Weekly Trends

PRIVATE CLIENT SOLUTIONS

Ryan Lewenza, CFA, CMT, Private Client Strategist

December 5, 2014

OPEC Declares War on US Producers

- The decline in oil prices and energy shares has been shockingly quick and deep, with West Texas Intermediate (WTI) declining 37% in just six months. The key problem in the oil markets is the current oversupply, stemming from a dramatic increase in US oil production.
- In response to US production increases, OPEC has made a major policy change with respect to oil prices. Historically, OPEC has cut production in response to excess supply and weak oil prices. With OPEC deciding not to cut production in the face of a market clearly oversupplied, it signals to us, that OPEC is more concerned about its declining market share than supporting prices.
- As a result of this new strategy from OPEC, we believe WTI oil prices are set to trade in a new lower range of roughly US$60/bbl to US$80/bbl in the coming months. Given this view, our outlook for oil prices and the energy sector is less constructive than just a few months ago.
- For now, we are maintaining our overweight recommendation for the energy sector. However, the sector is currently on downgrade watch and we may look to downgrade the sector on short-term strength, which we believe may be coming. In the near-term, we see the potential for the energy sector to bounce in the coming months (see Chart of the Week).

This will be our last Weekly Trends publication until the New Year when we will publish our 2015 market outlook in early January.

Chart of the Week

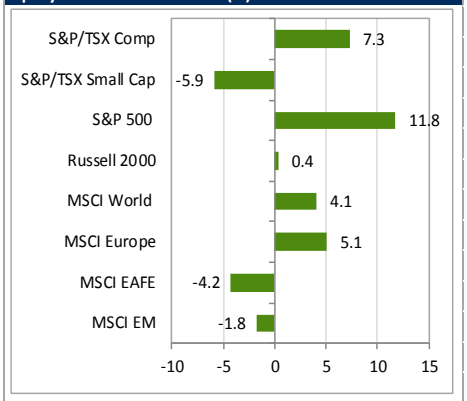
Historically When The S&P/TSX Energy Sector Has Become This Oversold

It Has Rallied Sharply In Subsequent Three Months Periods

Period	Pct Below 200-DMA	Subsequent S&P/TSX Energy Returns 1 Month	2 Months	3 Months
24-Feb-00	-11%	6.7%	22.3%	43.0%
3-Oct-06	-14%	8.4%	15.1%	9.7%
21-Jan-08	-12%	11.7%	9.4%	27.9%
20-Nov-08	-47%	16.5%	21.2%	10.0%
3-Oct-11	-23%	19.9%	16.4%	16.2%
25-Jun-12	-12%	8.6%	13.8%	15.1%
3-Dec-14	-16%	?	?	?
Average	**-19%**	**10.3%**	**14.0%**	**17.4%**

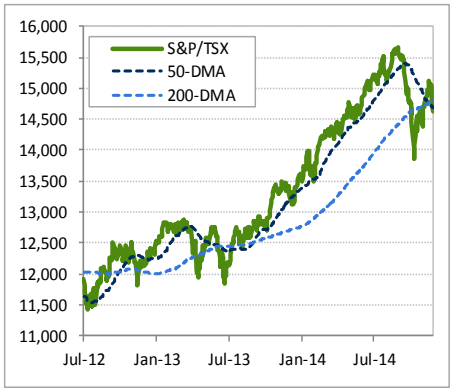
Source: Bloomberg, Raymond James Ltd.

Equity Market YTD Returns (%)



Canadian Sector	Curr. Wt	Recommendation
Consumer Discretionary	6.4	Market weight
Consumer Staples	3.5	Market weight
Energy	21.6	Overweight
Financials	36.5	Overweight
Health Care	3.6	Underweight
Industrials	8.6	Overweight
Information Technology	2.1	Overweight
Materials	10.6	Market weight
Telecom	4.9	Underweight
Utilities	2.2	Underweight

Technical Considerations	Level	Reading
S&P/TSX Composite	14,620.1	
50-DMA	14,689.8	Downtrend
200-DMA	14,808.8	Downtrend
RSI (14-day)	42.3	Neutral



Source: Bloomberg, Raymond James Ltd.

Raymond James Ltd. 5300-40 King St W. | Toronto ON Canada M5H 3Y2.
2200-925 West Georgia Street | Vancouver BC Canada V6C 3L2.

RAYMOND JAMES

OPEC's About Face

The decline in oil prices and energy shares has been shockingly quick and deep, with WTI declining 37% in just six months. Oil prices have suffered from a deluge of negative headlines in recent months including: 1) slowing global economic growth, led by weakness in Japan, China and Europe; 2) a strong US dollar (DXY), which is up 10% year-to-date (YTD); 3) a bearish report from the International Energy Agency (IEA) which signaled the potential for further "downside price pressures" as a result of excess supply; and 4) OPEC's decision not to cut oil production last week. In this week's report we provide an update on the outlook for oil prices and the energy sector following OPEC's "game changer" decision not to cut production.

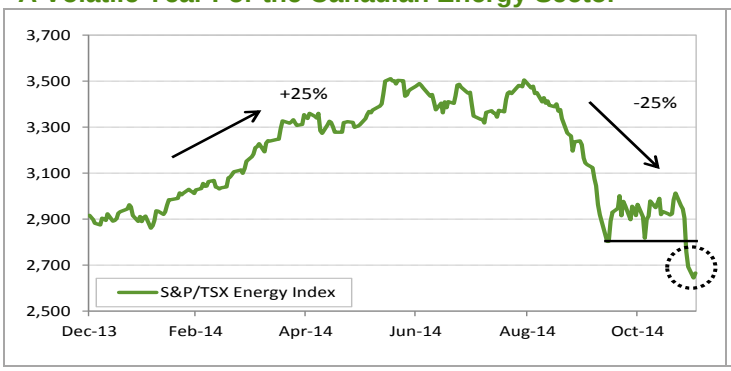
The key problem in the oil markets is the current oversupply, stemming from a dramatic increase in US oil production. The US economy has experienced an unprecedented energy renaissance in just a few years with US oil production more than doubling from 4 mln b/d in mid-2008 to 9 mln b/d today. This increase of roughly 5 mln barrels equates to about 4% of global production. While that may not seem like a lot, the US shale revolution has single-handedly altered the global oil supply/demand dynamics, with it having significant ramifications on prices.

Source: The Economist

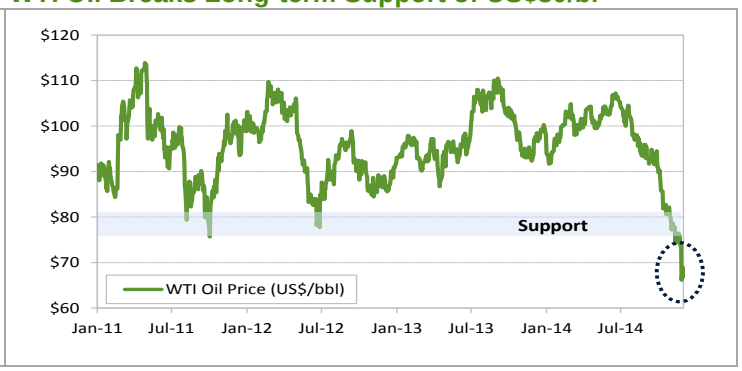
In response to US production increases, OPEC has made a major policy change with respect to oil prices. Historically, OPEC has cut production in response to excess supply and weak oil prices (e.g., 1998, 2001 and 2008), in efforts to help stabilize prices. This explains why we were in the camp that believed OPEC would cut production at their last meeting (note: our energy analysts correctly called for OPEC not to cut at the meeting). With OPEC deciding not to cut production in the face of a market clearly oversupplied, it signals to us, that OPEC is more concerned about its declining market share than supporting prices. Essentially, OPEC is willing to sacrifice short-term pain for long-term gain, by sending a clear message to US producers that they are in a battle for market share. This is accurately captured in the most recent *Economist* magazine which depicts a Saudi Sheikh going back-to-back against a US oil worker (sidebar).

As a result of this new strategy from OPEC, we believe WTI oil prices are set to trade in a new lower range of roughly US$60/bbl to US$80/bbl in the coming months. Technically, WTI oil prices broke below the important US$80/bbl support level, which will now act as resistance. For oil to move materially higher and break back above the US$80/bbl level, we would need to see either OPEC or the US cut back on production. With oil likely to trade in a new lower range, our outlook for the energy sector is less constructive than just a few months ago.

A Volatile Year For the Canadian Energy Sector



WTI Oil Breaks Long-term Support of US$80/bl



Source: Bloomberg, Raymond James Ltd.

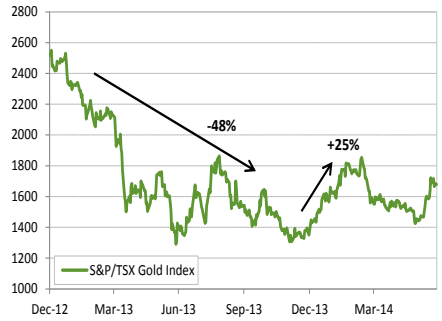
Potential for a Trading Bounce

While our longer term outlook for the sector has become more cautious, we are maintaining our overweight recommendation for the energy sector. However, the sector is currently on downgrade watch and we may look to downgrade the sector on short-term strength. In the near-term, we believe the energy sector could be setting up for a bounce in the coming months given the following factors:

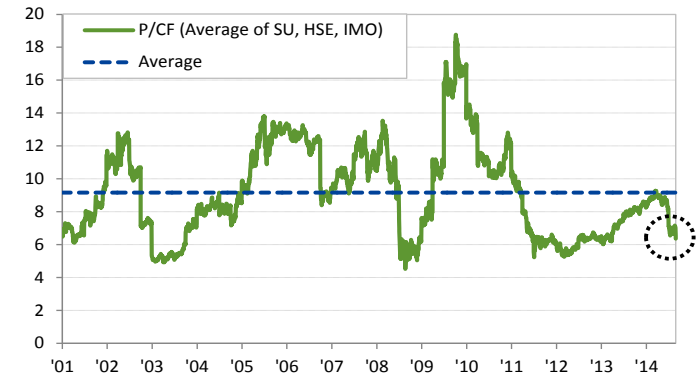
- Valuations have become very compelling in certain areas of the energy sector. In particular, we see good value in the integrateds, which remains our preferred sector. Currently, the average P/CF ratio for Suncor Inc., Husky Energy Inc., and Imperial Oil Ltd. is 6.4x, which is a 30% discount to the long-term average and near typical trough valuation levels. While cash flows will clearly come under pressure with lower oil prices, current stock prices have already discounted some of this.
- Currently we're in the heart of tax loss selling, which is likely contributing to the aggressive declines. We saw this pattern play-out with the gold miners in 2013, with the S&P/TSX Gold Index declining materially in October and November before bottoming on December 6, 2013. Gold stocks then went on to post a 25% rally in the first few months of 2014. We believe this pattern repeat for energy stocks in early 2015.
- Finally, we believe the energy sector is very oversold, which could result in an oversold bounce over the next few months. We analyzed previous periods when the S&P/TSX Energy Index was this oversold, looking at the percentage that the Index was below its 200-day moving average (MA). We found that in the six cases when the energy sector was this oversold, that it posted average returns of 10.3%, 14%, and 17.4% in the subsequent one, two and three months, respectively, with no periods of subsequent negative returns. We find these historical results very compelling for an oversold bounce in the early part of 2015.

OPEC's decision not to cut was a game changer in our view. As such, the outlook for the energy sector looks challenged over the next year. However, we believe the energy sector could be setting up a tradable rally over the next few months.

Gold Miners Rallied 25% Following Their Bottom in December 2013



Canadian Integrateds Are Inexpensive at 6x P/CF



Energy Sector Typically Rallies When This Oversold

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