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Energy Risk
Management Services

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Good Morning

Overview

- Hydrocarbon prices were mixed overnight. **Crude oil up \$0.46 to \$49.71 per barrel; natural gas down \$0.018 to \$3.675 per mmBtu.**

News/Views

- Yesterday once again proved that market participants are willing to ignore the current state of U.S. crude oil inventories and choose instead to trade on other factors. Stocks continue to fall at Cushing, and yesterday the term structure flattened slightly, but Cushing supplies have been falling fairly consistently over the last several weeks and yet the market on average moved into a larger contango, reacting to the rising *aggregate* level of stocks. As we discussed yesterday, “olden day” fundamentals alone would have implied prompt WTI trading at half its current price but, as with the equity market, is willing to discount the prospects that 1) economic activity will stabilize and begin to improve, thus leading to a recovery in oil demand; 2) refiners will respond by increasing runs; and 3) all else equal crude oil stocks will begin to fall. The “all else equal” of course includes OPEC continuing to hold the line where it is, since we have not assumed that compliance will improve from here, particularly given the time frame now required to reduce supplies. Despite a larger than expected crude oil build, product draws were somewhat more constructive than the market was looking for. On the negative side, the OPEC Secretariat joined the crowd and cut its outlook for 2009 world oil demand. On the *other* side of the coin, providing some price support has been Shell’s declaration of force majeure on Bonny exports out of Nigeria due to a recent fire on a major trunk pipeline. Perhaps more importantly, however, the markets in general believe that the worst is over for the U.S. economy, responding to yesterday’s Beige Book report which suggested that the weakness was beginning to moderate in select districts across the U.S. such as New York and Chicago.
- The market’s resilience nonetheless reminds us once again of market activity in the spring and early summer of 1990. OPEC was “flooding the market” seeking market share, and yet crude oil prices did not continue to crater. One well-known commodity trader started buying crude and when asked why in the face of rising supplies, he said the market is telling me otherwise. A couple months later, Saddam invaded Kuwait. We are not suggesting that there is a major disruption on the horizon and the market “knows about it”, but we should always listen to the market, even though it may now be infiltrated to a degree by neotradors. Sentiment towards the global balance could not get much worse, and yet the market appears to be saying that if there is even a hint of demand stability, given the likely falloff in non-OPEC supplies prices can recover further. In terms of demand, the other day we offered a somewhat different perspective on the IEA estimate of a collapse in world oil demand in the first quarter. Namely, that the drop in reported *implied* demand, in addition to reflecting a reduction in actual “burn”, also included an element of destocking on down the supply chain. We argued that once the secondary stocking ended, implied demand would rebound even with no change in underlying consumption. In this regard, highly preliminary data for German for March suggest such a rebound in gas oil demand, perhaps confirming our thesis.

Today is May crude oil options expiration, and as we issue this note there appear to be once again both positive and negative influences on oil prices. We would guess that absent major news one way or another, the market will probably trade around the “nice round” strike of \$50.00 per barrel. Month to date prompt WTI has

averaged \$50.41 per barrel, compared to our Base Case forecast for calendar April of about \$51.15 per barrel. If all what we are discussing above continues to unfold for the rest of the month, our estimate has a good chance of ending up close to the mark. The obvious key from here from the equity standpoint, however, is whether our outlook continues on track for the next several months which, if so, will boost our stocks, leading to a catch up to the rest of the market, particularly once first quarter earnings reports are history.

W.H. Brown, III

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