



OUTLOOK

"Energy Stocks Ready to Blast Off"
7/28/2008

We currently hold a bullish view on energy stocks and expect them to rally within the next 2 months. Since mid-May, the XOI, an index of oil stocks, has declined relentlessly for 9 out of the last 10 weeks. As shown in Graph 1, the XOI has recently declined below 1290 from its closing high of 1630.09 on 5/20/08.



Energy stocks have faced a double whammy of a declining stock market and falling oil prices, as shown in Graph 2. Between June to mid-July, the broader market, S&P 500, corrected over 10% which was a downward drag on energy stocks. In addition, crude oil corrected steeply after Bush's decision on 7/14/08 to lift the executive ban on offshore oil drilling. After Bush's decision to lift the ban, crude oil declined over 15% from over \$145 to less than \$125 in a matter of 2 weeks. Given the strong correlation between energy stocks and crude oil, the fall in crude oil served to accentuate the decline in energy stocks.

Graph 2



So why do we believe this is a good entry point for energy stocks? One, the % of stocks above their 50 day moving average in the XOI Index is 0%. We are at the lowest end of the range so the upside potential outweighs the downside risk. Two, the so-called smart money, commercial hedgers, are the most net long in crude oil in more than one year. A strong bid in crude oil by the commercial hedgers would be very supportive for energy stocks. Three, the volume in the energy ETF, XLE, has been extremely high during the recent sell-off in energy stocks. Historically, these peak volume levels in XLE have signaled capitulation in energy stocks which have been good buying opportunities. See graph 3.

