



HIGHLY CONFIDENTIAL

February 20, 2009

Good Morning

Overview

- Hydrocarbon prices declined overnight. **Crude oil down \$1.68 to \$37.80 per barrel; natural gas down \$0.041 to \$4.037 per mmBtu.**

News/Views

- Yesterday was one of those rare days when the crude oil market did not move in relatively “harmony” with the S&P 500. Equity markets unfortunately remain plagued by bad economic news, and the willingness of the Dow to hit bear market territory simply compounded negative sentiment. In terms of crude oil, as we approach March contract expiration traders sought to unwind short March/long April and beyond trades, now that the “elephant indexes” have rolled. The unwinding was also catalyzed by the fact that last week Cushing crude oil inventories were unchanged on the week.
- We had previously suggested that the market had so thoroughly discounted further builds at Cushing that the mere *lack* of any further increases would likely cause some recovery in the prompt contract relative to the outer months. Yesterday was a good example of our point. Having said this, however, and remaining relatively constructive on prices for later in 2009, we are the first to concede that one day does not a recovery make. As we issue this note hydrocarbon markets are retracing, with sellers no doubt re-emerging in response to what is likely to start out as a negative opening for equity markets.
- Returning to the weekly data, crude oil stocks in fact rose in PAD III and the gasoline build ran counter to market expectations due in part to a recovery in refinery production. This is evidence of a previous point we have made. That is, refiners are doing a good job of adjusting to weaker demand and have successfully trimmed excess gasoline inventories, leading to an improvement in margins. However, until demand surges once again and/or refinery capacity is closed, there is what one might call a “terminal value” for margins, beyond which incremental refined product output is induced. We have hit this “wall” for the time being until gasoline begins to recover on a seasonal basis relative to the first quarter, which is bound to occur irrespective of economic activity.
- In addition to the crude oil stats, we believe the market also took note of the fact that over the last four weeks total refined product demand turned in the best performance relative to the prior year we have seen in a substantial number of months. We had previously commented on reasons why gasoline demand is looking a bit better, ever mindful of the possibility that the DOE could revise down January demand when the Petroleum Supply Monthly numbers are released for last month. What struck us about the latest numbers is implied distillate demand which, for the last four weeks, was up by 0.3% versus last year. We know that January manufacturing activity was abysmal, and thus there is no reason why diesel demand should not be down versus last year.

With regard to weather, however, NOAA reported that on a home oil-furnace weighted basis, January was 11.1% colder than normal but a full 22.2% colder than last year. For the week ending February 7, on the same basis weather was 6.2% colder than normal and 43.4% colder than last year. Thus, despite likely conservation, lower heating oil prices and colder weather led to incremental heating oil demand that more than offset falling

diesel consumption. However, for the week ending February 14, NOAA reported, once again on a home oil furnace-weighted basis, that weather was 24.8% warmer than normal and 28.5% warmer than last year. Thus, we should remain somewhat cautious, since as we move further into February the odds favor distillate demand comparisons with last year moving back into negative territory, barring severely cold weather for the remainder of the month or a sudden, highly unlikely recovery in manufacturing output.

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