



HORNSBY & COMPANY, INC.  
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Energy Risk  
Management Services

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October 2, 2008

## Monthly Energy Equity Review and Outlook

### Summary

Aside from those net short equities and commodities, most investors and traders wish September had never happened. Virtually unprecedented economic and financial turmoil led to major declines in equities across the board with markets marked by extreme volatility. Energy equities were obviously not immune to the downturn either, with hydrocarbon prices falling as well. To quantify, the S&P 500 declined by 9.2% in September, but the major energy equity indices fared even worse. The OIX fell by 12.3%, while the OSX dropped by 19.7%, marking the third month in 2008, the others being January and July, of double-digit declines for these indices. The best performer in our universe was “poor old” ExxonMobil, down by “only” 2.9% in September since it had taken its licks earlier in the year from Wall Street and is naturally turned to in times of uncertainty.

During September prompt WTI fell by 13.2% while prompt NYMEX natural declined by 11.1%. Aiding crude oil’s decline was the 4.1% recovery in the dollar versus the euro during the month. While clearly some investors were reducing energy equity exposure under the assumption that hydrocarbon prices could collapse, we believe energy stocks were most impacted by hedge fund liquidation reflecting a combination of forced/voluntary fund closures and investor redemptions. This suggests that more shoes may fall even if hydrocarbon prices ultimately stabilize at lower levels as we assume in our Base Case.

Nor should we assume that Washington’s “bailout” or “rescue” plan, if ultimately approved by the House, will be *the* market panacea. We had identified long before the most recent financial and credit market upheavals justified concern over economic activity which in turn was adversely impacting oil demand in the OECD. Clearly there are as of yet no indications that demand has begun to stabilize. On the contrary, in the visible U.S. market oil demand continues to come in even weaker than consensus expectations, and as we recently discussed the odds have increased there will be no gain in world oil demand this year at all.

In terms of oil prices, our Base Case has called for prompt WTI to average \$90.00 per barrel next year, and although the consensus now appears to be moving toward or to our view, at this point we see no reason to amend our outlook. Although as we have discussed we believe WTI on a purely fundamental basis “should be” trading well below \$90.00 per barrel, we have not assumed that non-commercial oil participation will completely disappear in 2009. For natural gas, we are still looking for a prompt NYMEX/Henry Hub average for next year of \$8.25 per mmBtu, continuing to assume a reduction in natural’s current discount to crude oil.

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

**Major International Oils**

BP	-12.9
Chevron	-4.4
ConocoPhillips	-11.2
ENI	-18.6
ExxonMobil	-2.9
Hess	-21.6
Marathon	-11.5
Royal Dutch	-15.1
Total	-15.6

**Select Independent Producers**

Anadarko	-21.4
Apache	-8.8
Chesapeake	-25.9
Devon	-10.6
Noble Energy	-22.5
Pioneer	-17.2
Plains	-34.8

**Select Refining Equities**

Frontier	-4.9
Sun	-19.8
Tesoro	-11.1
Valero	-12.8

**Select Service/Drilling Equities**

Baker Hughes	-24.3
Diamond Offshore	-6.2
EnSCO	-15.0
Halliburton	-26.3
Rowan	-17.3
Schlumberger	-17.1
Smith	-15.9
Tidewater	-8.8
Transocean	-13.6

As we issue this report the OIX and OSX are standing at levels not seen since March of 2007 when prompt WTI was trading in the \$60s per barrel but prompt NYMEX natural was valued at around current levels, a striking illustration of how much natural gas prices have lagged the non-commercial influenced run-up in crude oil prices. On a hydrocarbon price-weighted basis, therefore, one would be justified in arguing that energy stocks in general are quite undervalued. Since these are difficult and unprecedented times, however, with stock prices influenced as much by required/restricted liquidation, credit freeze ups and other dislocating factors as opposed to a “balanced” valuation process, at least some dust probably needs to settle before longer-term investors take stock of the attractive energy equity asset values that now present themselves.

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