Energy
Industry Brief

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EQUITY RESEARCH

October 23, 2006

RAYMOND JAMES®

Raymond James` Energy "Stat of the Week"

Time to "Cowboy Up" and Buy Energy Stocks

Six weeks ago we became cautious on the energy group as surging U.S. natural storage injections caused us to question our bullish winter natural gas thesis. Since then, storage injections have moderated considerably and we are once again comfortable with our original view that the summer injection season will end October with a little over 3,500 Bcf of natural gas in storage. In addition to becoming more comfortable with our U.S. natural gas outlook, a 25% pull back in oil prices over the last two months, and an OPEC production cut, extremely cheap stock valuations lead us to believe that **now is the time to get more aggressive in increasing weightings for energy stocks.**

Any way you slice it, energy stocks are discounting a major decline in 2007/2008 earnings
Before we explain why bullish commodity fundamentals are likely to drive strong energy earnings in 2007 and 2008, it is important for investors to understand just what the market is saying about the energy earnings outlook for the upcoming years. **In very simple terms, the stock market is either saying 1) current 2007 earnings estimates are overstated by some 30% to 70%, or 2) the energy earnings outlook for 2008 and beyond is very ugly.** How do we know this? Looking at the table below, the left hand column shows the current 2007 P/E multiple of the different oilservice subgroups, and the next column shows the ten-year averages for forward multiples. As you can see by the third column (which shows the current discount in percentage terms), the discrepancy between the ten-year average and 2007 P/E multiples is remarkable. Current multiples are nearly 50% **lower** than the 10-year average. Put another way, the market is saying we are currently at peak energy earnings and the market expects earnings growth to be negative over the coming years, thus bringing multiples back in line with long term averages. We completely disagree with both of these conclusions!

Groups	2007 P/E	10 Yr. Avg. P/E	Discount to Market	Discount to 10 Yr. Avg
Oilservice	**10.3x**	**19.6x**	**33%**	**47%**
Diversified	12.7x	22.0x	17%	42%
Manufacturing	12.3x	18.0x	20%	32%
Offshore Construction	11.1x	16.2x	27%	31%
Offshore Drilling	7.3x	21.4x	52%	66%
Onshore Drilling	6.6x	21.9x	57%	70%
Production & Workover	12.1x	17.9x	21%	32%
Tubular Manufacturers	9.7x	18.6x	37%	48%
E&P	**11.2x**	**14.0x**	**27%**	**20%**

Source: Fact Set

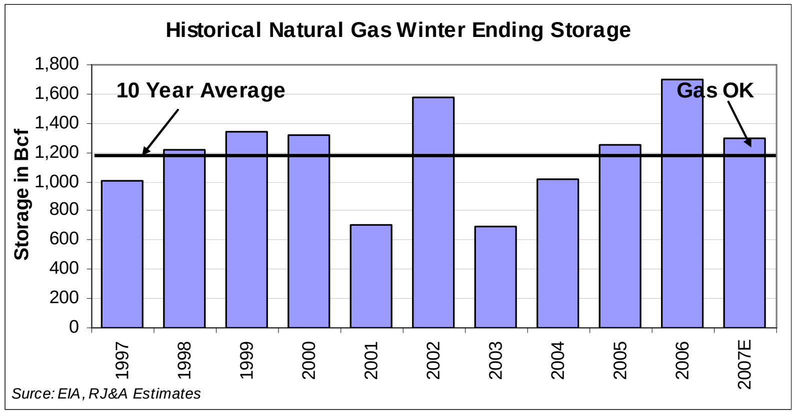
A final way of looking at the extreme valuation discrepancy is to examine the current P/E multiple discount to the broader market (S&P 500), as shown in the second column from the right in the table above. Here, the large valuation discount implies that future earnings growth potential for energy stocks is substantially lower than it is for the broader market. Given our bullish oil and natural gas price forecast, we think that not only will the earnings growth rates for energy stocks be substantially higher than market averages over the next two to three years but that earnings estimates for **most** of the energy sub groups will be revised upwards rather than downwards over the next two to three quarters. We recognize this would be an impressive feat given that the average oil service company is already expected to grow earnings over 40% between 2006 and 2007.

Please read disclosure/risk information on page 6 and Analyst Certification on page 7.

We believe that the extremely attractive valuations are confirmed by the fact the numerous sell-side firms have finally capitulated and thrown in the towel on the group. Our experience says this is usually a good sign that we are nearing a bottom. Anecdotally, our conversations with buy-siders over the past several months lead us to believe that there is a significant amount of “dry powder” waiting on the side-lines until clear technical and fundamental indicators convince them that it is time to jump in. From a fundamental perspective, we believe that those signs are evident already.

Natural gas prices are turning the corner

As we mentioned above and in numerous pieces over the past month and a half, the exceptional large gas inventory builds experienced during September caused us to question our 2007 natural gas outlook. In a nutshell, our year-over-year gas supply /demand equation went from being consistently 2 Bcf/day tighter for most of the summer to about 3 Bcf/day looser in early September. We were concerned that if that trend continued, storage would end October above 3,700 Bcf and a normal winter would be insufficient to bring storage back to normal levels. While we still haven’t gotten a firm handle on exactly why the gas storage numbers ballooned in early September, we have seen weekly improvements in the gas storage situation consistently over the past five weeks. Given that we now think we’ll see closer to 3,550 Bcf at the end of October, **we are comfortable saying that a normal winter will push winter ending storage back towards more normal levels** as shown in the graph above. Without rehashing the details of how we get from 3,550 in storage at the end of October to 1,300 in storage at the end of March, suffice to say that both the year-over-year and demand and weather comps will get much easier over the next four months. Again, we should reemphasize that our outlook is based upon weather returning to a 30-year normal this winter.

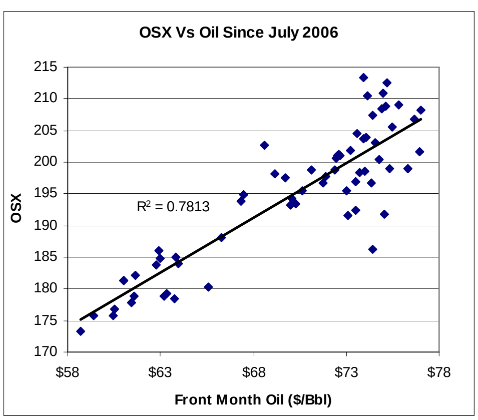


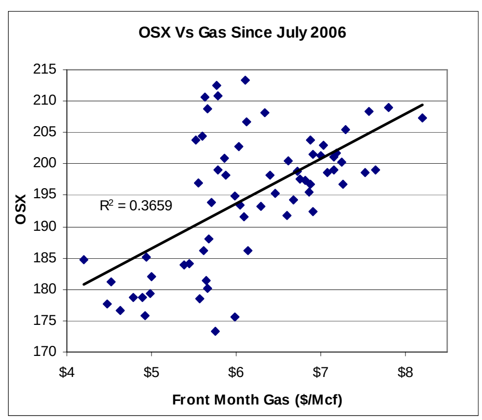
Surce: EIA, RJ&A Estimates

What happens if the weather is warmer than normal again? Of course, if we have warmer than normal weather, our gas model will be off and gas prices will be lower than we anticipated. It is our view that if the natural gas future strip for 2007 falls below $7.00 per Mcf for any meaningful period of time, then the U.S. energy market will face a slowing in drilling activity and our earnings estimates for many of our oil service companies and E&P companies will be revised downward. The stocks are already telling you this is going to happen. We think the stock market is missing the fact that any flattening or reduction in drilling activity is likely to result in a rapid correction in both natural gas production and natural gas prices. The market seems to be ignoring the fact that U.S. natural gas decline rates are steeper than ever and gas production is not responding in any meaningful way to record levels of drilling activity that occurred over the past several years. **Bottom line: Even if we are wrong in our natural gas outlook, we think that the natural gas supply/demand equation will likely correct fairly quickly if activity does roll over.**

Are oil prices near the bottom?

Because the U.S. natural gas price pull-back this fall was widely anticipated in the stock market, it had relatively little impact on the stocks. Instead, we believe it was the roughly 25% pull back in oil prices over the past two months that drove the sharp correction in energy stock prices. As shown in the accompanying graph, the oil service stock correlation for oil has been much tighter than with gas prices over the past several months.





Fundamentals for oil remain very strong

Given this close relationship between oil prices and energy stocks, obviously one of the keys to the turnaround in the stocks is the bottoming in oil prices. We believe that oil prices are relatively close to a bottom for the following reasons. **1)** We believe that counter-seasonal builds in U.S. oil inventories were part of the reason oil prices have declined over the past two months. We do not believe these inventory builds in the U.S. are indicative or representative of a similar increase in global oil inventories. In fact, we think oil inventories have merrily been "sloshing" in to the U.S. and away from other parts of the world. It is probably due to the fact that BP (BP/$67.80) Alaska production was not off-line as long as oil marketers thought. Regardless of the reason, this "sloshing" usually only lasts for short periods of time. **2)** We believe that the market's perception that political risk surrounding oil supply has diminished is misplaced. We do not believe for a minute that any of the political issues surrounding Iran, Iraq, Venezuela, or Nigeria have been solved over the past two months. **3)** Our global oil supply/demand equations show a very tight oil situation as we move through 2007, even when assuming that the global growth of oil consumption slows dramatically from growth rates experienced over the past three years. In other words, we have to model in economic slow down to keep our supply/demand equation balanced in 2007. **4)** Most importantly, OPEC has officially confirmed a production cut of 1,200 MBpd starting in November, which is actually 200 MBpd higher than previously expected. Frankly, we are not too surprised as we had noticed that OPEC production had already declined substantially over the past year as shown in the adjacent table's September y/y results. We think this cut confirms OPEC's intention to defend oil prices in at least the $60 range. **The bottom line is that there are many valid fundamental reasons why oil prices should begin to firm in the coming months and likely move higher as we move through 2007.**

OPEC Production by Country
(Thousands of Bbl/day)

Country	Actual Sep-05	Sep-06	Year/Year Decline	Stated OPEC Cuts	RJ Est. Actual Cuts	New RJ Estimates w/ Cuts	Nov-05	Nov Y/Y Change
Saudi Arabia	9,580	9,180	-400	380	350	8,830	9,550	-720
Iran	3,850	3,900	50	176	75	3,825	3,910	-85
Venezuela*	2,700	2,470	-230	138	50	2,420	2,600	-180
Iraq	2,055	2,000	-55	0	0	2,000	1,960**	40
U.A.E.	2,580	2,600	20	101	100	2,500	2,570	-70
Kuwait	2,500	2,490	-10	100	100	2,390	2,510	-120
Nigeria	2,425	2,210	-215	100	50	2,160	2,450	-290
Libya	1,680	1,720	40	72	40	1,680	1,680	0
Indonesia	930	865	-65	39	0	865	935	-70
Algeria	1,370	1,380	10	59	0	1,380	1,380	0
Qatar	790	820	30	35	0	820	800	20
Total	**30,460**	**29,635**	**-825**	**1,200**	**765**	**28,870**	**30,345**	**-1,475**

Source: Bloomberg * includes 590,000 bbl/day of heavy crude production **RJ Estimates

Conclusion

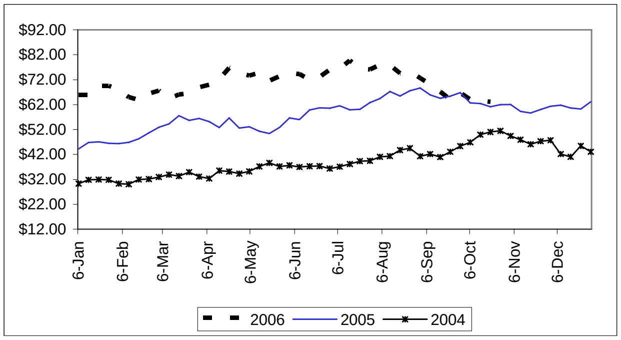
Over the past several weeks we have seen many sell-side analyst throw in the towel on energy stocks. While we have been somewhat concerned about gas inventory builds over the past six weeks, we are now becoming increasingly confident that natural gas prices will firm up as we move through the winter. Likewise, the roughly 25% pull back in oil prices over the past couple of months is contrary to the many bullish fundamentals that we think will drive oil prices higher through 2007. Ultimately, we believe that OPEC's recently announced cut should support domestic inventory reductions as we move through the winter, and ultimately provide a floor for oil prices in the mid $50 range.

Contrary to our belief that both oil and natural gas prices are near a bottom, the market seems convinced that 2007 earnings estimates are too high and that energy earnings have peaked. Given our bullish stance on oil and gas, we think there is still meaningful growth ahead for energy companies over the next five years**, the cycle has not peaked**, and 2007 earnings are not 50% too high. **Simply put, we think it is time for investors to saddle up and get ready for a bumpy, but fun, upward ride in energy stocks.**

Raymond James Weekly Oilfield Review

For Week Ending: 20-Oct-06

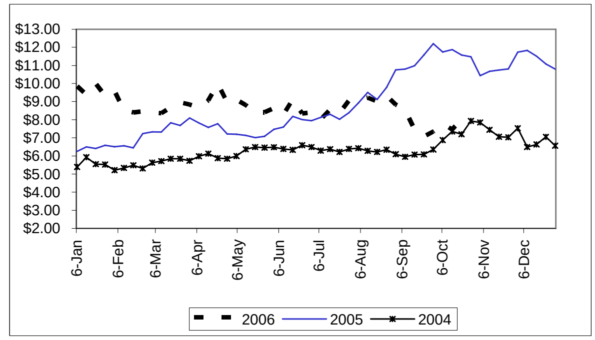
12 Month Oil Calendar Strip
West Texas Intermediate



	This Week	Last Week	Beginning of Year	Last Year
Price	$63.15	$63.67	$65.92	$61.12
Percent Change		-0.8%	-4.2%	3.3%

Source: Bloomberg

12 Month Gas Calendar Strip
Henry Hub



	This Week	Last Week	Beginning of Year	Last Year
Price	$8.00	$7.46	$9.85	$11.58
Percent Change		7.2%	-18.8%	-30.9%

Source: Bloomberg

	20-Oct-06 This Week	13-Oct-06 Last Week	21-Oct-05 Last Year	Change From: Last Week	Change From: Last Year
1. U.S.Rig Activity					
U.S. Oil	291	284	216	2.5%	34.7%
U.S. Gas	1,442	1,439	1,253	0.2%	15.1%
U.S. Miscellaneous	6	5	5		
U.S. Total	**1,739**	**1,728**	**1,474**	**0.6%**	**18.0%**
U.S. Horizontal	323	322	205	0.3%	57.6%
U.S. Directional	393	403	350	-2.5%	12.3%
U.S. Offshore	89	94	88	-5.3%	1.1%
U.S. Offshore Gulf of Mexico					
Fleet Size	143	145	157	-1.4%	-8.9%
# Contracted	117	119	125	-1.7%	-6.4%
Utilization	81.9%	82.1%	76.6%	-0.3%	6.9%
U.S. Weekly Rig Permits *	NA	NA	1458	NA	NA
2. Canadian Activity					
Rig Count	455	477	567	-4.6%	-19.8%
Total Well Completions (Incl. Dry)	NA	NA	NA	NA	NA
3. Stock Prices (10/20/06)					
OSX	188.0	183.7	155.6	2.4%	20.8%
S&P 500	1,368.6	1,365.6	1,179.6	0.2%	16.0%
DJIA	12,002.4	11,960.5	10,215.2	0.3%	17.5%
S&P 1500 E&P Index	415.0	402.2	355.0	3.2%	16.9%
4. Inventories					
U.S. Gas Storage (Bcf)	3,442	3,389	3,062	1.6%	12.4%
Canadian Gas Storage (Bcf)	457	453	494	0.8%	-7.4%
Total Petroleum Inventories ('000 bbls)	733,424	738,752	664,516	-0.7%	10.4%
5. Spot Prices (US$)					
Oil (W.T.I. Cushing)	$56.82	$58.57	$61.23	-3.0%	-7.2%
Oil (Hardisty Med.)	$36.12	$36.06	$39.77	0.2%	-9.2%
Gas (Henry Hub)	$6.90	$4.30	$13.24	60.5%	-47.9%
Residual Fuel Oil (New York)	$6.58	$6.31	$8.29	4.3%	-20.6%
Gas (AECO)	$6.17	$4.61	$10.10	33.8%	-38.9%

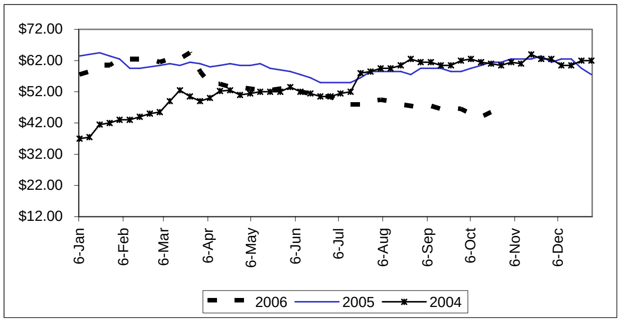
Sources: Baker Hughes, ODS-Petrodata, API, EIA, Oil Week, Bloomberg

** Note: Weekly rig permits reflect a 1 week lag*

Raymond James Weekly Coal Review

For Week Ending: 20-Oct-06

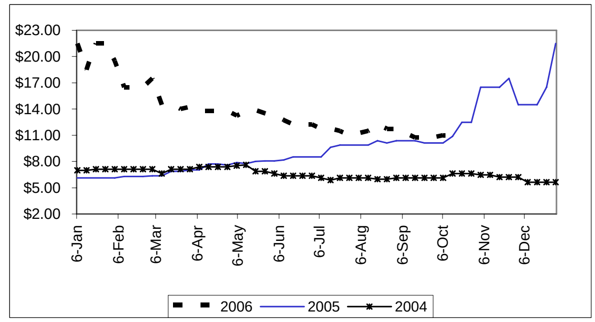
12 Month Big Sandy Barge Prices



	This Week	Last Week	Beginning of Year	Last Year
Price	$45.50	$44.00	$57.50	$61.50
Percent Change		3.4%	-20.9%	-26.0%

Source: Bloomberg

12 Month Powder River Basin 8800 Prices



	This Week	Last Week	Beginning of Year	Last Year
Price	$11.25	$11.00	$21.50	$12.50
Percent Change		2.3%	-47.7%	-10.0%

Source: Bloomberg

	20-Oct-06 This Week	13-Oct-06 Last Week	21-Oct-05 Last Year	Change From: Last Week	Change From: Last Year
1. Coal Prices					
Eastern U.S.					
Big Sandy Barge	$45.50	$44.00	$61.50	3.4%	-26.0%
Penn. Railcar	$39.50	$39.50	$54.50	0.0%	-27.5%
Illinois Basin Mid Sulfur	$35.50	$35.50	$35.50	0.0%	0.0%
Illinois Basin High Sulfer	$33.50	$33.50	$35.50	0.0%	-5.6%
Western U.S.					
Powder River 8800	$11.25	$11.00	$12.50	2.3%	-10.0%
Powder River 8400	$8.80	$8.50	$10.50	3.5%	-16.2%
Colorodo/Utah 1% Sul	$36.00	$36.00	$36.50	0.0%	-1.4%
2. Production	**13-Oct-06**	**6-Oct-06**	**14-Oct-05**		
Eastern U.S.	9,553	9,534	8,906	0.2%	7.3%
Western U.S.	12,427	12,331	11,951	0.8%	4.0%
Total	21,980	21,865	20,858	0.5%	5.4%

Sources: Bloomberg

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Strong Buy (SB1) .... Expected to appreciate and produce a total return of at least 15% and outperform the S&P 500 over the next six months. For higher yielding and more conservative equities, such as REITs and certain MLPs, a total return of at least 15% is expected to be realized over the next 12 months.

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Market Perform (MP3) .... Expected to perform generally in line with the S&P 500 over the next 12 months and is potentially a source of funds for more highly rated securities.

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