

RMB Special Situation Report

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Special Update

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The Gusher Strategy

Remember Peak Oil? It seems so quaint, doesn't it? The notion that the world might run out of oil is almost laughable in today's post-crash environment. Concerns about the survival of the global banking system, the threat of worldwide depression and the fate of capitalism itself have made the Malthusian, peak-oil arguments of the bulls seemingly irrelevant. Oil's death-defying dive from \$147 to \$35 per barrel cut prices 76% in a mere six months discrediting the bulls. But the black, sticky stuff has fought its way back to the \$100 per barrel mark. Maybe those "peak oil" zealots weren't so crazy after all...

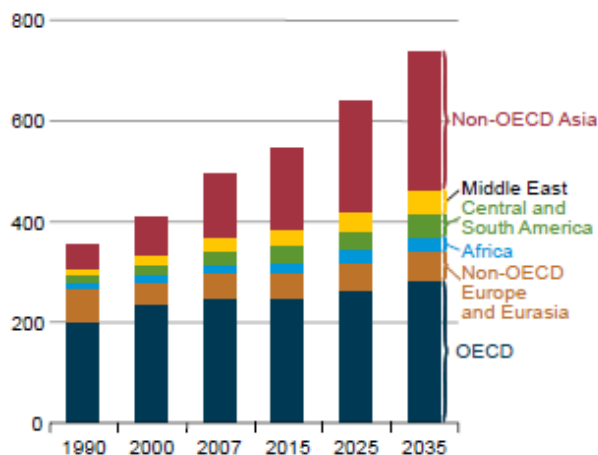
Crude's \$147 per barrel high turned out to be unsupportable. In our opinion, prices much below \$100 per barrel will be equally unsupportable. Stagnant production and the countdown to a nuclear Iran means a new and sudden "crude awakening" could take place very soon. The question is...how do we play it?

John Kenneth Galbraith's warning, "Markets can stay irrational a lot longer than you can remain solvent" describes the current environment perfectly. We need to come up with a strategy that doesn't require a lot of capital, but gives us enough time and staying power to take advantage of the bullish mega-trend in oil we see coming. We'll

outline a *limited risk, long-term, potentially-powerful strategy* in this report - - but before we do, let's examine some of the major fundamental forces that will help put a floor under crude oil prices soon.

Non-OECD nations account for 84 percent of growth in world energy use

Figure 50. World energy consumption by region, 1990-2035 (quadrillion Btu)

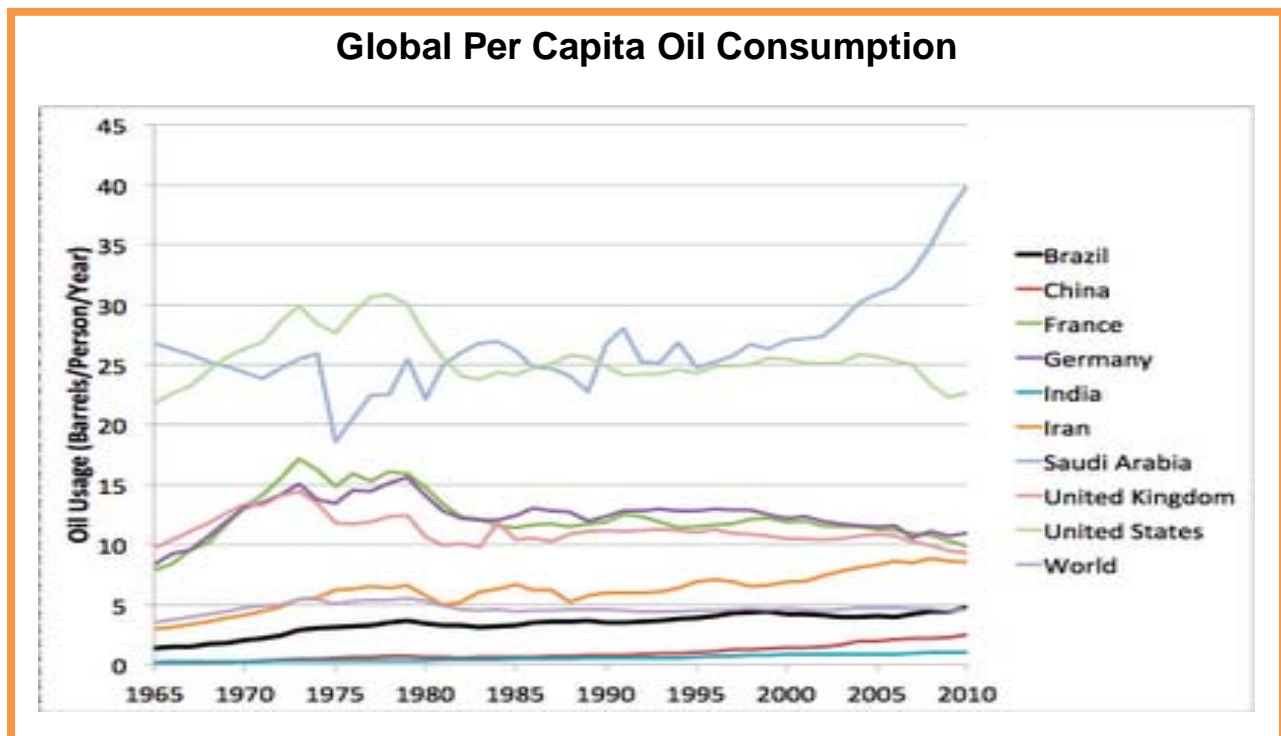


The genie of raised expectations in both the developing world and oil-producing nations is not going back in the bottle any time soon – especially since the developing world has grown accustomed to Western lifestyles. Chinese drivers are not going to turn in their newly-purchased cars and hop back onto their bicycles. Neither are their Indian neighbors. Property developers in Dubai have no plans to ditch their brand new, air-conditioned skyscrapers for Bedouin tents.

Big Populations Mean Growing Demand

China is home to 1.4 billion people. India is home to nearly as many. That means small changes in energy consumption in these two nations alone can have outsized effects. In today's world of raised expectations, their large populations cannot be ignored. In one decade (1995 to 2005), US oil demand grew from 17.7 million barrels per day (mbpd) to 20.7 million – a gain of 17%. Chinese demand rose from 3.4 mbpd to 7 mbpd – an increase of 106%. India's oil imports are expected to triple by 2020, rising to 5 million barrels per day. China, India and the rest of Asia currently account for 60% of the globe's new oil demand. Expect this percentage to grow, despite the pummeling global stock markets took during the recession of 2008.

America, with a population of a little over 300 million, consumes roughly 21 barrels of oil per person per year. Europe, with roughly the same population, burns 10 barrels per person per year. China's per capita consumption is miniscule –approximately 2.5 barrels per person per year. India consumes even less. It doesn't take a math degree to figure out what small increases in consumption in these nations will do to global oil demand.



Indian and Chinese economies are suffering post-crash global slowdowns like everyone else. But both nations are growing at rates almost unimaginable for the developed world. China's growth rate has slowed but still tops 8% which is pretty darn impressive when seen through the lens of the West. India's growth is roughly 7 percent. Both China and India will need to mechanize more and more of their food production to

feed their growing populations. This will require more energy. So will millions of their new appliances and automobiles.

The petrodollars that poured into oil-producing nations during the run-up in crude have increased standards of living to the point where these nations are using more and more of their own oil, leaving less for export. Both infrastructure and electricity are in short supply in China and India, but also in the Mideast as well. Resolving these shortages will require energy. The nations of the Persian Gulf and northern Africa already use almost as much oil as China. Since most of this oil is subsidized, Middle East demand for its own oil is practically guaranteed to increase, leaving even less for export. Oil giant Saudi Arabia's per capita consumption of crude oil is a massive 40 barrels per year.

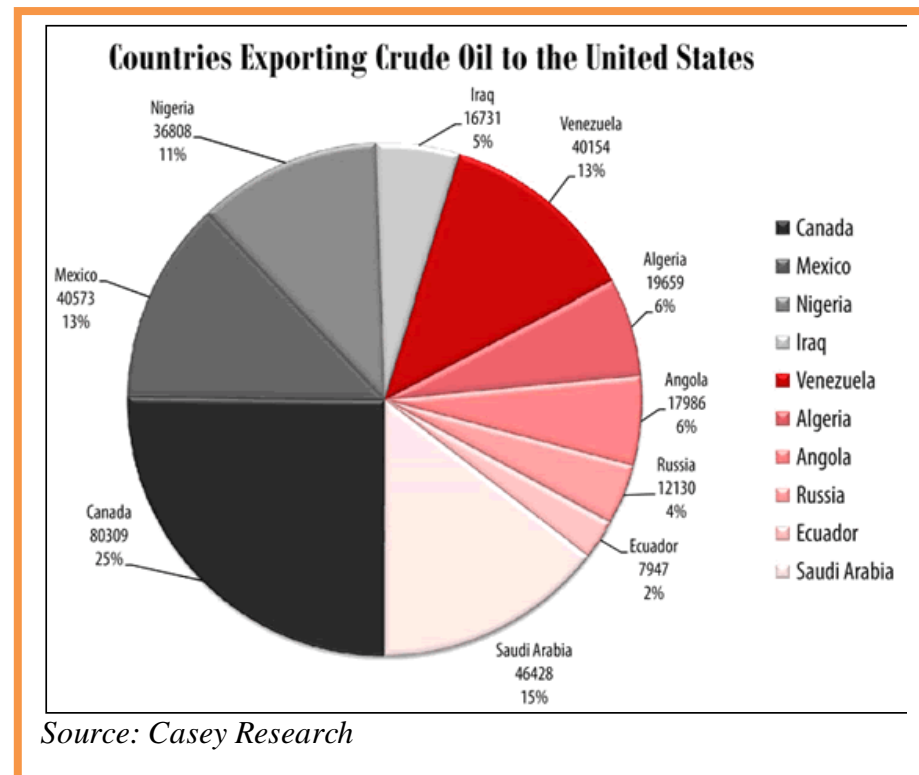
Threats to Supply Still Exist – Especially from Non-OPEC Producers

The US Energy Industry Administration (EIA) believes global production leveled off in 2004 and peaked in 2006. So far they have been proven right. Oil production has remained flat for the past 6 years, despite a series of new discoveries. In 2006, a Saudi Aramco spokesman admitted its most mature fields were depleting by roughly 8% per year. Nine of the world's largest 21 oil fields are in decline. The 10 largest pools of oil reserves are held either by states or by state-owned entities not subject to the forces of

free-market competition. That makes them relatively inefficient.

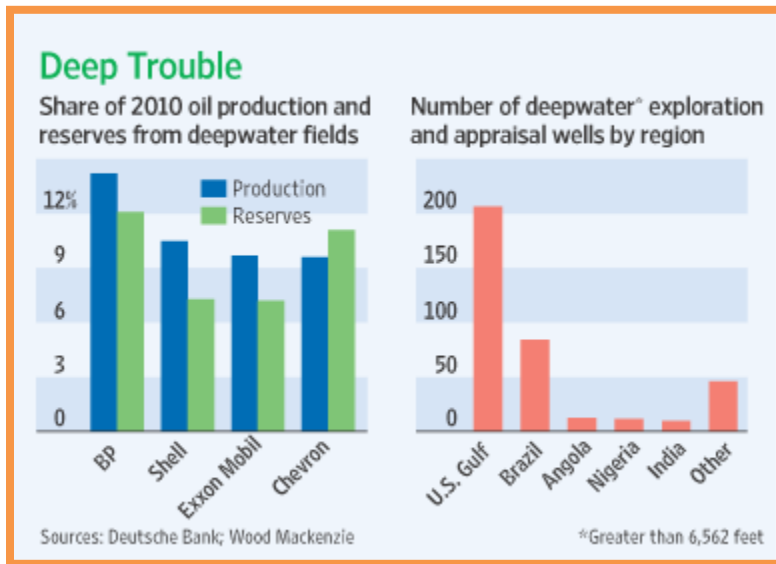
The world may *not be running out of oil, but it is running out of places where it can be extracted inexpensively.*

The chart on the left (courtesy of Casey Research) shows the sources of US imports. OPEC is currently responsible for roughly 40% of the



world's oil production, but doesn't supply the bulk of America's oil. Canada, Africa and Mexico vie for that honor.

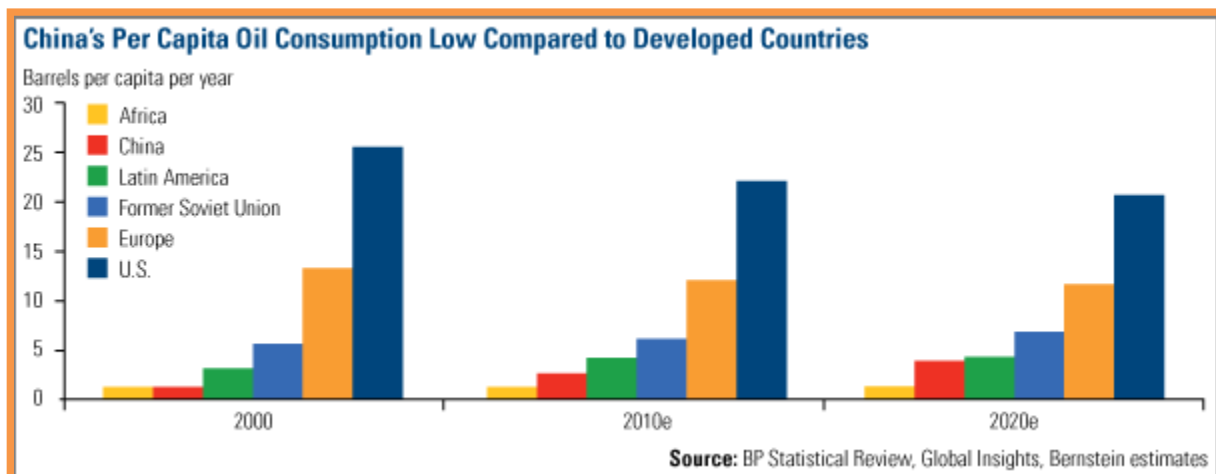
Africa has been an increasingly-important swing producer because it is responsible for a lighter, sweeter version of crude oil that is more easily refined than heavier, sourer Saudi crude. Africa supplies approximately 12% of global oil production. Some analysts predict production will continue be stymied by the high cost of developing African fields and near-endless rebel attacks in unstable areas of Nigeria. Until the African continent sheds its unstable and violent reputation, exploration, drilling and production costs will remain high.



At the same time, production is falling off a cliff in Mexico. The land of mescal produced 2.7 million barrels of oil per day in September 2008 – its lowest output since 1995. Mexico’s overall output fell 10% in the first 9 months and Mexican exports plummeted a whopping 18%. Things have gotten so bad south-of-the-border that the once-fervently nationalistic Mexican government is considering loosening some restrictions on

private development in order to boost production. The global market crash and flight-to-cash have masked these and other ominous long-term threats to supply.

Meanwhile, Venezuela is struggling to maintain basic needs like electricity. Poor electrical service is eroding support for Hugo Chavez in the barrios – the original source of his power. Nationalization of the prolific Venezuelan oil industry has left Chavez’s money machine short of parts, short of expertise and long on commitments to supply oil and gas to other Latin American nations in exchange for political support. Like its cousin Mexico, Venezuelan oil production is in danger of falling off the proverbial cliff.



Middle East Is Aflame

Finally, there is the Middle East. The main source of the world's oil is smoldering and in some cases burning. Revolution is spreading across the oil patch like a virus. And the geopolitical risk is growing... Iran is the third largest producer of oil is getting ever closer to developing a nuclear weapon. The US and UK recently discussed joint action for a potential pre-emptive strike. Israel remains a wildcard. It could preemptively strike Iran with little public notice. Any kind of attack on Iran would send oil prices soaring. \$200 per barrel would not be out of the question.

The question is...how do we play it? Big volatile swings mean we do not want to tie up a lot of capital in energy stocks or ETFs – *both* of which have a long history of underperforming crude oil. Big volatile swings in nearly all markets means we do not want to tie up a lot of capital long or short any market right now. That's why we'd rather "rent" crude oil.

"Renting" Crude Oil for Pennies on the Dollar

We'll do this by using NYMEX crude oil options. NYMEX crude oil options are the most liquid (no pun intended) oil option market in the world – making buying and selling them about as easy as buying and selling most stocks. NYMEX crude options are a *DIRECT PLAY* on the price of the oil itself. *NYMEX crude oil options also provide big leverage with limited risk.* That means we can devote a small amount of capital to our oil investment while keeping the bulk of our hard-earned dollars in safe, interest-bearing instruments. *Unlike a stock or ETF investor, we'll get to "earn interest" on our oil.* How is this possible? We'll explain... But first let's look at how options work.

A Short Course in Options

Buyers of call options pay money, known as a "premium" for the right but not the obligation to be long the underlying market at a specific price for a specific period of time. Call option buyers are not buying the market; they are merely buying the right to be long that market. The option buyer is essentially "leasing" the right to profit from higher crude oil prices. The key phrase is "*but not the obligation.*" Since a call option holder does not have the obligation to buy, all he or she has at risk is the cost of the call option. Should the underlying market (in this case, crude oil) decline or fail to rally before the option expires, the option buyer will simply not exercise the right to buy. That means all he or she has at risk is the premium paid (plus any transaction costs) for the option.

Call option sellers receive money in exchange for the obligation to sell the underlying market (in this case crude oil) for a specific price over a certain timeframe. Notice how this definition is the *exact opposite* of the call option buyer. Instead of paying money, call option sellers *receive money.* Instead of having a "*right to buy*", call

option sellers have an “*obligation to sell.*” Think of it this way: if you are an employer, you pay money to your employees. This gives you the right to tell them what to do. As an employee, you *receive money* from your employer, obligating you to do what your employer tells you. Options work the same way.

As we write this, crude oil is trading at approximately \$100 per barrel. For all the reasons listed in this report, we expect crude oil to bounce and trade well above \$125.00 per barrel within the next few years. Big volatility means the straight-up purchase of call options, while less expensive than the purchase of crude oil or an equivalent dollar amount of energy stocks outright, is still too rich for our blood. What we do instead is take the bulk of this “volatility premium” out of the equation by combining the sale of a call option with a higher strike price with the purchase of an option with a lower strike price. This lowers our risk and leaves us plenty of room for gains.

Fast-growing investor interest in crude oil has driven the prices of more distant “out-of-the-money” crude oil calls to extremely high levels. We want to use the cash we receive for selling these overpriced calls to help pay for calls closer to the market, thereby creating a long term, fixed-risk bullish position with a greater probability of success than the simple purchase of call options outright. This professional trading strategy is known as a “bull call spread.” We call it the “**Gusher Strategy**” because of its potential to yield outsized returns for a relatively small cash outlay.

The “Gusher Strategy”: Just “Set It and Forget It”

The “**Gusher Strategy**” pairs the *right to buy a 1,000-barrel crude oil futures contract at a price of \$125* with the *obligation to sell a 1,000-barrel crude oil futures contract at a price of \$150*. If filled at our recommended price, our total cost and risk will be \$3,000 plus transaction costs for each “bull call spread”. If crude fails to rally above \$125 per barrel by option expiration in November 2015 we can lose the entire amount of our \$3,000 investment plus transaction costs, but no more. If we are right and crude recovers to old highs, we can make as much as \$22,000.

Instead of buying crude oil outright or an equivalent amount of energy stocks, we use the strategy below to “rent” crude instead. Our “lease” is good until the expiration of the December 2015 options – approximately 4 years from now. *We get big exposure to an upside rebound in the world’s most essential commodity for a relatively small cash outlay.*

When we put this trade together, December 2015 \$125 calls were going for \$6.30 each. Multiply times the 1,000 barrel “*contract size*” and you get a dollar cost of \$6,300. Our \$6,300 buys us *the right but not the obligation* to be long a 1,000-barrel crude oil futures contract at a price of \$125 per barrel from now until option expiration in mid-November 2015. Since \$6,300 is more money than we wished to risk on this idea, we looked at other strike prices and discovered the December 2015 \$150 calls were going for

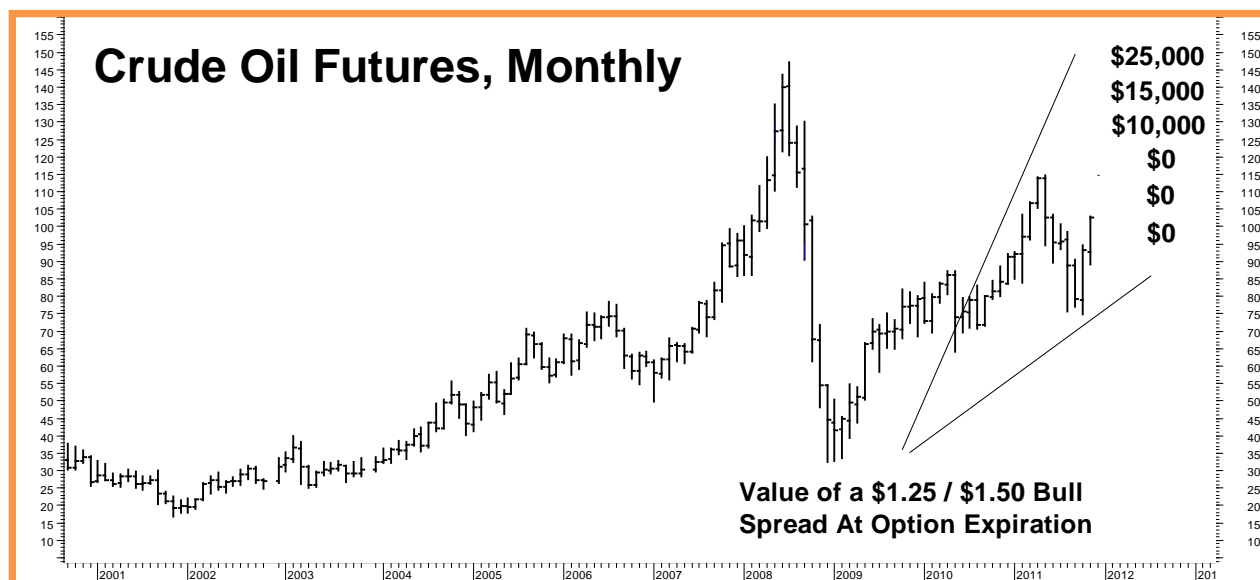
\$3.30. (Multiply times the 1,000-barrel contract size and you get a total dollar value of \$3,300.)

→ **Suggested Action** -- consider placing an order to “buy December 2015 \$125 NYMEX crude oil calls while simultaneously selling an equal number of December 2015 \$150 crude oil calls for a net cost \$3.00 (\$3,000) or less, looking for crude to rally back above \$125 per barrel prior to option expiration in mid-November 2015.

(Note: Prices may have changed, so work with your broker to adjust strike prices based on moves in the underlying crude oil contract.)

By selling the \$150 call we collect \$3,300 for the *obligation to sell crude oil at \$150 per barrel*. We can now use this cash to offset part of the \$6,300 we paid for the \$125 call. Instead of \$6,300, our total cost now is the \$6,300 we pay for the *right to be long* 1,000 barrels of crude at \$125 per barrel *MINUS* the \$3,300 we receive for our *obligation to sell* 1,000 barrels of crude at \$150 per barrel. That makes our total net outlay \$6,300 minus \$3,300 or \$3,000. We have now paired our right to buy at \$125 per barrel with a corresponding obligation to sell at \$150. That means we can make the \$25 difference (\$25,000) – but no more.

The phrase “...net cost of \$3.00 (\$3,000) or less.” tells the broker on the trading floor that we want to do *BOTH* legs of this trade simultaneously and we want to spend no more than a net of \$3,000 for the *entire position*. We do not care at what prices he fills either option, as long as he fills them both, and the result adds up to no more than our specified net price of \$3,000.



(Please Note: the chart above is for educational purposes only and in no way suggests that you will profit from the trading suggestion contained in this report.)

The chart above shows the profile of this trade at option expiration. Subtract the \$3,000 costs of our spreads (plus transaction cost) from the gross profit shown to get net profit potential. Gains will be capped over \$150 per barrel, but there is still plenty of room if we are right and crude bounces as we expect.

Even if we are wrong and crude heads lower, the most we have at risk is \$3,000 plus our transaction cost. We can now take the money we didn't spend to buy crude or crude equivalents and do something safer. 1,000 barrels of crude oil at \$100 per barrel (or its equivalent in stocks or ETFs) would set us back \$100,000. Instead we risk just \$3,000.

As we write this, you can buy a 5-year CD at a three-star bank with a yield of 2.0% APY. Forty eight months of interest on the \$97,000 we didn't have to spend for our bullish crude position works out to roughly \$7,760-- or 2.5 times the \$3,000 cost of our trade. We could lose the entire amount of our long-term option spread and still come out slightly ahead. This is how professionals gain exposure to volatile markets like crude oil without breaking the bank. Now you can do the same. You've, in essence, created your own oil-backed "CD." Better still, the "**Gusher Strategy**" requires little ongoing management so we can basically "set it and forget it."

Getting Started

You cannot trade the options in this report in a stock account. You need a separate commodity account. If you don't have one, the brokers at the **Rutsen Meier Belmont Group (RMB Group)**, know this strategy inside out and can help you implement it. Call them toll-free at **800-345-7026** or **312-373-4970** direct. They'll send you everything you need to get started.

Tell the **RMB Group** you read this report and receive the *IPS Short Course in Futures and Options*, a \$14.99 value, plus *Certified Exchange Bullion: How to Buy Gold, Silver and Platinum with no Markups or Premiums* (a \$29.99 value) absolutely free.

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