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Energy market rebound

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Blessed with an abundance of natural resources, Canada's economic growth has historically relied upon their development. This resource base is one of the reasons that Canada was ranked as the 15th wealthiest nation in 2021.[1] Energy price gains have recently fueled a resurgence of interest in Canada among international equity investors. Despite the broader equity weakness seen during the calendar's transition from 2021 to 2022, stock buyers that helped pushed the S&P/TSX Composite Index to new highs in 2021 have returned. The index hit 21,784.7 during trading on February 10th, 2022. The intra-day high was just 11 points shy of the all-time high on November 16, 2021 and marked a 95% gain since the pandemic low of 11,172.7 on March 23, 2020. A Global Industry Classification Standard (GICS) sector breakdown of the Canadian stock market revealed that the sector weighting for energy was 13.1%[2] at the end of 2021, which was only second to financials (32.2%). As a result, it's not surprising that changes in energy prices are clearly reflected in the price performance of Canada's primary stock index, as outlined in the accompanying graph. Still, these influences can represent a double-edged sword for investors. The upward price moves in energy products can translate into commensurate gains in the equity investments. However, higher energy costs have also helped to reawaken inflationary pressures. Higher inflation and rising interest rates have not been part of the investing landscape for an extended period of time. Given these changes, seeking the guidance of a professional advisor and having a robust financial plan can help to calm investor anxieties during uncertain times.

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[1] **World Economic Outlook Database. International Monetary Fund. 2021.**
[2] **Canada Stock Market - Sector Weightings. Sibilis Research. December 31, 2021.**

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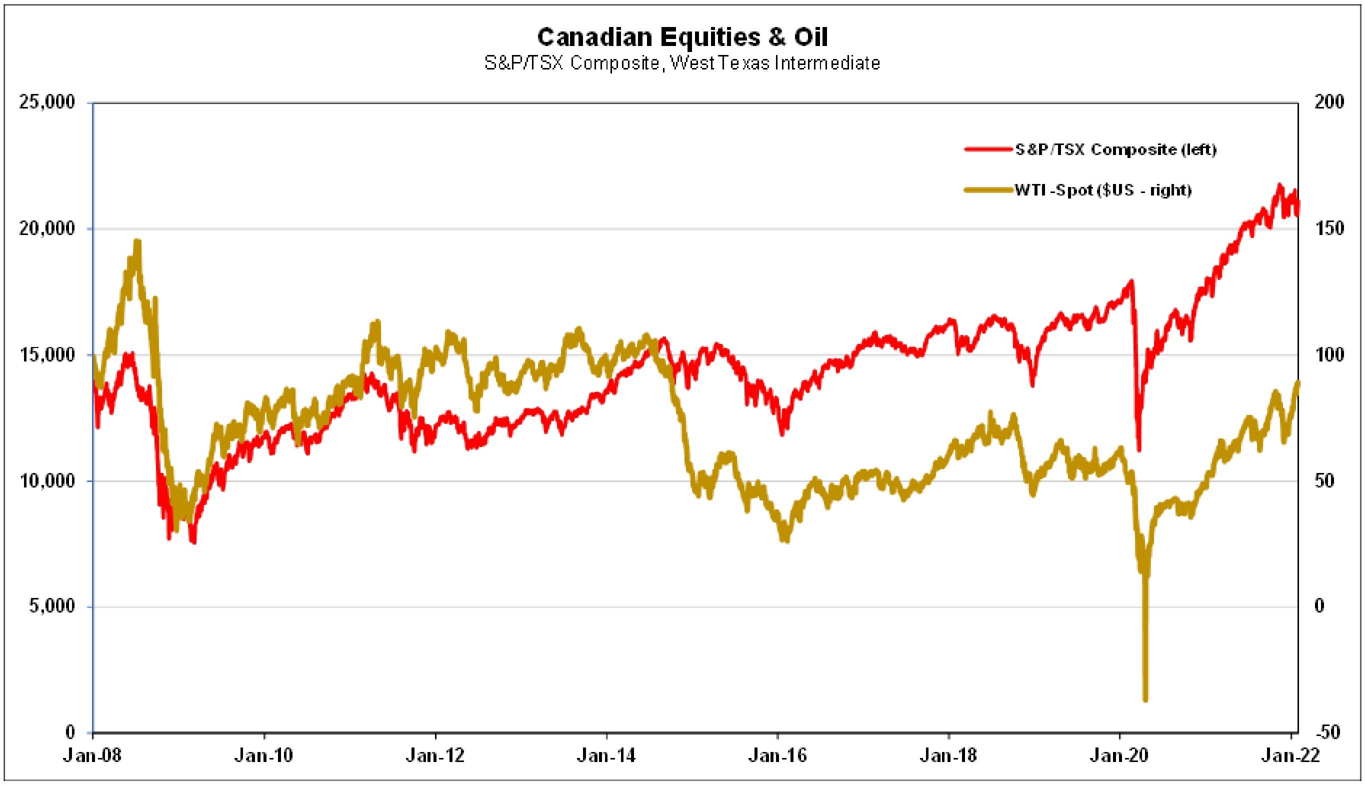
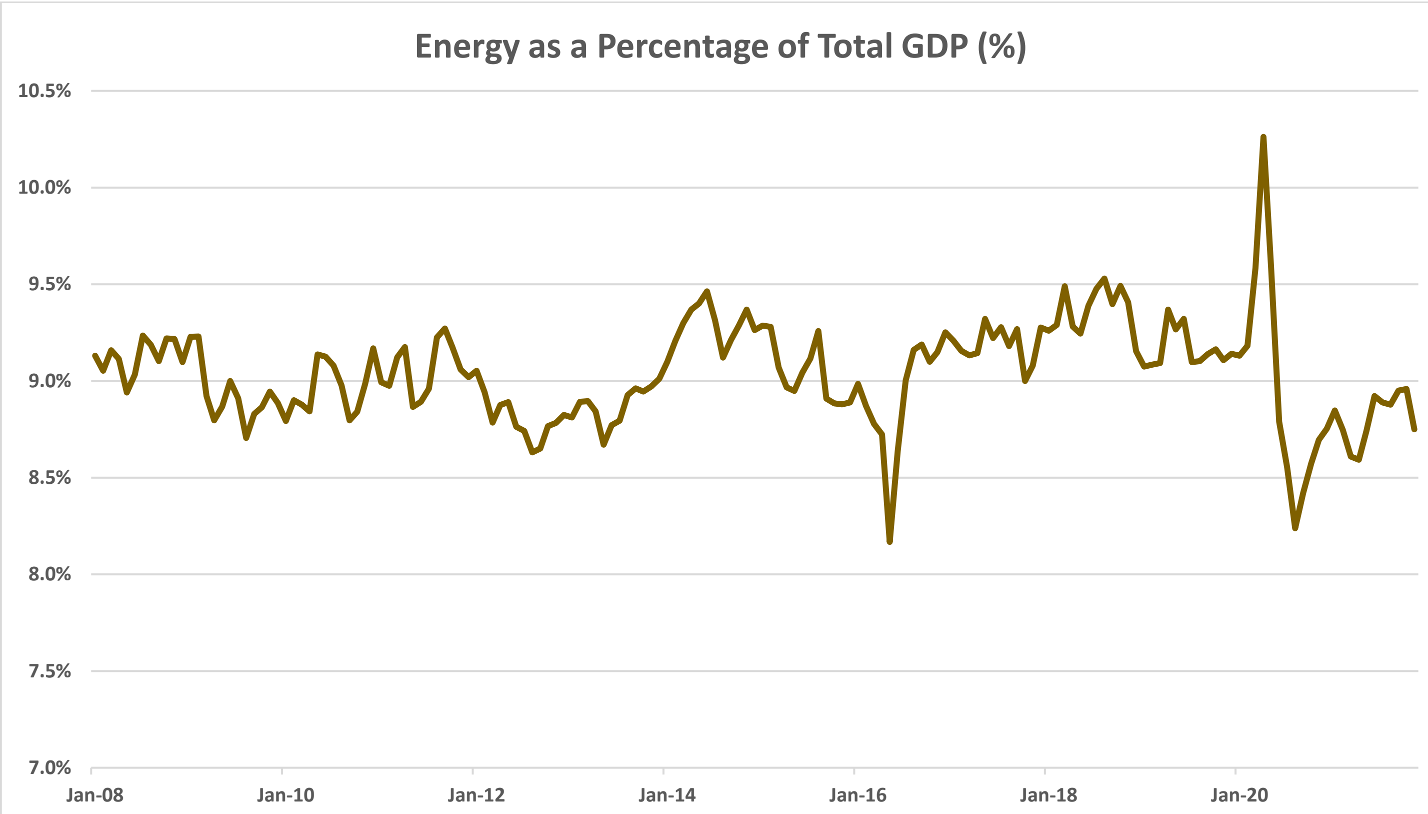


Source: Commodity Systems Inc.; U.S. Energy Information Administration. [February, 2022].

Domestic output and trade

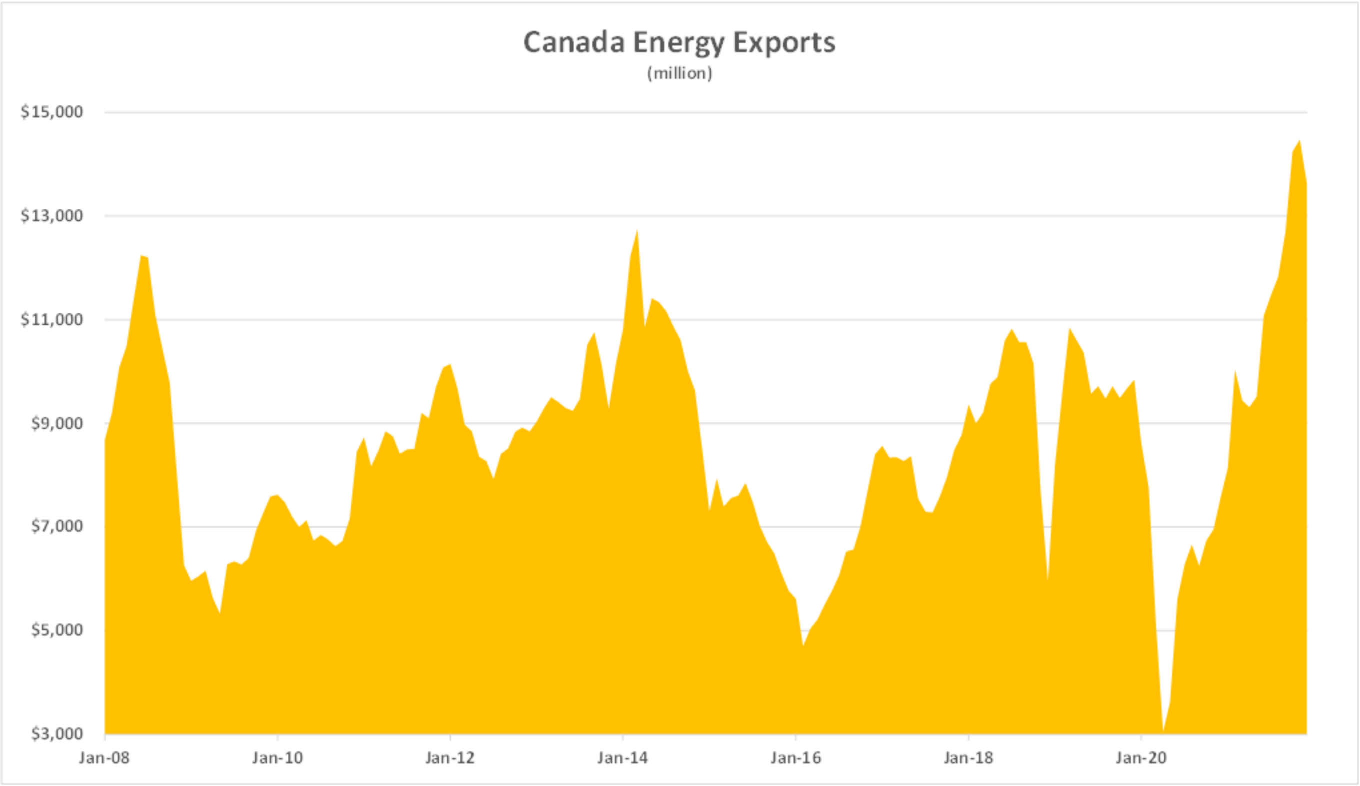
In its November report, Statistics Canada revealed that the energy sector was responsible for 8.7% of the nation's total economic output. During the early stages of the COVID-19 pandemic, as global activity came to a halt, oil prices hit historic lows. The spot price of West Texas Intermediate crude oil (WTI) fell into ***negative*** territory for the first time in its history. On April 20, 2020, ***sellers paid buyers*** US$36.98 to take a barrel of oil off of their hands. As outlined in the graph below, despite the sharp price drop, severe weakness in the rest of the economy allowed the energy sector's proportion of Canada's total economic output to surge to the 10.3% level in April 2020. This marked the highest point since October 1999 (10.4%). The subsequent reversal saw this proportion drop to 8.2% by August 2020. This was the lowest level since consistent records were first kept in 1997. A move back toward the three-year average of 9.2% (2017 to 2019) now appears to be underway.



Source: Statistics Canada. [November, 2021]

Canada is typically ranked as number three[3] in established oil reserves, and commodity buyers have been very supportive in recent months. Heightened demand, coupled with diminished worldwide investment in new energy development projects in the past several years, has also helped boost Canadian exports. The most recent data available shows that Canada's exports of energy products hit $14.7 billion in November 2021. This is the highest on record dating back to 1988. The subsequent rebound in global energy demand that is expected to accompany a broader economic reopening is likely to push this figure higher. In addition, the appearance of policy moves in a number of nations that support traditional energy use will further boost global demand.

[3] **U.S. Energy Information Administration.**



Source: Statistics Canada [December, 2021]

Global energy security rises in importance

An early cold snap in Europe this winter, which coincided with a period of prolonged low wind speeds, left electricity providers scrambling to avoid rolling blackouts. Not surprisingly, by late September 2021, coal prices had already moved to US$200 per metric ton, their highest point since 2008. Natural gas prices also hit a 13-year high of US$6.70 per million BTU on February 2, 2022. Similarly, spot prices for WTI breached the US$95 per barrel mark on February 14, 2022. This was the first move above that mark since September 26, 2014. Further, concerns have spread that Europe's energy crunch may be longer lived than first anticipated. Colder temperatures and rising expectations for a protracted winter, coupled with the developing situation in the Ukraine, have added to worries over Western Europe's energy security. On February 1, 2022, the European Union announced that investments in natural gas and nuclear power would now be deemed "sustainable."[4] This further opened the door to move away from wind and solar, and back toward the development of more conventional energy sources

Despite considerable efforts to present a united front at the Glasgow climate change conference (COP26), the final announcement came only after extended negotiations took the conference beyond its scheduled close. The final agreement stated that coal use would be "phased down" rather than "phased out" as India, China and the U.S. negotiated a far more modest

[4] **EU Unveils Controversial Green Label for Gas and Nuclear. Bloomberg. February 1, 2022.**

pledge.[5] China has agreed to start reducing coal consumption, but only after the current expansion phase is set to end in 2025.[6] Further, "a report published this month by researchers at China's State Grid Corporation said energy security concerns mean the country is likely to build as much as 150 gigawatts (GW) of new coal-fired power capacity over the 2021 to 2025 period, bringing the total to 1,230 GW."[7]

Coal use in India is also unlikely to decline any time soon. "Today 70% of the country's electricity comes from coal."[8] The nation has 74 coal-fired plants either under construction or at pre-construction status. Japan also approved a revised energy plan that would revive its nuclear capacity and includes 22 state-of-the-art coal fired plants.[9] The Japanese strategy calls for the share of oil and natural gas produced either domestically or under the control of Japanese enterprises overseas to increase from 34.7% in fiscal year 2019 to more than 60% in 2040. According to the cabinet report, "no compromise is acceptable to ensure energy security, and it is the obligation of a nation to continue securing necessary resources." Given these developments, it appears that many nations are far more focused on energy security than reducing emissions.

U.S. demand

U.S. energy security has also made headlines as OPEC and its allied oil-producing nations (OPEC+) rebuffed President Biden's call for the group to significantly increase production at their November 2021 meeting.[10] Despite meaningful advances in electric vehicles, the U.S Energy Information Administration forecasts that the fleet of vehicles using internal combustion engines will not actually reach a peak until 2038. As can be seen in the graph below, technology changes that allowed the use of fracking to become more economical, saw U.S oil production reverse the downward trend that emerged in mid-2015. Still, even with renewed interest in reducing the nation's dependence on foreign supplies, oil production has yet to return to the December 2019 peak.

[5] From a carbon market to a coal "phase down," here are the 8 key takeaways from COP26. Fortune. November 15, 2021.
[6] China fires up giant coal power plant in face of calls for cuts. Reuters. December 28, 2021.
[7] Ibid.
[8] Why is India clinging to coal? The Economist. November 16, 2021.
[9] Japan Is Backing Oil and Gas Even After COP26 Climate Talks. Bloomberg. December 1, 2021.
[10] OPEC says to Biden: If you want more oil, pump it yourself. Forbes. November 9, 2021.

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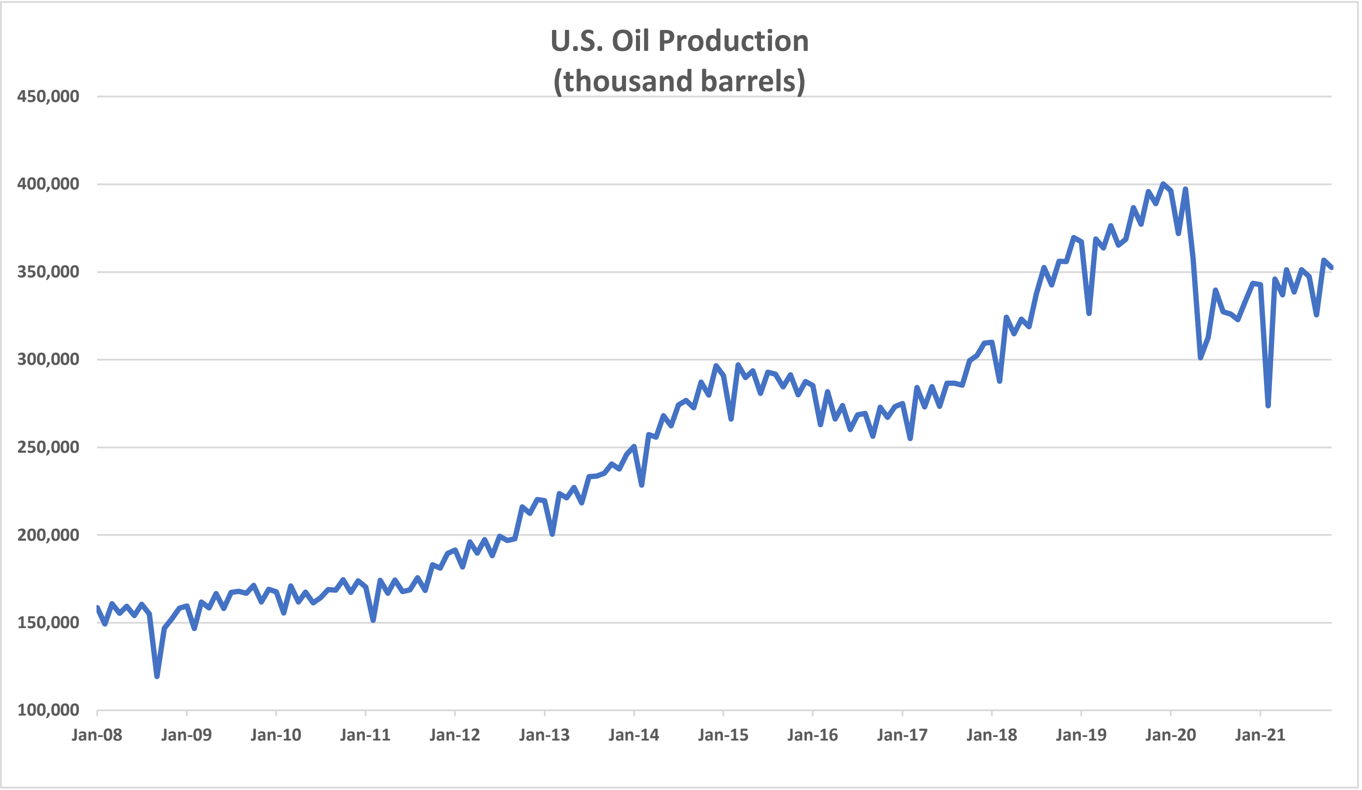

Source: U.S. Energy Information Administration [November, 2021]

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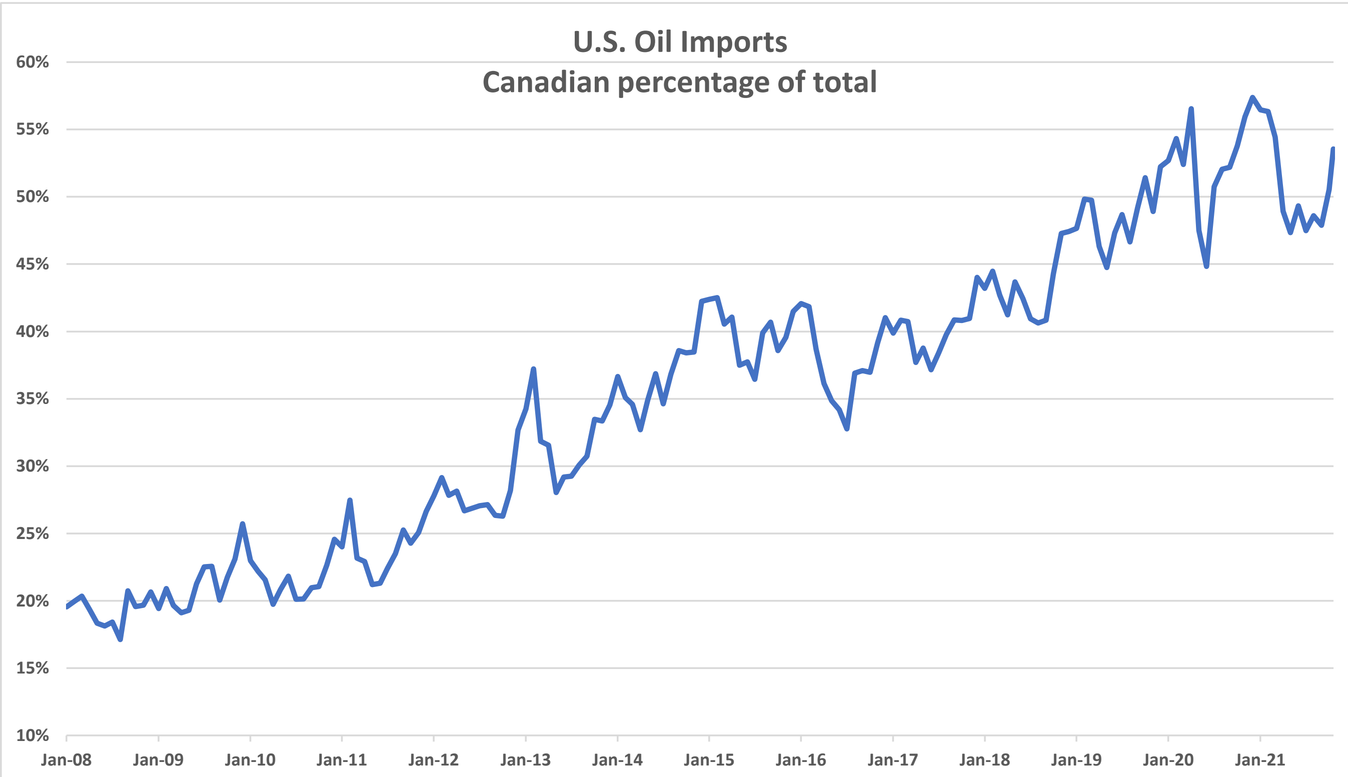
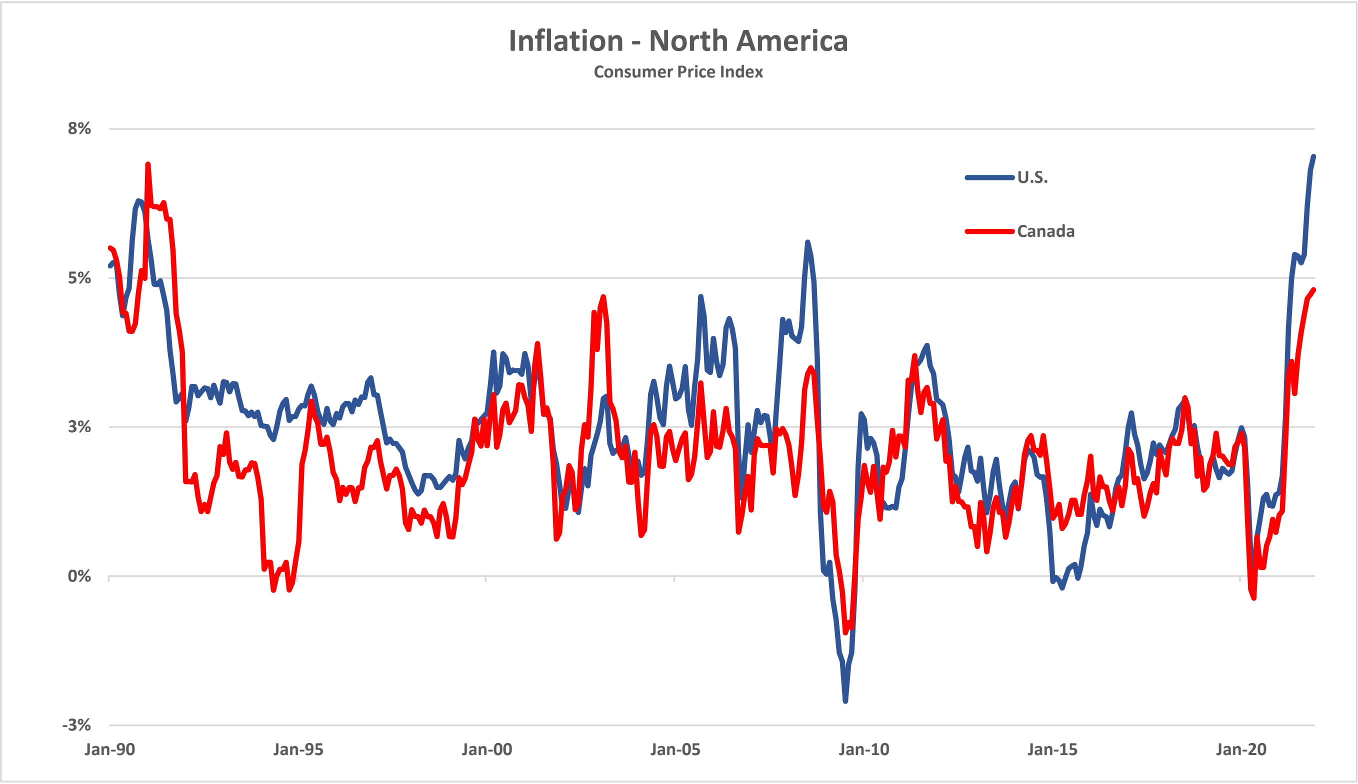


Source: U.S. Energy Information Administration (November, 2021]

While many conflicting policies and headlines continue to dominate discussions of the energy sector, Canada has quietly become an increasingly important provider of energy to the U.S. In 2001, Canada was the source of 15.4% of American imports of crude oil and petroleum products. As outlined in the graph above, that figure had climbed to 23.9% in 2011, and stood at 51.0% for the first 11 months of 2021. The last time WTI traded at US$100 per barrel was on July 30, 2014. Given the current demand pressures, analysts are beginning to discuss a return to that level. Not surprisingly, energy price inflation is reflected in the consumer price data.

Inflation and the Canadian dollar

As outlined in the graph below, inflation in North America has been well-contained for most of the past three decades. In fact, the balance of risks has typically been characterized as the risk of a move to the downside or outright ***deflation***. With North American economies reopening in fits and starts, concerns over inflationary pressures have resurfaced. From supply-chain disruptions to labour shortages to increased global demand, upward price pressures have accumulated. The U.S. Bureau of Labour Statistics reported that the Consumer Price Index rose 0.5% (seasonally adjusted) in January. The monthly gain was sufficient to return the annual pace of inflation to 7.5% (unadjusted), which is now the fastest rate since February 1982 (7.6%). As outlined in the chart below, domestically, Statistics Canada reported that consumer prices rose 0.6% (seasonally adjusted) in January with a somewhat less alarming 5.1% advance on a year-over-year basis. Regardless, this is the fastest pace of inflation in Canada since September, 1991 (5.5%). Both the data in Canada and the U.S. continue suggest that inflationary pressures have yet to peak. Having abandoned rhetoric on the "transitory" nature of the current inflationary period, the central banks of both countries have been clear that a tightening cycle of higher interest rates will begin in 2022.



Source: U.S. Bureau of Labor Statistics; Statistics Canada. {January, 2022)

As has been the case since the currency was allowed to float freely, inflation and the value of the Canadian dollar are inexorably linked. After the recovery from the financial crisis in 2008, the Canadian dollar traded above parity with its U.S. counterpart for an extended period. As outlined in the graph below, the loonie broke weaker in February 2013 and has not been par since. The Canadian dollar eventually established a near 13-year low of US$0.682 on January 20, 2016. Since then, it has seen significant bouts of volatility. The onset of the pandemic was no different. By March 18, 2020, the Canadian dollar had broken lower to US$0.689. In a surprise move by the Bank of Canada, administered interest rates were left unchanged following its January 26, 2022 policy meeting. While the bank has always stated that it does not seek to target the value of the currency, analysts suggested that the delay in raising rates may have been due to a desire to prevent a move up in the Canadian dollar, ahead of any interest rate action by the U.S. Federal Reserve. A higher value for the Canadian dollar would make our exports less attractive globally. Nevertheless, the same higher value currency would equally act as a brake being applied to any imported inflation. The moves by the two central banks over 2022 will be reflected by movements in the currency market.

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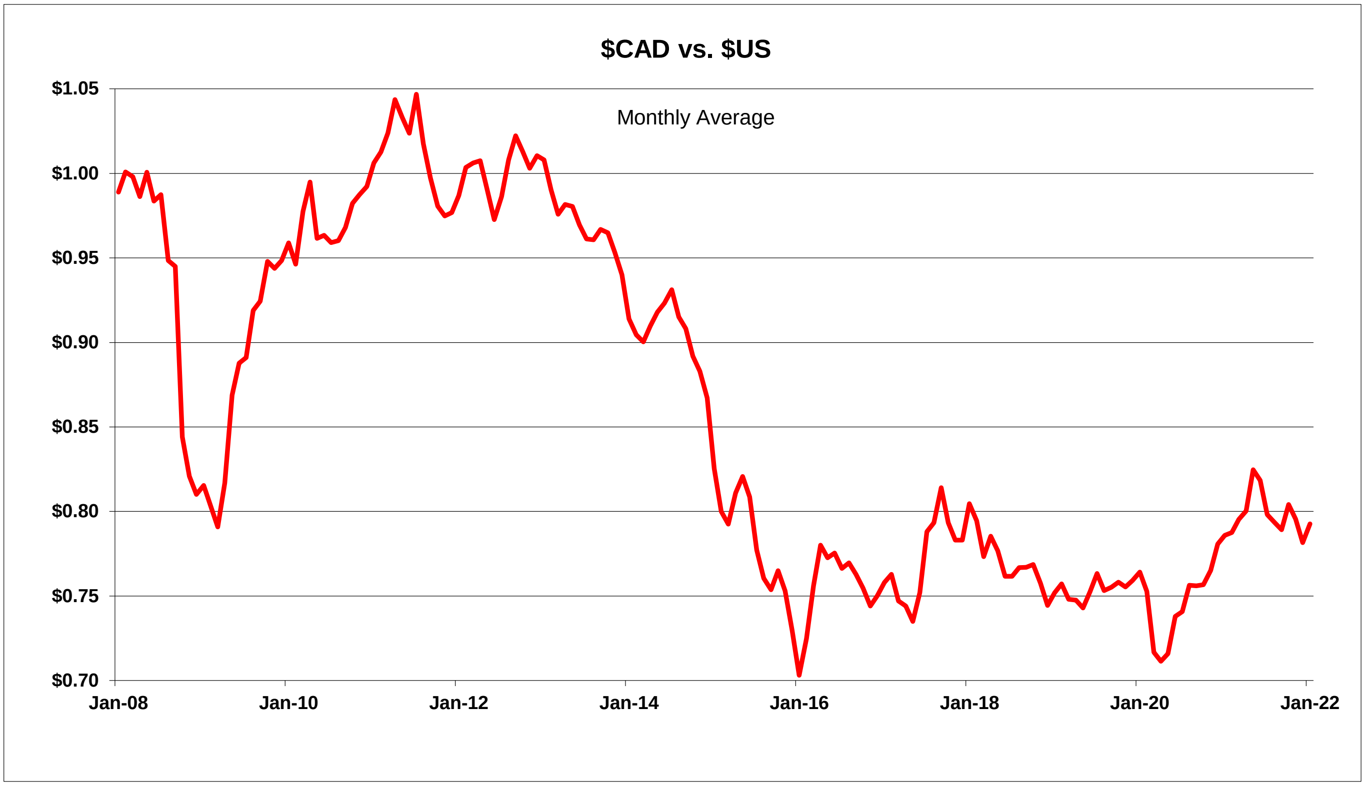

Source: Bank of Canada [January, 2021]

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CONCLUSIONS

- Canada’s wealth of natural resources has long been a key part of the economy. Strong commodity cycles and higher global prices tend to support international investments in these sectors.
- The transition away from traditional energy sources will take considerable time. A global resurgence in political rhetoric surrounding energy security will fuel further interest in fossil fuels.
- A fluctuating Canadian dollar, amid both rising inflation and interest rates, will result in a volatile investing landscape. Maintaining a longer-term view is key to maximizing portfolio performance. Taking advantage of professional advice ensures that investors are well-positioned for changing market environments.

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