



HIGHLY CONFIDENTIAL

January 27, 2009

Good Morning

Overview

- Hydrocarbon prices firmed overnight. **Crude oil up \$0.69 to \$46.42 per barrel; natural gas up \$0.009 to \$4.499 per mmBtu.**

News/Views

- The hydrocarbon markets still have not yet decided where they wish to go for the time being, with crude oil trying to exert some fundamentally-driven independence only to ultimately succumb to the vagaries and uncertainties of the equity market. If we sound a bit snobby about our beloved oil and gas we absolutely are, since although we appear to have re-entered a world where demand and supply compounded by a periodic layer of geopolitics really matters, there still remain some neotradlers who do not know what to do with their commodity exposure other than follow the fate of stocks and banks. For those who are able and well seasoned in commodity as well as equity trading/investing, however, as are all of you, such correlations provide attractive hedging opportunities without quite the extreme commodity/equity “basis risk” that characterized the market last year. In any event, crude oil is also being restrained by news of periodic sales of floating crude oil storage, such as word that Shell has sold a cargo from tanker storage off the U.K. Such events, whether in the U.K., the USGC, or Malaysia will by definition keep a lid on things at the least, since particularly with the visible U.S. data, reported stock builds now have “embedded”, by definition, a number of floating storage “shoes to fall” in subsequent weeks. On the other side of the coin, there is also word that the Ukraine is considering annulling the recent gas accord with Russia, claiming it was “forced” to sign.
- In the interim, our task is to lay out a number of factors that in our minds will form the basis of our “best guess Base Case” WTI scenario for 2009. In addition to what has now become our “conventional” layered analysis, i.e. assessing the fundamental versus financial price components, we also examine those factors which we suggest are fundamental in nature but may be compounded by financial participants as they unfold. We thus fully recognize that a lot of what we will be discussing is not mutually exclusive, and we believe that there remain complex forces at work these days, both complementary and antagonistic in nature. One of the most important of these in our mind is the **seasonality of crude oil prices.** This is something we discuss every year, because the consensus and OPEC ministers remain of a mind that crude oil prices follow the first to second quarter seasonal downturn in global refined product demand, **which can easily be shown is rarely the case.** The numbers below represent a quarterly index we have devised where 1.00 equals the annual average for WTI. The numbers also comprise the average of the last five years, i.e. 2004-2008, which represent the evolution of the interplay between fundamental and financial factors that led to the crude oil price boom and bust that we all have witnessed. The numbers clearly indicate that for the period as a whole, the first quarter represented the price bottom for the year.

	2004-2008	1998
Q1	0.93	1.11
Q2	1.03	1.04
Q3	1.08	0.95
Q4	0.95	0.90

- As previously discussed, however, one of the few years where such seasonality was clearly *not* in evidence was 1998, representing the height of the Asian financial crisis, which is generally recognized to have begun in July of 1997. Crude oil prices just kept heading south through 1998, and thus one of the questions in our minds is whether despite current global economic malaise seasonality will emerge once again this year or, as in 1998, it will be overwhelmed by macroeconomic factors. **The answer to this question has major implications for both commodity and energy equity performance in the first half of the year.** Tomorrow we will be able to spend more space providing the monthly details over the periods in question, as well as the factors that account for seasonality and how influential they may be this time around.

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