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Fourth Quarter Petroleum Update

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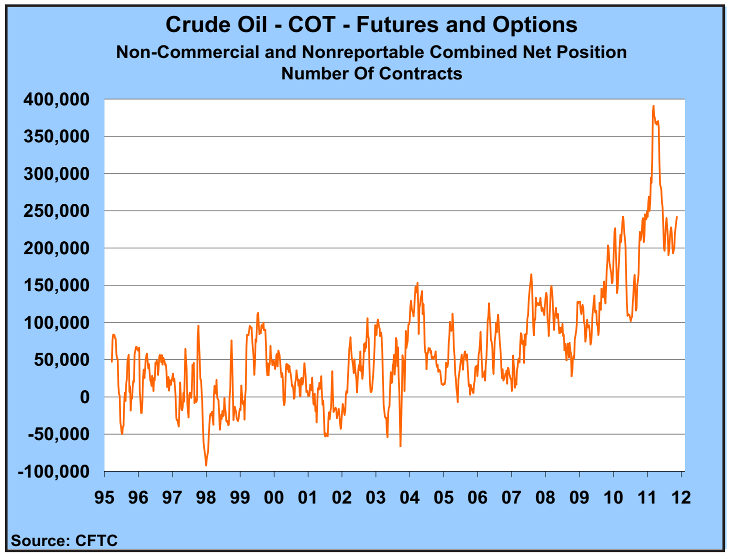
The recent rise in nearby crude oil prices above $103 didn't seem to elicit many complaints of excess speculation in the energy markets. Perhaps this was because the move was not accompanied by an increase in speculator net long positions. Regardless, this rally seems to confirm that supply and demand conditions in the market have tightened, even in the face of a possible recession. In other words, the world threw a recession party and the energy complex failed to show up.

Crude oil prices recently topped out a two-month rally on reports that the flow of crude oil from the Seaway pipeline would be shifting directions. Where previously it had flowed north from the Gulf Coast to Cushing, Oklahoma, it was announced that it would now flow from Cushing to the Gulf Coast. This is expected to alleviate the glut of supply at Cushing and ease tightness at the Gulf Coast, where refiners had been using Brent crude and others as feedstocks. This move has had a major impact on the Brent/WTI spreads. Tight North Sea supplies were one of the key factors that sent Brent's premium to WTI to a record wide level of $28.00 in October. As conditions changed by mid-November, that spread fell below $6.00. While part of the decline in the premium of Brent relative to West Texas Intermediate was aggressive unwinding out of long Brent/short WTI positions, it was also pressured by the flow change in the Seaway pipeline.



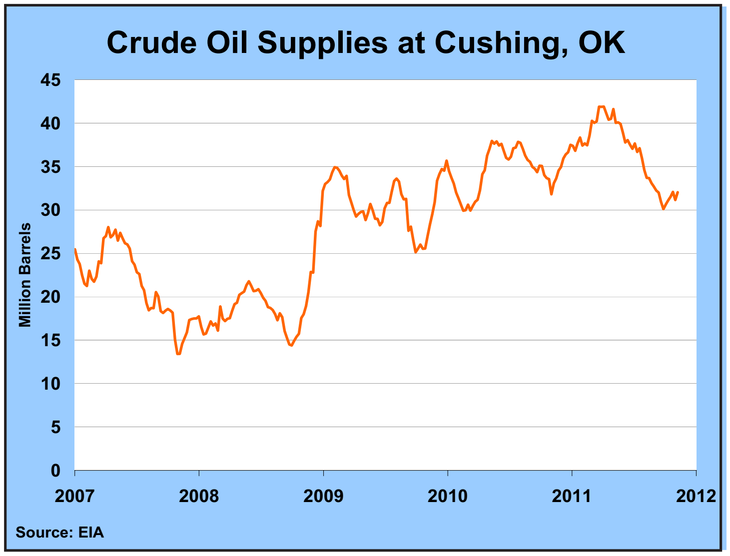
This Special Report was prepared by

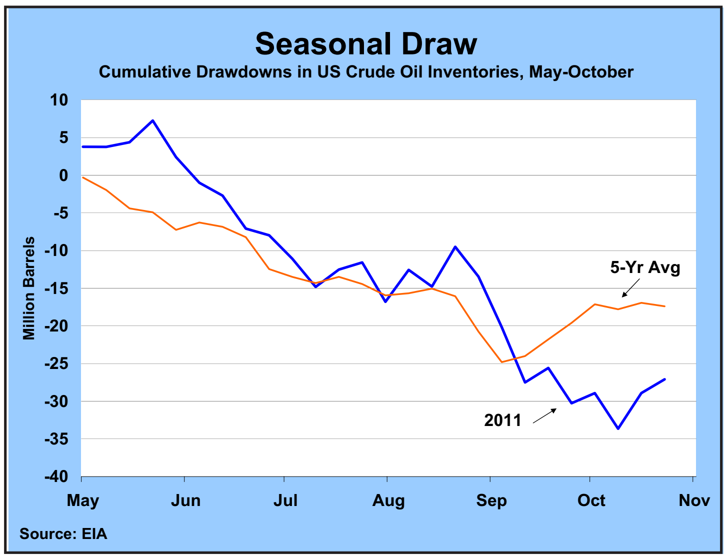
The Hightower Report

Futures Analysis & Forecasting

This is widely seen as a force that will draw demand back to WTI crude oil and eventually chew down one of the world's largest supply caches at Cushing and thereby lift WTI prices relative to Brent.

Economic conditions on both sides of the Atlantic have played a more dominant role in crude oil's demand prospects recently, as the Euro zone crisis has simply not gone away. At its October low, the crude oil market was clearly pricing in slower economic growth and slower energy demand. Some traders suggested that WTI crude oil below $80 was pricing in another recession. But as growth forecasts were ratcheted lower, investors called for more Fed support, which seemed offer some hope of avoiding a recession. In addition, unemployment levels held steady around 9.0% and consumer sentiment held together. Therefore it is possible that WTI crude oil prices in an $80.00 to $87.50 range represents too much of a discount for an economy that is still capable of avoiding a recession. The EIA has continued to downgrade their world GDP forecasts, from 4.5% in 2010 to 3.0% in 2011. They expect world growth to moderate in 2012 turn back above 3.5% by the end of the year. The odds of avoiding a macroeconomic crisis aren't particularly impressive, but it is possible that nearby crude oil prices might have relatively strong value at the $92.50 level.





Even more interesting is that US crude oil inventories fell by nearly 9.0% during the May through October time frame when economic growth and demand prospects diminished. This was almost two times greater than the normal seasonal decline for that period, and it suggests that there was something else causing supplies to disappear.

Demand Holds Steady despite Global Economic Concerns

Recent EIA estimates for 4th quarter 2011 global oil demand were pegged at 89.42 million barrels per day, up from 88.86 million in the 3rd quarter and up from an average of 87.06 million in 2010. Demand is expected to inch towards 89.6 million in 2012. While OECD (developed country) demand is expected to be fractionally lower in 2012, non-OECD demand is expected increase by 3.4%. This comes from solid demand growth expected for Brazil, China and Africa.

Another factor that could lift crude oil prices would be if China and India were to increase their strategic petroleum reserve (SPR) holdings. Recent estimates have indicated that China's strategic reserves are around 110 million barrels, but

China has expressed plans to increase those reserves to 500 million barrels in the next 8 years. That comes to about 133,000 barrels per day of added "implied" demand. India is only 25% of the way towards reaching its SPR target of 40 million barrels. As a comparison, the requirement to become an IEA member nation is to hold reserves of oil products to a level equal to 90 days of supply of net imports. Chinese and Indian reserves remain at only a fraction of the levels deemed to be "adequate." By our estimates Chinese strategic reserves are below 40 days worth, and Indian reserves might be less than 2 weeks!

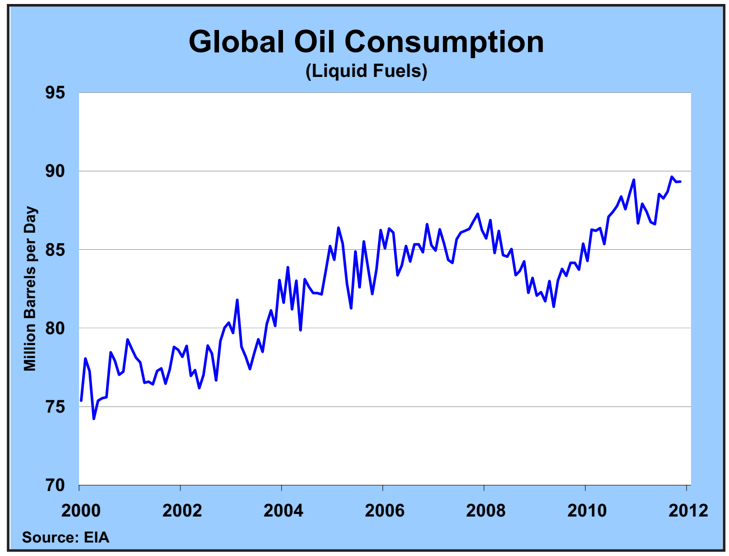
Chinese car sales in October were up nearly 6.0% from year ago levels, despite reduced government subsidies for smaller car purchases. While some industry insiders have lowered their 2012 Chinese auto sales growth projections to 3% to 5% above 2011 levels, Chinese auto sales are still expected to surpass 18.5 million units in 2011.

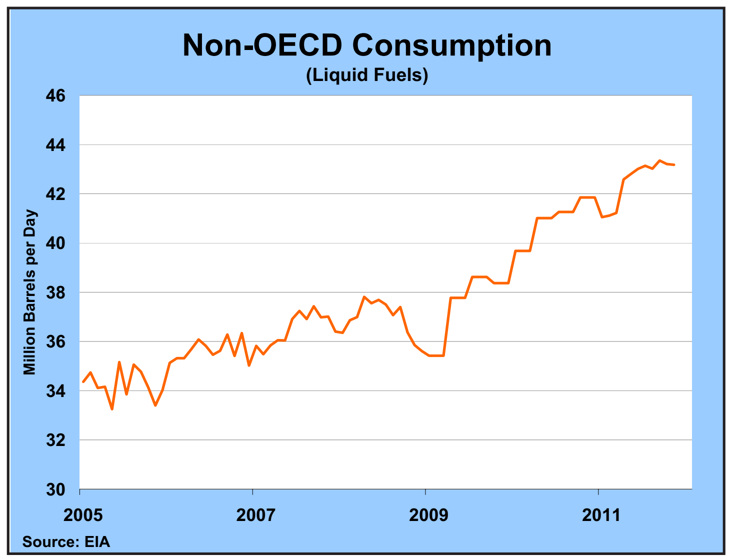
Strong Chinese energy demand is also highlighted by new record imports of coal in September. Chinese officials have said that they expect to continue to post extremely high refinery run rates into the end of 2011. This suggests that energy demand in China is strong and relatively inelastic, similar to the US.

Distillate Demand Firm, Gasoline Supplies Dwindle

Product market fundamentals are tightening, and this should help boost refinery activity and boost crude oil demand. US distillate demand increased a little more than 2% in 2011 from 2010. The EIA expects this demand growth to pick up in 2012 and increase by as much as 4.3% by the end of 2012, to just over 4 million barrels per day. Meanwhile, distillate supplies have grown tighter. In early November, the EIA estimated that US distillate supplies would cover a little more than 21 days of current needs, which is the lowest amount since July 2008. Distillate demand appears to be healthy relative to supply, which in some cases is also tighter than would be expected in the current economic environment.

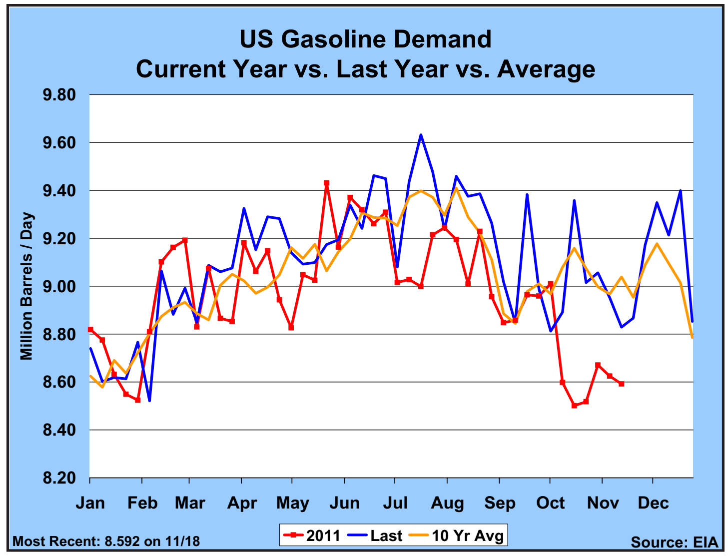
Meanwhile, US gasoline demand has averaged about 2.5% below 2010 levels for most of 2011, at a rate of 8.99 million barrels per day. Despite the sluggish demand, there has been a notable decline in supplies. US gasoline supplies experienced a 15.5% seasonal decline this year, from their 2011 peak to trough, which is nearly two times the 15 year average decline of 8.7%. US gasoline inventories usually peak





Trading futures contracts and commodity options involves substantial risk of loss, and thus is not appropriate for all investors. Investors should carefully consider the inherent risks of such an investment in light of their financial condition.

out in February and bottom near the end of October. There also seems to be a similar situation taking place in Europe, where gasoline supplies held in the Amsterdam-Rotterdam-Antwerp storage hub fell to their lowest level since October 2003 in September. While inventory levels have recovered somewhat, they are still more than 36.0% below their highs of the year.



End of Ethanol Subsidy Could Tighten Gasoline Supplies

The product markets also face the potential of losing a portion of US biofuel supplies in the wake of plans to eliminate the US ethanol subsidy. It remains unclear the extent to which ethanol production will decline when the subsidy ends, given the robust profit margins that ethanol producers were experiencing at the end of November, 2011. But any shortfall that would require additional draws from an already tight gasoline market could set the stage for a surge in retail gasoline prices. It is our view that the energy market needs the US ethanol supply. Ethanol's share of total gasoline consumption has grown steadily over the past few years, from 4% in 2007 to 9.5% in the latter part of 2011.

While we doubt that the market will see a wholesale shutdown of ethanol plants in 2012, periodic interruptions could have a dramatic impact on energy prices. When the markets saw a temporary shutdown of just two Midwest US refineries in 2009, gasoline prices rallied 45 cents/gallon. In the wake of hurricane flooding in 2011, as much as 4% of the refinery capacity was feared to be lost, and gasoline prices rallied 90 cents. Traders should not underestimate the potential price reaction if US ethanol production is even temporarily idled.

Crude Oil Supply Tight and Vulnerable

The crude oil market has grown especially concerned about tight supply, whether from geopolitical risks or from potential disruptions to output. The latest example of this comes from November reports indicating that Iran might have moved beyond the development stage and may actually be in the process of building nuclear weapons. The recent revelations have brought a fresh chorus of calls to impose even greater sanctions on Iran, but Russia has suggested that new sanctions were too severe or even illegal. Even if this most recent flap does not escalate into something more severe, the fear of a disruption of shipping traffic through the Straight of Hormuz, a key waterway for oil flows from Bahrain, Iran, Iraq, Kuwait, Qatar and Saudi Arabia, could at any time become a huge concern for the energy markets and for the world in general.

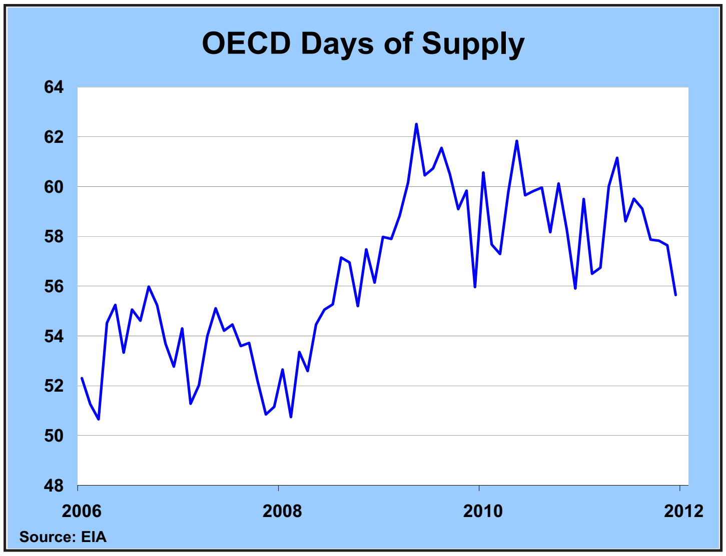
Then there is Libya, which continues to recover from its toppling of the Gaddafi regime. Current market forecasts call for Libyan crude oil production to return to its 1.6 million barrel-per-day capacity by mid-2012. However, much of their infrastructure has been compromised, and the political situation there remains in a state of flux. Returning to full capacity might become more of a challenge than initially forecasted. The status of those 1.6 million barrels of daily supply is a key variable in the global supply and demand balance.

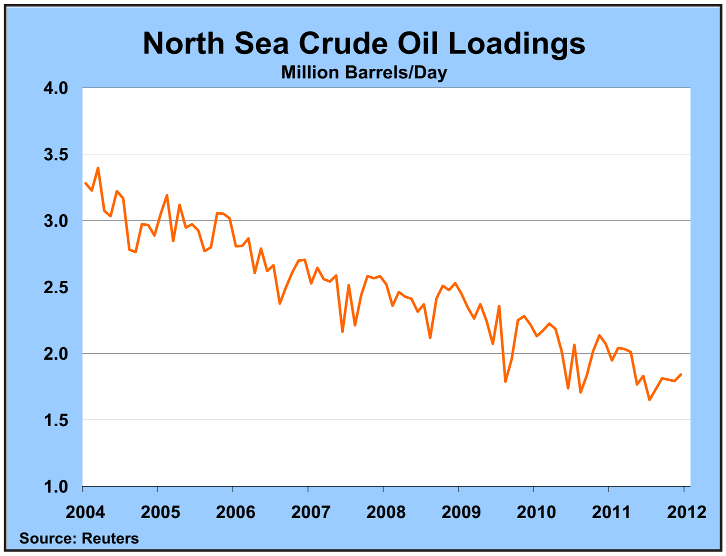
The US crude oil supply outlook becomes tighter when we factor in the nearly 300,000 barrels per day drop in production out of the Gulf of Mexico that has resulted from the offshore drilling moratorium and the new regulations that have made it more difficult for firms to acquire leasing permits. The latest EIA forecast calls for a 3% decline from 2011 levels in Gulf of Mexico production for 2012.

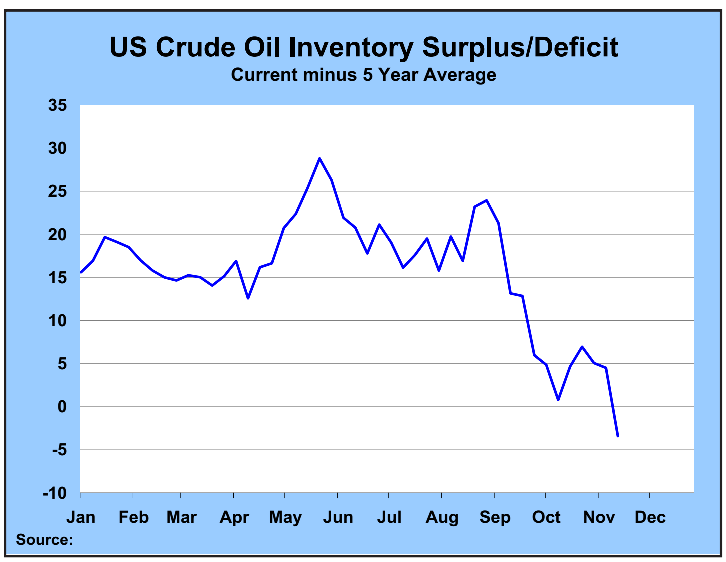
In November, the EIA estimated the amount of days of demand held in current inventories of OECD nations stood at 57 days, down from 63 days in May, 2009. That figure fell to 51 back in late 2007, which precipitated rally to $150 per barrel for nearby crude oil. Clearly, there is very little room for further supply disruptions.

North Sea crude oil production has been on a steady grind lower over the last six years. In mid-November 2011 total North Sea output came in at 1.842 million barrels per day, down 16.1% from year-ago levels. This has been a key force driving the spread differential between Brent and WTI crude oil. Production levels are down 47% from their 2004 peak.

WTI crude oil has experienced brief bouts of backwardation in recent months, largely as the cushion between current inventories and their 5 year average has diminished. (chart 10) So far during Q4 2011, current crude oil inventories have fallen below their 5-year average by 3.42 million barrels. This is down from a peak in late May, when current inventories were 29 million barrels above the 5-year average. Anything less than 10 million barrels above the 5-year average would be considered worrisome, and we would expect it to keep the market in a backwardated pricing structure. With this sort of inventory backdrop, nearby prices could reach as high as $110.50 or even $119.60.







We think there is a good chance for the inventory balance to tighten further as more WTI supplies are made available to the Gulf coast region for refining. This should reduce demand for North Sea crude oil as it is replaced by cheaper WTI.

The supply/demand balance for crude oil is tight, which in turn provides little cushion for unforeseen supply disruptions or an even a slight improvement in the global economy. (Residual supply tightness coupled with steadily emerging demand and peaking North Sea production was probably behind the October-November rally of almost $28 per barrel.) However, since expectations don't necessarily call for solid growth in 2012 (and we can hardly discount further erosion in the Euro zone debt outlook), traders should probably avoid paying up for January crude oil above $94. Our pick for a December low in January crude oil is $92.79. In the event that the world avoids a full-on debacle from Europe and US political disarray becomes less of a daily focal point for the economy, we would expect crude oil prices to spend a significant amount of 2012 above the $100 level.

Suggested Trading Strategies: 1) Buy 1 February crude oil 105.00 call for 280 and then look to sell 1 January crude oil 104.50 call for 155. Use an objective of 50 on the short 104.50 call and risk it to a close below 235. Use an objective on the long February $105 call of 450 and risk it to a close below 90. 2) Buy a February crude oil 89.00 put for 290 and then look to buy a March crude oil futures at the market. Use an objective of $104 basis the March futures for the entire position. Risk the combination to a net loss of $2,200.