Ninepoint Energy Fund Market View

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Investment Team

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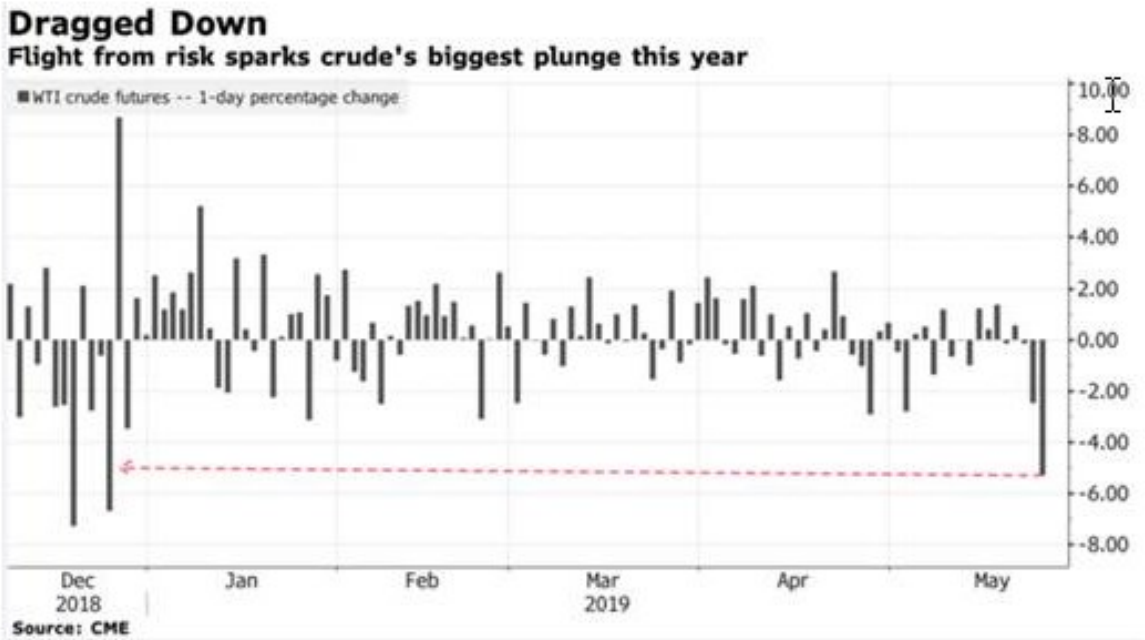
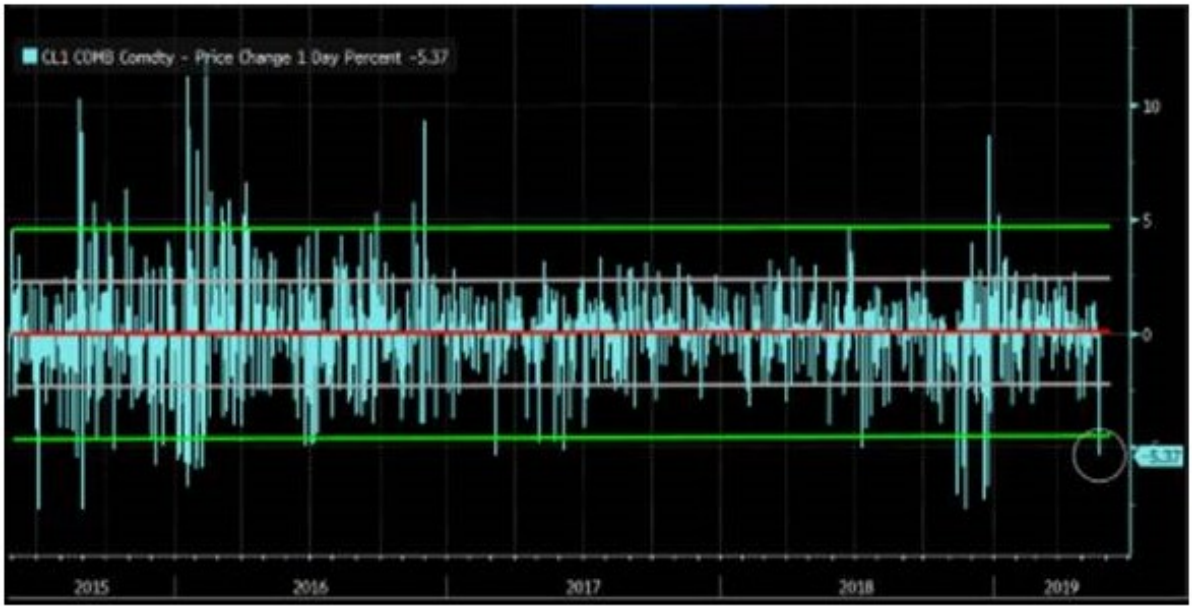
Oil is falling by 6% on overnight increases in trade tensions between the US and China and on yesterday's crude build (crude has built in 4 of the past 5 weeks). Today's move reminds us of the technical selloff in November/December 2018 when the net spec length in oil fell by the greatest extent in history that led to several daily moves in the oil price that were well beyond historical norms:



Source: CME



Source: Bloomberg

It is clear that today's sell off is quant/algo driven…as soon as oil broke below the 200 day moving average it almost immediately fell to the 100 day moving average. What fundamentally happened for the largest commodity in the world to drop by 4.2% in value just because on a stock chart it breached its 200 day moving average?

Source: Bloomberg

Given today's (and the past month's) sell off we think it is critical to separate the short term noise from the medium term (July) outlook. It is ironic to us that while some respected consultants that we use as recently as last week described the physical oil market as "one of the tightest physical markets since at least 2011" oil has sold off today by the most in 5 months. What gives? Driving the recent surge in negativity are 2 dynamics:

1. Trump's blacklisting of Huawei meaningfully reduced the prospect of a near-term trade deal thereby decreasing the outlook for global GDP by an estimated 0.4% and this is turn is leading to worries of oil demand growth collapsing
2. US crude builds above seasonal norms in recent weeks and the (wrong) implication of weak demand

While difficult to positively spin #1 we can speak to how the US crude builds are distorting the market's view of underlying tightness. Recent US crude builds have been driven not by weak end product demand (gasoline inventories are below the 5 year average) but rather by unplanned refinery outages (0.4-0.5MM Bbl/d...tough to process crude oil into end products when you cannot run your refinery due to a fire and hence the builds in inventories until repair work is completed), short term noise around shipping interruptions in the Houston Channel due to oil spills and fog, and simply bad data (the "adjustment" factor...essentially an accounting plug needed to balance the DOE estimates is off the charts recently accounting for 872,000Bbl/d of unaccounted for oil). Given that US oil production remains constrained by E&P's toeing the line on underspending cashflow and returning capital to shareholders we believe that US crude stocks will begin to draw in the coming weeks and this will meaningfully improve sentiment.

Why are we bullish on WTI for the remainder of the year? We believe that as global refiners come back online (7MM Bbl/d of capacity that will be back online in the next month) that global (and hence US) inventories are about to begin to draw **MEANINGFULLY**. Why meaningfully?

1. OPEC compliance has been excellent with OPEC ex Iran+Venezuela production down 1.1MM Bbl/d since December 2018
2. Iranian exports have fallen to 0.4MM Bbl/d in May from 1.2MM Bbl/d in April on account of US sanctions (India, Iran's second largest customer, announced today that they have stopped importing all Iranian oil)
3. Venezuela has fallen from 1.2MM Bbl/d in Q4'18 to 0.8MM Bbl/d in April and is now in a stalemate between Guaido and Maduro lessening the likelihood of a near-term improvement

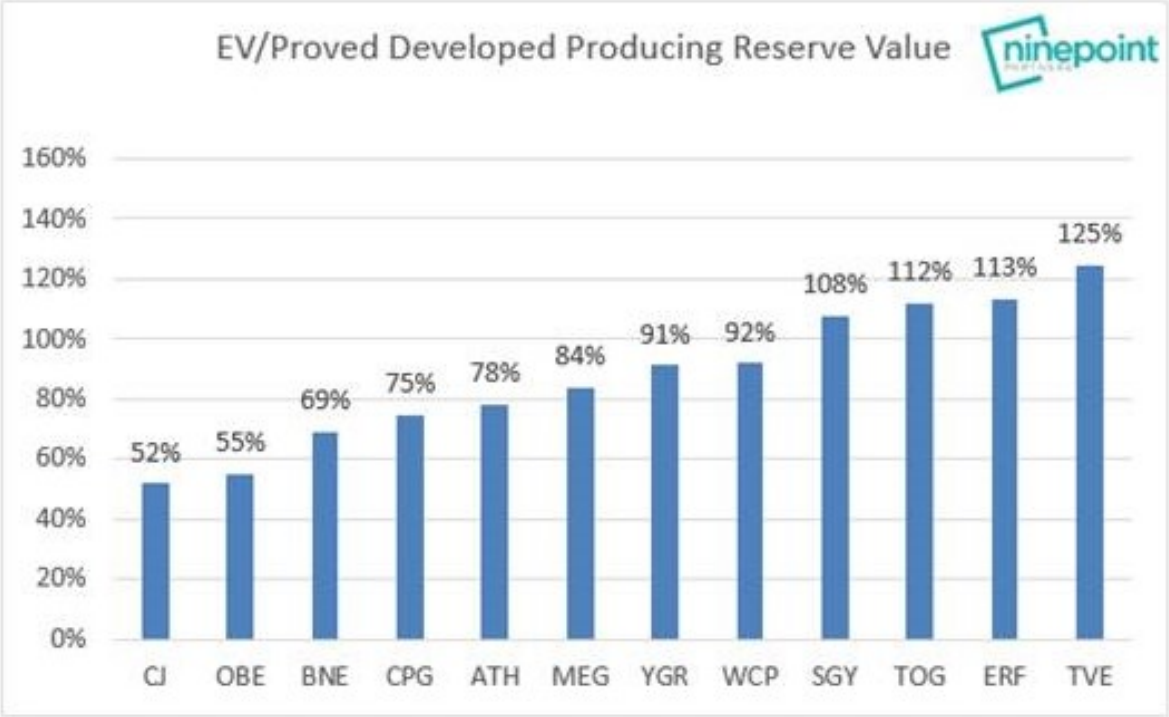
That amounts to a reduction of 2.3MM Bbl/d of supply. Even with a moderation in demand forecasts and US production growth the oil market is on the precipice of highly meaningful inventory draws. We estimate draws of 1.2MM Bbl/d in the coming months and other like Morgan Stanley are calling for Q2/Q3 draws of 0.6/1.1MM Bbl/d and Energy Aspects is calling for Q2/Q3 draws of 1MM/2MM Bbl/d. This would be one of the fastest drawdowns of inventory in history.

Why else are we bullish?

1. The Niger Delta Republic Fighters have ordered foreign oil companies to vacate by May 29th lest they begin bombing onshore/offshore infrastructure threatening some of Nigeria's 1.9MM Bbl/d of production

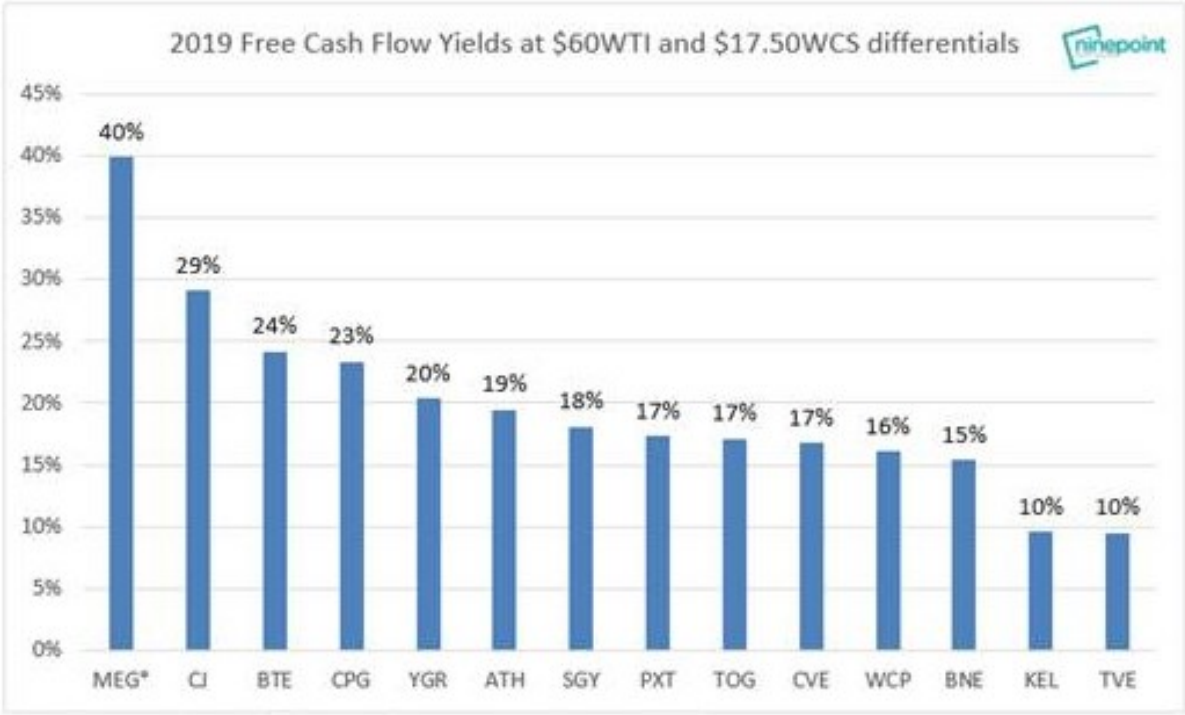
2. Libya remains volatile despite production at near-multi year highs as Haftar advances on the Capital
3. Saudi Arabia still needs over $70/Brent to remain solvent
4. Iran/Saudi tensions are increasing as Iranian-backed Houthis (allegedly) have been hitting Saudi infrastructure with advanced bomb-laden drones
5. US producers remain "disciplined" and are increasing share buybacks and dividends rather than growth capital

The buyer's strike in the energy markets have created the cheapest valuations in my career. Companies are trading at fractions of their liquidation value and at 20%+ free cash flow yields:



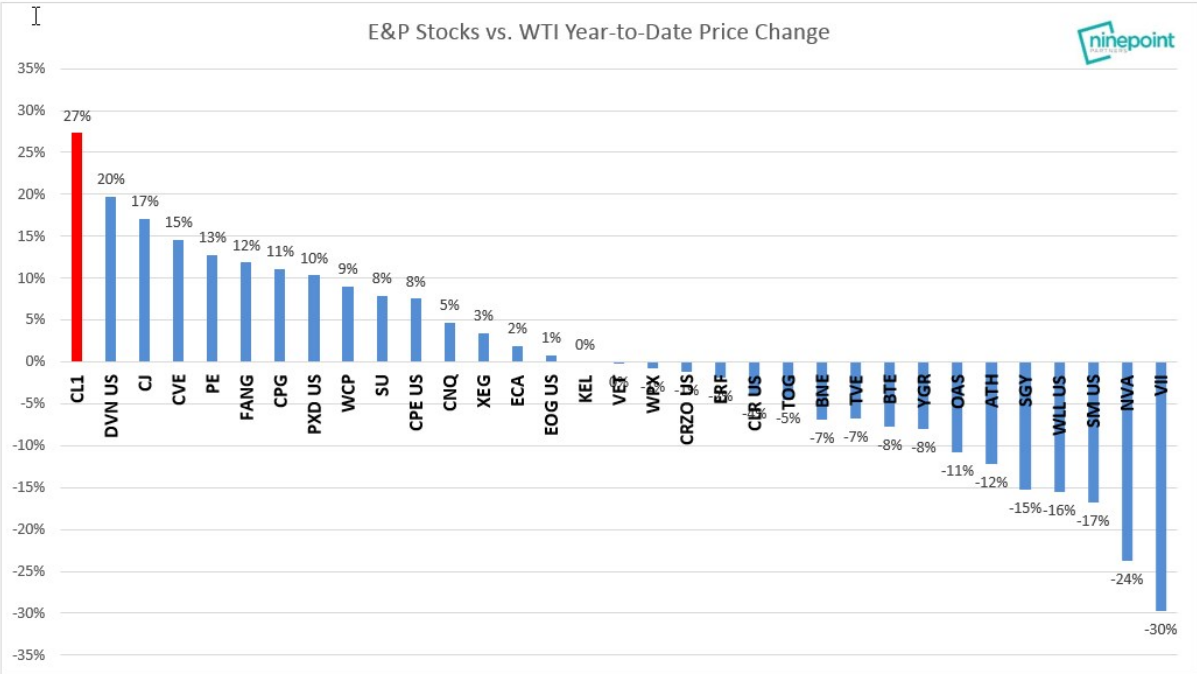
Excludes value for land and seismic

Source: Company Reports, Ninepoint Partners



Free cash flow = operating cash flow (pre-hedging) minus capex required to keep production flat
*MEG FCF yield is for 2020 and assumes Christina Lake Phase2B expansion

Source: Bloomberg, Ninepoint Partners



Source: Bloomberg

While we have had this same conversation too many times over the past year valuations have finally fallen to the point where corporates MUST begin to become buyers of their own stock given the above disconnect (we have had modest but growing success on this front). As well, it is inevitable that either PE or better valued larger entities begin to acquire smaller companies given literally billions of free dollars up for grabs. There are many cases today where a company using

their existing free cash flow stream at $60/bbl could buy back all of their outstanding shares before having to drill any further wells.

Days like today are truly awful and do great damage to investor psychology further alienating the sector due to heightened volatility. In exchange for this level of risk, stocks trade as if they are in a sunset industry (more on this in our next commentary once the fog of war, i.e. the pending birth of my third child wears off). Where else can you literally buy a company whose current trading value is a fraction of their existing cashflow stream?

For energy stocks to work we need:

1. crude volatility to lessen
2. corporates to demonstrate the viability of their business models and strength of their free cash flow through meaningful share buybacks
3. potential M&A such as Oxy/Chevron fighting over Anadarko.

In the mean time companies are harvesting free cash flow and either paying down already strong balance sheets or gearing up for share repurchases.

Eric

NINEPOINT ENERGY FUND - COMPOUNDED RETURNS[1]

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	15YR	INCEPTION
Fund	8.9%	16.4%	9.0%	-11.8%	-29.6%	-16.6%	-15.7%	0.4%	0.9%	0.9%
Index	5.3%	18.1%	9.4%	-1.3%	-16.6%	-2.4%	-10.1%	-0.9%	2.6%	2.3%

[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 April 30, 2019; 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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