Market Insights

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I would like to extend my best wishes to you for 2016. I expect 2016 to be a very good year for Canadian oriented investors despite the current challenging environment.

2015 in review

TThe much awaited 'Santa Claus rally' was not to be had this year. It melted away, possibly due to climate change. The end of December 2015 marked a losing streak for both the Canadian and US exchanges. The Canadian dollar's weakness continued to show as well closing at a 13 year low.

	December 31, 2014	December 31, 2015	Year to date Performance
TSX	14,632	13,009	-11.09%
TSX Venture	695	525	-24.46%
Copper	$2.92	$2.18	-25.34%
Gold	$1,184	$1,060	-10.47%
Silver	$15.59	$13.80	-11.48%
Nat Gas	$2.91	$2.35	-19.24%
Oil (WTI)	$53.27	$37.04	-30.47%

Table 1 **Source:** *Dataphile*

Current investment climate

After seven years of near zero rates, the US Fed finally raised them in December of 2015. The wording the US Fed used called for a gradual tightening path over the next three years. The anticipated rate hike had been the most anticipated and talked-about hike in history, and as a result, the market reaction ended up being rather muted. The timing of the Fed rate hike is rather interesting as it happened during the sixth straight month of declines as reported by the Purchasing Managers Index, an indicator of the strength of the economy. Historically speaking when the ISM dips below 50 (Chart 1) the chances of a **recession in the US increase to 65%.** As such the current tightening policy by the Fed into a weakening economy seems to be contrary to the fundamentals of economics. Needless to say, it is absolutely imperative the US Fed does not lose credibility in its efforts to guide the anemic growth of the US economy.

United States ISM Purchasing Manager Index (PMI)

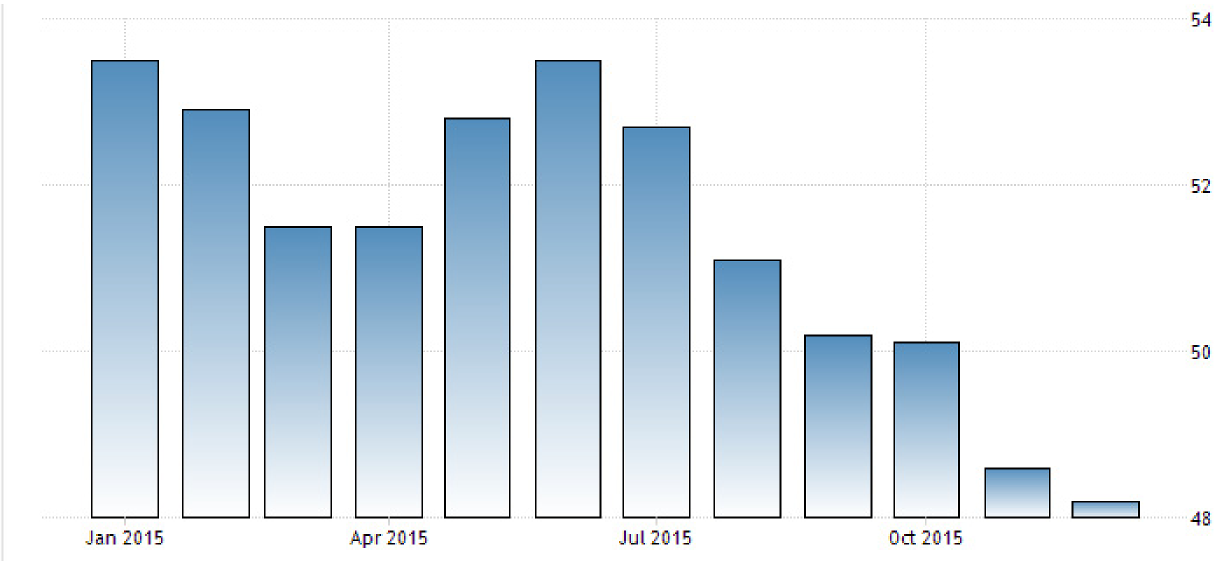


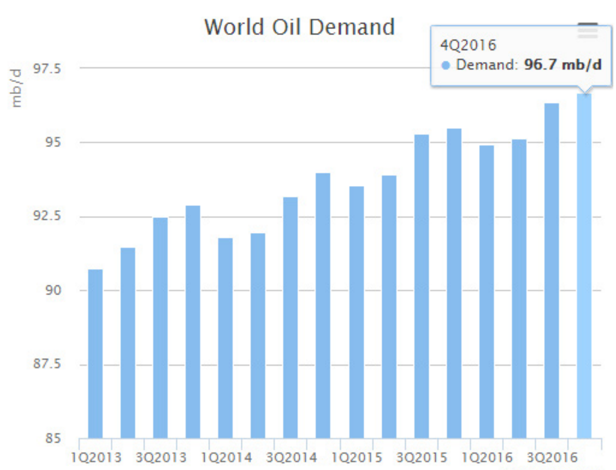
Chart 1 **Source:** *Trading Economics*

Energy and Materials Commodities

The Canadian Materials Sector and Energy Sectors have been under tremendous pressure the past year. The situation has reached such a dire state that it now appears to be an enormously attractive buying opportunity. I am convinced that the time to take advantage of this once-in-a-lifetime opportunity is now while commodity prices are at low prices. Even though both materials and energy have been under significant pricing pressure the past few years, I believe Energy has reached critically low levels.

Executive Summary

The premise behind the strong oil fundamentals is that the current global demand for oil continues to increase by 1.2 to 1.8 million barrels per year. Global oil demand in the last half of 2016 will approach 97.5 million barrels per day. In four short years, the world is anticipated to consume 104 million barrels per day. Looking out to 2040, the world is projected to grow its oil demand to 120 million barrels per day. During their most recent yearly outlook, OPEC stated a **$10 Trillion investment** is needed to avoid a massive oil price spike. IEAs global demand projection can be seen in the chart below.

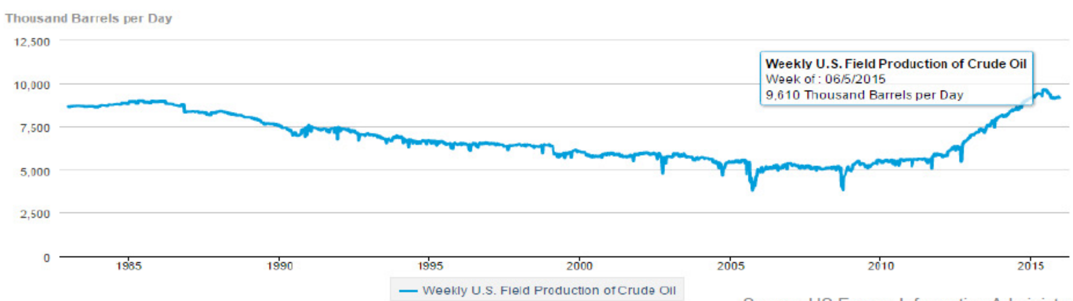


The global decline rate is an enormously important component of the supply and demand side of oil, but I have yet to hear it mentioned in popular media. The global decline rate is the depletion of current production from existing oilfields. If oil is priced at $80-$100, the global decline rate is around 6.2% which means the world has to find new production of 7.2 million barrels every year just to keep afloat. Without proper investment, the decline rate is around 9% or 9 million barrels that have to be found every single year just to keep up with current consumption. Without adequate oil prices, there will not be sufficient investments to maintain current production. [3]

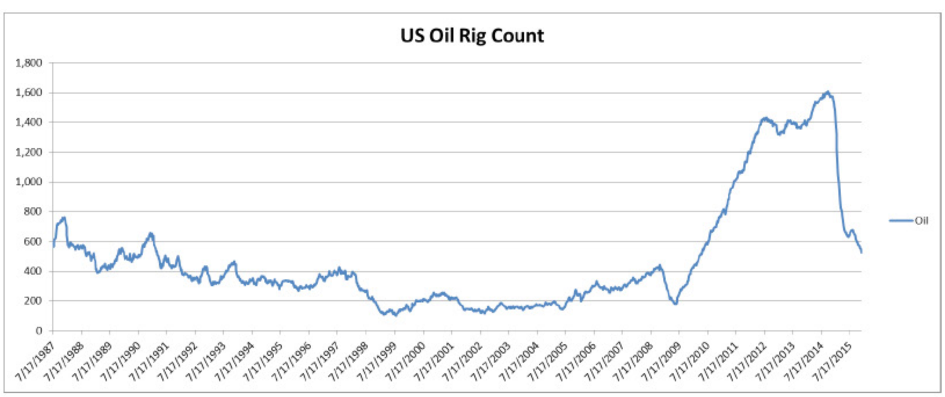
On the supply side, it seems that popular media is only broadcasting the message that there is an oversupply of 1.5 million barrels per day. What the media does not mention is that OPEC has had to actually increase its production by over 2 million barrels just to create this 1.5 million barrel "surplus" in the first place[1]. The policy of market share protection as broadcasted by Saudi Arabia is structurally flawed as the world consumption grows more each year than the Saudis can increase their production. OPEC's "protection of market share" policy driven by Saudi Arabia is synonymous to a **jihadist** oil policy – self destructive.

The possibility of Iranian oil flooding the global markets is another gross misrepresentation of facts by the media. Prior to the Iranian embargo, Iran produced around 3.7 million barrels per day[2]. According to the most recent OPEC monthly production report, Iran is already producing 3.3 million barrels per day. In reality, lifting the oil embargo from Iran will have very little impact on world oil supply. It will however free up $100 billion to Iran, currently frozen due to the embargo. Gaining access to their frozen funds is likely the main driving force behind Iran wanting the embargo lifted, not to flood the world with more oil.

As you can see (Chart 2), a comparison is made between the past 30 years of US crude production and drill rig activity. When fracking was introduced in 2009, drilling activity exploded, drill rigs increased from around 400 active rigs in 2009 to nearly 1600 in early 2015. As the bottom chart clearly shows, the number of active drilling rigs has subsequently dropped back to around 500 from 1600. As the number of active drill rigs has fallen off, so too will US oil production. The peak in production was in April of last year at 9.6 million barrels, and since then it has slowly decreased to the current 9.2 million barrels. It will only be a matter of time before production will drop off a cliff putting fundamental strain on the oil complex.



Source: US Energy Information Administration



Source: Data from Baker Hughes, Dec. 2015

Chart 2

If you wish to receive a more detailed slide presentation on the supply and demand fundamentals of Crude, please let me know and I will email it to you immediately.

[1] http://www.opec.org/opec_web/static_files_project/media/downloads/publications/MOMR_August_2014.pdf

[2] http://www.financialexpress.com/article/industry/iran-nuclear-deal-means-more-oil-but-not-in-2015/60192/

[3] http://www.ft.com/intl/cms/s/0/12f07588-a95f-11e5-9700-2b669a5aeb83.html#axzz3xLQr68JM