Infomail

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Crude Awakening

HAS TIME CALLED THE BOTTOM AGAIN?: Time magazine has an uncanny way of calling the tops and bottoms of so many different markets by telling us of the death of equities in the summer of '82 just as the greatest bull market in history was beginning, or telling us about the fools buying gold in '97 when gold was trading $300/oz. (cf. the front page of that issue further along in today's TGL) Now it is asking the question regarding gasoline, "How low will it go?" If Time's record is intact, the answer to the question is "Probably not very much further."

(Source: Gartman Letter 01/26/2015)

The price of oil is at its lowest level in five years, and much is being written on how low it can go. While not a single soul predicted the over 50% decline, many have strong opinions now. The question, in my mind, should not be how <u>low</u> prices can go, but rather, how long will it last? Again, no one can accurately predict that, but let's look at past cycles and try to get some clues. It's anyone's guess as to exactly where oil prices are headed – some "experts" think they could fall to the $30's, others say we are near a bottom.

It wasn't that long ago, as recently as 2005-2006, that the theory of "peak Oil" was circulating, the theory that global oil production was in terminal decline, and the concept of an energy independent USA seemed remote. As the US fracking miracle exploded, that theory went the way of the dodo.

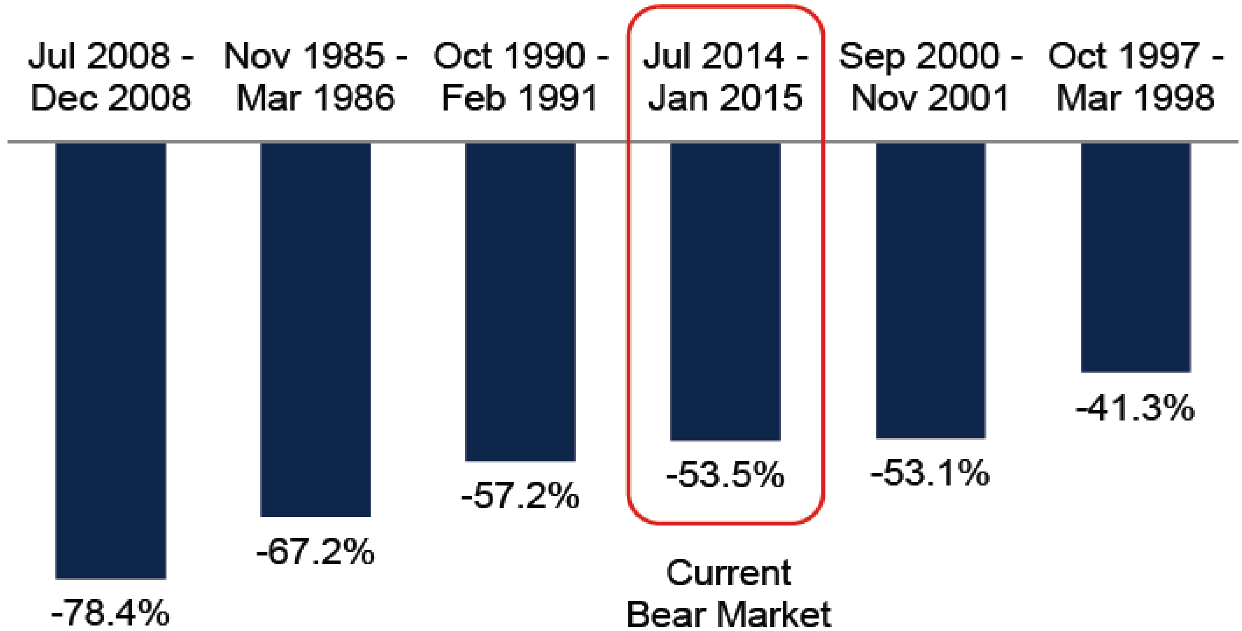
Tensions in the Middle East seem worse today than in recent history, but surprisingly markets are not worried about supply shutdowns as they once were.

Most commentary on the energy complex frames it as a supply problem, that there's just too much oil, combined with beat up natural gas prices and a coal sector that has been decimated, and there are lots of sources of cheap energy. The demand side seems to have come down as well as China's investment boom began to slow down in 2011 as they moved from an investment to more of a consumption driven economy. It's an easy argument to make why prices could remain down for some time.

The collapse in oil prices has impacted global markets and assets in the past recent months. Energy stocks have been beat up, transportation and airline stocks have risen, the US dollar has rallied, while the Russian ruble has collapsed. Last week, the Bank of Canada felt an urge to cut interest rates in a surprise move, and blamed it on worries on the impact of low oil prices on the nation's economy. The Canadian dollar dropped over two cents on the news. Lower commodity prices, in general, represent a deflationary shock to Canada.

They say the cure for low oil prices <u>is</u> low oil prices. Production and capex cut backs are being announced daily. Giant oil service name Schlumberger announced 9,000 layoffs last week. Supposedly 200 oil rigs were capped in Western Canada last week.

Since 1984, there have been six severe crude oil bear markets:



Source: RBC Wealth Management, Bloomberg

Crude oversupply for 2015 is less than 1% of the total supply, so based on the past corrections, crude oil prices could be close to bottoming, and when they do, the rebounds can be substantial:

	6 Major Corrections since 1985 (avg)	Current Correction
WTI price decline	-59.9%	-57.2%
Oil Equity price decline	-28.2%	-29.1%
WTI correction length (peak-to-trough, trading days)	227	141
Equity recovery prior to WTI (trading days)	46	?
1-year Equity price rebound (from low point)	+21.0%	?
3-year Equity price rebound (cumulative, from low point)	+48.4%	?

For oil prices to rise, assuming the OPEC cartel maintains current production, increased demand would have to come from somewhere else. The current shake out in oil markets has shifted the wealth transfer from producers to oil importers. In time, low oil prices help consumers and importing nations where demand pickup manifests itself over time as economic growth kicks in, resulting in a creep up in prices.

An immediate catalyst could result from an OPEC cut in production, but they have publicly said that they don't plan to slash output. Trying to regain market share has historically proven tougher. In 1986, OPEC gave up trying to support oil prices and caused a plunge in prices from $30 to $10. Although the following decade saw an explosion in global growth, oil prices traded mostly between $10 to $20 USD.

The reality is, most market moves tend to go further and longer in direction than most anticipate. Witness the dot-com boom in the late 1990's which went on two years after they were supposedly too expensive. The last run in gold is another. In the case of oil, prices could go lower and longer than some think.

Under $60, it is said most of the US shale production in not profitable. I would not rule out a Black Swan type event that could see prices heading back up quicker than many currently predict.

Oil prices have dropped 50% on five occasions in the last 30 years. Each time, six months later, prices were higher. My guess is we are 80-85% of the way through it, and Canadian energy names will prove to be great names to own at current prices for patient investors.

Stay tuned,

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