Weekly Trends

PRIVATE CLIENT SOLUTIONS

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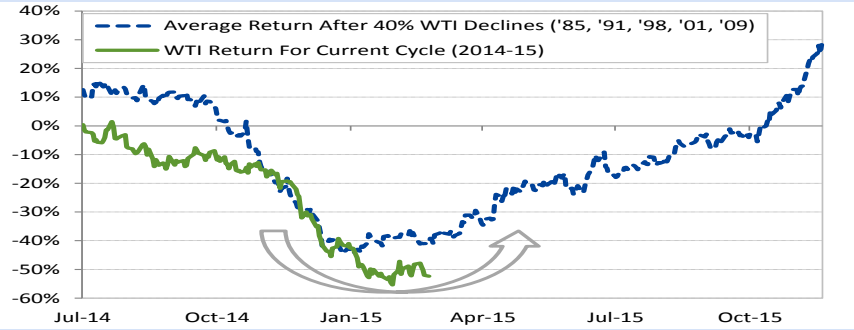
February 27, 2015

Oil Outlook – H2/15 Recovery

- The West Texas Intermediate (WTI) oil price is down a remarkable 45% since its July 2014 peak of US$107/bbl. In our view, the price shock has largely been supply-driven, rather than demand-driven. Through this challenging period for prices global oil demand has remained strong at 94.7 mln bbl/day in Q4/14, up 1.5 mln bbl/day from the previous quarter.
- It is estimated that the global oil market is currently oversupplied by 1 to 2 mln bbl/day, or roughly 1% of daily oil demand. With OPEC drawing a line in the sand, and deciding not to cut production to balance the market, it will likely come down to US producers to trim production and balance the market.
- This has started to playout as seen by the material reduction in US rig count over the last few months. As of February 20, the US oil rig count declined to 1,019, which is down 29% Y/Y and 37% since the October 2014 high of 1,609. While rig count is down significantly, this has not yet triggered a decline in US oil production, which as of last week was at a 30-year high of 9.28 mln bbl/day. We believe there will be a lag in US oil production levels, as rig count reflects more on exploration & development rather than actual production.
- Interestingly, history points to a near-term bottom in WTI. We looked at previous +40% oil declines over the last three decades and calculated the average oil price recovery following a 40% drop. Based on historical patterns, this signals a low in the coming months. This would align with our US energy analyst, Pavel Molchanov and Chief Investment Strategist, Jeff Saut, who see higher prices later this year. We concur, believing oil is likely to consolidate in H1/15 before moving higher in H2/15.

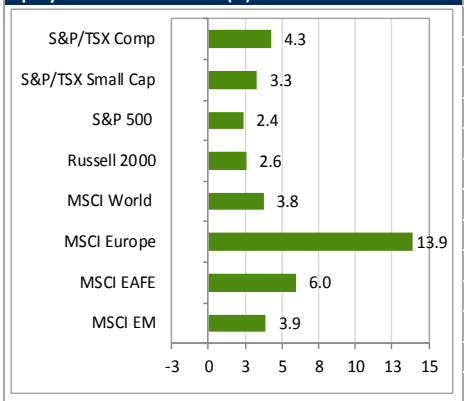
Chart of the Week

Historically Oil Has Rallied Sharply One Year After +40% Declines In WTI



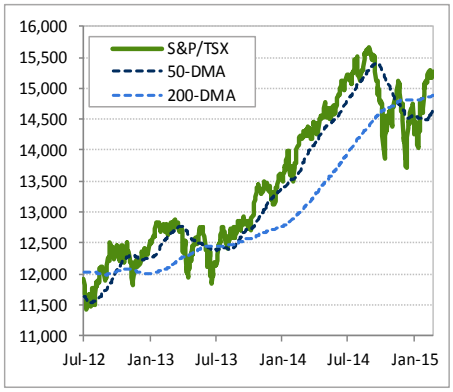
Source: Bloomberg, Raymond James Ltd.

Equity Market YTD Returns (%)



Canadian Sector	Curr. Wt	Recommendation
Consumer Discretionary	6.6	Overweight
Consumer Staples	3.7	Market weight
Energy	20.9	Market weight
Financials	34.5	Overweight
Health Care	4.8	Underweight
Industrials	8.5	Overweight
Information Technology	2.5	Overweight
Materials	11.6	Underweight
Telecom	4.8	Market weight
Utilities	2.2	Underweight

Technical Considerations	Level	Reading
S&P/TSX Composite	15,259.6	
50-DMA	14,691.1	Uptrend
200-DMA	14,885.6	Uptrend
RSI (14-day)	64.9	Neutral



Source: Bloomberg, Raymond James Ltd.

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Oil Outlook

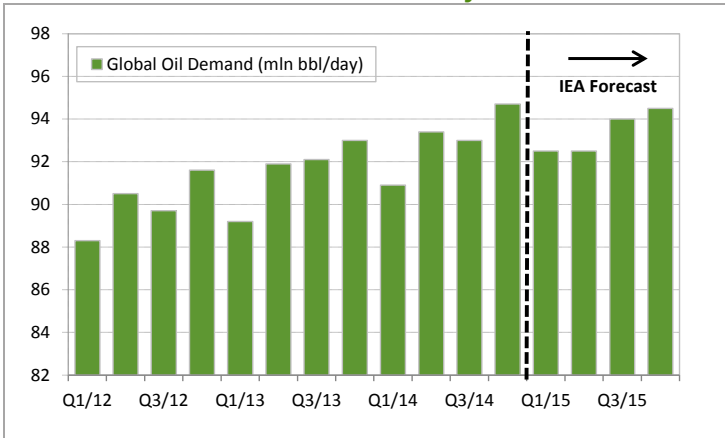
The WTI oil price is down a remarkable 45% since its July 2014 peak of US$107/bbl. In our view, the price shock has largely been supply-driven, rather than demand-driven. Through this challenging period for prices global oil demand has remained strong at 94.7 mln bbl/day in Q4/14, up 1.5 mln bbl/day from the previous quarter. Moreover, global daily oil demand has remained above the 90 mln bbl/day level since early 2013. Continued healthy oil demand supports our view that the weakness in the oil markets is largely a supply problem. It is estimated that the global oil market is currently oversupplied by 1 to 2 mln bbl/day, or roughly 1% of daily oil demand. With OPEC drawing a line in the sand, and deciding not to cut production to balance the market, it will likely come down to non-OPEC producers, in particular the US, to trim production and balance the market. So far, this has yet to show up in the data.

We believe finding equilibrium in the oil market will start with a reduction in US rig count. Baker Hughes publishes this data weekly and we have witnessed a material reduction in US rig count over the last few months. As of February 20, the US oil rig count declined to 1,019, which is down 29% Y/Y and 37% since the October 2014 high of 1,609. We believe this is the first step to finding equilibrium in the oil markets.

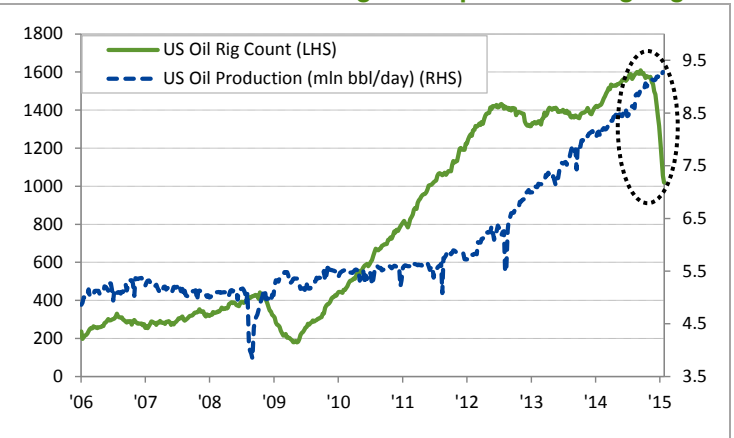
While rig count is down significantly, this has not yet triggered a decline in US oil production, which as of last week was at a 30-year high of 9.28 mln bbl/day. We believe there will be a lag in US oil production levels, as rig count reflects more on exploration & development rather than actual production.

With supply still plentiful and global production remaining high, we believe oil prices could remain under pressure through the spring. The International Energy Agency (IEA) forecasts a decline in demand in H1/15, but then an improvement in H2/15. With our expectation that US production will begin to slowly decline in the coming months, along with stronger demand in H2/15, this could set up oil for a stronger second half.

Global Oil Demand Remains Healthy



US Production At Record Highs Despite Declining Rigs



Source: Bloomberg, Raymond James Ltd., IEA

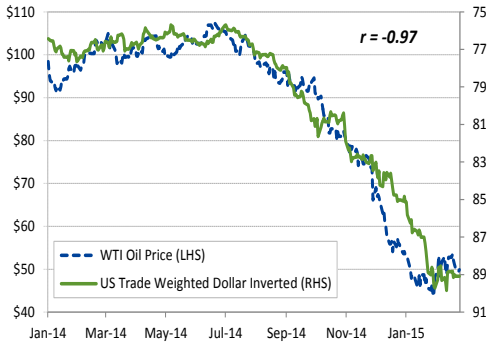
H2/15 Recovery

While the first step to finding equilibrium in the oil markets through lower rig counts is occurring, we still see numerous headwinds to oil prices which could cap upside in H1/15. Key headwinds to oil prices in the near-term include:

- **Strong US dollar:** The current oversupply of oil (1-2 mln bbl/day) has clearly weighed on oil prices. However, other factors are at play with the strong US dollar being front and center. In the accompanying chart (sidebar) we illustrate the strong relationship between the US trade-weighted dollar (inverted on the chart) and oil prices. There is a tight fit between the two, with a high negative correlation of -0.97 since early 2014. As the US dollar has rallied 16% since January 2014, WTI oil has experienced a contemporaneous decline of 50%. Given our view that the US dollar could trend higher still, this could continue to provide a headwind to oil prices.
- **Record inventories:** The second major headwind to prices in the near-term is the record amount of US inventories. As of last week US inventories stood at 425 mln bbls, which is the highest level recorded on data going back to 1982. This excess inventory will need to be worked off before oil can experience a sustained move higher, in our opnion.
- **US production:** As previously covered, we believe US oil producers will need to cut back on production in order to address the oversupply. We expect this to occur in the coming months.
- **Weak technicals:** Given the technical damage to oil prices, there requires much "healing" in the charts before we can declare the end of the bear market in oil prices. Key technical levels for WTI include US$51 (50-day MA), US$55 (short-term downtrend), and US$64 (100-day MA).

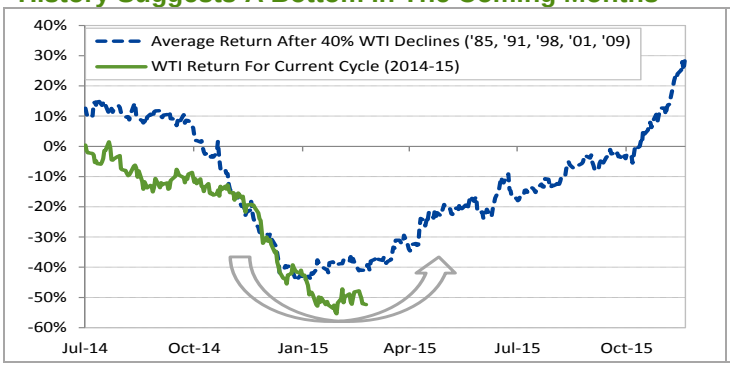
Interestingly, history points to a near-term bottom in WTI. We looked at previous +40% oil declines over the last three decades and calculated the average oil price recovery following a 40% drop. Based on historical patterns, this signals a low in the coming months. This would align with our US energy analyst, Pavel Molchanov and Chief Investment Strategist, Jeff Saut, who see higher prices later this year. We concur, believing oil is likely to consolidate in H1/15 before moving higher in H2/15. The key question in our view is whether we see a V- or U-shaped recovery. We are in the U-shaped recovery camp, which translates into a period of consolidation (as excess supply is worked off) followed by a recovery in oil prices in H2/15. This is our projected playbook for oil prices in 2015.

Strong US Dollar Is Weighing On Oil Price

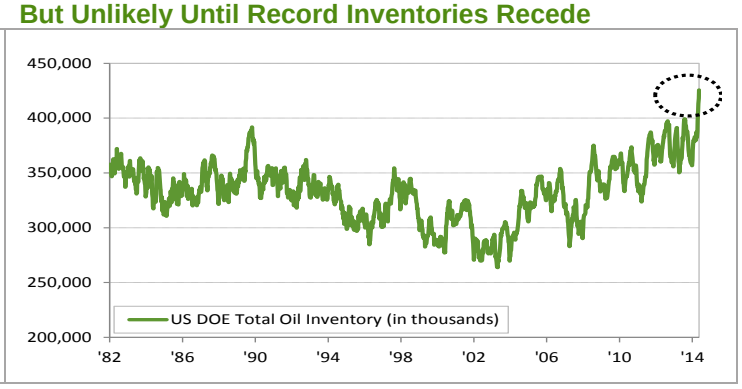


Source: Bloomberg, Raymond James Ltd.

History Suggests A Bottom In The Coming Months



But Unlikely Until Record Inventories Recede



Source: Bloomberg, Raymond James Ltd.

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