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Issue #32 - "Black Tar Friday"

Interesting Links from Around the Web

Holiday Season : A New WestJet Christmas Miracle : Westjet
Life : The Science Behind a Happy Relationship : Happify
Travel : Places in Canada You Won't Believe : Huffington

"Formula for Success: rise early, work hard, strike oil" **- Paul Getty**

Black Friday 2014 will be remembered as the day that even barrels of oil followed the now global tradition of slashing prices ahead of the US Thanksgiving weekend. When all was said and done, the price of West Texas Intermediate Crude closed on Black Friday at $66.15 down some 10.2%. This represented the largest single day drop of the recent bear market that has wreaked havoc on the commodity seeing its price slashed by 40% from its peak in June of this year. With that in mind, this month's issue of Market Insights will discuss some of the cause of this recent drop, its effect on your portfolio and on your wallet!

Why so glum, chum?

As with all traded goods, the prices of commodities such as oil are influenced by three major factors**: supply, demand and speculation**. All three of these aspects have aligned to produce the cliff-like descent of the last few months culminating in the one-day crash we experienced on Friday.

Demand

Economic news from around the world is starting to show signs that the great recovery engine is sputtering. Japan, China, Latin America and the Eurozone are revising growth figures to accommodate for what will likely prove to be a dismal economic year. When combined with the increasing number of fuel efficient vehicles on the roads today, according to the US Energy Information Administration[1], the global demand for petroleum is expected to shrink in the first quarter of 2015.

Supply

Only 20 years ago, text based search engines were introduced to what we now call the Internet. Too many, this advent unleashed the power of the network to the average user. The ramifications of the advancements in information systems are still shaking up industries to this day, and the oil business is no different. Thanks to better computer-based analytics, wells are being dug deeper, accessing more oil and tapping into oil caches that were once considered unattainable. Shale oil, Tar sands and other unconventional oil deposits are now online and have helped make the United States the second largest (and by some accounts the largest) producer of oil in the world.

On the other side of the planet, the Organization of Petroleum Exporting Countries (OPEC) cartel sees these new forms of production as a threat to the monopoly benefitting its member countries. As with all businesses, you create a product and hope to sell it at a price that is in excess of your total costs of production. In the case of unconventional oil deposits such as shale oil and tar sands, a large amount of energy and resources is required to produce a quality of petrol suitable for you at the pumps, and so the cost of production is much higher than in say Saudi Arabia, when a straw in the sand can produce top quality oil.

Despite the recent drop in oil prices caused by the fear of a global economic slow-down, OPEC announced on November 27th that it would not be slowing down production which in the event of a slow-down in demand, would lead to an excess of supply and thus a drop in the price of oil.

Speculation

Adding to the economic argument to explain the price movements, speculation on the oil industry has run rampant. Two popular theories are currently in play to explain the precipitous movement in the price of oil.

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1- OPECs War on Shale Gas

Contrary to market expectations, on November 27th OPEC elected not to slow-down production in the face of falling oil prices. This lead many to speculate that OPEC was effectively waging a price war against unconventional producers such as tar-sands and shale oil from fear that projects like Keystone XL would further entrench energy independence of the world's largest consumer of petrol (US). Estimating that these sources of petrol cannot be extracted at profit when oil trades below $70, they opted to maintain production levels to protect their market share and force unconventional producers to shelf expansion projects. This thought process lead energy speculators to jump on the "shorting" train that sent oil prices tumbling the day after the announcement.[2]

2- Russia vs the World

When Russia invaded Crimea in early 2014, the European Union and United States vowed that there would be ramifications for Mr. Putin's aggression. Although many expected this to mean a military-based intervention, the non-NATO status of Ukraine provided Western Leaders the luxury of not having to engage costly ground troops thus opening the door for an equally devastating campaign against Mother Russia; economic warfare.

Starting with broad sanctions affecting the political class, some speculators believe that world leaders have sought to punish Russia for their aggressions by hitting it where it hurts most; its pocket book. In conspiring to lower the market price of oil through over-production and according to some, open market operations, some speculators believe that it is open season on Russia's oil industry, which accounted for some 52% of its federal budget revenues in 2012.

The impact of this policy has begun to spill-over into other sectors of Russia's economy, most notably international companies who have seen their ability to borrow from foreign lenders frozen. Since the start of the drop in oil prices, the Russian Rouble has dropped more than 50% against the US dollar to its lowest point in history.[3]

What does this mean for you?

For your pocketbook, a drop in the price of oil should coincide with a drop in the price of oil at the pumps. So long as the Canadian Dollar does not march in lock-step with this decline, the Canadian consumer will benefit from the savings. Reductions in economic activity in the oil sands will likely be absorbed by gains in the manufacturing and exporting sectors both of whom will stand to benefit from a drop in the loonie.

From an investment standpoint, we are happy to report that we are considerably underweight energy stocks in our average client portfolio. This has enabled us to minimize the impacts of the recent down-market through September-October that saw the TSX shed 10% of its value within 30 days.

That being said, our concerns with the economic impact on the US energy sector, specifically as it relates to the high yield bond market where oil and gas ventures make-up 20% of the issuers, is worthy of mention. Over the last three months, we have sought to reduce our exposure to high yield US bonds fearing that a bubble in that sector had skewed the risk-reward relationship. As discussed in the past, we are pleased to see cash positions increasing in your portfolios with hopes that this can provide us safety in the event of a broader stock market correction while granting us the liquidity to profit from share price declines, should the latter occur.

Sources:
[1] Short-Term Energy Outlook : EIA: http://www.eia.gov/forecasts/steo/report/global_oil.cfm
[2] Guess What Happened: SNYDER, Michael: http://www.globalresearch.ca/guess-what-happened-the-last-time-the-price-of-oil-crashed-like-this/5417215
[3] Ruble Just Crashed: BI : http://www.businessinsider.com/russia-rouble-sinking-dollar-2014-12

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