The Hightower Report

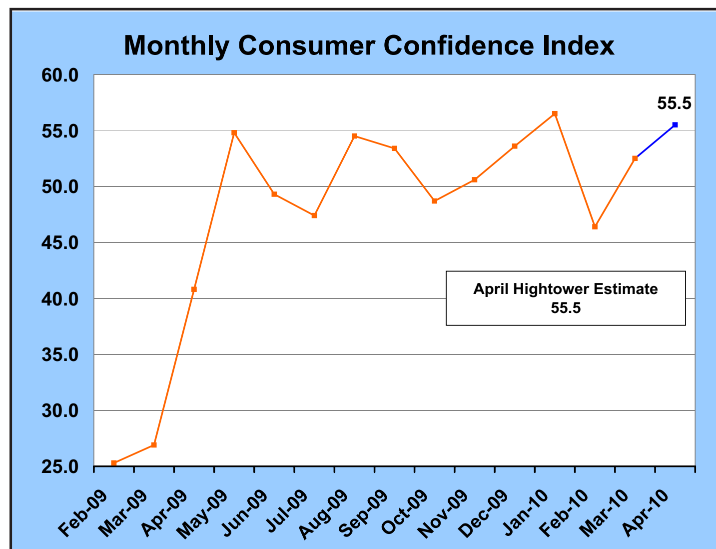
Futures Analysis & Forecasting

141 W. Jackson Boulevard
Suite 4002
Chicago, IL 60604
312.786.4450 / 800.662.9346

Natural Gas: Positioning for a Major Bottom

April 23, 2010

The global economy continues claw its way toward recovery and is doing so despite the added weight of Euro zone debt travails and legal wrangling in the US. The evidence of forward motion is quite compelling, with various economic readings flashing positives, corporate earnings showing improvement in revenues and profits, and very impressive ongoing evidence that China continues to be an ultra-strong engine of global growth.



In addition to favorable retail sales readings and the initial positive US Non-farm payroll reading, other positive economic developments have caught our eye. Perhaps one of the more subtle ones is news that Colonial Pipeline has recently seen a string of days where requests for shipment of gasoline and distillate products were rejected because of capacity constraints in that key US pipeline. Another rather telling sign is that Chinese oil demand rose more than 12% in March, and according to PetroChina, China has seen seven straight months of double-digit energy demand growth. When one also notes that in March Chinese copper concentrate imports were 17% above year ago levels and up 27% from the prior month, it is clear that the Chinese economy is not hitting the skids, contrary to what was predicted by many Wall Street analysts last month.

Within the US, we would like to point out the stellar performance at UPS, which recently managed impressive

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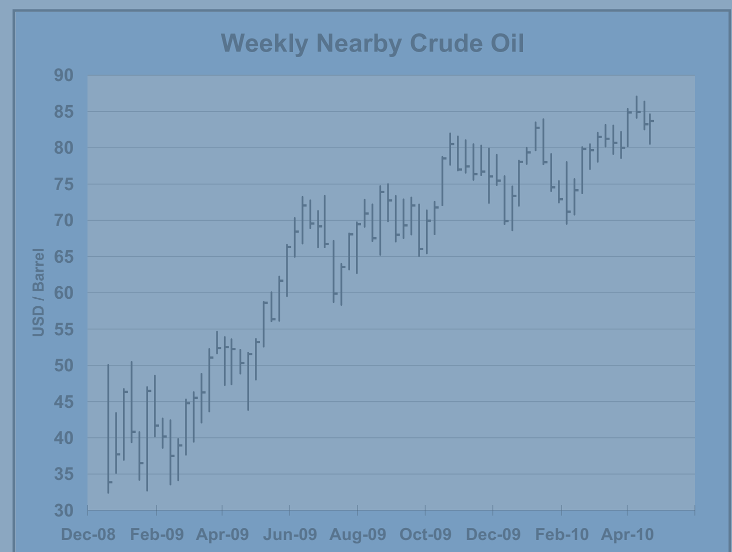
earnings and revenues. With many pundits suggesting that consumers were still wounded and that high energy costs were going to make it hard for companies to perform, the UPS results seem to suggest that the consumer is okay and that many companies can deal with the high oil prices. Many transportation companies have implemented fuel service charges. From our own personal experiences, fuel charges levied on trash pickup, lawn services, etc. have generally remained in place since the $140 crude oil days, and the economy has made allowances. In other words, the economy is recovering and there appears to be a bit of pricing capacity returning.

As for the valuation of equity prices, the pundits have been calling for a "correction" for a large portion of the last four months. Into the April high reversal, those calls were given added credence by the resurgence of EU debt fears and the Goldman lawsuit.

But as we have said a number of times since the beginning of 2009, the equity market gains off the 2009 lows were largely the return of a tide of investment that was forced out of the market in the darkest hours of the sub-prime crisis. Again, the bears are suggesting that the stellar gains in stocks (using the 2009 lows as a starting point) are signaling more growth than can be justified by conditions. Our view is that panic and expectations for a "depression" were factored into the S&P from September 22, 2008 through March 6, 2009 and that the stock market gains since that time have come from scared money flowing back into place, not from funds pricing in a robust economic recovery.

In the event that the economy continues to recover, we suspect that it will in turn lead to even more strength in crude oil and petroleum prices. In our mind, seeing nearby crude oil prices manage a sustained rise above the $90.00 level in the coming months could rekindle energy-related buying interest in markets like sugar, natural gas, corn and soybean oil. Make no mistake about it; certain physical commodities are facing negative supply side issues, but demand and investment interest are showing signs of tempering the supply side threats.

At first blush this report might seem to be mislabeled, as it appears the be more focused on the petroleum complex than natural gas, but the foundation of our bullish view towards natural gas is derived from the pricing and the residual power of the bull market in crude oil.



Developing World Leads Demand Growth

With oil prices climbing back within striking distance of $90 per barrel on the back of rather anemic economic activity, there have been all sorts of claims that energy prices are once again deviating from economic reality. The widely held view in Washington is that speculation is lifting oil prices, not classic fundamentals. And, someone only looking at the *US* market fundamental in the crude oil and gasoline markets might conclude that something other than supply and demand principles are lifting energy prices.

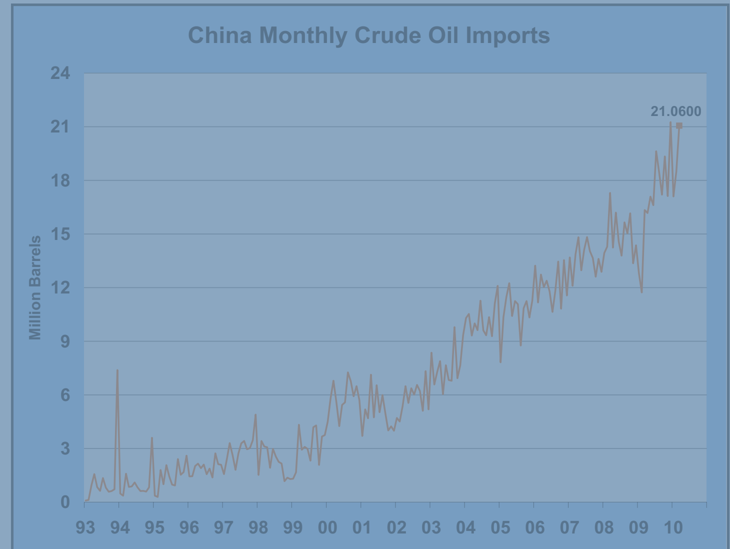
But what is missing in the anti-speculation camp's analysis is the acceptance that the US is losing it's dominance as "the only consumer in town." US energy consumption as a percentage of global deamnd is rapidly declining, and the driving force behind the 2009/10 price recovery has been demand growth from outside the US.

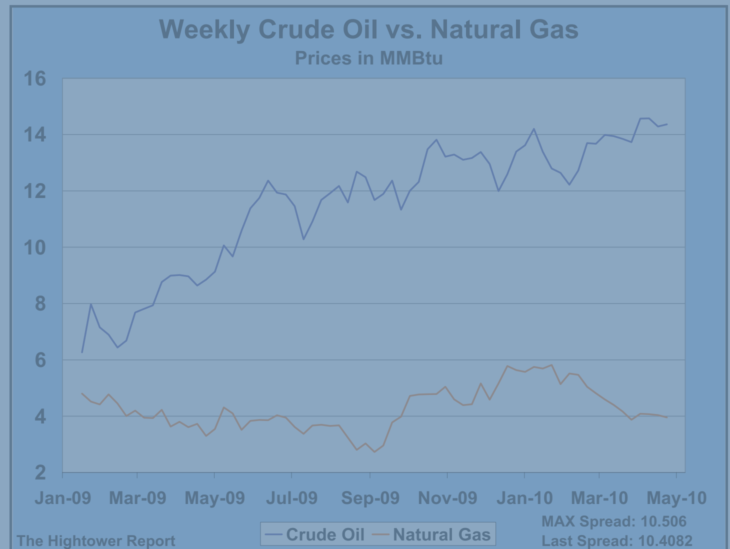
We maintain that the real focus of most energy markets is on the lack of "marginal" global supply. With developing countries like China and India already taking aggressive efforts to secure long term energy supplies at their source, one could suggest that the US' normal supply channels are destined to be "cut off at the pass" by developing country consumers.

A recent US military study (by the Joint Forces Command) suggested that the world oil surplus could be gone as early as 2012, with a worldwide shortage possibly developing by 2015. The basis behind this view is that declining output from traditional petroleum sources will not keep pace with the growth in world demand and that shortages will ensue unless markedly higher prices spark sustained global recessions.

We heard a lot of talk about "Peak Demand" during the sub-prime crisis, and for almost a year that seemed to be a good argument. But in retrospect, sagging demand in developed countries appears to have been offset by soaring demand in developing countries. The EIA thinks that the Chinese oil-import gap is set to go from currently levels of just under 4,000 barrels per day to over 8,000 by the end of 2010.

Just to highlight how important international demand news has become in determining daily energy prices, we compare action in crude oil with the ebb and flow of Chinese economic news. In the week of April 12-16, the US crude oil market mounted a $3.50 rally despite a recovery in the Dollar and in the face of renewed concerns that the US economy was set to falter. We maintain that rally was the result of suggestions from China that 12 of their largest refineries were going to run at record throughput levels for the month of April.

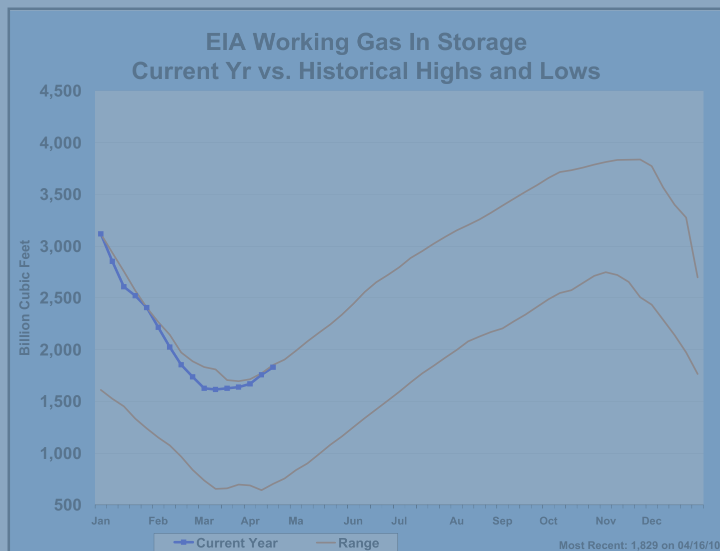




The Internal Story for Natural Gas

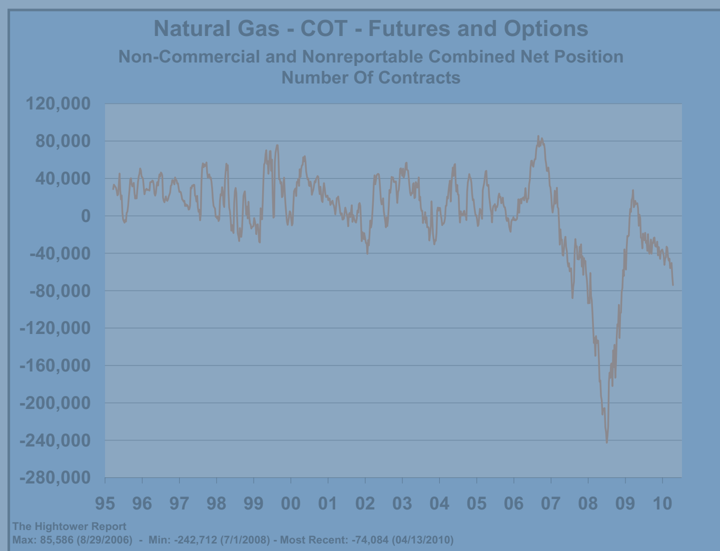
The natural gas market is finally beginning to show fundamental and technical signs of a major bottoming. It might be folly to hope for swift enactment of a U.S. energy policy that would expand the role of natural gas and soak up excess supply. But given the relative price advantage that natural gas has over many other petroleum inputs, the logical course of events should be to a move towards more natural gas usage. Recently the BTU price of natural gas reached 16 month-lows relative to crude oil, and that should begin to get the attention of more users. Perhaps maybe even someone in Washington who is willing to look beyond the tip of their nose.

Clearly, the natural gas market is being weighed down by supply, but a bull market has to begin somewhere, and seeing the EIA revise its 2010 US electricity demand upward is certainly a start.



Throughout most of the price decline from early 2008 into the 2009 low, the natural gas trade seemed to be factoring in a sustained and significant setback in industrial usage. And while there hasn't been any major tightening in the EIA natural gas storage figures, there has been news that overall US supplies might have been overstated by the government.

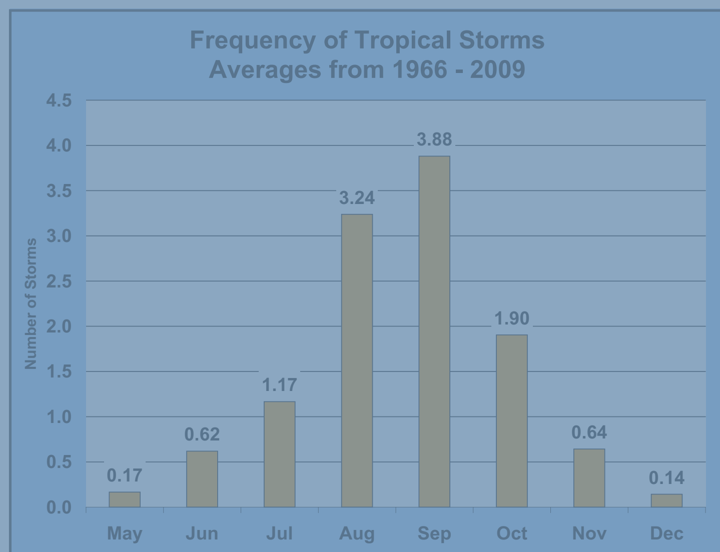
The slide from the 2008 high price of $13.69 per mmbtu to the 2009 low of $2.40 was blamed on fears of a recession or perhaps even a depression. Now that a depression has been averted and the recession seems to be lifting, we suspect that the trade will move to reinsert some premium back into natural gas prices. Recent Commitments of Traders showed speculators holding a rather large net short position in natural gas, in the neighborhood of 74,000 contracts. One would think that the evidence of a sustained recovery would prompt a moderate portion of these shorts to cover their positions.



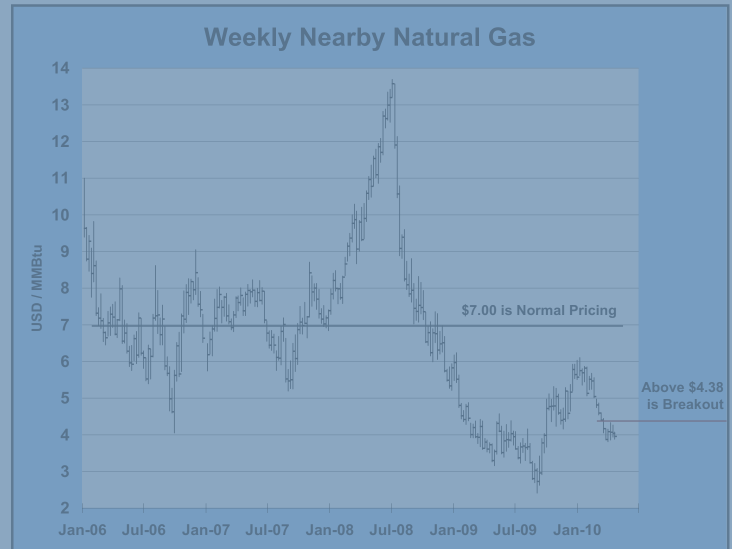
The number of U.S. natural gas rigs in operation has risen off the 2009 lows, but it is still running at nearly half of peak levels. As the economy catches hold and/or consumers decide to use more natural gas, it is possible that demand could improve more quickly than many have expected. So while natural gas stock levels are to be considered flush, it is possible that increased cyclical demand could be joined by "new" demand from petroleum users who are looking for a cheaper fuel alternative. That could be the force behind the initial move off the lows on the charts.

A Threat Against Supply?

Colorado State University's hurricane forecast team is calling for four of the expected eight hurricanes this coming season to be classified as "major" storms, which could serve to spook out some of position shorts in this market. With hurricane threats tamped down over the last two seasons, the energy markets might not be overly concerned with the "potential threat" of weather at this time. However, if there are some signs of storm activity in May (which is early in the annual cycle), attitudes on the weather supply threat could begin to change. As the accompanying chart of tropical storm frequency indicates, some minor activity has historically occurred during the month of May and the markets will probably be watching for those closely this year.



We are only coming into the end of April as of this writing, but the natural gas trade has already seen enough fundamental change and enough positive momentum in the overall economy to begin to have some respect for weather-related threats.



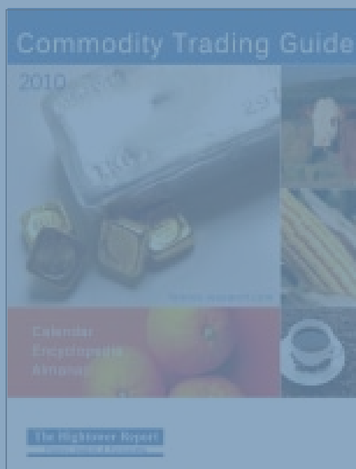
In the meantime, we think that corrective action back down to the $4.00 level in the June natural gas contract should be considered a long term buying opportunity, especially if the spec net short positioning expands beyond the 85,000 contract level. On the other hand, if natural gas prices manage a breakout above the $4.35 level on the weekly charts, it could be the beginning of an initial return to levels above $6.00.

In our opinion natural gas prices will be too cheap until the nearby contract manages a return to the middle of the 2006 through early 208 consolidation zone around $7.00.

Suggested Trading Strategies:

1) Buy September Natural Gas futures at $4.58 and then look to wrap up the position by buying a September Natural Gas $4.40 put and selling a September natural gas $5.25 call for a net cost of $1,800. Use an initial objective of $5.40 basis the futures and an initial objective on the short call of 100 points. Risk the combination to a net loss of $1,900.

2) Buy a September Natural Gas $5.30 call for 220 points with an objective of 395 points. Risk the option to a close below 100.



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