# The Bigger Picture

**A weekly snapshot of the markets**

Issue No. 285
February 2, 2015

## Four reasons why energy producers are turning around

***Have we seen the bottom for crude oil in Canadian dollar terms?***

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Canadian energy producers seem to be turning around, with the 66-member TSX Energy Index up almost 17% from a low of 2332.68 reached on December 15, 2014, its lowest level since October 2011. Opinion in the market continue to be sharply divided on whether this is a bear market rally in crude oil and energy producers, or whether the bottom has been reached for them. Here are four reasons why the energy producers sector is turning around and could continue to rally, in our view:

1. **The sliding C$ is mitigating some of the impact from lower oil prices**: The loonie has been sliding in lockstep with crude oil over the past year (Figure 1), and this close correlation is mitigating the impact from lower oil prices on Canadian producers. In C$ terms, crude oil reached a six-year low of $52.81 on January 13, 2015, and is up almost $10 or 18% since then. As can be seen in Fig. 2, crude oil has solid long-term support around $40; those lows were reached in late 2008-early 2009, at the peak of the bear market. We are optimistic that crude oil will not break below $50, and in fact, believe the odds that WTI crude oil may have seen bottom at the recent low of $52.81 are 50-50.

2. **Bad news is being absorbed positively**: Experienced traders are aware that a turnaround may be occurring when bad news is received positively by investors. While energy stocks were crushed by the spate of capex and dividend cuts in Q4 of 2014, the tide seems to have turned in recent weeks, as the positive reception to last week's dividend cut by Canadian Oil Sands (COS, $9.45) demonstrates. COS had reduced its dividend by 43% to $0.20 in December, and last week, slashed it by 75% to $0.05; the company also reduced its 2015 capex forecast by 20% from its December estimate to $451 million. The stock has gained more than 40% since it announced the news on January 29, and while part of the stock price surge could be attributed to short covering and a rally in crude oil, it appears as though investors are viewing dividend and capex cuts as a prudent and necessary measure to conserve capital if crude oil continues to stay at depressed levels.

3. **Crude oil is finding support in the high US$40s**: Crude is up more than US$6 or about 14% from its near six-year low of US$43.58 reached on January 29. It had tumbled last week after the EIA's weekly report showed that U.S. crude inventories rose by 8.87 million barrels to 406.7 million, the most since at least August 1982. But crude oil spiked on January 30 after Baker Hughes said drillers pulled a record 94 rigs from U.S. fields in a single week, triggering speculation that oil production will slow. Crude oil still faces headwinds in the form of the supply-demand imbalance and ongoing negative headlines (the latest development being a strike by U.S. oil workers at plants accounting for 10% of U.S. refining capacity, which could boost oil inventories), but if it finds support in the US$45 – US$55 region, energy producers could continue to rebound from depressed levels.

4. **Promising technicals**: The TSX Energy index shows a pattern of higher lows from its bottom on December 15, 2014, and while higher highs have not yet developed, it may only be a matter of time, given that the index has gapped up today and is trading above its 50-day moving average. In addition, the biggest stocks in the Energy index continue to display leadership. Over the past three months, the five biggest energy producers on the Energy index (SU, IMO, CNQ, HSE, CVE) are down by an average of  4.4%, compared with -8.4% for the index.

**Bottom-Line: The best-case scenario for investors in the Canadian energy patch would be one where the C$ continues to decline but crude oil prices rally, a situation that had developed for about a one-year period from mid-2013 onwards**. Note that the C$ looks oversold in the short term, and despite overwhelming bearish momentum, could continue to rebound along with crude. As most Canadian investors already hold substantial energy exposure in their portfolios, we suggest refraining from chasing this rally but look to add positions in the best names on a sharp pullback.

**Figure 1: Close correlation between the CAD and Crude Oil (one-year)**

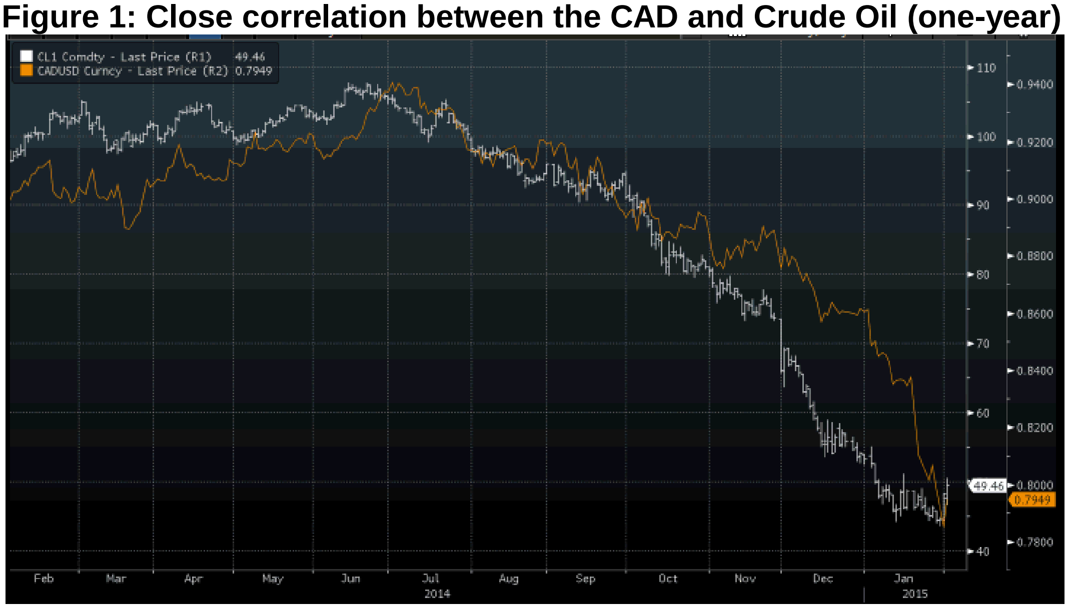

**Figure 2: Crude Oil (1st month futures) in C$ - 2005 to Present**


Source: Bloomberg

## The Week Ahead

**Economic news** – Canada and the U.S. report jobs numbers for January on Friday, February 6. The average forecast from economists is that the Canadian economy added 5,000 jobs last month, having shed a combined 15,000 positions in the previous two months, while the unemployment rate is expected to edge up to 6.7%. The U.S. economy is forecast to have added an average 230,000 jobs in December, having added an average of just over 300,000 positions in the preceding two months. Canadian jobs numbers are notoriously volatile, and the biggest impact from Friday's figures may be on the loonie. There has been marked divergence between U.S. and Canadian jobs numbers in the final months of 2014, and it remains to be seen whether this trend continued into 2015 as well.

### Market Snapshot

**At close today**

| **S&P TSX** | 14910.75 | +237.27 | **Commodities** | | | **Yields (%)** | **Can.** | **US** |
|---|---|---|---|---|---|---|---|---|
| **TSX Venture** | 684.54 | +7.73 | Canadian $ (US cents) | 79.57 | +1.03 | 90 Day T-Bill | 0.55 | 0.01 |
| **DJIA** | 17361.04 | +196.09 | Gold (Spot)-US$ | 1274.66 | -9.11 | 2-Year Bond | 0.39 | 0.46 |
| **S&P 500** | 2020.78 | +25.79 | Oil (WTI-Mar.) | 49.74 | +1.50 | 10-Yr.Bond | 1.23 | 1.67 |
| **NASDAQ** | 4676.69 | +41.45 | CRB Index | 220.44 | +1.60 | 30-Yr. Bond | 1.83 | 2.24 |

### Thought for the Day

"If winning isn't everything, why do they keep score?" – Vince Lombardi

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