

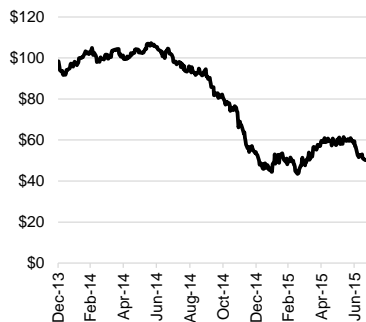
The Ws

July 22nd, 2015

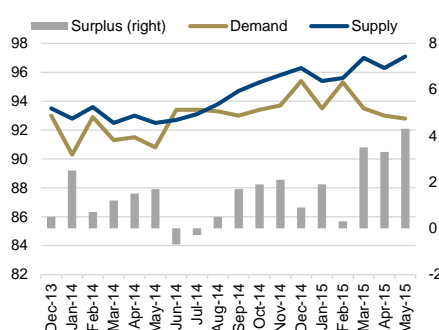
It was a full year ago that oil did its six-month swan dive bringing the West Texas price from \$105 to \$50 per barrel (chart below left). A truly monstrous decline, especially for energy heavy markets such as ours. After any such decline, many begin to focus on how the market will shape up over the coming quarters and, of course, how to position / reposition investments. Clearly a “V” shaped recovery is not in the cards given oil bounced back to only \$60 and has since retreated back to \$50. The bears point to an “L” shaped recovery that is down and flat for a long time. There is even a new one, the “bathtub”, which is a decline followed by a long flat period at depressed prices, then a strong recovery down the road. We are much too humble to even try and predict oil prices beyond a year or longer, there are simply too many moving parts. But we do believe that in the quarters ahead we will witness a market best described by Ws (or WW if you prefer). That is a range bound and oscillating market, both up and down to a significant degree.

It has become apparent to every investor from Canada to Dubai that technological advancements coupled with a lot of capital have changed the demand / supply dynamics of the global oil markets. Of course we are referring to unconventional oil production and more specifically U.S. tight oil (that is shale). Global oil production has increased by 9mb/d during the past five years to the current 97mb/d pace. The U.S. was responsible for almost half this increase. Add Canadian oil sands, deep water drilling, Iraq and others, well there is too much oil. Based on Energy Intelligence Group, global oil demand of 92.8mb/d was well short of supply at 97.1mb/d creating a monthly surplus of 4.3mb/d (chart below right). That is the biggest one-month surplus since 1995.

The Drop in oil



Too much supply, not enough demand



Source: Richardson GMP Asset Management, Bloomberg

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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America is a terrible swing producer

The issue is a little more complicated than simply supply growth outpacing demand growth, which is clearly evident. In the fall, OPEC opted to not cut production in light of falling prices, with the attempt to force the U.S. shale and other unconventional oil producers to pick up the mantra of swing producer. The premise was straight forward, higher cost production would fall with lower oil prices and OPEC would regain market share while driving global supply down. Unfortunately, as a swing producer, America, or capitalism for that matter, is terrible. For all of OPEC's faults, they had the ability to turn the oil taps on or off to maintain balance. With no "king of shale", each individual company decides independently about their production plans. Given they answer to shareholders and bondholders, cutting production is not an option. Based on current prices many shale wells are uneconomical from initial drilling to casing to tying in to fracking. However, for an operational flowing well, the costs are minimal and operating cash flow is positive. Even wells that were partially completed have been finished over the past year. It is for this reason that U.S. oil production has kept rising over the past year, despite lower prices, to the tune of another million barrels per day (top chart).

Capital markets did not help matters. Sure, during the bleeding of Q4 last year the capital markets largely closed their doors to many energy companies. But these doors opened again in Q1 which saw more equity raised than either Q1 or Q2 of 2014, a frothy time when oil prices were around \$100. If the capital markets are going to keep funding companies, this certainly loosens their capital discipline. Similar trends were evident in the debt markets. We believe this is symptomatic of interest rates being held artificially too low for too long and QE flooding the market with liquidity. Capital has become less discerning, which can be dangerous. But that is a blog for another time. Back to energy.

What do we mean by Ws

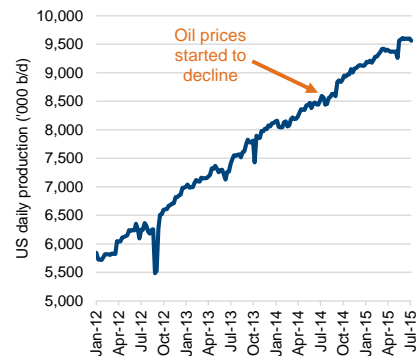
Our "Ws" hypothesis is based on supply reacting slowly to surpluses. While cutting production would be the easiest and quickest path to returning the market to equilibrium, individual companies will opt to curtail spending focused on future production. Capex goes down but the money being spent is used 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. This doesn't affect current production very much, instead it cuts production 9 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. 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. As an anecdotal note, even when oil recovered to \$60, some producers were talking increasing drilling activity.

This looks like one of the troughs in the Ws

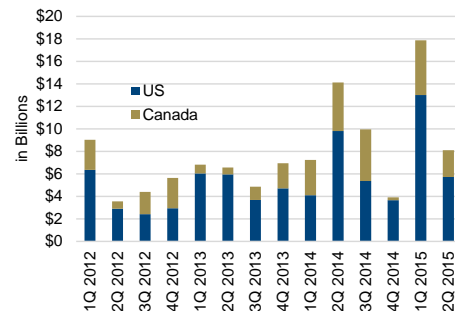
With oil back down to \$50/bbl, we believe we could be at or near one of the troughs for a few reasons:

- 1) The impact of fewer drilling rigs and lowered capex is FINALLY starting to impact production rates. Companies have been cutting capex spending and budgets over the past year, bringing the spending pace for integrations and North American E&Ps from over \$500B in 2013 to an estimated \$386B for 2015. This has also brought the number of land based drilling rigs active in the U.S. from over 1,750 to 824 (bottom charts). Of course this isn't new information but it is beginning to impact production.

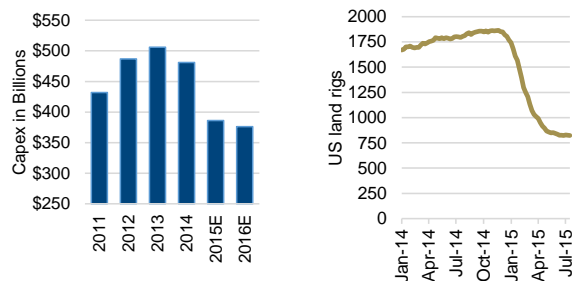
U.S. Oil Production – has it finally peaked a year after oil started decline



Oil & Gas equity issuance came roaring back in Q1



Spending & Drilling is way down



Source: Richardson GMP Asset Management, Bloomberg

The three biggest shale formations, based on production, are starting to roll over. We have seen declines in the Bakken and big declines in Eagle Ford. Permian remains more resilient, but it too will decline given reduced spending and drilling. The market underestimated how long it would take for production to turn, much like a very large ship. Now the question is will the market underestimate the downward momentum on production.

- 2) OPEC and the Iran deal – OPEC is pumping oil at 32.1mb/d, which is close to a record. The big contributor to increased production has been Iraq, adding 1.3mb/d over the past year. And as export logistics ease, this could continue to rise. Saudi Arabia has also added another 1mbd during that period to produce at an all-time record for the Kingdom. No doubt OPEC has the tap open all the way.

This brings us to the deal with Iran and the potential for another half to 1mbd as sanctions are eased. We don't doubt this production will be coming to market, and that is what brought oil prices from \$60 to \$50. Of course how much is already priced in is the big question. We have to believe most of the upside production surprises have come out of OPEC already. And a negative supply surprise is always a possibility.

- 3) Demand has softened but it always softens in Q2 – As if all the supply we discussed wasn't enough, demand has been softening which has strengthened the resolve of the oil bears. The demand / supply chart on page one clearly shows demand has declined down from 95 to 93mbd. However, this data is as of May and there is a season soft patch during the 2nd quarter. In fact April and May especially are the two months that typically come in below the rolling average of demand (-0.6% and -1.7% respectively). Simply put, emerging market oil demand tends to dip in Q2 and this is often mistaken as a change in direction of demand.

Demand growth could easily come back strong in the 2nd half. The U.S. economy continues to expand at a decent pace and their energy demand has reached a record. U.S. weekly demand reached 17.5m barrels earlier in July and is currently running 4-5% above the same pace last year. The real wildcard is China, which imported 34.4m tons of oil and related products in June, which was a huge rebound from a soft May. There is speculation given the commodity price and as the 2nd of 3 stages for creating a strategic petroleum reserve (SPR) comes online, China may do some additional buying to fill this new capacity.

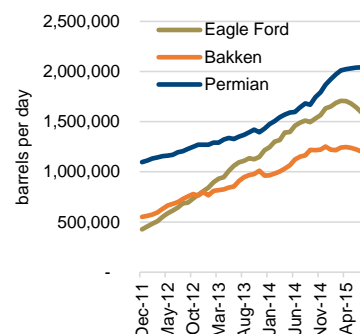
Or the seasonal soft Q2 could simply be followed by a normal regression back to steady demand growth. Any combination would likely be a positive for the price of oil when it sits at or below \$50.

Conclusions/Implications

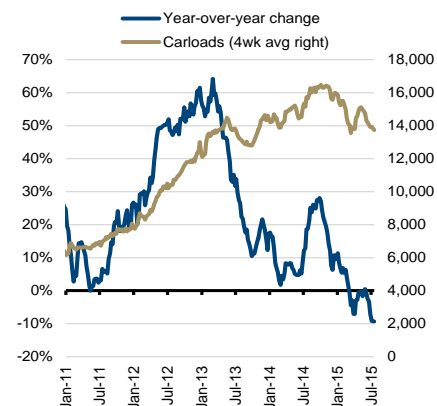
- ▶ Don't mistake our comments for being energy bulls, we are not pro-energy nor would we consider becoming even market weight. Within our portfolios we remain underweight (bottom chart), defensively positioned and where possible, less Alberta exposure given uncertainties around infrastructure and royalties. 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.
- ▶ The bad news for oil does appear to be reaching an extreme including Iran, rising production, softening demand, bond spreads rising, the list goes on. This is the kind of news flow one would expect at or near one of the troughs in the Ws. As a result we have taken this opportunity to add to our energy exposure.

For more information about Connected Wealth and our services, please visit www.connectedwealth.com

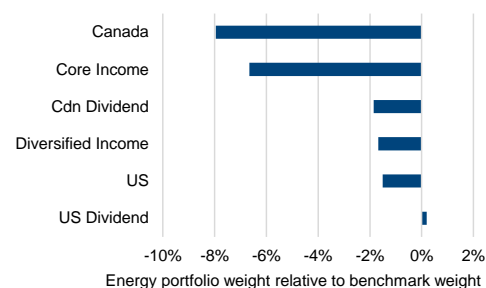
U.S. shale production starting to roll over



Oil by rail is shrinking, as it tends to be more expensive



Even after adding some energy we remain underweight



Source: Richardson GMP Asset Management, Bloomberg

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