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Energy Risk
Management Services

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Good Morning

Overview

- Hydrocarbon prices firmed overnight. **Crude oil up \$0.38 to \$53.02 per barrel; natural gas up \$0.052 to \$3.834 per mmBtu.**

News/Views

- There is a common and rather indelicate term to characterize yesterday's crude oil action, but we would prefer to use the phrase we coined when prompt WTI was on its way to \$150.00 per barrel. That is, the obvious financial inflow is like trying to funnel a lake into a fishbowl. The effect is exacerbated when the big gorillas such as U.S. Oil Fund are forced to buy when investors pile into indexes. Clearly yesterday proved our points once again with extreme prejudice. Namely, financial players remain alive and well in the commodity space, and given their leverage and inordinate impact on price, if the fundamental picture unfolds later this year as we anticipate our outlier Base Case price forecast should be achievable.
- Yesterday's gains were spurred by surging equity markets and a response to FASB and G-20 news, exacerbated by a weaker dollar. Normally after such a move we should be aware of the possibility of "profit taking" as the neopress likes to say, with a test back to \$50.00 per barrel easily in the cards, depending upon this morning's employment data and anything else that may come out of the woodwork. Of course, a North Korean missile launch over the weekend could take some air out of the equity markets as well. Most analysts are saying that fundamentals do not support such crude oil prices at the present time, but this is not the point. The market is "always right" because this is what the price *is* and when capital is at risk there is not a great deal one can do about it. Clearly when fundamental data emerge that will encourage those who still only look at demand and supply balances to estimate prices, it will already largely be in the market. While financially-driven gains in WTI are restraining the consensus from revising up their price forecasts, once fundamentals begin to stabilize the Street will fall over itself raising its price targets, pulling energy equities up further in the process, which is clearly what we are hoping for. If our Base Case unfolds, therefore, we would not be surprised in the least to hear talk of \$100.00-\$150.00 per barrel once again. Traders must be salivating at the prospect of making the \$100.00 per barrel gain that they may have missed previously, and it is "easier" and less stressful to go long and stay long, since one does not have to worry about a disruption overnight somewhere, destroying profits if one is short. After all, it happened before so why can't it happen again if global economic growth resumes and non-OPEC supply growth is limited?
- It may be a bit premature to think in these terms, but as previously discussed our Base Case calls for a progressive rise in WTI to roughly \$70.00 per barrel or so in August before peaking and subsequently declining through the remainder of the year. The rationale is the above, i.e. further financial inflows if global demand trends begin to stabilize. We would note that good, bad or indifferent, Ibrahim al-Muhanna, an adviser to Saudi oil minister Ali Naimi, is more in our camp than the consensus, since he believes there is a chance that global oil demand growth could possibly resume later this year. Our Base Case calls for demand growth *in fact* beginning to show positive year-over-year comparisons by later in the third quarter. Having said all this, however, the likely consensus view that once prices begin to rise one's forecast should assume further annual gains forever is inconsistent with historic commodity behavior. We believe there is currently a "terminal" price for WTI that is probably in the \$60's or so per

barrel, say \$65.00 per barrel. First, the Obama Administration will likely take a different view of where crude oil “should be” than the Bush Administration. This does not mean anything would be done at \$65.00-\$70.00 per barrel, but traders are likely to *believe* so, therefore constraining further length beyond these numbers. From a fundamental standpoint such numbers approach OPEC’s “target”, with the consensus therefore correctly assuming that compliance will ease. Also, the consensus believes average cost structures for marginal barrels hover around these numbers, and will therefore assume, right or wrong, that incremental supply will be forthcoming. Finally, although we were in the minority in this view, we first began observing an impact on oil demand, particularly in Europe, once WTI reached \$65.00 per barrel previously.

W.H. Brown, III

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