VIEWS FROM THE PATCH
ENERGY UPDATE

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First Quarter 2015 Update
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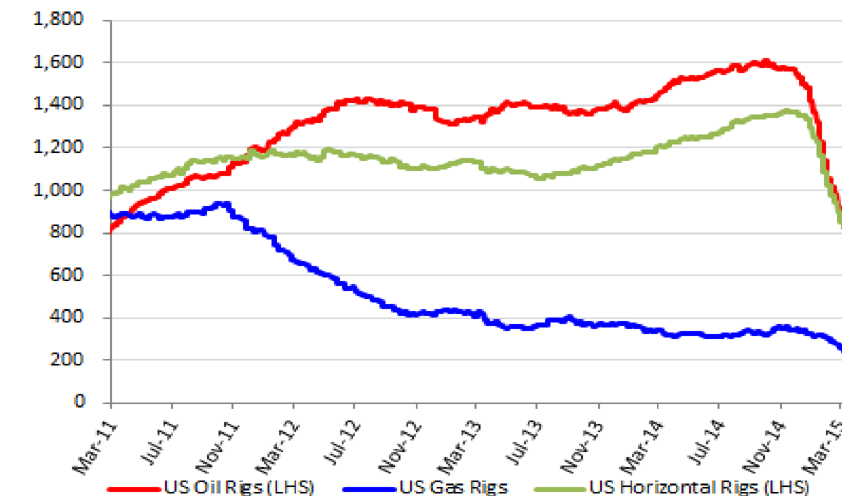
Looking Long-Term, Living Day-to-Day
So much changes daily in the energy sector, but the fundamental outlook does not. This is not an industry whose production growth engine, that being North America, can add volumes over time at $50 WTI oil prices. It is an industry whose product continues to see ongoing global growth. To supply this ongoing growth in demand, oil prices have to be higher and costs have to be lower. We have seen prices test the low $40s level a few times now and come back.

Rig Counts Declining
Costs have continued to fall as drilling rigs have been pulled from use and the need for other services, like completions (pressure pumping, sand, etc.), has decreased dramatically. Figure 1 below highlights the dramatic drop-off in rig utilization in the US, and so it is not surprising that costs come down when the rig count falls in half. Canadian numbers are similar, other than seasonality (winter drilling and spring break-up).

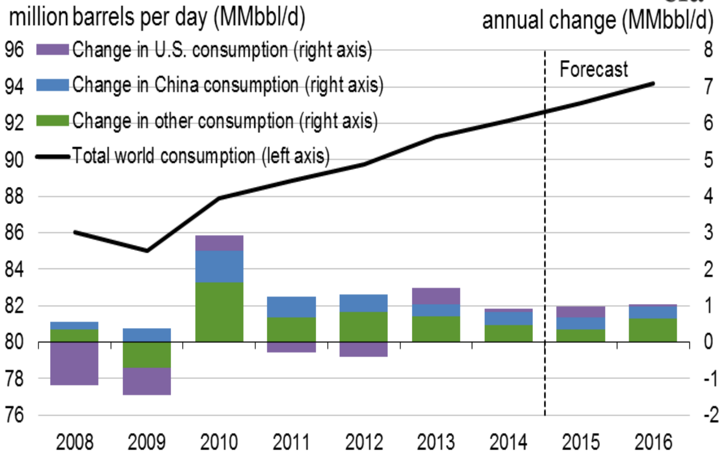
Figure 1: US Rig Counts Declining



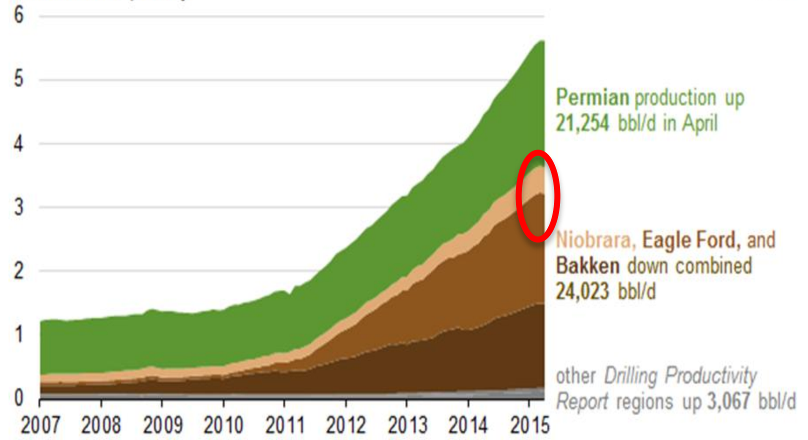
Source: Wolfe Research, Baker Hughes, Bloomberg Finance L.P., March 2015

Supply & Demand Dynamics
The pricing challenges facing the oil industry are not demand driven. Global demand marches along, driven by emerging markets and augmented now by gasoline demand in the US as well as China, as shown in Figure 2. The issue is supply and there are many drivers, the most significant being the growth rate in North America. This growth rate will slow based on the sharp decline in the rig count as shown above. Not to get too excited too early, but last week we did see the first decline in production from the Niobrara, Eagle Ford and Bakken plays in the US as shown on the right hand side of Figure 2. There are of course other areas of focus for supply that could both increase and decrease volumes. Continued unrest in Libya, Iraq, Yemen and Syria can increase and decrease volumes as violence escalates and ebbs. The election of a new government in Nigeria was done relatively peacefully, but we remain concerned that this is a temporary lull and oil volumes could be at risk. The signing of a Framework Agreement between Iran and the P5+1 could, if/when a final agreement is reached by June 30, 2015, allow for the return of some Iranian volumes to the market. There is still much to negotiate to permit this supply, and interestingly, those volumes may just be needed by the time they arrive, given demand forecasts.

Figure 2: Global Demand Continues to Rise; First Signs of Production Declines Emerge



Source: Wolfe Research, Baker Hughes, Bloomberg Finance LP March 2015

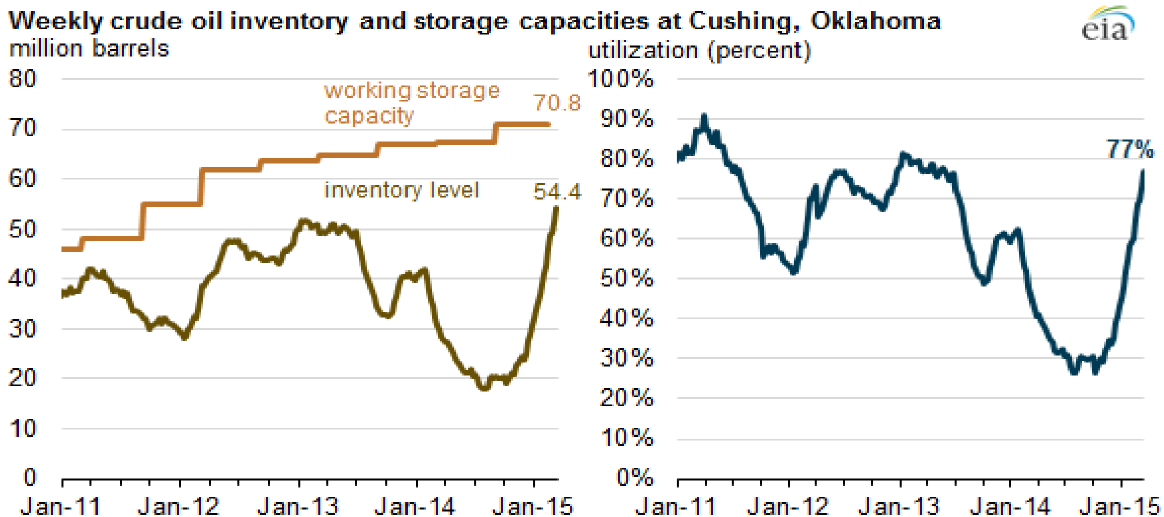


Source: U.S. Energy Information Administration, Drilling Productivity Report, March 2015

Storage Concerns

Much has been made of "US storage filling up" in the past month. The fear mongers point to Cushing, Oklahoma storage filling up. As this is where WTI is priced, it could have a negative effect on the price if storage were to actually fill to tank tops. It won't, for a few reasons. First, there have been increases in storage capacity at Cushing in recent years, such that at the current record inventory level we are still only at 77% of capacity compared to previous highs of over 90% of capacity. A percent is a lot of barrels as shown in Figure 3. In addition, we are entering the time when the refineries increase their demand for crude oil as they come off seasonal maintenance (called turnaround) so there will be less inventory build given refinery demand increases and we may just be seeing the start of production growth slowing (right hand side of Figure 2), which will help on the supply side.

Figure 3: Additional Storage Capacity at Cushing Makes Record Inventory Level Manageable



Source: U.S. Energy Information Administration, Weekly Petroleum Status Report and Working and Net Available Shell Storage Capacity, March 2015

In addition, it is important to keep in mind how adept the oil industry is at responding to price signals. There is over 200 million barrels of storage capacity in the US Gulf Coast (USGC) and the USGC is now very well pipeline connected to Cushing, so well over one million barrels of oil can move every day from Cushing to the USGC. What makes this happen is a slight change in pricing between WTI (priced in Cushing) and light oil priced on the USGC,

such as Houston Light Sweet or Louisiana Light Sweet. This small price change has already occurred, which is opening up the storage arbitrage to move volumes to the USGC and voilà, more available storage.

Corrections are Useful

These price corrections in the energy sector that we regularly endure are very important in rebasing company and employee views on reasonable costs, as well as getting them to make use of the most efficient and cost effective technology to advance projects. I think it is healthy and necessary and makes the industry stronger. The sector is in the midst of this recalibration now and it is great to see the changes already made in attitudes, costs and capital efficiencies. This sets the sector up for future profitability achievement at lower commodity prices.

Fund Positioning

Our approach has been to carefully deploy cash on negative market days to attain the best value in our favourite names, while keeping our focus on best-in-class names with top assets, deep project inventories and well-managed balance sheets with experienced, invested management teams.

In Dynamic Strategic Energy Class we continue to maintain a larger cash weight with a small hedge. We made several opportunistic and strategic investments and switches over the quarter and will continue to do so going forward.

In Dynamic Energy Income Fund we are balancing between maintaining a high level of hedging to mitigate volatility and protect downside while making sure we have a much higher level of investment so that the dollars invested in the Fund are earning distributions. These strategies have each worked well for these respective funds.

This is an “every day is different” kind of energy market, which makes daily focus on the participants in it so necessary but also rewarding. I have been in this sector for 25 years and have been through these corrections before. I have seen them from the buyside, from the sellside and from within an energy producer company. They are all different, but in many ways the learnings from them are similar and this is when we position our portfolios for long-term investments in excellent energy businesses, as they produce a product for which global demand continues to increase.

As of March 31, 2015	1 mth	3 mth	6 mth	1 yr	3 yr	5 yr	10yr	SIR
Dynamic Energy Income Fund	-2.3%	-1.2%	-16.7%	-12.1%	-1.5%	2.6%	5.2%	8.6%*
Dynamic Strategic Energy Class	-0.3%	0.7%	-16.6%	-8.4%	5.7%	4.4%	1.1%*	-0.3%**
S&P/TSX Capped Energy Index	-1.4%	-0.8%	-24.2%	-24.3%	-3.2%	-1.7%	3.5%	-

* Fund launched August 2003
** Fund launched July 2007

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