



HIGHLY CONFIDENTIAL

January 20, 2009

Good Morning

Once again for the sake of good order we wish to remind everyone that we will be leaving on our brief vacation first thing tomorrow morning immediately following the issuance of our Morning Notes, with no further reports published through the remainder of this week.

W.H. Brown

Overview

- Hydrocarbon prices declined overnight. **Crude oil down \$0.60 to \$33.80 per barrel; natural gas down \$0.117 to \$4.590 per mmBtu.**

News/Views

- Today marks February crude oil contract expiration, and thus we should expect a fair degree of volatility. As we have also discussed, our longer-term recovery in crude oil prices over the next several months allows for the expectation that once March becomes the prompt contract there is a strong likelihood that traders will continue to sell the prompt relative to the outer months as the “contango trade” endures, since Cushing inventories are unlikely to begin an expected seasonal decline for a few weeks. For those who trade commodities and are considering a long position, therefore, patience is likely in order. The possibility of weaker equity markets today pending a possible “Obama bounce” in combination with the resolution of the Russia/Ukraine gas standoff and a tenuous Gaza cease fire all continue to weaken hydrocarbon prices in the context of the consensus view that economic activity will not recover in the foreseeable future.
- Otherwise, we wish to provide some comments on the latest IEA report issued last Friday as we prepare our updated Base Case global balances and price forecast for 2009. The IEA slashed its estimate of world oil demand for this year by a full 1.0 MMB/D, now expecting a decline of 0.6%, or some 500 MB/D. The downward revisions were about evenly split between the OECD and non-OECD countries, with the latter focused on China. While we have stated that the IEA has consistently fallen behind the curve when inflection points arrive in either direction, in fairness to the analysts we should point out that there is high degree of bureaucratic and political “lag” when it comes to assumption revisions, and the IEA is technically bound to have a forecast consistent with the IMF economic outlook, which has now been cut in half for this year. Nonetheless, although our forecast, which had been more conservative than anyone to begin with more than seven months ago, may be subject to minor revisions, when all is said and done we would expect we will still come up with a view of world oil demand for 2009 in its entirety which is more optimistic than the IEA or the consensus.
- While we can “barrel count” like everyone else until the cows come home, the only thing that really matters to us and your portfolios is price. In this context, the accuracy of any forecast average for 2009 is substantially less important than trying to call the inflection points in either direction as accurately as

possible, as well as the magnitude of price change. When we return from our vacation we will be concentrating on the various layers of crude oil price determination to make a hopefully final judgment on the probabilities of where price will go this year. From a fundamental standpoint, the layers include basic supply and demand but also seasonality and the degree to which global economic malaise may or may not outweigh this influence. Also, as we have previously discussed our tendency these days is to wait until the end of January to put together our official Base Case price outlook for the year, preferring to observe what we estimate to be the magnitude of non-commercial asset allocation to commodities which takes place at the beginning of the year and helps set the stage for the financial influence on price in concert with the fundamentals as we move forward.

W.H. Brown, III

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