H.M. Payson & Co.

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RESEARCH NOTES

ARE THE FUTURES TOO BRIGHT? **MAY 28, 2008**

CONCLUSIONS:

Energy market sentiment is extremely positive, posing the possibility that prices, especially in the futures market, could fall precipitously if energy fundamentals prove not to be as compelling as the market expects – triggering a flood of new near-term supply currently held in storage awaiting higher prices.

There is evidence that the spike in futures prices for crude oil last week was caused by a wave of buyers closing out their losing short positions (bets in the market that oil prices would fall from current lofty levels after recent sharp gains), suggesting recent price gains may be temporal.

For the first time in over five years, we have moved to a Neutral rating and Portfolio weight in the Energy sector. Accordingly, we are looking to reduce near-term exposure to group.

We recommend our clients use this opportunity to accelerate any charitable gifts they plan to make in 2008 using appreciated energy stocks.

Additionally, we believe any weakness in the energy markets will bolster the beleaguered dollar - posing a potential headwind to international holdings. Therefore, we are waiting to make any new allocations to non-dollar denominated assets, our intermediate-term bearish stance on the dollar, notwithstanding.

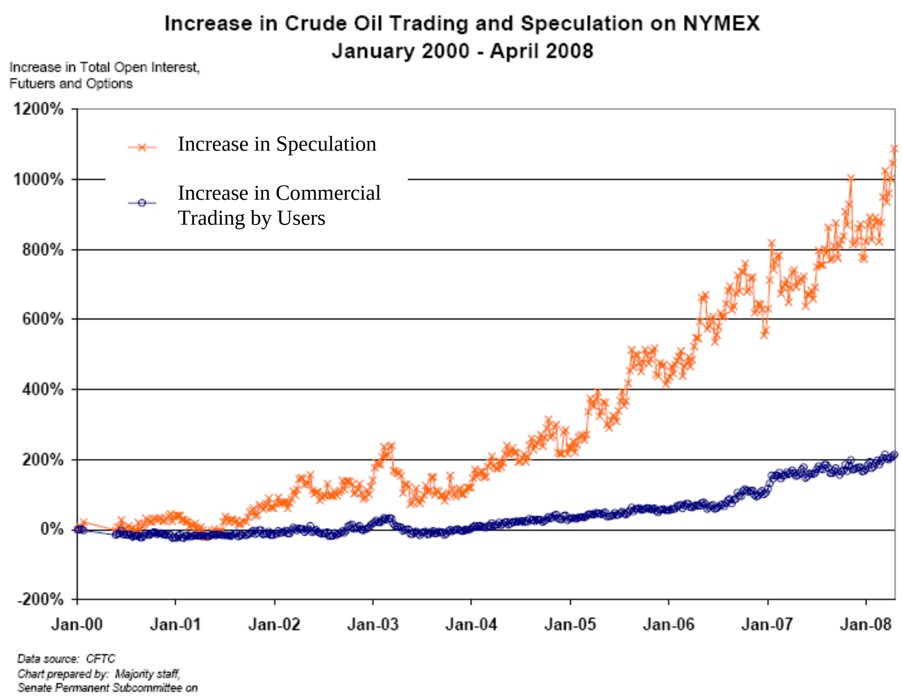
DISCUSSION:

Since 2002, most commodities and certainly energy have been in powerful bull markets. Indeed, we wrote that year at length in an edition of our newsletter, Perspectives, about the possibility that the Iraq war, and the deficits it would take to finance it, would be the straw that finally broke the dollar's back. One of the most efficient ways we saw to protect ourselves from the possibility of a serious decline in the dollar was to maintain significant exposure to energy stocks since the international market for oil and gas is, for the most part, conducted in dollars. Moreover, as our largest import product, our portfolios would have some direct protection against the possibility that oil and gas would significantly appreciate in dollar terms. This position, combined with our early forays into emerging markets, has served our portfolios very well since then.

The fundamental drivers of the energy markets are now all too well known to be the continued increase in demand by large and developing economies in India and China, especially. New supply, or at least access to new supply, has been hard to come by; and once again the talk of the possibility the world is now operating at "peak supply" is gaining currency.

The confluence of strong energy demand, tight supply and a weak and indefensible US dollar has attracted large amounts of institutional investment into commodities strategies, comprised mainly of energy. According to Bloomberg, assets invested in such Commodity Index investment strategies have ballooned to $260 billion as of March from $13 billion in 2003. Most of this strategy is implemented by buying and rolling over futures contracts rather than taking physical possession of the commodity. Clearly, this type of heightened interest in an asset class or strategy poses the possibility that the market has become dangerously ebullient.

We have no doubt that the expanded institutional participation in the energy futures markets affects the price of longer-dated contracts; however, spot prices, or the cash price, is determined daily by current supply and demand - and futures prices eventually converge to the cash price. This is to say, all the "speculation" ascribed to institutions who garner commodities exposure through the futures markets should have little to no impact on the daily cash price of commodities.



However, we have seen the very plausible argument that there are inventories of crude being held back from the cash market in an attempt to realize a higher price at a later date through the sale of futures contracts when market conditions encourage such a strategy. It's difficult to quantify how much of an impact the arrival of such inventories would have on spot prices should they come to market all at once. At some point, though, the cost of storing large amounts of inventory eats into profits - and so the possibility of a sudden liquidation of inventories now being held off the market is a real near-term risk to the spot price of oil.

Further, in extractive industries such as energy and minerals the equilibrium cash price will approximate the marginal cost of extracting an additional unit of the commodity, or the price at which competitive technologies become commercially viable. Last week in congressional testimony executives from many large energy companies posited that the equilibrium price of crude oil is somewhere between $65 and $90 - both significantly below the current price of about $127.

Although it appears to us energy stocks are discounting a lower price than the current cash price for crude, we are convinced a significant retrenchment in the spot price of oil would certainly turn a highly positive market sentiment much more negative - and lead to lower stock prices across the sector.

We are still bullish longer term on the fundamentals of oil and gas; but near-term we are reducing our exposure, after a long and profitable strategy of maintaining significant commitments to the sector.

If you have questions or comments regarding this Research Note, please click here to contact the Research Department.