



HORNSBY & COMPANY, INC.

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Energy Risk  
Management Services

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**HIGHLY CONFIDENTIAL**

March 10, 2009

**Good Morning**

**Overview**

- Hydrocarbon prices were mixed overnight. **Crude oil up \$0.14 to \$47.21 per barrel; natural gas down \$0.052 to \$3.813 per mmBtu.**

**News/Views**

- With due respect to the Oracle of Omaha, we would not buy crude oil simply in response to Warren Buffett's suggestion that the stimulus package will be inflationary. We happen to agree with him in general when it comes to the overall impact of the program, yet history has proven as quite fallacious the argument that oil is an attractive long-term inflation hedge. Yet, yesterday the neopress were attributing much of crude oil's gains to his CNBC interview, as well as crediting him with tanking the equity market via his comment that the U.S. economy has fallen off a cliff. If one had listened to the actual interview in its entirety, however, one would have come away with a much more moderate and balanced picture. In reality, there were other factors at work accounting for the bulk of crude oil's gain. Monday's crude oil trading was characterized by a disproportionate rise in April relative to the outer months. We suspect, as discussed yesterday morning, there were still some neotraders who assumed the second day of the USO roll would be the "big one", and thus sold April and bought outer months early on, only to be faced with the need to short cover once again later in the day when the market did not weaken despite the decline in the S&P 500. One catalyst was Shell declaring force majeure on Forcados cargoes, adding some dash to previous OPEC meeting speculation. On top of this, and pointed out to us by our physical trading friends, was the fact that those who had been short big time prompt WTI versus Brent decided to head for the hills when the prompt strength began developing, adding fuel to the fire. In terms of OPEC, however, we would caution that Saudi Arabia is sending out signals that its "druthers" at the OPEC meeting may be to seek better compliance with the current agreement, as we originally assumed. Since the Kingdom is now at or below its official quota, it may press Iran and Venezuela to cut or else.
- In any event, April WTI settled at \$47.07 per barrel yesterday, the highest prompt contract settlement since January 6. Month to date prompt WTI has averaged \$43.88 per barrel. In this context, when we were so bold (or stupid) to publish our Base Case 2009 outlook for prompt WTI by month back in January, our forecast average for March was \$47.80 per barrel incorporating both our fundamental and financial variables. Our models suggested that on the basis of fundamentals alone, March would average about \$45.50, some \$2.30 per barrel below our Base Case. Thus far, at least, our factors including inventory stability in the visible U.S. market and the subsequent "revaluing" of prompt WTI relative to other crudes have begun to unfold, but whether we achieve our forecast average for this month remains to be seen. Although there is a good chance that weekly crude oil data could continue to support our outlook, we are always concerned that OPEC ministers may end up creating overly optimistic expectations prior to the March 15 meeting. If OPEC does not cut once again it would not be inconsistent with our Base Case from a fundamental standpoint, but a run up to \$50.00 per barrel or so in advance of the meeting could be followed by a larger and swifter decline given how this market has been functioning.

Looking longer term, as you are all aware our perspective has been that financial entities played a substantial role in contributing to the inordinate crude oil price gain from 2004 through 2008, and we believe our research and the behavior of the market since last summer has confirmed our thoughts. We have also believed, however, that financial entities would continue to have an influence on crude oil prices in varying degrees for the foreseeable future. This assumption is integral to our forecast for much higher prices in the third quarter. In this context, we would note that Barclays Capital, following a recent conference for European investors, took a poll of those attendees, and the results would be consistent with our overall thesis, although obviously the Barclay sample does not necessarily equate to the sentiment of all investors around the world. Nonetheless, of those surveyed, 79% expect to initiate or increase their exposure to commodities over the next three years. Most anticipate positive returns, of course, but we do not know whether this implied a net long position by these investors or not. We would suspect, however, that at current prices most investors are thinking on the long side. Crude oil was ranked second only to gold in expected returns over the next several years. They may be right or wrong, but the sentiment of the survey suggests we are justified in maintaining a combined fundamental/financial perspective on crude oil price forecasting.

William H. Brown, III

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