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"As Europe Rushes Toward the Brink, Global Oil Markets Could Get Pounded. Where Does That Leave Oil Investors Like Us?"

"If the European crisis ends badly, many oil investors could take huge losses. But here in *Gold & Energy Advisor*, we're not 'most oil investors'.

"We're preparing to make huge profits during this crisis. Here's how!"

James DiGeorgia, Editor

"Kicking the can down the road" is a phrase meaning 'to procrastinate, defer, or avoid addressing a problem'.

Over in Europe, we're witnessing the mother of all can-kickings today. Rather than deal with the growing financial crisis, European leaders are trying desperately to stall, delay, and slow down its momentum—hoping that somehow, the crisis might resolve itself.

Just look at last month's elections in Greece. Everybody cheered when the pro-bailout coalition pulled off a (narrow) victory, because Greece will stay in the Eurozone—for now.

European leaders acted as if a big disaster had been averted.

But Greece is still broke. Its economy is still in depression. And it still has no hope of paying back its debt.

Worst of all, its sovereign debt still threatens the financial viability of the European banking system. The elections solved nothing. As Moody Analytic's chief economist told *USA Today*, "We dodged a bullet, but they've got a lot more bullets coming."

And Greece isn't even the gravest threat to Europe right now. That dubious honor goes to Spain and Italy. Nobody wants to talk about these threats—because nobody has a clue how to solve them.

Day by day, Europe moves closer to a financial catastrophe. As investors, we need to plan for this, and take a hard look at the aftermath.

If Europe goes down, several markets will implode. One of them will probably be oil.

Where does that leave oil investors like us? Well, if it gets as bad as I think, most oil investors are facing huge losses.

Grim news for us? Not at all! Here in *GEA,* we aren't like 'most oil investors'. Thanks to our unique investing approach, there are tremendous opportunities ahead of us. I think we can make a killing if we play it right.

But we must prepare properly, as I'll explain. So let's dive in, starting with…

Multiple Threats to Europe

While the world's attention has been fixated on Greece, a far bigger financial explosion is building up in Spain.

In some ways, Spain is replaying the US financial crisis of 2007/2008. In the US, the burst of the housing bubble wiped out entire categories of securities in the debt markets. This destroyed several major banks and almost took down the entire US financial system.

Greece's Problems Are Just Beginning

The elections in Greece raised just as many questions as they 'solved'.

The pro-bailout coalition barely squeaked out a victory. Almost half of the Greek electorate voted <u>against</u> the bailout, <u>against</u> austerity, and by implication, <u>against</u> honoring its sovereign debt.

(Pity the poor Greek voters. As the *Economist* put it, the vote was a choice between the "acute disaster" of a euro exit and the "chronic misery" of a deep recession.)

Not only that, the barely-victorious coalition is unstable. No single party won enough votes to form a government. Instead, the government will be made up of three parties, which have very different agendas otherwise.

Even before the new government was fully formed, its leaders were already talking about "restructuring" Greek obligations. Translation: they want debt relief.

The rest of Europe will <u>not</u> be impressed by this demand—especially since Greece will run out of money (*again*) this month, if the ECB and IMF don't give them another tranche of bailout cash.

However, they have little choice. If the bankers don't cough up the money, Greece goes bye-bye. And so does the value of its sovereign debt on European bank balance sheets.

Maybe the can didn't get kicked as far as everybody thinks.

Spain is following a similar path.

As in the US, Spain's real estate market inflated a bubble, which then burst. As in the US, Spain's major banks have been battered by the destruction of debt securities.

But unlike the US, Spain has also been hit with a slow-motion national bank run. Money is draining out of the banking system.

In a country with unemployment above 24 percent, and retail sales plunging 9.8 percent in April year-on-year, Spanish depositors know their banks are on the brink of ruin. And they're getting their money out before the banks go under.

In just the first three months of 2012, depositors pulled a net $121 billion out of Spanish banks.

This is a serious threat to Spain's economic viability. By extension, it also threatens the viability of the entire Eurozone.

Bank runs are terrifying for two reasons. First, they can destroy banks overnight. They usually start slowly, but once critical mass is achieved, depositors panic and stampede into the banks *en masse* to empty their accounts.

As Citigroup analyst Matt King told the *New York Times*, "A bank run can happen very quickly. You are fine the night before, but on the morning after it's too late."

Second, bank runs can torpedo entire markets. As the *New York Times* has observed about the Spanish banking withdrawals, "It was a similar liquidity crisis on Wall Street in September 2008 — which started with nervous investors pulling money from troubled institutions, then quickly from healthier ones — that set off the financial crisis."

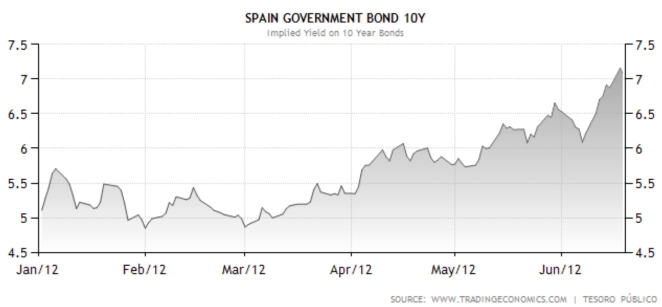
So far, Spain's bank runs have been sporadic and isolated. But even at this relatively low level, they've combined with Spain's other problems to inflict serious damage on the national economy.

Analysts already estimate that Spain will need a bailout of €450 billion ($560 billion).

And that's just the current number. If a full-blown banking panic hits Spain, the bill could shoot up above $1 trillion.

Madrid doesn't have the money to rescue its banking system. More importantly, it can't borrow the money either. As the Spanish economy sinks, bond buyers are stampeding for the exits.

As *The Atlantic* described it, in mid-June "Spain's yield on the ten-year bond blew past the bright red line of 7%, which divides the merely-terrifying-and-unsustainable territory to the land of screwed-without-a-massive-bailout. The bloc's fourth biggest economy is one step closer to bailout or bust."



As interest rates shoot up, so do the government's borrowing costs. Madrid desperately needs a massive infusion of cash, but can no longer afford to borrow any.

Spain's economy is four times the size of Greece's. It's the twelfth largest economy in the world. If it implodes—which is looking more and more likely—a bailout will be impossible.

As bad as Greece is, Spain poses a far graver threat to the world economy.

As *Business Day* noted, "The most significant event in the euro crisis over the past seven days was, therefore, not the Greek election but the failure of the bail-out of the Spanish banks the previous weekend. The Europeans thought they had exceeded market expectations by coming up with €100bn. In fact, the yield on Spanish bonds actually rose after the bail-out was announced. Investors seem to have concluded that if Spain cannot borrow directly to bail out its banks, it is perilously close to losing access to the markets completely.

"That raises the prospect that Spain might need a full sovereign bail-out, which could cost €500bn or more — burning through almost the entire financial firewall that the EU has constructed to contain the crisis."

As bad as Greece is, the Greek crisis is a sideshow compared to the much-larger crisis growing in Spain. And the terrifying fact for Eurozone leaders is that…

Drained Dry

European nations are split into two groups: those needing bailouts, and those paying for the bailouts.

As more and more bailout money is needed, the rest of Europe is being drained—not only of cash, but also of willpower to prop up their bankrupt neighbors.

There's a growing desire in Northern Europe to cut off payments to Greece. 'Why should we pay for their irresponsibility? Let the Greeks reap what they have sown.'

But this would start a nasty chain of events:

1. Greece would exit the euro, and then…
2. The Greeks would default on their sovereign debt, whether formally (by repudiating it) or informally (by repaying it in drachmas).
3. Investors would then correctly perceive a much higher risk in lending to Spain and Italy.
4. Spanish and Italian bond yields would skyrocket…
5. And Spain and Italy would also be forced to default on their sovereign debt.

Obviously, this would break up the Eurozone. Most likely, it would also destroy the major European banks.

Thus, to save their continent's banking system, Northern European leaders must defy the growing anger of their own voters. How long this can last is anybody's guess.

Even Spain Is a Sideshow Compared to the Looming Disaster in Italy

Italy is running a budget deficit of more than 120 percent of GDP. Its debt recently hit a new record: €1.95 trillion. And hundreds of billions of euros must be borrowed from the markets soon, because much of its debt matures this year.

But Italian bond yields are skyrocketing just as Spain's are. Ten-year bond rates surged up more than a full point in the last few months, and are now above 6 percent. (Compare this to a mere 1.6 percent rate for US Treasuries.)

Again, borrowing costs are soaring, just as Rome needs to borrow a mountain of cash.

Italy is broke. And as the eighth-largest economy in the world, it's too big to bail out. Greece is the most immediate threat to Europe, and Spain is next in line—but Italy might be the Eurozone's deathblow.

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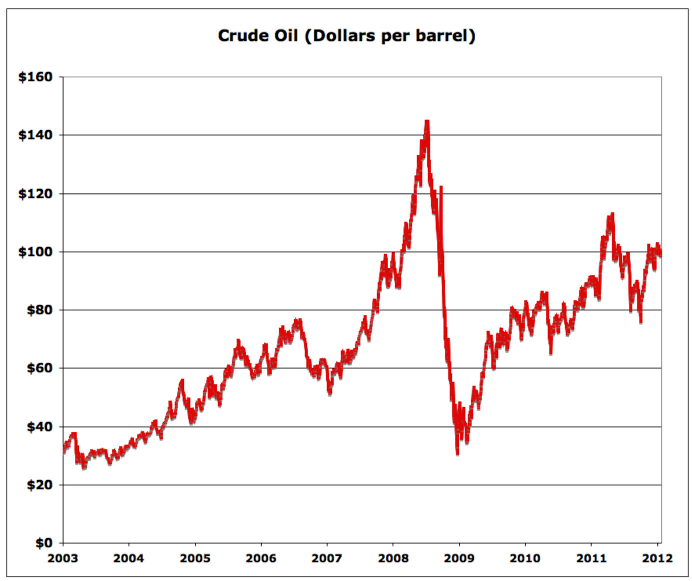
Why Oil Will Get Clobbered

If Europe plunges into chaos, the oil market will get hit hard—at least initially.

First of all, the deeper Europe falls into recession, the more its oil consumption will sink. Obviously, this will drive oil prices down.

At the same time, global capital is going to flee the euro and stampede into the dollar. Since oil is priced in dollars, a stronger dollar means oil's price will get driven down even further.

In fact, these two factors combined have the potential to trigger an oil crash just as steep as the one we saw during the market panic in 2008.



Oil crashed by over 70 percent (!) in late 2008, and experienced violent whipsaws afterwards.

I'm not making specific predictions yet, but if Europe goes down, we could see crude prices fall like a stone once again.

And surprisingly, for us this is…

Great News!

If you've been with *GEA* for a while, you know that we made a killing after the 2008 oil crash. We jumped in after oil bottomed, and made 88 percent—almost doubling our money—in a very short time as the price rose again.

If crude falls off a cliff again, I believe it will be a massive buying opportunity. Even if the price tanks, oil's fundamentals won't change much.

That means a market plunge would introduce a massive distortion between what the market is offering and what the price should actually be.

Situations like this create massive lashbacks. These are where fortunes can be made.

In short, our plan is to wait to see if Europe collapses, and for the markets to bottom and then base (technically). Then we'll move in and buy aggressively.

(What if Europe doesn't collapse? Then oil will remain strong, and our normal trading strategies will allow us to prosper as we usually do. But Europe seems headed for a fall in one form or another.)

Unless we see a major depression in Europe and a chain reaction of collapses around the world, I believe oil is strong enough to bounce back after a financial shock. To see why, let's look at a recent report issued by the International Monetary Fund (IMF).

IMF Issues Grim Report on Global Oil Supplies

As petroleum has skyrocketed over the last decade, analysts have been under great pressure to forecast future price moves.

The IMF recently waded into the debate with a report called "The Future of Oil: Geology versus Technology." It's unusual because it tries to reconcile "two diametrically opposed views concerning the future of world oil production and prices": geological analysis and technological analysis.

Oil analysts tend to fall into two opposing camps: geological and technological. Geological analysts look at how much petroleum is left in the world. They try to calculate how much oil can reasonably be extracted using today's technology.

Their analysis confirms that there's still a tremendous amount of crude left in the world. But the vast majority is far too expensive to produce. Meanwhile, the world's cheap oil is depleting rapidly and not being replaced.

Their conclusion: we aren't running out of oil, but we are running out of cheap oil. Thus, prices will be far higher in the future.

Technological analysts tend to believe the opposite. They point out that technology will continue to improve, and production costs will shrink. Therefore, a lot of oil that's currently unavailable to the market will become cost-effective to produce.

Their conclusion: there will be plenty of reasonably-priced oil for the foreseeable future.

Unsurprisingly, the two analyst camps tend to scoff at each other.

Geological analysts look at how the world is, while scoffing that technological analysts merely hope for technological miracles that might never arrive. 'You can hope all you want,' they say. 'But that won't magically refill the world's depleting oil fields.'

Technological analysts retort that geological analysis ignores evidence that's easily available just by visiting an oil field. Thanks to horizontal drilling and some other new techniques, we're getting more oil from many fields than we originally expected.

Which approach is correct? Both sides have evidence to support their views. As the IMF report notes:

"The geological view expects that physical constraints will dominate the future evolution of oil output and prices. It is supported by the fact that world oil production has plateaued since 2005 despite historically high prices, and that spare capacity has been near historic lows.

"The technological view of oil expects that higher oil prices must eventually have a decisive effect on oil output, by encouraging technological solutions. It is supported by the fact that high prices have, since 2003, led to upward revisions in production forecasts based on a purely geological view."

That's why the IMF report is important. Its authors include both viewpoints in their analysis, deliberately excluding preconceived ideas about "the relative importance of binding resource constraints versus the price mechanism for world oil supply."

The IMF authors' willingness to approach oil objectively has been very successful. The model they created "performs far better than competing models in predicting either oil production or oil prices out of sample, in a field where predictability has historically been low."

That makes its ultimate conclusion all the more ominous.

IMF Predicts: Oil Is Going to $250!

Even when accounting for optimistic technological advances, the IMF authors unhappily admit that cheap oil is almost gone. "If the model's predictions continue to be as accurate as they have been over the last decade, **the future will not be easy**" (my emphasis).

At best, we can expect only "small further increases in world oil production."

As a result, there will be a "near **doubling**, permanently, of real oil prices over the coming decade. This is uncharted territory for the world economy, which has never experienced such prices for more than a few months."

With Brent crude at $100 when the report was issued, this is a prediction for $200 oil in "real" terms—in other words, before adjusting for inflation.

According to the government's Consumer Price Index, inflation is currently running at 2.3 percent per year. Extend this out 10 years, and **$200 in real terms equals more than $250 in nominal terms**. And that's assuming inflation remains at today's extremely low rate—which is very unlikely. A more realistic level for inflation means oil prices will be that much higher.

A Complicated Model

Most oil price analysis tends to be simplified extrapolations of current trends. As the IMF authors note, this approach has never worked very well.

Their analysis is considerably more complicated. For example, their oil supply equation combines the "linearization equation, whereby oil is more and more difficult to extract as cumulative production increases, with the economic/technological view of a standard supply curve," and looks like this:

$$\frac{q_t}{Q_t} = \underset{(507.7)}{\alpha_s} - \underset{(0.243)}{\beta_1} Q_t + \underset{(0.624)}{\beta_2} p_t + \underset{(0.056)}{\beta_3} \frac{1}{3} \sum_{k=4}^{6} p_{t-k}$$

The complexity pays off, though, because the model is very successful.

But How Can This Be?

How can oil prices rise if Europe has a financial meltdown? Would the IMF analysis still be relevant in those circumstances?

Yes—eventually.

If the Eurozone has a violent financial shock, the market's emotions will (for a short time) overcome crude's fundamentals. As I said earlier, we could see the oil market crash.

But I expect prices will recover. Unless the global financial system melts down, oil will still be under strong demand, with weak supply.

Yes, European demand will fall, but that's not as big of a deal as it used to be. The Europeans have been working hard to transition away from oil as an energy source. In the last decade, European demand has fallen from 20.6 percent of the global total, down to 17.2 percent.

In just the last five years, Europe's consumption has fallen by 1.3 million barrels. (That's over a million barrels' reduction in daily consumption.)

So a reduction in European demand won't hit the market as hard as many might think.

Also, a global economic softening could depress the supply of oil. For example, marginal costs are very high for Canadian oil sands. Production there could take a big hit if oil prices fall, or if credit markets tighten, or both.

Meanwhile, demand in other parts of the

world is surging up. For example, Chinese consumption continues to rise, while domestic production is flattening out.

Over the last decade, net Chinese demand has soared from 1.5 million daily barrels to 5.7 million. In the last two years alone, demand has leaped up by 1.3 million daily barrels.

The most recent figures show that Chinese consumption is growing by 8.7 percent per year—and this is while China's economy is *slowing*. If Chinese leaders are successful in their current efforts to create a 'soft landing' for their economy and turn it around, oil demand will shoot up even faster.

Elsewhere, there are more market shifts occurring. Many analysts are worried especially about Egypt, which used to be a large exporter but is starting to consume all its own production. Soon it will be competing for imports with other consuming nations.

Egypt also poses a threat to the stability of global supplies, as I discussed last month. Political unrest in Egypt threatens both the Suez Canal (a major chokepoint for global oil transport) and the Sumed pipeline.

In addition, if oil prices fall, OPEC can do what they've done in the past: cut production quotas and thus oil supply, to push prices back up.

There are other reasons to remain bullish on oil. I'll have more to say about them in future issues. But for now we need to discuss…

What to Do Now

How should we prepare for everything that's coming?

If I'm right about Europe's potential effect on the oil markets, most conventional oil investors are going to get clobbered sometime in the next year or so.

Steep losses are very difficult to recover from, even after the market recovers. Investors tend to sell during the middle of the crash, locking in their losses.

Even if you don't sell, if a crash is coming it's far better to be out of the market when it happens. Then, once prices find a bottom and base, you can jump back in and make monster profits on the way back up.

Portfolio Update

In Update #1353, we opened a new position on Conoco Phillips (symbol COP). We sold short the August $52.50 puts (symbol COP120818P52.50).

In Update #1355, we closed our hedge on the SPDR S&P ETF (SPY). We sold to close our 2 contracts of the July $136 puts (SPY120721P136).

In Update #1357, we rolled up our short puts on Apache Corp. (APA). We bought to close the July $90 puts (APA120721P90) and sold to open the Aug. $90 puts (APA120818P90).

In Update #1358, we took profits on our short puts on Anadarko Petroleum (APC). We bought to close the Aug. $70 puts (APC120818P70). Our profit was $176.

That's our plan here in *Gold & Energy Advisor*.

As the publisher of *GEA*, I can't offer you individual investing advice. But here are my thoughts about how to prepare. Evaluate them according to your own situation, and make up your own mind about what to do.

Getting ready for an oil crash has two aspects: protection and profit. First, protect yourself against losses. Second, position yourself for maximum profits.

Protection means examining your portfolio and seeing if you're vulnerable to falling oil prices. Energy ETFs, mutual funds, and individual conventional stocks might be very unhealthy places to be, if Europe melts down.

Again, I can't recommend that you sell anything from your portfolio. You need to evaluate your individual situation and make your own decisions. But I am urging you to think about what might be coming. If the oil market goes through a violent period of disruption, you need to have considered it ahead of time.

If nothing else, being emotionally prepared for the disruption will put you far ahead of other investors, many of whom will panic and sell at the bottom—which is the worst possible thing to do.

So that's protection. Now let's talk about profits.

First, you should prepare to be in the game for the long haul. The Greek elections have delayed the immediate consequences of a 'Grexit', and it's impossible to know how long it might be before Spain (or even worse, Italy) trigger a European banking meltdown and then an upheaval in oil.

Second, if oil takes a dive, we're going to wring as much profit from it as we can. We might short the market on the way down. Or we might wait for it to hit bottom and then ride it back up. Maybe we'll do both, at different stages in the crisis.

We'll be using our full arsenal of trading strategies during this time, including the use of options. If your trading account doesn't currently allow you to trade options, now is a good time to set it up to do so.

Lastly, you should…

Make sure you can pounce on the opportunities once they arrive.

This includes maintaining your access to our recommendations here in *Gold & Energy Advisor*.

The price of a *GEA* membership recently went up to $129 per year. However, I want to give valued members like you a chance to keep your *GEA* access at a much lower rate.

For a short time, you can renew/extend your membership for one year for just $79. That's a savings of 38 percent.

You'll also lock in this low rate for as long as you remain a member. Even if the price goes up later, you'll be grandfathered in.

Consider the math here. That works out to only $6.58 per month, for trading recommendations that have produced an average cash flow of $550 per month.

That's already a screaming deal, but I'll make it even better. You can extend your membership for two years for just $159—a savings of $99. And you'll also get several bonuses, including:

- **A third year of *GEA* for FREE**. This brings the rate down to just $4.41 per month...
- **And two Morgan Silver Dollars, with a retail value of $99**. These handsome silver coins were struck by the US government from 1878 through 1921.

(There's just one reasonable 'catch' to this offer. If you decide to cancel your subscription later, we'll ask you to return the coins. Or you can keep them, and we'll deduct the $99 value of the coins from your refund.)

Get two Morgan Silver Dollar coins as a bonus with your two-year extension/renewal

This offer is as close to a no-brainer as I can think of. Just click on the link below (or type the address into your web browser), then click on one of the big green buttons on that page:

http://www.goldandenergyadvisor.com/page/gez/subscribe/index28.html?x=web0624

You'll be sent to a secure page where you can complete your order.

Or if you want to extend by phone, call toll-free **1-800-819-8693** and mention offer code **WEB0624** to ensure you get this special deal. (That's a zero in the code, not a capital "O".)

But you should act quickly. I'm only going to leave the offer up for a short time.

Also, I don't know if I'll ever offer *GEA* extensions for such a low rate again. If you want the returns that our recommendations generate, now's the time to extend your membership.

Remember, since inception in 2004 *GEA* has produced an average return of 29.1 percent per year, and an average cash flow of about $550 per month.

That includes the oil market crash of 2008. We got out as the market plunged, then jumped back in at the bottom, making 88 percent—almost double our money—on the way back up.

Even while other investors got steamrolled, we flourished.

If I'm right about the European crisis, it's going to serve us up another monster profit opportunity. Don't be left behind!