PALOS

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Weekly Commentary

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By Charles Marleau CIM® and William Mitchell CIM®

Oil Demand is Recovering - Supply isn't

Last week we discussed how global energy prices have been on an upward trajectory since hitting bottom in the spring of 2020. By no coincidence the April 2020 lows in crude oil, natural gas, and gasoline coincided with plummeting demand attributed to Covid.

In North America, futures contracts on crude oil, natural gas, heating oil, gasoline and propane are traded on the New York Mercantile Exchange (NYMEX). Crude oil, as measured by the NYMEX West Texas Intermediate (WTI) futures contract, traded above USD$95/barrel on February 14 surpassing a level not seen since the summer of 2014. Similarly, natural gas prices as measured by NYMEX Henry Hub Natural Gas, spiked above the USD$7 level in January, reaching its highest level since 2008. NYMEX gasoline futures have also returned to 2014 levels: the recovery in prices has been dramatic.

Canada produces an average of 5.2 million barrels of oil per day, or 6 percent of the global supply. This ranks Canada fourth behind the U.S., Saudi Arabia and Russia. In terms of consumption, Canada ranks ninth, consuming an estimated 2.5 million barrels per day (Source: U.S. Energy Information Administration, EIA). With regards to natural gas, Canada ranks sixth with approximately 71% of total production coming from Alberta and 27% from B.C. Virtually 100% of exports are sold into the U.S. market and are transported by pipeline.

The oil and gas industry in Canada continues to face many challenges. Capital expenditures in exploration and development have been in decline as societal pressures to transition away from fossil fuels mount. In addition, uncertainty surrounding long-term demand and a lack of clarity on future carbon policies are hampering capital commitments to resource development. Meanwhile, growth in global demand for fossil fuels is expected to outpace supply well into this century. This presents a conundrum: the demand for petroleum-based energy will continue to rise while at the same time, supply is projected to fall. The economic consequence will be higher prices for consumers.

We do not pretend to be experts on climate change; however, we believe we have enough experience and common sense to recognize that the notion of decarbonizing the planet by destroying the fossil fuel industry is a nonstarter. China relies on coal-fired power generation for approximately 60% of its energy needs. India, *By Charles Marleau CIM® and William Mitchell CIM®*

which is the world's second most populous country behind China, uses 70%. Coal consumption appeared to have peaked in 2018, yet coal-fired power generation apparently reached an all-time high in 2021. Prices for natural gas, also used for power generation but considered a "cleaner transition fuel", skyrocketed in 2021. Combined with an insufficient supply of renewable alternatives and growing post-pandemic industrial output, demand for all fossil fuels is expected to grow.

At best, the transition to clean energy will take decades. In the meantime, growing global demand for energy will necessitate the consumption of fossil fuels. As Canadians, we should consider ourselves fortunate to possess massive reserves of oil and gas and we should be grateful for the associated economic benefits we derive from this. Detractors may argue that the fossil fuel industry must be banned completely to save the planet. Objectively, we conclude that any expectations for near-term demise of fossil fuels are simply misguided and irrational. The prospects of convincing governments around the globe to take urgent measures to decarbonize will require unprecedented cooperation and economic burden. This is a particularly sensitive issue for nations like Russia, Saudi Arabia, China, India, and Iraq that benefit economically from fossil fuels. The likelihood of a concerted, rapid transition away from fossil fuel dependency is extremely small.

The energy sector is vitally important to Canada as it is a key contributor to national GDP. The confluence of energy transition, supply constraints, capital prudence, carbon reduction policy and most recently geopolitics, are contributing to a "new energy reality". Fortunately for Canadians, companies operating in our oil and gas industry have been busy elevating commitments to environmental sustainability, social responsibility, and progressive corporate governance (ESG). In our view, many Canadian energy companies are better positioned than ever to thrive. In coming editions we'll be taking a closer look at some of the companies we currently hold in our Palos Funds.

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$9.79	-0.44%
Palos Equity Income Fund - RRSP	PAL101	$7.20	-0.58%
Palos Merchant Fund L.P. (Dec 31, 2021) [2]	PAL500	$1.16	24.67%
Palos WP Growth Fund - RRSP	PAL213	$17.46	-7.89%
Palos-Mitchell Alpha Fund [3]	PAL300	$10.55	2.63%
S&P TSX Composite (Total Return with dividends reinvested)			-0.75%
S&P 500 (Total Return with dividends reinvested)			-8.57%
S&P TSX Venture (Total Return with dividends reinvested)			-9.26%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			1.93%
Canadian Government 10-Year			1.88%
Crude Oil Spot			US $91.07
Gold Spot			US $1,898.60
US Gov't10-Year/Moody BAA Corp. Spread			213 bps
USD/CAD Exchange Rate Spot			US $0.7842

[1] *Period ending February 18th, 2022. Data extracted from Bloomberg*
[2] *Fund is priced annually*
[3] *Fund is priced weekly on Tuesdays*

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