

Energy (Overweight): Crude and Share Prices in a Sweet Spot

Yesterday, energy stocks enjoyed a strong session with bullish crude inventories sending the US XLE and OIH indexes above their 40-week moving average. We see this price move as a trend-change, understanding that energy shares are finally reacting to the recovery in US energy consumption in the third quarter. We expect outperformance to carry through in Q4/10 considering the sector undervaluation conditions.

In September, we upgraded the integrated energy group to an overweight stance citing improved gasoline consumption, low raw gasoline inventories and cheap valuation ([September 2 Incubator](#)). In today's Incubator, we look at crude oil fundamentals where we believe conditions are slowly building up for another cyclical push in crude oil over the next 3 to 6 months. A move into a higher range should allow for a positive valuation re-rating of the unloved energy sector.

Contrary to the beliefs of many investors, crude oil fundamentals have improved this year. Case in point, US crude oil apparent consumption (production + net imports) has recovered and is now growing YoY (Chart at right, 3rd panel). This is the fastest growth rate since Q2/07. This is a welcome development given that oil demand over the past three years has been mostly China driven. But as we mentioned in previous strategy wires, US energy consumption is a lagging indicator which responds several months after a recovery in workers' wages (employment * weekly hours * hourly earnings).

Now, could the energy inventory drawdown witnessed yesterday mark the beginning of a much awaited downward reversal for inventories? We believe so! Indeed, if the 2002 and 2006 experiences are any guide, growth (not levels) in energy consumption should translate into a positive inventory response in Q4/10 with YoY growth in crude inventories (not levels) entering contraction territory (Chart at right, 3rd and 4th panels). Such a dynamic has historically marked the beginning of a turnaround and a strong cycle for crude oil and the energy sector.

Finally, a very cheap valuation launchpad makes the energy sector a potential outperformer in the fourth quarter. In Canada, the sector trades at 1.8x book value vs. 2x for the S&P/TSX and 2.1 for the banking group. These 10% and 16% price-to-book discounts stand at or near all-time lows.

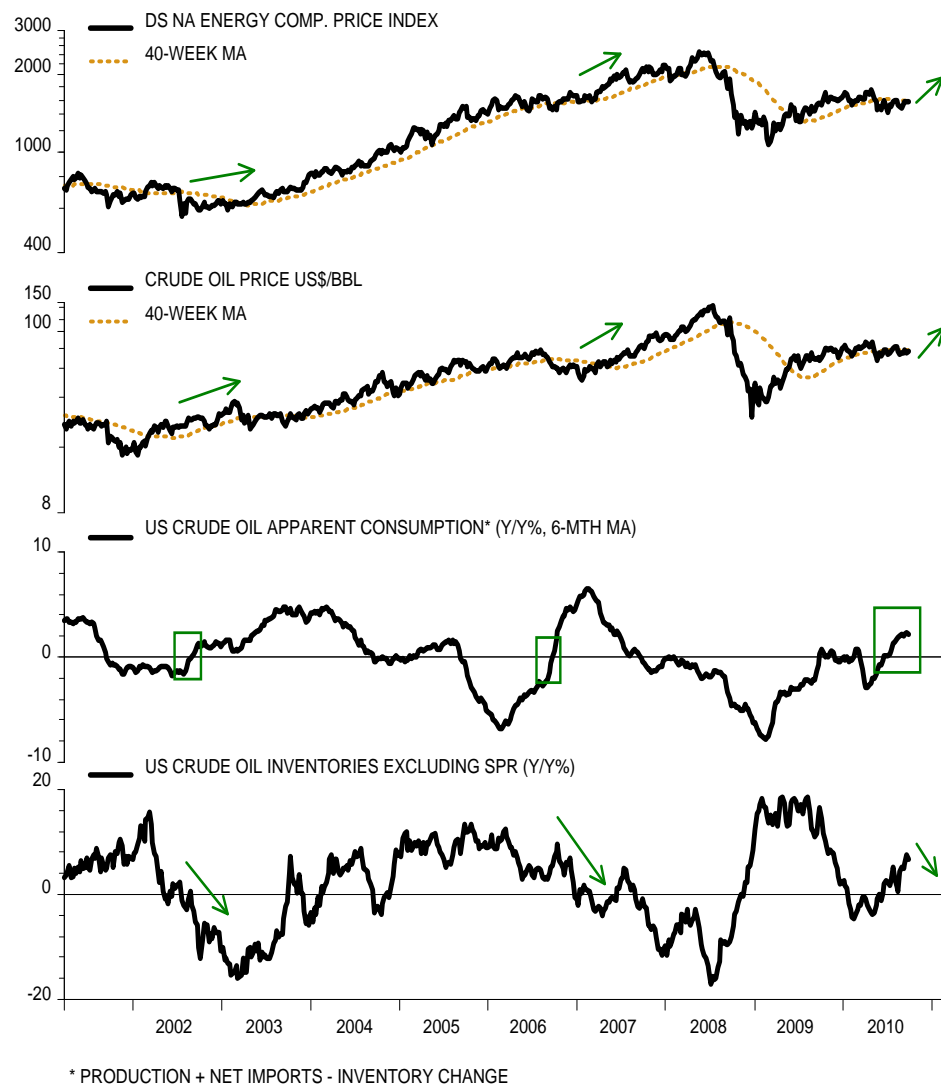
Bottom line: Buy/overweight cheap energy stocks. Yesterday's price move represents, in our view, a sentiment/trend change. The break above key price resistance levels on US energy indexes is supported by a sharp recovery in US energy consumption in the third quarter, which should eventually translate into a positive inventory response in the fourth quarter.

The following sector ETFs provide energy exposure to investors:

Canadian Energy: XEG

US Energy: XLE

CRUDE OIL: US CONSUMPTION FINALLY RECOVERING



Source: Dundee Securities Corp., Thomson Reuters Datastr

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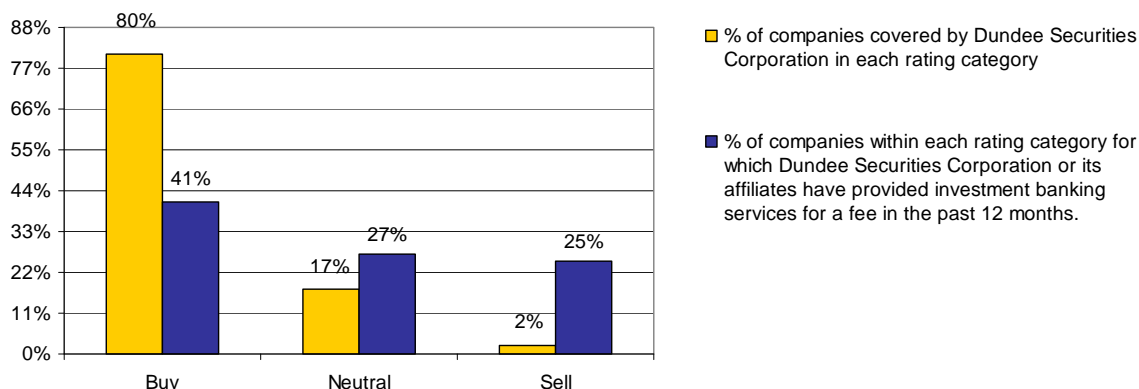
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Dundee Securities Equity Research Ratings



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