COMMENTARY

October 31, 2014

Dear clients and colleagues,

After reaching a high in June at $107 for WTI, the price of oil has since declined to around $80. Many analysts have lowered their oil price forecast with Goldman Sachs being the latest and forecasting oil at $75. Natural gas prices have followed a similar trend and are now at $3.50 per mcf, and with no cold weather in sight, they may yet go lower.

For companies in the sector, it has been a scary ride. From January to the end of June, Energy was the top performing sector of equity benchmarks up 14% in the US and up 23% in Canada. YTD it is down 2.6% in the US and down 4.6% in Canada.

The picture for smaller cap companies is even scarier. Names in our portfolios have been liquidated as if they were on the verge of bankruptcy. Comstock Resources (CRK US), a US shale oil and gas producer was up 59.4% YTD at the end of June. It has since dropped 61% and is down 37% for the year. Schoeller-Bleckmann (SBO AV), an Austrian producer of drilling equipment in our International small cap portfolio was up 18% YTD at the end of June. It is now down 14% for the year. These are not unique, but representative of the whole sector.

Overdone? We think so.

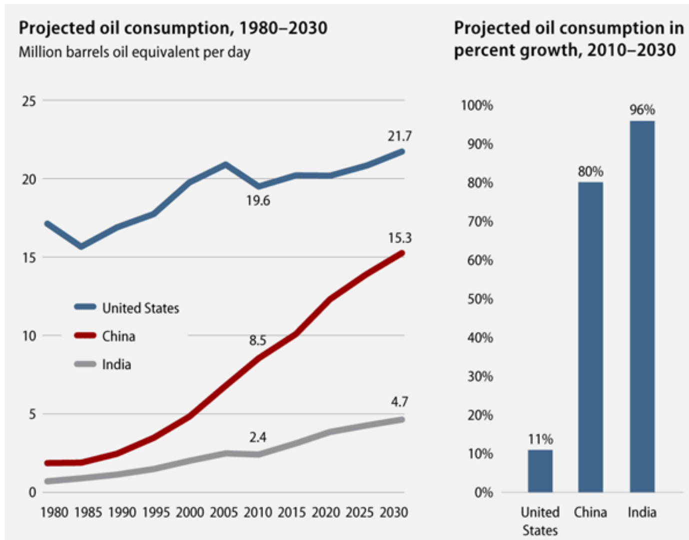
In its latest quarter, Comstock Resources, http://crkfrisco.com/, reported that its oil production had increased 103% yoy to 12.2 MBbls/d. Its all-in cost was around $45 per Bbl, one of the lowest in the industry. The company has a solid balance sheet, prime acreage, important reserves and is a dividend payer with a yield above 4% at the current stock price. The company stock price is at a 10-year low, actually lower than in 2012, when gas prices were at $1.90 per mcf and oil prices were around $80. Back then, the company also had a much weaker balance sheet.

So what is next?

It is difficult to forecast commodity prices and oil in particular due to the geopolitical nature of the oil market. However, we believe that $80 is the price needed to ensure supply growth. Commodity prices are driven by demand, not supply. We see continued growth in oil demand. China released its oil consumption statistics this week. It was a new record for the month of September and up over 7% from the year before, the fastest growth level in 15 months. And it was not stockpiling; gasoline demand was up 18% year over year, and China imported gasoline for the first time since 2011. China will continue to grow and countries like India, Vietnam and Indonesia are large future users.

We are particularly optimistic about US natural gas prices. Starting in 2015, the first US LNG export facility will open at Sabine Pass. It will export the equivalent of 2Bcf of gas daily. So far, four such facilities have been approved and are being built for a total export capacity of 6 Bcf/d, which is the equivalent of 8% of US daily production. There are currently numerous other applications for export totaling 40 bcf/d, over 50% of current production.

Not all will go forward, but we believe that natural gas will become a global commodity. Today, it sells at $3.50 per mcf in the US, over $14 in Europe and $17 in Japan. We forecast the price in the US will slowly rise to $6-$6.50 per mcf in the next 24 months. A level not reflected in the stock price of our companies.



Source: Energy Information Administration, Office of Energy Markets and End Use, "World Petroleum Consumption, Annual Estimates, 1980-2008," October 6, 2009, available at: http://www.eia.gov/emeu/international/RecentPetroleumConsumptionBarrelsperDay.xls (accessed February 26, 2010); EIA, International Energy Outlook 2009, Table A5, "World Liquids Consumption by Region, Reference Case, 1990-1930," May 2009, available at: http://www.eia.doe.gov/oiaf/ieo/excel/ieoreftab_5.xls (accessed February 26, 2010).

Have a good Halloween.

The Global Alpha Team