



HORNSBY & COMPANY, INC.

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Energy Risk
Management Services

Monthly Energy Equity Review and Outlook

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Summary

After a dismal January, energy equities generally recovered in February, both in absolute terms and relative to the S&P 500. On February 8 when the OIX and the OSX closed the day before at 756.45 and 252.18, respectively, we stated that the stocks were not far from the bottom and that we were preparing to pull the trigger and reinstate our short-term “Buy” on the sector. We will obviously not take credit for thinking this way, however, since we did not officially change our rating at that time. The stocks subsequently recovered, and we are gratified to have seen this for all who are long. In addition, our thesis that incremental investment capital should be dedicated to the producing and service/drilling sector at the expense of the refining sector has ended up making sense thus far.

Recovering crude oil prices helped the stocks, as well as recovering sentiment towards the natural gas market as the balance improved as we have anticipated and prices gained due in part due to short covering by Saracen and other funds as well as a refusal to lag rising crude oil prices any further. Where we go from here is somewhat problematic, since as crude oil prices continue to gain underlying fundamentals, particularly in the OECD, continue to deteriorate. There is more and more publicity devoted to our long-standing conservative gasoline thesis for 2008, and inventories are likely to recover further, although the thirst for commodities has thus far relegated any market response to the weekly data to a one or two day event. A collapsing, pathetic dollar and ongoing geopolitical issues have been claimed by the neopress for oil’s advance, but as we have discussed in previous reports the need to allocate capital and seek more favorable returns in alternatives to equity markets by pension funds and others continue to support hydrocarbon prices.

A major part of our rationale in January for boosting our crude oil price outlook for 2008 above the consensus was the anticipation that favorable oil index returns in 2007 would lead to sizeable allocation to oil early in 2008 in hopes those returns would continue this year. Fundamentally, we are at the point where declining U.S. and total OECD oil demand is beginning to dent into the impact of non-OECD growth. While we would not be surprised to see energy equities gain some more ground in March, our best guess is that following the gains of February the group will tend to tread a bit of water this month.

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Reviewing February's performance, the OIX and OSX gained by 6.3% and 10.8% respectively, while the S&P 500 fell by 3.5%. WTI rose by 11.0% during the month, while the prompt NYMEX natural gas contract gained by 16.0%.

**Select Energy Equity Performance,
February 2008
(Percentage Gain/Loss)**

Major International Oils		Select Independent Producers	
BP	+1.4	Anadarko	+9.0
Chevron	+4.1	Apache	+20.3
ConocoPhillips	+3.2	Chesapeake	+21.7
ENI	+6.6	Devon	+20.8
ExxonMobil	+0.7	Noble Energy	+6.6
Marathon	+12.9	Pioneer	+6.9
Royal Dutch	+0.1	Plains	+11.2
Total	+3.6		
Select Refining Equities		Select Service/Drilling Equities	
Frontier	+1.4	Baker Hughes	+3.7
Sun	-1.8	Diamond Offshore	+7.2
Tesoro	-4.5	Ensco	+17.1
Valero	-2.2	Halliburton	+15.5
		Rowan	+18.4
		Schlumberger	+14.7
		Smith	+16.5
		Tidewater	+6.0
		Transocean	+14.9

In looking at our customary table above laying out February performance for select energy equities, a couple things are worth noting. The independents far outperformed the refiners and we have included a few select equities in the refining sector for the first time. Although previously we had little interest in the group under our downstream view of 2008, since the consensus has begun to gravitate toward our Base Case scenario we will monitor these equities more closely going forward.

Our only concern is the price of the stocks in the context of our outlook, and as we have discussed before price is the great equalizer. While we still believe it is premature, we would wait until the broad consensus has completely thrown in the towel with regard to oil demand for this year, and look to upgrade the stocks at that time, since the refining industry has a long

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history of being able to adapt to almost any environment, be it favorable or unfavorable. Although not listed above, one stock we are working hard on is Petroplus, knowing that our friend Tom O'Malley is the savviest and most influential man in the downstream sector, whatever position he may hold.