Foyston, Gordon & Payne Inc.

Investment Counsel

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Oil Prices:
Opportunity in Volatility

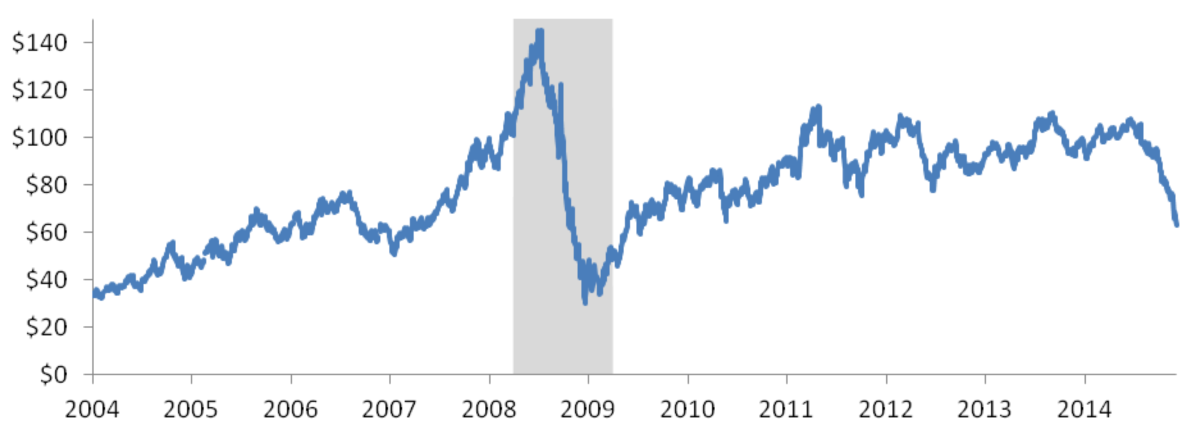
Behind every dark cloud is a silver lining. The same holds true for the recent oil price plunge. Despite the big headlines about the negative effects of falling oil prices, we are confident about the upside to our stock positions and about finding attractive opportunities.

Exploration and production companies as well as oil service companies have been especially hit hard by falling oil prices. Integrated companies have fared relatively better but are still down. Declining crude oil prices since mid-2014 have reduced the Energy sector's weight in the S&P/TSX Composite Index from 27.1% on June 30 to 21.7% on Nov. 30.

The weaker crude oil prices appear to reflect a number of negative developments:

- a global oversupply of nearly 1 million barrels per day, in particular some of the growth from "tight oil" plays in the United States;
- deteriorating global growth, and thus slowing demand;
- OPEC's decision not to cut production or adhere to quotas.

We do know that oil prices will always be somewhat volatile. The graph below, using data from the U.S. Energy Information Administration, shows the price of West Texas Intermediate (WTI) crude oil in U.S. dollars per barrel for the last 10 years. The shaded area represents a one year period encompassing the last big oil price plunge. The final stage of the price rise, the decline, then the beginning of the rebound all happened within this time frame.



For example, back in 2008, the demand for oil fell due to a slowing global economy, and oil prices plunged as a result. The price decline lasted six months before turning around once supply fell to meet demand.

This year, the oil price decline that started in June was likely caused by too much supply, as the United States increased its production. Similar to what happened in 2008, we believe oil prices will stabilize then move higher as demand and supply adjust. On the demand side, lower prices will lead to increased consumption as U.S. drivers take more frequent trips for the same or lower total fuel cost. We have begun to see this trend of increasing U.S. gasoline demand for the last three weeks.

On the supply side, the crude oil market will eventually reduce production as higher cost producers in North America, such as newer shale and oil sands projects, curtail their uneconomic projects. Reservoir depletion rates will also reduce supply. We believe that the economic reaction to lower oil prices is that market forces should start to drive prices back up.

In our company analysis, we are using a crude oil price range of $70 U.S. to $90 U.S. per barrel. We believe this range is sustainable given expected supply and demand over the next five years.

From a portfolio perspective, we already took some profits earlier this year (we sold our position in oil services company Tri-Can Well Services) and we recently added to some of our positions where the valuations have compressed. We also want to remind our clients that our portfolio is skewed to the highest quality producers (Canadian Natural Resources Ltd.) and integrated companies (Suncor Energy and Imperial Oil Ltd.) which tend to be less volatile than riskier junior and mid-size companies. Our core companies all feature strong balance sheets and credible management teams.

The negative sentiment facing Canadian energy stocks is at extreme levels, and buying opportunities are often created when pessimism is at these levels. Our view is that these significant price pullbacks have created a long-term buying opportunity for patient, contrarian investors.

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