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Energy Risk
Management Services

HIGHLY CONFIDENTIAL

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Good Morning

Overview

- Hydrocarbon prices firmed over the weekend. **Crude oil (Apr.) up $0.30 to $40.33 per barrel; natural gas up $0.014 to $4.020 per mmBtu.**

News/Views

- As we issue this note there is the prospect for a modest rebound in the equity market, at least on the opening this morning, in response to word from the WSJ that the U.S. Government may take as much as a 40% common equity stake in Citigroup by converting preferred shares it bought last year. The April crude oil contract has thus been able to generally trade above its Friday settlement of $40.03 per barrel after initial weakness last night. Also aiding oil is a weaker dollar versus the euro. While crude oil is not exactly setting the world on fire, the ability to settle two days in a row above $40.00 per barrel has encouraged some renewed buying, aided by the Citi news.

- While our Base Case continues to call for a modest seasonal rebound in crude oil prices off what we believe will be a first quarter trough, however, it is probably premature to start singing "Happy Days Are Here Again". Economic data rotten to the core is likely to be released in the days ahead, but hopefully the market will begin to ignore history. This may in fact be "it", but we would like to reserve final judgment until a bit later in the week to see how hydrocarbons respond to upcoming macro as well as energy-specific data. At the least, however, all monitoring should be on the "front burner" to be prepared to make a final "portfolio response" if this indeed is the beginning of the rebound, since we have previously discussed how we believe, right or wrong, that February is the month to increase weightings in energy equities.

- One of the clear keys in terms of oil in all this is the extent to which crude oil inventories have or have not peaked and precisely what the market has discounted. Most analysts assume that in the upcoming weeks crude stocks will remain high, particularly at Cushing, and that therefore the market will witness yet another round of selling prompt and buying outer months, which thus far has helped restrain the prompt NYMEX crude oil contract below $40.00 per barrel. This action ends up compounded by index rolls which merely exacerbate the contango, and for the market to begin witnessing a sustainable rebound, this cycle has to be broken. Our balances assume it will in fact be broken as we move into the second quarter, with crude oil stocks peaking and subsequently beginning to decline, which will help flatten the curve, encouraging further destocking, leading in turn to a positive price response. In this context, however, we would be a bit cautious for the extreme short term since this morning's modest market rebound has not yet been characterized by a stronger prompt month relative to the rest of the curve.

- In terms of natural gas, we have been encouraged by the fact that at least on a settlement basis the prompt natural contract has not dropped below $4.00 per mmBtu. Famous last words, of course and as with crude oil, we believe this week's market response to data will be critical. We are finalizing our updated natural gas balances for this year. While weaker than expected manufacturing data has compelled us to revise down a bit our demand outlook, we have also cut our production estimates for the second half of the year, with the net result no material change in our forecast net build in working storage for 2009 as a whole compared to our previous report.

- With regard to the latest CFTC data, on Tuesday February 17 when the prompt NYMEX crude oil contract settled at $34.93 per barrel, non-commercials held futures-only net long positions totaling 45,016 contracts, a rise in net length from the previous week by 28,438 contracts. Commercials held futures-only net short positions of 35,691 contracts, a rise in net shorts from the previous week by 18,666 contracts. In terms of natural gas, on February 17 when the prompt NYMEX natural contract settled at $4.203 per mmBtu, funds held futures-only net short positions of 140,524 contracts, a decline in net shorts from the previous week by 2,158 contracts. Commercials held futures-only net long positions of 101,812 contracts, a fall in net length from the previous week by 2,434 contracts.

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