CONNECTED WEALTH

Market Ethos

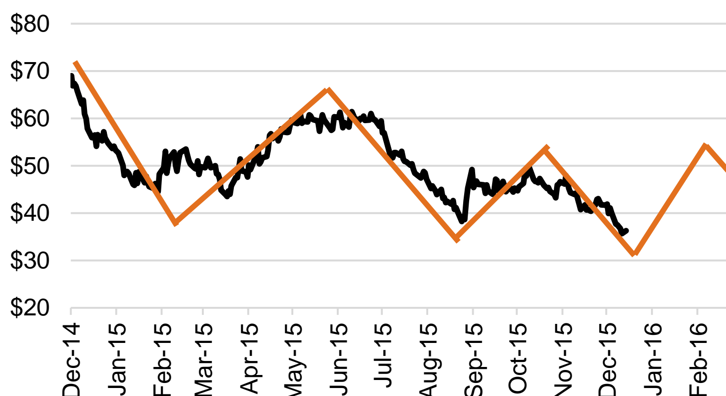
The Ws – a trough?

December 15, 2015

Oil prices have collapsed this month and briefly traded below $35/barrel, a level not seen since the financial crisis. Share prices of energy companies have naturally been hit hard, with the double whammy of natural gas moving below $2/MMBtu as the warm weather persists. Add a deteriorating corporate debt market for energy companies, OPEC not explicitly stating a quota and tax loss selling. Maybe this is more of a quintuple whammy.

Why do we call it the Ws

Our "Ws" hypothesis is based on supply reacting more slowly to surpluses and subsequent rapid tightening of supply as cuts finally take hold (The Ws 24 July 2015). In a world with too much oil such as today, cutting production would be the easiest and quickest path to returning the market to equilibrium. However, individual companies will opt to curtail spending focused on future production while maintaining current and near term production growth. Capex goes down but the money being spent is used to finish wells under construction, focus drilling only on the most profitable zones (read lowest cost) and leave some completed wells disconnected from the system (DUCs as they are now called). This doesn't affect current production very much, instead it cuts production nine months or longer into the future. So what we get is a trough in the "W" when production is still high or rising despite depressed prices, further exacerbating the issue (like right now in the market). Yet, beneath the surface, future production growth has been curtailed. As the market begins to absorb or come around to this falling production, we start the climb out of one of the troughs in the Ws towards a peak. Unfortunately, production can be quickly ramped in response to higher prices, so if prices recover too much, supply comes back pretty quickly. We could be in the Ws for years.



Connected Wealth Market Ethos posts are market thought pieces from the Richardson GMP Asset Management team. As part of our philosophy for managing money, we believe in providing quality objective advice and services with greater transparency. These reports are designed to provide a deeper look into our current thinking.

Market Ethos - Ethos is defined as the character or disposition of a group. In this case it's the disposition of the market itself.

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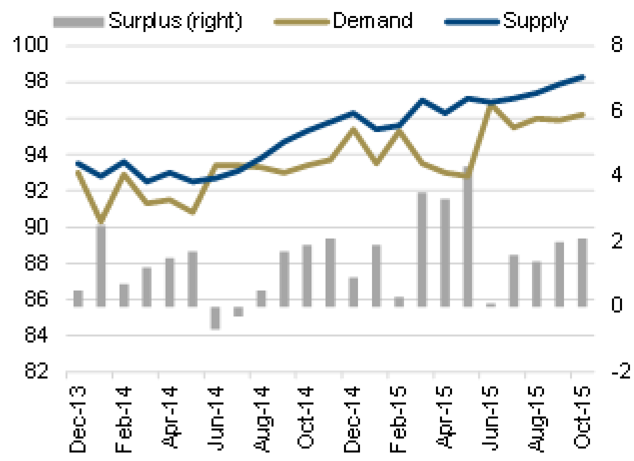
Is this the bottom of a W or more to come?

We don't know but we do know the negatives are piled extremely high at the moment. Some of which may be less founded. In this report we will go through our thinking on the space, how we are positioned and changes we may endeavour to implement in our portfolios.

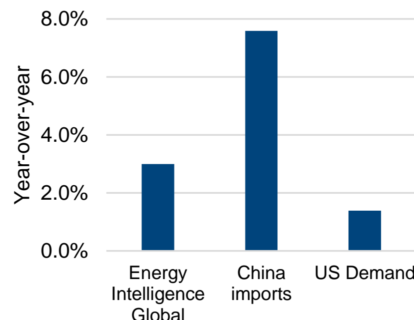
Supply and demand basics

The top oil producers in the world are the U.S., Saudi Arabia, Russia, China, Canada and the United Arab Emirates. Global production continues to rise – even though prices continue to fall. The problem is that no one wants to lower output. In other words, everyone is waiting for someone else to stop pumping. As a result, there is still ~2 million barrels per day of excess supply.



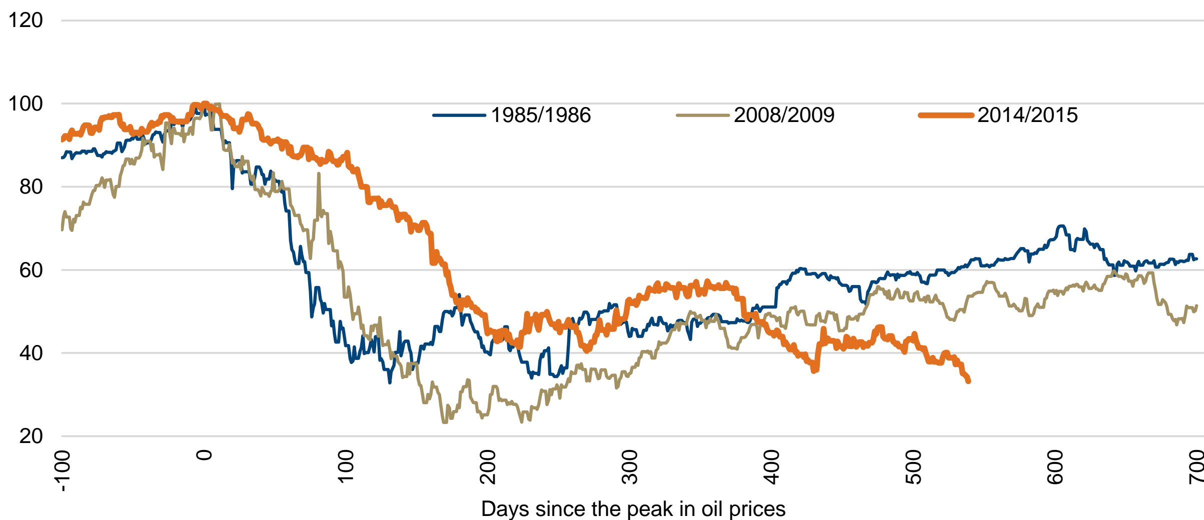
If it was not obvious before, then it should be now. We are in an all-out price war. Countries such as Saudi Arabia and Russia are increasing production in an attempt to maintain or increase market share. This is more than offsetting falling or flat supply from Libya, Nigeria, Canada, China and the North Sea. But it is not all bad.

On the supply side, we believe that unplanned disruptions are more likely than positive oil supply shocks. Saudi Arabia, Russia, the U.S. and Iraq are producing more than they were in 2007. The only country that is not is Iran. In our view, the market has already priced in increasing supply from the Middle East. Unplanned oil production outages (OPEC and non-OPEC) have been relatively flat since mid-2013. It is possible that economic or political issues in countries such as Iraq, Nigeria and Brazil may lead to supply disruptions.



On the demand side, which has been all but forgotten, there are few signs of slowdown. New world (total world – U.S., Western Europe, Japan) demand has been decent. Energy Intelligence estimates China imports and U.S. crude demand are all higher than they were this time last year (chart, right). We expect that trend to continue. According to the EIA, excess supply will fall in 2016 as consumption catches up to world production. That should bode well for oil prices.

Still, there is simply too much oil and this is turning out to be a tougher market for oil than the past busts. The chart below indexes peak oil prices to 100 and measures the subsequent move in the commodity price.



Worst Swing Producer Ever

In our previous Ws report we highlighted how OPEC abandoned the role of swing oil producer and opted to protect market share, thrusting America into this role. Unfortunately, America is a terrible swing oil producer. While all participants agree the world needs less oil, each private company operating in their individual self-interest creates an environment where nobody cuts production. This is where having a King who can turn off or turn on oil production by edict comes in handy. With no king, self-interest becomes the invisible hand and it's a very slow hand. Companies have cut capex, laid down rigs and rationalized capital spending/distributions, but they keep the oil flowing as much as possible because that represents much needed cash flow.

Keep in mind a well doesn't cost much to keep producing once the oil is flowing. Even if the price of oil is below cost, most cost estimates or internal rates of return (IRR) calculations incorporate all the costs including land, drilling, casing, tying-in, etc. Most of these costs are upfront and sunk, so once producing, there is little or no incentive to turn off even if it has a total cost per barrel of $60 or higher. Hence why America is a bad swing producer.

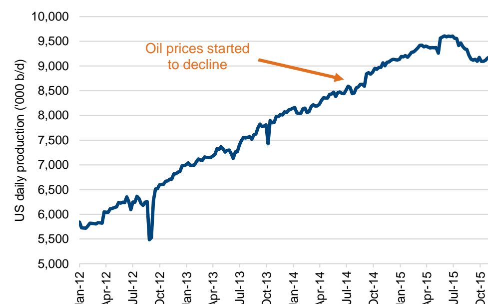
Two things may be on the cusp of changing. The slow moving invisible hand appears to be starting to impact production. And it is the financial taps, not oil spigots, that really matter, and the taps appear to have turned off.

It is the financial taps not the oil spigots that matter

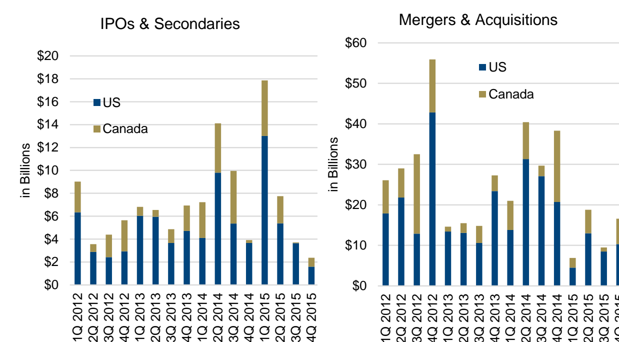
The ability of energy companies to continue to grow production is a function of financing. Gradually, we have seen equity issuance, both IPOs and secondary equity raises, dwindle to a near trickle (middle charts, left). While equity is only one source of funding, the debt market and bank lines of credit are also extremely constrained. Either difficult or impossible to raise capital while many face shrinking credit facilities. This doesn't limit existing production but it certainly limits a company's ability to fund new or expanded production.

Of interest is a slight uptick in mergers and acquisitions (middle charts, right). With still over three weeks left in Q4, the value of deals announced is almost the highest we have seen since Q4 of last year. Companies with strong balance sheets are taking advantage of their weaker peers and buying production at what may prove to be bargain basement prices. You don't need to look further than Suncor's bid for Canadian Oil Sands.

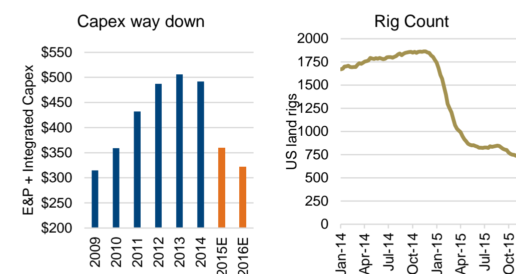
U.S. Oil Production – has fallen, expect much more to come



Equity issuance down to a trickle, M&A still low but improving



Spending & Drilling are way down



Source: Richardson GMP Asset Management, Bloomberg

The energy sector is becoming starved of capital, which has fled for the obvious reason that returns have been dismal. Less credit has companies doing their best to contain costs, reducing both spending on production and payments to shareholders. About 20% of energy companies in the S&P 500 and TSX Composite that paid a dividend have reduced their payments in the past year. It is this capital constrained environment that will lead to less oil production in the future.

Delayed impact of spending cuts

Estimated capex spending by global integrateds and E&Ps is expected to be about $350 billion in 2015. That is down from almost $500 billion in each of the past three years (bottom chart, left). This spending can be seen in canceled or shelved longer term projects, which has no impact on current production but signals a more conservative use of capital. In the shorter term, less spending can also be seen in the dramatic decline in drilling activity. The Rig count is down from 1,800 active rigs at the end of 2014 to fewer than 750 today (bottom charts, right). Now this too did little to impact near production but should start becoming more apparent in the

next few quarters. Again, it is this lag time that makes capitalism a poor swing producer but it may be a double edged sword. The production declines may accelerate faster than many expect and surprise to the downside on production in 2016.

Oil by rail is the canary in the fracking coal mine

Ok, maybe too many analogies but bear with us. Oil by rail is the more expensive method to get a barrel to market, relative to pipelines. Given the choice in today's world, a producer would be likely to tie in a well that had access to a pipeline than rail. Simply because the producer will receive more for its oil. When a barrel reaches Cushing they all cost about the same (ignoring grade) so the cheaper the transport, the greater the price for the producers. As a result, the volume of oil by rail is more sensitive to price than overall production, hence it is the earlier indication of change. Like the canary in the coal mine thanks to its small lung capacity.

If this is the case, production may be set to roll over faster than the market expects in the U.S. Rail shipments of oil have been declining since the start of 2015 and appear to be accelerating to the downside. In fact, rail volumes are now down 25% from their peak.

This is most evident in the big shale regions in the U.S. Eagle Ford has dropped half a million barrels per day of production, while the Bakken is starting to decline. Permian is still rising slightly, which we believe is thanks to more productive wells / drilling rigs and better infrastructure. But would welcome anyone else to opine on why. Regardless, in aggregate the trend appears to be to the downside and strengthening.

This looks like one of the troughs in the Ws

With oil back down into the mid $30s/bbl, we believe we could be at or near one of the troughs for a few reasons:

1) Reduced capex and lower rig activity appears to be finally having an increased impact on reducing production.

2) Investor sentiment is clearly at an extreme negative level for energy. Looking at the speculative futures contracts, we are at an extreme for those taking bearish bets against the price of oil. Historically, such extremely bearish points have signalled a rally in the price of crude.

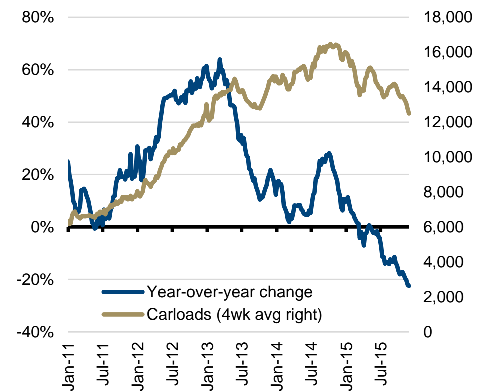
3) OPEC didn't provide a production quota that has spooked the market. That being said, if they had given a quota it may have spooked the market even more, as the new quota would have increased due to Indonesia being added back into the cartel and potentially some future production from Iran.

4) Then there is the additional factors including weather and the U.S. dollar. El Nino appears to be a big one this time which may provide warmer weather especially in North America.

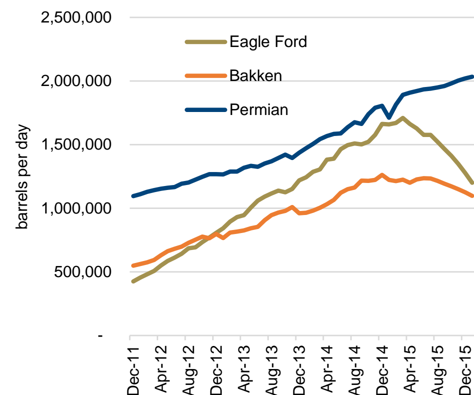
Conclusions/Implications

► Don't mistake our comments for being energy bulls, we are not pro-energy nor would we consider becoming even market weight. Within our portfolios we remain underweight, defensively positioned and where possible, less exposed to Canada given uncertainties around infrastructure, costs and royalties. That being said, if we are going to experience a Ws patterns over the coming quarters there will be profitable times to increase and times to decrease energy exposure.

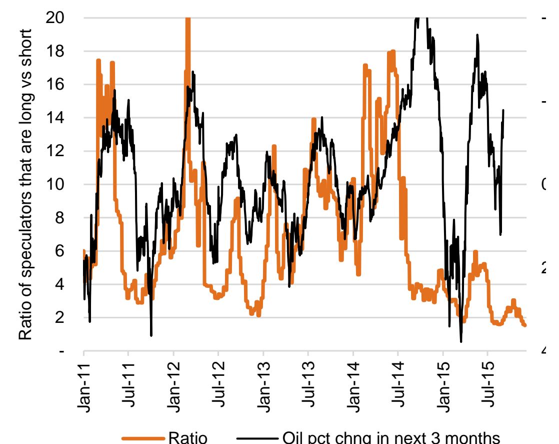
Oil by rail is falling fast



Shale production falling fast, except Permian



Futures long/short ratio is very bearish, which is usually bullish for crude out 3 months



Source: Richardson GMP Asset Management, Bloomberg

- Fundamentally, it does become challenging. We looked at 74 E&P and Integrated energy companies listed in North America. The companies in our sample lost a combined total of $36 billion during the most recent quarter. Only 20% of them were profitable during that time. The debt market has become very challenging, if not closed. Dividends continue to be cut. As a result, we do focus on companies that are potentially higher quality, have less leverage and better geographic diversification in our attempt to manage this risky sector. But let's be honest, the quality is being thrown out with the trash thus creating some opportunities.

- As we believe we are at or near a trough in the Ws, we are adding some exposure in energy, reducing our underweight. Focusing on higher quality, integrateds and infrastructure.

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