



HORNSBY & COMPANY, INC.

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Energy Risk
Management Services

July 2, 2008

Monthly Energy Equity Review and Outlook

Summary

In last month's energy equity review we suggested that following two strong months of performance in April and May, it would not surprise us to see the stocks retrace modestly, setting the stage for the second half of 2008. While this turned out to be accurate for most of the OIX, the OSX advanced on, turning in robust results both in absolute terms and relative to the S&P 500. In terms of specific numbers, for the month of June the S&P 500 declined by 8.6%, haunted by higher energy prices, a weakening economy, and ongoing financial sector woes. The OIX eased by 0.1% for the month, while the OSX rose by 4.4%. With regard to hydrocarbon prices, during June prompt WTI rose 9.9%, while prompt natural gained by a full 14.1%.

For the first six months of 2008, the S&P 500 is unfortunately off by 12.5%, while the OIX and OSX are up by 8.0% and 18.3%, respectively. Crude oil has gained by 46.8%, while natural gas is up by a substantial 80.5%. While we fully anticipated early in 2008 that WTI would average above prevailing consensus expectations due to financial inflows despite an expected weakening demand environment, obviously WTI has reached peaks we did *not* anticipate. For natural gas, we forecast a progressive improvement in the U.S. natural gas balance, and coming off record pre-winter working storage, we suggested that natural gas prices were "coiled springs", ready to recover if our outlook was close to the mark.

For the second half of the year, the outlook is as uncertain as ever, and with that "value added" comment we provide some elaboration. There are movements afoot in Congress to curb "speculation" in energy markets. At this point we doubt that any such legislation signed into law will have a sudden and materially negative impact on oil, and in sympathy, natural gas prices. Our long-standing view has called for a progressive easing of oil prices over time, due to what we see as major structural changes in world oil demand growth, particularly in the OECD. In addition, we see a move by pension funds toward *active* commodity asset management, in contrast to the near-universal *passive long* strategy that has characterized these institutions since 2004. The geopolitical environment will remain supportive until Israel launches a strike against Iranian nuclear facilities, but as we have discussed we believe there is a low probability of any material impact on Arabian Gulf oil flows.

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

Major International Oils

BP	-3.6
Chevron	0.0
ConocoPhillips	+1.4
ENI	-9.0
ExxonMobil	-0.7
Hess	+2.8
Marathon	+0.9
Royal Dutch	-4.4
Total	-2.3

Select Independent Producers

Anadarko	-0.2
Apache	+3.7
Chesapeake	+20.4
Devon	+3.6
Noble Energy	+3.2
Pioneer	+9.0
Plains	+2.1

Select Refining Equities

Frontier	-20.6
Sun	-8.5
Tesoro	-20.4
Valero	-19.0

Select Service/Drilling Equities

Baker Hughes	-1.4
Diamond Offshore	+2.0
Ensco	+12.4
Halliburton	+9.2
Rowan	+5.9
Schlumberger	+6.2
Smith	+5.3
Tidewater	-4.8
Transocean	+1.5

In this context of the hydrocarbon pricing environment, our primary concern remains the fate of the energy equities. After all, since 2004 a substantial amount of individual and institutional wealth has been created by the progressive surge in oil and gas prices, and these entities are hardly to blame for high gasoline prices, something that Congress has not taken into account. Let us get off our soap box, however, and suggest that if by chance oil and gas prices do “collapse”, which again we do not anticipate, we would view this as a short-term buying opportunity, to accompany the long-term “Buy” which we retain for our group. At current equity prices in the context of where energy prices are trading, however, we will remain on the sidelines. For the month of July, we will suggest a possibly mixed performance once again for the group, but unless WTI advances to \$150.00 per barrel, we would look for some “rest” for the independent producers with a modest recovery for the refining sector, given their severe underperformance.

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