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The Palos - Mitchell Report

JULY 8, 2019

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Portfolio Manager and Equities Strategist

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The month of June

While the markets lost some ground in May, the opposite rang true in June with most North American indices putting in a bottom on June 6th. By month's end the Dow Industrials, S&P 500 and the NASDAQ had recouped virtually all of the May pullback. The exceptions were the Dow Transports and the TSX Composite in Canada which have some work to do in order to test recent highs.

June was an exceptional month for gold with the COMEX futures contract reaching a peak of $1,433 (usd) per ounce on June 25th before closing the month at $1,490, for an 8% gain. NYMEX crude oil also recouped some of the May swoon and closed out June at $58.86 (usd) per barrel; a 10% gain on the month. In commodities markets, rising prices are usually good news for the Canadian dollar. Our *'Loonie'* closed out May at 73.99 cents in U.S. dollar terms and by June 28th the Canadian dollar had reached 76.37 cents U.S. for a gain of 3.2%. The last time we saw the *'Loonie'* at these levels was February 2nd of this year - good news for those headed south for a summer vacation.

G20 Summit

The G20 Summit took place on June 28th and 29th in Osaka, Japan. Market watchers monitored developments closely, looking for any signs of progress in the trade dispute. The much-anticipated meeting between President Trump and President Xi Jinping of China ended with Trump backing off on his threat to increase tariffs on a further $350 billion of Chinese goods. In return, China agreed to increase purchases of agricultural goods from the U.S while Huawei, the Chinese telecom giant that was banned from using U.S. components, was permitted limited access to these vital parts. According to Trump, trade negotiations were 'progressing well'. While status quo is viewed as a positive for risk-off, the reality is that markets remain susceptible to a presidential *'twitter storm'* at any moment in time. Further reason to remain optimistic, but cautious.

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Why Canadian energy is important

According to the U.S. Energy Information Administration (EIA), global consumption of petroleum and other liquid products will exceed 100 million barrels for every single day of 2019. Canadian producers will supply roughly five million of those barrels and in Canada we will consume about 2.4 million barrels per day *(source: www.eia.gov).* We are the world's sixth largest producer, the fifth largest exporter, and the eighth largest consumer *(source: Natural Resources Canada).* In 2017, Canada's energy sector directly employed more than 276,000 people and indirectly supported over 624,000 jobs. The energy sector is not only vital to our national economy – it's contributions massively impact our ability to fund Canada's social programs.

The energy sector has had a tough go in recent years. In the October issue of the Palos-Mitchell report we discussed the price *'differential'* between U.S. West Texas Intermediate (WTI) and Western Canadian Select (WCS). The differential refers to the discount between prices that Canadian producers receive compared to producers who sell their barrels into the U.S. gulf coast markets (Texas and Louisiana). While the differential reached record levels last fall, production curtailments mandated by the Alberta government have worked as intended. Canadian inventories began to decline, and the differential narrowed substantially. The improved pricing is positive for Canadian producers.

Pipelines are badly needed

There are currently three major pipeline projects that have been delayed. The Trans Mountain Pipeline (TMX) currently carries Canadian resources from our interior to the B.C. coast, where it's loaded on tankers and exported to higher priced markets in Asia. Expansion of the TMX was recently approved and its expected that by 2022, volumes on TMX could triple to over 800,000 barrels per day. Keystone XL (KXL) is a pipeline network that could move another 800,000 barrels per day from Alberta to the U.S. Gulf Coast. Again, higher pricing. The KXL project, approved by Washington, has been delayed on multiple occasions by injunctions filed at the state level in Nebraska and Montana. In the meantime, crude continues to move south by rail, more costly and more dangerous. Finally, the Enbridge Line 3 replacement project, intended to replace the aging pipeline that has been in operation for about 60 years, could double the volumes that flow into the Chicago & mid-west markets.

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Canadian energy stocks

In the first week of June we attended the BMO Capital Markets Canadian Energy Conference held in Montreal. This two-day event provided the opportunity to meet face-to-face with senior management from several of our largest publicly traded energy companies. Among those we met with were Suncor, which is a fully integrated energy company and Canada's largest by market capitalization. We also met with several intermediate producers including Vermillion Energy, Prairie Sky Royalty, Enerplus, Whitecap Resources, MEG Energy, Seven Generations, ARC Resources, TORC Oil & Gas, and Kelt Exploration. While it would be beyond the scope of this letter to furnish a company-by-company review, I certainly believe it's worth sharing some of the prevailing sentiment being expressed from the companies we met with.

- Challenges over the last few years have forced Canadian producers to take defensive measures (survival mode)
- Fiscal responsibility has resulted in balance sheets that are in good shape (sustainability)
- Lack of clarity with regards to Canada's national energy policy has damaged our reputation (negative sentiment)
- Foreign investment is exiting Canadian energy (lack of confidence)
- Lack of egress is discounting prices (to be resolved with pipelines & growth in crude by rail)
- The fundamentals are improving, and cash flow is positive (cannot be ignored forever)
- Some companies are buying back their own stock (high conviction)

Sticking to our guns

While the energy sector has underperformed the overall market, we believe there are reasons to be optimistic (see bullet points above). The companies we've identified as most promising have '*checked all our boxes'* and we are confident in our risk-return assessment. Our approach is always discipline-based and as such we strive to maintain a well-diversified, capped allocation within any sector.

It's important to remember that superior performance over the long-term is based on two key factors; having the ability to recognize opportunities while others are ignoring them and having the conviction to stick to stick to a plan. We've done our homework and we're confident that our Canadian energy holdings will reward us in due time. The best ideas often require patience and discipline. We're sticking to our guns.

The Art of Investing

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We invest our clients' money as we do our own.

Our interests are aligned with yours.

William Mitchell, B Comm., CIM

I am a portfolio manager at Palos Wealth Management based in Montreal, Quebec, Canada. My experience in the investment industry is extensive, having spent more than twenty-nine years analyzing, trading and investing in global financial markets.

At Palos, we are driven by our values. We believe in the principles of honesty, integrity and transparency. We subscribe to a strong work ethic and we have a passion for investing. The pursuit of excellence is our motivating force. We take our fiduciary duty to heart and we always act in the best interests of our clients.

If you have any questions about investing, our services, or becoming a client of Palos Wealth Management, please contact me at:

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