From the Portfolio Management Desk

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The Recent Decline in Oil Prices

There has been a lot of discussion around the sharp decline in oil prices recently; we just wanted to take this opportunity to highlight some of the key issues and the potential impact of this trend.

There has been negative momentum in the price of oil for the last several months, but what is surprising is the speed of the recent drop – over the last six months the price of oil has dropped by almost 40 %, from a high of $107 in June to just over $62 in December, a new low for this year. It should be noted that although this is a significant market event, it is not anything we haven't seen before, and certainly does not compare to the magnitude of the decrease in 2008 – at that time we saw the price of oil drop 78% from $145 per barrel down to $31 in a few short months. So what is to blame this time? Several key factors are at play here, including to a large extent, geopolitical issues. But what this ultimately boils down to is economics 101: supply and demand.

Most recently

OPEC nations currently produce about 40 % of the global oil supply, so when they decided last week not to cut production, it meant an oversupply of oil globally, resulting in a drastic drop in price. That's the explanation in a nutshell. But let's dig a little deeper. What exacerbated the issue is that we were already witnessing a slow decline in prices – this decision by OPEC merely magnified what was already a global phenomenon. Some analysts expected OPEC to cut production in order to slow the decline, but instead their decision to continue producing at current levels caused the market to react.

Longer term reasons

Let's take a step back and look at some of the causes for the general slump in oil prices over the last several months:

Demand

Global demand for oil in developed nations has been down for several reasons; among them increased efficiencies in manufacturing paired with a general shift towards a service oriented economy, technological advances in alternate fuel sources and the rise of fuel efficient vehicles. The slow economic recovery in Europe and Japan is also softening demand – growing economies use more fuel, the opposite is true when economies struggle.

WHAT OUR MANAGERS SAY:

We believe that the marginal cost of oil production should range between US$85-90 over the long term and that current prices are not sustainable over the long term. In the short term, we believe the continued volatility in oil prices will continue and we may see further weakness in the next few months as supply adjusts to the new environment. Some energy companies will definitely be challenged to maintain their production levels, and will likely shut down unprofitable wells and stop further exploration. The pullback in oil prices is providing some attractive opportunities, especially in higher quality businesses that are being sold indiscriminately in the market.

Kim Shannon,
Sionna Investment Mangers
Sub-advisor for Counsel Canadian Value and Private Wealth North American Value

Supply

Despite OPEC's attempts to maintain oil production at steady levels, the same is not true for non-OPEC nations. Thanks to countries such as U.S. and Canada, where oil production is booming, we have seen an overall increase in oil production worldwide. This increase in production, combined with the general decline in demand is a textbook example of what happens when supply outweighs demand.

What does all of this mean?

Cheap oil means two things: a decrease in annual revenue for oil producing nations, and an economic boost to oil importers such as Japan, the U.S., and China. Cheap oil is good for industry; reduced operating costs and increased consumer spending add up to a higher GDP (when consumers are saving at the pump, they have more to spend on other things).

Analysts reckon that oil prices will eventually settle well above today's prices – the marginal cost to produce shale oil is around $75 - $85, and so it is likely that the price will settle at the point where these producers can still make money. Analysts are also saying that oil prices could continue to decline for some time. In spite of this, most agree that it is time to keep a close watch on Energy companies as the drop in price is not a result of deteriorating fundamentals, and many see this as a good time to increase exposure to the Energy space.

Whatever happens next, it is never a good idea to react to market events such as this – the fact that the Energy sector is down is not a reason to sell out of Energy, and perhaps a contrarian view would be that the price correction is overdone and as such one may want to add to existing energy holdings over time in a prudent fashion. We are likely to see continued volatility in all market sectors and this recent volatility in Energy is no different – we recommend that investors stay the course, invest in a well diversified portfolio, and follow a long term financial plan.

Sincerely,

Corrado Tiralongo
Chief Investment Officer, Counsel Portfolio Services,
Portfolio Manager, IPC Private Wealth

WHAT OUR MANAGERS SAY:

We believe OPEC's decision not to cut their own production, despite their internal view that the global market is oversupplied by somewhere between 600,000 to 1.5mm b/d has broad implications in the North American energy universe. OPEC (Saudi Arabia in particular), has clearly taken the view that these excess barrels should be forced out of the market by pressuring those that produce with the highest costs (i.e. North American barrels).

In order for these excess barrels to be removed, our view is that oil prices will need to stay very low ($65 to $70/bbl) for an extended period of time (6 to 12 months). In such a scenario, capital spending drops by at least 20% in Canada, and the economics of most Canadian oil plays become very stressed.

David Picton,
Picton Mahoney
Sub-advisor for Counsel Canadian Growth

MORE FROM OUR MANAGERS:

Click to see a BNN Interview with Ryan Bushell of Leon Frazer & Associates, Sub-advisor for Counsel Canadian Dividend, Private Wealth Canadian Dividend and Private Wealth North American Dividend.

Click for a full "Update on Oil" from Eric Lascelles of RBC Global Asset Management, Sub-advisor to the Canadian dividend component in Counsel Regular Pay Portfolio and Counsel Income Managed Portfolio

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