Hello,

Investors familiar with our periodic Market Updates know that we have been consistently bullish on oil and gas stocks for a long time. In this Update, we take a closer look at oil and gas, and at what investors can do to gain exposure to the sector.

Since the beginning of the year, WTI crude oil is up 53%, while the energy index is up just over 18% including dividends. In light of recent market volatility, such as the TSX Energy Index **breaking below** its **near-term uptrend line** set from its bottom of February 4 (see chart below), should investors begin to accumulate positions in oil and gas stocks?

Source: www.globeinvestor.com

Oil: Less Of It Around Every Day

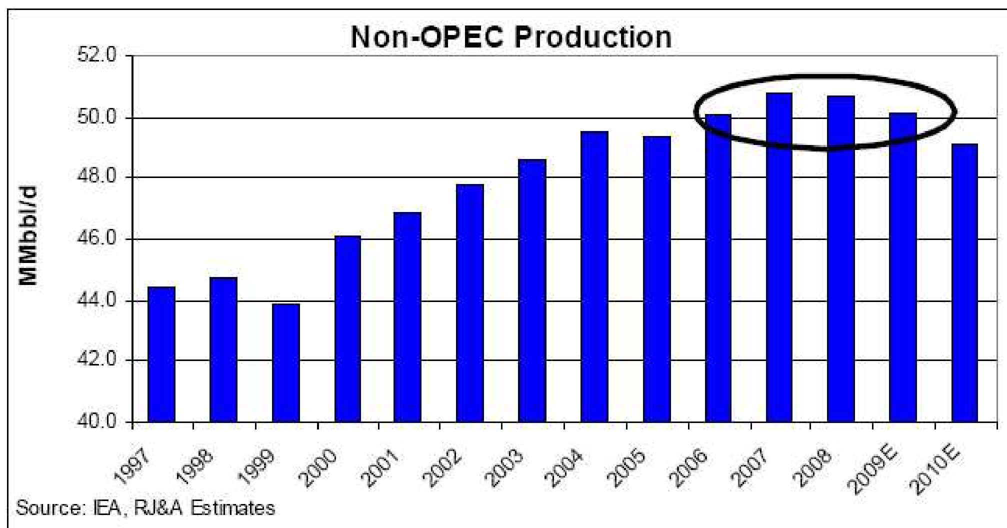
Current oil demand of about 83 million barrels per day translates into nearly 1,000 barrels per second of consumption. Production capacity is not much higher than demand, and the world's "spare capacity" (ability to increase production in the case of a supply disruption) is at a record low. Saudi Arabia is the only country that can immediately increase production to meet a short-term demand increase or mitigate a supply disruption. However, it is worth noting that Saudi oil is heavy and high in sulphur, requiring more refining capacity to transform it into usable form.

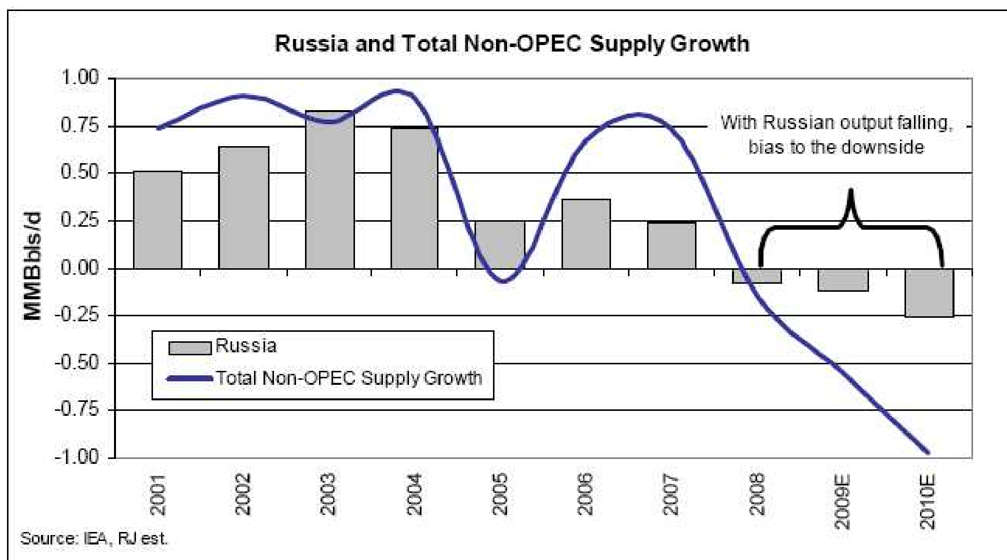
Many investors are familiar with the concept of "peak oil" and can intuitively understand that since oil is a non-renewable resource, it stands to reason that supply will continue to diminish. In the meantime, as developing countries such as China and India industrialize, demand will increase. We will not attempt to debate what this means for the future of energy (such as whether other technologies will adequately replace oil

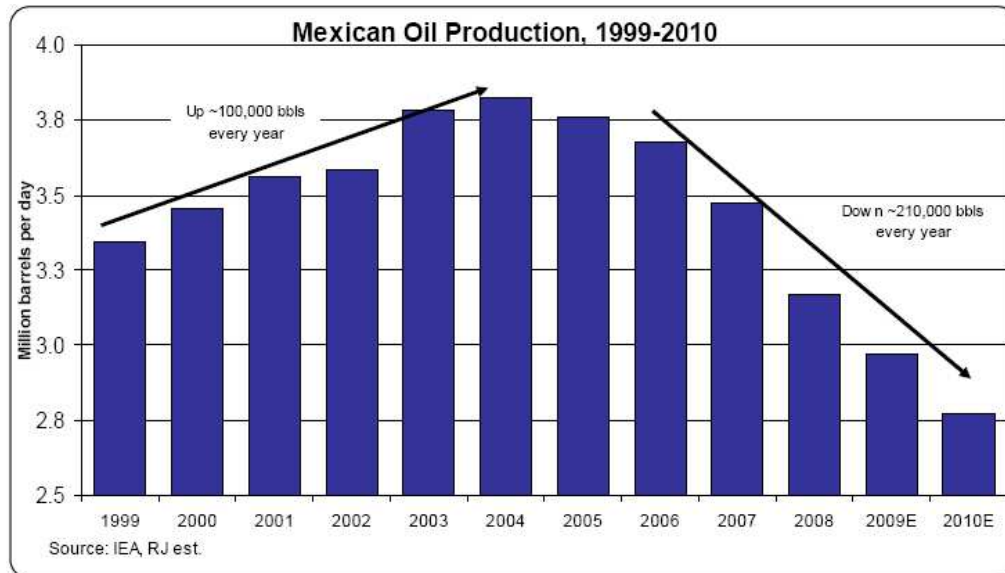
and/or reduce demand) or whether "peak oil" is a fact of life or an alarmist non-event, but instead will focus on what we know about current production.

Oil Supply: Low-Hanging Fruit Has Been Picked

Oil companies around the world continue to push into geologically and politically risky areas to maintain and grow reserves, a sign that economically recoverable reserves are getting harder and harder to find. OPEC supplies about 40% of the world's oil, but more importantly, is the only oil-producing bloc that can increase supply if necessary. OPEC has for the first time in recent history actually stuck to its recent production quotas (likely due to the increased difficulty of boosting supply). Non-OPEC producers always supply as much as they can no matter what prices are doing, and their supply peaked in 2007 and has been declining ever since. Russia and Mexico, two of the most important non-OPEC producers, have seen their production drop significantly.

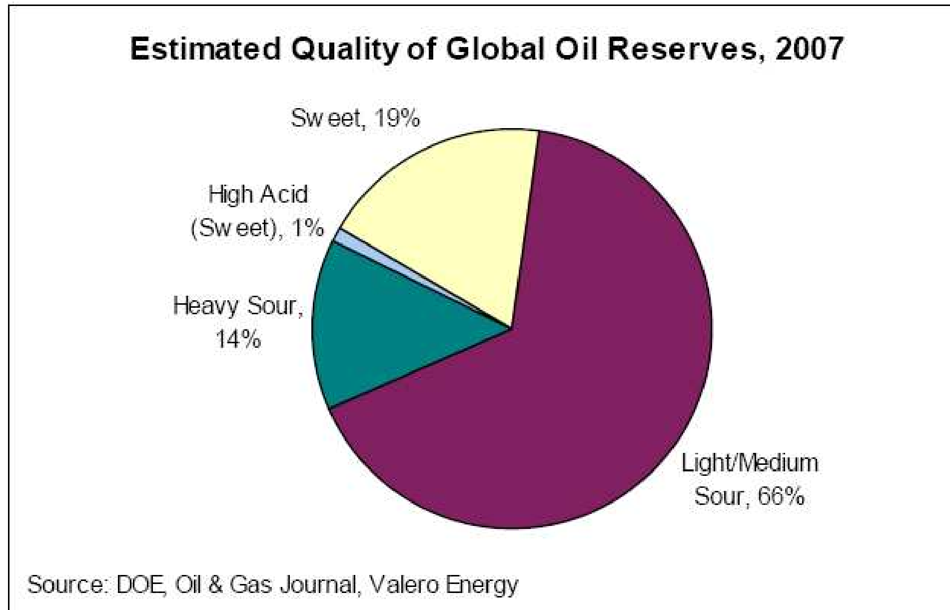






Mexico provides 4% of the world's oil, or about 7% of non-OPEC production. The country's Cantarell oil field, one of the world's largest, provides a good example of what is taking place in non-OPEC production. This oil field used to provide two-thirds of Mexico's total production but is declining so rapidly that in 2012 it is expected to only produce just over one-eighth of Mexico's production. One of the main reasons for Mexico's production decline is that its oil industry is nationalized and run by Pemex, the state oil company, which provides 40% of the government's tax revenue. Unfortunately, state ownership is not conducive to proper investment in the latest technology to extract the resource from its fields in the most efficient manner, so Mexico's production began to decline in 2005. The situation is similar in Russia, where corruption and nationalization fears have kept foreign investors at bay.

So any increase in oil supply will have to be provided by OPEC suppliers, led by Saudi Arabia. But since its crude is heavy and "sour" (high in sulphur), it needs more refining to be useful. We found the following chart to be of interest, as it implies that refiners could be one way to gain exposure to greater demand for "sweet" (more usable) oil.



One consequence of the credit crunch has been that many oil and gas companies around the world have not been able to finance reinvestment into growing their reserves. While the economic crisis has temporarily depressed demand, we believe that the recent lack of investment will result in reduced supply availability in a few years.

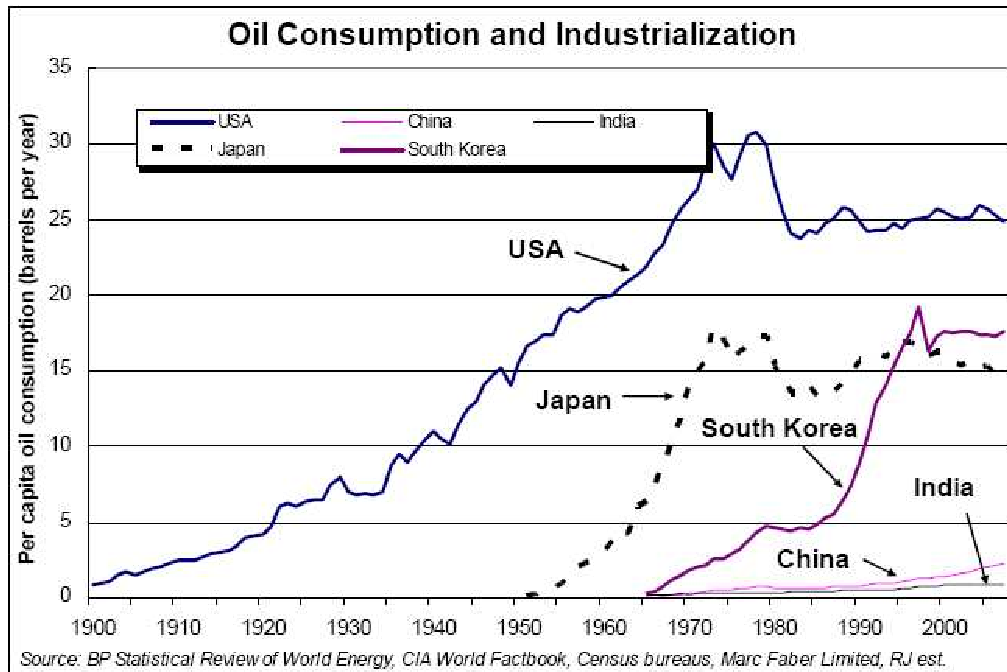
Finally, we note that two-thirds of world oil reserves are actually state-controlled, only leaving one-third of reserves controlled by companies that investors can actually buy shares in (there are some publicly traded state-owned oil companies, but investors in these will always own a minority stake):

Who Controls the World's Oil?			
Company	**Based in**	**Publicly Traded?**	**Est. % of World Oil Reserves**
State-owned/controlled			
Saudi Aramco	Saudi Arabia	No	20.3%
NIOC	Iran	No	10.2%
INOC	Iraq	No	8.9%
KPC	Kuwait	No	6.9%
PdVSA	Venezuela	No	6.0%
ADNOC	UAE	No	4.1%
Libya NOC	Libya	No	2.2%
NNPC	Nigeria	No	1.6%
Rosneft	Russia	Yes	1.3%
Pemex	Mexico	No	1.1%
PetroChina	China	Yes	0.9%
Petrobras	Brazil	Yes	0.8%
Sonatrach	Algeria	No	0.8%
QP	Qatar	No	0.8%
Gazprom	Russia	Yes	0.6%
StatoilHydro	Norway	Yes	0.2%
Subtotal			**66.7%**
Not state-owned/controlled			
Lukoil	Russia	Yes	1.2%
BP	UK	Yes	0.8%
ExxonMobil	U.S.	Yes	0.8%
Chevron	U.S.	Yes	0.5%
ConocoPhillips	U.S.	Yes	0.4%
Total	France	Yes	0.4%
Royal Dutch Shell	Netherlands	Yes	0.3%
Subtotal			**4.4%**

Source: Reuters, EIA, company reports

Oil Demand: Not Going Away Any Time Soon

The chart below is well-known to oil and gas investors with a long-term view on oil demand. It implies that China and India have a long way to go to increase their per capita oil demand as they industrialize. Due to supply and environmental constraints it is unlikely they will reach industrialized nation consumption levels, but the demand trend direction is nevertheless visible.



The Chinese state oil company and sovereign funds have been taking advantage of the economic downturn to pick up conventional oil and gas assets at good prices. They are very tolerant of political risk and are willing to invest in places like Africa and gain the favour of the locals by building infrastructure such as roads and hospitals. Sinopec's recent purchase of Addax Petroleum is a good example of a Chinese acquisition. China takes the security of its energy sources very seriously and is trying to diversify away from Middle Eastern oil suppliers.

Oil and gas has always been a core component of our Balanced Portfolio, and earlier this year we doubled the weighting to 4%. If prices pull back in the short-term, we will definitely consider increasing this weighting. For investors looking for company-specific exposure to the production or refining sectors, we suggest the majors such as ExxonMobil and Valero Energy are worth a look, as they have been beaten up in the general market downdraft and pay you to wait with dividends (that have been growing).

We have some excellent research reports available on the global oil and gas sector, as well as company-specific reports on all the majors and independent producers not to mention sub-sectors such as oil and gas royalty trusts or oil field services. If you would like more information on these or on energy investing in general, feel free to contact us by phone or email.

All the best,

Andrew Johns