



## CRM Customized Strategy Report

*Our name reflects our mission to capture/seal profits of producers and end-users by utilizing futures and options to form a barrier around profound market volatility in the energy space.*

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# Energy Markets

### *Energy Complex Retesting August Lows*

*Energy prices at a critical point, advise staying on the sidelines*

- Oil: Crude oil prices are at a critical point. Last week, we highlighted that a breach of \$78 a barrel would generate a red flag. Currently, crude oil prices are now trading near \$77 a barrel and are retesting the lows set in August.
- We expect volatility to pick up significantly following the retest of the August lows, which is now taking place and would advise staying on the sidelines until this process is complete.
- Fundamentally, supplies remain at healthy for crude and product stocks for this time of the year.
- At this point, energy followers should zone in on the equity markets as equities are also retesting their August lows as well. If equities can hold the August lows, the energy complex will likely follow and find support at current levels.
- Natural Gas: Last week's EIA natural gas data (week 38), Caprock forecasted an injection of +97 BCF while the Reuter's survey of analysts forecasted an injection of +100 BCF.
- The actual number was +111 BCF, above analysts' estimates. The trailing 5-year average for week 38 is +68 BCF. Last year, we saw an injection of +73 BCF.
- Through week 38, natural gas storage levels are currently at 3,312 BCF, which is 1% above the 5-year average.
- Natural gas prices are now hovering around \$3.66 and at a critical support level. A breach here could see prices drop further to the \$3.20 level.
- Coal: It appears Wall Street's fear of the dreaded "Double-Dip Recession" (DDR) or "Double Dip Depression" (DDD) is happening and "coal" has been branded a leading indicator; as such, coal stocks continue to retreat despite good fundamentals as we have been reporting.
- Utilities: Now that it appears Wall Street has convinced itself we are in the DDR/DDD (perhaps a self-fulfilling prophecy) we are pleased to report that most analysts are in agreement that the utility industry is perhaps "the only industry" (as one analyst stated on a CNBC interview) that has publicly traded shares that have not been hurt of late.



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### ***Petroleum Markets: Energy Prices at a Critical Point***

Crude oil prices are at a critical point. Last week, we highlighted that a breach of \$78 a barrel would generate a red flag. Currently, crude oil prices are now trading near \$77 a barrel and are retesting the lows set in August. This would be the second retest of the August lows (in mid-September, prices fell to \$77 a barrel before bouncing to nearly \$85 a barrel). In short, this is a critical level as a breach of the August lows would generate a strong sell signal and likely bring in a new wave of selling. However, a successful retest of the August lows could also set a new near-term floor for crude oil prices at the \$76/\$77 level. In any case, we expect volatility to pick up significantly following the retest of the August lows, which is now taking place and would advise staying on the sidelines until this process is complete.

*“Energy Prices are at a critical level and we expect a major move following the retest of the August lows for the complex... Keeping an eye on equities for a cue”*

Fundamentally, supplies remain healthy for crude and product stocks for this time of the year (see exhibits 1 and 2 on the following page). Demand year-over-year for gasoline continues to be weak, down 2% from the same time period last year. Distillate demand saw a slight uptick year-over-year but remains relatively weak with the U.S. economy muddling along in a stagnant funk. With that said, lower gasoline prices as well as entering the heating season, we believe demand for products could improve over the next several weeks.

Technically, we are below our 2011 range of \$80 to \$100 a barrel as the markets retest the August low. A successful retest of the August low, which would be the second successful retest, would likely set a near-term floor of \$76/\$77 a barrel and generate a wave of buying from speculators. However, a breach of this level would also generate a sell-signal bringing in a new wave of selling. Bulls and bears need to be very cautious at this level as we expect a decent move up or down following the second retest of the August lows. We prefer to stay on the sidelines and wait for the dust to settle before establishing a new bias to the downside or reiterate our trading range of \$80 to \$100 a barrel.

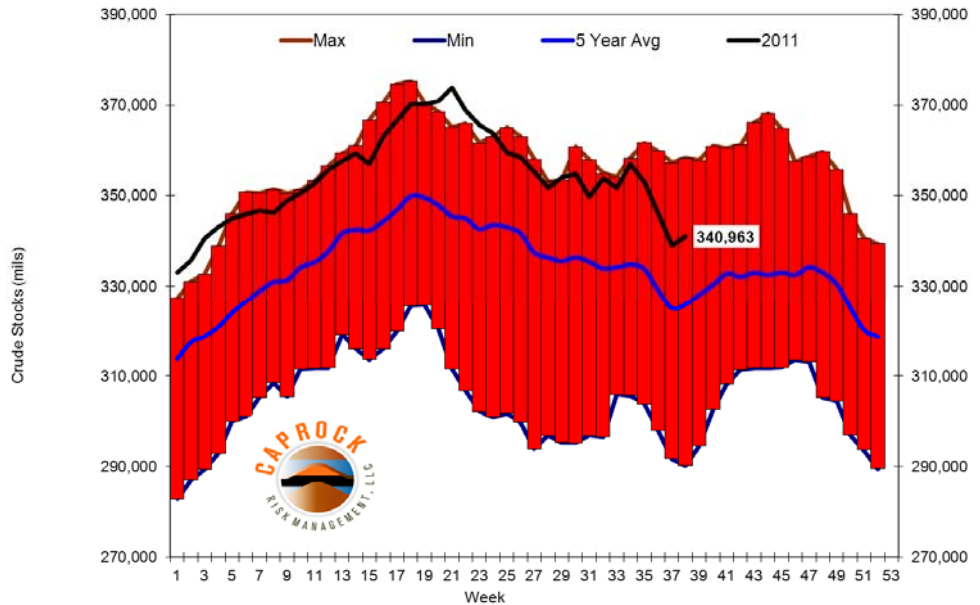
In summary and as we stated last week, we expect volatility to remain elevated especially where prices are currently trading. At this point, energy followers should zone in on the equity markets as equities are also retesting their August lows. If equities can hold the August lows, the energy complex will likely follow and find support at current levels. At times like these, we have found intra-market analysis is typically the best tool to ascertain the pulse of the markets and economy.



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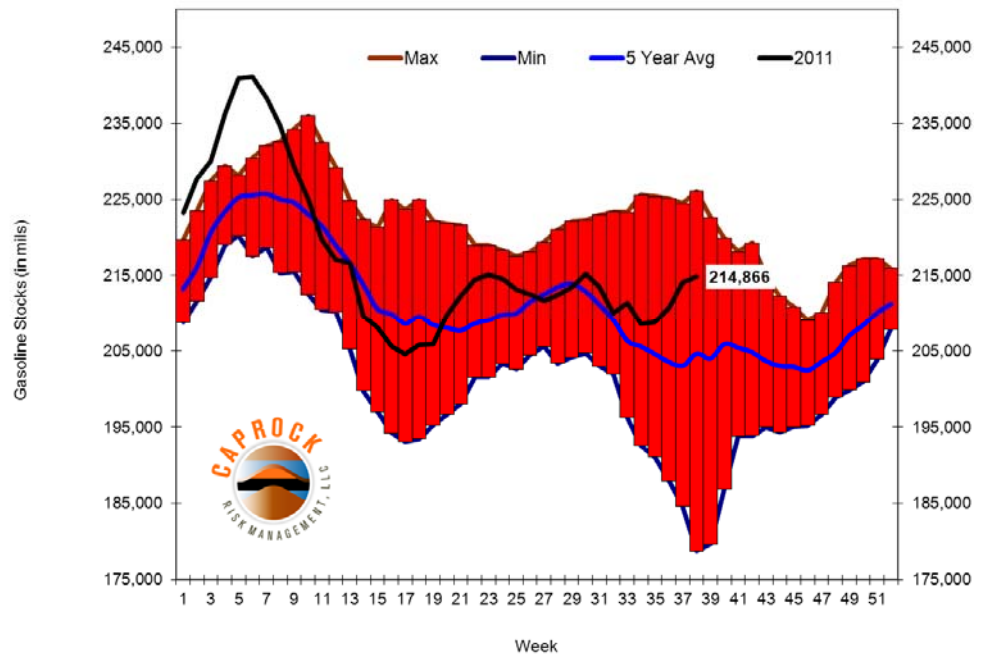
**Exhibit 1: Crude Oil Stocks (in mils)**



Source: EIA Data, CRM Estimates

*“Robust Crack Spreads Have Finally Caught Up With the Market, Refiners Drawing Crude and to Boost Product Inventories”*

**Exhibit 2: Gasoline Stocks (in mils)**



Source: EIA Data, CRM Estimates



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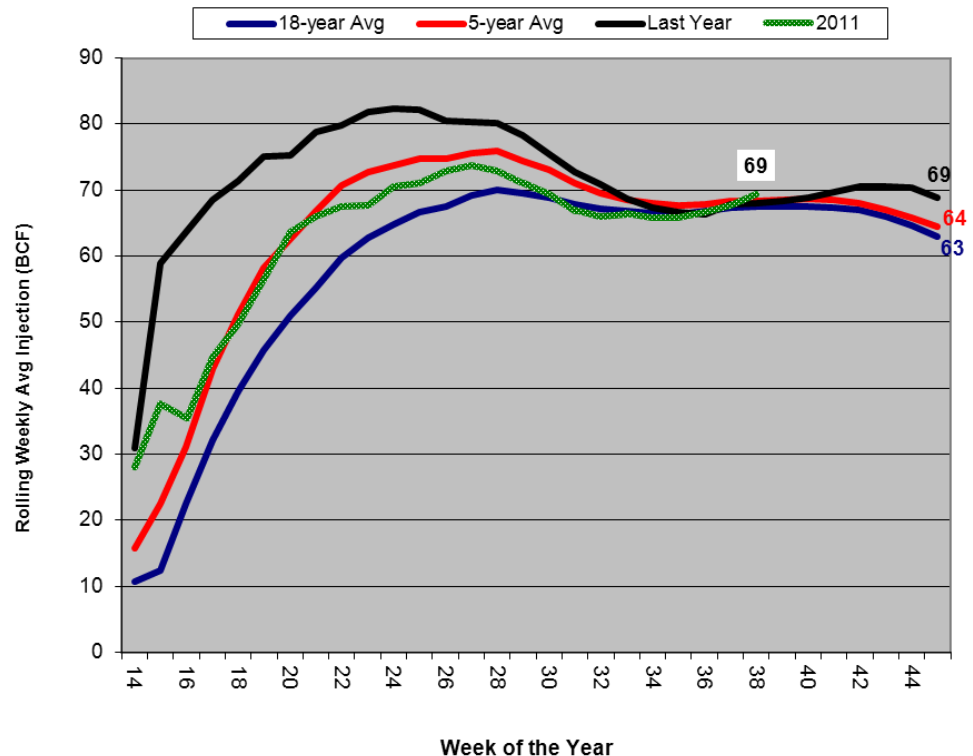
### Natural Gas: Injection Season Still Weaker than Expected

EIA Data: Last week's EIA natural gas data (week 38), Caprock forecasted an injection of 97 BCF while the Reuter's survey of analysts forecasted an injection of +100 BCF. The actual number was +111 BCF (record for this time of the year), higher than analysts' estimates. The trailing 5-year average for week 38 is +68 BCF. Last year, we saw an injection of +73 BCF. Through week 38, natural gas storage levels are currently at 3,312 BCF, about 1% higher than the 5-year average (see exhibit 4).

Based on our models, the trailing 18-year average for this period in the injection cycle has averaged +68 BCF. To date, weekly injections are now averaging +69 BCF, slightly higher than the trailing 18-year average. This time last year, the U.S. was averaging +68 BCF while the trailing 5-year average is +68 BCF. Weather was the predominant factor driving a bigger than expected build in stocks as temperatures nationally hovered near 65 degrees (basis for cooling and heating degree days) resulting in little demand for heating and cooling (see exhibit 3).

*“Natural Gas Fundamentals took a turn more bearish as weather demand softened considerable for this time of the year”*

### Exhibit #3: Rolling Weekly Average Injection



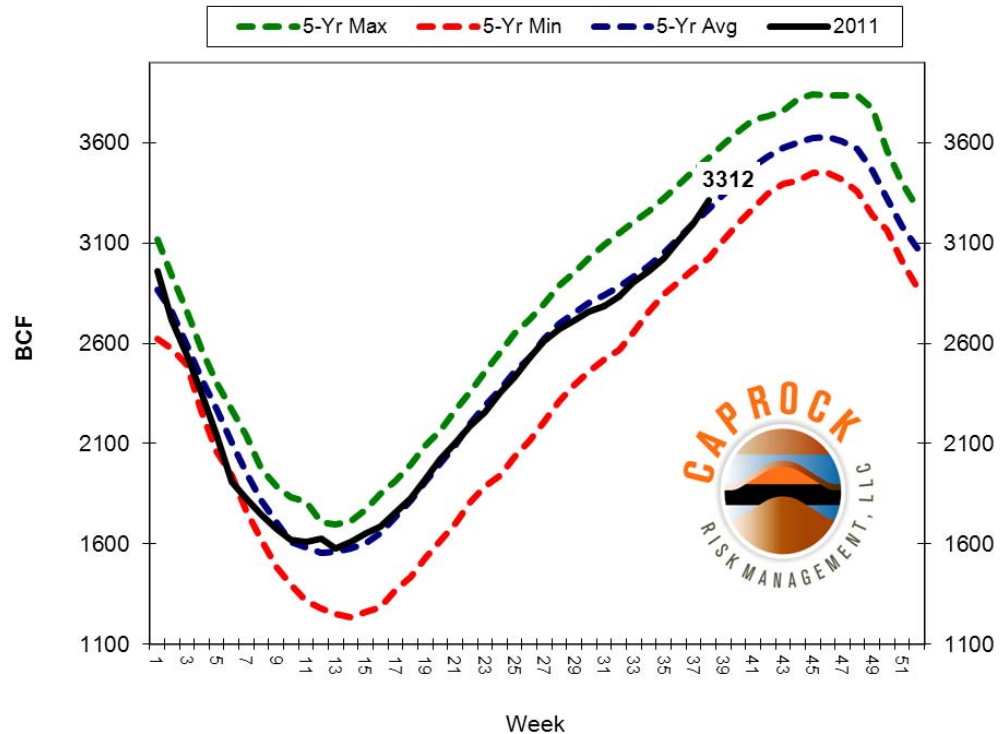
Source: EIA Data, CRM Estimates



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### Exhibit #4: Natural Gas Stocks



*“2011 Injection Season Ranks 7<sup>th</sup> out of 18, NG Stocks (3,312 BCF) about 1% higher than the 5-Year Average”*

Source: EIA Data, CRM Estimates

### Natural Gas Conclusion

Weather has had the biggest impact on natural gas prices as demand for heating and cooling was weak considering national temperatures average close to 65 degrees, the basis for demand. In addition, the lack of a hurricane season, which we are now out of peak hurricane season, has also limited any supply disruptions. Couple this with a stagnant U.S. economy, natural gas prices are now hovering around \$3.66 and at a critical support level. A breach here could see prices drop further to the \$3.20 level.

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### Coal & Utilities:

- **Coal:** It appears Wall Street's fear of the dreaded "Double-Dip Recession" (DDR) or "Double Dip Depression" (DDD) is happening and "coal" has been branded a leading indicator; as such, coal stocks continue to retreat despite good fundamentals as we have been reporting.
- In fact, CONSOL Energy, Inc. (NYSE:CNX) has been reporting "good performance," albeit "this quarter's performance" but management's company guidance has not changed as we move through the "shoulder" months toward winter when utilities still require lots of steam coal; demand for metallurgical coal in the international markets remains strong.
- **Utilities:** Now that it appears Wall Street has convinced itself we are in the DDR/DDD (perhaps a self-fulfilling prophecy) we are pleased to report that most analysts are in agreement that the utility industry is perhaps "the only industry" (as one analyst stated on a CNBC interview) that has publicly traded shares that have not been hurt of late.
- Key factors have been confirmed that utility stocks have attractive dividends (3 to 5%) and given the fact that most have been controlling costs already expect to weather a DDR/DDD fairly well; the thinking being that it really cannot get worse so the buying of utility securities of late have actually resulted in price increases.

### COAL:

As we have been reporting, demand for domestic coal remains strong. The National Mining Association (NMA) reports weekly on production levels, coal inventories and prices (although the pricing information is a repackaging of federal Energy Information Agency or EIA data).

Production data show that coal output is up 1.6% over a 52-week rolling forward analysis. While 1.6% is not "dramatic" growth/increase, prices are higher in 2011 versus 2010; costs have remained in check, which means margins are better.

Nevertheless, analysts seem convinced that coal is a leading indicator industry of the Double Dip Recession/Double Dip Depression (DDR/DDD) – whether or not it should be. We do not agree. Many times industries appear to cycle with the economy because in the past the trends (and/or betas) show the linkage. However, we think it is better to truly understand that business dynamics can and do change so that history should not repeat itself. We think that is what is happening in utilities (discussed below). If the new dynamics and fundamentals are misunderstood, then the "self-fulfilling prophecy" is at



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play and the stocks retreat in similar fashion to the herd of lemmings running over the cliff.

We continue to examine the China Coal Industry Association (CCIA) announcement that 2011 domestic demand for coal might be several hundred million metric tons higher than expected. American producers should benefit through increased export demand. That coupled with demonstrated US domestic demand should indicate coal stocks like CONSOL Energy, Inc. (NYSE:CNX) and Peabody Energy, Inc. (NYSE:BTU) should be good buys.

CNX certainly has been reporting good news and management guidance looking forward is positive. CNX's September 22, 2011 press release confirmed that CNX's exports might be up 500,000 short tons this year over the projected 10.0 million short tons. CNX management states that the 3rd quarter coal shipments "have been strong." However, despite "positive news" both CNX and BTU have fallen back to \$33.93 and \$33.88 per share, respectfully.

We have learned that it is not auspicious to buck the trend. Given the recent treatment, if you have been selling coal stocks we would not disagree with such action. Again, we see good fundamentals and had expected coal to have similar performance as utilities, the major customer segment of coal producers.

That being said, we are looking for a "coal bottom" per se at which time we think the good earnings reports will demonstrate that indeed coal stocks are greatly undervalued and will represent good buying opportunities. We are of the mind that coal stocks are being "oversold" given the discussion above and this will be recognized.

### **UTILITIES:**

We will shift this week's news letter to some positive news. We will "take a break" from reporting on the "negative" news about the Solyndra Corporation scandal, that highly visible solar-panel manufacturer in California raided by the Federal Bureau of Investigation (FBI). There are new reports about how the "road signs" were there that Solyndra's financial performance "was at risk" and that our government should have been more prudent with OUR MONEY. But enough of Solyndra for now, we wait in anticipation to read what the FBI has to report.

In the meantime, there is "good news" to share. Most utility sectors have been showing favorable market performance despite the DDR/DDD. The electric utilities, on which we are focusing, appear to have been performing better than the other segments (natural gas, water, etc.). We were pleased this week to have heard (and/or read) analysts' ideas that confirm what we have been reporting that utility stocks are good buys.



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That being said, for the short-term we continue to believe that investment in utilities remains a smart play. We must disclose that it does make us a little nervous when so many analysts agree on the same point. Experience has shown that “universal” agreement is a “red flag” that perhaps one needs to consider the contrarian strategy. We will be sensitive to such thinking and factor that into future newsletters. For now, we still see utilities as attractive buys if one has some cash to spend in the market.

The three large utilities we have been following are American Electric Power (NYSE:AEP), Southern Company (NYSE:SO) and Exelon (NYSE:EXC), two coal-burning utilities and a leading US nuclear utility, respectively.

The share prices of AEP, SO and EXC last week continued to perform well despite the drop in the Dow Jones Average. AEP ended the week (September 30, 2011) with a price of \$38.02, up \$0.57 per share from last Friday; SO and EXC closed at week’s end \$42.37 and \$42.61 respectively. SO is off 5 cents since last Friday, while EXC’s price is up \$0.18 per share.

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### Analysts' Bios:



**Christopher Jarvis, CFA, CMT** is the Chairman, Chief Executive Officer, and President of Caprock. He served as the Senior Commodities Strategist for vFinance Investments, a holding company of National Holdings Corporation and as the Head of vFinance Investments Commodities division. vFinance is a wholly owned subsidiary of National Holdings. Prior to working at vFinance Investments, Mr. Jarvis was a senior energy and commodities strategist with Merrill Lynch and Advest. Mr. Jarvis is a regular contributor to CNBC, Fox Business, Reuters, Bloomberg, The Street.com, and Dow Jones wire service, among others.

He holds a BA from University of Massachusetts and a MBA from University of Connecticut. Christopher has earned the right to use the Chartered Financial Analyst (CFA) designation. He is a member of the CFA Institute. Lastly, Christopher has also earned the right to use the Chartered Market Technician (CMT) designation and is a member of Market Technicians Association (MTA).



**Glenn Wattley** has over 30 years of management and technology experience having started his career with CONSOL Energy, Inc and MSA in Pittsburgh, PA. He spent almost twenty years with Arthur D. Little, Inc., leading its utilities practice and Andersen Consulting (now Accenture) as a partner in strategic services. Most recently he has been managing director of West Bay Energy, LLC, a management strategy firm he founded in 1999.

Over the years Glenn has brought to a range of energy and utility clients strategic business expertise. His consulting work is practical including implementation. He has been retained as a CEO for a privately held startup company, as well as advisor to client board of directors and C-level managements for business turnaround and performance improvement. His work includes due diligence on investment opportunities including merger and acquisition and initial public offerings of energy and technology companies. Glenn is a recognized thought leader and analyst having appeared on NBC, CBS, ABC, CNBC and PBS. He is quoted extensively in the press and has given dozens of keynote addresses at industry conferences. He is also a recognized expert in the application of advanced energy technology such as Smart Grid, distributed generation, renewable energy, fuel cells, coal gasification, etc. Glenn has been retained as an expert witness on industry, business and financial matters. His client base includes investment banks, utilities, public utility commissions, energy and mining companies and the Federal Department of Justice.

Glenn holds a BS in Mechanical Engineering from Columbia University's School of Engineering and Applied Science, and a MBA from Harvard Business School.



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