Sionna Investment Managers®

SOUNDBITE

April 2023

Energy Update

We thought this would be an ideal time to provide you with an update on our energy views given the continual decline in pricing since last summer. Let's start with the big picture, what has changed and move to specific catalysts on the horizon.

Global Energy Tug of War

WTI Oil ($65)
NYMEX Gas ($2.25)

$40 +/- $2

$100 +/- $6

Demand

Negatives

- Mild/severe global recession?
- Typically, little demand destruction, non-OECD nations drive demand vs modest contraction in OECD nation demand

Positives

- Substitution into oil/coal occurred in 2022 given elevated natural gas price in EU…likely reverses somewhat in 2023 given price changes
- China COVID-19 lockdowns lifted

Supply

Negatives

- Energy conservation (emphasis EU)
- Continued mandated SPR release in 2023 of ~26M bbls; refill unlikely in 2023 as two caverns damaged and in need of repair

Positives

- Lower reinvestment rate from energy companies, prefer continued debt retirement and shareholder returns
- OPEC at capacity? Signalling a production cut
- Windfall taxes in EU/UK may continue to pressure supply
- Global power shortages continue (hydro/nuclear/renewables) pushing nations to oil/thermal coal use
- U.S. on track to double LNG exports by 2027 (~12 BCF/day to +25 BCF/day)

As illustrated above, the market continues to debate if we are in, entering, or will escape a recession. Will it be localized in North America, the EU or will it be global, and what of its severity? All good questions that will continue to take time to reveal. That said, energy prices are discounting a typical recessionary environment given the pullback of WTI crude falling from ~$120/bbl and natural gas from ~$10/mcf. During a "typical" global recession, total oil demand does not decline. However, demand within OECD nations modestly declines, but it is completely offset by demand growth in non-OECD nations. The two instances this relationship has not held up include the 2008-2009 period (modest decline for a few quarters) and in 2020 during the COVID-19 pandemic. Presently, the demand side of the equation has not changed with all major agencies (EIA/IEA/OPEC) forecasting oil demand growth over the next two years. On the supply side, growth remains constrained both within and outside of OPEC. The new mantra, as a generalization, remains for public energy companies to reduce debt, return excess free cash flow to shareholders (via dividends/share buybacks) and flat to modest production growth (typically 1-3%). We continue to believe this new business model will hold as shareholders have demanded this change and management compensation structures have aligned their interests to this new model.

With Russia's invasion of Ukraine, global logistics continue to be re-routed with the cut of natural gas to the EU and crude oil moving towards mainly developing nations or the Middle East. The EU consumed less natural gas given a mild winter, energy conservation, substitution into oil/diesel/thermal coal, and increased electricity imports from neighbouring nations; however, their challenge from replacing this supply is far from over.

As China’s economy reopens from post Covid-19 lock-downs, demand for energy will very likely increase from constrained levels pushing China to compete for these resources once again. Since the beginning of 2022, the U.S. also released more than 200M bbls from their strategic petroleum reserve (SPR), with another 26M bbls to be released from April to June of 2023. It’s our understanding that no further releases will occur; however, the SPR refill will likely be delayed until 2024 as damage has occurred to two caverns that store these barrels. As we write this update, OPEC+ made a somewhat surprising production cut of ~1.1M bbl/d with Russia confirming a continuation of their 500k/d cut until year end – meaning total quota cuts amount to ~1.6M bbl/d. It is worth mentioning that OPEC+ is currently producing ~2M bbl/d under their quota so the quota is simply coming in line with current supply. However, the optics of this quota cut are supportive of oil prices and may be both economically/geopolitically oriented. As we move from the seasonally slowest quarter of the year into stronger demand-pull quarters, it will be interesting to learn if companies will continue with their cap ex plans (given they were contemplated at ~$75WTI/$3-3.50 natural gas) or modify plans with the release of their first quarter results.

Closer to home, the long awaited TMX pipeline is expected to start operating in late Q4 or early next year, providing Canadian producers another outlet to ship heavy oil vs. sending it to our southern neighbours. This, combined with lower heavy oil flowing from Mexico to the U.S., should command higher pricing for Canadian energy. Within Sionna’s Large Cap Strategy, our holdings in MEG Energy and Suncor should be beneficiaries in the quarters and years ahead.

Turning to natural gas, the NGTL system in Canada is once again under maintenance, which is expected to negatively impact AECO natural gas pricing sporadically into early Q4. Some energy companies, such as Advantage Energy (held in our High Conviction Strategy), ARC Resources (held in our High Conviction and Large Cap Strategies) and NuVista (held in our Large Cap Strategy) have taken action by reducing or eliminating exposure during this time. Looking at the bigger picture, liquefied natural gas (LNG) is set to grow substantially over the next decade, with Canada and the U.S. set to benefit. Current capacity of LNG export terminals in the U.S. amounts to ~12-13 BCF/D and is set to grow to ~25+BCF/D by 2026, which also coincides with the startup of LNG Canada with potential exports of up to ~5 BCF/D (note: Canadian production is ~17-18 BCF/D), which are significant volumes. Given the inroads that natural gas has made as a ‘cleaner fuel’ choice amongst fossil fuels to bridge the gaps in energy transition and the global communities bias towards lower emissions, this LNG buildout is likely to gain additional momentum. Our energy holdings are poised to benefit from these medium-term trends, with ARC Resources already signing contracts to provide volumes with LNG Canada and with Cheniere Energy in the U.S.

As the markets continually attempt to discount the future through share price movements, one thought comes to mind in the energy space that has remained true through time. If prices do not incentivize reinvestment, then supply typically stalls or falls, hence a self-correcting mechanism is embedded. What’s different this time around? In our minds, we now have producers returning cash to shareholders with significantly less debt burden, a stronger incentivized OPEC desiring price vs. volumes, energy transition spending, large shale base production in the U.S. with higher decline rates coupled with rising profitable wells requiring $55-65WTI, and a tenuous geo-political environment.

We thank you for your continued support and encourage you to reach out to us with any questions.

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