HORNSBY & COMPANY, INC.

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Energy Risk
Management Services

HIGHLY CONFIDENTIAL

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Good Morning

Overview

- Hydrocarbon prices firmed overnight. **Crude oil up $0.91 to $44.52 per barrel; natural gas up $0.033 to $4.121 per mmBtu.**

News/Views

- It appears that in fact one day does *not* a market make, and we hope that is true of yesterday as well. More bad words out of GM, Citi selling at less than a hat size, and other sundry sordid news led to a near-4.3% drop in the S&P 500 accompanied, of course, by crude oil. The markets will be anxiously awaiting the latest jobs report to be issued later this morning, and if bearish it will likely preclude a revisit to 700+ on the S&P 500 over the short term. Crude oil, of course, does not necessarily have to continue to follow the stock market, but absent sudden bullish news there is a risk that it will. Adding some concern, despite the modest rebound in crude oil thus far this morning, is the fact that U.S. Oil Fund, our 500-pound gorilla, will begin its four-day roll period today. This activity could compound any potential weakness in response to dire economic data. We shall see.

- Stepping back for a moment in the context of fundamentals, tanker trackers report that OPEC exports are falling at one of the fastest rates in history. Evidence suggests that this month exports will drop in excess of 400 MB/D compared to last month. If so, it would, according to our calculations, still come up somewhat short of 100% compliance with the current agreement. As we have previously discussed, however, the key will be whether the March average can be held through the second quarter. The demand for crude oil is declining in the first quarter, no doubt contributing to OPEC's "compliance". If and when crude demand begins to recover and OPEC more or less "holds the line", however, then we will witness the magnitude of crude oil stock draw that is required and assumed under our balances to begin leveraging prices up on a more sustainable basis and more effectively de-link crude oil from the S&P 500.

- Aside from the equity market influence, the neopress brings up the dollar and its impact on crude oil whenever it seems to make sense on a given day. When we update our relationships between prompt WTI and the dollar/euro rate, using the last two years as our observation period yields an r-squared of only 0.83. This still implies significance, but when we isolate a more recent period the r-squared drops substantially more. This compares to the hedge fund trading frenzy of the two instruments a number of months ago, when the r-squared well exceeded 0.95.

- We ourselves have appreciated this phenomenon, and we wish to emphasize that a particular dollar/euro rate through the end of the year has relatively little influence on our crude oil price forecast, although the behavior of financial entities *has* a major influence, but for different reasons. Simply "for the sake of good order", however, we updated our model to determine where WTI "should be" based on the current dollar/euro rate in isolation. The magic number just happens to be $45.00 per barrel. Coincidence or not, it is evidence that while substantially less of a factor, the strength of the dollar has contributed at least some magnitude of influence to the current level of crude oil prices.

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