



HIGHLY CONFIDENTIAL

January 14, 2009

Good Morning

Overview

- Hydrocarbon prices were mixed overnight. **Crude oil up \$0.97 to \$38.875 per barrel; natural gas down \$0.013 to \$5.171 per mmbtu.**

News/Views

- Experiencing a deepening contango as prices rose, the NYMEX attempted a recovery off the recent trough without yet fully falling to the lows of December. Whether such a move reflects simply a short-term trading range, the beginnings of a recovery, or a dead cat bounce may be tested later this morning via the combination of the weekly stats and February crude oil options expiration. There is reasonable volume of open interest at the \$40.00 strike, with puts outweighing calls, presumably more long puts than short puts. It would be logical to assume that if the weekly data are bullish, then \$40.00 per barrel will be tested for the February contract, but we shall see. In terms of overall market structure, it is not unheard of to see a rising market within a contango term structure, but "conventional" commodity economics would suggest that as prices rise the curve should flatten, reflecting progressively tighter prompt month availability. A contango market as prices rise is not completely favorable to non-commercials and index traders, since over time contracts are rolled over to higher numbers and therefore one is already starting "in the hole" if one is long.
- The current contango is clearly a function of ample prompt supplies which is feeding on itself. As word emerges of rising stocks, both on land and in chartered tankers, the contango deepens. As it deepens there is a greater incentive to store despite the overall credit crunch. Adding fuel to the fire may also be trader games at Cushing, playing one against another in the February-March calendar spread. The contango is also compounded by the unwillingness of producers to hedge along the curve at current prices. This all has some relevance to the energy equity side of the equation, since if for a number of reasons over the next few days February were to strengthen dramatically versus March prior to expiration, the market would take this as bullish and Wall Street would spread the word. If not, the market would then assume that March is "too expensive" and assume, right or wrong, that March will fall back toward \$40.00 and below mimicking February behavior. We should have a better idea in the next couple days or so.
- Otherwise, the neopress attributed yesterday's gains to basically colder weather and Saudi "cuts", although Gazprom's declaration of force majeure was probably the largest influence. In terms of weather, not speaking for the planet we can nonetheless say that we are not burning any more heating oil despite the cold due to our use of wood stoves and more efficient fireplaces, although we are probably burning more dollars via wood than No. 2 oil. Despite lower prices, however, the massive backlog of pellet stove installation this past summer, as one example, suggests we should be cautious when estimating heating oil demand this winter. The Saudi "cut" news was beyond ancient in our view, since we previously discussed precisely the numbers that were disseminated in the market as part of our Base Case balances. Saudi oil minister Ali Naimi stated in New Delhi that since last summer Saudi production has declined by 1.7 MMB/D. This implies a decline from about 9.6 MMB/D to some 7.9 MMB/D, close to our assumed deliveries for the first quarter reflecting 1) lower "normalized" refiner needs given lower refined product demand 2) "decremental" volumes due to the credit crunch and 3) a proactive effort on the part of the

Kingdom to tighten markets and force a net drawdown of global inventory. The market also responded to word that additional OPEC cuts may come in March. We are not trying to dampen enthusiasm since we remain more constructive than the consensus for the next several months, but simply wish to differentiate between new, solid evidence and potential false starts.

- With regard to the weekly stats due out later this morning, the latest Reuters poll suggests that for the week ending January 9, crude stocks rose by 2.2 million barrels, distillate supplies gained by 1.1 million barrels, while gasoline inventories increased by 1.6 million barrels. Our estimates would imply somewhat smaller builds than the market expects across the board.

W.H. Brown, III

Information contained herein is believed to be reliable but its accuracy cannot be guaranteed. Past performance is not indicative of future results and the risk of loss is substantial in futures trading. Hornsby & Company, Inc. and W.H. Brown may, from time to time, have positions in the futures market relative to these recommendations.