Brompton Insights

May 2022

Drilling Like it's $40 Oil

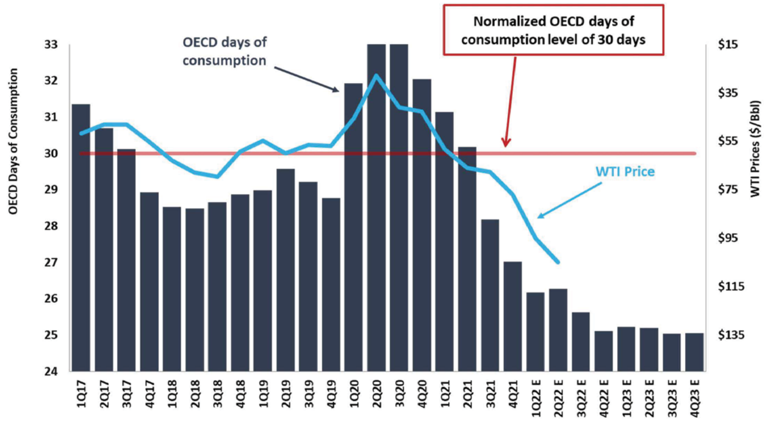
Fund in focus: Brompton Oil Split Corp. (OSP, OSP.PR.A), Brompton Sustainable Real Assets ETF (BREA)

You know oil prices are high when the President of the United States releases reserves from the Strategic Petroleum Reserve ("SPR") twice in less than a year. President Biden announced the first release of 50 million barrels ("Mbbl") on November 23, 2021 and again in March of this year for another 1 million barrels a day over 6 months totaling another 180 million barrels – the largest release ever.

What is not well known is that under the Agreement on International Energy Programme, each IEA (International Energy Agency) country is obligated to hold emergency oil reserves of at least 90 days of net imports. Since the U.S. imports net 3.5 Mbbl per day, the minimum should be 315 Mbbl. By the end of the latest release, the SPR should have approximately 300 Mbbl putting it below the minimum requirement, meaning that the U.S. will have to buy the oil back. The Biden administration has announced a bid process in the fall of 2022 to buy back 60 Mbbl. The SPR release reduces the prices of oil over the next 6 months, but that also gives less incentive for companies to drill.

Supply is tight thanks to strong adherence to production quotas by OPEC+ (OPEC + Russia). Since global inventories peaked in the second quarter of 2020, International Energy Agency ("IEA") data shows an average draw of more than 2 million bpd from end of Q2/20 to year-end 2021. With the Omicron waves receding, demand for oil is returning. Workers are driving to work, and tourists are flying in airplanes. As shown in exhibit 1, inventories are so low that we need to rebuild inventories with more production growth, not just with releasing strategic reserves.

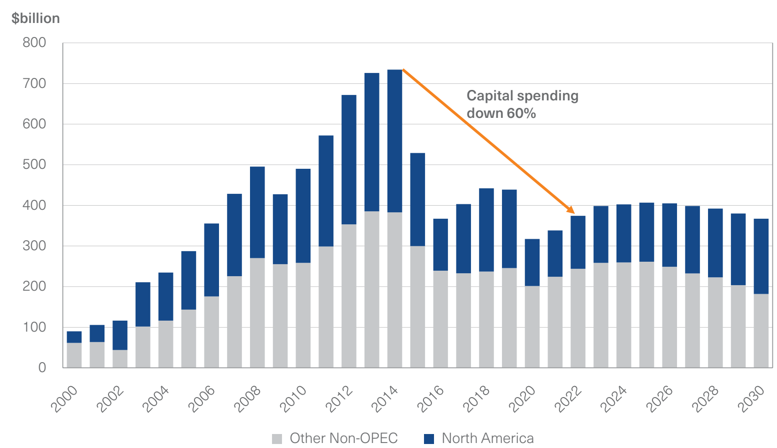
Exhibit 1: OECD Days of Consumption vs Oil Prices (Inverted)



Source: Raymond James as of May 2, 2022

Brompton believes the energy industry has been under-investing since capital spending peaked in 2014, with investments in traditional energy falling approximately 60% from the peak as shown in exhibit 2.

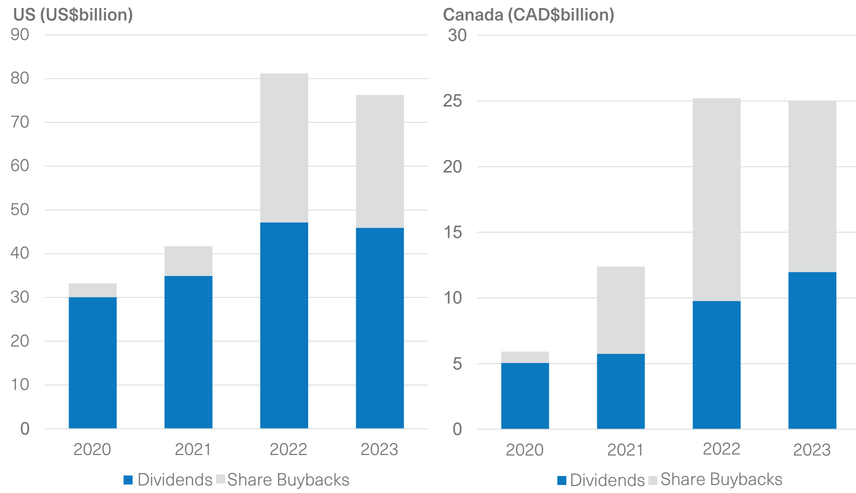
Exhibit 2: Non-OPEC Capital spending trends



Source: BMO Capital Markets, Wood Mackenzie as of May 2022

Instead, oil companies have shown remarkable capital discipline. Instead of sinking money into the ground, they have been paying down debt, increasing dividends and buying back shares. Exhibit 3 below shows the dividends and share buybacks energy companies have returned to shareholders in the U.S. & Canada.

Exhibit 3: Higher Dividends and Share Buybacks



Source: BMO Capital Markets as of May 2022

There are also constraints on oil pipeline capacity in Canada and gas pipeline capacity in the U.S. With a hot job market, it has been hard to entice workers to live and work in remote camps with difficult working conditions. Many oilfield workers refuse to return to such a cyclical business after being laid off in previous cycles. In the past, oil companies chased production growth with higher oil prices triggering drilling and higher production. Most companies are spending as if oil was still $40, not the current $100. There will be production growth, but Brompton believes the response will be severely muted compared to previous cycles. As a result, Brompton believes oil and gas prices could stay higher for longer this cycle.

In terms of valuation, oil and gas stocks are still very attractively valued. At 4% of the market capitalization of the S&P 500, energy actually comprises a far larger 8.4% of the earnings and 11.8% of the free cash flow.

Brompton's Approach

Brompton Oil Split Corp. (OSP, OSP.PR.A) offers exposure to large capitalization North American energy issuers with significant exposure to oil. In addition, we actively manage the energy weighting across our global dividend portfolios (BREA, BDIV, GDV, DGS, EDGF). We also use an actively managed covered call writing overlay to harvest volatility risk premium which enhances risk-adjusted returns.

BROMPTON FUNDS

VALUE
INTEGRITY
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