Canadian Crude – You are missing an opportunity

January 1st, 2020

Despite a late year surge, neither commodities, nor any other asset classes, kept up to the strength of the equity markets in 2019 (BCOM +5%, S&P500 +29%). There were pockets of performance in commodities - some well talked about and others largely ignored. While markets like oil and gold can dominate the discussion and are often proxies for the entire sector, the reality is the vast diversity of the global commodity sector beyond oil and gold provides other opportunities. In 2019, performance of WTI oil and gold was solid at 33% and 16% yet was eclipsed by palladium (used in auto catalytic converters) adding 54%. While not so much a commodity as a resource equity, pulling in the worst performance was the marijuana sector as represented by the popular Horizons HMMJ ETF, losing 34%. See table below.

Market	Return	ETF or Index
Canadian Oil	108%	CCX - Canadian Crude Index ETF (NPU)
Palladium	54%	PALL
WTI Oil	33%	USO
S&P500	29%	Index
WTI Oil	20%	Horizons HUC ETF
Gold	16%	Horizons HUG ETF
GSCI	15%	Goldman Sachs Commodity Index
Energy Stocks	7%	S&P/TSX Capped Energy Index
BCOM	5%	Bloomberg Commodity Index
Marijuana	-34%	Horizons HMMJ ETF

However, there is another commodity that outperformed them all - Canadian Heavy Oil gained 108% (as measured by the CCX ETF (NAV per unit) or the underlying Canadian Crude Index (CCI). While less talked about globally, most traders in the energy markets understand the importance of Canadian crude oil. Canada is the 5th largest global producer and arguably has the largest oil reserves in the world based on modern recovery factors [1]. The U.S. imports more oil from Canada than any other nation, more than 3 times the amount from Saudi Arabia and more than all of OPEC nations combined. Heavy oil from Canada is vital to the U.S. market in supplying its massive refinery system focused in the mid-west (Chicago PADD2) and the Gulf Coast. Over the last 15 years, U.S. refineries have become more dependent on heavy oil and this demand is growing as refineries have been upgraded and purpose built to process heavy oil into gasoline and diesel at cheaper costs for greater margins than light-sweet oil which the US principally produces. Canada has a long-term and reliable supply of heavy oil, while other sources from Venezuela and Mexico have struggled and face increasing supply constraints.

National Bank of Canada (NBC) published a report in September highlighting the importance of Canadian heavy crude and forecasted that the Canadian heavy oil market-share will likely continue to grow and Western Canadian Select (WCS) is well positioned to become the global benchmark for heavy oil. Additionally, the report pointed out that:

- Global heavy oil demand is growing.
- Canadian heavy oil is ideally positioned to meet demand from US and a growing Asian demand.
- The Canadian market will benefit greatly from additional takeaway by pipeline or rail. Both are needed and are coming.
- Link to research here.

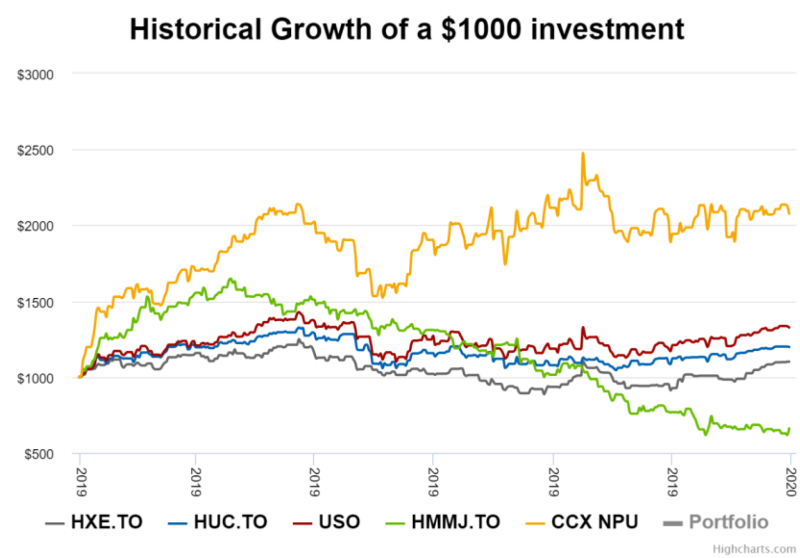
So, what caused the out-performance? While the a commonly held belief is that the (previous) Alberta government "Curtailment Program", which narrowed the differential to WTI in late 2018, was the reason for the out-performance (relative to WTI) in 2019, the reality is different. The discount for the 90-day term covered by the CCI ended 2018 at -17.93, which is close to the long-term average. It then narrowed in Q1 2019 and steadily widened into year-end as pipeline, rail and storage issues began to restrict and thus concern the market. It closed at -20.67.

[1] Mike Priaro: http://www.jwnenergy.com/article/2017/3/how-its-quite-possible-canada-has-worlds-largest-oil-reserves/

Here again NBC has weighed in on the CCX ETF with an institutional bulletin in November 2019 regarding the CCX ETF. Please contact info@auspicecapital.com for a copy. It highlighted (quotes):

- CCX doesn't trade on sentiment for broader energy equities, this vehicle is a pure play call on WCS oil.
- NBC views CCX as a purely unconstrained competitor to other North American crude ETF products (HUC, USO) and Canadian oil producer equity names as represented by Horizons S&P/TSX Capped Energy Index ETF (HXE).
- Enormous CCX outperformance to both US & CAD denominated ETF's representing either commodity or the resource equity names (CCX peers).
- Performance is approximately 1.5x better than its peers every day.
- When you own CCX you own an instrument that is ~50% cheaper than the competing peer group, your performance therefore will be 50% greater.

The chart below highlights the out-performance of the CCX ETF versus the Horizons WTI Oil ETF (HUC), the Horizon's S&P/TSX Capped Energy Index ETF (HXE) and the massive USO Oil ETF in the US. Since it was so topical, we have again included the Horizons Marijuana Life Sciences Index ETF (HMMJ.TO) for comparison.



Will the performance continue? What hasn't changed is that in addition to the important demand drivers highlighted above, the WCS market and the CCX ETF has embedded leverage in the price.

If you are a buyer, would you rather buy crude oil at $60 (WTI) or $40 (WCS)? If the market rallies, the better return is obviously in the lower price. The question becomes what will the WCS differential do going forward? We don't have a crystal ball, but given the current level is slightly wider than the long-term average, this implies good leverage due to the discount and the potential for narrowing as additional takeaway capacity is added with rail and pipeline long-term. Per National Bank, given the extension in curtailment into 2020, *"the Alberta government has put a floor under WCS diffs until further egress capacity (+500k bpd, not including rail) comes in 2020 and 2021".* As such, at Auspice we believe that should the differential widen substantially, it may provide a brief and significant buying opportunity (all other things equal).

With respect to the late year gains in commodities, Societe Generale published end-of-year research highlighting that widespread commodity buying to December 17th represented the largest speculative inflows since August 2017 (please contact info@auspicecapital.com for a copy of the report). Inflows covered a range of commodities with 23 of 24 markets rallying as optimism developed regarding a US-China trade pact. Complacency regarding inflation and low interest rates[2] coupled with an over emphasis on slowing economies[3] makes the 11-year bull run in equities look a little overdue for a correction which may present an opportunity for commodities. As for which commodities, given the structural and fundamental advantages of the Canadian Crude market and the CCX ETF, the current level provides a better return potential than WTI based ETF products and the only "pure play" in Canadian oil.

[2] https://www.marketwatch.com/story/investors-are-too-complacent-about-inflation-and-low-interest-rates-says-schwab-strategist-2019-09-18

[3] https://www.cnbc.com/2019/11/21/goldman-the-worst-of-the-global-economic-slowdown-may-be-in-the-past.html

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The Canadian Crude Oil Index ETF (CCX), seeks to replicate, to the extent possible, the performance of the Canadian Crude Excess Return Index (CCIER) net of expenses, and allows investors to access the price of Oil produced in Canada. The ETF does not employ leverage, but in order to achieve its investment objectives, CCXTM will invest in derivatives and other financial instruments from time to time, which may include interest bearing accounts and T-Bills.

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