

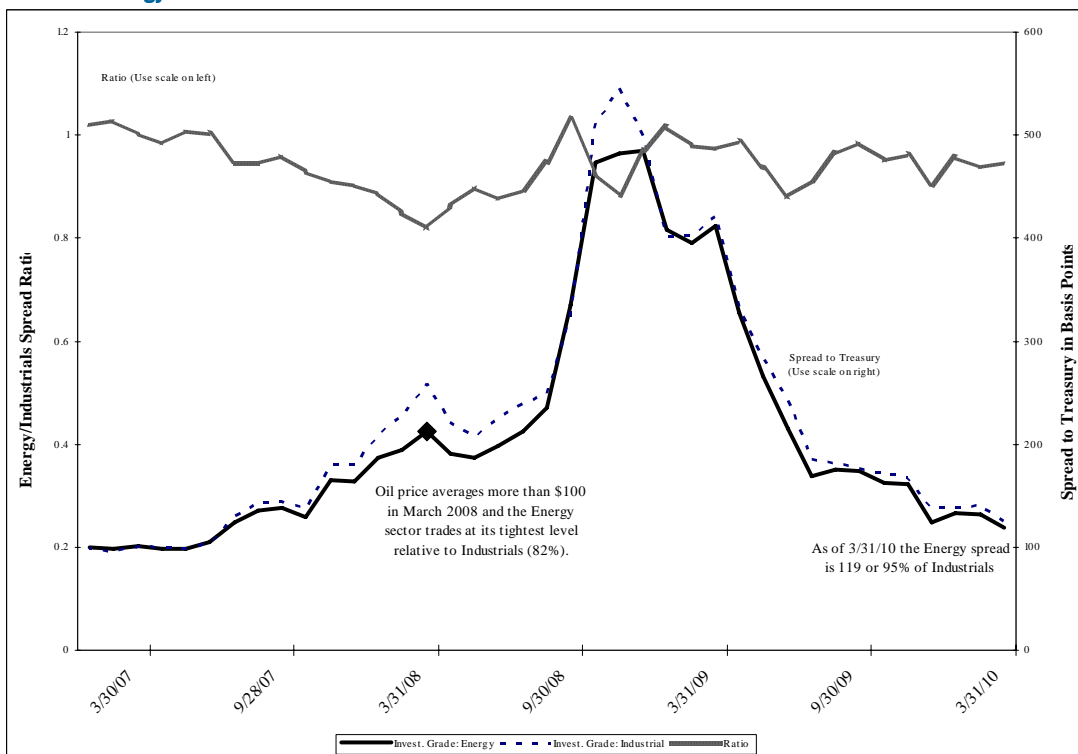
As Demand For Oil Keeps Rising, Costs To Supply It Do Too

Strong demand from emerging markets in 2009 caused oil consumption to decline less than expected, given the contraction of the worldwide economy. As economic growth rebounds in the ensuing years, worldwide demand for crude oil is likely to eclipse the previous high within the next 18 to 24 months. Supply to meet that demand will require drilling in high cost regions such as the Canadian Oil Sands and Deepwater Gulf of Mexico where breakeven costs are now estimated to be greater than \$65 per barrel. While high oil prices will improve cash flows to energy companies, history suggests that the Energy sector is likely to produce returns similar to Industrials in general. Therefore, outperformance will be driven by security selection targeted toward companies which can most benefit from historically high oil prices.

Cash Flows To Improve in the Energy Sector – Will Spreads Too?

We have updated our consumption and supply model for crude oil and raised our estimate for the price of oil to \$90 per barrel. However, we do not necessarily believe that the higher price will translate into outperformance for the Energy sector (Exhibit 1). If the 18 month period from January 2007 through June 2008 period (oil averaged \$86 per barrel during this period) is an indicator of what to expect, then the Energy sector is priced fairly relative to Industrials. Similar to other sectors within Corporates, we expect credit selection to drive outperformance in the Energy sector.

Exhibit 1: Energy Relative to Industrials Since 2007



Source: Barclays Capital, AAM



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Oil prices have rallied more than 75% in the past year and exceeded our forecast largely due to a surge in demand from energy intense emerging markets (Energy consumed per dollar of GDP), a factor we highlighted in April 2009 (Oil consumption decreased only 2.1% in 2009, much stronger than the 6.7% decline our model suggested based on worldwide GDP contraction of 2.2%). The resulting improved credit profiles from \$72 per barrel crude oil along with a very healthy corporate bond market played a role in the single-A, 10-year energy sector tightening in 119 basis points in the past year (Industrials rallied 126 basis points in the same period).

In the following pages, we provide the rationale for increasing our oil price estimate to \$90 per barrel and the risks to our forecast. We also provide our rationale for our Add recommendations in the Energy sector, which include Cenovus Energy Inc., Hess Corp., and Weatherford International Ltd. While we believe the bonds from these issuers will outperform in a high oil price environment, the three companies will also maintain a reasonably strong credit profile in much lower commodity environment.

The Rationale for \$90 Per Barrel Oil is Primarily a Demand Story...

A linear regression analysis of data from 1970 through 2009 suggests 60% of the variability in crude oil consumption is explained by worldwide economic growth. Additionally, the data suggests that oil consumption increases when worldwide economic growth exceeds 1.75%. Given the expectation that in 2010 the amount of oil consumed will average 85.9 million barrels per day¹ and that we expect average worldwide economic growth of 3.2% in 2011 and 3% beyond, we anticipate the average amount of oil consumed in 2014 will be approximately 92 million barrels per day.

Worth noting, in our publication from April 2009, we forecast that oil consumption would near 88 million barrels per day some time in 2013. We now expect to hit that consumption level a full two years earlier! Notably, peak crude oil consumption of 88.0 million barrels per day occurred in February 2008 according to OPEC and oil averaged \$95 per barrel that month.

Several factors on the demand side of the equation could cause our oil price forecast to be too conservative, primarily an accommodative monetary policy in the U.S., more stimulus funding in the U.S., and surging automobile ownership in developing countries.

In the near term, it seems reasonable to assume that regardless of the timing and magnitude of an increase in rates by the Fed, borrowing costs will be low and monetary supply will be high by historical standards. This supports strong commodity prices and oil specifically. The Fed's view is that borrowing costs are likely to stay low for an "extended period," which in our opinion means as long as required to see a meaningful improvement in the unemployment rate. In addition to a Fed Funds Rate Target of 0.25%, stimulus in U.S. will likely continue through early 2011. According to Moody's.com, more than \$260 billion of the fiscal stimulus passed in 2009 has yet to be paid out, which will likely provide growth in the second and third quarters of 2010.

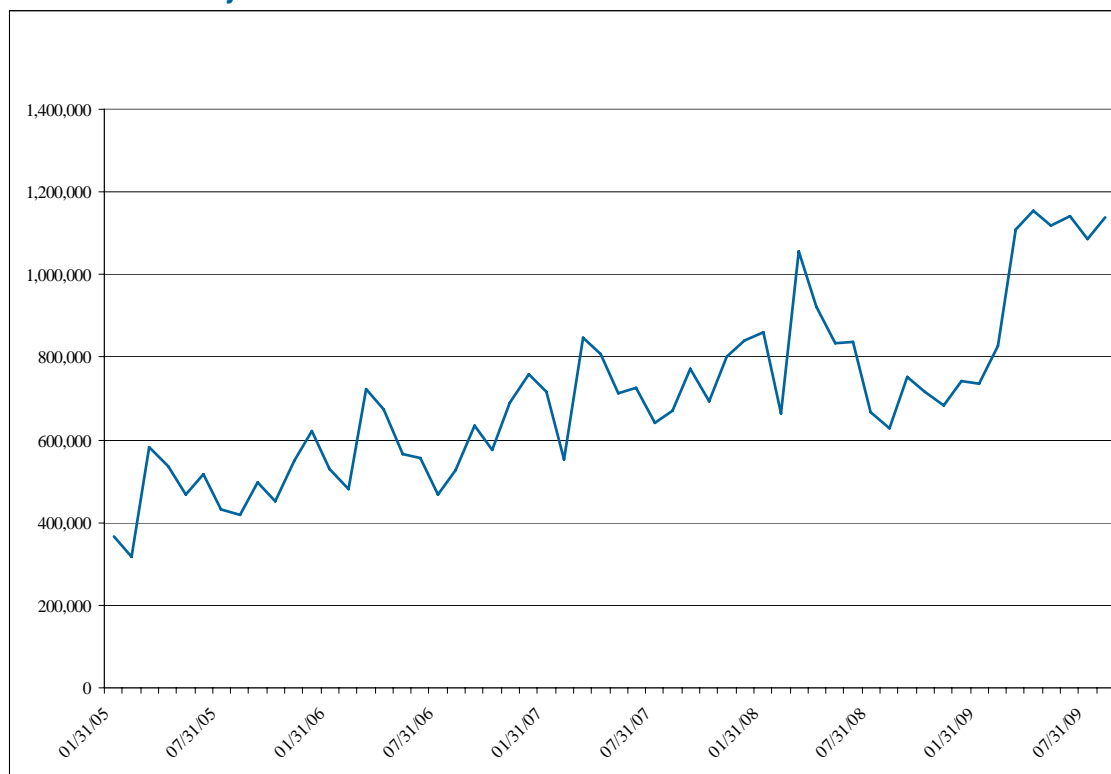
¹ Based on the average expectation from OPEC and the International Energy Agency as of April 2010.

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The other factor which could result in crude oil consumption exceeding our expectation is a secular change with regard to vehicle ownership in China and other Developing Countries. Vehicle ownership in China increased to 28 per 1000 people, a 17% increase over the previous year.² We believe that vehicle ownership per capita in China will increase for many years as it narrows the gap with the 648 cars per 1000 people of North America. Evidence of this continues to emerge as the China Automotive Information Network recently reported that auto sales in China increased 56% from a year earlier to a monthly record of 1.74 million units and were up 72% for the quarter (Exhibit 2).

Exhibit 2: China Monthly Auto Sales



Source: China Automotive Information Network

...But a Lack of Meaningful Supply Growth Will Support Oil Prices in the Intermediate Term Too.

Last year we mentioned several supply-side issues including decline curves (depletion rates), reduced capital devoted to production projects and marginal costs, which supported \$65 to \$70 per barrel oil in the intermediate term. The details of industry decline curves remain unchanged and are a continuous issue that the upstream has to deal with. However, upward pressure on oil prices remains due to delayed projects and rising marginal cost curves. According to Barclays Capital "Original E&P Spending Survey," capital expenditures declined by approximately 15% in 2009³, which delayed many production start dates. While

² Hasan M. Qabazard et al., "World Oil Outlook 2009," *Organization of the Petroleum Exporting Countries (OPEC)*, p. 79.

³ James D. Crandell and James C. West, "The Original E&P Spending Survey," *Barclays Capital Oil Service & Drilling Industry Outlook* (December 17, 2009), p. 1 and 17.

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As Demand for Oil Keeps Rising, Costs To Supply It Do Too

expenditures are expected to rebound 11% in 2010, we do not believe the increase is enough to offset the decline curves and provide supply growth. An example of this problem is the Manifa mega-project in Saudi Arabia. Work started on the project in 2006 and at the time Aramco hoped initial production of oil would begin in 2011. In early 2009, it delayed completion of the project and has now pushed the start date back to 2015. This scenario is playing out throughout the world and in short order, OPEC will have to tap into its 5 million barrel per day of excess capacity to meet demand.

Equally concerning is the rising marginal cost of supply. A study by Goldman Sachs suggests that the Canadian Oil Sands, Deepwater Africa and Lower Tertiary Gulf of Mexico will eventually provide the marginal supply necessary to meet demand at breakeven rates ranging from \$65 to \$95 per barrel.⁴ Supply from some of these regions is now coming on, which suggests that prices probably won't go below \$65 for an extended period of time.

Where Are The Holes In Our \$90 Per Barrel Forecast?

The reduced influence of government intervention is the primary item that could diminish oil consumption beyond 2010. Throughout the world, governments are removing stimuli (be it reduced loan growth at banks, raising interest rates or reduced fiscal expenditures) that were extended in 2008 and 2009 to offset the Great Recession. In our opinion, government-related decisions from China, India and the EU pose the biggest risk to oil consumption in the next 18 months.

To mitigate inflation, Chinese banks lent 43% less in the first quarter of 2010 than in the same quarter last year when banks ramped up loans for construction and other projects as part of its 4 trillion Yuan stimulus. The Chinese government is reducing the quantity of lending by China's banks, almost all of which are government controlled. Authorities have set a lower target for loan growth this year and have required banks to keep more money in reserves. Moreover, to cool home-building related components of the economy, China raised down-payment requirements for owners of more than one home after announcing that economic growth in the first quarter surged to 11.9% from a year earlier.

Additionally, there is widespread speculation that China will, at some point in the next year, remove the strict peg of the Yuan relative to the U.S. Dollar. According to the Wall Street Journal, there is "general belief among analysts that while a sudden, large jump in the value of the Yuan against the U.S. dollar is unlikely, China is probably willing to allow its currency to gradually climb upwards in the coming months." By allowing the Yuan to appreciate relative to the dollar, Chinese exports to the U.S. would likely decline and its economy would cool.

India is also attempting to ease the pace of its economic growth, which is expected to expand 8% in 2010. On April 20, 2010, the Reserve Bank of India (RBI) raised the repurchase rate and reverse repurchase rate for the second time in as many months. It also drained 125 billion rupees (\$2.8 billion) of liquidity from the banking system by increasing the cash reserve ratio, or the part of deposits that banks must set aside with the RBI, by 0.25% to 6.00%. This follows the decision by the RBI in March 2010 to increase interest rates for the first time in nearly two years due to uncomfortably fast growth and inflation at a 17-month high

⁴ Michele della Vinga, CRA et al., "208 projects to change the world," *Goldman Sachs Investment Research – Global: Energy* (January 15, 2010), p.9.

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As Demand for Oil Keeps Rising, Costs To Supply It Do Too

(wholesale prices increased 9.9% in March year over year). Industrial output expanded more than 15% for a third straight month in February as demand rose. India's economy is expected to grow more than 8% in 2010, but it appears as though higher interest rates are necessary to reduce the pace of an economy that seems to be overheating.

Given Greece's difficulty in raising capital in recent months, we believe other countries within the EU will do all they can to avoid a similar fate. The most obvious actions are to reduce government spending and/or increase taxes, neither of which will promote growth. With major fiscal changes to take place in Greece, Spain, Portugal, Ireland and Italy in the near term, it is reasonable to believe that that economic growth will remain stagnant, resulting in oil consumption declining even more than 2% as OPEC suggests. January 2010 data indicated a 12% decline in total oil usage year over year from Europe's largest countries. Almost all products showed a decline led by transport and industrial sectors.

In the next 12 months, we do not see any supply-side issues that could put pressure on oil prices. However, in the intermediate term, we believe substantially increased supply from Iraq has the most potential to negatively affect our \$90 per barrel price estimate. In early 2010, the Iraqi Cabinet authorized the development of four large oilfields as part of Iraq's increasing capacity to 12 million barrels per day, a huge increase from today's output of around 2.5 million barrels per day. We believe that the market currently anticipates production from Iraq to be near 3 million barrels per day by the end of 2012. If that level were to be exceeded greatly, then there could be some pressure on crude prices.

How Will \$90 Per Barrel Oil Affect Our Add Recommendations?

In a \$90 per barrel oil environment, we believe Cenovus could generate cash flow 30% greater than it did in 2009. While the company will likely engage in some type of shareholder friendly activity, the strength of its credit profile, cash flow and liquidity should make any actions a non-event from a spread perspective. Its very low finding costs, "oily" assets and benign political risk may make Cenovus an attractive target in the future.

According to the "Original E&P Spending Survey" from Barclays Capital, the 2010 capital budgets were on average based on \$70 per barrel crude oil. If exploration and production companies gain confidence that higher oil prices are likely to remain for an extended period, then their capital budgets will expand even more than the 10% currently forecast. Weatherford continues to be an Add, based on the premise that it will benefit in 2010 and 2011 from the increased capital spending from Super-Majors, National Oil Companies, and Independents, particularly as it gets directed to international and Canadian locales. Weatherford's bonds understandably trade at a discount to larger and stronger oil service companies such as Halliburton and Transocean, but we believe that the discount between Weatherford and its peers will narrow in the next twelve months as Weatherford's credit profile improves.

We have changed our relative value recommendation of Hess Corp. to Add from Hold based on reasonably attractive assets, a reputable management team, a good credit profile and a corporate bond market that is seeking out higher beta credits such as Hess. Currently, Hess 10-year bonds are quoted 108/103, which is approximately 5-10 basis points behind inferior credits such as Suncor and flat with Marathon Oil. We

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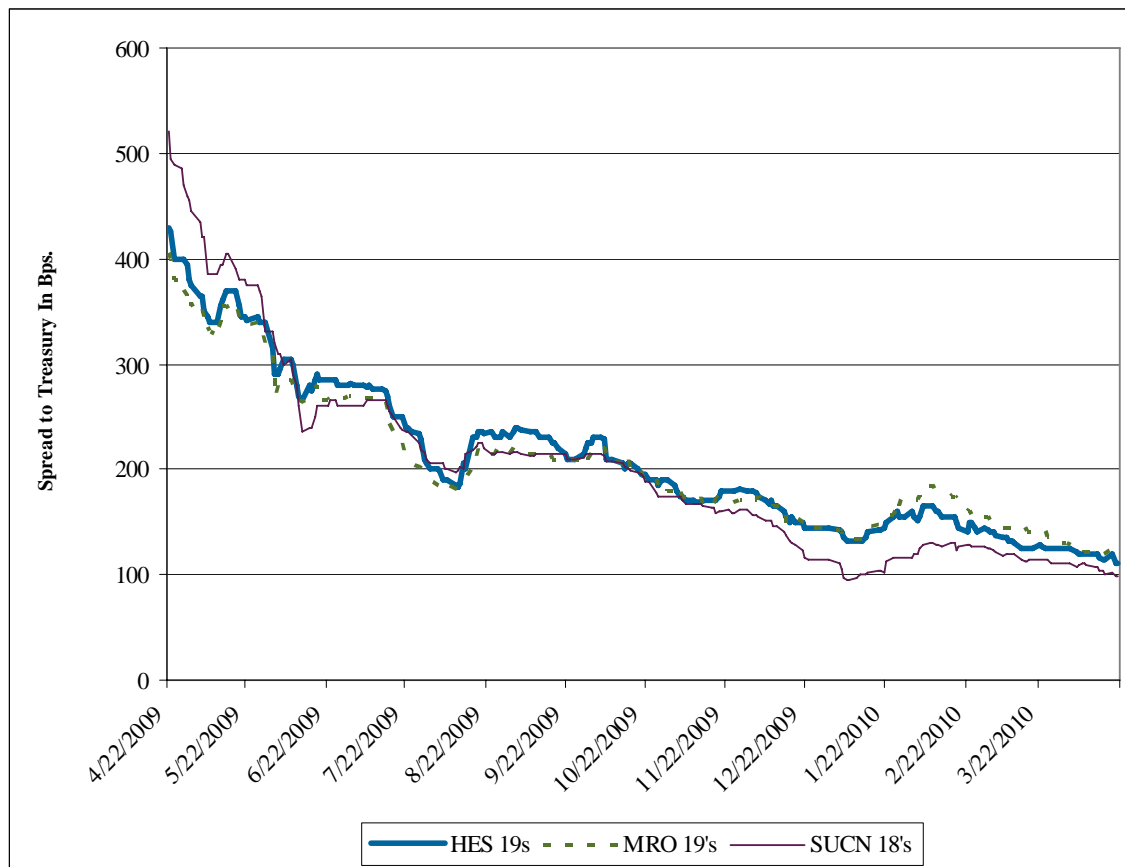
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believe Hess should trade 10-15 basis points inside of each of those weaker credits based on a relatively strong credit profile despite very similar integrated business models (Exhibit 3).

How Would These Credits Perform If Oil Were to Decline to \$40 Per Barrel Again?

As we indicated previously, higher oil prices do not necessarily translate into outperformance for the energy space in the Corporate market. Conversely, lower oil prices do not foreshadow an underperformance of the Energy sector relative to Industrials. In a \$40 per barrel oil environment, we believe our three Add recommendations would maintain investment grade credit profiles and have more than adequate liquidity and asset coverage. However, the bonds of these three credits could underperform given their relative size and strength compared with lower risk peers.

Exhibit 3: Spread to Treasury - Hess (HES) vs. Marathon Oil (MRO) & Suncor (SUCN)



Source: Barclays Capital and AAM

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