



HORNSBY & COMPANY, INC.

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Energy Risk
Management Services

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Monthly Energy Equity Review and Outlook

Summary

In last month's energy equity review, we suggested that the month of July would be characterized by a mixed performance for the group, with some "rest" for the independent producers given the strong performance of the previous months. Given market volatility, it appears that no matter what we say it is an understatement in either direction. Despite crude oil setting an all-time record nominal price high last month, both the OIX and the OSX registered double-digit declines in July. The stocks were discounting a watershed turning point in hydrocarbon prices, plus the fact that WTI fell by 11.4% during the month, despite setting the record on a settlement basis on July 11. Natural gas prices fared even worse, since their peaks were reached earlier in the month, and during July the prompt NYMEX natural contract dropped by a full 31.7%. In this context of weaker hydrocarbon prices, last month the OIX declined by 14.5% while the OSX fell by 13.2%, all versus a 1.0% decline in the S&P 500. Year to date the S&P 500 is off by 12.5%, while the OIX and OSX have declined by 11.4% and 3.8%, respectively.

As the equities continued to fall from their previous intra-year peaks, on July 17 we upgraded the entire energy sector to "Buy", with a particular emphasis on integrated companies and refiners. In our note issued at that date, we suggested that the stocks had discounted much lower prices than prevailing at the time, in addition to assuming a continued erosion of profitability in the downstream sector. Having said this, we also stated that "we anticipate further weakness, however, to afford an opportunity to build up positions." There is the old saying, watch what you wish for, you might just get it. As we anticipated the stocks continued to erode, affording indeed an opportunity to average down, but thus far have weakened from our upgrade date less than hydrocarbon prices. As we issue this report, since our upgrade on July 17 the OIX is off by 1.1% while the OSX has weakened by 7.1%.

At this point, however, we believe that over time the sector will begin to recover. In addition to our view that the group is trading below levels discounting \$90.00 per barrel WTI and \$8.75 per mmBtu natural, our Base Case assumptions for 2009, we have always believed that the stocks appreciate price *duration* as much or more than price *level*. That is to say, we believe that the recent velocity of hydrocarbon price decline has led to excessive extrapolation of where prices are likely to lie next year. If, over time, equity investors sense the beginnings of stability, albeit at much lower levels, then the equities should benefit.

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