

PERITUS

ASSET MANAGEMENT, LLC

Market Commentary

Independent Credit Research – Leveraged Finance – February 2013

STATE OF DISARRAY: OIL MARKETS, KEYSTONE AND THE BEGINNING OF THE END

“As long as countries like China keep going all-in on clean energy, so must we.”

President Obama, State of the Union Address, 2-12-13

Thoughts

As many Americans did, I sat through another State of the Union speech by President Obama. Though it would be great sport to dissect this oration, let's focus on the topic of great concern to us: oil prices. The quote above was from this week's speech. This is either a) stupidity, b) disinformation, c) a lie or d) something worse. China is all in on clean energy? Really? Here are the facts. China is the largest producer of coal and the largest importer of coal in the world. Did the White House forget to pay its cable bill? Recent television footage from Beijing showed people barely visible to each other an arms-length away, needing masks to even go outside. China is the fastest growing consumer of oil in the world. Currently, they rank in second place behind the U.S. in consumption, but their appetite is just beginning, as they are now the largest automobile market in the planet.

This week saw another protest regarding the northern leg of the Keystone XL pipeline in front of the White House. The Executive Director of the Sierra Club and actress Daryl Hannah were both arrested. Hey America, China is one of the largest owners and financiers in the Alberta oilsands, which ranks among the largest oil reserves in the world. Athabasca Oilsands, Sunshine Oilsands, MEG Energy and a host of other producers are being financed by Sinopec, PetroChina and CNOOC. To put an exclamation on that, CNOOC (China's National Offshore Oil Company) just received final clearance for the total purchase of Canadian-based Nexen this week! Would it surprise you to know that the Sierra Club receives a great deal of money from China?¹ And why not? After all, the Chinese are “all-in” on that clean energy, right? So if we kill the Keystone XL pipeline, we force the Canadians further into the hands of the Chinese. Make no mistake, that oil will make its way west onto Chinese vessels. For us it will be checkmate.

The news gets worse. The Chinese are in the process of completing a giant loan to the Kremlin so that Russian-based Rosneft can complete the acquisition of TNK-BP to become the biggest oil producer in the world. And for it, the Chinese are getting paid in oil. The Chinese have also been lending money to Hugo Chavez so that Venezuela can ship oil to them in return.² While North America panders to special interest groups, the Russians, the Chinese, the Saudis and Venezuelans are linking themselves together. Do you think there will be a protest on the steps of the Kremlin when they want to add to Transneft's pipeline? Do you think Daryl Hannah and the Sierra Club Executive Director will commit acts of “civil disobedience” in front of Mr. Putin, as they just completed in the U.S.?

¹ Levant, Ezra. *Ethical Oil: The Case for Canada's Oil Sands*. McClelland & Stewart, 2010.

² Devereux, Charlie, “China Bankrolling Chavez's Re-Election Bid With Oil Loans,” Bloomberg, September 26, 2012.

Aren't communism and dictatorships (China, Russia, Venezuela and Saudi Arabia) much more closely aligned than democracy? Ask yourself another question. As oil prices march stubbornly higher even in the face of mediocre growth, who benefits most? Climate change is absolutely occurring. The climate is becoming much more dangerous and unstable with each passing week. Not the pseudo-science and theories of global warming, but the growing reality of who is going to be ruling the world over the coming decades. Not to worry though because none of these countries have any interest in anything but going green and peacefully co-existing in the world today. Just ask Japan about China's recent military forays or perhaps your memory needs to be jogged about Russia just turning off the gas to some of their former territories, literally freezing them.

I have been an investor in the energy space for over 25 years. Outside of interest rates, I don't believe there is anything that dominates the global economy more than oil prices. It is a product that touches every area of our lives. Like it or hate it, that is the reality. In my opinion, there is something dramatically wrong, as crude oil and gasoline prices are near all-time highs, yet the global economy remains stuck in neutral. I believe that we are being fed a bunch of nonsense with the rhetoric that the U.S. will be energy independent and that new technologies have released a torrent of new oil reserves. The price action is telling us something else entirely. Some takeaways are as follows:³

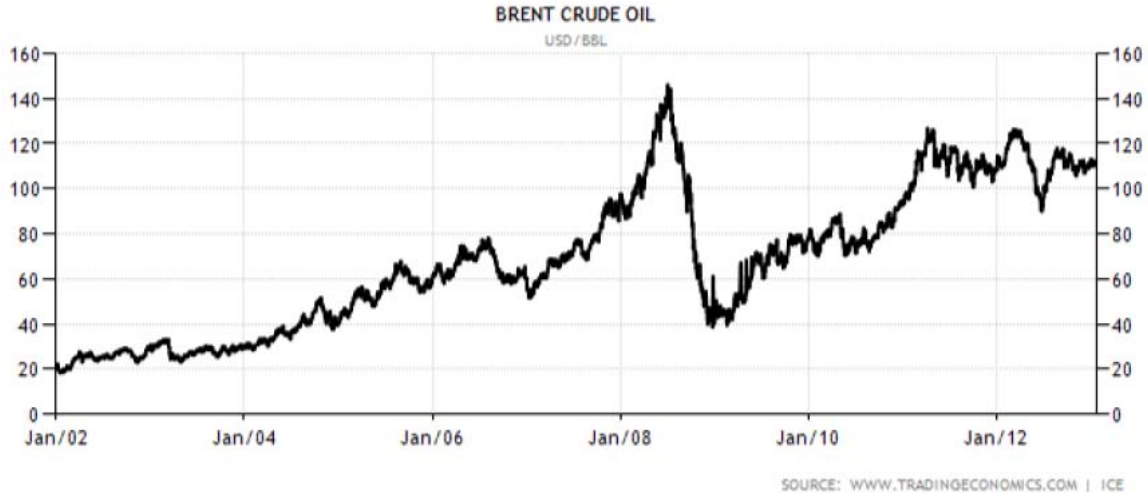
- Global demand is slowly growing, but by itself does not explain the massive price move we have seen.
- U.S. energy independence is a myth, as we are producing 7 million barrels per day of oil and consuming 19 million barrels per day.
- Newly tapped shale oil reserves such as the Bakken and Eagle Ford are not traditional oil reservoirs. These wells are expensive and possess high decline rates and short production lives.
- Russia is the world's largest oil producer, with Saudi Arabia running a close second. Saudi Arabia is now its own biggest client and China is their second biggest.
- A list of some of the bigger producers is a who's who of dictators and despots. It would be safe to assume that re-investment into long lived production or infrastructure is not their top priority. Sustainability of current production seems unlikely.
- China is the fourth largest oil producer and the second biggest consumer, and growing rapidly. They are lending money to both Russia (world's biggest producer) and Venezuela (world's largest oil reserves) to secure future production/supply.

Oil Price Action

If the world is awash in oil given all of these new technologies and shale oil, why is Brent Crude near \$120? This has occurred against a backdrop of terrible global economic growth. Starting in mid-2007, oil prices began to rise dramatically from \$50 to approximately \$150.⁴ While speculation may have played a partial role, there is much more to the story.

³ Consumption and Production data and rankings based upon: Half, Antoine, "Oil Market Reports," International Energy Agency, January 18, 2013. © OECD/IEA 2013

⁴ Data sourced from www.tradingeconomics.com, covering the period January 2002 to February 2013.



The spectacular rise was followed by a collapse, but this collapse was short lived. By mid-2009, oil prices were once again back above \$75.

Demand Data

The dramatic rise in prices in early 2008 and then the comeback in 2009 does not appear to be demand driven, as global consumption was essentially unchanged during that period of time.⁵

year	consumption	change
2007	85,803.09	0.79 %
2008	85,433.89	-0.43 %
2009	84,574.45	-1.01 %

While demand has grown to around 89 million barrels per day, this represents an annual compounded growth rate of about 0.8% from the end of 2007.⁶ While certainly helping, this type of growth does not seem to explain the current \$120 price of Brent crude.

SUMMARY OF GLOBAL OIL DEMAND																
	2010	1Q11	2Q11	3Q11	4Q11	2011	1Q12	2Q12	3Q12	4Q12	2012	1Q13	2Q13	3Q13	4Q13	2013
Demand (mb/d)																
Americas ¹	24.14	24.24	23.81	24.21	23.99	24.06	23.51	23.81	23.89	24.07	23.82	23.61	23.60	23.99	24.13	23.84
Europe ²	14.65	14.28	14.16	14.70	14.11	14.31	13.75	13.78	13.82	13.85	13.80	13.36	13.32	13.78	13.79	13.56
Asia Oceania ³	8.10	8.60	7.36	7.98	8.58	8.13	9.08	7.97	8.23	8.60	8.47	9.02	7.86	8.03	8.38	8.32
Total OECD	46.89	47.11	45.33	46.88	46.68	46.50	46.34	45.56	45.94	46.52	46.09	45.99	44.78	45.81	46.30	45.72
Asia	19.65	20.36	20.32	19.80	20.65	20.28	20.88	20.70	20.58	21.67	20.96	21.57	21.51	21.26	22.12	21.62
Middle East	7.32	6.92	7.38	7.82	7.34	7.37	7.12	7.70	8.05	7.51	7.60	7.33	7.85	8.25	7.71	7.79
Latin America	6.04	6.05	6.26	6.47	6.38	6.29	6.25	6.45	6.63	6.65	6.50	6.42	6.61	6.84	6.73	6.65
FSU	4.15	4.22	4.36	4.58	4.57	4.43	4.45	4.47	4.66	4.68	4.57	4.59	4.64	4.82	4.87	4.73
Africa	3.30	3.34	3.31	3.19	3.33	3.29	3.40	3.38	3.39	3.46	3.41	3.50	3.53	3.53	3.58	3.53
Europe	0.68	0.66	0.68	0.71	0.72	0.69	0.68	0.73	0.72	0.73	0.72	0.69	0.73	0.75	0.74	0.73
Total Non-OECD	41.14	41.55	42.31	42.56	42.99	42.36	42.79	43.42	44.03	44.71	43.74	44.10	44.87	45.45	45.75	45.05
World	88.02	88.66	87.64	89.44	89.68	88.86	89.13	88.98	89.98	91.23	89.83	90.08	89.65	91.25	92.05	90.76

⁵ Data sourced from Index Mundi, www.indexmundi.com/energy/asp.., who gathered data from the United States Energy Information Administration.

⁶ Halff, Antoine, "Oil Market Reports," International Energy Agency, January 18, 2013, p. 63. © OECD/IEA 2013

U.S. Energy Independence?

Let us expose the next myth, namely that the United States will be energy independent in the near future. The fact is that the U.S. consumes approximately 19 million barrels of oil per day.⁷ Actual oil production in 2013 should average just over 7 million barrels per day. The statistics often seen of production close to 10 million barrels per day includes biofuels, such as ethanol, not purely oil.

OIL DEMAND IN SELECT OECD COUNTRIES⁸

(million barrels per day)

	2010	2011	4Q11	1Q12	2Q12	3Q12	Aug 12	Sep 12	Oct 12 ²	Latest month vs.	
										Sep 12	Oct 11
United States³											
LPG	2.17	2.28	2.42	2.38	2.11	2.19	2.20	2.24	2.41	0.17	0.16
Naphtha	0.26	0.26	0.26	0.26	0.25	0.22	0.24	0.21	0.26	0.05	-0.02
Motor Gasoline	8.99	8.76	8.63	8.49	8.96	8.86	9.15	8.57	8.71	0.13	0.05
Jet/Kerosene	1.45	1.44	1.40	1.36	1.45	1.45	1.48	1.38	1.35	-0.04	-0.04
Gasoil	3.80	3.90	3.99	3.83	3.73	3.66	3.75	3.69	3.84	0.15	-0.17
Residual Fuel Oil	0.54	0.46	0.44	0.42	0.35	0.35	0.35	0.29	0.28	-0.01	-0.13
Other Products	1.97	1.90	1.80	1.75	1.88	2.00	2.13	1.82	1.95	0.13	0.01
Total	19.18	19.01	18.94	18.49	18.72	18.73	19.30	18.20	18.78	0.58	-0.12

Americas

US – December preliminary, Alaska actual, other states estimated: US crude oil production grew by almost 900 kb/d y-o-y in December to 6.9 mb/d. **Based on this preliminary estimate, 2012 output grew by a total of 780 kb/d to 6.4 mb/d.** In addition to revisions to October estimates from EIA's *Petroleum Supply Monthly*, 1Q-3Q12 historical production data were also adjusted upwards slightly by around 30 kb/d based on EIA's revisions. For the week ending 4 January, EIA data showed that production reached over 7 mb/d, a level not seen for 20 years. **In 2013, US crude output is forecast to grow by around 600 kb/d y-o-y to around 7.1 mb/d,** 170 kb/d higher than previously estimated. Despite the

While certainly impressive, production growth is likely to slow. Horizontal drilling and fracking have aided domestic production, but what is not being discussed is that decline rates of individual wells in both the Bakken and Marcellus shales are very high. These are not conventional oil reservoirs and they don't act like them. These wells have short production lives and are very expensive and time consuming to drill.

Production Data

Let us turn our attention to production data. Who is the largest oil producer in the world today? My first thought would be Saudi Arabia. However that is incorrect. While they are running neck and neck, the correct answer is Russia. However, if we broaden it out to include the former USSR territories, they are the biggest producers by a significant margin. While this is not a comfortable proposition, the news gets much worse. Here is a list of some of the more "interesting" producers in the world today.⁹

⁷ Halff, Antoine, "Oil Market Reports," International Energy Agency, January 18, 2013, p. 65. © OECD/IEA 2013

⁸ Halff, Antoine, "Oil Market Reports," International Energy Agency, January 18, 2013, p. 65, 20. Emphasis added. © OECD/IEA 2013

⁹ Barrels per day production data sourced from Halff, Antoine, "Oil Market Reports," International Energy Agency, January 18, 2013, p. 66.

<u>Country</u>	<u>Leadership</u>	<u>Millions of Barrels per Day</u>
Russia/Former USSR	Vladimir Putin	13.8
Iraq*	Nouri al-Maliki	3.0
Iran	Mahmoud Ahmadinejad	2.7
Venezuela	Hugo Chavez	2.5
Nigeria*	None-Chaos	2.1
Angola	Jose Eduardo dos Santos	1.7
Libya*	Mohammed Magarief	1.4
Algeria	Abdelaziz Bouteflika	<u>1.2</u>
		28.4

* Iraq, Nigeria and Libya are all dealing with transition governments.

Total production for these “democratic friends of the U.S.” equates to 28.4 million barrels per day, or almost 30% of the world’s daily production. When the market talks about a “fear premium,” it appears well justified. Ask yourself, how many of these countries are politically stable and are concerned about re-investing into infrastructure to maintain production rates? Dictators, despots and basically lack of/transitional governments dominate the list. Regime change (Iraq, Libya, Nigeria, and perhaps Venezuela soon) rarely leads to production increases.

Final Thoughts

The oil business is a zero sum game. High oil prices will likely continue to suppress growth in the developed world as the U.S., Japan and Europe are captive to these imports. China is securing supplies from the biggest producer and biggest reserve holder. My suggestion is to approve the Keystone XL yesterday before that oil finds its way to the west coast of Canada and off to China. This is not a matter of having excess supply, it is a matter of our survival.

And the implications reach further than just the oil markets. Understand that the Chinese hold somewhere around \$3.5 trillion of foreign currency reserves. Approximately \$1 trillion of that is in U.S. Treasury bonds. They are leaving the U.S. dollar, and I believe that is a major reason why the Federal Reserve is doing QE-4(ever). Since we do not want to deal with our unsustainable and growing debt, the Fed will be the last buyer of Treasury bonds, taking up the slack from China. How’s that for a Ponzi scheme? Printing money to buy your own money.

Back to their Russian oil loan, with an already massive amount of dollars in foreign exchange reserves, China is now buying oil with their money, not re-investing in the Treasury market. Now that the U.S. growth rates have been exploited they will simply turn their attention to their domestic economy. By not re-investing in the U.S. dollar, the dollar will fall and the Yuan will begin to soar. This will dramatically help the Chinese consumer-based economy as import prices fall. And what is one of their biggest costs going forward: oil.

WORLD OIL PRODUCTION¹⁰

(million barrels per day)

	2011	2012	2013	3Q12	4Q12	1Q13	2Q13	3Q13	Oct 12	Nov 12	Dec 12
OPEC											
Crude Oil											
Saudi Arabia	9.04	9.59		9.60	9.39				9.69	9.39	9.10
Iran	3.62	3.00		2.81	2.71				2.72	2.70	2.70
Iraq	2.67	2.95		3.07	3.12				3.20	3.21	2.97
UAE	2.50	2.65		2.69	2.67				2.67	2.65	2.68
Kuwait	2.24	2.46		2.47	2.51				2.52	2.48	2.52
Neutral Zone	0.59	0.56		0.54	0.52				0.52	0.52	0.52
Qatar	0.74	0.74		0.75	0.73				0.73	0.73	0.74
Angola	1.66	1.75		1.72	1.74				1.73	1.75	1.73
Nigeria	2.18	2.10		2.17	1.99				1.98	1.88	2.10
Libya	0.46	1.39		1.43	1.42				1.42	1.45	1.40
Algeria	1.18	1.17		1.18	1.16				1.12	1.18	1.18
Ecuador	0.50	0.50		0.50	0.50				0.51	0.50	0.50
Venezuela	2.50	2.50		2.52	2.48				2.48	2.47	2.50
Total Crude Oil³	29.88	31.36		31.45	30.94				31.29	30.90	30.64
Total NGLs ^{1,6}	5.78	6.20	6.48	6.31	6.33	6.34	6.36	6.60	6.33	6.33	6.33
Total OPEC⁴	35.65	37.56		37.76	37.27				37.62	37.23	36.97
OPEC: Historical Composition ⁵	35.65	37.56		37.76	37.27				37.62	37.23	36.97
NON-OPEC²											
OECD											
Americas ⁷											
United States ⁸	8.13	9.10	9.77	9.06	9.59	9.65	9.68	9.76	9.58	9.58	9.62
Mexico	2.94	2.92	2.84	2.93	2.92	2.87	2.84	2.83	2.88	2.93	2.96
Canada	3.51	3.76	4.09	3.66	3.92	4.06	4.01	4.09	3.79	3.91	4.05
Chile	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.02
Europe ⁹	3.77	3.45	3.25	3.14	3.28	3.41	3.21	3.07	3.14	3.25	3.44
UK	1.11	0.95	0.85	0.82	0.87	0.97	0.85	0.73	0.73	0.91	0.98
Norway	2.04	1.91	1.82	1.75	1.82	1.85	1.78	1.78	1.83	1.75	1.87
Others	0.61	0.60	0.57	0.58	0.59	0.59	0.58	0.57	0.58	0.59	0.59
Asia Oceania ⁷	0.57	0.58	0.55	0.51	0.65	0.51	0.54	0.57	0.67	0.63	0.64
Australia	0.48	0.49	0.47	0.53	0.57	0.43	0.46	0.49	0.59	0.55	0.56
Others	0.09	0.08	0.08	0.08	0.08	0.08	0.08	0.08	0.07	0.08	0.08
Total OECD	18.93	19.83	20.50	19.41	20.36	20.52	20.28	20.33	20.06	20.31	20.72
NON-OECD											
Former USSR											
Russia	13.58	13.70	13.62	13.60	13.83	13.76	13.64	13.42	13.82	13.90	13.78
Others	10.60	10.73	10.66	10.71	10.81	10.76	10.68	10.53	10.80	10.85	10.79
Asia	2.98	2.97	2.96	2.89	3.02	3.00	2.96	2.89	3.02	3.05	2.99
China	7.68	7.72	7.72	7.71	7.77	7.78	7.75	7.70	7.75	7.79	7.77
Malaysia	4.10	4.17	4.24	4.17	4.25	4.23	4.25	4.25	4.26	4.28	4.23
India	0.65	0.66	0.66	0.65	0.65	0.66	0.65	0.66	0.65	0.65	0.66
Indonesia	0.91	0.90	0.91	0.91	0.90	0.93	0.91	0.90	0.89	0.89	0.93
Others	0.93	0.87	0.82	0.85	0.85	0.85	0.83	0.81	0.84	0.85	0.85
Europe	1.09	1.11	1.09	1.13	1.11	1.10	1.10	1.09	1.11	1.12	1.10
Latin America	0.14	0.14	0.13	0.14	0.13	0.13	0.13	0.13	0.14	0.13	0.13
Brazil ²	4.23	4.18	4.28	4.10	4.20	4.21	4.27	4.28	4.15	4.15	4.28
Argentina	2.19	2.15	2.27	2.07	2.15	2.23	2.27	2.25	2.10	2.13	2.22
Colombia	0.69	0.67	0.62	0.68	0.66	0.63	0.62	0.62	0.68	0.65	0.66
Others	0.92	0.95	1.00	0.94	0.98	0.96	1.00	1.01	0.96	0.97	0.99
Middle East ³	0.43	0.41	0.39	0.41	0.41	0.39	0.39	0.39	0.41	0.40	0.41
Oman	1.65	1.46	1.47	1.50	1.48	1.45	1.47	1.47	1.50	1.49	1.44
Syria	0.89	0.92	0.95	0.93	0.94	0.92	0.94	0.97	0.94	0.93	0.94
Yemen	0.33	0.16	0.14	0.16	0.16	0.15	0.14	0.14	0.16	0.16	0.15
Others	0.23	0.18	0.18	0.21	0.19	0.19	0.19	0.18	0.21	0.21	0.16
Africa	0.20	0.19	0.19	0.19	0.19	0.19	0.19	0.19	0.19	0.19	0.19
Egypt	2.60	2.31	2.40	2.25	2.29	2.32	2.38	2.43	2.28	2.29	2.29
Gabon	0.74	0.73	0.72	0.73	0.73	0.73	0.73	0.72	0.73	0.73	0.73
Others	0.25	0.25	0.25	0.24	0.25	0.25	0.25	0.24	0.25	0.25	0.25
Total Non-OECD	29.88	29.50	29.61	29.30	29.70	29.65	29.64	29.43	29.64	29.75	29.70
Processing Gains ⁴	2.11	2.14	2.16	2.16	2.13	2.16	2.16	2.20	2.09	2.16	2.15
Global Biofuels ⁵	1.87	1.87	2.02	2.14	1.90	1.61	2.03	2.34	2.09	1.94	1.67
TOTAL NON-OPEC⁴	52.78	53.34	54.32	53.01	54.09	53.97	54.11	54.30	53.88	54.16	54.25
Non-OPEC: Historical Composition ⁵	52.78	53.34	54.32	53.01	54.09	53.97	54.11	54.30	53.88	54.16	54.25
TOTAL SUPPLY	88.44	90.90		90.77	91.37				91.50	91.39	91.22

1 Includes condensates reported by OPEC countries, oil from non-conventional sources, e.g. Venezuelan Orimulsion (but not Orinoco extra-heavy oil), and non-oil inputs to Saudi Arabian MTBE. Orimulsion production reportedly ceased from January 2007.

2 Comprises crude oil, condensates, NGLs and oil from non-conventional sources

3 Includes small amounts of production from Jordan and Bahrain.

4 Net volumetric gains and losses in refining and marine transportation losses.

5 As of the July 2010 OMR, Global Biofuels comprises all world biofuel production including fuel ethanol from the US and Brazil.

6 Total OPEC comprises all countries which were OPEC members at 1 January 2009. OPEC Historical Composition comprises countries which were OPEC members at that point in time.

7 Total Non-OPEC excludes all countries that were OPEC members at 1 January 2009. Non-OPEC Historical Composition excludes countries that were OPEC members at that point in time.

8 As of the August 2012 OMR, includes Latvia.

9 As of the August 2012 OMR, includes Estonia and Slovenia.

10 As of the August 2012 OMR, includes Israel.

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