Avenue
Investment Management

47 Colborne Street, Suite 300
Toronto, Ontario, Canada M5E 1P8
T 416.482.2004 • 888.482.2007 F 416.482.0007
www.avenueinvestment.com

FOURTH QUARTER 2014 - MARKET COMMENTARY

A Case Study on the Oil Price

Avenue believes that with time, the price of oil should recover to the $75 to $80 price level. However, lower prices might be needed in the short term to reduce the excess supply from the global oil market.

We have described Canada as a developed consumer and industrial economy, with a resource heavy stock market. This is compared to the US which is a developed consumer and industrial economy, with a consumer and industrial stock market. The difference is important because a falling oil price is a net positive for the Canadian economy, but definitely a negative for the Canadian stock market performance. At the height of the mini energy bull market this past summer the TSX Index was 26% weighted to the energy sector. As a Canadian-based investor, having an understanding and a view on the oil price is important.

Commodity price forecasts are rarely accurate although, ironically, many analysts are paid to make them. At Avenue, we do not try to predict the future. Our strategy is to understand the marginal cost of production, which in today's market is roughly $80 US per barrel. We then put a fairly wide $20 price band around $80. This gives us our high price of $100 per barrel where we would underweight the energy sector in our portfolio and our low price of $60 per barrel where we would overweight the energy sector.

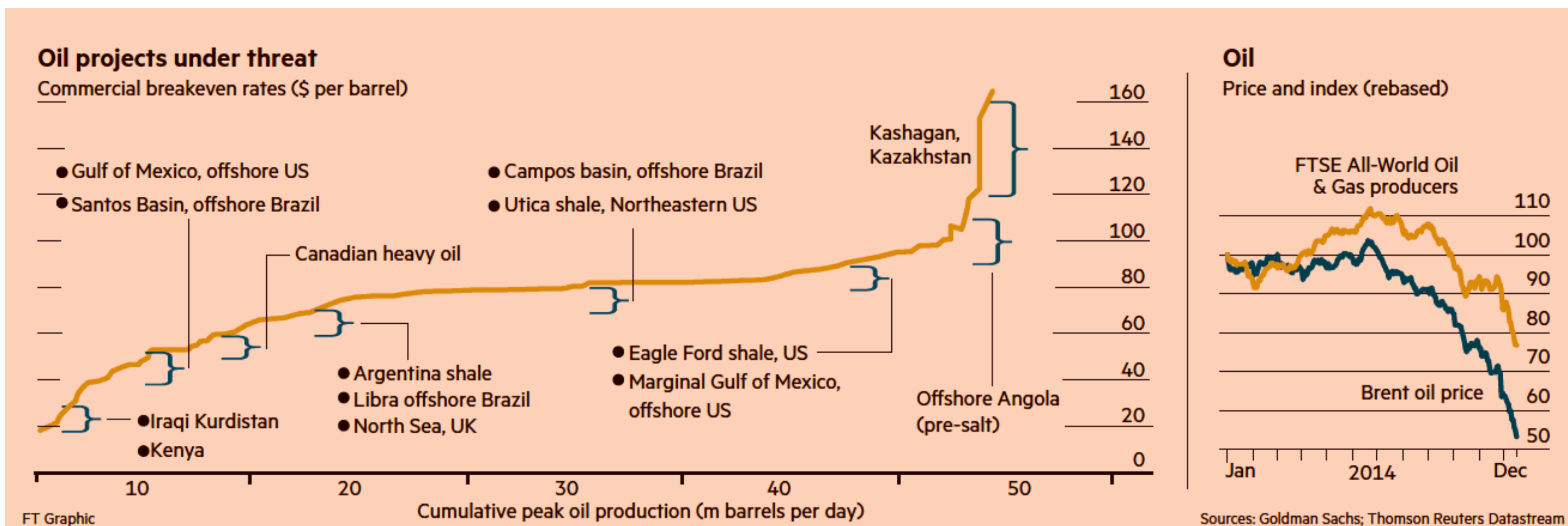
The marginal cost of production is a theoretical price. An absolute price is hard to nail down because it is always adjusting to the level of demand and the cost of supplying the commodity. To use the oil market as our example, the World consumes 93 million barrels of oil per day, so the marginal price is where the cost of bringing on the final well to produce 93 million barrels per day basically breaks even. Today, this price is about $80 per barrel. There is much more oil to drill for in the World but the costs are above this breakeven point, therefore these wells will not be drilled until either demand goes up or costs come down.

Paul Harris, CFA
Partner
pharris@avenueinvestment.com

Paul Gardner, CFA
Partner
pgardner@avenueinvestment.com

Bill Harris, CFA
Partner
bharris@avenueinvestment.com

This chart is a great depiction of why the marginal cost of producing oil is likely around $80 per barrel.



Oil was at $100 per barrel as recently as this summer because there were real supply concerns until US shale oil production surged. In the last three years the US increased their domestic production by 4 million barrels per day, thereby pushing the oil market into oversupply. We believe the world is likely oversupplied by about 1.5 million barrels per day, so as long as oil stays at this price of around $50, it will knock out the high cost supply. This is not just higher cost US shale, but many other high cost projects around the World, including some Canadian oil sands development projects.

Having patience is often the hardest part of investing. The oil price can stay above or below the marginal cost of production for years. However, there are always opportunities to invest in money-making companies at both high and low commodity prices. It just makes it a little easier when we get the chance to buy a great company at low valuations and when the next direction for the oil price is heading up from a cyclical low.

Avenue Investment Management
Getting there together

DISCLAIMER
This report is provided by Avenue Investment Management Inc. (Avenue) for customers of Avenue. It is for information purposes only and may not be appropriate for other purposes. The report does not provide material information about the business and affairs of Avenue. Charts, diagrams and other information contained in this report have been drawn from sources believed to be reliable, but are not guaranteed to be accurate or complete. The report contains economic analysis and views, including about future economic and financial markets performance. These are based on certain assumptions and other factors, and are subject to inherent risks and uncertainties. The actual outcome may be materially different. Avenue Investment Management Inc. is not liable for any errors or omissions in the information, analysis or views contained in this report, or for any loss or damage suffered.