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Energy Risk
Management Services

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January 16, 2009

Good Morning

Overview

- Hydrocarbon prices were stable overnight. **Crude oil up \$0.02 to \$35.42 per barrel; natural gas up \$0.033 to \$4.876 per mmBtu.**

News/Views

- The market must have been listening to our discussion in yesterday's morning notes, since hydrocarbon prices finally chose to react to negative economic news and bearish weekly inventory data in a more "reasonable" magnitude relative to the day before. Crude oil options expiration on Wednesday no doubt distorted price behavior to a certain degree, and yesterday for much of the trading session crude oil was weak not only in the February contract with players still selling Feb and buying March, but generally across the board. Adding fuel to the fire was the dissemination of OPEC's latest world oil demand outlook for 2009 which, as expected, was trimmed from their previous assessment. Nonetheless, by the end of the day the market was still able to exhibit what we previously termed "relative resiliency", aided by a recovery in the equity market. Thus, financial influences and the S&P "correlation trade" remain alive and well.
- Returning to OPEC's latest forecast for the moment, the Secretariat now believes world oil demand will decline by 180 MB/D this year, a 30 MB/D downward revision from their previous forecast. These numbers are almost statistically insignificant, but the market is in no mood to hear any more bearish news. OPEC's outlook also assumes a rise in non-OPEC supply this year averaging 580 MB/D, which once again we believe is too optimistic. The IEA, OPEC, and the consensus were all too bullish on non-OPEC supply growth for 2008 as we fully anticipated, and we believe 2009 will ultimately witness similar downgrades to supply gains as the year progresses.
- Back to price, it is quite clear that prompt WTI is now the cheapest hydrocarbon on the planet when looking at virtually any other crude oil elsewhere in the world, even adjusting for quality differentials. The discount to Brent is quite substantial, and many of you have questioned why this should be so. We believe that Brent is reflecting concerns over European gas availability as the Russia/Ukraine dispute continues as well as lower Russian crude oil production. In terms of the former, there is a chance the dispute could finally be resolved this weekend during the meeting of European gas consumers, the EU, Russia, and possibly the Ukraine. Prompt WTI, on the other hand, continues to suffer from "contango selling" as stocks in Cushing continue to build. Domestic sour grades such as Mars are selling at a premium to WTI, the result of reduced sour import expectations as Saudi sales to the U.S. are curtailed in combination with, once again, the "contango selling" of prompt WTI.
- The degree to which sub-\$40.00 per barrel prompt WTI is influencing energy equities in general is of course difficult to ascertain. There may be some impact, but we would expect investors to generally "look down the curve". Nonetheless, over time once February crude expires next week, assuming the Russia/Ukraine dispute is ultimately resolved and stocks at Cushing finally peak and subsequently decline on a seasonal basis, we would look for the prompt contract to firm and other crude oils such as Brent

weaken, bringing the differentials a bit closer, but probably not returning to, historical relationships. The recent recovery in refining margins in the United States may also lead to a modest recovery in runs and, in combination with lower imports, boost WTI relative to other grades. A sustainable gain in energy equities, however, will come about through the perception and ultimate reality that the global balance is not as onerous as consensus expectations, which we expect to unfold as we move toward the end of the first quarter and through the second, therefore requiring some patience on the part of investors.

W.H. Brown, III

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