



HORNSBY & COMPANY, INC.
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Energy Risk
Management Services

International Petroleum Analysis

September 3, 2008

Monthly Energy Equity Review and Outlook

Summary

Energy equities in general declined in August, although the weakness was substantially more moderate than the performance of July and concentrated in the drilling/service subsectors. In last month's energy equity review we suggested that August might be characterized by "relative stability" for the total energy group, since we believed the equities had broadly discounted much lower oil and gas prices than those prevailing at the time of publication. For the record, August witnessed a 1.2% gain for the S&P 500. Within this context, the OIX eased by 0.2% while the OSX experienced a larger decline of 4.2%. The equity performance reflected the fact that prompt WTI fell by 6.5%, with prompt NYMEX natural dropping by 8.3%. The greenback gained by 5.9% versus the euro, confirming our modeling work detailing the impact of non-fundamental factors on oil and, partially in sympathy, natural gas prices.

Looking out over the next month, as we have previously discussed we are looking for WTI to decline below \$100.00 per barrel at some point, but our Base Case does not assume such a scenario until the first quarter of 2009, impacted by seasonal factors including the decline in refiner crude oil demand, coupled with an early-2009 decision on the part of pension funds and others to allocate less incremental capital to passive length and, in some cases, reduce such exposure. We are trading within only \$8.00-\$9.00 per barrel or so of the "century mark", and given market volatility it might not take much to challenge \$100.00 per barrel from here. However, we expect this level to represent one of the "Mother of All Bogies" with a greater battle between bulls and bears than that which occurred at \$110.00 per barrel.

In addition, with next week's OPEC meeting on the horizon, the "hawks" such as Iran and Venezuela who have been calling for a possible production "cut" may well receive more of the market's "ear", leading to some pre-meeting short covering. We have suggested in recent writings that odds may favor an OPEC production cut, but if so it would simply ratify the decline in refiner crude oil demand that will occur anyway under our Base Case scenario. Even if OPEC does not act officially but, for example, merely emphasizes the need for quota discipline, our U.S. refinery balances are calling for a progressive decline in crude oil inventories once hurricane perturbations are past, which may lead some neotradors to assume a tightening crude oil balance. This could well help counter those inclined to sell as global fundamentals continue to weaken.

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

Major International Oils

BP	-6.2
Chevron	+2.1
ConocoPhillips	-1.1
ENI	-3.5
ExxonMobil	-0.5
Hess	+3.3
Marathon	-8.9
Royal Dutch	-1.8
Total	-6.0

Select Independent Producers

Anadarko	+6.6
Apache	+2.0
Chesapeake	-3.5
Devon	+7.5
Noble Energy	-2.9
Pioneer	+6.3
Plains	-3.7

Select Refining Equities

Frontier	+6.1
Sun	+9.3
Tesoro	+20.1
Valero	+4.0

Select Service/Drilling Equities

Baker Hughes	-3.5
Diamond Offshore	-7.9
Ensco	-2.0
Halliburton	-2.0
Rowan	-7.2
Schlumberger	-7.3
Smith	-6.3
Tidewater	+1.2
Transocean	-6.5

Since we customarily provide our thoughts for the coming month, our best guess regarding the equities is continued stability/modest recovery. We still strongly believe that the equities have discounted much lower hydrocarbon values, and all that is needed is the perception as well as the reality that prices will not completely collapse far below \$100.00 per barrel over a brief period of time. We fully concede, however, that thus far the fast money and the hydrocarbon price/equity “correlators” are exerting greater influence than long-term investors at this time, although there is some evidence that the most recent energy equity weakness has reflected massive hedge fund liquidation as these funds are closed.

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