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Oil's comeback

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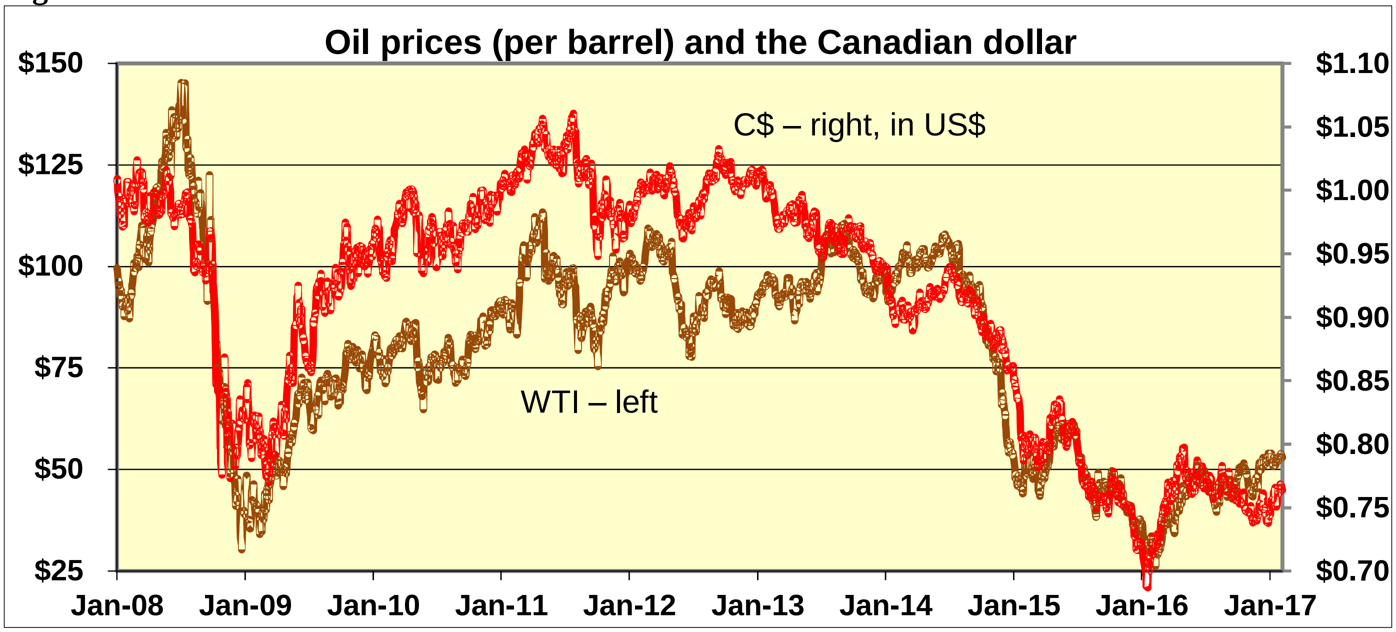
Last year will be remembered for a number of surprise events that raised market volatility and sent countless pollsters scurrying to their drawing boards to figure out where they went wrong. In addition to the political events, including the U.K.'s June referendum to leave the European Union and Donald Trump winning the U.S. presidential election, was the surprise November 2016 OPEC agreement to limit oil production – the first such deal in eight years. Perhaps more surprisingly, it extended beyond the cartel's membership, as Russia agreed to unprecedented cuts to its own output. While the agreement is still largely untested, Canada stands to benefit. Subdued economic activity at home during 2015 and 2016 has placed greater importance on Canada's export sector. At the same time, weakness in the Canadian dollar has supported foreign buying interest in our trade goods. The revival in world energy prices that has followed the OPEC accord has augmented this foreign interest. While investors would typically focus on the positive aspects of a stronger energy market, there is also an ancillary risk as inflationary pressures, while being largely absent for a number of years, may be fuelled by higher energy prices. Investors should be aware of both sides of the story. Taking advantage of professional advice can ensure that one's investment portfolio is positioned to capitalize on opportunities while protecting against risks.

Oil prices and the currency

The secular advance in world oil prices, which began in the early 2000s, provided a material lift to the Canadian economy. The run-up in oil prices eventually produced an all-time high of US$147.27 for the West Texas Intermediate (WTI) spot price on July 11, 2008[1]. At these elevated levels, unconventional reserves, including Canada's oilsands, were pushed well into economically viable territory. In terms of proven oil reserves, Canada ranks third behind only Venezuela and Saudi Arabia[2]. The Canadian dollar was soon tagged with a "petro-currency" label. As can be seen in Figure 1, over the past decade the Canadian dollar has exhibited price movements, in U.S. dollars, which generally correspond with price movements in oil, also priced in U.S. dollars.

[1] The spot price is the current market price at which an asset is bought or sold for immediate payment and delivery.
[2] U.S. Energy Information Administration, International Energy Statistics, 2015.

Figure 1

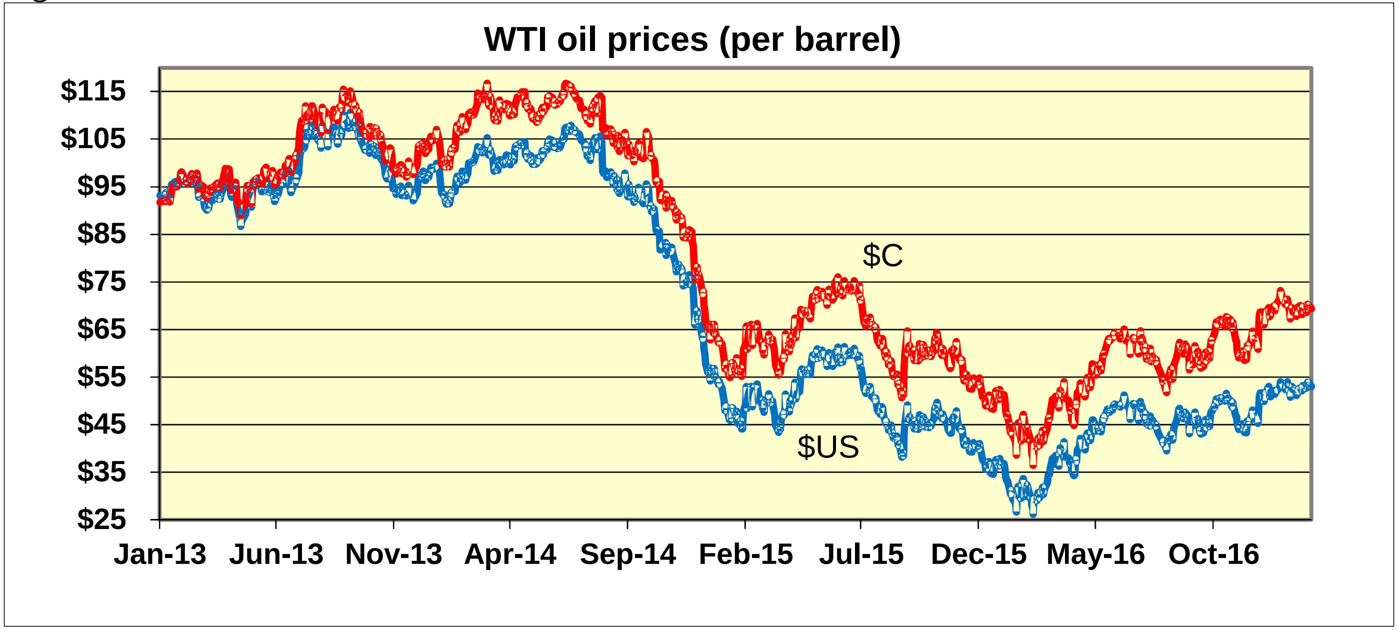


Source: U.S. Energy Information Administration; Bank of Canada

On September 20, 2007, the Canadian dollar broke above par with its U.S. counterpart for the first time since January 1977. The move up culminated in a modern-era high of $US1.1030 on November 7, 2007. The subsequent financial crisis and Canada's economic resilience during that period allowed for continued currency strength. As can be seen in Figure 2, with the Canadian and U.S. dollar priced near par in early 2013, the West Texas Intermediate (WTI) price of oil shows virtually identical pricing in either currency. However, in mid-February 2013, the loonie took its last look at par and began to slide. Over the past few years, weak economic activity globally has served to curtail demand for crude oil, while unrestrained oil output, which frequently resembles free-market production, significantly boosted supply. During this time, some nations appeared to be vying for market share regardless of price. World oil prices actually fell below the lows seen during the financial crisis, hitting US$26.19 per barrel on February 11, 2016, the lowest level since May 6, 2003. By September 2016, U.S. crude oil inventories reached the highest levels in more than 80 years[3]. Over this span, the free-floating dollar acted as intended and was a buffer for the Canadian economy. The decline in the value of the currency meant that oil (again, priced in U.S. dollars) did not weaken to the same extent in domestic terms (i.e. domestic producers received more Canadian dollars for their production – illustrated by the gap between the two lines in Figure 2). Nevertheless, there was a material impact on Canada's international trade.

[3] U.S. Energy Information Administration, Weekly Report, September 9, 2016.

Figure 2



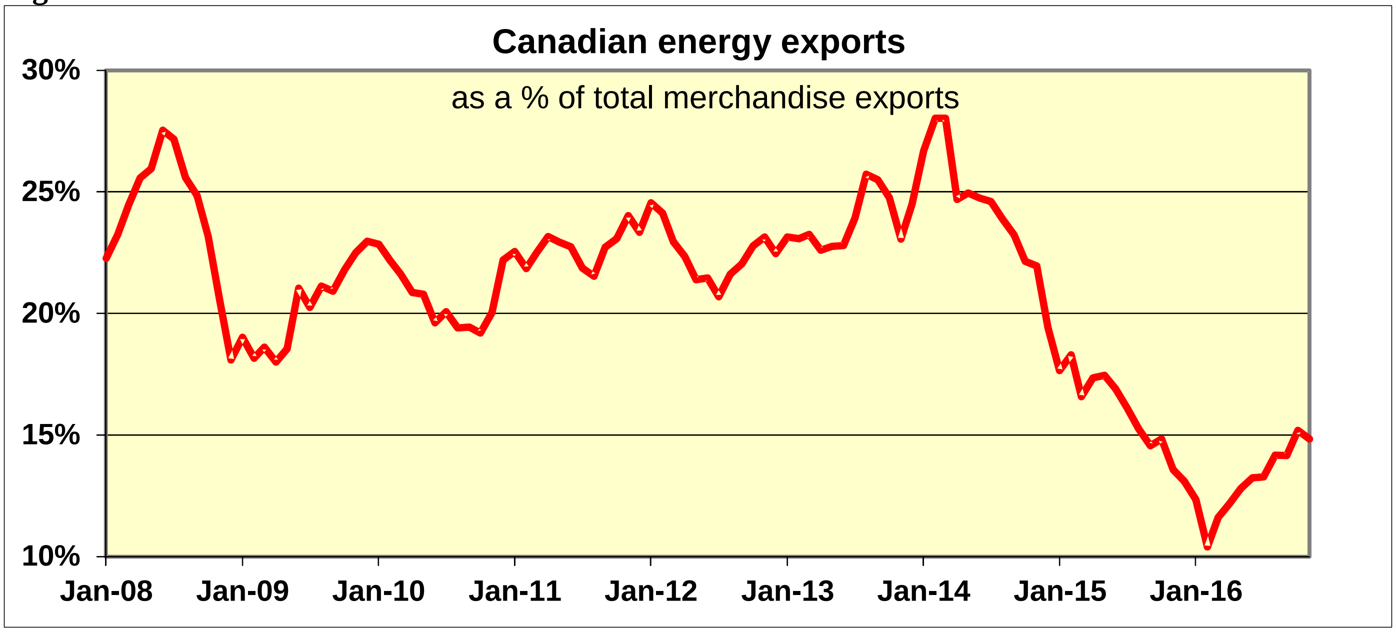
Source: U.S. Energy Information Administration; Bank of Canada

International trade

The value of Canada's energy exports hit an all-time high in March 2014 ($12.4 billion) representing 28.0% of all exports. However, as can be seen in the following graph, the portion of energy exports, relative to all merchandise exports, fell heavily from this point. By February 2016, energy exports as a percentage of total exports had bottomed out at 10.4%, the lowest figure seen since January 2002 (8.8%) when the price of oil averaged only US$19.71 per barrel. The subsequent recovery in oil prices has helped, but as a percentage of total exports, energy products remain well below historic levels, reaching 18.4% by the end of 2016.

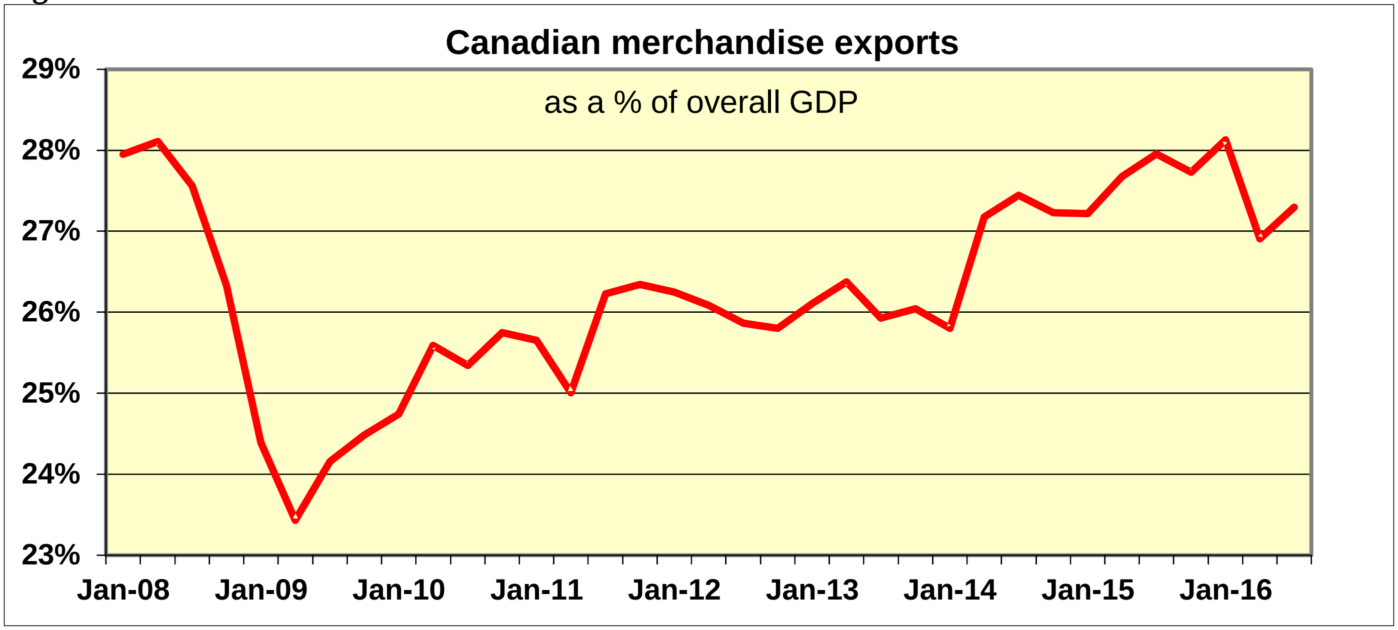
Even though the proportion of energy exports has not recovered to previous levels, the importance of overall exports to the economy has increased in recent years. As illustrated in Figure 4, merchandise exports as a percentage of GDP fell heavily during the financial crisis as world trade patterns reacted sharply to a dramatic deterioration in global liquidity. An unwinding of some of these risks permitted a resumption in normal international trade patterns in the following years. Canadian exports represented an increasingly important part of overall domestic GDP growth during this period. However, even the sharply weakening currency proved to be insufficient to fully buoy the terms of trade and Canada's overall merchandise trade balance hit a record monthly deficit of $4.2 billion in September 2016. Since then and coincidental with the rise in world energy prices, Canada's trade balance has improved. Statistics Canada's November and December 2016 data revealed the first back-to-back surpluses ($1.0 billion and $0.9 billion, respectively) since August and September 2014. The improvement was sufficient to produce a quarterly merchandise trade surplus to close the year, the first time since the third quarter of 2013. The current political and environmental climate raises additional questions with respect to energy use both domestically and internationally. Questions regarding the construction of pipelines or even the further development of fossil fuels represent risks for both traditional and untraditional suppliers.

Figure 3



Source: Statistics Canada

Figure 4

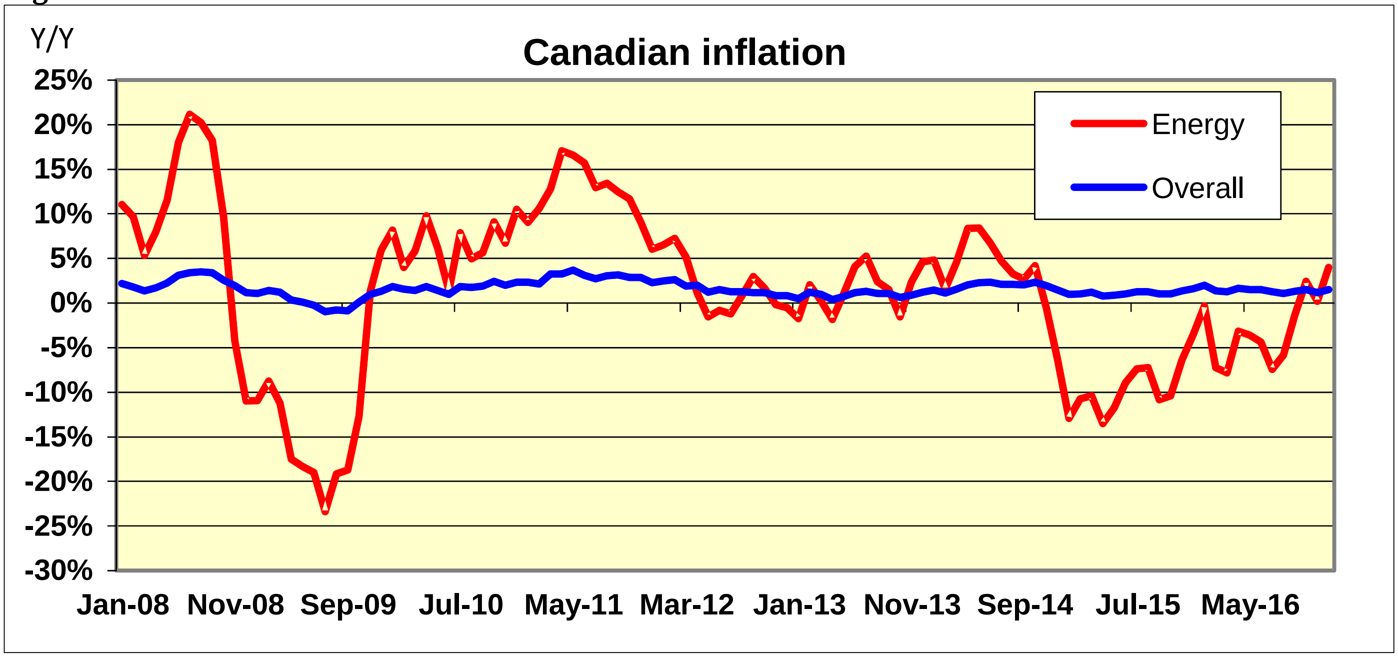


Source: Statistics Canada

Inflation

Another risk worthy of note is the re-emergence of inflationary pressures, as higher energy prices work through the economy. As recently as September 2015, the U.S. consumer price index was in negative territory (year over year). The latest data from the U.S. Bureau of Labor Statistics revealed a 0.6% (seasonally adjusted) advance in the overall CPI in January, sufficient to drive the year-over-year growth rate to 2.5%. This is the fastest pace of inflation since March 2012 (2.7%). While this pace of inflation is far from alarming, it does represent a meaningful change from the past several years. Most analysts anticipate that higher interest rates, in the U.S. at least, will be forthcoming as a policy response. As well, U.S. international trade policy remains far from being fully formed. In both the run-up to the presidential election and subsequently, there has been considerable rhetoric over trade, tariffs and self-reliance in energy. At the same time, this rhetoric has been quick to change both in direction and in tone over the past several months. Unfortunately, at this juncture, the future is quite unclear as to the direction of trade in energy and the broader implications for inflation. Domestically, inflation has been quite stable. Figure 5 shows very little change even as energy prices have exhibited considerable volatility. Still, inflation risks, at present, are not simply a product of changing energy prices. Taxes too, play a significant role in consumer prices. Ontario's cap-and-trade program and Alberta's carbon tax, both of which came into effect on January 1, 2017, raised gasoline prices dramatically. In addition, the longer-term weakness in the Canadian dollar has meant that import prices of all goods and services have increased.

Figure 5



Source: Statistics Canada

Conclusions

- Volatile changes in politics and industry sectors characterized much of 2016. Significant uncertainty remains as future events may fuel additional spikes in market volatility.
- The recovery in world prices for one of Canada's key raw materials is a welcome development both economically and from an investor perspective. However, taking measured steps and seeking professional advice will help keep the focus on achieving investors' financial goals.
- Along with opportunities, risks naturally present themselves. From politics and currencies to the prevailing interest rate environment, a financial advisor is well positioned to help foster a more circumspect, disciplined approach to investing.