, a separate issue from contract lifting variation.

- Otherwise, with prompt WTI trying to find short-term support around $50.00 per barrel it will have little or no tolerance for bearish weekly stats, depending of course on the path of the S&P 500 this week. In this regard, the latest Platts survey is looking for a 2.3 million barrel build in crude oil stocks, a 1.5 million barrel decline in gasoline supplies, and a 600,000 barrel draw in distillate inventories. We would guess at this point that the crude oil build will be somewhat less, and that refined product stock draws will be somewhat larger than consensus expectations. In the case of gasoline, this would be due to lower imports from the previous week, while with regard to distillate it would derive from a recovery in implied demand back toward the underlying mean.

W.H. Brown, III

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