The Oil Question

Working in investments means you are never at a loss for a conversation at a party, in a taxi, on a plane, or in fact in any other social scene. Your vocation is of more than a passing interest to others; professionals are solicited for their hot stock tips, or asked about interest rates, where the Canadian dollar is headed, and of late what is happening to the price of oil. All of those questions are front and centre today, but funnily enough are not actually different questions; they are one and the same, inextricably linked. What is happening with the price of oil?

And of course, a significant part of that story revolves around what has happened. The good news is that in June of 2015, the price has largely stabilized near $60US per barrel, which is a forty percent gain from the low of $42.25 in mid-March. The bad news is that just one year ago, a barrel fetched over $105US, and the worse news is the knock-on impact throughout the Canadian economy.

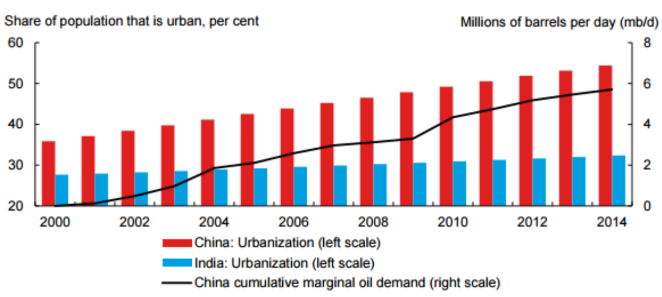
Natural Resources Canada's count of direct employment in the oil and gas industry was 190,170 for the 2013 calendar year, with another 170,650 jobs indirectly involved in ongoing construction of oil and gas projects. This direct and indirect employment represented two percent of the Canadian work force, but of course the knock-on employment impact is substantial. The energy industry provides jobs from the well-head to downtown law firms and investment banks, construction and maintenance jobs, and all the way on down to burger flippers in boom towns. On the employment side alone, oil and gas is critically important, but it hardly stops there. Estimates of capital expenditures in the energy industry for 2013 topped one-hundred billion dollars, a staggering 27% of all total private and public investments for the year in Canada. Both capital expenditure and dividend policies, easily sustainable at much higher oil prices, suffer when oil prices fall.

And there lies the question of interest rates. On January 13th, with oil trading near $45, Deputy Bank of Canada Governor Timothy Lane delivered this as part of a speech in Madison, Wisconsin. *"The recent movements in oil prices have been dramatic, but they are not random. Once we sort through the different economic forces at play, we see that underlying the recent drop in oil prices is a surge in unconventional oil supply against the backdrop of slower growth of global demand. Over time, higher-cost oil is still likely to be needed to satisfy growing global demand, but prices could go lower, or remain low, for a significant period before those medium-term forces do their work. These developments are among the most important that the Bank of Canada takes into account in making monetary policy."* The Bank of Canada saw fit to react to the price of oil in January, moving their overnight lending rate lower; their rationale was clearly articulated in the second sentence of their press release. "The Bank of Canada today announced that it is lowering its target for the overnight rate by one-quarter of one percentage point to 3/4 per cent. This decision is in response to the recent sharp drop in oil prices, which will be negative for growth and underlying inflation in Canada." The most recent inflation and GDP data suggest that the Canadian economy contracted in the first quarter, by one-tenth of one percent, and with capital expenditures being delayed or cancelled, the prospects for Canada to enter recession – which is heuristically defined by two quarters of negative economic growth – is entirely possible. This recession, if it arrives, will be technical at best; manufacturing, banking, and other industries continue to grow and can even profit from lower oil pricing. The Bank of Canada stands poised and ready to reduce rates again; as goes oil, so too will go interest rates in Canada. With interest rates on the floor, and the potential for at least this technical recession, foreign investors could hardly be blamed for taking the attitude of 'sell Canada'. This is reflected in the general weakness in the Canadian dollar, which has fallen 13.72 cents versus its American counterpart; selling pressure on the SPTSX Canadian index saw it decline nearly four percent from June 30th 2014 to June 30th 2015. While Canadians recognize that we are not strictly a petro-economy with a petro-dollar, the perception outside our borders has become the truth inside them.

Oil and gas are important to the Canadian economy; this should come as no surprise to anyone. Of course this now begs the question – if interest rates, economic growth, and the dollar are all highly linked to the price of oil, what next for oil pricing?

First, we need to dismiss anyone who states with certainly that the price of oil will be X on any particular day; the number of economists and bank analysts who a year ago projected oil trading in the sixty dollar range today is a handful at most, and most likely zero. To say that oil must trade for ninety dollars at some time in the future because it used to trade for ninety dollars is a facile argument and easily deconstructed. To be an oil producer, and to be a nation heavily invested in oil production, is to be a price-taker. Oil will be found, drilled for, shipped to market, and sold for whatever the prevailing market price is; other than storing it and hoping for higher prices tomorrow, there are no outs available other than taking the price that someone is prepared to pay. Which makes the question not what is next for oil pricing, but which factors can impact pricing?

The OPEC cartel plays heavily into how much oil is available on the open market, though that bloc represents forty percent of the oil production globally, down from just over fifty percent in the 1990's. Production caps have historically been their most useful policy tool to push the price of oil higher, and traditionally each nation in OPEC has cheated here and there for their own interests. Production has not slowed significantly as the price of oil has dropped, which is an atypical reaction from OPEC; in no small part their goal is to keep oil pricing below the cost of production in the oil-sands and shale-fields, effectively driving the competition under – or at least away for now. As for how long these nations are prepared to take the economic hit, this remains a great unknown. Production will come back on-line when break-even costs can be achieved, a huge number of wells, tar-sands, and shale deposits sit idle today, awaiting higher pricing; increased production is negative for oil pricing broadly. Alternative energy sources also hang over the potential recovery in oil pricing. The costs of solar and other alternatives continue to fall, the technology improves daily. The developed World continues to move towards both reduced use and greener sources of energy. There are certainly headwinds to oil pricing recovering quickly and even fully.



But there are reasons for optimism as well. Chiefly, there are more people on this planet today than there were yesterday, and those who were here yesterday are pursuing the luxuries of the First World. Cars, plastics, reliable power grids, these are all things that are simply taken for granted in the developed economies; all require oil or its byproducts. For perspective, the urban population of China has grown by three-hundred million since the turn of the century, but still only fifty-five percent of their population now live in major centres. The trend in the developing economies is toward urbanizing, and toward increased use of oil. And while Canadian deposits, in particular in the oil-sands, tend to be higher on the continuum than in many OPEC nations, innovation, capital expenditures already in place in the form of pipes and roads, new technologies, and our stable democracy make our resources more and more attractive.

The questions of what is happening to the Canadian dollar and our interest rate policies can be answered in part by viewing the impact of oil on our economy. Energy represents a huge volume of our trade, and higher oil prices help create jobs, tax revenues, and spur growth. The future path of the price of oil cannot be known; it will trade higher sometimes, and sometimes lower. As a price-taker, Canada will likely see more volatility in our markets and currency than might be comfortable. The good news is that the long-term trend is likely higher, though precisely when cannot be stated with crystal clarity. The price of oil today feels low, and considering only the shorter term it is, but it has been much lower than the price today for much longer than this particular trough.

The news is certainly not all bad, consumers are getting a break at the gas pump, and it costs less to run a household with lower energy prices. Manufacturing in Eastern Canada can rebound and flourish when the Canadian dollar is lower. The energy sector is certainly important to Canada, and has been very much in the news as pricing has fallen. Does the perception match the reality? Canada remains open for business, and but for one sector continues to tick along just fine. Oil is down, but that is no reason for Canadians to sell Canada. Oil may be down, but the Canadian economy is not out.