CIBC Wood Gundy | Papau Armstrong Schmidt Financial Group

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Petro-States Playing High Stakes Poker

The steadily appreciating, low-volatility environment we experienced in North American stock markets during the first half of 2014 now feels like a distant memory. The U.S. S&P 500 Index finished the year close to its highs with an 11.4% gain, even after a volatile October. Its Canadian counterpart, the S&P TSX Composite Index, gave back around half of its gain for the year and ended up 7.4% (10.6% assuming reinvestment of all dividends). Our resource-heavy index simply could not maintain its elevated levels when confronted with an oil price “crash” on top of weak prices for industrial and precious metals and household debt concerns.

We do not use the term “crash” lightly, as it is sensationalistic, but it fits in this instance. West Texas Intermediate (WTI) crude was trading as high as US$107 in July and closed the year at US$53. The 50%+ decline far exceeded the yardsticks to be classified as a -10% “correction” or -20%+ “bear market”. We may be biased, living in Western Canada, but we would nominate the oil price crash as the defining economic event of the year.

It has contributed to the re-emergence of volatility in exchange rates between the Canadian and U.S. dollars and the growing perception that the growth and interest rate outlook of the Canadian economy could diverge from the U.S. economy. It has also put the concept of a continuing “commodity supercycle” to rest, when combined with the recent decline in copper prices, as most other commodities were already in bear markets.

The oil price crash has increased concerns that 2015 will be the year Canada’s record household debt to income ratios and high housing prices may finally lead to tangible economic consequences. Housing bulls often argue that a catalyst such as higher interest rates or unemployment is necessary to cause a downturn, and we are starting to see emerging signs of energy sector unemployment.

Canadian interest rates could now remain extremely low for longer than previously expected. In December, Bank of Canada Governor Stephen Poloz acknowledged that the move in oil could cut Canada’s economic growth by 1/3 of a percentage point.[1] Since then, the oil price has fallen further. The Bank of Canada’s benchmark rate has remained at 1% since in September of 2010, and could potentially stay at that level throughout 2015. In the U.S., rate hikes are still projected, with an initial move expected for mid-year and a second move before year-end.

So what do we make of the oil price crash? It is a major global economic event. Some are calling it a “once in a generation” event, which doesn’t quite ring true to those who navigated the harrowing declines of 2008 and 1998-99. We have spent considerable time lately sifting through the voluminous commentary on oil to find insights with practical value – those that will contribute to client returns. We will attempt to answer

three key questions: 1) why have oil prices crashed?; 2) who wins and loses as a result?; and 3) what is our investment outlook for the energy sector?

Why Have Oil Prices Crashed?

Let's start with the fundamentals of global supply and demand (a topic that has more practical value to us as investors than the topic of the geopolitical intrigues that may or may not have affected oil prices). Despite being the king of commodities, oil is still a commodity, governed by supply and demand. The oil price simply would not have crashed in the past six months without significant changes to supply and demand fundamentals.

Global Oil Supply

The U.S. continues to be a well-documented source of oil supply growth. Currently producing around 9 million barrels a day, 50% more than three years ago, the U.S. is projected to increase production again during 2015.[2] The production gains are being driven in large part by improved extraction technology. With the U.S. producing more oil internally, its imports from other nations have been declining – a very positive trend for the U.S. economy.

Oil supply growth in two other large producers – Iraq and Russia – is also noteworthy. Combined, these two countries provide around 15% of the world's oil. In December, Russian oil production rose to a post-Soviet record of 10.667 million barrels a day, and Iraq exported 2.94 million barrels a day, the most since the 1980s.[3] In Iraq's case, the supply growth could easily persist. The International Energy Organization's (IEA) base case forecast for Iraqi production is 4.2 million barrels per day by 2015 and 6.1 million by 2020.[4]

Analysts also project near-term supply increases from areas such as West Africa and Latin America. Of course we must also mention that Canada is producing at a record pace of nearly 4 million barrels a day. The key theme is that global supply growth over the past few years has exceeded expectations.

That is why many oil analysts were closely watching the Organization of Petroleum Exporting Countries' (OPEC) November 27th meeting in Vienna. OPEC countries pump close to 40% of the world's oil - 30.24 million barrels a day in December. A strong declaration by OPEC that it would cut production would have given oil prices some support, but the group instead decided to maintain its current output quota at 30 million barrels a day.[5]

Global Oil Demand

Global oil demand has not been rising quickly enough to support prices. The main reason is weak economic growth in many countries. The International Energy Agency (IEA) has revised its global oil demand forecast for 2015 downwards on several occasions. Demand is now expected to increase by only 900,000 barrels to 93.3 million barrels per day.[6]

China was supposed to lead the way to higher global oil demand, according to the IEA's website:

> *In the next five years, almost half of global oil demand growth will come from China, and this trend is set to continue to 2035, as oil demand from the transportation sector is growing strongly in countries such as*

> *China and India. In contrast, oil demand among OECD countries is expected to decline over the next two decades, driven mostly by government policies on fuel efficiency and the fact that rates of vehicle ownership are already high.*[7]

However, in the short run we are seeing actual Chinese oil demand growth languish in the 2% range.[8] Fuel efficiency is also slowing demand. For example, the new cars being sold in the U.S. today average 25.8 miles per gallon, up 28% since 2007.[9]

When we acknowledge that demand has been weak and supply strong in recent months, the oil price crash becomes more understandable. There has also been an element of financial speculation that has exacerbated the price movement.

Certain investment funds and other institutions have been purchasing oil futures as a speculation. Within the past couple of years, they increased their long positions, taking advantage of the low cost and high availability credit environment promoted by central banks around the world. The rationale for the speculation was to diversify into hard assets and hedge against predicted inflation. The returns were generally good, until now.

On the other side of the trade have been hedgers – actual producers and users of crude oil. While speculators were piling into record-sized long positions in oil futures, hedgers built up record-sized short positions. It appears likely that some of the speculators have become aggressive sellers in recent months, exacerbating oil's decline.[10]

<u>The Winners and Losers</u>

With any commodity price movement of this magnitude, there are going to be big winners and losers among various countries, companies and individuals.

On a net basis, the global economy in aggregate is set to benefit moderately from the oil price crash. JP Morgan recently estimated that sustained US$60 per barrel crude prices will add 0.5% to global GDP.[11] Looking at specific countries, large producers such as Saudi Arabia and Russia are most often mentioned as countries to be harmed by current prices. Many Asian countries are set to benefit. China is a fairly clear winner, as is Japan, which imports nearly all of its oil, and India, which imports 75% of what it consumes.[12] In the U.S., there will be an economic drag in those regions where drilling activity has boomed; however, we still view the country as a whole as a net beneficiary, due to its status as a massive consumer-driven economy.

Canada is going to be an interesting case. Some of the media coverage of the effect on Canada has remained fairly sanguine. One point of view is that Ontario will benefit greatly, while Alberta's struggles will be manageable. This scenario depends on manufacturers prospering from the weaker Canadian dollar and individuals increasing consumer spending, while oil-related unemployment remains minimal. In mid-December, TD Economics predicted Alberta's unemployment rate would increase to 5% next year and then rise further to 5.2% in 2016, which would be a manageable scenario.[13]

On the other hand, there are plenty of reasons to downgrade Canada's near-term growth expectations. Alberta Premier Jim Prentice recently stated, "the circumstances that we're in are the most serious financial circumstance we have seen in this province in 25 years, if not fifty, and certainly they will affect every Albertan."[14] The spillover into real estate in Alberta may be starting, as listings of Calgary homes rose 42% in December on a year-over-year basis.[15] We will be monitoring the news for signs that oil companies are delaying or cancelling large capital projects. Energy consultants Wood MacKenzie recently warned that close to $60 billion of investment in Canadian energy projects could be deferred over the next three years if oil prices remain at current levels.[16]

Until we see evidence to the contrary, we are going to adopt the more conservative view that the oil price crash is to the net detriment of the Canadian economy and will require us to be vigilant in our risk management. Canada and the U.S. are not in the same boat here, despite both countries being large oil producers. In comparison to the U.S., Canada is a large net exporter of oil, while the U.S. still consumes much more than it produces internally, despite its impressive recent production growth.

Looking at specific companies, identifying winners and losers is often straightforward; for example, we know that oil companies will suffer and airlines benefit. However, we have not yet purchased shares of any companies specifically for the reason that they will benefit from cheaper oil. We may yet do so, but they will have to pass our quality and valuation tests, and we will have to ensure that there is no time horizon mismatch between the hold period we believe the shares require to perform and the estimated length of this down cycle in oil prices.

<u>Our Oil Investment Outlook</u>

Based on the evidence before us, we need to be prepared for oil prices to average US$65 or lower for the rest of 2015 or possibly longer. We will not venture a prediction on where the price bottoms for this cycle, but sub US$40 is entirely possible. The duration of the down cycle will prove to be more important than the ultimate low price.

On the demand side, low prices cure the problem of low prices because they stimulate consumption and constrain production. We follow Toyota Motor Corp. (NYSE:TM), and it recently announced December numbers that included sales of the fuel-efficient hybrid Prius dropping 8.3% year-over-year while sales of trucks rose 13.6%.[17] Shares of electric vehicle innovator Tesla Motors Inc. (NASDAQ:TSLA) have recently weakened for this reason. People seem to already be responding to changing incentives when making vehicle purchase decisions (which may not be entirely wise, depending on how long they plan to keep their cars).

On the supply side, many of the discussions of which oil producers will exit the market seem to be based on very general estimates of production costs. U.S. "shale" oil is not one unified thing. It is numerous oil fields scattered around areas thousands of kilometers apart. Canadian oil sands projects are similarly diverse. In many cases, if there have been large upfront costs to bring an oilfield into production, it may be rational to continue to produce oil, even if capital would never have been invested in the project assuming today's prices. Canadian projects also benefit from the weaker Canadian dollar on the cost side.

Investors looking for supply cuts must watch for the following factors: a) oil producers announcing that major projects are being shelved; b) declining production from existing wells, which can happen faster in U.S. "shale" oil projects that require fracking; c) OPEC deciding to curtail production; and d) investors shying away from financing new drilling. We are going to watch the data closely in coming months.

OPEC is playing a game of high stakes poker with other oil producers around the world. Many OPEC nations face significant pressure in the form of budget deficits, as oil revenues finance their social spending. To balance their budgets, many OPEC members rely on US$100 plus oil prices. For example, Saudi Arabia is estimated to require US$104 oil to balance its budget.[18] In the near term, Saudi Arabia will draw from its large foreign currency reserves to cover shortfalls.

We doubt that all members of OPEC anticipated such a rapid oil price crash. Pressure will now build on their governments to act. If they curtail their own production too rapidly in an effort to influence prices, they may cut their own revenues while helping competitors survive. If they are content to watch oil prices settle wherever they may with minimal intervention, they face extreme short-term pain, but could force some competitors out of the market. Their upcoming meetings and public statements will be heavily scrutinized.

Bargain hunting in the energy sector is tempting, but we are treading carefully at the moment. Our outlook comes from our perspective – we are long-term investors focused on producing good returns in client portfolios while limiting risk to acceptable levels.

Conclusion

The oil price crash is a major economic event that will have a modestly positive impact on global GDP growth and a wide array of positive and negative impacts on various companies, countries and individuals. Canada will face serious challenges. With household debt to disposable income ratios near 163%,[19] we are not facing these challenges from a position of strength. With the ongoing U.S. economic recovery intact, and our expectation that the U.S. will be a net beneficiary of the oil price crash, we may, in some cases, adjust client portfolios to gradually increase the weighting in U.S.-based investments. As always, we thank you for your business and invite you to contact us with any questions.

David W. Papau *BA, CIM, FCSI*
Portfolio Manager
T: 604 641-4358
david.papau@cibc.ca

Michael H.F. Armstrong *BA, CIM, FCSI*
Portfolio Manager
T: 604 608-5223
michael.armstrong@cibc.ca

Andrey Schmidt *BA, LLB*
Investment Advisor
T: 604-608-5224
andrey.schmidt@cibc.ca

CIBC Wood Gundy | Papau Armstrong Schmidt Financial Group

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Returns on Major Indices Around The World

January 1, 2014 to December 31, 2014 (in Cdn. Dlr. terms)

	Level	YTD Returns
North American Indices		
Dow Jones Industrial Avg.	17,823	17.6%
S&P 500	2,059	21.9%
NASDAQ Comp	4,736	24.0%
Russell 2000	1,204	13.3%
S&P/TSX Comp	14,632	7.4%
Europe		
EuroTop 100	2,757	-0.5%
FT-SE 100	6,566	0.1%
Pacific Rim		
Nikkei 225	17,450	3.0%
Hang Seng	23,605	10.8%
Other		
MSCI World Equity	1,709	12.6%
C$ Bonds		8.6%
US$ Bonds		12.9%
US$/C$	$0.8605	9.4%
C$/US$	$1.1621	-8.6%

Source: Bloomberg, CIBC Wood Gundy, **all returns expressed in terms of Canadian currency**

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