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Palos Weekly Commentary

Issue **No. 50** | **DECEMBER 13** 2018

CONTENTS

Palos Funds

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Canadian Wide Oil Differentials Have Disappeared

On December 2, 2018 the Alberta Premier, Rachel Notley, announced that they will be imposing cuts to oil production. The proposed cuts will take effect sometime in January 2019 and would equate to approximately 300,000 barrels per day. Canadian oil prices immediately reacted to the news positively. As of December 12, 2018, differentials are back to their average.

	Time	Price	Chg	Diff	Chg
Canada					
Edmonton Syncrude Swe	09:04	51.07	.57	.25	.90
Edmonton Mixed Sweet	09:04	47.97	.07	-2.85	.40
Edmonton C5 Condensate	09:04	47.57	-.08	-3.25	.25
West Canada Select (WC	09:04	38.32	-.08	-12.50	.25
Implied Bitumen	09:04	34.36	-.08	-16.46	.25

Figure 1 Canadian Oil Prices (December 13, 2018)

To better understand the price action, I have attached a chart of the Edmonton Mixed Sweet differential (Figure 2). On November 01, 2018, the differential reached -$40 USD. We are of the opinion that production curtailment will be short lived and will probably be eliminated by April 2019. By mid to end of 2019, Enbridge line 3 will be at full capacity, which will be enough to take the slack out of system in the short run. However, we will need more than line 3 in the future as production grows.

Figure 2 Edmonton Mixed Sweet Differential

Differentials are now back to normal, and global oil prices have stabilized from their aggressive sell off. Furthermore, OPEC announced that they are cutting production by 1.2 million barrels. The oil market is also facing geopolitical risk in Libya. In our view, oil prices should firm up in the coming month. So why are Canadian energy equities still trading like no one cares? The first reason is tax selling, especially with the performance of the energy sector this year. It's an easy place for investors to crystalize losses. Secondly, no one likes it when the government needs to intervene in free markets. Investors are probably annoyed that their Alberta energy companies need to shrink rather than grow production. With that said, we are of the opinion that Notley made the correct decision especially considering the circumstances and the expected length of the cut. I see significant value in high quality energy companies as they are being painted with the same brush.

One my favorite names in the Canadian energy space is Torc Oil & Gas. (TSX:TOG). I believe that they have the most sustainable model in the space. Strong balance sheet, low decline rates, high netbacks, and a low payout ratio, which makes their 6% dividend safe. Secondly, they are benefiting from the Alberta cut, but not getting affected by them as 80% of their production is in Saskatchewan. In the past, TOG has been very successful in buying smaller private producers. In this environment, we see TOG making more of those accretive tuck in acquisitions.

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$8.22	-13.66%
Palos Equity Income Fund - RRSP	PAL101	$5.54	-13.18%
Palos Merchant Fund L.P. (Mar 31, 2018) [2]	PAL500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL210	$7.22	-33.07%
S&P TSX Composite (Total Return with dividends reinvested)			-6.22%
S&P 500 (Total Return with dividends reinvested)			1.01%
S&P TSX Venture (Total Return with dividends reinvested)			-33.76%

Chart 2: Market Data [1]			Value
US Government 10-Year			2.91%
Canadian Government 10-Year			2.13%
Crude Oil Spot			US $51.15
Gold Spot			US $1,241.00
US Gov't10-Year/Moody BAA Corp. Spread			228 bps
USD/CAD Exchange Rate Spot			US $0.7490

[1] *Period ending Dec 12, 2018. Data extracted from Bloomberg*

[2] *Fund is priced annually*

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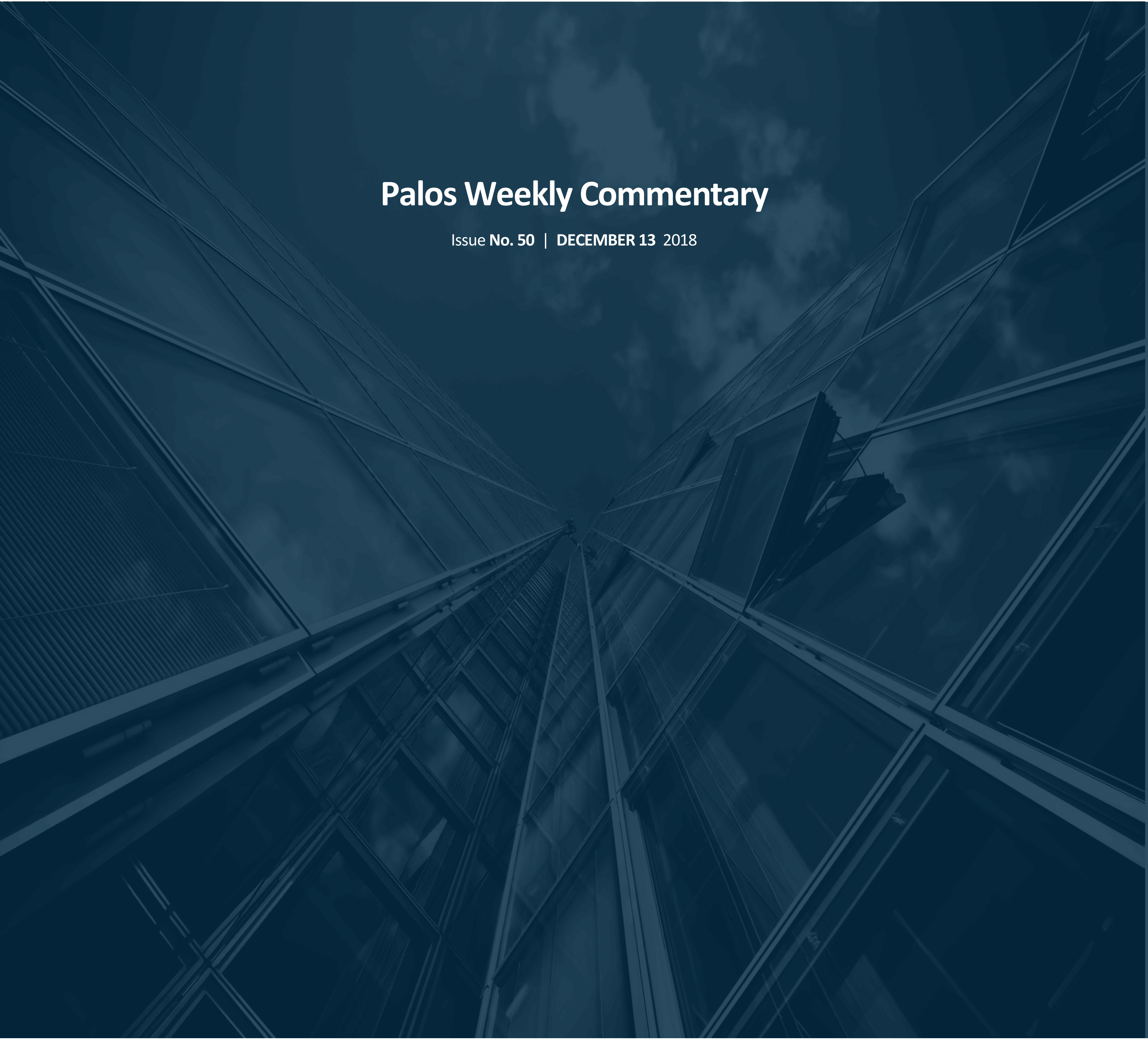

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