2005
2004
2003
2002
2001
2000
1999
1998
1997

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In this issue:

- **Global Outlook: Precipitous Decline or Slow Economic Adjustment?**
- **The Bush Trade Policy Agenda in 2005**
- **Bidding War – Investors Still have an Appetite for Korea**
- **China-Taiwan Relations in 2005: Bluster but (Probably) No Blows**
- **The Return of Russia**

KWR Viewpoints
- **U.S. Stock Market: Storm Clouds on the Horizon?**

Special Section: Energy Dynamics
- **Asian Energy Buyers Launch New Regional Grouping**
- **Asian Oil Demand Poised to Slow after a Record 2004**
- **Fruitful Year Predicted for Foreign Oil and Gas Firms in the Middle East**
- **Jet Fuel Markets in Asia Take Tsunami Effect in Stride**

Equity Spotlight:
- **TransMontaigne, Inc. (AMEX: TMG)**

- **Letters to the Editor**

- **Emerging Market Briefs: Indonesia, Philippines**

- **Media Highlights**

(full-text Advisor below, or click on title for single article window)

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Global Outlook: Precipitous Decline or Slow Economic Adjustment?

by Scott B. MacDonald and Keith W. Rabin

NEW YORK (KWR) The usual set of strikes in France, the possibility that reform of Japan's postal bank will be diluted, and apprehension that the Bush administration will not make much headway on reducing the sea of red ink on the federal fiscal ledger all point to one thing – a certain warped convergence between the world's major economies. In a very simple sense, U.S., European, Japanese and even the Chinese economies need each other – to maintain a status quo that allows them to put off politically painful and hardnosed economic reforms. The current system of mutual support – the flow of funds from Asian and European investors into the United States in the form of Treasury and corporate bonds and, in return, the active stance of U.S. consumers in buying imported goods with that borrowed money, keeps Japanese, Germany and French companies pumping out products, making profits and workers employed. At some point the music in this dance must come to an end and the band paid. Yet, this day of reckoning could well be postponed for several more years. While this will make the inevitable meltdown all the more harsh -- until the carousel ride stops, the party goes on.

The sad thing is all the players recognize the problems. For the United States, it is a combination of large fiscal and current account deficits, a top-heavy reliance on the consumer, an alarming depletion of personal savings, a pressing need for tort reform, and serious issues concerning social security. For Japan, its is the government's massive build-up of debt to about 150 percent of GDP, the need for further structural reforms such as postal system privatization, a continuing reliance on the export sector, and a rapidly aging population.

For the Europeans, in particular the continental giants of France, Germany and Italy, critical reforms are required in terms of labor markets, pension systems and competition laws. Current efforts remain inadequate. Failure to reform has resulted in anemic economic growth, higher-than-expected government spending and deficits and, in some cases, a failure to meet EU Growth and Stability Pact targets. Europe also has to consider similar, though not as extreme, demographic trends as Japan.

China has also bought into this system. It is in the process of a massive economic transformation. For it's leadership to be successful, it must have strong economic growth and some ability to distribute its national wealth. To achieve this goal, China needs markets for its goods and the ability to source industrial inputs such coal, copper and oil. China also requires some degree of stability in international currency markets, hence its glacier-like approach to allowing its currency to float. If Europe, the United States and Japan were to embark upon needed reforms, economic growth in those countries could slow. If that were to happen, the current great Chinese leap forward which started in 1978 could sputter. Any major slowdown could result in social unrest, perhaps even upheaval.

What all of this means is that the United States, Europe, Japan and China are locked into their current patterns of economic growth. The nagging issues of high unemployment, looming pension and social security crises, and untidy fiscal accounts are likely to continue. As for China, do not look for any floating of the currency in 2005 and for growth only to modify down to 8 percent in 2005 from last years, 9.6 percent. China will achieve a soft landing, but is likely to be longer and bumpier than many expect.

What keeps this system in place is that no one really wants to see it collapse. Change will be painful for everyone, so it remains easier to push the day of reckoning further into the future, beyond current political terms. The U.S. current account deficit will continue to be a problem, with no one wanting to make the adjustments – in terms of allowing the Euro or Yen to appreciate too much to threaten growth. We have already seen a recent round of squabbling between Europe and Asia over who will assume the burden of another round of dollar weakening. In 2004 it fell more on Europe; now the Europeans want to see the Asians pick up some of the adjustment burdens. Japan was quick to indicate it might intervene in international currency markets, especially if the dollar/yen ratio drifts toward the 100 mark.

The results of failing to act on economic problems in the world's largest economies is likely to be one of ongoing budget and current account deficits in the United

States, marked by periodic weakening in the U.S. dollar. Japanese economic growth, while positive, is likely to remain below its potential, and the nation will struggle to deal with the public sector debt it has taken on. As for Europe, the pressures on pension and social services are likely to mount, as there will be fewer people to support an aging population. And Europe's large economies will face strong pressures to move businesses further East to countries like the Ukraine, with well educated populations, but far lower wages and social costs.

The ultimate result of this system is a long, range-bound era of moderate to weak economic growth, eroded by a lack of the changes badly required to address population shifts and the necessary economic transition. At some point, something may give – a plunge in the dollar that does not stop, an unexpected currency move by China, or a major financial meltdown caused by mistakes with derivatives. Such a meltdown could be far worse than anything seen in recent history due to the accumulation of debt and structural inefficiencies – sadly all of which could have been corrected at an earlier period.

From an investment standpoint, however, the key question is whether we will see things unwind in a slow economic crumble or a precipitous drop off the cliff. The former would suggest the Fed is likely to continue or even reverse its "measured pace" posture. Under that scenario, current trends such as rising commodity prices, an out-performance of emerging over developed markets and even perhaps the "bubble-like" appreciation of U.S. real estate markets may continue for sometime. A drop off the cliff, however – and many extremely smart investors have patiently waited and underperformed over several years believing this to be inevitable – would have ominous implications.

While entirely possible – and even justified based on the underlying fundamentals – it is hard to see how anyone would benefit from an abrupt systemic shock and major economic dislocation. This does not mean it will not happen, and things could certainly get out of hand. Massive liquidity, however, and the complementary though admittedly dysfunctional relationship highlighted above, does indicate that a more gradual adjustment is entirely possible. While this does not eliminate the potential for manic, volatile swings as we seek to determine whether inflation or deflation will gain the upper hand. It does, however, argue against a doomsday "imminent depression" in the immediate future. These alternatives have very different implications for both fixed income and equity investors.

The Bush Trade Policy Agenda in 2005

by Russell L. Smith and Caroline G. Cooper, Willkie Farr & Gallagher LLP

WASHINGTON (KWR) Trade and security policy often went hand-in-hand during President George W. Bush's first term in office, particularly following the September 11, 2001 terrorist attacks. Trade policy was often used as a tool to advance the

President's security policy agenda. USTR Robert Zoellick pursued free trade agreements (FTAs) with a range of countries, most of which supported to one degree or another U.S. policy in Afghanistan and Iraq. In 2004, the President added a focus on the Middle East to the trade agenda, again to further foreign and strategic policy goals. Perhaps the only exceptions were the Central American Free Trade Agreement (CAFTA) and bilateral FTAs with Panama, Colombia, Ecuador, and Peru, which Bush and Zoellick pressed to complete and began to negotiate, in part because of the lack of any real progress on the broader Free Trade Agreement of the Americas (FTAA). This was in part to honor Bush's 2000 campaign commitment to focus on the southern hemisphere, which he otherwise did not do during his first term.

The agenda also included what many regard as a good-faith effort by Zoellick to revive the faltering Doha Development Agenda negotiations. While still another agreement in principle was reached on the keystone issue--agricultural subsidies--as 2004 closed, the prospects for successful and timely conclusion of the Doha Round were still quite uncertain.

Will the second Bush term that began on January 20, 2005 mean more of the same on trade? The answer appears to be a qualified yes. Bush and his new USTR, whoever that may be, will need to broaden the scope of their trade activities beyond strategic allies and politically helpful neighbors to address fundamental bilateral, regional, and global trade problems and opportunities. Bush and Zoellick have already acknowledged this to some extent through their post-election remarks, Zoellick's global travels, and Bush's planned trip to Europe not long after Inauguration Day.

At the bilateral level, there is a recognition that trade disputes with the EU need to be addressed more methodically. Ideally they would be resolved, before they become full-blown trade confrontations, since the damage that retaliatory tariffs do to the trading relationship is often counterproductive for both EU and U.S. companies, and in some cases does not resolve the trade conflict at all. The same is true of the seemingly endless question of duties on Canadian softwood lumber, as well as disputes over a large number of dumping law issues that affect dozens of U.S. trading partners.

The bilateral challenges also include China. The United States has yet to settle upon an effective and constructive approach to its huge and growing trading relationship with China. USTR and the U.S. Commerce Department simultaneously praise and excoriate China on trade issues, pressure China to restrict textile and apparel exports, and then reportedly challenge China's announced apparel export tax as both insufficient and potentially WTO-illegal. Beyond official Administration ambivalence, many Members of the U.S. Congress have now substituted China for Japan as the scapegoat for all U.S. manufacturing competitiveness problems. China is the target of a substantial flow of U.S. dumping cases, and the United States appears ready to trigger special safeguard measures to place new quotas of Chinese apparel exports. At the same time, U.S. retailers and their customers demand the inexpensive consumer goods that are the backbone of China's capitalist economic development, and major U.S. companies (autos, for example) grow more and more

uncomfortable with the risk that a souring of the trade relationship will be taken out on their facilities in China. The nature of China as a strategic rival, as well as a massive trading partner and potential market, is not the same as that of Japan when it began to be perceived as a trade "problem." The Bush Administration would be well advised not to view its approach to Japan--regular pressure and threats with the occasional confrontation--as a template for China. The emergence of China as a major economic and strategic force in the world, with a clear impact on U.S. policy, demands a more orderly and measured U.S. approach to the bilateral relationship.

Beyond China, the rest of Asia should and will receive more attention in the second Bush term. Japan is emerging, albeit slowly, from it recession, and the U.S.-Korea trade relationship needs to be nurtured. Korea is hopeful of progress on an FTA with the United States, and as noted by USTR, there is a potential for such progress if some threshold issues (telecommunications and pharmaceuticals, for example) can be taken "off the table." U.S. assistance to the countries devastated by the December 2004 tsunami is almost inevitably going to have a trade and development component, which, hopefully, will go far toward enhancing the perception of the United States in the region. While the issues in the U.S.-Thailand FTA negotiations are difficult, there appears to be a relatively cooperative spirit on both sides and a natural alliance that indicates that an agreement is possible by the end of 2005 or just thereafter.

At the global level, without strong leadership from the United States, the Doha Round will not move forward. The Hong Kong Ministerial at the end of 2005 may define whether the DDA is a success or a failure. While all the major parties profess to support the elimination of agricultural subsidies, the devil is definitely in the details. The personality and determination of the new USTR will be by far the most important element in determining whether any substantive agreements can be reached. Zoellick was willing to take significant political risks, make controversial concessions, and "carry the ball" virtually alone simply to keep the DDA alive and achieve an agreement in principle. Whether the new USTR can or will do the same is open to serious question. If not, recent history indicates that no other country can or will provide such leadership.

At home, Bush and his trade officials will also face some challenges that could affect how they conduct themselves abroad. President Bush will inform Congress that he wishes to extend his negotiating flexibility under Trade Promotion Authority (TPA) for two additional years, and Congress will have the opportunity to vote this down. While the risk of defeat is small, the debate may be quite bitter and some of the proposals that are thrown up as a "price" for the extension may be most unattractive. Again, the worst of these will be rejected, but the experience of the last three decades in U.S. trade legislation has been that the integrity of U.S. trade laws and of the openness of U.S. markets is degraded to some extent whenever Congress takes up Presidential negotiating authority.

While there will be efforts to repeal the WTO-illegal Byrd Amendment, which pays dumping duties to supporters of dumping petitions, the entrenched opposition to such repeal in the U.S. Congress is substantial. Again the price of repeal or change in the law, if it introduces further bias in U.S. dumping or other trade remedy laws, may ultimately be more distasteful than living with Byrd. Such is the reality of the

very unreliable political support for true free trade principles in the Congress today.

Finally, to conclude on a positive note, free trade principles should prevail when Congress reviews U.S. participation in the WTO. Any Member of Congress may call for the U.S. to withdraw from the WTO every five years, and the second such anniversary comes in 2005. It is inevitable that a number of Members of Congress may introduce a withdrawal resolution, but the necessity that neither the President nor the Republican leadership in Congress be embarrassed by the passage of such a resolution virtually guarantees its defeat.

This analysis indicates that the second Bush term, whatever its other priorities, will give more attention to trade than in the first term, and that it will be forced to deal with more complicated and difficult trade issues as well. It is always possible that the Administration, by simple lack of commitment or talent, will not give trade the appropriate attention, but that inattention will come at great peril to U.S. long-term economic strength and global influence.

Bidding War – Investors Still have an Appetite for Korea

by Scott B. MacDonald

NEW YORK (KWR) Although Korea's economic performance over the past year has not been as robust as it has been in the past and the North Korean issue still looms like a dark cloud on the horizon, foreign investors still appear to have a strong interest in buying into this market. This was recently underscored by a bidding war over Korea First Bank. In early January a bid by London-based HSBC was beaten by a $3.3 billion offer from Standard Chartered Plc, another UK-based bank, which makes two-thirds of its earnings in the region, and a strong tradition and operating presence in Asian markets. The winners in this deal are San Francisco-based buy-out firm Newbridge Capital and the South Korean government. Standard Chartered's determination to win Korea First reflects an understanding that the East Asian nation is increasingly a service driven economy and there will be an attractive market for more sophisticated financial products.

International banks are looking at South Korean market given that there are around $44 billion of annual banking fees generated in the country. That is more than three times the amount generated in Hong Kong, one of Asia's more developed economies. Along these lines, Korea First is attractive – it holds six percent of the market, has 404 branches spread across the country, and is profitable. The bank has 1.1 million credit cards issued and 2,100 automated cash machines. There are a little over 5,000 employees. The purchase will allow Standard Chartered a platform upon which to compete with Citigroup and HSBC, both of which are already active in this East Asian country.

Clearly Standard Charted felt compelled to act. In 2004, the UK bank sold its 9.8 percent holding in South Korea's Koram to Citigroup after the U.S. bank beat Standard Chartered's bid for the entire bank. Koram sold for $3 billion. However, Korea First has solidified Standard Chartered's position in a key Asian economy. Indeed, after the purchase, South Korea will account for 16 percent of Standard Chartered's revenue and about 22 percent of its asset base. The expectation is that Korea will soon bypass Hong Kong as the bank's largest market by revenue, assets and branches. As Standard Chartered's CEO Mervyn Davies stated: "South Korea's population of about 48 million people gives the country a very strong banking revenue pool."

Standard Chartered's action is being questioned – economic growth in South Korea is slowing to under five percent and many of Korea's credit card holders have built up high levels of debt. LG Card, the nation's major credit card company, is struggling to stave off bankruptcy caused by too many deadbeat creditors. In addition, the some are concerned that Korean companies are likely to hold back on spending plans and might borrow less in anticipation that there will be a slow patch in the economy. Yet, Standard Chartered plans to capture 10 percent of the market and sees South Korea as a market where it must be involved.

South Korea is increasingly attractive for international banks. The country has a high level of GDP per capita, is developing a credit card culture (despite LG Card's problems), and has a sizeable population. Citigroup has Koram and Standard Chatered has Korea First. The next battle over bank ownership could come up in November 2005, when the U.S. firm Lone Star has the option to sell its 51 percent share of Korea Exchange Bank, Korea's fifth largest lender and worth $5 billion. The challenge for foreign banks is multiple – they have to be sensitive to the local business culture, maintain a high level of transparency and disclosure, and know how to market new products. As seen by the large-scale introduction of business cards and relatively substantial problems with deadbeat borrowers, Korea's financial markets still offer some challenges. All the same, the purchases of Korean banks and the prices being gained reflect that the country's banking system has come a long way since the dark days of 1997-98.

China-Taiwan Relations in 2005: Bluster but (Probably) No Blows

by Jean-Marc F. Blanchard, Ph.D. Senior Consultant

SAN FRANCISCO (KWR) China-Taiwan relations started the year auspiciously with an agreement this month for cross-Strait charter flights, the first direct air services between the two antagonists since 1949. Many have heralded this accord as evidence that China is now willing to adopt a more moderate stance towards Taiwan. The agreement came in the wake of the positive outcome, at least from the

perspective of China-Taiwan relations, of Taiwan's December 2004 legislative elections. This election gave a majority of seats in Taiwan's parliament to the Guomindang and its allies while handing a defeat to Taiwanese President Chen Shui-bian's independence minded Democratic Progressive Party (DPP) and its allies. Pundits forecast that the composition of the new parliament will, at a minimum, restrain President Chen from moves towards Taiwanese independence such as the pursuit of a new constitution.

One should not exaggerate, however, the implications of the DPP's electoral loss. First, the DPP actually gained seats and maintained its position as the largest party in the legislature. Second, demographic trends in Taiwan will continue to bolster the number of ethnic Taiwanese relative to the number of ethnic Chinese. Third, Taiwanese policymakers have grown increasingly comfortable advancing political proposals that would further separate China and Taiwan from one another. These proposals include the renaming of Taiwan, its state-owned enterprises and overseas offices, as well as a public campaign to get the U.S. to abandon its one-China policy.

To the north, existing trends also are problematic. For its part, China seems increasingly keen to assert its right to Taiwan. To illustrate, in late December 2004, the Standing Committee of China's National People's Congress approved a draft anti-secession law directed at Taiwan while China's military released a white paper stating that it has a "sacred responsibility" to crush Taiwanese moves towards independence "whatever the cost." Furthermore, China's military build-up, which entails the acquisition of military capabilities that enhance its ability to coerce Taiwan, will continue unabated. Finally, the Chinese regime faces daunting political, economic, and social issues that will challenge its ability to maintain domestic political stability. This is consequential because it gives Chinese policymakers incentives to act aggressively to bolster their domestic standing.

Many assume that economic interdependence between China and Taiwan and between China and the rest of the world will guarantee peaceful cross-Strait relations. These "commercial liberals" reason that Chinese leaders, who deeply want to sustain economic growth to provide legitimacy for the Chinese Communist Party (CCP), employment for China's huge labor pools, and funds for China's military development, would be averse to taking action against Taiwan because it would endanger China's external economic linkages. They further argue that economic interdependence eventually will synchronize Chinese and Taiwanese identities and interests.

One should not place great faith in commercial liberal thinking, however. First, the work of international relations specialists demonstrates that economic linkages have little power to deter policymakers from waging war where the highest national interests (e.g., territorial integrity) are involved. Second, extensive economic intercourse does not automatically synchronize national identities or interests. Even now, many Europeans still see themselves as French, Italian, or Polish rather than European.

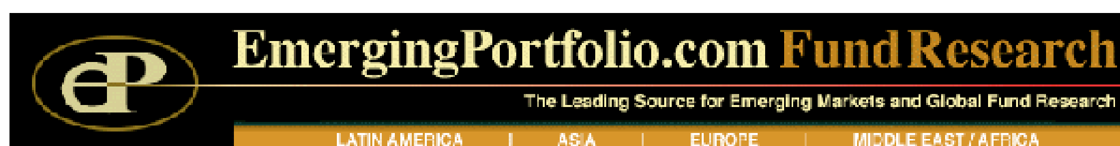
Ultimately, the course of China-Taiwan relations in 2005 will depend greatly upon domestic political developments in China. Recent reports suggest that Chinese

President Hu Jintao has consolidated his position in the CCP's political hierarchy. Not only has he assumed control of the powerful Central Military Commission, but he also has put his allies into key political and military positions. If true, these developments are a positive for cross-Strait relations because external Chinese aggressiveness historically has occurred in concert with the country's domestic political problems or the leadership's domestic political woes. If, however, domestic political competition threatens Hu or domestic problems threaten the regime, then 2005 could be a very rocky year indeed for China-Taiwan relations.

Shifting outside China, it is clear that American policies will exert a tremendous effect on the cross-Strait dynamic. On the bright side, there are those in the Bush Administration who seek to preserve the status quo. On the other hand, there are many in the Administration and in Congress who champion greater support for Taiwan. If the balance of power swings in favor of the moderate camp, then the U.S. likely will exert a dampening influence on China-Taiwan frictions in 2005. Conversely, if the balance of power swings in favor of the latter camp, then the U.S. likely will fan cross-Strait tensions.

Japan also is critical to China-Taiwan relations. One reason is that Japanese forces are part of the implicit deterrent against Chinese military action against Taiwan. Another reason is that Sino-Japanese economic ties must enter into the calculations of Chinese leaders contemplating aggressive action against Taiwan, although they are no guarantee of restraint. A final reason is that Japan's growing efforts to assert itself internationally, manifested by its increasing role in UN peacekeeping operations and adoption of a more realpolitik stance towards China and China's allies, will exacerbate Chinese sensitivities about Taiwan. This is so because a more "normal" Japan is likely to take a more independent stance with respect to Taiwan. As well, a more "normal" Japan places pressure on Chinese leaders not to back down on Taiwan lest they seem weak in Japanese eyes.

According to the Chinese calendar, 2005 is the Year of the Green Wooden Rooster. Chinese astrologers note that roosters are blunt, flamboyant, and self-assured and that the Year of the Green Wooden Rooster is expected to entail conflict. For the reasons discussed above, China-Taiwan relations will manifest a number of Rooster and Rooster-year characteristics in 2005. These frictions should not explode into military conflict, provided that the domestic political situation in China remains stable, the U.S. ameliorates rather than accentuates conflict between the two protagonists, and China-Japan relations do not dramatically deteriorate. Unfortunately, uncertainties in each of these areas make it difficult to predict with any confidence whether relations between China and Taiwan will end the year on as positive a note as they began it.



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The Return of Russia

by Scott B. MacDonald

NEW YORK (KWR) The political map of Eurasia is changing. Following the victory of the Western-oriented presidential candidate in Ukraine in December 2004, in what was a highly controversial election, Russian President Vladimir Putin is further consolidating his power at home and the more liberal members of his government are being shunted aside. The process of creating a more hardline government started earlier than the Ukraine election, but events in Russia's neighbor re-emphasized that the Eurasian landmass is still very much in play in terms of political ideas. Along these lines, it should be alarming to the West and Asia that there is a shift from the democratic-capitalist experiment started under Boris Yeltsin to a soft authoritarianism dominated by strong nationalists, who have a marked preference for a larger role of the state in guiding the economy. While Russia has not quite returned to the state sitting at the commanding heights of the economy, it is certainly moving in that direction. Moreover, the nationalists are deeply concerned that the West is seeking to encroach further into what should be Russia's sphere of influence.

Since the fall of the Soviet Union in the early 1990s, Russia's international position has been highly challenged. Moscow lost control over its former empire in Central Asia, NATO and the European Union rolled the border back several thousand miles, and American influence became a factor in the Caspian Sea region's oil fields. The once greatly feared Russian military struggled against a spirited Chechen uprising and terrorism. And at home, Russia's leaders presided over a difficult and painful transformation that entailed an overhaul of an inefficient state-dominated economy, a feeble banking sector, and a weak grasp of market economics (including the idea of rule of law). That is beginning to change. Russia is beginning to re-assert itself.

President Vladimir Putin is remaking Russia's role in the world. While he has consolidated his position at home by breaking the power of the oligarchs (the big business barons that came out of the 1990s), he is pushing a stronger, more vocal Russian agenda in its relations with its neighbors. Russia has been vocal about the disputed elections in Ukraine -- clearly favoring the pro-Russian candidate, critical of the U.S. "soft" approach in Afghanistan and for having moderates from the Taliban in the government, and is seeking to rekindle trade relations with India. The Russian military is also getting a weapons system upgrade.

Putin is also working to repay Russia's Paris Club debt over the next 2-3 years, removing one possible area of economic weakness. In addition, higher energy prices are providing a nice cash inflow – Russia now has over $110 billion in foreign exchange reserves and the budget and current account are both in surplus. It is very possible that Russia will be upgraded by S&P in early 2005, making it fully investment grade.

What does this mean? Going forward, the United States, Europe, China and Japan are going to have to pay more attention to Moscow. Russian natural gas and oil is attractive to those nations and this means power. Indeed, Western Europe is increasingly dependent on Russian natural gas for its energy needs.

Putin is demonstrating to Washington, Tokyo, Berlin and Beijing that the Russian bear is back. Although Russian power is still no match for European economic and U.S. military power, it is growing and Russian national interests are increasingly going to be a factor. This ranges from trade and investment to the war against international terrorism and North Asian energy politics. The recent crisis in Ukraine underscores that although the old Cold War is over, the potential for a New Cold War remains.

We expect to see a more assertive Russia dealing with Europe, which will point out its energy dependence, playing off Japan and China over energy in North Asia, and a more pronounced role in the Middle East vis-à-vis the United States. Russia also wants and needs greater foreign investment. Russia now lags Eastern Europe and even parts of Latin America in terms of investment inflows. While much of this can be played out within the current framework of international relations, Russia's desire to once again be seen as a player is one more factor for Washington and Tokyo to calculate in what is becoming an increasingly more complicated international environment.

KWR VIEWPOINTS

Featured Guest Opinion

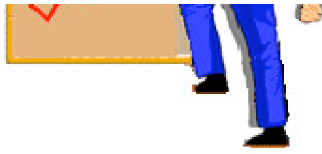
(note: Featured Guest Opinions do not necessarily reflect the opinions of KWR Intl.)

U.S. Stock Market Outlook –2005: Storm Clouds on the Horizon?

by Mark Reiner, The Doctor's Investment Fund, LLC

NEW YORK -- Volatility is likely to increase in the equities market in 2005 from the historically low levels witnessed last year. This confluence of events will likely add to uncertainty, making it a bear market year.

Equity investors are currently complacent. Their optimism is reflected in record high investment advisor bullishness, low



levels of equity derivatives volatility and a surge of insider sales. Late last year, insiders were selling approximately $60 in stock for every dollar purchased. This is troubling, as corporate management is generally more astute about their respective businesses, than perpetually optimistic Wall Street analysts.

While equity markets had been contained in a very narrow trading band for much of last year, the reelection of President Bush proved to be the catalyst for a relief rally, which measured approximately 5% on a monthly closing basis. Post election rallies are common in bear markets. During the last secular bear market of the 1970-80s, we experienced four post-election rallies. Each peaked during the following January, followed by harsh declines that did not bottom until the following year. The average move of these four rallies was 5.92% with subsequent declines measuring approximately 34%. These rallies occurred during periods of rising short-term rates and an expanding economy -- conditions similar to the current environment.

Bear markets have spectacular rallies, designed to suck investors in, whereas bull markets have violent corrections to shake out as many shareholders as possible before resuming their steady climb. The market has recently been contained to a narrow trading range, marking approximately a 50% retracement of its previous drop. Historical patterns from previous bear markets suggest the market may stall at this juncture, before resuming the next leg down of the bear market.

Subsequent to the president's reelection, the US Dollar weakened markedly, while US equities continued to rise. This dollar weakness can be attributed to the twin deficits and record low consumer solvency. There is also concern amongst foreigners, that the U.S. will not be able to finance its current account deficit as foreign inflows lag the liabilities generated.

The dollar fell approximately 30% during Bush's first term. The trajectory of this move is more than the "adjustment", called for by many politicians and journalists. If this trend continues, a number of U.S. trading partners could be thrown into recession. In a worst-case scenario, the dollar could lose its status as the world's reserve currency, with ominous implications. That is not a far-fetched thesis, as the English pound had been the world's reserve currency earlier this century. The pound lost its prized status, as England became the world's largest debtor. During the last year, a number of OPEC members proposed that oil should be priced in Euros and as world economic power and concentration moves to the Asian block, there remains the possibility of a drastic change in world currency supremacy.

A major propellant extending this rally has been the president's plan to privatize Social Security. This proposal has created more greed in the market, as Wall Street strategists extrapolate an insatiable demand for equities. If this measure passes, there will be a supply of securities to meet the investment dollars, as Wall Street has traditionally been more than willing to issue new issues for public consumption.

However, most individuals are not capable of prudently managing their portfolios and this initiative may lead to financial hardship for many intended participants. We have recently witnessed a return of the public investor to the equities market. This group had been sitting on the sidelines, after being devastated by the puncturing of

the NASDAQ bubble. Today, however, many have been actively purchasing many new "dream tickets", such as satellite radio stocks, new internet concepts and stun-gun plays. This type of activity is not the foundation of a sustained market advance. It is usually witnessed as the market enters its last leg, prior to rolling over.

Even more worrisome is the additional debt burden this proposal would put on the system. Adding retirement accounts in place of Social Security could cost the government close to $2 trillion over the next decade, since these accounts would not go towards paying current retirees. To fund this expenditure, the government would have to borrow additional funds. As the president promised he would not increase taxes, passage of this proposal would be an additional fiscal burden.

To date, foreigners have been the largest purchaser of U.S. debt. This has helped to stabilize interest rates. As the dollar continues to decline, their purchasing habits may change, and they will look to be compensated for additional currency risk and the potential for principle erosion. Any sudden or significant change is likely to have a negative impact. It would be wise to remember upward movement in interest rates and a precipitous dollar decline were the primary causes of the 1987 correction.

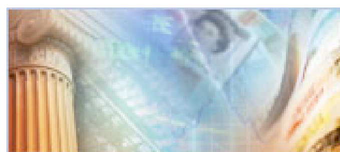
Short-term rates have backed up at an unprecedented rate since the summer. While base rates were at a 46-year low when this move started -- the speed of the increase and rate of change is alarming. Changes in monetary policy take approximately six to nine months to impact the economy. Having assumed record levels of adjustable debt, U.S. consumers may be forced to drastically change their spending habits. This would have a dramatic impact -- as consumer spending has been responsible for 70% of GDP growth.

A forecasted slow down of the economy is also reflected in a narrowing yield-curve since the Federal Reserve Board embarked on a policy change. On June 30th, the overnight cost of capital was 1% and the 10-year Treasury note was yielding 4.60%. Last month -- with 2.25% overnight rates, the 10-year note yielded 4.15%. The 30-year US Treasury bond also had a commensurate drop in yield. If the economy was truly expanding, intermediate and longer term rates would have had commensurate increases. One might imagine, however, the change in relative rates is expressing the reality of the economy as opposed to the hope currently reflected in stock prices.

Other factors the market will have to wrestle with during the new-year include Alan Greenspan's retirement, a possible economic slowdown in China, a permanently higher floor for the price in energy, inflationary pressures and the end of the re-finance boom. In addition, FASB 123, takes affect on 06/15/04. This regulation requires public companies to expense stock options in their current financial statements. It is projected that this expense will impact S and P 500 earnings by 3-5 percent. At a minimum this means these are additional elements of risk that will enter the equation.

While the current direction remains to be seen, investors would be well advised to consider that the bear market we entered in 2000 may again resume over the

coming year. As the honeymoon period for the re-election continues to fade, and investors start to focus on trouble within the U.S. economy, it is unclear whether it will be possible to sustain the optimism now prevalent within the investment community.



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Asian Energy Buyers Launch New Regional Grouping

by Kumar Amitav Chaliha

NEW DELHI (KWR) At face value, nothing concrete emerged from the first roundtable of Asian and Middle East ministers on regional oil and gas cooperation in New Delhi on January 6, except the usual proclamations on the importance of stability and security in oil supplies.

However, the confab marked the political launch of a possible new regional grouping, which is being dubbed the Asian Energy Forum or Asian Energy Agency. "We have made a start and this is going to continue," Mani Shankar Aiyar, India's petroleum minister and host of the conference, said. Aiyar said that getting all the oil ministers under one roof to discuss Asian energy cooperation was an achievement in itself.

Saudi Arabia has offered to hold the next Asian roundtable, with Japan acting as the co-host. Tokyo has also agreed to hold the third conference, with Qatar as co-host, while Kuwait would host the fourth meeting, with Korea as co-host. Aiyar could not confirm if the ministers of producing and consuming countries would meet once or twice a year. The date for the second meeting has not been set, but it would likely be next year, Saudi Oil Minister Ali Naimi told reporters.

"An Asian dialogue is indispensable and is aimed at evolving an Asian consensus," Aiyar said in his concluding remarks.

Aiyar, a career diplomat, argued that Asia is emerging as an important production and consumption center. The Middle East accounts for nearly 70% of Asian crude imports, but Asia still behaves as if it were a residual consumer of Asian oil production, said Aiyar.

The Indian minister stressed the need for the emergence of an Asian crude benchmark and development of a regional spot market.

He also said that Asian countries should invest in the Middle East region, which need an estimated $1.6 trillion in investments in upstream, midstream and downstream, and stressed to create strategic storage facilities to avoid oil shocks.

Saudi Minister Naimi said that Asia should continue to depend on the Middle East instead of diversifying supplies in the name of security.

" I'd like to assure our customers in Asia that Saudi Arabia is both capable of, and committed to, meeting the petroleum needs of its Asian partners," Naimi told the conference. "We closely monitor growth of petroleum demand in Asia to anticipate future needs so we can meet them without delay."

Saudi Arabia ships more than 4.5 million barrels per day to Asia, representing nearly 60% of its crude exports and 20% of Asia's current consumption.

Naimi also said the kingdom is dedicated to maintaining spare production capacity of 1.5 million-2 million barrels per day (bpd) should the need arise. He invited India to submit bids for gas exploration and investments in downstream.

For its part, Saudi Arabia is actively pursuing investments in refining capacity in Asia, Naimi said, pointing to investments in South Korea, Japan, Philippines and China.

" Restructuring of the industry in some Asian countries has brought more opportunities for joint investment in downstream activities," Naimi said. "We'll continue looking for partners across the continent for refining and marketing investments. We've the capacity to supply crude to our joint ventures throughout Asia."
Kuwaiti officials also stressed the importance of Asia as a key consumer of Middle East crude.

UAE Oil Minister Mohamed al-Hamili said that the Middle East is expected to increase its production capacity to 40 million bpd by 2020 from around 25 million bpd today. He reinforced Saudi Arabia's view that Asia will continue as a key market for Middle East crude.

Iran's Bijan Zangeneh floated the idea of creating an Asian Bank for Energy Development to invest in oil infrastructure in Asia. Zangeneh said the oil majors are not the commercial agents for countries such as China, India, Japan and Korea, and said these large consumers should invest in developing petroleum resources in the main producing countries.

The oil consuming countries led by Japan, South Korea and China stressed the need for stability and security of supplies through mutual investments, stockpiling and the forging of an Asian energy policy. Japan suggested that a combination of stockpiling crude -- it has 73 days of storage -- energy conservation measures, spare upstream capacity, and increased upstream investment is needed to ensure supply security. Tokyo stressed the need for transparency in crude prices to avoid paying a premium.

Zhang Xiaoqiang, vice chairman of China's National Development and Reform Commission, noted that his country imported more than 2.6 million bpd, with domestic production estimated at 3.5 million bpd. He said that China was not

responsible for a spurt in global crude prices last year, because it imports less than 40% of its total consumption.

Korean officials mooted the idea of creating a joint oil stockpile for Asia, storing supplies in countries where facilities are available. They also stressed the need for an Asian energy policy forum at the ministerial level, saying that organizations such as the International Energy Agency do not take care of Asian interests.

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Asian Oil Demand Poised to Slow after a Record 2004

by Kumar Amitav Chaliha

NEW DELHI (KWR) Asia's oil demand growth is expected to slow in 2005, as key markets including China, India, Japan and South Korea appear poised to grow at slower rates as their economies cool and alternative sources of fuel are consumed in place of expensive crude, according to Facts, a US-based oil consulting firm.
Facts chief economist Jeffery Brown said in a report on Asia-Pacific demand that 2004 had been a record year for Asia with oil demand growth of 1.019 million barrels per day (bpd). Brown expects growth from 2005 to 2010 to slow to 600,000 bpd to 800,000 bpd.

China was the driving force behind Asia's demand growth for 2004, contributing 737,000 bpd, equivalent to 72.3% of the region's total increase in consumption, with its "robust economic performance and the corresponding growth in petroleum use in almost every sector of the economy." Brown said that he expects China's incremental demand for oil to slow in 2005 on forecasts of slower economic growth.

He also said China's power shortages in 2004 had temporarily boosted oil demand for power generation. More coal- and gas-fired power plants are scheduled to come on line in China this year, which would significantly impact oil demand for power generation. Over the long run, Brown believes a sustainable growth rate for Chinese oil demand is 350,000 bpd to 400,000 bpd.

Other key countries including India, Japan and South Korea will most likely to post little or negative growth in oil demand, Brown said.

India's oil demand growth has been stagnant, at just 141,000 bpd in 2004. Brown said India's "inter-fuel substitution away from oil, which contributed to slow growth over the period 2000-03, has reached a peak" and demand should increase by between 70,000 bpd and 90,000 bpd from 2005 to 2010.

Japanese oil demand is expected to dip in the coming years, in large part due to its mature economy and shrinking population.

South Korea will follow Japan's footsteps and show a fall in demand, again largely as a result of the country's mature economy. South Korea is expected to have a growth rate of 40,000 bpd this year, according to Facts.

Smaller countries such as Thailand and Indonesia will show continued growth, assuming their governments maintain subsidies on high oil prices. Both countries have been working to reduce subsidies without affecting the local economy. Government officials in Thailand and Indonesia are finding it increasingly difficult to sustain the costs in the current high price environment.

Fruitful Year Predicted for Foreign Oil and Gas Firms in the Middle East

by Kumar Amitav Chaliha

NEW DEHLI (KWR) After a slow 2004, this year could prove to be a period of progress in oil and gas developments in the Middle East, with the conclusion of many large deals for upstream developments and a greater role for foreign companies in the region, according to UK consultants Wood Mackenzie (Woodmac).

Spiraling oil prices in 2004 brought to light the scarcity of global spare capacity as OPEC producers pumped oil at maximum rates to cool markets. But while several deals were completed, there was "little progress with the 'big oil' opportunities in Iraq, Kuwait, Abu Dhabi and Iran," said a recent report by Woodmac. Major projects were delayed by factors such as security in Iraq, political wrangling in Kuwait and protracted negotiations in Iran.

With sustained growth in oil demand and high oil prices, 2005 shows signs of being a more successful year for the Middle East in terms of concluding contracts, said the report. This year could "be the year which sees the international majors assume a more pivotal role in the growth of OPEC production capacity," Woodmac predicted.

"Based on current status of negotiations and the perceived desire for progress, we expect the Yadavaran project in Iran, the Upper Zakum development project in Abu Dhabi and Project Kuwait to proceed to contract agreement in 2005," Woodmac said. Other pending contracts include liquefied natural gas ventures in Iran and gas projects in Syria.

Still, Woodmac stopped short of unbridled optimism, cautioning that regional or global events could "intervene to dictate otherwise."

Domestic politics remain "the primary influence" on the progress of expansion

projects, the report said, "whether it be parliamentary wrangling in Kuwait, presidential elections in Iran or the new ruler in Abu Dhabi. While developments in the oil market and the prevailing oil price will influence considerations, it is policies which will dictate the pace. This makes forecasting developments in 2005 a precarious business."

In Saudi Arabia, state Saudi Aramco has the technology to maintain and increase capacity, so the question is one of cost rather than capability, noted Colin Lothian, senior Middle East energy consultant at Woodmac. Saudi Arabia late last year confirmed its intention to increase capacity to 12.5 million barrels per day.

Manouchehr Takin, upstream analyst at the Center for Global Energy Studies in London, noted that: "History has shown that plans can change, depending on events and unknown factors," but he also agreed that the Middle East should progress this year in the development of its vast hydrocarbon resources.

As an example, "Iran needs to open and expand its oil and gas industry. … Even the most conservative in Iran recognize that business needs to be pragmatic and de-politicized," Takin suggested. "The environment in Iran and in other Middle Eastern countries needs to be more geared towards business."

Of the significant deals signed in 2004, most were gas projects. In Saudi Arabia, three gas exploration licenses were awarded to Russian Lukoil, China's Sinopec and an Eni/Repsol joint venture, with Aramco taking 20% of each deal. These contracts followed the award of the South Rub al-Khali exploration block to Royal Dutch/Shell and Total in 2003.

In Qatar last year, Shell signed an integrated development and production sharing agreement for the Pearl gas-to-liquids (GTL) project. The deal signed in July 2004 will see the installation of gas production facilities with a capacity for 140,000 barrels per day (bpd) of GTL products. The first phase of the two-stage project is expected to be completed in 2009.

Elsewhere, Iran awarded the South Azadegan block to a Japanese consortium led by Inpex as well as three exploration blocks -- the Tousan Block to Brazil's Petrobras, and the Iran-Mehr and Forooz Blocks to Repsol.
Petroleum Development Oman -- in which Shell has a 34% interest -- saw its concession extended for a further 40 years. PDO is 60% owned by the government, with Total holding 4% and independent Partex the remaining 2%. The concession that covers nearly 114,000 square kilometers accounts for more than two-thirds of the sultanate's production.

However, ongoing security issues, domestic politics and poor regulatory and fiscal systems in Iraq, Kuwait and Iran, respectively, continued to hold up the finalization of major projects, Woodmac said.

"The buybacks offered in Iran limit rates of return and do not offer the international investor entitlement to oil production," said Woodmac consultant Lothian.

"Top managers in the National Iranian Oil Co. feel handicapped in negotiating more attractive terms for foreign investors for fear of being reprimanded by the politicians," another analyst said.

Iraq is a different case, in that security issues are the greatest hindrance to utilizing its vast resources more effectively. However, observers are watching the development of its contractual terms and fiscal regime, according to Woodmac.

"They have a model contract which is very similar to the Iranian buyback called the development and production contract, which was modified in 2000," said Lothian. "It will be interesting to see if they will use this model or whether they will revert back to the production sharing agreement to attract inward investment."

In Kuwait, the long-awaited Project Kuwait, which would enlist foreign companies to develop crude production in the north, has been the subject of intense political debate in parliament. Woodmac does not see approval being given before mid-2005.

Success stories are apparent in Oman and Qatar, however.

"Qatar recognized an opportunity and grabbed it firmly with both hands. They developed fiscal terms which were sufficiently attractive to international companies to invest under and have seen this approach bear fruit," Lothian said.

Likewise,Oman's contractual models have been modified several times over the years, noted Lothian, who believes that the Omanis' willingness to talk to international companies sets a good example for neighboring countries.

Oman's latest initiative is to offer alliance contracts -- structured as service agreements giving a high degree of autonomy to the contractor -- to operate 17 small fields within the Nimr-Karim cluster in the south of the sultanate. The cluster currently holds 70 million barrels of oil yet to be recovered, with current production of 16,000 bpd.

Further ahead, there is a possibility that Oman will relinquish some of its acreage in the medium term to help reverse the country's decline in production, observers say.

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Jet Fuel Markets in Asia Take Tsunami Effect in Stride

by Kumar Amitav Chaliha

NEW DELHI (KWR) Relief efforts in the wake of the Asian tsunami are prompting a temporary upsurge in US military needs in the Indian Ocean and parts of the Pacific. The fact that commercial airlines are also involved in relief missions is offsetting any decline from cancelled flights to the afflicted areas. Logistical constraints pose the biggest hurdle to supply lines, as countries redouble their financial commitment to the world's largest-ever humanitarian mission.

The Defense Energy Support Center (DESC), the Pentagon's fuel purchasing arm, is relying on the flexibility of its fuel purchasing system to see it through a temporary upsurge in demand in the Indian Ocean and Pacific theaters. To support an increase in Department of Defense jet fuel usage, the DESC has engaged in two to three supplemental into-plane contracts at airports in the affected regions. In areas where the DESC has no current into-plane contracts, military pilots have been purchasing fuel with the Department of Defense's aviation fuel card. Known as the Aviation Into-Plane Reimbursement (AIR) Card, this system of military credit card payment provides refueling flexibility and is heavily relied upon in times of crisis.

Into-plane contracts at commercial airfields account for a relatively small 6% of the Pentagon's annual jet fuel purchases of 98 million barrels, most of which are procured through an extensive network of bulk jet fuel contracts with suppliers around the world. Airport facilities in parts of Indonesia and other regions affected by the tsunami are not equipped to support such a massive airlift, in terms of the size and scope of their fuel facilities. The US military has been concentrating its efforts in the hardest-hit parts of Indonesia, where C-40 cargo planes have been landing in Banda Aceh to distribute food, water and medical supplies.

Commercial carriers demonstrated remarkable agility in dealing with the SARS crisis in 2003, and that experience will serve them well in coping with this latest challenge. Airlines operated additional services to bring travelers home after the disaster struck. They are now working to overcome the tsunami's impact with competitively-priced fares and efforts to divert travelers to alternative destinations, according to the Sydney-based Centre for Asia Pacific Aviation. It said that airlines and tourism associations were reporting little or no operational impact from the disaster. Moreover, the growing role of low-cost airlines serving destinations in southern Thailand should lure travelers back to resorts such as Phuket following a temporary hiatus.

Commercial carriers were also using their aircraft for relief missions. Among others, AirAsia offered seats for relief and rescue workers, Austrian Airlines operated nine relief services to the area, while Indian Airlines has been providing relief services from Chennai to the Andaman islands. Qantas operated humanitarian flights to Thailand and Sri Lanka, carrying medical teams and equipment and bringing passengers back to Australia. Many carriers have waived cancellations fees through end January on flights booked to the affected areas. Lufthansa said the tsunami had no impact on forward bookings and its schedules remain unchanged.

India’s state-owned Indian Oil Corporation (IOC), which accounts for the largest share of refueling services at airports across India, said that its personnel have been

working around the clock at southern locations since December 26 to refuel aircraft involved in relief efforts. IOC has re-deployed staff from other departments to assist in aircraft and helicopter refueling for government officials and the Navy, Air Force and Coast Guard. IOC is the only company that sells jet fuel and other products in the southern Andaman and Nicobar Islands, which were hard-hit by the tsunami. It operates a refueling station at Car Nicobar for the Indian Army and Navy, which was badly damaged and forced military planes to divert to nearby Port Blair for refueling. In the southern part of the country, IOC said that it had moved aviation fuel facilities to parts of Tamil Nadu and Andhra Pradesh.

"We have already positioned backup manpower and fuel storage at these places to help fuel the aircraft involved in search and rescue as well as relief measures. Until the situation is normal, Indian Oil will continue to enforce a "non-stop" refueling system with adequate manpower and material support," said N.G. Kannan, director of marketing for IOC. The Indian Ministry of Tourism pointed out that rather than spurring a drop-off in tourism, the tsunami had prompted an upsurge in interest in travel to India, with the Home Ministry approving visas on arrival for foreigners during this period.

With Asian cargo markets currently awash in jet fuel, the region should be able to handle the rise in offtake from the relief efforts without an upward price correction, market sources say. Traders expect that the "tsunami effect" of displaced jet fuel usage will be taken in stride given the currently weak outlook for jet fuel across Asia.

High refinery margins in Japan and South Korea have prompted refiners in those countries to produce flat out, helping to replenish stock levels. Mild winter weather so far has kept inventories ample and put a lid on regional demand. "We should see some shifting of demand patterns around the region from the tsunami, with military planes refueling in places that don't normally see a lot of commercial activity. This displacement effect should be easily absorbed by the market," said one trader.

Equity Spotlight: TransMontaigne, Inc. (AMEX: TMG)
(note: Guest Opinions do not necessarily reflect the opinions of KWR Intl.)

Pending Restructuring Play in the Energy Sector to Unlock Shareholder Value

by Mark Reiner, The Doctor's Investment Fund, LLC

NEW YORK (KWR) TransMontaigne Inc. (AMEX: TMG) is a refined petroleum products distribution and supply company, whose principal activities consist of three business segments. These include: 1) terminal, pipeline and tug and barge

operations, 2) supply, distribution and marketing and 3) supply chain management services.

Background:

TMG has assembled an asset infrastructure, using common carrier pipelines to distribute refined petroleum products. TMG also provides integrated terminal, transportation, storage, supply, distribution and marketing services to refiners, wholesalers, distributors, marketers and industrial and commercial end users.

TMG owns and operates terminal infrastructure utilizing pipelines, tankers, barges, rail cars and trucks to company owned or third party facilities. At company owned terminals, TMG provides throughput, storage, injection and distribution related services to distributors, marketers, retail gasoline station operators and industrial and commercial end-users. TMG operates 55 terminals with an aggregate capacity of approximately 21.4 million barrels.

In the supply, distribution and marketing segment, TMG purchases refined product primarily from refineries along the Gulf Coast and schedules them for delivery to company-owned terminals, as well as terminals owned by third parties, in the Gulf Coast, Midwest and East Coast regions of the United States. TMG then sells this product primarily through rack spot, contract and bulk sales to cruise ship operators, commercial and industrial end-users, independent retailers, distributors, marketers, government entities and other wholesalers of refined petroleum products.

The supply, distribution and marketing operations and their terminal, pipeline and barge operations have synergistic characteristics in that they each utilize and benefit from each other. This creates opportunities to achieve additional value that could not be realized if each segment were operated independently.

Due to recent historical price volatility associated with energy prices, many companies and governmental agencies have opted to outsource their energy purchasing function. These end users need to focus on their core competencies and to reduce price volatility. This trend is creating a growth business in the energy supply management/logistics sector. TMG offers services that include fuel supply, monitoring, excise tax administration, and price management solutions. This allows customers to obtain fuel supply management functions from a single source. TMG is the only significant independent fuel supply chain management services provider in the U.S. offering this extensive suite of services.

Catalyst: This past July, TMG hired UBS to assist the company in evaluating strategic alternatives to enhance shareholder value As a result, TMG announced on September 22nd, that its Board had authorized management to pursue the formation of a new Master Limited Partnership (MLP) to hold their qualifying assets. TMG would be the General Partner of the new MLP. It is anticipated that the new MLP initially would own certain TMG terminal, pipeline and tug and barge businesses while TMG would retain the distribution and marketing business.

In a press release at that time, the company stated "It became obvious to the

Board that the existing MLPs that participated in the Company's evaluation of its strategic alternatives were unwilling to share with TMG's shareholders the economic benefits that an acquisition of TMG's extensive terminaling network would have provided to their MLP unit holders and their respective general partners. Consequently, forming our own MLP allows our current shareholders to share in both of those economic benefits."

Given that the regulatory approval process for a transaction of this kind can take up to about six months, TMG's GP/MLP transaction is likely to materialize during the first half of 05, once it receives necessary regulatory approvals., To date, there has been no further company announcements or guidance, however, in recent conversations with the firm, it was noted that. the transaction is moving along, as per their public announcement.

There are several alternatives as to how the transaction may occur. Options include an IPO for the MLP, a spin-off of to TMG shareholders, or possibly a hybrid of the two. TMG shareholders may become owners in the General Partner, which should retain a large percentage of the new MLP, as per previous transactions in this sector. Based upon previous cases, it might be expected that the total valuation of these new holdings will trade higher than the current security. A new public issue of the MLP should also bring attention of this company to the investment community.

There are a number of precedent GP/MLP structures in the public market. Some examples include Holly Corp/ Holly Partners, Crosstex Energy/Crosstex Energy, LP and Kaneb Services/ Kaneb Partners, L.P. These deals were structured in a unique fashion, as the GP retained a majority interest in the MLP. The GP's sole source of income is the cash flow from the distributions of the MLP plus incentive distribution rights, which entitle the GP to a higher percentage of future cash flows from the MLP, once certain hurdles are attained. This structure motivates the GP, to make accretive acquisitions for the MLP, with the goal of increasing the terminal value of the MLP's cash flow.

Management of TMG has proved adept at accretive acquisitions. The company expanded in 2003, with the acquisition of facilities in Florida and Virginia. Both of these transactions have proved accretive to date. Management credited these acquisitions for the increase in net operating margins for fiscal year 2004.
There are approximately 30 natural resource/ energy related MLPs that are publicly traded. MLPs appear to be more complex and daunting to investors. These structures are in essence just corporate-type entities that are taxed at the unit holder level, thus avoiding double taxation. Historically, MLPs are operations that were spun out of major corporations to reduce debt or to reallocate assets to faster growth areas. MLPs are usually steady, high-cash flow businesses that do not require large amounts of capital spending to sustain competitiveness within their businesses.

TMG's new structure is likely to help to attract a new group of income-oriented shareholders, while strengthening its balance sheet. It will also enable TMG to arbitrage the differences between public markets pricing versus the private market for energy facility transactions. In addition, it will be able to generate additional cash flows from these potential transactions. Private market deals in this industry

are currently transpiring at 7 times cash flow, while the average energy MLP is trading at 14 times cash flow. Based on these metrics, management will have the flexibility to exploit this discrepancy and facilitate more accretive deals going forward. Approximately 25% of TMG's equity is owned by management, creating an incentive to enhance current value and increase current income for shareholders.

An additional catalyst is the recently signed product agreement with Morgan Stanley Capital Group (MSCG). In the Sept 22nd press release, the Board of Directors announced their authorization to management to procure long-term supply agreements from one or more major refined petroleum product suppliers. A long-term supply agreement would eliminate the need for the Company to manage the commodity price risks associated with its sizable inventory positions. This would stabilize the Company's marketing and distribution margins.

In November, TMG signed a 7-year, product supply agreement with MSCG. Under the terms of the agreement, MSCG will be the exclusive supplier of gasoline and distillate to TMG terminals connected to the Colonial and Plantation Pipelines and its Florida waterborne terminals at market-based rates. MSCG will begin supplying certain TMG terminals in January 2005 with complete implementation expected in February. The supply agreement expires on December 31, 2011, subject to provisions for early termination. In connection with this agreement, TMG issued warrants allowing MSCG to purchase 5,500,000 shares of TMG common stock at an exercise price equal to $6.60 per share, subject to adjustments in accordance with the terms and conditions of the warrant certificate.

This transaction should prove beneficial to TMG for a number of reasons. The agreement will strengthen TMG's balance sheet, as less working capital will be deployed in procuring and carrying a volatile commodity, This should lead to more consistent earnings and cash flow streams. TMG has an extensive risk management operation, however, lost money on hedging over the last three years, as there is no perfect correlation between the cash petroleum and futures market for energy products. In addition, the equity relationship with MSCG should provide an incentive for MSCG to bring potential acquisitions and deal flow to TMG in the future.

This transaction is also likely to help TMG attain higher margins, which should lead to a higher multiple for their share price. Below is a breakdown of gross margins for the firm's two main segments for the last three years:

Supply, Distribution and Marketing:

	2004	2003	2002
Gross Sales	11,215,351	8,241,001	6,001,170
Cost of products sold	(11,060,105	(8,072,877	(5,875,791
Net margin before other direct costs and expenses	155,246	168,124	125,379
Other direct costs and exoenses			
Net losses on risk management activities	(54,739)	(84,146)	(56,826)

		2004	2003	2002
	Change in unrealized gains (losses) on derivative contracts	(25,323)	(21,460)	194
	Lower of cost or market write-downs on base operating inventory volumes	(5,334)	(12,435)	N.A.
	Net operating margins	$69,850	$50,083	$68,747

Terminals, Tugs, Barges and Pipelines:

	2004	2003	2002
Throughput fees	$ 32,019	$ 30,359	$ 26,544
Storage fees	36,036	25,979	18,053
Additive injection fees, net	7,908	7,921	6,611
Pipeline transportation fees	7,073	5,758	6,492
Tugs and barges	11,667	4,335	N.A.
Management fees and cost reimbursements	4,975	4,461	4,899
Other	9,562	8,154	5,686
Revenue	109,240	86,967	68,285
Less direct operating costs and expenses	(53,966)	(39,175)	(32,567)
Net operating margins	$ 55,274	$ 47,792	$ 35,718

Within this data, one can see that the margins in the infrastructure business are consistent and fall with in the context of a traditional MLP.

As a result of the proposed transaction, the securities that are issued to current TMG shareholders, via the new structure are likely to trade at a premium to the current market value of TMG. Today, the unknown variable is the exact structure of the new entity, as per the prorating of GP or MLP to the current TMG shareholder.

Finally, this deal is likely to create more investor and institutional awareness of this $11 billion dollar company -- which to date -- has been largely unrecognized and undervalued by the market. This is evidenced by its meager EV/EBITDA ratio of 6.43, whereas its peer group is trading at much higher multiples.

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Letters to the Editor

In response to the lead article in our last issue:

Gentlemen: Many thanks for your very astute analysis of the election. However, I believe you dismiss what I call the "core value" vote at your own peril. While I agree that foreign policy, ie: the war; was a critical factor, the 20 plus percent who stated their concerns about moral or core values as a reason for favoring Bush was real, and the President would not have won without them. While I would not categorize all liberals as secular nor all conservatives as religious, the data seem to indicate that Bush was seen as having certain principle beliefs and in sticking to them, while Kerry was seen as vascillating on whatever it is that he believes, ie: abortion, gays, etc. Many red state voters apparently saw this difference as important.

Ronn Cupp

Dear Dr. MacDonald,

I was puzzled by your analysis about what Bush needs to do in order to avoid the stain of previous Republican presidents from the gilded age. Particularly since in his first term he has done nothing but enact policies that will only make the growing inequalities in America even greater.

You seem to pre-suppose that Republican leadership won't necessarily make the needed choices to address our problems, but that just maybe it could happen!. That given hard choices they just might adopt a pragmatic rather than an ideological approach to governance. Oh! If only that were possible! Unfortunately, there is almost no chance that Bush and his advisors will choose a flexible pragmatic approach to solve problems. They are single mindedly driven by a radical market ideology and militaristic foreign policy and nothing can shake their faith. Any suggestions or realities to the contrary are simply ignored. These people are true believers in their own magic. So if you don't believe as they do save your breath.

Americans had a chance to chart a different path and they fucked up. That's the best description that I can think of. Working families had a chance to look out for their own economic interests and they chose not to. There is a price for this lack of insight.

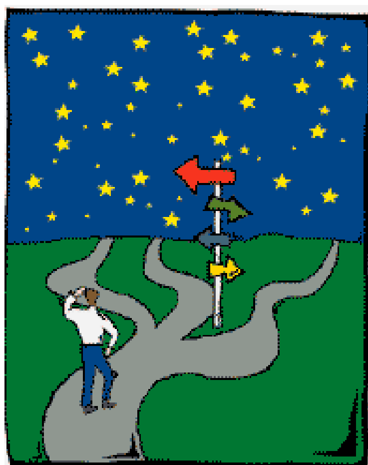
We are already sliding into another gilded age, which is masked to a considerable degree by the New Deal and Great Society social safety nets enacted by past Democratic administrations. In other words it hasn't become as obvious yet to many working people, unlike in the previous gilded age, when there were no safety nets and everyone but the Republican presidents and Wall Street Bankers knew about it or cared. Bush and his ideologues don't care either. Working people will be paying the price.

Expect things to get worse over the next four years because of either neglect or worse yet, irrelevant and destructive policies pretending to solve our social problems. A good example is the Medicare prescription drug bill. Every healthcare expert who understands it knows that it's a bad bill. The nonpartisan American Association of Retired People called it a bad piece of legislation that will need significant modification before it comes into effect in 2006. And they initially supported it because seniors need affordable prescription drug coverage and they just wanted to get a bill passed, one that would be changed later. Unfortunately they failed to realize that you need people in government who also care about the effect rather than just the headline.

Make no mistake about it the best these people could do for us over the next four years is nothing at all. But they're to arrogant for that. Sooner or later the Democrats will eventually inherit their mess. I hope that when they do, that like FDR they shame them and publicly ridicule them every time they open their mouths.

Sincerely,
Gary Anderson
Kalispell, Mt. USA

EMERGING MARKET BRIEFS



Indonesia – S&P Upgrades the Sovereign: Standard and Poor's earlier this week upgraded Indonesia's foreign currency rating by one notch, to B+, and its local currency rating by two notches, to BB. S&P also left its outlook unchanged, at Positive. This differs from the example of S&P's upgrade of Pakistan to B+ last month, in which S&P lowered its outlook to Stable. Moody's rating for Indonesia is B, but with only a Stable outlook. S&P was the first credit rating agency to rate Indonesia, having initiated coverage on the country in July 1992 with a BBB- rating, which was somewhat controversial at the time. Fitch rates Indonesia at B+ with a Positive Outlook. S&P cited Indonesia's macroeconomic stability, steadfast fiscal management, and favorable foreign liquidity position. This positive outlook suggests that a further upgrade could be on the way once the administration of President Yudhoyono and Vice President Jusuf Kalla articulates a clear-cut economic strategy for economic recovery and demonstrates observable progress in implementing it. In addition to macroeconomic stability, the voters of Indonesia want to see a recovery in investment and employment soon. Vice President Kalla's recent political coup of gaining the chairmanship of the Golkar political party would appear to have greatly

increased his status and influence in the new government. We only hope that Kalla's role in the new government contributes to, rather than detracts from, the coherence of government policy.

Philippines – That Old Problem, The Budget Deficit Just Won't Go Away: One of the most persistent problems facing Philippine governments over the past two decades has been the budget deficit. For a number of reasons, the government has been unable to close the gap. Most recently, the International Monetary Fund (IMF) recommended to the Philippine government the undertaking of up-front fiscal adjustment to keep budget within target despite projected slower economic growth for next year. According to Masahiko Takeda, head of the IMF Post-Program Monitoring Mission: "GDP has been robust in 2004, but is expected to be moderate in 2005. We are currently reviewing our 4.2 per cent GDP projection for the Philippines."

Takeda also noted the IMF took into consideration inflation, which has risen sharply in 2004 due to supply shocks in such commodities as meat and oil. Inflation is expected to rise above the target of 4-5% in 2004-2005. "The outlook for exports and global oil prices is also highly uncertain," he said. "Combined with the possibilities for rating actions, these uncertainties highlight the case for rapid implementation of the government's reform agenda." With this, Takeda cited the need for early implementation of high quality measures to raise government revenues that can help maintain investors, confidence.

The increase in generation tariffs provisionally awarded to the National Power Corporation (Napocor) in September is also the first major step in this regard, he noted.

The administration has identified eight legislative tax measures for Congressional approval that could generate P83.4 billion in revenues. Some of these measures, including the two-percent tariff imposed on fuel imports and additional taxes on alcohol and tobacco products, were expected to reduce the government's budget deficit. Congress was expected to approve before year-end these two measures and another bill that seeks to reform the Bureau of Internal Revenue through the lateral attrition law. Of these bills, only the one on alcohol and tobacco excise taxes has so far been passed by the House.

In view of this, Takeda said the mission looks forward to the further strengthening of alcohol and tobacco taxes as well as "the passage of more substantive revenue-raising measures in the coming months." Nevertheless, he commended authorities for their efforts in making sure that big-ticket measures for 2005 will be approved by Congress. "A large initial reduction in the deficit would send a strong signal to the markets of the authorities commitment to balancing the budget".

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- KWR International Advisor #25
- KWR International Advisor #24
- KWR International Advisor #23
- KWR International Advisor #22
- KWR International Advisor #21
- KWR International Advisor #20

- KWR International Advisor #19
- KWR International Advisor #18
- KWR International Advisor #17
- KWR International Advisor #16
- KWR International Advisor #15
- KWR International Advisor #14
- KWR International Advisor #13
- KWR International Advisor #12
- KWR International Advisor #11
- KWR International Advisor #10
- KWR International Advisor #9
- KWR International Advisor #8
- KWR International Advisor #7
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