



HORNSBY & COMPANY, INC.
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Energy Risk
Management Services

October 4, 2008

Monthly Energy Equity Review and Outlook

Summary

As if September wasn't bad enough, the equity gods decided more punishment was required, and therefore gave us October. While some funds may have been fortunate to have been net short during the month, most were clearly not, and even those who were able to be short hydrocarbons as a hedge against long energy equity positions had a difficult time. Not to add insult to injury, but to provide the numbers that we already know, in the month of October the S&P 500 declined by 16.8%. In comparison, the OIX fell by 16.6% while the OSX dropped by 35.1%. The prompt NYMEX crude oil contract declined by 32.6% during October, while the prompt NYMEX natural contract fell by 8.8%.

With quantifying the bloodbath out of the way, let's look forward. In previous reports we suggested that if a recovery were to occur as we expected, we would look for the energy equities to lead the commodity, and thus far at least they have. The OIX and OSX bottomed out on October 27, with WTI reaching its settlement low thus far the next day. As we have often said, the analyst graveyard is full of corpses who would dare call market tops or bottoms. However, we believe the bottom has in fact occurred, and we would look for crude oil and gas prices, following what may be more "backing and filling" for a while, to progressively rise over time, with the odds more favoring \$70.00+ per barrel crude oil than \$50.00 per barrel or below.

There are a few reasons for our thoughts in this regard. First, our quantitative analysis of crude oil prices over the past couple years, through either our "layered" approach or more recently our integrated modeling efforts, have consistently concluded that WTI had embedded a substantially larger non-commercial component than the consensus believed. As such, seeing prices where they are today does not come as a complete surprise to us and we are therefore able to assess the situation objectively with our tools in hand. We believe that most of the non-commercial component of oil prices has "left the building", based on current industry cost assessments. In this context, many analysts are now substantially more bearish than we are in terms of the global oil balance for 2009, and we therefore believe the consensus has now gone too far the other way.

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

Major International Oils

BP	-0.9
Chevron	-9.6
ConocoPhillips	-29.0
ENI	-9.3
ExxonMobil	-4.6
Hess	-26.6
Marathon	-27.0
Royal Dutch	-5.4
Total	-8.6

Select Independent Producers

Anadarko	-27.2
Apache	-21.0
Chesapeake	-38.7
Devon	-11.3
Noble Energy	-6.8
Pioneer	-46.8
Plains	-19.8

Select Refining Equities

Frontier	-28.3
Sun	-14.3
Tesoro	-41.4
Valero	-32.1

Select Service/Drilling Equities

Baker Hughes	-42.3
Diamond Offshore	-13.8
Ensco	-34.0
Halliburton	-38.9
Rowan	-40.6
Schlumberger	-33.9
Smith	-41.2
Tidewater	-21.2
Transocean	-25.0

Next, although we have consistently believed that OPEC agreements to “cut” or “increase” production reflect a response to lower or higher refiner needs and not a proactive effort on the part of an effective cartel, they nonetheless have their place in price determination. We previously discussed our expectation that due both to lower underlying refiner requirements as well as “decremental” demand due to the global credit freeze, Saudi crude oil deliveries would decline toward 8.7 MMB/D by the first quarter. As we issue this report crude oil prices are rising reflecting word that in fact customers are indicating that volumes are declining toward the target we have already anticipated.

Finally, as also previously discussed we believe that U.S. crude oil stocks are in the process of peaking, and should start to decline seasonally, particularly during December. Although this is part and parcel of normal refiner behavior, the neotrader will assume it reflects a tightening global crude oil market, leading in turn to price support. On balance, we continue to believe that energy equities have bottomed for the year.

W.H. Brown, III