REVIEW AND COMMENTARY
3RD QUARTER – 2015

What if oil prices have bottomed?

Both Canadian and U.S. equities have had a difficult quarter. The TSX/SP index was down 7.9%, the SP 500 was down 6.4% (USD). 18% of the TSX/SP index is weighted towards Energy stocks and that sub index was down just over 17% in the quarter. Rightly or wrongly, Canada is still viewed as a resource economy which has a spillover effect on our currency. While it may be too soon to tell, so far the Loonie and the Oil prices seem to have found a bottom in Q3 2015- what if this was true?

Crude Oil (WTI), in US dollars, hit a low in August in the $38 (USD) range. The loonie bottomed in late September at approximately 1.345 (CDN/USD). As of now (early October) the levels have improved (if your Canadian) to $49.10 and 1.301 respectively. The end of August was a particularly difficult time in the equity and commodity markets. On August 11th, 2015 China had marginally devalued their currency with limited immediate reaction in the equity markets though the currency markets reacted immediately. Roughly two weeks later on August 24th, after a particularly weak equity session in China, the Dow Jones Industrial Average opening trades put the index down approximately 1100 points. Some of the US blue chips lost a fifth of their value in minutes and things were so volatile that in an overtone of irony the Chicago Board Options Exchange had trouble pricing its volatility index. Equity markets rebounded partially that day and rallied sharply a few days later. Since then it the index has been volatile but trending upward.

Throughout the quarter prognostications regarding the direction of oil prices were mostly down; many larger US brokerages predicted new lows, some in the $20 range. The Saudi's were unrelenting in their oil productions levels and though worldwide demand was starting to increase, crude prices drifted downward until, oddly enough, the August 24th, the same day as the initial downdraft in equity prices at the open of North America markets. Prices over the next day or two found a bottom. Is it temporary? Could it be the bottom?

Here are some reasons why we may have seen a low in oil prices. First of all, China. While the growth prospects for the Chinese economy continue to be revised downward, the Chinese continue to buy oil well in excess of their daily needs. They are stockpiling and building reserves much like the US did years ago. The International Energy Agency estimates that their reserves presently stand at 200 million barrels of crude and are estimated to reach 500 million barrels by the 2020. Of course this is strategic rather than a call on price but it certainly is better to do it now rather than at much higher prices. What if their economy is not as weak as many expect? Their economy is slowing, not going into a recession.

Second, speculation was rampant by traders and hedge funds in August. According to an article written by Leonard Brecken during August, short positions in oil options and futures "exceeded levels in the great financial meltdown of 2008." Further he quotes Reuters as stating that "50 to 60 hedge funds had

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taken out short positions that amounted to the equivalent of 160 million barrels." This was in August, when prices hit a bottom (to date).

A third factor is the rumours that Russia, OPEC and other producers are talking about collaborating regarding oil production quotas. Historically, the Saudi's have been the most disciplined in sticking to OPEC's stated production levels while others regularly didn't. They sacrificed some production in order to provide price stability benefiting their fellow members as well as those producers such as Russia, Canada and the US. They made it quite clear last year that they no longer would be a price taker. They turned on the spigots in order to maintain market share rather than price and oil prices halved. Few producers can balance their budgets at these levels, even the Saudi's. And there is some evidence that they are suffering along with fellow producers. For only the second time in the history of modern Saudi Arabia, the Saudi government issued a sovereign bond issue to raise funds to assist the funding of their extensive and expensive social programs that require considerably higher oil prices to balance their budget. While denying such talks , and only days after dropping prices on certain exports , on October 6th, 2015, the Secretary General of OPEC stated in a conference in London that OPEC and non OPEC producers should "work together to reduce the global supply glut. " Oil prices rallied significantly. These prices have been determined by the Saudis and fellow producers who are producing as much oil as possible. What if these larger producers agreed to cut back production – and actually worked collaboratively? Prices would improve. Russia's economy has been in a depression for years and will continue to be if oil prices remain depressed. If the Saudi's are hurting at these price levels imagine the pain Venezuelan and Nigerian producers are experiencing.

Finally, a fourth reason is that the forces of supply and demand are finally starting to take hold. Due to lower prices, production is falling- particularly in the United States where many of the larger tight oil plays have higher decline rates. The US Energy Independence Agency (EIA) stated recently estimated that that US production would fall approximately one million barrels a day over the next year at present price levels. In their September report, the EIA stated " On the face of it, the Saudi led OPEC strategy to defend market share regardless of price appears to be having the intended effect of driving out costly , 'inefficient 'production". While there are concerns that Iranian oil production will fill any void left from declining production either in the US or other producers, it would appear that the laws of supply and demand are finally winning out over production at any cost. Dividends and capex reductions are common among many of the smaller Exploration and Production companies.

Certainly Suncor has bet with their recent bid for Canadian Oil Sands that if we haven't bottomed yet there is more upside than there is downside to prices. For those of you who have been investing for some time, the last time Oil was around these levels Suncor bought Petro Canada- as it turns out a pretty good deal. But what if Oil prices have bottomed? It would not be unreasonable to think that the Loonie will improve along with the Canadian economy. The TSX/SP index should improve as Energy shares prices advance and instead of lagging the US indices the TSX/SP does better. The arguments of deflation will not be as easily defended and other commodities might improve as well. What if supply and demand come back into play with equities as bond investors realize that the after tax returns on a 10 year bond will pale in comparison to a solid blue chip dividend paying company? Interest rates in the U.S. appear to be ready to be moved upward but not by much. If this happens it should mean that the U.S. economy is stronger which may translate into higher demand for commodities. What if oil prices have hit bottom? It should be good for Canada and investors.