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THE WEEKLYVIEW

Oil Sector: Give It Time

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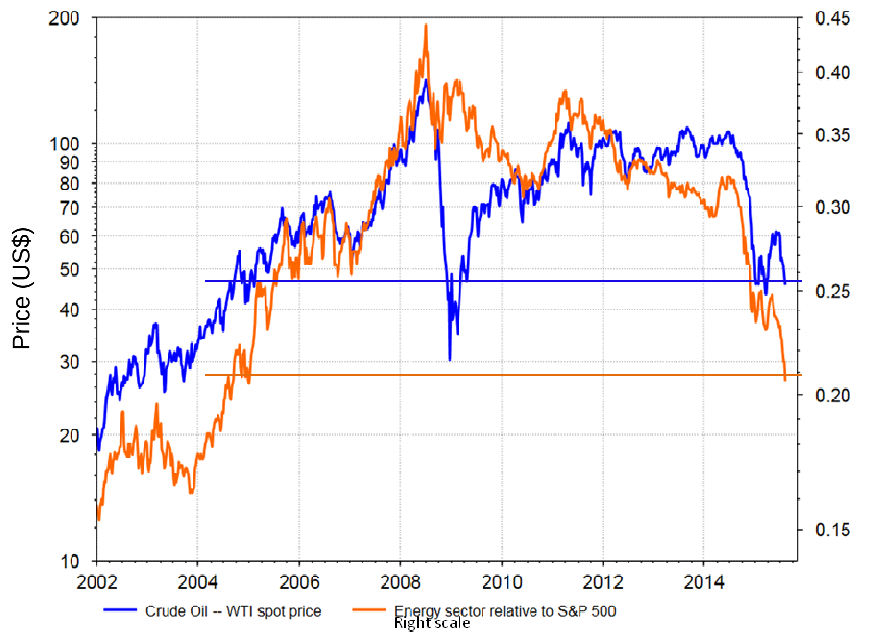
Although the most recent down-leg in energy stocks has brought much greater realism to share prices, we are not tempted to buy.

From a timing perspective, oil prices may soon have a bounce, simply because investor sentiment has become very pessimistic, as shown in our Weekly Chart on page 2.

Oil prices are back to their lows of the start of the year, and oil stocks have broken to new absolute and relative lows (see chart below). This type of change will usually make a value investor curious, so this week we evaluate the sector and conclude that while the most recent down-leg in energy stocks has brought much greater realism to share prices, we are not tempted to buy. Thanks to our global equity team, we have been generally cautious about all commodity sectors and regions since late 2013, stemming from our anticipation of a slowdown in China's investment cycle. This belief has manifest itself in an underweight to materials and commodity industrials in the US; significantly reduced exposure to emerging markets; very little exposure to Australia; an underweight to the UK; and no exposure to Canada.

Within the sector, we made a mistake by underestimating the sensitivity of oil and gas pipeline companies (Master Limited Partnerships [MLPs])[1] to the price of oil; however, our risk management process caused us to reevaluate the position, resulting in the sale of MLPs from our portfolios in two rounds at the beginning and end of July.

The decision that faces us now is how long to remain underweight these groups. Our belief is that we should be patient, because oil prices and the energy sector's relative performance (shown below) have yet to hit a clear bottom.



Source: Thomson Reuters Datastream. Past performance is no guarantee of future results.

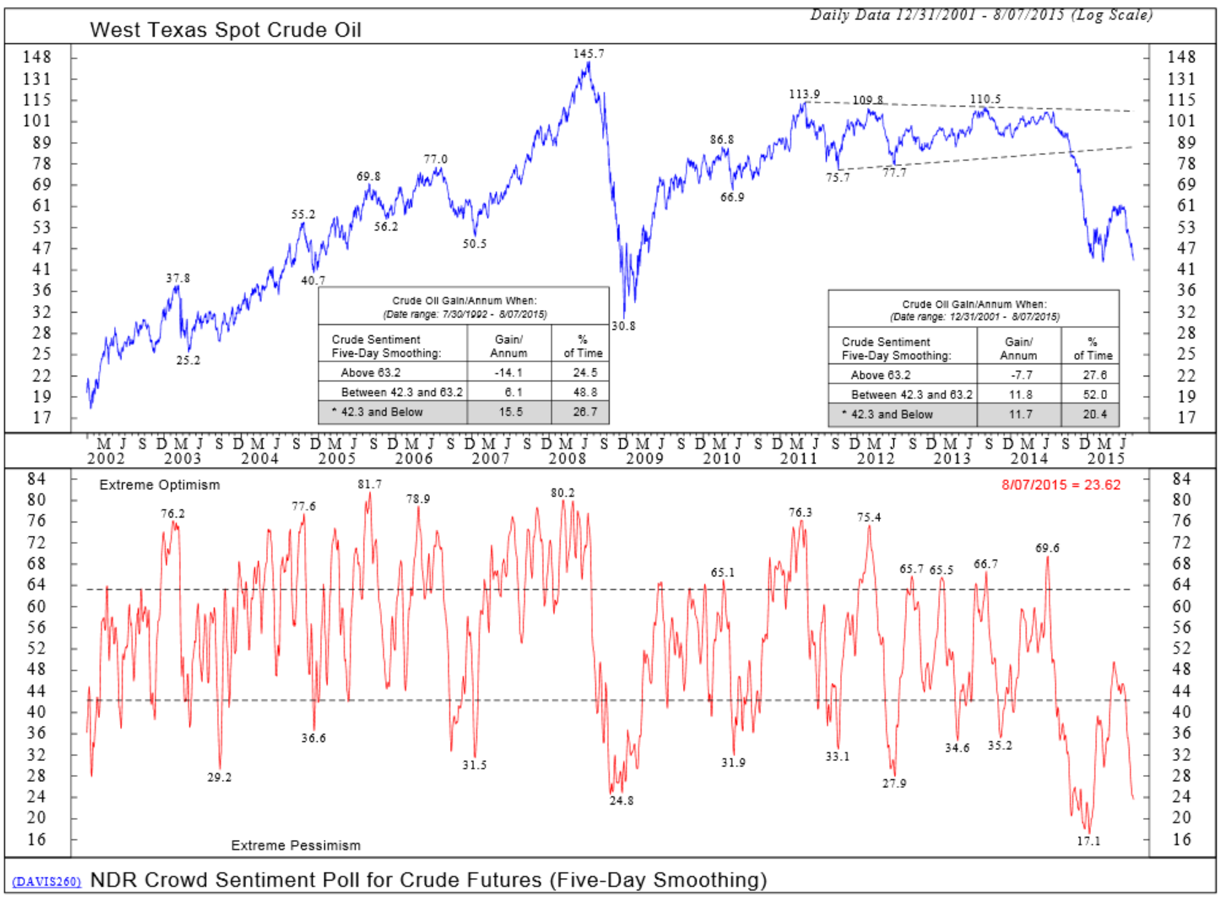
When we look at their price patterns, there is some technical support at current levels for both (see horizontal lines above). Sentiment in the short term is getting close to a pessimistic

[1] *Master Limited Partnerships (MLP) investing includes risks such as equity- and commodity-like volatility. Also, distribution payouts sometimes include the return of principal and, in these instances, references to these payouts as "dividends" or "yields" may be inaccurate and may overstate the profitability/success of the MLP. Additionally, there are potentially complex and adverse tax consequences associated with investing in MLPs. This is largely dependent on how the MLPs are structured and the vehicle used to invest in the MLPs. It is strongly recommended that an investor consider and understand these characteristics of MLPs and consult with a financial and tax professional prior to investment.*

extreme (see Weekly Chart below), but the primary trends (not shown) are still firmly down. Interestingly, our chart above shows the energy sector's relative performance has clearly broken below its March low, whereas oil prices have not. This observation suggests to us that energy investors are now coming to terms with the idea of lower oil prices for a longer period of time. We think they are right, and the risk for oil prices is that they ultimately break down to a lower low, potentially even re-testing the 2008 lows in the mid- to low-$30s price range. Should that occur, the fundamental case for a longer term bottom would be more compelling as it would likely solicit both a supply and a demand response. Our current fundamental view on oil prices is that a trading range is forming with an upside cap somewhere between $60 and $70, which is where the short-term supply from US producers will increase. As yet, we do not have a strong fundamental view regarding the bottom of the range. In the meantime, we suggest patience.

From a timing perspective, oil prices may soon have a bounce, simply because investor sentiment has become very pessimistic, as our chart below shows. While this kind of sentiment work tells us little about the primary trend for oil prices, it does alert us when sentiment gets overly optimistic or pessimistic, which is often a signal for a temporary reversal. Sentiment mostly oscillates between optimism and neutrality in a healthy bull market, and we think it is indicative of the lack of a clear bottom for oil prices that in the most recent bounce, sentiment did not even get to the middle of neutrality.

THE WEEKLY CHART: SHORT-TERM BOUNCE POTENTIAL AS SENTIMENT GETS OVERSOLD



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