H1 2023 Market Review and Outlook

July 20, 2023

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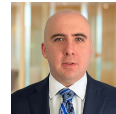

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NINEPOINT ENERGY FUND - COMPOUNDED RETURNS[1] AS OF JUNE 30, 2023 (SERIES F NPP008) | INCEPTION DATE: APRIL 15, 2004

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	15YR	INCEPTION
Fund	1.1%	-9.9%	-6.6%	-9.9%	-1.5%	83.1%	15.3%	7.7%	-0.4%	6.8%
Index	4.3%	-5.0%	-0.8%	-5.0%	3.0%	48.7%	5.7%	2.6%	-1.3%	4.5%

Transcript

Eric Nuttall: Hi, it's Eric Nuttall of the Ninepoint Energy Fund, and the Ninepoint Energy Income Fund. We want to spend a few minutes to give our outlook for the second half of this year. And it's important to do so because 2023 really is a year of two halves, you know, the first half of this year versus the second.

The first half, quite frankly, has been frustrating as energy investors as we've had to contend with a number of a headwind. So I don't want to spend too much time reflecting on those, but we need to think about where we've come from to understand where we're going. We've had to deal with so much this year about recessionary fears and the concern that it will have on oil demand.

It's a fear that we've had to contend with for over a year now. When the Fed really started to raise interest rates June of last year, and it's perverting the market's ability to see the inherent tightness in the market. We've had to deal with the seasonal weakness in demand compounded by a very, very warm winter. And in fact, one of the warmest winters in history in January and February, which impacted into heating demand both in Europe and the United States and again helped fuel the concerns of a recession.

We've had to deal with the ongoing release from the SPR, from the United States. Again, that was supposed to offset, you know, I suppose, a 3 million barrel per day loss of Russian production last year, which we now know never came, you know, thanks to the IEA for for suggesting that and getting the Biden administration cover to release barrels that were unwarranted heading into midterm election in November of last year, crushing bullishness in the oil market with it.

And finally, we had to deal with China. Obviously, as they unlock or unlocked from COVID zero policies, we were all really keen to see the normalization in oil demand, both from a rail congestion and air traffic. That's been disappointing somewhat. You know, we had a very strong surge in some some weakness recently, you know, still pointing in the right direction, but not as strong as many people, myself included, would have hoped for.

And so that's really been the story of the first half. The story of the second half is radically different. And it really all comes down to inventory draws. We believe that and we're seeing it now in real time data. We've been talking with this for many, many months now is that as we emerge from seasonal weakness in demand, you know, Q1 weakness is always the worst.

It progressively gets stronger through to Q4. That combined with China, you know, gradual normalization and most importantly, the OPEC cuts both from OPEC plus from Russia and from Saudi Arabia. The culmination of demand normalizing, supply growth we think is going to be telling in the second half of this year. We'll touch on that. And then finally, the addition of the OPEC cuts from those three different areas are going to lead to the sharpest draws in inventories in history.

In fact, they're going to the peak is going to be next month, we believe, in August, when inventories could fall by more than 3 million barrels per day, absolutely unseen. And so we believe that we are on the cusp of this. We're seeing that in real time data now. We're seeing compliance very strong from all members of OPEC, that when we look at the month of July so far relative to April, which was the high watermark, exports collectively from those areas is down 3 million barrels per day, which is very, very strong when we look at compliance from Saudi, visible exports so far down 700,000 barrels per day relative to their 1 million barrels per day voluntary cut. That is a month to month to month basis of so compliance there is strong. We think compliance is going to reach 100% from Saudi Arabia and then finally, Russia. You know, so much of the frustration last year was this belief that, well, there's all these sanctions. The service companies are largely pulling out price caps and all this other nonsense.

Well, it's going to impact Russian production. And we never saw that last year as well. And then one note that I would touch on last year that was especially concerning or frustrating, and it's something

that we all have to keep in mind as energy investors, is that two times earlier this year, in March and in April, the financial markets went into a tizzy over banking crises, which we don't even hear about anymore.

And in fact, many will have forgotten. So there was also Silicon Valley Bank Credit Suisse failures which led to oil being used as a financial instrument to reflect bearish views or financial unwind. And so there were two times this year when oil collapsed by 10 to $15 in a single week and had nothing to do with demand.

It had nothing to do with supply. It had all to do with the financial demand for those barrels, not the physical. And so it's that's a really, really important distinction that I want everybody to keep in mind, because the financial market for oil is 30 times bigger than the physical market, and yet the physical market for oil is the biggest commodity by far in the world.

And so you can have these points in time when you have deviations between what we call fundamentals and not counting barrel supply demand, also the inventories and the financial market for oil, because people want to use oils as an instrument to reflect their views on interest rates or inflation or the overall economy, etc.. And so our belief has been there's this chasm between those two markets, the financial market and the physical market, and you need a significant catalyst to bridge that schism.

We see that catalyst occurring or beginning to occur now with very, very sharp draws. And so we have inventories falling by about 276 million barrels in the second half of this year. Massive. It will take inventory levels globally. So that's oil and water plus global onshore inventories as measured by Kepler data to the lowest levels in about 8 to 10 years.

So that's very, very important. Also, coincidentally or not, that reduction in inventories we think will almost exactly match the US SPR release. And so why is that, in our opinion? Is the SPR release in modern history is one of the most disruptive forces to sentiment and the ability of people to see the inherent tightness in the market, because you have these artificial barrels coming on.

And we know again, started to meant to offset Russian production, the net losses that never came. And so people saw, well, my God, inventories are going up because of the biggest release in history from the SPR. And at the same time, you're hearing this narrative about wild use. You know, I keep hearing it's been over a year now we're going into into recession.

The must mean that that demand for oil is going to tank and then you see inventories going up like, oh my, jeez, it's right demand must suck. And so we're in this point where price was setting narratives. The price of oil would do something. It would reinforce the negative sentiment, and it was all from the SPR release. And so when you fast forward to the end of this year, the negative impact of that SPR release will be no more.

And so we don't think it's coincidental that the drops in inventories in the second half of this year will exactly match the SPR release. And it goes back to the will and intent of OPEC and more specifically, Saudi Arabia and the oil minister, whom we very much respect. We are not doubting his will and we are not doubting his intent.

We believe and it's our opinion that they share the opinion, that there is this massive chasim between those two markets for oil. And they had to act to bridge the chasim because the financial markets were running away and owning the narrative. And so that's the real story about the second

half of this year, historic drops in inventories, which we are finally now seeing in oil on water and soon to be in inventories as well.

The other aspect is really comes down to demand. You know, how is demand now? How do we measure demand? We've always been a student of measuring inventories, but we wanted to add more weapons to our arsenal. And so we've recently teamed up with Rystad, who's globally a respected oil macro firm. And we're using a tool that they have called real time queue.

And so it's it's a tool that uses hundreds, if not thousands of different variables to measure oil demand in real time, both for gasoline, diesel and jet fuel. So it's not just tracking the number of planes in the sky. You've got to know, you know, are they wide by narrow bodies, short haul, long haul, etc., gasoline, diesel? What kind of really trucks are the cars, how much are they driving, etc..

And so it's a good tool that we're now using. As of last week, they have oil demand up 1.3 million barrels per year to year, and that's for transportation. That's only 50% of oil demand. We think other areas are growing as well. And so it shows you or it shows us at least that there's no validity to concerns about demand destruction yet at least when we look at the other of a narrative this year, it's all been about supply growth, which has been surprising slightly to the upside US shale, more specifically as of the month of April, was up 570,000 barrels per day year to date.

We do believe that that we mean we have been calling for growth this year. Collectively we thought about 500,000 barrels per day. So it's running a little hotter than we thought. When we look to the rest of this year. The rig count is now down about 17%. You know, it's high at about 625 in December. It's now fallen by 88 rigs.

So we think that that portends a meaningful drop off in year over year growth. We've also partnered up with a firm called Flow, it's a group of analysts, so they scrub I think it's 6 million wells every month to try to get productivity trends from US shale. US shale by far, you know, it's the most important short cycle source of supply to to measure.

And so for energy investors, there's two questions that we really have to answer. One is demand. What is demand going to do in a recession, possible recession? And two, what is the US shale going to do in the short and medium term? Because without shale growth, we're really relying on long cycle production and we've written about and talked about all of the challenges of that, you know, seven year cycle time.

You mean Saudi. The only areas of meaningful long cycle with the OPEC coming online is 2025, 2027. You've got other areas of growth such as Guyana, you know, Exxon, etc. But outside of that, most basins in the world are in decline. And so their analysis would show and it confirms what we've been being told. Even at a conference a couple of months ago, we met with the major U.S. shale companies that are you know, we've got five years of inventory that can stand up to everybody else.

Another five years after that, you know, it's fine. And then after that, there's a discernible decrease. Well, to me that says they have five years of tier one inventory, five years of tier two. So it means a higher oil price required to achieve the same rates of return. And after that probably stuff they don't want to drill.

Well, if you only have ten years of inventory, how many years of growth do you have? Much, much less than that. And so it corroborates Flow's view that U.S. shale is going to be peaking much, much, much sooner than the average believes. And that's coming in the next, we think, two years. So that's

a meaningful, meaningful catalyst coming at us as well.

And so when we look to the rest of this year with the what we believe will be the largest stock rise in history, leading to inventories at an 8 to 10 year low, we look to 2024, we believe the market will remain undersupplied. The inventories will continue to fall. We remain bullish. We believe that oil will exit this year between 80 to $100 oil.

We're trading at roughly $75 now. And so what does that mean for energy stocks that are down roughly 6%? It feels like our fund is down about six now. It feels like we're down 60. Sentiment is awful. If you look at net speculative lengths in oil contracts, that's a measurement for sentiment. Recently hit the same level as April of 2020, when we were all locked in our homes during COVID.

It's mind blowing to me, that sentiment is that negative with what is before us coming at us. We do not understand yet why people don't see what we see. And this is really a market where they have to see it to believe it. And so we are we are literally in it now we're not even months away from now.

We're in weeks away from now where the stock draws the magnitude of that should become much more obvious to people. We think that will lead to an increase in in funds flow back to energy stocks. And we think the second half is going to be meaningfully better than the first off, when we look at valuations today from a free cash flow perspective, you don't have to believe in $150 oil tomorrow to get excited about energy stocks at 70.

So $5 below current levels. We have the sector trading at a 10% free cash flow yield ie you could keep production flat with cash flow and still pay us a 10% dividend or buy back 10% of their stock. That's not terrible. That goes up about 5% with every $10 move. So at $80, oil, much more interesting, 15% free cash flow, and yield.

So a 15% dividend, 15% buyback. When we look at, okay, what have companies pledged, most companies would say, well, we're going to give you a 75% of that free cash flow back. We measure that at $80 oil, the average company next year will pay us a 12% dividend or buy back 12% of their stock. So very, very attractive.

And importantly, that's average. We always try to do better than average. And so we have names that we think are going to pay us over 20% if we're correct, at 80 to 100. All are very, very attractive in our opinion. When we look at our positioning. So of the Ninepoint Energy Fund, we have 13 names, 96% of those are oil focused.

And we scour the world for opportunities. We look at services, natural gas, oil, etc. In our mind, the only thing I want to own now, as much as I possibly can, is oil and specifically heavy oil. Which brings us to the Canadian oil sands. The longest life reserves of almost every jurisdiction in the world outside of Saudi Aramco.

So you've got long reserves, you've got low declines so you don't have to consume a lot of your cash flow is sustaining production like US shale. So that means more free cash flow, strongest balance sheets in history, most amount of free cash flow in history, and most importantly, a pledge, a promise that once ultimate leverage targets are met, which is going to be happening by year end, the will get 75 to 100% of our free cash flow back to us.

And so that's a catalyst, in our opinion, to drive every rating. And so, again, 96% of the fund right now approximately is focused on oil. We want no services and we want no natural gas. I don't want

to dilute our exposure to oil. For natural gas we remain bulls for 2,000 and second half 2024 to 2025, as inventories eventually get drawn down to more historic levels as the US builds out more of its LNG capacity. Canada as well. 2025-2026. Well, that's a long time to wait. Services names have done better than we thought, especially the United States. Amidst a low natural gas pricing, volatile oil, high producer discipline in the U.S. shale names, which we think is the new normal. And so we don't want to be exposed to service names. Six of our ten, oh sorry, six of our top ten names are U.S..

And that's that one caller we did get right. We've been too bullish, at least for now, on on oil year to date. What we did to get right was the tightening of the Western Canadian select king heavy oil, given the increase in demand finally from China began earlier this year, an eventual build out of egress with the TMX pipeline expansion.

That's 590,000 barrels per day coming online. We think line fill is by the end of this year. So we're adding markets right in diversity. And we've had that differential fall to about $12 now. We think about an 8 to $12 level next year and going forward is reasonable. That's mega, mega bullish for the EPS producers. And so that's where we want to be focused for the Ninepoint Energy Income Fund. Despite the volatility and weakness in the oil price, we think our our average name is going to yield about a 6% dividend that's base plus variable this year. We've been making about 10 to 12% annualized on the calls that we've been writing. And so that's that means that the current yield right now we think is completely protected with no return of capital. You know, so that's a true cash on cash yield.

So just to summarize, we remain bullish. This is a year of two halves. The first half we tried to deal with a lot of headwinds. We've had to deal with, you know, Iranian production going back almost a pre sanction levels. The U.S. government is turning a blind eye to enforcing sanctions.

We've had to deal with the warm weather that's impacted demand. We've had to deal with the China reopening, which has been fine, but not as bullish as what we would have hoped for. We've had to deal with Russia production not falling off all of these different things. As we look to the second half of this year, what we may see is a moderation in supply growth out of the United States.

But most importantly, we see demand continuing to hold in increasing as seasonally China reopening. And now finally the OPEC cuts from Saudi OPEC+ Russia, which we can see using Kepler data in real time compliance is very, very strong. So we still think we end this year at an 8 to 10 year low and inventory levels, that is to us suggestive of a meaningfully higher oil price, how high it's going to come down to how wide is the chasm between the physical market and the finished market, How much can that narrow?

If it's this, it's 80. If it's that we think it's 100 or higher by the end of this year and going forward. But you don't have to be a believer in 100 or 120 hundred $50 oil. Do you see meaningful upside in energy stocks given the valuations from today? And so I wish you everybody a phenomenal rest of the summer with we're excited, we're bullish on the second half and going forward. We still believe we're in a multiyear bull market for oil and we wake up every morning still asking ourselves, what do we not own that we need to own? We're very, very confident in the names that we own, in the strategies of our companies. The strength of their balance sheets, their commitment to return the free cash flow back to us increasingly from 50% of free cash flow to 75 to 100 in the coming quarters.

And so with that, thanks so much for your attention. We look forward to future updates. Have a great summer.

[1] All returns and fund details are a) based on Series F units; b) net of fees; c) annualized if period is greater than one year; d) as at June 30, 2023; e) 2004 annual returns are from 04/15/04 to 12/31/04. The index is 100% S&P/TSX Capped Energy TRI and is computed by Ninepoint Partners LP based on publicly available index information.[†] Since inception of fund Series F.

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