Oil & Gas Equities – Evaluating the risk-reward proposition

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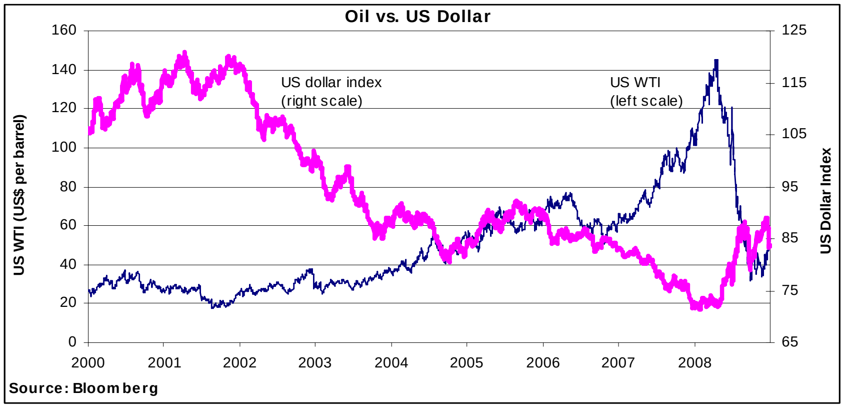
What's been driving oil and gas stocks?

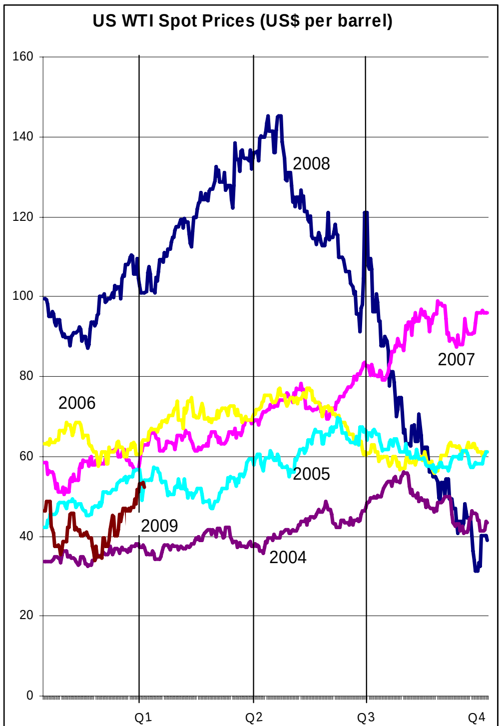
Oil and gas equities have performed extremely well over the past five weeks with the S&P Energy Index up 22.5%. The index recently tested the lows set in November 2008 and has bounced back with a vengeance. This corresponds with a 39.0% rebound in the spot price of oil over that same period, from US$37.54 to over US$52.00 per barrel, and a 6.4% rise in natural gas spot prices. Energy has certainly been one of the leading sectors helping to drive this current rally in the overall TSX Composite (up 15% over the past five weeks). From our observations, this strength can be attributed to several factors including:

- Inventory data released by the Department of Energy in the U.S. towards the end of February and in the first half of March helped to support the price of oil. While the weekly data points can be rather volatile in nature, some trends alluded to recovering motor gasoline demand (reflective of lower prices at the pumps) and modest crude oil stock draws relative to expectations.
- Leading up to the OPEC meeting in Vienna on March 15, speculation was that the organization would cut production by as much as one million barrels per day. Lower supply would have certainly supported a firmer oil price. Counter to expectations, however, OPEC chose to maintain its quotas. Nonetheless, the market reaction to this was rather muted as the decision appeared to be more semantic in nature, as the organization already had the capacity to eliminate a further one million barrels per day of production under existing agreements.
- On March 18, the Federal Reserve announced plans to buy up to US$300 billion in longer-term Treasuries and purchase up to an additional US$750 billion of mortgage-backed securities. This had a number of implications for the market including: i) pressure on the U.S. dollar as the Fed continues to stretch the country's balance sheet ii) increased inflationary concerns, thereby benefitting commodities (normally priced in U.S.$), and iii) provided a glimmer of hope for the global economy as the Fed and U.S. government remain committed to providing economic stimulus.



Source: Bloomberg

- With the price of oil having declined from a peak of approximately US$146 per barrel last year to levels not seen since 2004, there have been an increasing number of oil and gas companies announcing capital spending curtailments that will ultimately constrain supply over the medium term. Accordingly, for investors with a longer term view, the argument is that once the economy begins to recover, the rise in demand will outpace supply capabilities of producers.
- The recent merger announcement between Suncor (SU) and Petro-Canada (PCA) has spurred rampant speculation of merger and acquisition (M&A) activity within the Canadian energy sector. The mega deal has created a sense of euphoria among the media and certain investors over the attractiveness of Canada's resources and the appeal of "suppressed" valuations in the sector.
- Based on historical data, oil and the corresponding energy sector typically experience seasonal strength from March to June. One explanation for this trend is that refiners often use this time period to complete their annual maintenance activities and to convert facilities to gasoline production for the peak summer season from heating oil production for the winter. As well, given the reliable track record of this seasonal trend, perhaps one can attribute such a move to general market psychology.



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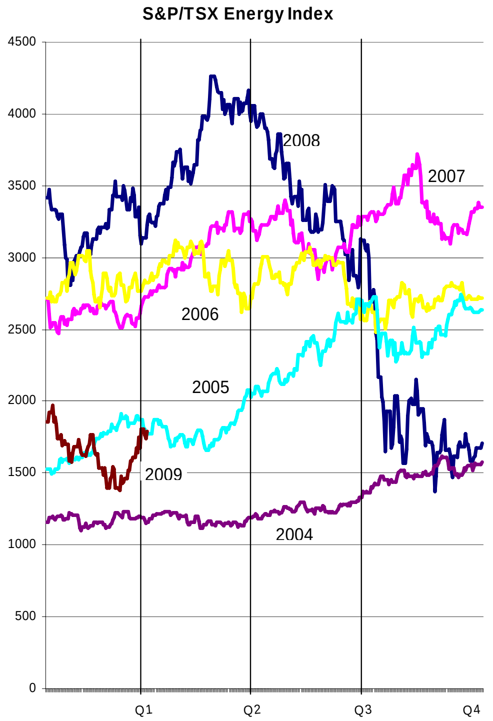
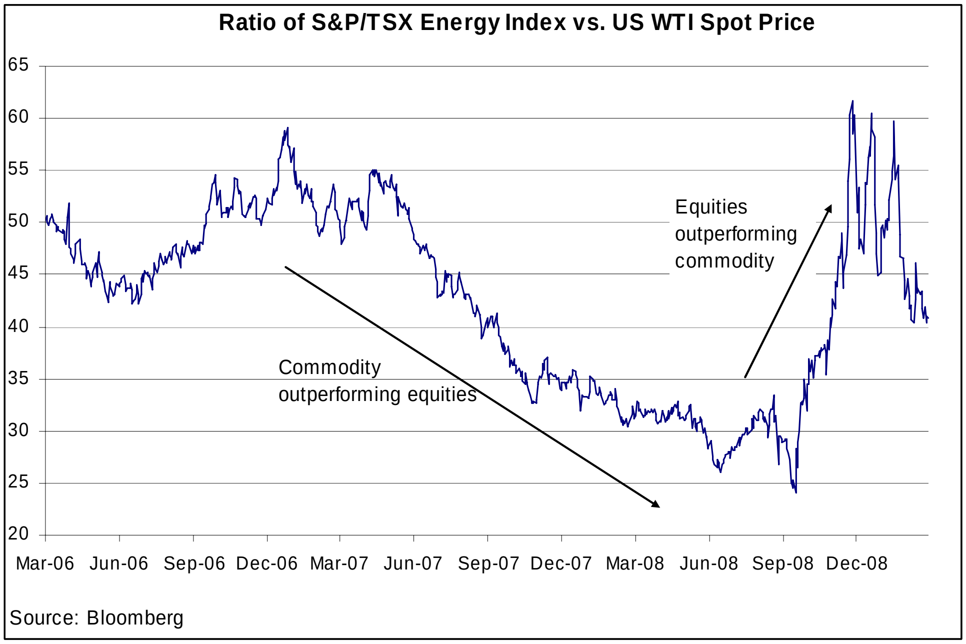


Source: Bloomberg

Highlighting the risks

With the tailwind of a weakening U.S. dollar, M&A speculation across the industry, and general seasonality, oil and gas stocks can certainly continue their upward movement. Momentum should not be underestimated and irrationality can linger much longer than expected as we have clearly witnessed this past year. At some point, however, share prices eventually realign with fundamentals and valuation. A lot of speculative premiums and positive news have arguably been priced in to share prices at current levels and as such, we highlight a number of potential risks associated with aggressively buying these stocks today:

- On the supply side of the equation, there are countless opinions out there on the break-even price of oil as well as peak oil theory (whereby oil prices are expected to spike given that oil resources are depleting at an irreversible rate). Some will argue that oil was well oversold and that this bounce is merely a ‘normalization’ process. Irrespective of where the price of crude is “supposed” to be, in looking at the relative performance of the commodity versus the equities, we see that the correlation between the price of crude and energy-related equities has broken down over the past two years. Therefore, looking ahead, the direction of the oil price may not necessarily dictate the direction of the related stocks given the volatility of financial markets.



- Demand will invariably fluctuate (ie. current rise in gasoline demand) but the underlying issue driving the overall trend is a weak economy. Despite some better-than-expected housing and wholesale numbers over the past few weeks, most would agree that a few data points do not make a trend. There remains abundant risk in the market with unemployment potentially reaching double-digit levels, the continued struggles in the financial sector, and a retrenching consumer burdened by high debt levels and falling home prices. The economy, and therefore the fundamental picture for oil demand, has not improved over the past several months, in our opinion.

- The Canadian energy sector includes a fair number of players focused on natural gas production. The outlook for natural gas remains soft based on weak end markets, strong supply, and the expectation of large LNG imports (refer to Scotia Capital's publication on March 12th titled "North America Has a Gas Problem"). Inventory data released by the U.S. Department of Energy has not been supportive of natural gas prices neither as they remain 29.0% above 2008 levels and 20.4% above the 5-year average.
- The recent strength in the price of energy stocks can be partly attributed to a weakening U.S. dollar and M&A speculation as opposed to a true fundamental trade. In terms of the former issue, since oil is priced in U.S. dollars, the weakening greenback increases demand for the commodity. However, offsetting some of this benefit is that most Canadian oil and gas companies report financials in Canadian-dollars and as such, there could be a negative translation effect for any unhedged sales. On the latter issue, M&A speculation and the inherent take-out premium often comes and goes but it is important to be mindful of the economic and credit environment we are working under. Tight credit conditions, extreme focus on balance sheets, conservative and prudent growth aspirations, are certainly not conducive to a significant number of mergers and acquisitions.

Summary

We remain constructive on the energy sector over a longer-term horizon. The operating landscape in Canada is attractive and a number of the Canadian companies represent world-class assets, in our opinion. However, over the near term, we are cautious of current valuations as a fair bit of speculative premium is already reflected in the share prices. We recognize the merits of a short-term momentum trade (ride the winners!) but purely from a fundamental perspective, we believe the risk-reward proposition of the sector has become somewhat uninspiring at current levels and continue to recommend underweighting the sector in equity portfolios.

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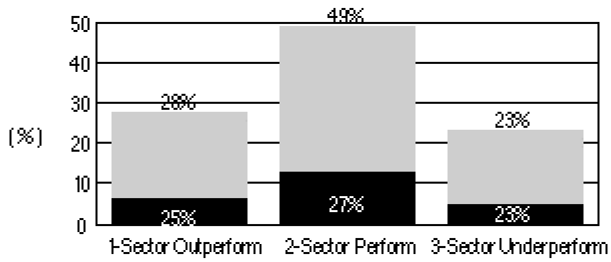

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