# Ninepoint Energy Fund Market View

April 17, 2020

## Is the end of the oil bloodbath in sight?

## Investment Team

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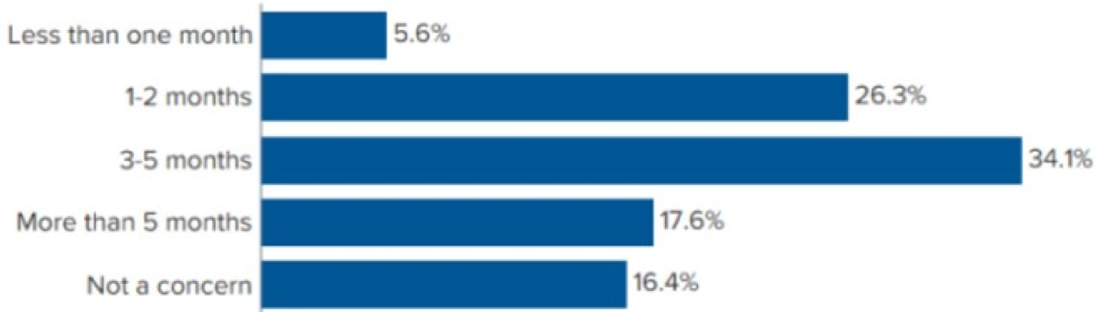
It's not easy being an oil bull these days. Everywhere you look (Twitter, Bloomberg, CNBC) analysts and pundits seem to take joy in professing just how bad the short-term outlook is for oil. Global storage to fill! Oil pricing to go negative! One month has destroyed 10 years of demand growth! COVID-19 to lead to permanent demand destruction! OPEC++ deal a scam! You get the point.

Could it be though that the end of the oil bloodbath is in plain sight? Aren't bottoms made when EVERYONE is seemingly bearish having completely given up hope (Morgan Stanley said yesterday they were "seeing a sense of defeat" in their clients who were still selling energy names)? Are we near a turning point for the sector when every negative variable that has weighed on oil starts to inflect to the positive (oil demand trajectory, US shale growth trends, Saudi/Russia price war impact, COVID-19 datapoints [hospitalizations, new rate of infections, rapid testing capabilities, antivirals trials and progress on the 70+ vaccines under development])?

We know that COVID-19 has led to approximately 50% of the world's population being put in some form of social isolation (86% of the US is now under stay-at-home orders). This has led to the greatest implosion in oil demand in history (by several orders of magnitude) as people are no longer driving to work, flying, or taking cruises with April demand contraction estimates ranging from 20MM Bbl/d (OPEC) to 29MM Bbl/d (IEA). Regardless of the actual number, there is uniform opinion that April is the peak month for demand destruction and will therefore mark the low: China is emerging from lockdown (air pollution and traffic congestion are back to 2019 levels while coal consumption/domestic flights are still -4%/-16% YOY though both metrics continue to improve) while it appears that North America and several European countries will slowly begin to relax social distancing orders in May lest irreparable damage to their economies ensue (26% of small US businesses surveyed said they were at risk of permanent closure if the lockdown were to extend another 1-2 months).

## Risk of small business closure

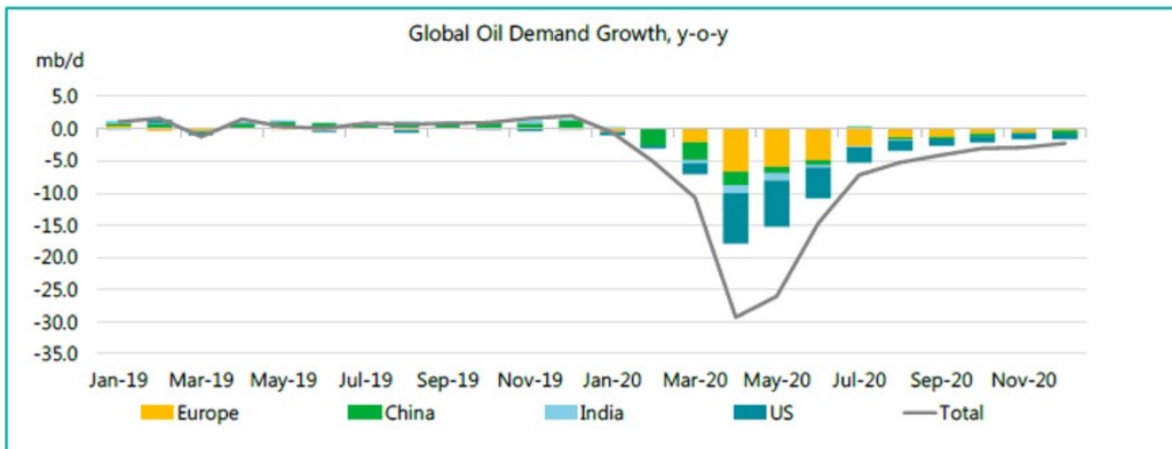
Share of responses to the question "If business disruption continues at the current rate, how soon will your business be at risk of closing permanently?"




SOURCE: Main Street America (MSA) online survey during the week of March 25 to April 6, 2020, including more than 5,850 small business owners.

Source: CNBC

While there is tremendous debate as to the pace of oil demand normalization few can argue that the trend will imminently begin to improve (how much worse can it get when no one is flying nor driving their cars?!?). Both the IEA and OPEC estimate that global demand will be down less than 3% from pre COVID-19 levels by December of this year coinciding with the IMF forecasting global economic expansion in the 2H'20:




Source: IEA, April 15, 2020

**Fig 5: OPEC summary balances, mb/d**

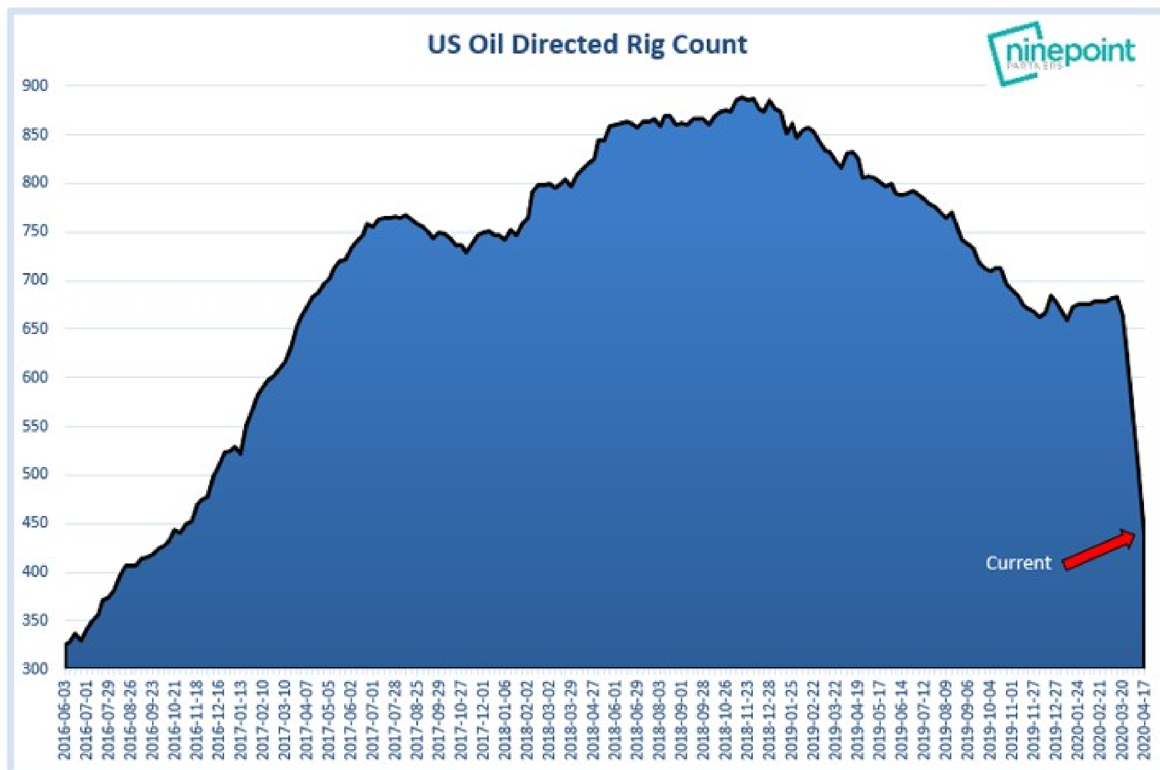
| | | 2019 Quarters | | | | | 2020 Quarters | | | | | y/y change | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2018 | Q1 | Q2 | Q3 | Q4 | 2019 | Q1 | Q2 | Q3 | Q4 | 2020 | 2019 | 2020 |
| **Demand** | **98.8** | **98.8** | **98.6** | **100.5** | **100.8** | **99.7** | **92.9** | **86.7** | **94.3** | **97.3** | **92.8** | **0.8** | **(6.9)** |
| OECD | 48.0 | 47.7 | 47.2 | 48.5 | 48.3 | 47.9 | 45.5 | 38.4 | 45.2 | 46.6 | 43.9 | (0.1) | (4.0) |
| Non-OECD | 50.8 | 51.0 | 51.4 | 52.1 | 52.5 | 51.8 | 47.4 | 48.3 | 49.1 | 50.8 | 48.9 | 0.9 | (2.9) |
| **Non-OPEC supply** | **63.0** | **64.4** | **64.4** | **64.8** | **66.3** | **65.0** | **66.6** | **62.2** | **62.7** | **62.5** | **63.5** | **2.0** | **(1.5)** |
| non-OPEC excl NA | 38.9 | 39.3 | 38.8 | 39.1 | 39.7 | 39.2 | 40.1 | 36.8 | 37.6 | 37.8 | 38.1 | 0.3 | (1.2) |
| North America | 24.1 | 25.1 | 25.6 | 25.7 | 26.6 | 25.7 | 26.6 | 25.4 | 25.1 | 24.7 | 25.4 | 1.7 | (0.3) |
| FSU | 14.3 | 14.6 | 14.2 | 14.3 | 14.4 | 14.4 | 14.5 | 11.8 | 12.4 | 12.4 | 12.8 | 0.1 | (1.6) |
| **OPEC NGLs/Condensates** | **4.8** | **4.8** | **4.8** | **4.7** | **4.9** | **4.8** | **4.9** | **4.8** | **4.8** | **4.8** | **4.8** | **0.0** | **0.0** |
| Call on OPEC crude | 31.1 | 29.6 | 29.4 | 31.1 | 29.6 | 29.9 | 21.4 | 19.7 | 26.8 | 30.0 | 24.5 | (1.2) | (5.4) |
| **OPEC crude** | **31.3** | **30.0** | **29.5** | **28.9** | **29.1** | **29.3** | **28.3** | - | - | - | - | - | - |
| Stockbuild | 0.2 | 0.3 | 0.1 | (2.2) | (0.5) | (0.6) | 6.8 | - | - | - | - | - | - |

Note: Some numbers in the table may not match up exactly with reported numbers due to rounding errors.

Source: OPEC April MOMR

Source: OPEC, Energy Aspects, April 16, 2020

With a line of sight for demand normalization in the next 9 or so months it is then incredibly important to oil balances that supply growth is imploding. Globally over $100BN of capital spending cuts have been announced…from already depressed levels in what is an incredibly capital intensive industry (Schlumberger today guided that their Q2 will one of the worst quarters in its 94 year history). The US rig count has fallen by 239 rigs (35%) year-to-date with a likely further 150+ rigs to be let go in the coming weeks. Consequently 2020 US oil production estimates have gone from +600-800k bbl/d to -100k bbl/d (2020 exit rate expectations are now for a decline of 1.5 to 2.0MM Bbl/d).

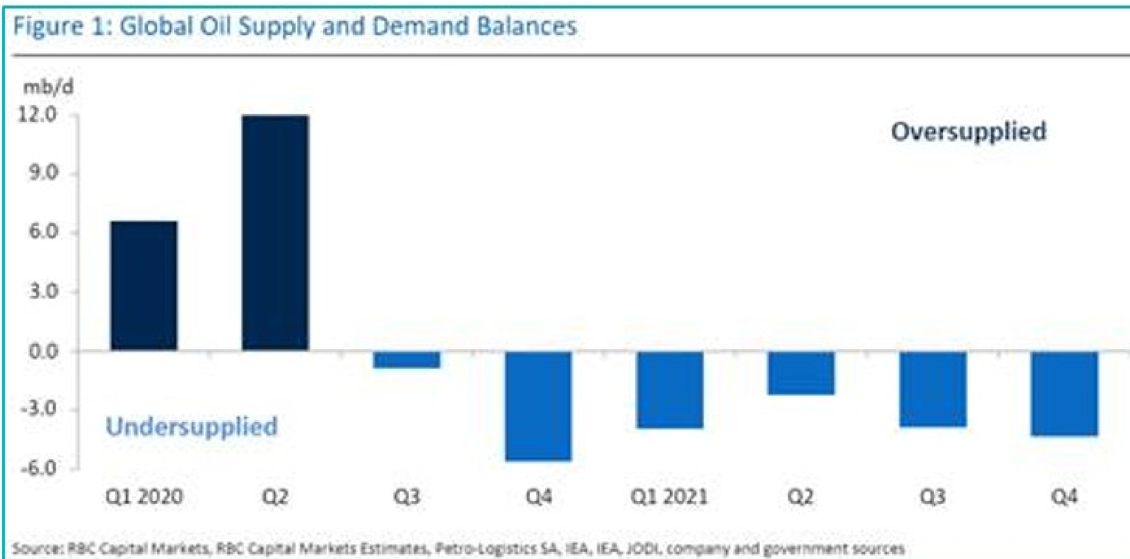


Source: Baker Hughes

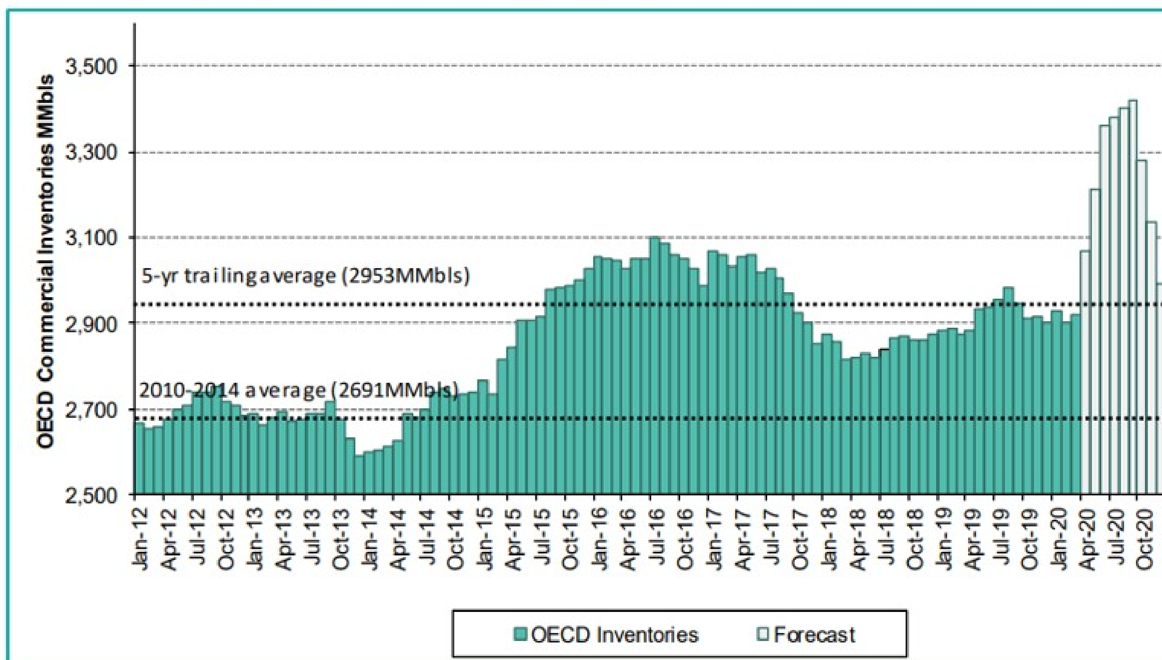
Further, the 2020 price drop has mortally wounded shale growth potential going forward and we do not think US shale can grow annually by more than ~0.3MM Bbl/d in the years ahead (20%-30% of normalized per annum demand growth versus 100%+ in years past) as management teams re-evaluate what "adequate balance sheet strength" means, no longer have the benefit of efficiency gains, are producing an oil quality that is increasingly out of favour with global refineries, and are more likely to be drilling a greater proportion of Tier 2 acreage (half as productive yet the same well cost).

Compounding the drop in US production growth is the global impact of insufficient investment in major offshore projects. Already global offshore production (about 1 in 4 barrels produced) was set to plateau in 2020 and begin a multi-year decline in 2021…the historic capex cuts this year will only serve to intensify and extend this trend. Finally, while the OPEC++ supply cut announced on April 12th of 9.7MM Bbl/d (a little less when adjusting for baselines) will do nothing to avoid regional tank tops in the coming months they will help to draw inventories down much faster once demand starts to pick up, especially if the extension of the cuts are enacted (7.7MM Bbl/d reduction from July-December and 5.8MM Bbl/d from January '21 to April '22).

Undeniably, the outlook for oil over the next few months is extremely challenging. Until demand normalizes by a magnitude that allows production cuts to balance the market, inventories will fill. With 1.2 to 1.5BN barrels of remaining capacity it is likely that regional hubs like Cushing will fill to maximum capabilities in the next 1 to 2 months. At that point, with a physical lack of remaining storage capacity production will have to be shut-in and either price or differentials will be the mechanism to achieve this. Importantly, while this will be a rather doomsday type milestone to hit it should only last for a few months assuming North America and European economies somewhat match China's pace of recovery. Both RBC and Bernstein forecast that stock draws should start in Q3 meaning the coming few months should be as bad as it gets:




RBC, April 15, 2020




Bernstein, April 15, 2020

As inventories begin to fall and eventually reach normal levels in the first half of 2021 oil will no longer need to remain low enough to force shut-ins meaning it can gradually rally to a point that encourages either cheating by OPEC++ members ($40?) or increased activity by US shale companies ($50+). A report from BMO a few days ago echoed this view:

> **From famine to feast.** As the coronavirus wanes and economies return to normal, non-OPEC supply will continue to decline due to the sharp drop in capital spending in 2020. We expect non-OPEC production to decline by 2.1 million b/d in 2020 and grow by only one million b/d as shut-in production comes back online. In some cases, production that is shut-in may not return. We also expect that many companies will want to shore up balance sheets in 2021, which means generally lower levels of capital spending. The combination of restrained OPEC production coupled with declining non-OPEC production could create the conditions for a much tighter oil market in 2021. This could lead to record draws on inventory as well as allowing OPEC to completely unwind its production cuts. We expect crude oil prices to trade in a $40-$60/bbl range in 2021, with a bias to the upside.

Source: BMO, April 15, 2020

We remain confident that the oil market is entering into a multi-year bull market given the dynamics of multi-decade demand growth, mortally wounded US shale growth potential, eventual exhaustion of OPEC spare capacity, and a multi-year period of global offshore declines. This view has remained constant for 2 years yet has been deferred by a US/China trade war in 2019 and an unforeseen global pandemic in 2020. <u>Make no mistake, the world will face an oil supply crisis in the years to come...the age of supply abundance is over.</u>

## Fund positioning

We remain 100% concentrated in Canadian oil and gas producers with a bias towards midcaps. Canada benefits from increasing pipeline takeaway capacity (Line 3, TMX, Keystone, 2019/20 optimizations), revenue denominated in USD yet operating costs in CAD, lower relative decline rates (which means they need to spend less maintaining production allowing for more free cashflow), and production of heavier grades of oil which will remain the product of choice for global refiners versus the light/ultra light US shale oil. Valuations are incredibly compelling with many names down 70%-80% year-to-date given the COVID-19 induced oil price crash. In 2016 our Fund rallied by ~143% from the point of maximum pessimism to year-end. Today, the opportunity set is meaningfully better given the velocity and extent of the stock collapses YTD and we own many Fund holdings in which we see multi-bagger potential. To weather the current storm we favour companies with hedge books to help immunize from catastrophic balance sheet damage as well as those with adequate liquidity with the absence of looming debt maturities. We have also increased our natural gas (plus condensate) exposure to about 40% as less oil drilling means less associated gas production...a major plague to natural gas pricing over the years. With the potential for $3/mcf AECO prices in 2021 the upside in some select natural gas names compares favourably to oil names with a $50-$60WTI price expectation.

The end to the oil bloodbath is in sight. While short-term dynamics will lead to weak oil pricing over the next few months the medium (Q3 onward) and long term outlook for oil is extremely strong. At some point energy stocks will begin to diverge from weak short-term pricing as the market starts to look beyond COVID-19 to a significantly tighter market. Progress on antivirals/vaccines and signs of easing stay-at-home orders will be key to arriving at this inflection point. As with the many challenges that have come up over the past few years for energy investors, this too shall pass.

Eric Nuttall
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**Ninepoint Partners**

## NINEPOINT ENERGY FUND - COMPOUNDED RETURNS[1]
AS OF MARCH 31, 2020 (SERIES F NPP008)

| | 1M | YTD | 3M | 6M | 1YR | 3YR | 5YR | 10YR | 15YR | INCEPTION |
|---|---|---|---|---|---|---|---|---|---|---|
| Fund | -63.5% | -74.7% | -74.7% | -71.0% | -71.9% | -46.9% | -32.6% | -17.0% | -11.0% | -7.4% |
| Index | -46.8% | -58.0% | -58.0% | -54.6% | -58.9% | -30.7% | -20.2% | -11.9% | -6.0% | -3.7% |

[1] All returns and fund details are a) based on Series F units; b) net of fees; c) annualized if period is greater than one year; d) as at March 31, 2020; e) 2004 annual returns are from 04/15/04 to 12/31/04. The index is 100% S&P/TSX Capped Energy TRI and is computed by Ninepoint Partners LP based on publicly available index information.

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