Portfolio Commentary

Fourth Quarter, 2014

2014 was another great year for stocks—*almost*

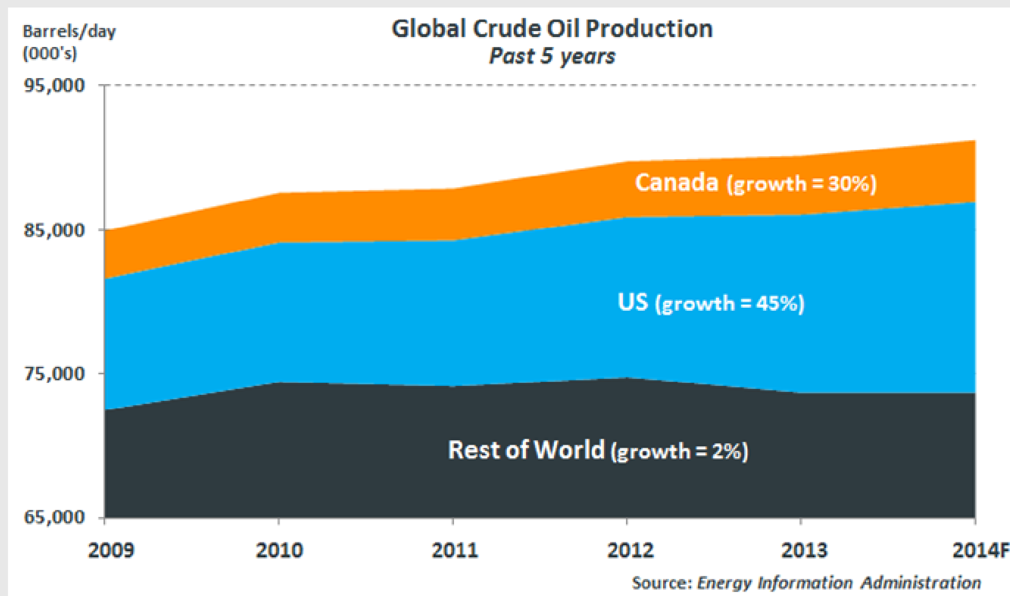
By the end of the summer, North American markets had set a brisk pace and, for the first time in many quarters, the TSX was making up for lost ground against its American counterpart. Following a broad pullback and quick recovery in October, however, the two indices parted ways when the price of crude oil plunged by nearly half to reach a six year low. This sharp divergence in index performance, coupled with the loonie's year-to-date slide, reminds us that resources remain an important part of our market and that the tentacles of the energy industry reach deep into the Canadian economy. It also reinforces the importance of portfolio diversification, both across asset classes and within equity allocations (much as with technology stocks in 2000, it's certain that many Canadians are now realizing – and lamenting – how energy-oriented their portfolios had recently become). Though we don't generally devote this space to a discussion of individual stocks or market sectors, we make an exception in this letter in recognition of the weight that the energy industry carries in both the TSX and our national economy.

Some context

At the outset, it must be said that the energy market is extremely complex with many moving parts and competing interests, not all of them economic. Accordingly, an exhaustive examination of the industry would run volumes and is well beyond the scope of this commentary. Nonetheless, the price of any commodity is ultimately determined at the nexus of supply and demand and given recent developments, it is worthwhile to examine this continuum as it applies to oil.

Though it has been frequently stated in recent weeks that "energy demand is weak", this flat assertion is somewhat misleading. In fact, worldwide energy consumption has *increased* every year since the financial crisis and, even at the nadir of economic despair in 2008, overall usage dipped by less than 2%. When commentators refer to "weakness", they're not saying that demand is *falling*, but only that it's not growing as quickly as some would like. Regardless, whether this sluggishness is attributable to slow economic growth in some corners of the globe, to the persistent rise in energy efficiency, to the emergence of alternatives, or to some combination of these factors, it has not been acute or abrupt enough to account for the sudden drop in oil prices experienced over the past three months.

Rather, it is the supply side of the equation that has tipped the balance, with output from countries such as Canada growing rapidly, previously shut-in exporters like Libya coming back on stream, and US production leaping with the development of its previously untapped "shale" reserves (see first chart below).

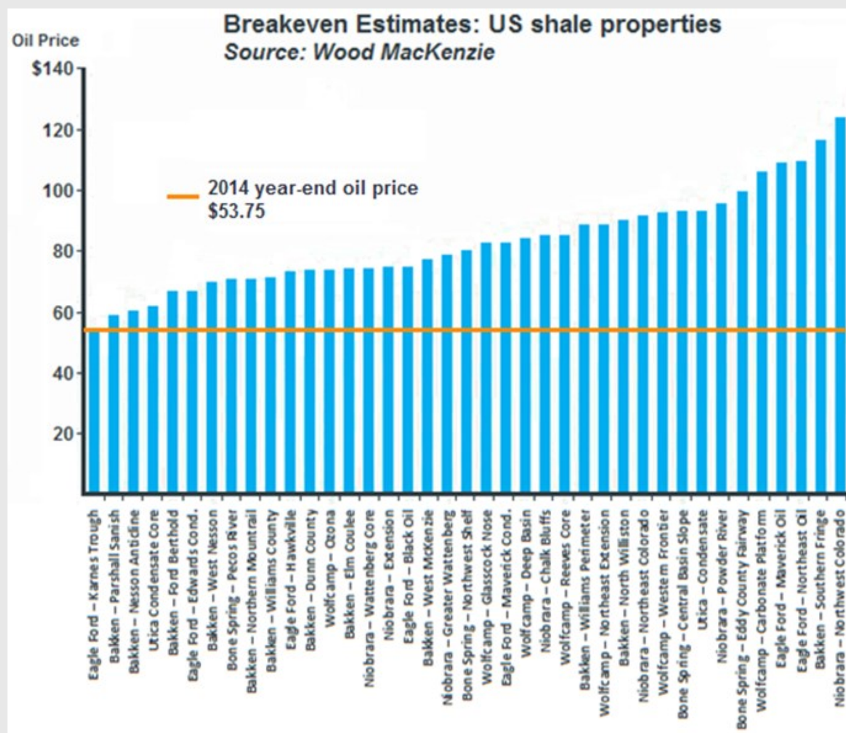


Because the bulk of this marginal growth has come from "non-OPEC" nations, the traditional steward of oil prices has been unable – and equally unwilling – to prop up crude prices by cutting its own production. In this sense, we are now closer to a pure market for oil than we have been in a generation, as the ability of a single large player to manipulate supply conditions has rapidly diminished. Combined with the fact that most of the increase in worldwide output has been brought on by public companies operating in transparent environments, this fundamental change has made analysis of the energy market a great deal more feasible than it was just a few years ago.

The best cure for low prices might be … low prices

Though crude oil is a fairly homogenous commodity, its sources and costs are not. Fuel used for similar purposes throughout the world may emanate from conventional wells in the Middle East, offshore platforms in the deep ocean, oil sands in the Athabasca region, or, more recently, shale properties throughout the US. As it happens, the lion's share of new production has come with fairly hefty price tags attached, cost levels which were taken as palatable when a barrel of crude was fetching $100 or more. Now, however, with oil trading at about half that value, the economics of many of these projects are being undermined. In fact, in a recent report, Goldman Sachs estimated that about $1 trillion worth of planned energy development will be abandoned if the current price structure persists. The chart on the following page punctuates this outlook by showing that the breakeven levels for many of the major shale properties in the US now reside well above the prevailing market price.

At best, the firms running these facilities and other high cost projects elsewhere in the world will be discouraged from expanding existing properties or developing new ones. At worst, some will run into cash flow and debt servicing difficulties, forcing the curtailment of operations, the liquidation of assets, or even financial failure. Over time, it is likely that such a rationalization will solve the problem that until now would have been addressed by cartel oriented supply management. Undoubtedly, the OPEC nations are banking on such an outcome.



The self-correcting nature of economics is exerting itself on the demand side of the energy equation as well. Airline traffic is rising and expected to jump to record levels during 2015; gas guzzling trucks outsold cars in December by the widest margin since 2005; and factories that were previously focused on conserving and, where possible, replacing oil-based fuels in their operations will no doubt be less parsimonious in the months to come.

DM portfolio impact

Though the energy positions in DM equity portfolios have been selected for their high quality (i.e. companies with long-life assets, relatively low production costs, and strong balance sheets), each of these stocks has suffered during the sector downturn. Because of their relative financial and operational strength, however, we expect that these firms will ultimately regard current industry dislocation as an opportunity to enhance positions, rather than as a threat to their existence.

In our first effort to take advantage of share price weakness, we've recently re-balanced into select energy names already owned in our portfolios to bring their weights back toward original levels. As we gain comfort with industry conditions through our analytical work and meetings with company management teams, we may increase these allocations further, or add new energy names whose prices we believe underestimate the quality of their assets and earnings potential.

Looking ahead

As we reevaluate the energy group, rebuild our risk/reward models for sector names, and determine our best course of action under current circumstances, a few key considerations are informing our work:

Production growth should slow – as mentioned above, the most effective way to cut supply in any good is to make its production uneconomic. The recent plunge in oil prices will exert pressure on many existing high cost operations and will almost certainly force the postponement or outright cancellation of several in the works. Though companies may choose to weather lower prices for a time to maintain market share, at some point the financial strain of operating at negative margins should begin to show up in falling output growth.

Industry consolidation likely – whenever an industry is buffeted by unexpected upheaval, Darwinian forces often prevail, with well-positioned participants preying on the vulnerable. We've already seen one significant Canadian producer, Talisman Energy, taken out at a steep premium by a cash-rich European major and it is probable that additional acquisitions will follow. With a stable operating environment, many attractive producing and development properties, and a freshly weakened currency, Canada could find itself on the shopping lists of global producers looking to add high quality assets at attractive long term prices.

Big moves in commodities are not uncommon, but rarely predicted – In 2009 and 2012 respectively the prices of industrial metals and natural gas also nosedived on concerns of weakening demand and over abundant supply. Just as analysts threw in the towel on the producers of these resources and declared that recoveries were too far off to merit investment, the two sectors rebounded on cue. Within two years, the diversified metals sub-group of the TSX had more than doubled, while it took just 10 months for natural gas to make a full recovery.

Early this year, Bloomberg's survey of the "most accurate" energy forecasters yielded a consensus prediction of $105 per barrel for 2014, with $75 being the outlier bearish estimate. At the same time, Chevron's CEO announced that the company's budgeting would be based on $110 crude, while asserting: "There is a new reality in our business … $100 per barrel is becoming the new $20 per barrel".

Needless to say, we are less likely to be moved by ambitious oil price predictions (most of which are now just extrapolations of the current downward trend) than we are by our own work on the energy sector and our assessment of individual companies therein. As with past commodity moves, a recovery in oil is likely to take place when least expected and when the fullest number of speculators have accumulated on the other side of the trade. For those able to take a dispassionate, measured, and analytical view, the current energy episode may produce a great investment opportunity. We'll be watching closely to see if such a condition appears to be developing in the weeks and months to come and will position assets accordingly.