



HIGHLY CONFIDENTIAL

December 31, 2007

Good Morning

Two pages this morning

We wish all of you of most Happy and Profitable New Year

Overview

- Hydrocarbon prices were mixed over the weekend. **Crude oil up \$0.04 to \$96.04 per barrel; natural gas down \$0.059 to \$7.327 per mmBtu.**

News/Views

- As a follow up to last week’s discussion of our “January effect” for crude oil and what it may or may not imply for the year as a whole, this morning we look at January versus the entire year for what is most important for most of you, the energy equity sectors. The table below lays out for January and each of the years 2004 through 2007 (with prices through December 28) the performance of the S&P 500, the OIX, and the OSX. First, the most striking thing overall is the absolutely phenomenal performance of energy equities in general over the past four years.

| | -----January----- | | | | -----Year----- | | | |
|------|-------------------|------|-------|------|----------------|-------|-------|-------|
| | 2004 | 2005 | 2006 | 2007 | 2004 | 2005 | 2006 | 2007 |
| SPIC | +1.7 | -2.7 | +2.5 | +1.4 | +9.1 | +2.9 | +13.6 | +4.2 |
| OIX | -0.7 | +3.1 | +15.4 | -1.7 | +25.1 | +30.3 | +24.7 | +38.6 |
| OSX | +7.4 | +4.6 | +21.6 | -1.9 | +31.9 | +47.0 | +9.8 | +53.3 |

What, if anything, did the January performance of the energy equities portend for the year as a whole? In 2004, January witnessed a mixed picture, with the OIX declining marginally in contrast to a healthy monthly gain for the OSX. By the time 2004 ended, however, both indices had attractive gains for the year. In 2005, both indices had nice gains for the month, and the year turned out to be even better than 2004. In 2006, portfolio managers saw the performance of the prior year and loaded up early in 2006 to avoid missing another strong year. The year in fact witnessed positive gains once again, but there months where performance suffered to a degree in absolute terms and relative to the S&P 500. Then we come to 2007. In January, as previously discussed the negative crude oil index returns led to some liquidation of passive length, pressuring crude oil prices in tandem with concerns over levels of world oil stocks and the inevitable, but incorrect, concerns about a springtime oil price collapse. Many pundits were looking for crude oil to have a “40’s handle” for much of the year. Energy stocks weakened during the month, underperforming the broader market. However, the rest was history, and by the time 2007 had approached a close energy equities in general turned in the strongest annual performance since the rally began over four years ago.

- After the New Year's Day holiday we will construct a representative energy equity portfolio that makes sense to us as a starting position for 2008. Given the strong performance of both the last four years and 2007 it would not surprise us to see some "treading water" for the group at best, even if crude oil prices retain their strength due to a stronger flow into passive length. As the month proceeds, however, we will weigh the behavior of hydrocarbon prices versus the performance of the equities to try and determine how an average energy equity portfolio should be fine tuned, e.g. if the stocks weaken but we decide that crude oil prices will average above expectations we would reinstate our trading "Buy" in tandem with our current long-term "Buy" on the sector at some point, and conversely if the stocks start strong as in January 2006 we would be a bit more cautious short term, almost irrespective of hydrocarbon price expectations. During the course of the year, however, there will invariably be attractive trading opportunities for our hedge fund friends as sentiment ebbs and flows, in addition to what should be a reasonable performance for the year as a whole for our long-only, long-term investor friends.
- With regard to the latest CFTC data, on December 24 when prompt NYMEX crude oil settled at \$94.13 per barrel, active CFTC-reporting funds held futures only net length of 52,847 contracts, a rise in net length from the previous week by 17,864 contracts. For natural gas, on December 24 such funds held net short positions of a "whopping" 112,546 contracts, setting once again an all-time net short record. Even though our research indicates less price influence from active fund position shifts due an average lower percentage of open interest compared to crude oil, we have to believe that if our natural gas balances are even remotely close to the mark our March (basis April NYMEX) target of \$7.55 per mmBtu has a good chance of being realized even if crude oil prices fall.

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