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Weekly Commentary

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By Charles Marleau CIM® and William Mitchell CIM®

Making Sense of Oil Prices

The Organization of the Petroleum Exporting Countries (OPEC) was established in 1960 and included original member nations Iran, Iraq, Kuwait, Saudi Arabia and Venezuela. OPEC's primary objectives are to "ensure stabilization of oil markets in order to secure an efficient, economic and regular supply of petroleum to consumers, a steady income to producers and a fair return on capital for those investing in the petroleum industry" according to their website. OPEC+, which expanded OPEC's membership to include 13 non-core nations, includes Russia which alone can produce over 10 million barrels per day making it the largest non-core nation in terms of reserves and capacity.

On Sunday, the 23 members of OPEC+ met in Vienna to decide on future production levels. The cartel, which accounts for 40% to 50% of global production, is led by Saudi oil minister Prince Abdulaziz bin Salman. Reports out of Vienna suggest that negotiations were contentious given frustrations from some nations like the U.A.E. that would like to increase production levels. Further, skepticism over the accuracy of production numbers from Russia has some believing that Russia may be overproducing and selling at discounted prices thus "defeating the purpose". Despite no formal announcement that previously planned oil production levels would remain unchanged, Saudi Arabia unilaterally declared a voluntary cut of 1 million barrels per day would commence in July.

The new production cuts fall on the heels of several previously announced cuts including a two million barrels per day cut in October, a voluntary cut of 500,000 barrels from Moscow in February and a 1.16 million Saudi led cut in April. The rationale behind the cuts is OPEC's concern about diminishing demand resulting in lower prices during a potential economic slowdown. While the intent was to bolster prices, the strategy has clearly not worked. Following OPEC's October announcement, President Biden countered with his own announcement that the U.S. SPR (Strategic Petroleum Reserve) would be used to ease prices for American consumers. International Brent crude futures have fallen by over 25% between October and last week and U.S. benchmark WTI (West Texas Intermediate) has witnessed a similar decline.

Shares of oil producers have felt the pricing impact. Through Friday, the U.S. based ***iShares Oil & Gas Exploration ETF (IEO:NYSE)*** has declined by 20.6% since a mid-November high point while in Canada the ***iShares S&P/TSX Capped Energy Index (XEG:TSX)*** is lower by 15.5% since early November. In a recent podcast with Goldman Sachs, commodities analyst Jeff Currie reiterated his bullish stance on oil despite the recent weakness. Currie floated the theory that both physical and financial based oil inventories are seeing a significant "unwind" through what he calls "the great destocking" for a variety of reasons including significantly higher carry costs related to rapidly rising interest rates, fears of a recession and "risk-off" investor sentiment.

By Charles Marleau CIM® and William Mitchell CIM®

Mr. Currie contends that oil demand, according to data provided by the International Energy Agency (IEA), remains robust despite the “apparent” economic headwinds. In fact, demand for crude has actually “increased every month since October” according to Currie, citing data from the IEA. In addition, Currie believes that oil prices in commodities markets are currently being depressed by short sellers who have “discounted” prices by $10 to $15 per barrel. Currie believes the upside going into the summer driving season is substantial and his forecast is for oil to trade around $97 per barrel by year-end and over $100 by next April. While Currie admits that a recession would be a headwind, he adds that much of the “recession likelihood” has already been priced in. Destocking has been going on for the past twelve months and Currie stressed that this simply cannot continue. In addition, we cannot underappreciate the resolve that Saudi Arabia is demonstrating as higher prices are a necessity for funding their many mega-projects and demand from China is showing signs of improving. Eventually, the tide will turn, and Currie believes this is imminent.

North of the border, fundamentals remain intact as most Canada’s producers prioritize debt reduction and returning cash to shareholders. In our ongoing conversations with management teams, we’re seeing laser focused discipline which is fostering balance sheet health and cash generation. What we find encouraging is that cash generation remains robust even at current prices. Should Currie be correct, and prices begin to move upwards, the recent fortunes of Canadian producers will be even more promising.

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$8.38	4.05%
Palos Equity Income Fund - RRSP	PAL101	$6.70	3.31%
Palos WP Growth Fund - RRSP	PAL213	$11.63	-6.67%
Palos-Mitchell Alpha Fund [3]	PAL300	$9.30	14.85%
S&P TSX Composite (Total Return with dividends reinvested)			4.68%
S&P 500 (Total Return with dividends reinvested)			12.35%
S&P TSX Venture (Total Return with dividends reinvested)			6.87%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			3.69%
Canadian Government 10-Year			3.23%
Crude Oil Spot			US $71.74
Gold Spot			US $1,952.40
US Gov't10-Year/Moody BAA Corp. Spread			217 bps
USD/CAD Exchange Rate Spot			US $0.7449

[1] *Period ending June 2nd, 2023. Data extracted from Bloomberg*

[2] *Fund is priced annually*

[3] *Fund is priced weekly on Tuesdays*

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