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Energy Risk
Management Services

HIGHLY CONFIDENTIAL

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Good Morning

I will be out of my office this morning to attend an urgent meeting until about 1:00. I will therefore issue the weekly natural gas storage report early this afternoon, and I apologize for this inconvenience.

Overview

- Hydrocarbon prices were mixed overnight. **Crude oil down \$0.54 to \$35.40 per barrel; natural gas up \$0.033 to \$4.565 per mmBtu.**

News/Views

- Markets have obviously yet to receive much comfort from the Administration's bank and economic stimulus plans. Although clearly there has never been the "instant fix" that traders and investors were searching for, nonetheless the markets appear to have run out of patience. Crude oil tried to retain some semblance of stability yesterday in sympathy with a draw in gasoline inventories that was unexpected by the consensus, but in the final analysis yet another build at Cushing and a larger than expected crude stock build overall led to further weakening in WTI. Thus, our scenario of a weaker crude oil complex, with March hit in particular leading up to contract expiration, continues to unfold as expected. The obvious key from here is whether once March is off the board is that "it" with prices beginning to recover, or is April also then destined to weaken relative to the outer months and suffer the same fate as February and March, and so on through much of 2009?
- This is obviously the \$64 question for anyone interested in long equity or commodity positions this year. With regard to the financial influence, based on recent behavior much will depend upon the path of the equity market over the near term. We would expect the Obama Administration to remain focused on the task at hand, and not be concerned with the day-to-day movements in the S&P 500. We would also surmise that employment data will continue to disappoint for the next month or so. It would therefore not surprise us to see another significant drop in the S&P 500 before things start to stabilize.
- Within the context of crude oil fundamentals, the market has been reacting to the latest bearish report from the IEA, but we would look for the market to have fully discounted their forecast over the next month or so. Crude oil inventories could continue to build, but as we mentioned yesterday we would estimate that we are approaching effective on-land shell capacity, which we would peg at around 355.0 million barrels. The highest end-month level of stocks we have seen over the last few years was 354.8 million barrels at end-June 2007. Following that peak stocks dropped by almost 70 million barrels by year end. Clearly the presence of tanker storage offshore has and will "feed" onshore storage for a while, and of course we could be off in our estimate of peak storage capacity. By the same token, however, prices tend to discount in advance turning points in inventory position. In 2007, for example, although the peak in stocks was not to come until June, prices bottomed in the first quarter.

- Other factors over the near term include the March 15 OPEC meeting. OPEC Secretary General el-Badri has recently suggested, as previously discussed, that if prices stay where they are OPEC may not cut again. However prices are now somewhat lower since his statements and further declines are likely to elicit revised comments. This still does not guarantee that production will be cut again in March, but the lower the price, the higher the odds of such a scenario in traders' minds, therefore providing some price support. In addition, March crude oil options expiration is next Tuesday, February 17. \$35.00 per barrel is a "nice round" number for expiration, but \$30.00 per barrel is also a popular strike with options traders. Today's activity will be important to determine which strike the market wishes to gravitate to next week. Our guess would be some support at around \$35.00 per barrel, but such support will also depend upon today's equity market move. Either way, however, we remain of the mind, right or wrong, that February will mark the best opportunity this year for increasing long positions in the energy equities and taking a shot at the commodity for a recovery by June and into the third quarter.

William H. Brown, III

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