OPINION

GOT AN OPINION THAT COUNTS?
Email wealthprofessional@kmimedia.ca

Where's the love for energy stocks?

By turning their backs on the energy sector, investors are missing out one of the most lucrative investment opportunities in decades, writes **Eric Nuttall**

MONTH AFTER month, energy stocks have continued to languish while the market's focus stubbornly remains on other areas like Bitcoin, marijuana stocks and the general tech space. Every morning on CNBC and BNN, significantly more airtime is given to discussing in-vogue names like Amazon or Canopy Growth rather than the $2.3 trillion oil market or the energy stocks that have dislocated from the price of oil by the greatest extent in history while oil trades at multi-year highs.

What makes this lack of interest – and commensurate lack of investment flow – so frustrating is that the current macro backdrop for oil is overwhelmingly positive. In addition, I believe that oil is in a multi-year bull market with few things capable of interrupting this reality.

According to Bloomberg, oil is trading at a near four-year high. The 'oil glut' (i.e. OECD surplus oil inventories to the rolling five-year average) has fallen from 334 million barrels in January 2017 to around a 26-million-barrel deficit. Ninepoint Partners predicts that this number could swell to a deficit of more than 300 million barrels by the end of 2018.

OPEC and Russia have pledged that their cut of 1.2 million barrels per day will continue throughout 2018, and their compliance to the cut has been impressively strong, consistently exceeding 100%. Even if they are lying and all of the shut-in production were to come online today, the market would be back to an undersupplied scenario by the end of 2018.

Meanwhile, oil demand remains strong. In 2017, demand was up around 1.7 million barrels per day, and 2018 is looking to be an even stronger year – firms like Goldman Sachs are calling for growth to exceed 2 million barrels per day.

> "What makes this lack of interest – and commensurate lack of investment flow – so frustrating is that the current macro backdrop for oil is overwhelmingly positive"

Then there's the big boogeyman in the room: US shale. But it will not grow as quickly as people believe and will be limited to around 1.2 million barrels per day. This is due to an incredibly important and yet still underappreciated shift in management mindset toward generating acceptable economic rates of return versus absolute production growth (aka 'growth for growth's sake'). Around 60% to 70% of companies have adopted returns-based incentive plans in 2018, up from 10% in 2015. In addition, infrastructure, labour and equipment shortages all are acting as further anchors to growth potential in this segment.

Putting this all together, the oil market in 2017 was undersupplied by 700,000 barrels per day (as evidenced by inventory drawdowns at the fastest pace in history). When combined with demand growth of 1.8 million barrels per day, this means supply would have to grow by 2.5 million barrels per day in 2018 to reach balance, which is highly unlikely; hence, the market will remain undersupplied. The last time OECD inventories reached this level, the price of oil was above $70 a barrel (versus around $62 at press time).

Given all of the above, it should be obvious that the current backdrop for oil is universally positive. This isn't just a short-term bullish call, but rather one that extends over the next four to five years.

The combination of limited US and OPEC supply, growing demand and, most importantly, a multi-year decline in non-OPEC/US production projected to start in 2019 all point to a market that will remain undersupplied. Even if demand growth rates taper, US supply grows, and OPEC brings back online all 1.2 million barrels of shut-in volumes, the market should remain undersupplied for at least the next several years. WP

Eric Nuttall is a partner and senior portfolio manager at Toronto-based Ninepoint Partners, where he oversees the firm's energy investment strategies, including managing the Sprott Energy Fund and the Sprott Small Cap Equity Fund.

16-17_Opinion-SUBBED.indd 16 6/04/2018 2:34:14 AM