



HORNSBY & COMPANY, INC.

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Energy Risk
Management Services

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Good Morning

Overview

- Hydrocarbon prices firmed overnight. **Crude oil up \$.52 to \$43.15 per barrel; natural gas up \$0.025 to \$5.897 per mmBtu.**

News/Views

- Yesterday's drop in oil and equity markets was a sober reminder that we are far from out of the woods at this point. While asset allocation strategies and geopolitical events managed to pull prompt WTI back up briefly to \$50.00 per barrel, invariably the weekly U.S. stats provided their customary reality check as the best gauge, however faulty, of coincident fundamentals in the largest and most visible oil market in the world. Interestingly enough, although the most recent implied demand data will no doubt be revised down in the upcoming months, the year-over-year comparisons revealed some moderation in decline from recent experience. The market chose not to embrace this phenomenon, however, choosing instead on the macro level to take the cue from the latest ADP data and the equity market itself.
- In addition, of course, traders and funds responded to the changes in stock levels themselves which, as discussed yesterday, were bearish across the board relative to expectations, particularly for crude oil and gasoline. Gasoline builds have reflected the continued decline in motor fuel demand which, as also previously discussed, has been and remains integral to our Base Case for 2009. In the aftermath of unending bullish sentiment in the downstream sector over the previous few years, the industry faces the scenario of survival of the fittest. It turns out, in line with our own thinking, that ExxonMobil was dead right about the lack of need for incremental refining capacity in the United States, even when bullish sentiment was at its peak. Even without the credit crisis gasoline demand would have been severely tempered by the impacts of higher retail prices themselves. In this context, we had discussed with some of you yesterday stories that ExxonMobil was considering a bid for BP. Anything is possible, of course, but as you are all aware XOM tends to be a bit "shy" in terms of government scrutiny, and the required divestiture of downstream assets, particularly under an Obama Administration, might not be worth the effort in the current environment.
- Back to the stats, it might be useful to review our short-term Base Case. Before the outbreak of war between Israel and Hamas combined with the Russia/Ukraine gas dispute, we suggested that crude oil prices would be subject to some weakness in January reflecting a couple factors. The first was the likelihood that U.S. crude oil stocks would recover as cargoes held offshore to minimize 2008 taxation would be landed and booked into the data. This tends to begin occurring within the first two weeks of January, as one might expect. Sometimes the timing is delayed until the second week of numbers, simply due to logistical issues. Thus far, however, the phenomenon has been right on cue, with last week's build for the week ending January 2 a manifestation of this strategy. Compounding the impact this year will be the landing of cargoes that were purchased and placed in storage due to the combination of deep contango and low tanker rates. As previously discussed, this strategy has helped delay the falloff in non-Saudi OPEC crude oil sales.

- The second factor we cited leading to first quarter price weakness was the inevitable concern about, and subsequent discounting of, the upcoming “weak” second quarter. From OPEC ministers to analysts, every first quarter there is the preoccupation with the assumed coincident correlation between crude oil prices and the seasonal downturn in world refined product demand reflecting the end of the Northern Hemisphere winter from the first to the second quarter. Invariably, however, this concern is incorrect, with crude oil prices rising from the first to the second quarter reflecting the recovery in Atlantic Basin crude oil demand combined with reduced North Sea production due to the beginnings of seasonal platform maintenance. The impact could be somewhat accentuated this year because the spring is scheduled to witness the largest monthly rates of SPR fill. The first to second quarter crude price strength does not always work, but usually does. It failed back during the Asian financial crisis, as the global picture outweighed seasonal factors. Clearly, there is the risk that current economic conditions could negate a seasonal price recovery. At current price levels, however, we believe the odds still favor such a scenario unfolding.

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