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The Krygier Report

An exclusive newsletter from Mark J. Krygier, Vice President & Portfolio Manager | March 2018 www.krygierwealthmanagement.ca

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All oiled up and no place to go...

Canadians are well aware that the Canadian economic and investment landscape is dominated by oil and other resources. On the broader Toronto Stock Market index (TSX), the energy sector comprises approximately 20% of the total Canadian stock market and the materials sector, such as copper, iron ore, etc., comprises another 11.5%. Only the financial sector with a weighting of about 35% of the Canadian stock market has a higher weighting than these two resource sectors combined at about 32%. Therefore, it seems only common sensical that to forecast the direction of the Canadian stock market, and by definition of the portfolios that are "index" tracking like many mutual funds and ETFs, one has to be attuned to the movement in the oil market. Looking back to November 1998, exactly two years after I initially entered the investment advisory business, West Texas Intermediate crude oil price (WTI) was below $19/bbl and headline news gloated about the end of oil usage in the foreseeable future. Fast forward ten years to June 2008 and WTI hit a peak of over $158/bbl., an amazing climb of over 700%, with at least one bank economist forecasting $200/bbl. by year-end. Shortly after that peak pricing, oil and other resource prices began to collapse so that by January 2009, a mere 6 months after hitting its peak, WTI was down below $50/bbl, a stunning drop of over 65% in six months. Fast forward another 10 years from the peak to February 2018 and WTI is sitting around $63/bbl., after hitting a low of less than $30/bbl. in January 2016. Not surprisingly, the Canadian dollar, with its aptly named "Petro Loonie" moniker, when compared to its US counterpart over longer-periods of time, has been moving lockstep during both the ups and downs of oil prices.

So where do we go from here – in the price of oil, in the direction of the Canadian stock market, and in the valuation of the Canadian currency – all of which affect Canadian investment decision-making. As well, since oil effectively acts as a currency in global trade, it is important to recognize that those with control over its pricing often hold political and economic influence over those that require it for industrial production and consumer consumption. Historically, it was the mostly Middle East based OPEC producers that wielded this control, but "the times they are a changin'". For all the talk of Canadian oil markets and their impact on trade relations with the U.S., consider that in 2017, the USA surpassed Saudi Arabia for the first time in history to become the world's second largest oil producer. The *International Energy Agency* (IEA) recently predicted that by 2019, and possibly as early as late 2018, the USA will surpass Russia to become the world's largest oil producer. This dramatic change could have massive political and economic repercussions as the influence of OPEC led nations diminishes, together with American needs for Canadian oil production. An investor has to ask what does that do to our dollar and what does that do to our stock market?

Another challenge for Canadian oil producers is getting the unrefined raw product to the refineries in order to turn it into a product ready to be sold into the global markets. Where are most of these refineries situated? In the southern Gulf Coast region of the U.S.A. close to ocean access. How does Canadian oil travel to the southern US? By train,

truck or through pipelines, with the first two being quite expensive and the latter being in insufficient supply following all the environmental and political wrangling of the past decade. Even with the more oil-friendly Trump administration, few new pipelines have been built to keep up with increased production. The result is that Canadian crude oil prices trade at an increasing discount to WTI as these transportation problems are worsening. Dennis Gartman, author of the widely-read *The Gartman Letter*, recently commented that "Canadian crude is currently trading at its largest discount to WTI in four years" which "cannot be bullish of WTI crude oil."

Commodity producers often want to lock-in profits, or to protect against volatility in their future sales, and they often rely on the "Futures Market" to do so. The futures market has great names for describing the various pricing of oil. When oil is in "contango" it means that longer-dated oil futures' pricing is higher than is the short-term pricing, which is normal as there is a cost to storing oil on tankers, storage tanks, etc. However, currently the oil market is in "backwardation", meaning that "forward" prices are actually lower than current or 'spot' prices. Speculators have been trying to take advantage of this anomaly and have been buying one-month forward contracts on the price of oil and "capturing" the gain when the forward "rolls up" to the spot price (i.e. when the forward contract expires at maturity). This trade is so large that a recent National Post article noted, "speculators now own more than a billion barrels of oil for the first time ever." Backwardation implies that the future price is anticipated to be less expensive than the current or spot price. This is yet another consideration for investors when evaluating the better "risk versus return" potential of a particular investment, geography or currency.

Bottom line

Canadian resource investors have some reasons to be concerned. Clearly the past 20 years have seen huge swings in oil pricing. Even without predicting particular pricing, getting a sense of the general direction of oil has to play a part in sound investment decision-making. Not being "indexers", at *Krygier Wealth Management* we have been "underweight" the resource market, and in particular the Canadian resource market, for several years with great success. Going with the mantra, "if it ain't broke, don't fix it," it will take significant changes to the macro-environment for us to change our positioning.

Global benchmarks
As at February 28, 2018 (Canadian $ Returns)

Asset class	1 year	3 years	5 years
S&P/TSX Composite T/R (Canada)	3.2%	3.5%	6.9%
S&P 500 TR - US$	17.1%	11.1%	14.7%
NASDAQ Composite - US$	24.8%	13.6%	18.1%
MSCI Europe Index Price Return	13.2%	2.3%	8.3%
MSCI Emerging Markets	23.2%	7.4%	7.1%
China S.E Shanghai A Price Return	5.3%	0.0%	11.0%
MSCI World Index Price Return	11.2%	7.0%	13.4%

Asset class	1 year	3 years	5 years
30-year U.S. T-Bond - US$	0.3%	-1.0%	2.6%
10-year U.S. T-Bond - US$	-1.8%	-0.5%	0.4%
Long GOC Bond (2048)	1.6%	-1.4%	2.9%
10-year GOC Bond	-2.6%	-0.7%	2.0%
5-year GOC Bond	-2.3%	-0.2%	1.3%
3-month CDN T-bill	0.7%	0.6%	0.7%
US$/CDN$ (1.2830)	-3.5%	0.9%	4.5%

Source: RBC Capital Markets Quantitative Research

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