



HORNSBY & COMPANY, INC.

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Energy Risk  
Management Services

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**HIGHLY CONFIDENTIAL**

February 13, 2009

**Good Morning**

**Overview**

- Hydrocarbon prices firmed overnight. **Crude oil up \$0.05 to \$34.03 per barrel; natural gas up \$0.006 to \$4.491 per mmBtu.**

**News/Views**

- Whatever Friday the 13<sup>th</sup> has in store for each of us it is hard to imagine it worse than the current market environment. Fear that the Obama Administration still does not have a handle on the depth of the banking and overall economic crisis led to an initial drop in the equity market yesterday, with crude oil following along. The March WTI decline relative to the outer months was exacerbated by ongoing index “rolls” that have contributed each month thus far in the New Year to a weak prompt performance leading up to expiration. By the end of the day, however, the equity market managed an heroic comeback, with hydrocarbons able to limit most losses compared to earlier in the session. We had boldly suggested yesterday that the equity market would be due for one more sizable drop before stabilizing and setting the stage for progressive recovery, but the duration and magnitude of yesterday’s decline may not have been sufficient to satisfy the bears.
- As such, we should remain opportunistic and “picky” when it comes to adding energy equity length this month as we have recommended. In terms of crude oil, we still have three more trading days until March options expiration, and we should therefore assume, right or wrong, sufficient volatility to be opportunistic in picking up some commodity length as well. From a risk/reward standpoint, however, we are still bothered by the deep contango, suggesting based on yesterday’s close that to achieve our price objective for the third quarter September NYMEX crude oil needs to “only” gain by \$15-\$20 per barrel. Measuring risk by such “bars” would seem patently absurd a few years ago and well “worth it”, but given all the fundamental and financial variables that are required to achieve \$65-\$70 crude oil this year, as we have previously discussed we would still prefer to see a “4 handle” on the outer-month contracts. If upon expiration March gains significantly and the outer months are sold aggressively as happened previously, then we believe one should establish a hedged long position under that scenario if commodity exposure is integral to the portfolio.
- Otherwise, we have previously discussed how at one time when crude oil prices were skyrocketing the inverse relationship between prompt WTI and the dollar was quite strong and was the basis of trading for many hedge funds. We also discussed how in more recent periods the relationship had progressively weakened as other factors began to exert a greater influence on crude oil. In addition to the fundamentals of global demand and the debilitating impact on the prompt month as a result of the contango trade, from a financial standpoint we have also emphasized more the relationship between prompt WTI and the S&P 500. Over the last six months, the crude oil/dollar relationship has deteriorated substantially to a point of virtual statistical insignificance. The relationship between crude oil and the S&P 500, however, has strengthened significantly compared to the average of the last couple years. Thus, the influence of financial variables on crude oil prices remains alive and well, it has simply shifted from one variable to another for the time being.

Summarizing recent developments, the bad news continues with fourth quarter Euro zone economic activity posting the largest contraction since records were first kept for the area in 1995, led by Germany which experienced the greatest quarterly fall in GDP in more than 20 years. China's crude oil imports in January dropped by 8% versus January 2008 reflecting reduced refiner demand as economic activity and refined product consumption moderates. Here at home, the deep contango has spurred talk of bringing some onshore shell tankage back on line. Although it may take a few months to do so, it may ultimately impact total U.S. onshore shall capacity, which we have estimated at around 355 million barrels or so. On the other hand, there is the possibility of Nigeria impacting oil prices once again, given the Niger Delta militants' ultimatum that companies should leave the area by tomorrow or face rising sabotage and kidnappings. Shell declared force majeure on Bonny shipments yesterday which is likely to extend through the end of March. The declaration was the result of an ongoing inability by company officials to "move freely" through the Niger Delta given the deteriorating security situation.

W.H. Brown, III

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