Bianco Research L.L.C.

An Arbor Research & Trading Company

Independent · Objective · Original

Volume 10, No. 36 | 1731 North Marcey, Chicago IL 60614 | www.biancoresearch.com

Market Facts

Petroleum Spreads Are Signal, Inventory Is Noise

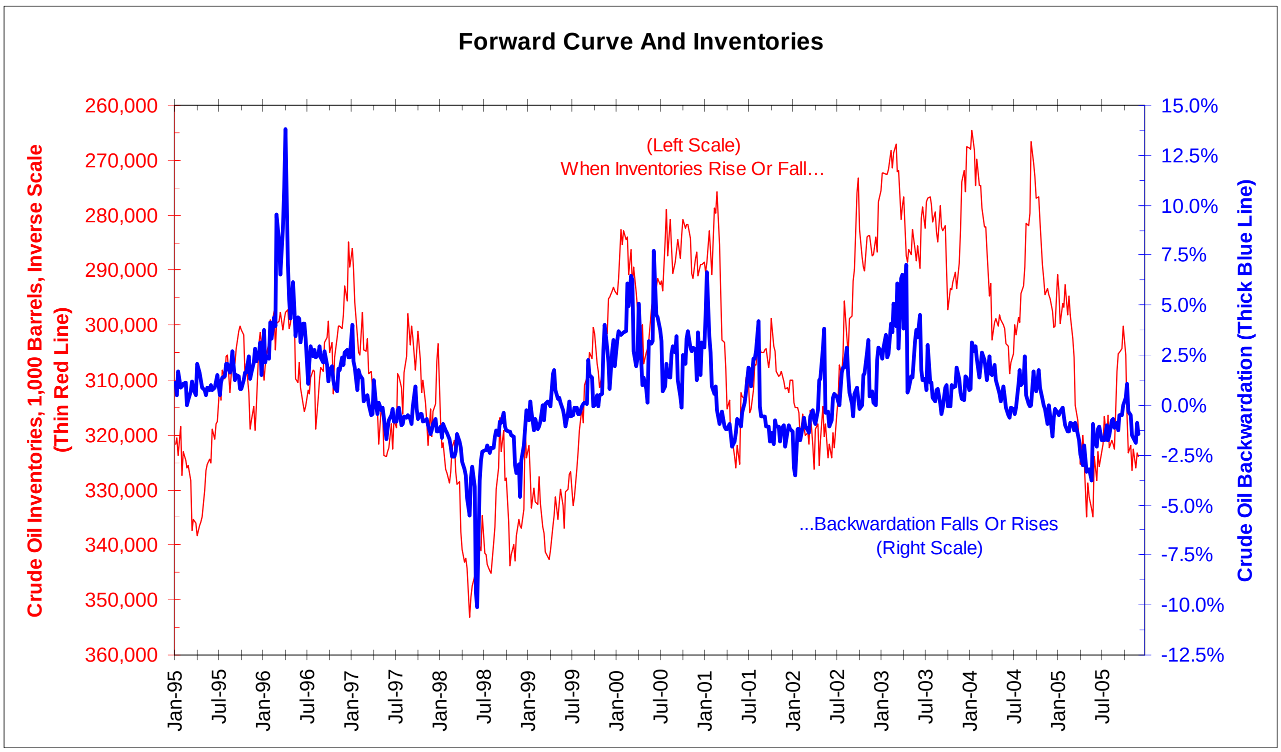
By Howard L. Simons (847) 304-1511

December 7, 2005

As we noted in a May 2005 **Market Facts**, few data points are as overrated as the weekly petroleum inventory changes. This morning, the Department of Energy reported crude oil inventories increased 2.72 million barrels over the previous week. This inventory change is no more than 4.75 hours of U.S. consumption. And these are primary inventory numbers only. They do not include the secondary, or distributor-level, stocks or the tertiary inventories such as your personal automobile or heating oil tanks.

Crude oil inventories (thin red line, inverse scale) have been rising throughout 2005. The cash price of West Texas Intermediate crude oil is up more than 40% on the year.

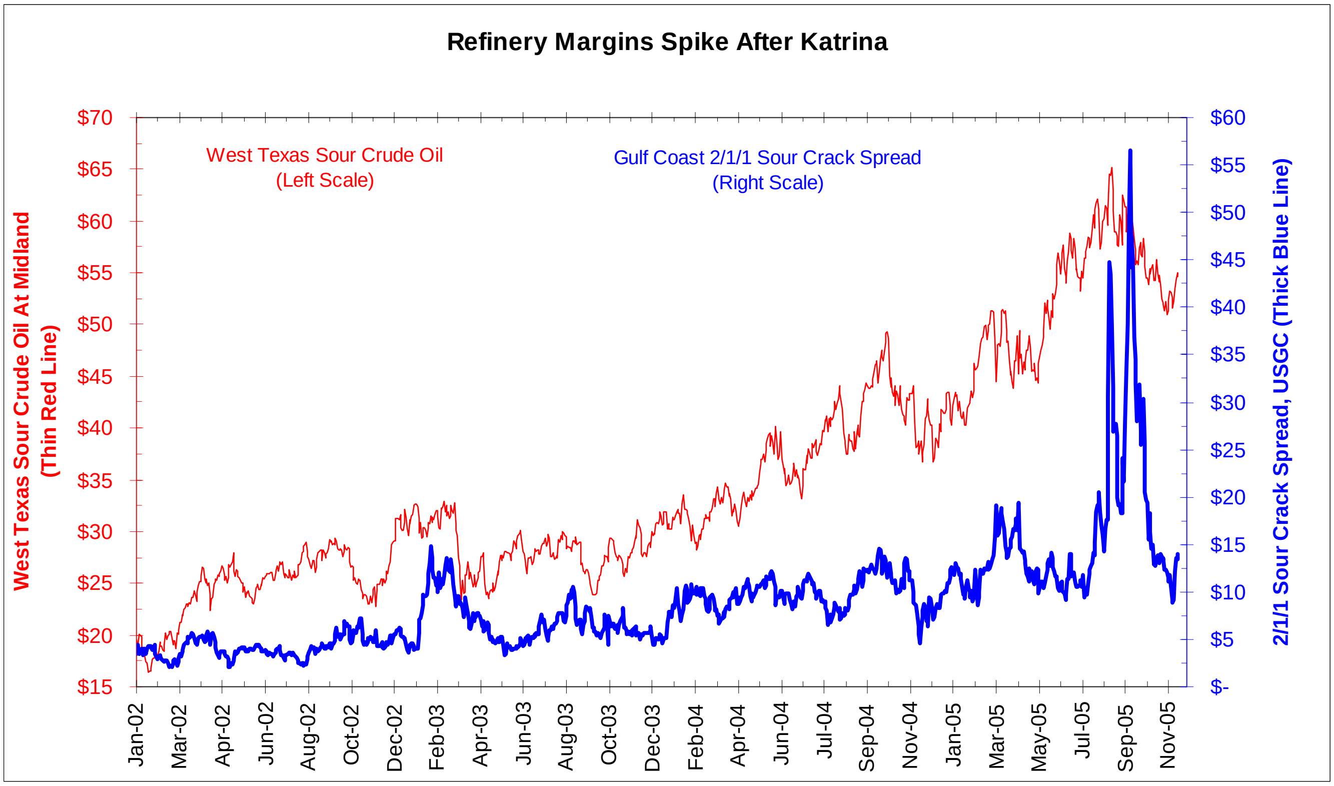
Have we uncovered a new economic mechanism of higher supplies leading to higher prices? No, but we should conclude trading the price of crude oil off inventories of crude oil is a losing proposition. The real effect of inventories is on the intermonth spreads in crude oil (thick blue line).



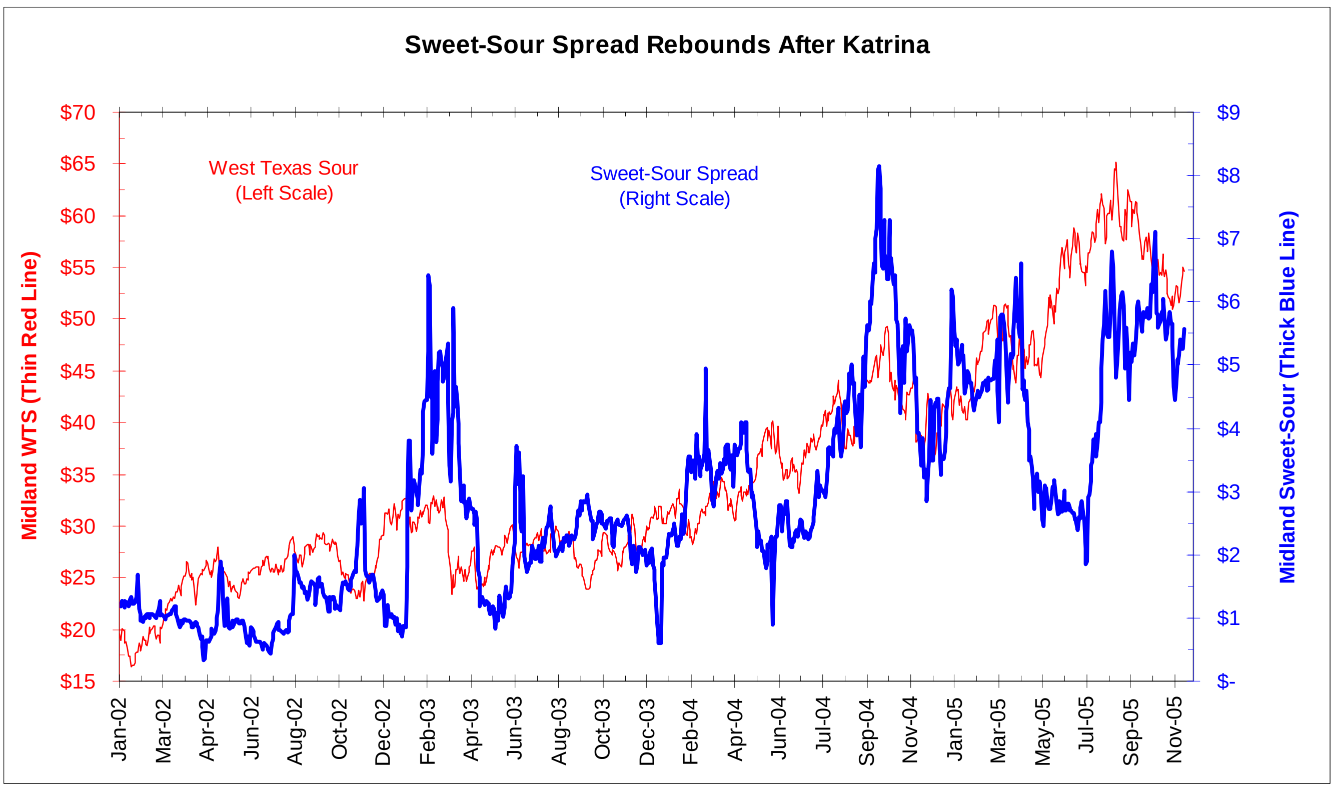
Still A Bull Market

Let's revisit some of the industry spreads discussed in a November 2005 **Commentary**. Our conclusion then was the then-ongoing price weakness was no more than a correction in a bull market.

The massive shock of the hurricanes expanded refining margins to unprecedented levels. The chart on the next page shows 2/1/1 sour (high-sulfur) crude oil crack spread (thick blue line, following page). This is the price of one barrel each of heating oil and gasoline less the price of two barrels of crude oil. Recently it returned to its pre-Katrina levels and is rising once again. As a rising crack spread signals rising refinery profitability, the incentive to buy more crude oil also rises (thin red line). **This is bullish.**

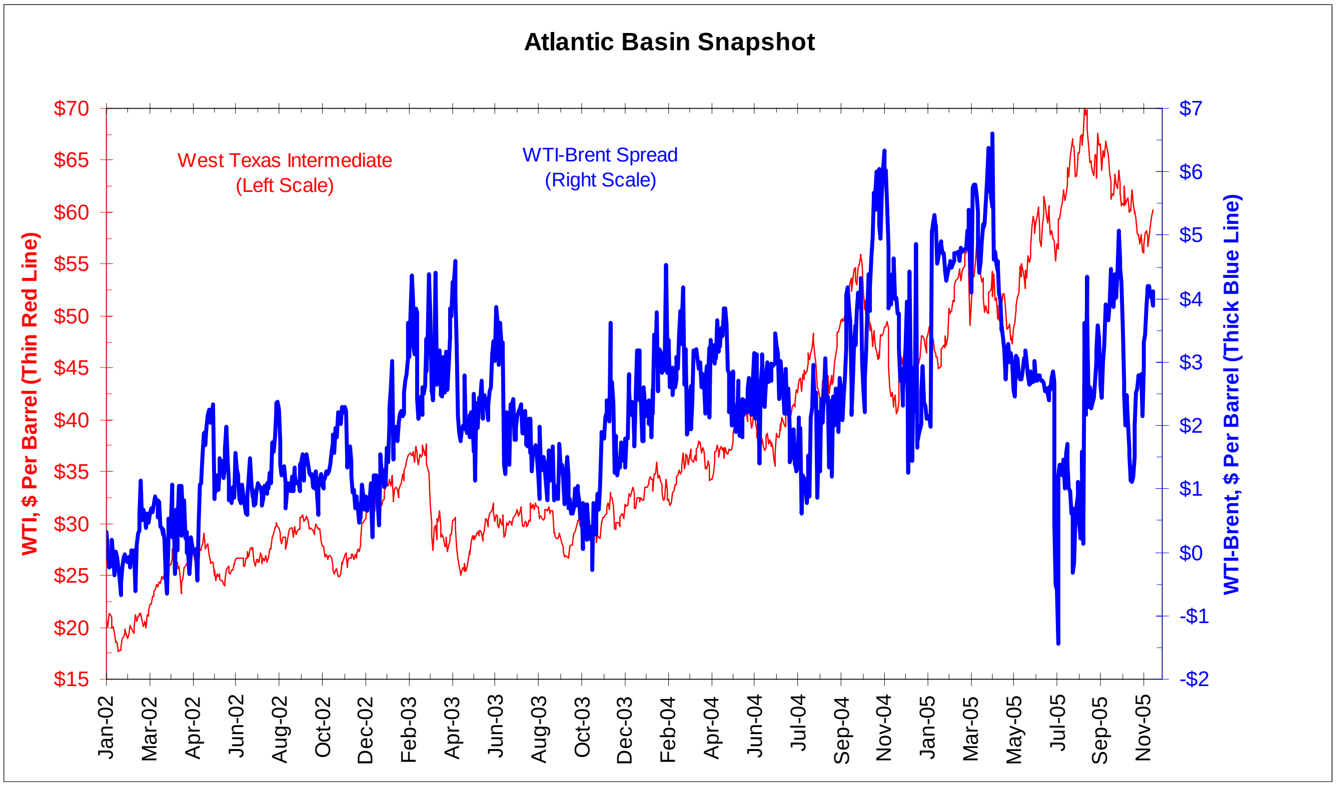


As refinery operations expand, less-efficient units are brought on-stream. Many of these only can process the more expensive sweet (low-sulfur) crude oil. A rising spread between sweet and sour crude oil (thick blue line) is supportive of price (thin red line) as it occurs only during periods of rising demand when refiners will pay up for sweet crude oil. **This, too, is bullish.**



A third indicator of strong U.S. crude oil demand is the spread between West Texas Intermediate (thin red line) and North Sea Brent Blend crude oil. Brent is delivered in discrete cargoes by tanker whereas WTI is delivered continuously by pipeline. The higher transport cost of Brent mandates a lower bid by refiners to make the two crude oils equivalent at delivery.

Rising demand in the U.S. expands this spread (thick blue line) as U.S. refiners bid for higher cost Atlantic Basin sweet crude oils from the North Sea and West Africa. This spread is at high, but not unusual, levels and is expanding.



Conclusion

The global economy has been able to weather higher crude oil prices because they are the result of strong economic growth and not a supply shock. Energy prices are simply a factor input to production, and so long as the benefits of heating your home or operating your factory exceed the cost of fuel, you will do so. If crude oil prices are being pushed up by higher demand, then the benefits using energy also rise, which justifies a higher price. This is the catalyst behind the rally of the last few years.

The weekly focus on petroleum inventory data is misplaced. These are supply numbers, and unless they have changed by more than a few hours' worth of demand, they are noise. We need to focus on the intersection of supply and demand. The industry spreads, an admittedly more arcane set of data, provide the signal on which we should focus. These are still supportive of high petroleum prices.

Bianco Research L.L.C.

1731 North Marcey, Suite 510
Chicago IL 60614

Phone: (847) 304-1511 Fax (847) 304-1749
e-mail: research@biancoresearch.com
http://www.biancoresearch.com

For more information about the contents/ opinions contained in these reports:

President (847) 756-3599
James A. Bianco jbianco@biancoresearch.com

Strategist/Analysts (847) 304-1511
Howard L. Simons hsimons@biancoresearch.com
Greg Blaha gblaha@biancoresearch.com
Neil Bouhan nbouhan@biancoresearch.com

For subscription/service Information:

Arbor Research & Trading, Inc.
Director of Sales & Marketing (800) 625-1860
Fritz Handler fritz.handler@arborresearch.com
Peter Forbes peter.forbes@arborresearch.com

Arbor Research & Trading, Inc.

1000 Hart Road, Suite 260
Barrington IL 60010

Phone (847) 304-1560 Fax (847) 304-1595

e-mail inforequest@arborresearch.com
http://www.arborresearch.com

For more information about Arbor Research & Trading and its services:

Chicago Sales Office

1 N. LaSalle Street, 40th Floor
Chicago IL 60602
Daniel Lustig dan.lustig@arborresearch.com
Phone (866) 877-0266

New York Sales Office

230 Park Avenue, Suite 2425
New York, NY 10169
Edward T. McElwreath ed.mcelwreath@arborresearch.com

Phone (212) 867-5326 Fax (212) 370-1218

For more information about Arbor Research & Trading and its services:

Director of International Sales (847) 756-3510
James L. Perry james.perry@arborresearch.com

London Sales Office

75 Cannon Street London England EC4N 5BN

Phone 44-207-556-7309 Fax 44-207-556-7468

For more information:

Director of Arbor (UK) 44-207-556-7309
Neil Tritton neil.tritton@arborresearch.com
Ben Gibson ben.gibson@arborresearch.com