



HORNSBY & COMPANY, INC.

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Energy Risk  
Management Services

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**HIGHLY CONFIDENTIAL**

**February 17, 2009**

**Good Morning**

**Overview**

- Hydrocarbon prices declined over the long weekend. **Crude oil down \$0.40 to \$37.11 per barrel; natural gas down \$0.163 to \$4.289 per mmBtu.**

**News/Views**

- We are starting to worry a bit. The other day we suggested that it would not surprise us if we were to see another significant drop in the S&P 500 before things start to stabilize, and lo and behold on Thursday the S&P unfortunately did exhibit such a fall, but subsequently recovered in response to the Obama Administration mortgage “bailout” plan. Last Friday morning we discussed how the deep contango “bothered us” from the standpoint of risk/reward when looking at the possibility of going long outer month crude oil. As such, we were looking for the possibility that upon expiration of the March contract March would gain and the outer months would weaken, leading to a more attractive “4 handle” on the outer months.
- Lo and behold on Friday such price action did occur to such a degree that March \$40 crude oil calls, which expire today, managed an attractive move from \$.05 to more than \$.50 in a day. We wish to cut off at the pass any suggestion of “be careful what you ask for, you might just get it” because we do not want anything except for all of you to make a lot of money this year. Our statements were made because when all is said and done the odds were on our side for such scenarios for a couple reasons. First, unfortunately there is still no end to the bad news that can and has adversely impacted the equity market. Today’s action may be influenced by news over the holiday that Japan experienced its worst quarterly economic contraction since the 1970s, joining previous bad news from Europe and the already dismal picture in the United States.
- In terms of crude oil specifically, we had indicated the other day the influence as we move toward index “roll” periods. These indexes have been trying to realize positive returns but to no avail, since the weaker flat prices combined with a deeper contango have pummeled any capital allocated to such instruments. Insult is added to injury when the prompt month needs to be sold and rolled into the next month. It sometimes has the subtlety of a bull in a China shop, given the interest in indexes and the resultant buildup in volume. Crude oil traders know this has to occur, smell blood, compounding prompt month weakness. When the indexes take a breather, traders then close out short prompt, long outer month positions, leading to the type of move up in March and move down in the “outers” that we witnessed on Friday. Until there is evidence that economic activity is stabilizing and/or seasonal factors begin to influence, this scenario is likely to continue.
- Prolonging such activity is the existence of crude oil stored in tankers offshore, which we have previously indicated remains for the time being a procession of “shoes” to drop. Just when crude oil imports appear to be falling reflecting a closed arb from Europe, barrels are landed. OPEC is worried about such volumes as well. In its latest monthly report, the OPEC Secretariat suggested that as much as 7%-8% of the global VLCC fleet was being utilized to store crude oil around the world representing some 70-80 million barrels, and we would suggest this is a reasonable assessment. The OPEC economists decided to triple

their expected decline in world oil demand this year to 580 MB/D, still less than the IEA's estimate of a 1.0 MMB/D drop. OPEC expects non-OPEC supply to rise by 550 MB/D, a cut from their previous assessment, but we believe they are still too optimistic with regard to growth from the FSU.

- In terms of the latest CFTC data, on Tuesday February 10 when the prompt NYMEX crude oil contract settled at \$37.55 per barrel, non-commercials held futures-only net length of 16,578 contracts, a decline in net length from the previous week by 12,698 contracts. Commercials held futures-only net short positions of 17,025 contracts, a decline in net shorts from the previous week by 9,630 contracts. For natural gas, on February 10 when the prompt NYMEX natural contract settled at \$4.543 per mMBtu, funds held futures-only net short positions of 142,682 contracts, a fall in net shorts from the previous week by 2,097 contracts. Commercials held future-only net long positions of 104,246 contracts, a decline in net length from the previous week by 6,241 contracts. we will publish a brief review of activity in our absence later in the day on Monday upon our return.

W.H. Brown, III

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