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The Bigger Picture

A weekly snapshot of the markets

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Summary

Energy Sector Overview: Integrated energy firms, while lower over the past month, have outperformed their peers and crude oil prices thanks to their refining operations.

Commodity Corner: Gold surges more than $40 as oil rebound, easing of India gold controls offset Swiss rejection of proposal for SNB to hold bullion.

Commentary – Plunge in energy patch is a long-term buying opportunity

OPEC's decision last week to keep output unchanged has intensified carnage in energy stocks

We recommend adding selectively to the best names to average down cost of holdings

Elvis Picardo, CFA

Crude oil futures rebounded on heavy volume today. WTI for January delivery turned around intra-day, gaining 4.3% to $69.00 after falling earlier to a low of $63.72, the lowest since July 2009. Brent for January delivery also rallied 3.4% to $72.54 today. WTI and Brent prices had plunged 18% last month, and even after today's gains, are down 30% and 35% YTD respectively. However, there was no respite from the relentless selling in the Canadian energy patch, with the TSX Energy index down 1.8% on the day. The abundance of bad news in the oil sector brings to mind the environment at the height of the one-month broad market correction in mid-October. Despite the ongoing selloff in the energy group, the TSX Composite and S&P 500 have advanced 7.2% and 12.8% respectively from their mid-October lows.

In our Market Bulletin dated October 14, we had listed four reasons why we thought the market correction was overdone. Somewhat similar reasons could help support crude oil prices before long, in our opinion, making the sector selloff a buying opportunity for the long term. **Here are three good reasons to add to energy exposure in diversified portfolios –**

1. **Geopolitical risk (fear premium) is being understated**: One of the reasons for the slide in oil prices since June is that the considerable fear premium built into crude oil has all but vanished, as the situation in the volatile Middle East has stabilized. Not only has this development eased concerns about supply disruptions, but perennial hotspots like Libya, Syria, Iraq and Iran have also boosted production in recent months.

But although a fear premium in the mid-teens may have been exaggerated, a risk premium of close to zero understates the danger of a geopolitical event and its impact on oil prices, in our opinion.

Present crude oil prices are far below the levels at which the budgets of OPEC members like Iran, Venezuela, Nigeria, Libya and Saudi Arabia can break even (**Figure 1**). While the rich Gulf nations can afford to live with lower oil prices for a while, countries like Iran, Venezuela and Nigeria cannot. After the unsettling experience of the "Arab Spring" three years ago, most OPEC nations have used cash flows from $100-oil on heavy subsidies to prevent unrest – precipitated by large-scale unemployment and authoritarian regimes – from spilling into the streets again. If these nations are forced to cut back subsidy spending, civil unrest can be expected to make a comeback before long.

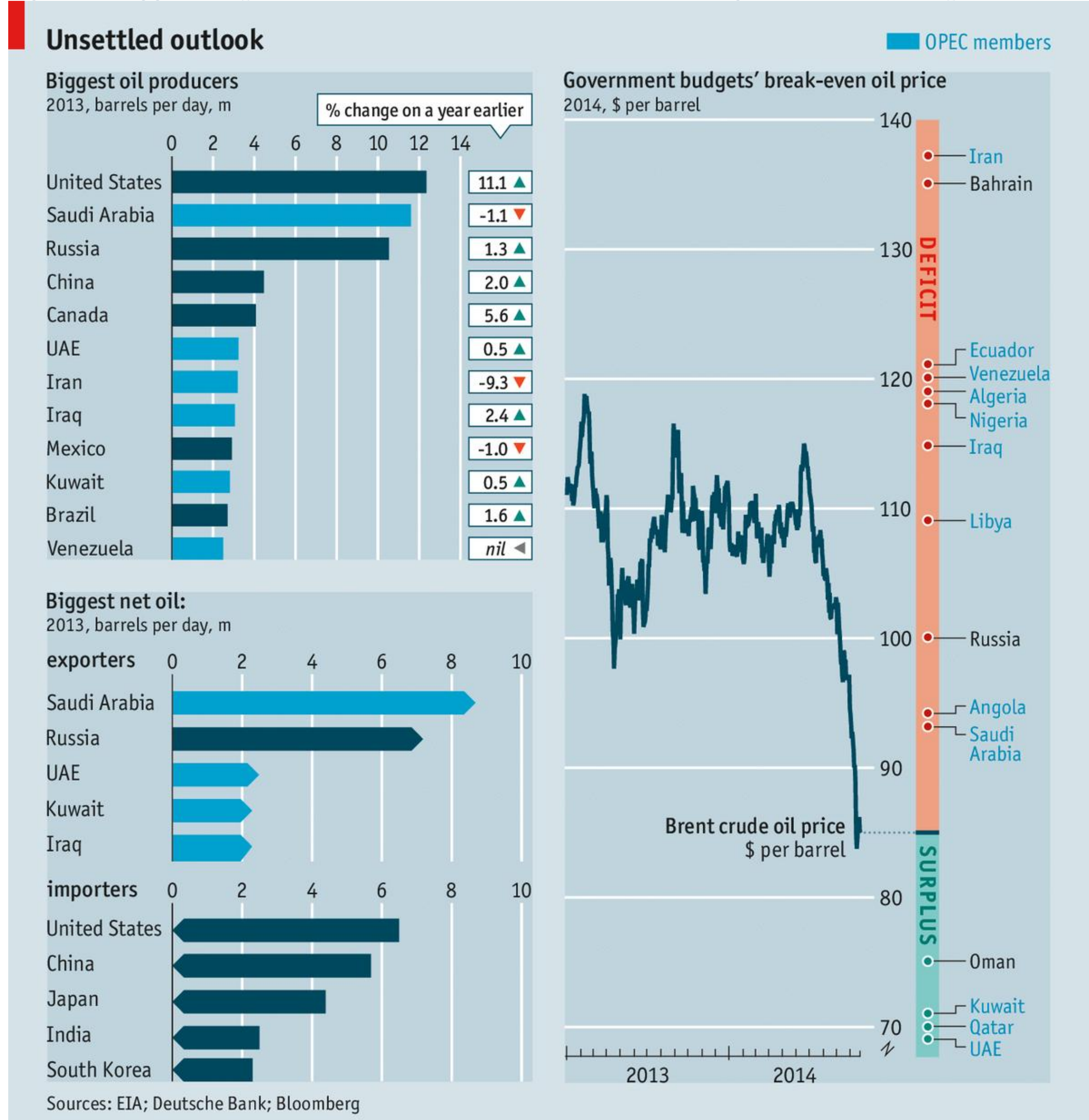
In addition, there are other major risks that could disrupt global oil production. One of these is ISIS, which continues to make inroads across wide swathes of the Middle East. Another is Russia, the third-biggest oil producer and second-largest exporter, which needs a crude oil price of about $101 for its budget to break even. The Russian economy has been hit hard by Western sanctions consequent to its involvement in Ukraine. Russian President Vladimir Putin is not one to back away in the face of Western "interference" into his nation's affairs; as the economic situation deteriorates, it would not be too much of a surprise to see the Ukraine situation worsen rather than improving.

2. **Lower energy prices boost global growth**: The plunge in oil prices could not have come at a better time for the flagging global economy. Cheaper oil boosts consumer spending and lowers manufacturing costs in the biggest oil importers, which includes advanced economies like the U.S. and Japan, as well as emerging-market giants China and India (Figure 1). The IMF estimates that a 10% change in the price of crude oil has a 0.2-percentage point impact on global GDP. The OECD has a similar estimate, with a $20 drop in crude oil adding 0.4-percentage point to growth of its member nations after two years. **If the steep decline (approx. $40) in crude oil from its June high boosts the global economy by even 0.2-percentage point in 2015, that would bring global GDP growth close to 4%. Crude oil is unlikely to stay depressed for long in a 4% global growth scenario, in our opinion**.

3. **Energy sector valuations have improved significantly**: The energy sector trades at better valuations than it did six months ago. The TSX Energy index trades at a multiple of approx 5.7x estimated cash flow for 2015, compared with about 7x on June 30, a multiple contraction of almost 20%. The index also trades at a forward EV / EBITDA multiple of 6.5x, down 14% from 7.5x on June 30.

Bottom-Line: Energy investors have been fretting about the demand-supply imbalance in crude oil for the foreseeable future, after the IEA cut its outlook for demand growth this year by 22% on October 14, as U.S. shale oil output reaches record levels. While some market watchers are of the view that crude oil could trade significantly lower from current levels, we think that a combination of rising geopolitical risk and faster global growth – plus the possibility of output cuts in high-cost areas – should provide support to oil prices. Given the improvement in sector valuations, we believe that this is an opportunity to average down on the best energy names.

Figure 1: Biggest oil producers (2013) and OPEC members' budget break-even oil price



Source:http://www.economist.com/news/international/21627642-america-and-its-friends-benefit-falling-oil-prices-its-most-strident-critics

Energy Sector Overview

Gint Austrins / Elvis Picardo

The plunge in share prices of Canadian energy producers led us to take a look at some key metrics for select names in the large-cap and mid-cap sectors (Table 1). Specifically, we looked at Q3 metrics like estimated netback/boe and capex as a percentage of operating cash flow, as well as leverage (measured by total debt to assets) and one-month stock performance. A couple of conclusions can be drawn from this Table. (**1**) The biggest names (by market cap) – have not sold off as much as their smaller counterparts, with an average decline of 7% compared to 24%. Integrated players Suncor and Husky have outperformed because of their refining operations, while CNQ has been the best performer over the past month on its plans to boost production by 11% next year. (**2**) As is to be expected, netbacks decrease as the proportion of natural gas in the production mix increases; COS and HSE are anomalies in this regard.

Table 1: Key metrics for select Canadian energy producers (ranked by % oil production)

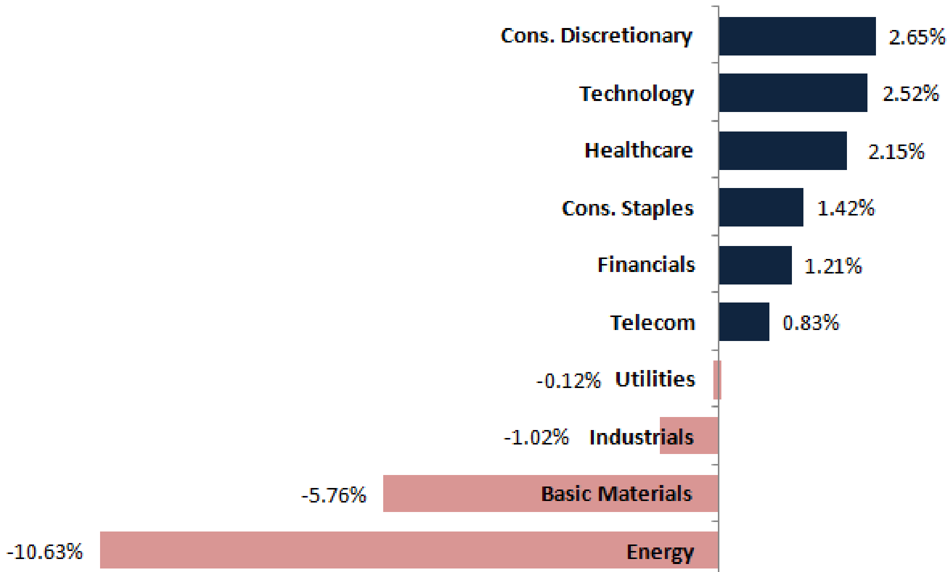
	Name	Ticker	Market Cap ($mm)	1 Month Total Return	3M Est.Netback /boe	% Oil Production Mix	3M Capex as % of OCF	Total Debt / Total Assets
Oil Focus	Canadian Oil Sands	COS	$6,496	-23%	$47.17	100%	74%	0.16
Oil Focus	Suncor Energy	SU	$52,728	-9%	$53.57	99%	75%	0.15
Oil Focus	Spartan Energy	SPE	$665	-18%	$52.64	94%	88%	0.00
Oil Focus	Crescent Point Energy	CPG	$12,634	-23%	$54.24	91%	104%	0.14
Oil Focus	Baytex Energy	BTE	$3,760	-34%	$41.97	87%	66%	0.25
Oil Focus	Surge Energy	SGY	$970	-29%	$45.40	85%	46%	0.20
Oil/Gas Mix	Canadian Natural Resources	CNQ	$41,575	-3%	$35.21	67%	89%	0.19
Oil/Gas Mix	Husky Energy	HSE	$23,752	-10%	$51.74	67%	70%	0.11
Oil/Gas Mix	Whitecap Resources	WCP	$2,885	-22%	$47.27	63%	114%	0.19
Oil/Gas Mix	RMP Energy	RMP	$603	-17%	$41.77	56%	41%	0.20
Oil/Gas Mix	Talisman Energy	TLM	$5,367	-28%	$25.06	38%	90%	0.27

Benchmarks	1 Month Total Return
Ishares S&P/Tsx Capped Energy ETF	-13%
WTI Crude Oil	-14%
Western Canada Select Crude Oil	-20%

Past 1 Month Performance Commentary	
Canadian Oil Sands	Underperformed; decent netbacks and leverage, seems oversold on dividend fears
Suncor Energy	Outperformed; helped by best of class netbacks and downstream segment
Spartan Energy	Underperformed; healthy netbacks, no debt, low capex, should outperform
Crescent Point Energy	Underperformed; great netbacks, but Bakken exposed and high capex a negative
Baytex Energy	Underperformed; higher debt levels and lowest netbacks of the oil focused group
Surge Energy	Underperformed; elevated debt a negative, but looks oversold on dividend fears
Canadian Natural Resources	Outperformed; helped by rally in early Nov, surprising considering its average metrics
Husky Energy	Outperformed; excellent netbacks and downstream business provide stability
Whitecap Resources	Underperformed; high capex spending/growth could be dialed back with lower oil price
RMP Energy	Underperformed; low capex but elevated debt and avg netbacks relative to peers
Talisman Energy	Underperformed; high capex, debt and low netbacks compared to gas peers

Source: Bloomberg, Company Reports, Global Securities

TSX Sector Watch – Weekly change for TSX sectors (week ended November 28, 2014)



The TSX retreated by 367 points or 2.4% last week, as the Energy sector plunged more than 10% after OPEC decided to keep output unchanged. The Materials group was the other notable laggard last week. On the plus side, the Consumer Discretionary sector was the biggest gainer, led by Hudson's Bay, Thomson Reuters and BRP. The slide in crude prices had a positive effect on airline and related stocks, with Air Canada, CAE and WestJet among the Top Ten gainers for the week.

Commodity Corner

Gold gains more than $40 on oil rebound, unexpected easing of India gold controls

Gold futures surged by close to $45 today, as the rebound in crude oil revived demand for the metal as a store of value. The bigger driver may have been the surprise end to gold controls in India on Friday, as the Reserve Bank of India eliminated rules requiring importers to sell 20% of their shipments to jewelers for re-export. These developments enabled gold to recover from the rejection of a Swiss proposal that would have required the Swiss National Bank to hold a fixed portion of its assets in bullion; if approved, this would have led to purchases of at least 1,500 metric tons over five years, according to analysts. But the proposal was rejected 77% to 23% in a referendum yesterday. Demand from India ahead of the wedding season may enable gold to hold on to its gains. The Indian Bullion and Jewellers Association estimates that the end of the regulation will reduce gold smuggling and return demand to normal levels of about 800 – 900 metric tons annually.

Market Snapshot

At close today

S&P TSX	14625.32	-119.38	**Commodities**			**Yields (%)**	**Can.**	**US**
TSX Venture	725.02	-16.85	Canadian $ (US cents)	88.28	+0.68	90 Day T-Bill	0.88	0.01
DJIA	17776.80	-51.44	Gold (Spot)-US$	1212.09	+44.68	2-Year Bond	0.99	0.50
S&P 500	2053.44	-14.12	Oil (WTI-Jan.)	69.00	+2.85	10-Yr.Bond	1.89	2.23
NASDAQ	4727.35	-64.28	CRB Index	258.78	+4.42	30-Yr. Bond	2.45	2.96

Thought for the Day

"We aren't addicted to oil, but our cars are."– James Woolsey

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