



HORNSBY & COMPANY, INC.

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Energy Risk
Management Services

HIGHLY CONFIDENTIAL

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Good Morning

Overview

- Hydrocarbon prices were once again mixed overnight. **Crude oil down \$0.16 to \$45.39 per barrel; natural gas up \$0.034 to \$3.874 per mmBtu.**

News/Views

- Equity investors reacted strongly yesterday to word that Citigroup was “profitable” in the first two months of the year as well as Barney Frank’s proposal to reinstate the uptick rule. Crude oil initially participated in the rally, managing to exceed \$48.00 per barrel for a brief period of time, but by the end of the day the gains were handed back. The neopress attributed the decline to reaction to the EIA’s latest short-term energy outlook, where they are looking for a 1.4 MMB/D decline in world oil demand for this year. When it rains, it pours, of course. With due respect, the EIA is somewhat akin to the IEA, presenting initial outlooks that basically extrapolate recent trends. In January of last year, for example, the IEA’s outlook for 2008 world oil demand exceeded our own conservative expectations by well over 1.0 MMB/D, and we ended up with little revision as the year progressed and close to the mark. In reality, we believe that much of yesterday’s decline may be attributed to U.S. Oil Fund and GSCI index rolls, the anticipation of which had previously caught many traders on the short side as bullish news precluded April from declining as much as they had expected.
- Thus far this morning, UBS has decided to rain on the parade by stating it saw its earnings at risk for some time, so we will see what effect the news has on the equity markets and possibly in turn, the hydrocarbon complex. The weekly DOE data may well win out in the final analysis, however, and traders have already reacted by a modest degree to the API numbers released yesterday afternoon. The API reported that crude oil stocks fell by 419,000 barrels, including a draw at Cushing of 513,000 barrels, consistent with our Base Case outlook. Gasoline supplies, however, rose by 1.653 million barrels, while distillate supplies fell by 279,000 barrels. The gasoline build thus far has had greatest influence, with crude prices weakening modestly after release of the data, but as usual the market will reserve final judgment until the DOE numbers are released later this morning.
- For those of you who trade natural gas, we have been looking for reasons for the market to start recovering, since our balances, as discussed in our regular monthly report, still suggest an improving storage picture by the third quarter, although we see the working storage “overage” versus last year rising somewhat further before stabilizing. The prompt month has witnessed a couple “round trips” within a roughly \$3.80-\$4.30 per mmBtu range. We believe a trade to look at if one is constructive and that is less volatile than the front month would be the March-April 2010 calendar spread. When we look at the behavior of the spread since the beginning of the year, it has declined about one-tenth the magnitude of the prompt month. While the relationship is not always this constant, the March-April spread tends to move *directionally* in line with the prompt month, representing the traditional inflection point between winter and spring. The spread settled yesterday at 27.5 cents, March over. We are thinking that at 25 cents and below the spread represents a reasonable risk/return ratio if our fundamental outlook unfolds over time. The spread margin requirements are much lower than the outright, and there is plenty of time to trade around and build positions. Invariably, the spread expires negative once it is realized that there is plenty of gas for winter, but between now and autumn there is scope for profit.

- We are in the process of finalizing our global oil balances and we hope to publish our regular monthly report some time tomorrow. We have made little revision, and we continue to see a more constructive balance for this year than the consensus, the EIA, the IEA, or just about anyone. We are looking for world oil demand to gain slightly this year by 0.3%, with a decline in the first two quarters basically offset by a recovery in the second half of the year. Non-OPEC supplies are forecast to rise by only 455 MB/D. As we have previously discussed, we believe the second quarter is the most critical, and if OPEC can basically hold the current line through this period, our balances suggest a net global stock draw in the second quarter, a phenomenon that to our recollection has never happened before.

W.H. Brown, III

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