TD Wealth

Industry Review

Portfolio Advice & Investment Research

November 14, 2014

Document prepared by:

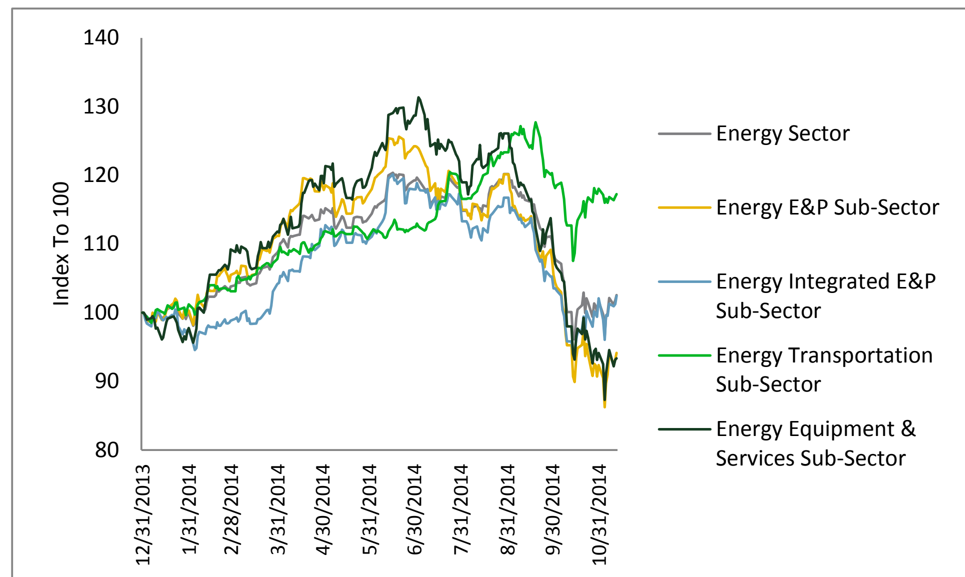
Catherine Carlin, CFA
Yogesh Oza, CFA

Energy Sector

For Canadian investors, the drop in the price of oil and energy equities have been top of mind, given that the sector accounts for roughly 24% of the S&P/TSX Composite Index (TSX). Since peaking at US$102/barrel on June 25, 2014, the price of West Texas Intermediate (WTI) crude oil has fallen roughly 25.0%, pressuring the energy sector lower by 13.1%. In turn, the sell-off in energy stocks has caused the TSX to underperform its U.S. counterpart; since June 25, the TSX has edged lower by 0.8% while the S&P 500 Index has gained 4.0%. In this article, we take a closer look at the influences of the recent sell-off in the energy sector and conclude there could be further volatility ahead. As such, when investing in the energy sector investors should do so selectively and focus on high quality companies.

Figure 1

TSX Energy Sub-Sectors



Source: Bloomberg L.P. As at November 12, 2014.

The headwinds of slow global growth

Recent global economic data has pressured oil prices and energy stocks lower. For instance, China's Purchasing Managers' Index fell to 50.8 in October, the lowest in five months (a reading above 50 indicates expansion, while a reading below 50 indicates contraction). In Europe, economic data has also been disconcerting, with unemployment remaining high and the overall economic outlook appearing gloomy.

While waning growth in the euro zone is a concern, cooling growth in the emerging markets has been a larger issue for the North American energy sector. The softer global growth outlook prompted the Paris-based International Energy Agency to conclude that worldwide demand for oil this year will increase at the slowest pace since 2009.

This document is for distribution to Canadian clients only.

Please refer to Appendix A of this report for important disclosure information.

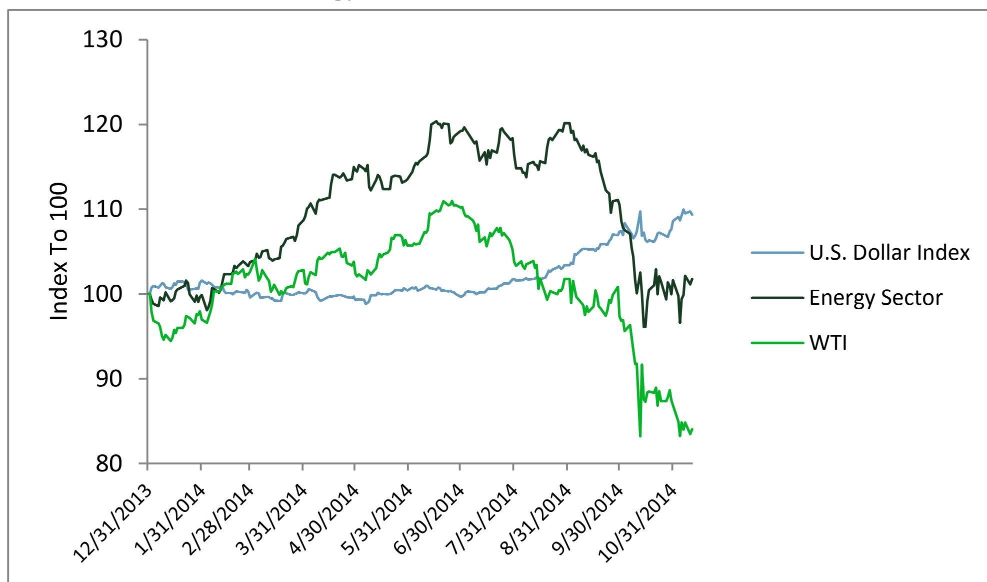
The rise of the greenback

During the depth of the Great Recession, few would have thought that it would be the U.S. (the epicenter of the crisis) that would emerge as a strong driver of global growth just a few years later. However, thanks to aggressive fiscal and monetary policies, the U.S. now appears well positioned, especially when compared to most of its G7 peers.

At a time when many advanced nations are trying to fend off the threat of deflationary prices, while emerging economies try to stabilize growth, the U.S. Federal Reserve (Fed) ended its third large-scale asset purchase program (Quantitative Easing (QE)) on October 29, 2014. With the end of the program well telegraphed by the Fed, investors have been flocking to the U.S. dollar, being of the view that interest rates are set to rise faster in the world's largest economy compared to its advanced nation peers.

Figure 2

U.S. Dollar Index vs. Energy Sector



Source: Bloomberg L.P. As at November 12, 2014.

A rising U.S. dollar is a headwind for commodities (such as oil) priced in U.S. dollars. All else being equal, a 1% rise in the greenback should result in a 1% decline in U.S. dollar denominated commodities in order to maintain equilibrium pricing. While the U.S. Dollar Index has surged 8.7% year-to-date, given the moderating ex-U.S. global growth outlook, the greenback could move higher as other G7 central maintain aggressive monetary policies for longer in order to combat disinflationary forces and bolster growth, placing pressure on their currencies.

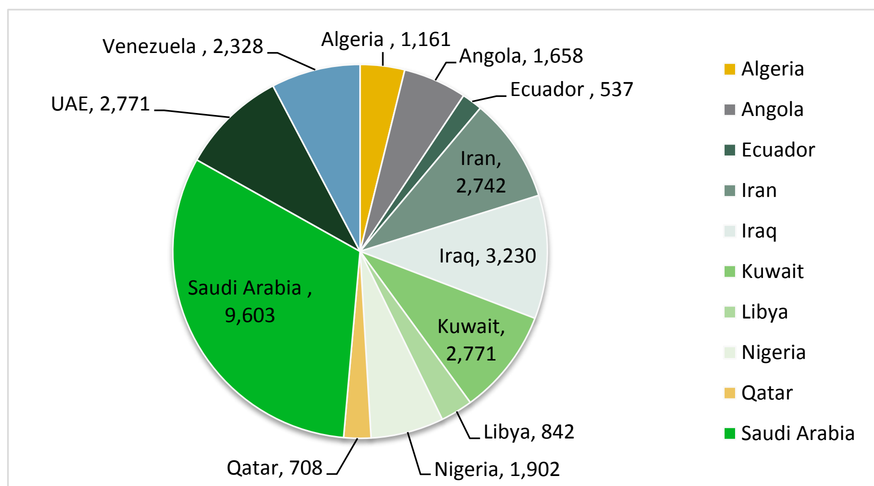
OPEC crashes the North American energy renaissance party

Advancements in drilling technology and supportive government policies have led to a surge in North American energy production over the past six years. Today, U.S. oil production stands at roughly 9 million barrels per day, the highest in three decades, according to the U.S. Energy Information Administration. With domestic production surging higher, U.S. imports of oil have fallen by 31% since 2005, according to Bloomberg. OPEC (Organization of the Petroleum Exporting Countries) is taking notice.

In early November, Saudi Arabia, the most influential member of OPEC, reduced the price for its oil exports to the U.S. in an attempt to defend its shrinking market share against rising North American shale production, igniting fears of price wars in the oil market. OPEC is estimated to produce nearly 40% of world's oil.

Figure 3

October 2014 OPEC Production



Source: OPEC. As at November 12, 2014.

While some of the fiscally healthy members of OPEC, such as Saudi Arabia, the United Arab Emirates and Kuwait can tolerate lower oil prices for some period of time given their massive reserves, other oil-sales dependent member countries are in a more precarious situation. For instance, countries including Venezuela, Iran, and Iraq require the price of Brent oil to be well north of US$100 per barrel in order to balance their budgets and fund crucial social programs. As such, the weaker member countries have been asking Saudi Arabia to cut the cartel's official production levels at the upcoming OPEC meeting (November 27, 2014) in order to buttress prices. However, if OPEC agrees to curtail output levels, the risk is that weaker member countries might respond by cheating and increasing production levels to offset the drop in price in order to bolster revenues. Under this scenario, the stronger member countries would effectively be giving up market share to weaker members of the same organization. Consequently, OPEC will likely only cut production if Brent prices were to trade closer to US$70 per barrel.

The path towards a new equilibrium

With global oil production continuing to rise at a time when demand is softening, it is likely that many energy exploration and producers on both sides of the border will nudge production growth rates lower as they continue to adjust to the dynamic global oil market. Already a number of large energy companies have indicated that they will lower spending on new projects given the slump in oil prices.

Further growth in North American energy infrastructure will likely mean that Canadian oil differentials remain tight with the U.S. WTI oil benchmark. While reaching a new equilibrium might result in more modest production growth rates, increased infrastructure will give Canadian companies the ability to realize better pricing for their output, supporting higher cash flows. Additionally, with oil production surging, the U.S. might repeal a 40-year ban on oil exports or allow for the export of lightly processed oil to international markets. In turn, this could help North American prices converge with higher global oil prices. For 2015, TD Securities Inc. (TDSI) expects WTI, Brent, and Edmonton Light oils to average US$85.00/barrel, US$90.00/barrel, and US$88.89/barrel, respectively.

On the natural gas front, Canadian and U.S. liquefied natural gas (LNG) projects continue to move forward, with first shipments from the U.S. to Asia and Europe expected in late 2015. The development of a North American LNG industry will result in large quantities of natural gas being earmarked for export, which should lend support to the price of the fossil fuel. Additionally, if the upcoming winter resembles that of last year, natural gas inventories could be drawn down materially ahead of the first U.S. LNG shipments. TDSI expects Henry Hub and AECO natural gas prices to average US$3.87/mmBtu and $3.70/mcf in 2015, respectively.

Energy as part of a diversified portfolio

It is especially during periods of market disruption or dislocation such as what we are experiencing currently in the oil market, that equity investors are reminded of the benefits of good portfolio construction, which at its core includes adequate diversification. We also encourage investors to focus on their overall portfolios, rather than on the performance of individual securities because investing is not about being perfect, but rather it is about finding a balance between risk and reward.

Diversification across sectors is important. Applying diversification principles to an equity portfolio, especially one that is Canadian-centric where the TSX Index is approximately 24% weighted to the energy sector, will mean that a portfolio will have exposure to the energy sector. It will also mean that the portfolio will not have too much exposure, whether direct or indirect, to the sector. During times of declining oil prices, while the energy companies in the portfolio will suffer, there are likely offsetting positives for other companies, such as manufacturers or transportation companies that may benefit from declining fuel prices.

Diversification within the energy sector is important as well. Generally speaking, investors can “bucket” the energy sector into: 1) energy producers (the largest category by weight and by number of securities); 2) energy infrastructure and transportation; and 3) drillers and service companies. Generally, transportation companies (pipelines) tend to be the least volatile of the three, while the drillers and service companies tend to be more cyclical. The risk of volatility within the energy sector can therefore be dampened by including positions in companies such as Enbridge Inc., TransCanada Corp. or Pembina Pipelines. Conversely, during periods of rising oil and gas prices, investors may wish to add leverage by including companies such as Precision Drilling Corp.

Further diversification is possible by ensuring that a portfolio has a balanced exposure to both oil and natural gas. A producer like ARC Resources Ltd. provides balanced commodity exposure with roughly 61% of its production being natural gas. Peyto Exploration and Development Corp. and Tourmaline Oil Corp. (despite its name) are weighted to natural gas.

Security selection: costs, hedging and balance sheets

At the security selection level, investors of energy producers must always remember that these are commodity companies, which means that the price of the product is not determined by the producers, but set independently by global markets. For “price takers” one of the key determinants to business success is costs. In other words, when evaluating commodity companies to own in a portfolio, the low-cost producers are generally more attractive. In an environment of declining commodity prices, such as we are currently experiencing in the oil patch, while the low-cost producers will still be impacted by declining prices, they will do better than their higher-cost competitors. Examples of energy companies with relatively low operating costs include Cenovus Energy Inc. and Baytex Energy Corp.

Hedging is a risk mitigation technique used by many, though not all, energy producers. A company that is well hedged has bought some time in terms of how quickly it will be impacted by a low pricing environment and may be able to ride out a short-term spike down in pricing. For example, Crescent Point Energy Corp. has hedged 37% of its oil production for next year. Integrated energy producers like Suncor Energy Inc. and Cenovus Energy Inc. have a natural, partial offset or hedge through their downstream (refining) operations, which benefit from lower feedstock pricing. The integrated producers are generally the largest Canadian companies and often form the cornerstone energy holding of a Canadian equity portfolio.

An evaluation of an energy company’s balance sheet is critically important during times of commodity price declines. Companies with strong balance sheets are better positioned against a downward spiral that begins when a company is capital constrained. It is especially important for those commodity producers that have stated strategies of paying dividends.

Headwinds likely to continue

What were tailwinds for the energy sector earlier this year have more recently turned into headwinds. A further deterioration in the global growth outlook, additional appreciation of the U.S. dollar, and the potential for OPEC to spark a price war could add volatility to this process. However, there are a number of positives that could begin to lend support to the sector. A more gradual development of unconventional resources will lead to more manageable production decline rates for companies and greater cash flow predictability. Increasing North American energy infrastructure and the eventual export of oil and gas to major international markets will help to eventually ensure Canadian companies receive globally competitive pricing for their production.

The recent increase in volatility underscores the importance of portfolio diversification. Within the energy component of one's portfolio, we suggest focusing on companies that are low-cost producers, have strong balance sheets and management teams, and hedge at least some of their production. As always, an equity investment requires a long time horizon and investors need to consider their investment goals, risk tolerance and overall portfolio before investing.

Appendix - Important Information

General Research Disclosure

The statements and statistics contained herein are based on material believed to be reliable, but are not guaranteed to be accurate or complete. This report is for informational purposes only and is not an offer or solicitation with respect to the purchase or sale of any investment fund, security or other product. Particular investment, trading, or tax strategies should be evaluated relative to each individual's objectives. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance. This document does not provide individual financial, legal, investment or tax advice. Please consult your own legal, investment and tax advisor. All opinions and other information in this document are subject to change without notice. The Toronto-Dominion Bank and its affiliates and related entities are not liable for any errors or omissions in the information or for any loss or damage suffered.

TD Waterhouse Canada Inc. and/or its affiliated persons or companies may hold a position in the securities mentioned, including options, futures and other derivative instruments thereon, and may, as principal or agent, buy or sell such securities. Affiliated persons or companies may also make a market in and participate in an underwriting of such securities.

Full disclosures for all companies covered by TD Securities Inc. can be viewed at
https://www.tdsresearch.com/equities/welcome.important.disclosure.action

Research Ratings

Action List BUY: The stock's total return is expected to exceed a minimum of 15%, on a risk-adjusted basis, over the next 12 months and it is a top pick in the Analyst's sector.

BUY: The stock's total return is expected to exceed a minimum of 15%, on a risk-adjusted basis, over the next 12 months.

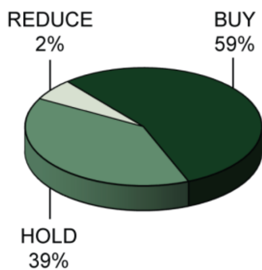
SPECULATIVE BUY: The stock's total return is expected to exceed 30% over the next 12 months; however, there is material event risk associated with the investment that could result in significant loss.

HOLD: The stock's total return is expected to be between 0% and 15%, on a risk-adjusted basis, over the next 12 months.

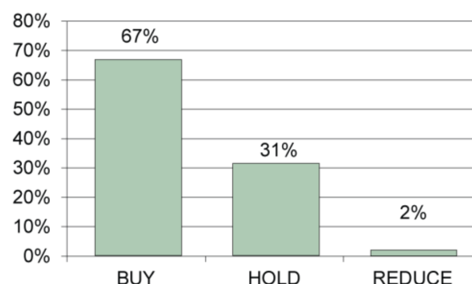
TENDER*:* Investors are advised to tender their shares to a specific offer for the company's securities.

REDUCE: The stock's total return is expected to be negative over the next 12 months.

Distribution of Research Ratings^



Investment banking Services Provide*



As at November 3, 2014.

* Percentage of subject companies within each of the three categories (BUY, HOLD and REDUCE) for which TD Securities Inc. has provided investment banking services within the last 12 months.

^ Percentage of subject companies under each rating category—BUY (covering Action List BUY, BUY and Spec. BUY ratings), HOLD and REDUCE (covering TENDER and REDUCE ratings).

Research Report Dissemination Policy

TD Waterhouse Canada Inc. makes its research products available in electronic format. These research products are posted to our proprietary websites for all eligible clients to access by password and we distribute the information to our sales personnel who then may distribute it to their retail clients under the appropriate circumstances either by email, fax or regular mail. No recipient may pass on to any other person, or reproduce by any means, the information contained in this report without our prior written consent.

Analyst Certification

The Portfolio Advice and Investment Research analyst(s) responsible for this report hereby certify that (i) the recommendations and technical opinions expressed in the research report accurately reflect the personal views of the analyst(s) about any and all of the securities or issuers discussed herein, and (ii) no part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the provision of specific recommendations or views expressed by the research analyst in the research report.

Conflicts of Interest

The Portfolio Advice & Investment Research analyst(s) responsible for this report may own securities of the issuer(s) discussed in this report. As with most other employees, the analyst(s) who prepared this report are compensated based upon (among other factors) the overall profitability of TD Waterhouse Canada Inc. and its affiliates, which includes the overall profitability of investment banking services, however TD Waterhouse Canada Inc. does not compensate its analysts based on specific investment banking transactions.

Corporate Disclosure

TD Wealth represents the products and services offered by TD Waterhouse Canada Inc. (Member – Canadian Investor Protection Fund), TD Waterhouse Private Investment Counsel Inc., TD Wealth Private Banking (offered by The Toronto-Dominion Bank) and TD Wealth Private Trust (offered by The Canada Trust Company).

The Portfolio Advice and Investment Research team is part of TD Waterhouse Canada Inc., a subsidiary of The Toronto-Dominion Bank.

Trade-mark Disclosures

Bloomberg and Bloomberg.com are trademarks and service marks of Bloomberg Finance L.P., a Delaware limited partnership, or its subsidiaries. All rights reserved.

“TD Securities” is the trade name which TD Securities Inc. and TD Securities (USA) LLC jointly use to market their institutional equity services.

TD Securities is a trade-mark of The Toronto-Dominion Bank representing TD Securities Inc., TD Securities (USA) LLC, TD Securities Limited and certain corporate and investment banking activities of The Toronto-Dominion Bank.

All trademarks are the property of their respective owners.

® The TD logo and other trade-marks are the property of The Toronto-Dominion Bank.