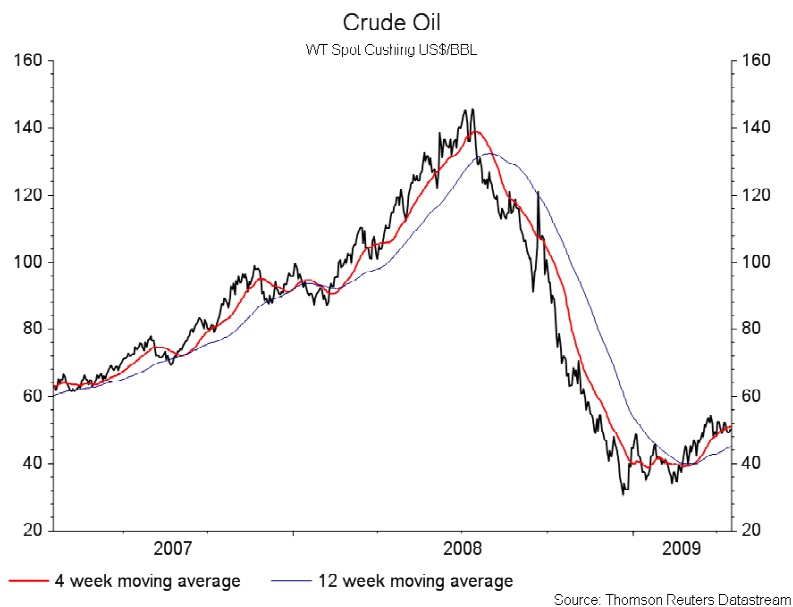


## Oil: Another Supply Shock Ahead?

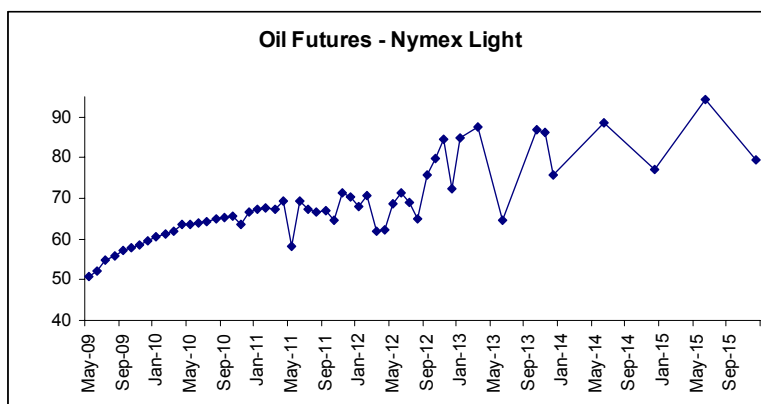
Despite the rally in crude prices and recent stabilization around \$50 per barrel, falling demand and rising inventories will keep a lid on price increases in the short term. However, looking out one to two years, the stage is set for a major supply shock resulting from the collapse in exploration and production investment. Low and volatile crude prices, combined with tight credit, have caused many projects to be postponed or cancelled outright. The price spike to \$140 last year was due to supply shortages creating huge speculation, a condition alleviated by the recession, not through the discovery of any major new sources.



From a technical perspective, the four and 12 week moving averages reversed in April, and it appears that a wide trading range around \$50 a barrel will continue until signs of an economic

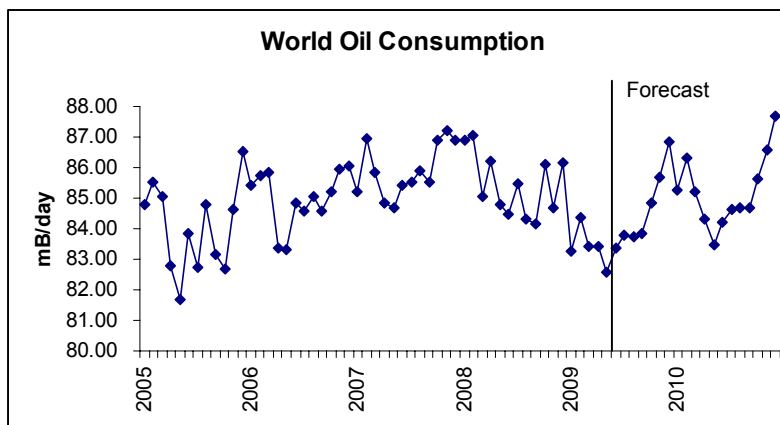
recovery emerge. Recent strength in longer dated futures reflects a forecast for economic recovery in 2010. (See chart on next page) For example, the November 2012 contract is currently trading at \$84.50, a 70% premium to spot prices.

While the timing of recovery is debatable, particularly given OPEC's efforts to target \$75 oil, the timing with which it plays out is far from certain. However, investors should pay attention to the resilience of crude prices to bad news.



Source: futures.tradingcharts.com

World oil consumption has fallen dramatically since early 2008, down about 5% YoY, and continues to decline. However, the Energy Information Administration (EIA) is forecasting a swift recovery in the 2<sup>nd</sup> half of 2009, based on their (probably optimistic) GDP forecasts. While the timing of demand recovery is debatable, its eventuality is not. Meanwhile, inventories continue to pile up. US crude stocks rose by 5.6m barrels last week, well above the consensus forecast of 1.9m barrels. Traders basically shrugged off this data. Interestingly, crude prices seem more sensitive to banks' earnings news than the inventory and demand data, showing that current prices already discount considerable bad news on the inventory/demand front and are looking for the economic recovery.



On the supply side, OPEC has cut production by an estimated 3.3 million barrels day since 4Q 2008, and is expected to hold its current level of production through the next two quarters. Non-OPEC supply is expected to remain constant, as large increases from the US, Brazil and Azerbaijan will be offset by declines in Russia, Mexico and the North Sea.

According to the EIA, “Even this pessimistic forecast still contains considerable downside risk, especially from additional project delays and higher-than-anticipated decline rates.”<sup>1</sup> Non-OPEC potential supply has been hit hard by both the collapse in oil prices and the credit crunch, resulting in many projects being mothballed or delayed. For example, the number of exploration wells being drilled in the North Sea has collapsed by 78% in the first quarter of 2009 compared with the same period last year. The industry group, Oil and Gas UK, is forecasting that total drilling could drop 66% this year.<sup>2</sup>

<sup>1</sup> Energy Information Agency. April 14, 2009. *Short-Term Energy and Summer Fuels Outlook* [www.eia.doe.gov/emeu/steo](http://www.eia.doe.gov/emeu/steo)

<sup>2</sup> Oil and Gas UK. 2009. Economic Report. [www.oilandgas.org.uk/issues/economic/econ08](http://www.oilandgas.org.uk/issues/economic/econ08)

## The Big Picture

Discussions of peak oil are much rarer with oil at \$50, than they were last year when analysts were forecasting \$200-300 oil. However, the conditions for a severe shortage are still in place. All large and easily accessible oilfields have likely been discovered, and many of the most significant fields are in decline, some severely so. An increasing proportion of new supplies are derived from unconventional sources, which now comprise an estimated 70% of proven and probable global reserves. For unconventional (tar sands, heavy oil and oil shale) and more logistically challenging supplies (smaller fields and deep water), the cost base of production is higher and projects require longer lead times to bring on line.

Exploitation of these sources is more energy intensive than conventional sources, leading to significantly higher CO<sub>2</sub> emissions. Whether or not you believe in climate change, there is a global consensus on the matter that will eventually affect the regulatory environment. Although the Obama Administration's push to deal with climate change may be slowed by the recession, the potential for a regulatory shock on some of the least efficient operators exists. This is a particular risk for many of Canada's tar sands operators, which generate 20% more emissions than conventional sources of crude, according to a recent RAND Corporation report.

Much hope has been placed on biofuels and carbon capture to meet greenhouse gas emission targets. These initiatives have shielded producers from having to significantly alter their practices, while regulators attempt to reduce aggregate emissions through other avenues. Clearly, crop-based biofuels have been a boon for farmers, but provide little environmental benefit. Technological breakthroughs on algal or lignocellulosic ethanol promise a bright future for the industry; however, like carbon capture, they are probably a long way from being commercialized.

In the short term, therefore, the only real source of emission reductions on the supply side is through the regulation of production efficiency. The timing of stricter regulations will likely be determined by crude prices. There is a “regulatory sweet-spot” with prices in the \$70-80 range where producers are profitable and consumers aren’t feeling excessive pain at the pump. As prices recover to this range, it is likely that the Obama Administration will move on the issue.

Consequently, companies that have developed more efficient production methods will stand to benefit over the next two to three years from more stringent regulation, and at the very least, provide a useful hedge against a potential regulatory shock. Look for in-situ operators in the tar sands with technologies that address the challenge of heating high-viscosity bitumen with less energy as one potential beneficiary – there are several listed on the TSX.

## **Investment Recommendations**

There are several strategies which should prove useful for outperforming within the energy sector.

- Picking small exploration companies with promising assets, and an opportunity to grow reserves significantly, relative to market capitalization
- Accepting country risk – Columbia, Nigeria, Libya, etc.
- Investing in companies with proprietary technology.

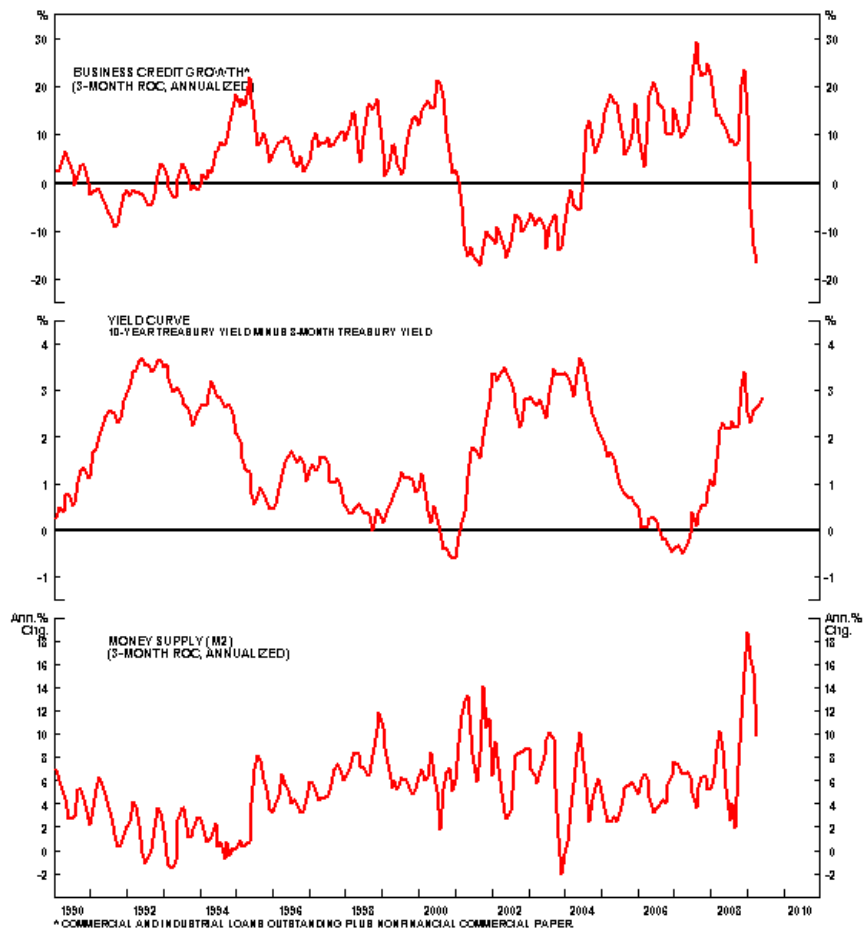
There are a number of such companies listed on the TSX which have suffered from sharp market declines as a result of the crash and are inexpensively valued. The TSX also provides generally good governance for companies operating in risky foreign locations.

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## The Markets

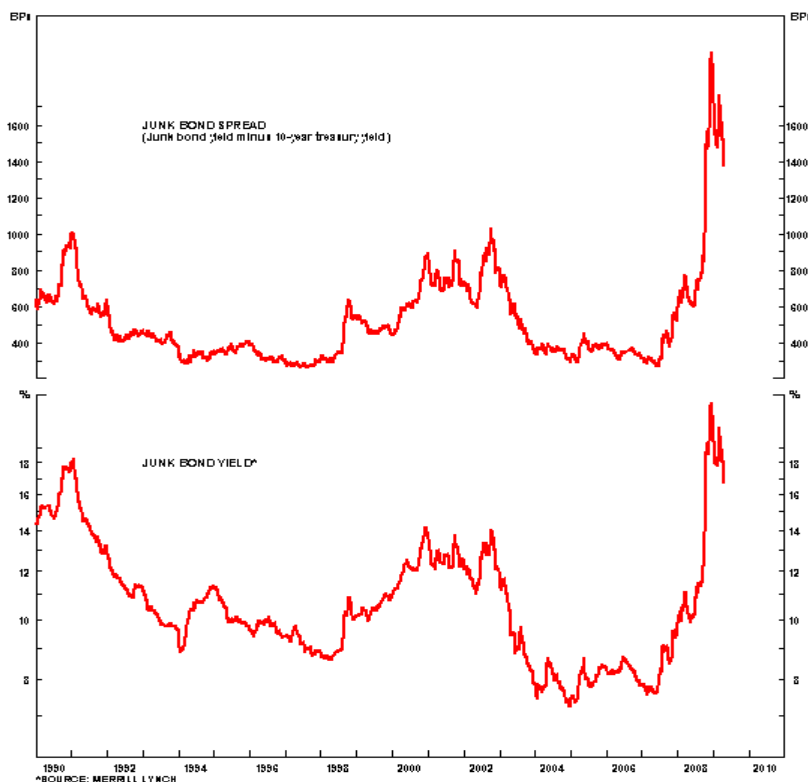
It has become increasingly clear that the self-feeding panic of 2008 and early 2009 has been checked, and conditions have been put in place for some economic recovery, probably in the IIIQ. The liquidation of business loans at banks has been dramatic, falling from a peak rate of increase of 30% in 2007 to – 15% annualized in the past three months, as can be seen in the top panel of Chart 1.

**Chart 1: U.S. Reliquifaction**



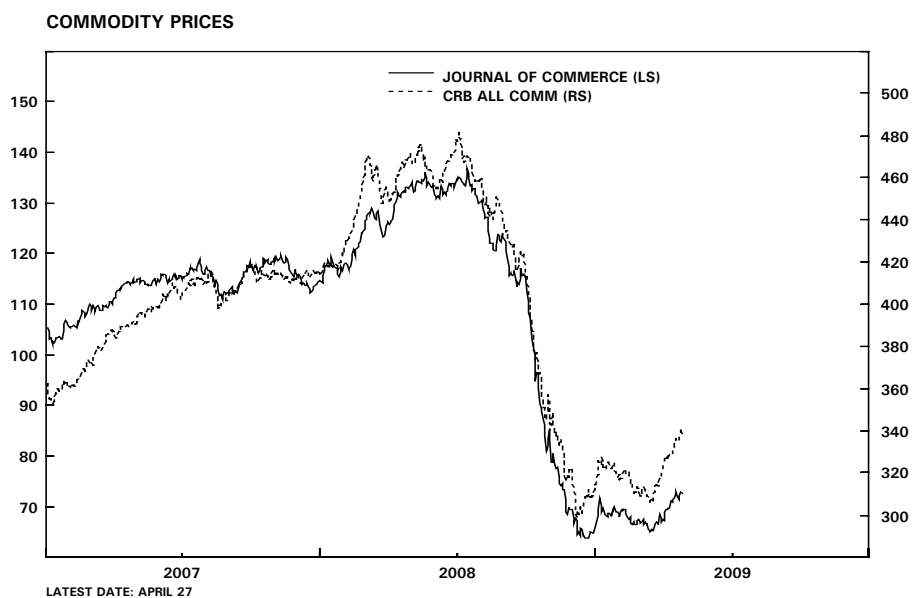
If we can assume that the economic and banking collapse has been halted – and that is a good assumption – then the liquidation of bank loans is a very positive pre-condition for a more sustainable recovery in financial markets. As the chart shows, such liquidation was also a very positive sign for the cyclical recovery in stocks after the 2002 and 1990 lows. The yield curve is extremely positive, showing the 10- year Treasury bond almost 300 basis points above the 90- day Treasury bill rate. Broad money supply (M2) is growing at 10% per annum. While down from its recent peak rate of growth, it is still a very high number relative to what is probably a negative change in nominal GDP in the IQ. The continued narrowing of credit spreads (Chart 2 on following page) at a time of bank loan liquidation and other improving signs of reliquifaction in the financial system is very positive, as it was after the two previous cyclical lows in stocks. Firming commodity prices, including energy, are a further bullish sign.

## CHART 2: U.S. High Yield Bonds



We remain positive on equities. Cyclical recovery should continue in the context of a wide-trading range. Whether stocks are in a new bull market that will break through the old highs is another question and we remain skeptical at present.

### CHART 3: Commodity Prices



Barring a renewed banking collapse and debt deflation scare, it is very likely that Treasury bond yields have put in their cyclical and secular lows. The over valuation at the late 2008 low in Treasury yields was a record, roughly 2 1/2 standard deviations from fair value. Any major surge in yields will, however, take time to develop. The U.S. and world economy will remain weak for many quarters and central banks will be reluctant to risk a renewed leg down in the economy and more bank and industrial failures.

A recent Federal Reserve study has shown that the appropriate level of U.S. short-term interest rates is currently around -5%. Since interest rates cannot go below zero, the Fed has, and will, take additional policy action to provide the equivalent stimulus. The Fed's two main objectives are A) to get the economy growing again so as to reduce unemployment and, B) to change inflationary expectations from negative to positive. This is hardly good news for holders of long-term Treasury bonds as well as U.S. dollars, a view reinforced by our conclusion that oil prices are headed significantly higher in the intermediate term. Rising oil prices not only add to actual and expected price inflation, but increase the U.S. current account deficit. Foreign central banks would have to buy even more dollars if they wish to avoid dollar depreciation.

Our outlook on gold in recent commentaries has been neutral in the short term, bullish in the long run. However, the recent disclosure by China that it has doubled its gold holdings to over 1000 tons in the past six years, albeit to a still small 2% of total reserves of almost \$2 trillion, could be a psychological and physical game changer. It makes one reflect back on France's role in putting an end to the first Bretton Woods agreement. In the early 1960s, Charles de Gaulle induced the Bank of France to convert large amounts of dollar reserves into gold. The reasoning was that the reserve currency role of the U.S. dollar was being seriously undermined by large and persistent U.S. balance of payments deficits that were inflationary under the gold-dollar international monetary system. The French were right; they bought their gold at \$35/oz from the U.S. Treasury. The dollar remained under pressure for some years, leading President Nixon to abandon the gold-dollar peg and convertibility of the dollar into gold in August 1971. Over the next eight years, gold rose in a series of moves to \$1,000/oz, not far from today's level. Price inflation in the U.S. and other major countries soared to almost 15% at the peak in the 1970s.

Will the Chinese play the same role that France did almost 50 years ago? One big difference compared to the earlier period is that the U.S Treasury has no legal obligation to redeem dollars for gold. However, continued Chinese purchases, even if they have been out of their own

production so far, could well play a role in reducing available new supply. If the Chinese persist in adding to their gold reserves, they could provide a ready market for IMF and central bank sales and even cause other central banks to consider buying gold.

Psychology is a huge factor in the demand for gold and foreign currencies. Therefore, the time to become more positive on gold and more negative on the U.S. dollar may well be drawing near. However, it must be kept in mind that a deep-pocketed buyer of any asset in potentially large quantities will not want to play their hand openly and push the price against themselves. We will explore the gold outlook more fully in future commentaries.

Tony Boeckh

Rob Boeckh

April 29, 2009