THE KWAMMENTARY

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ODLUM BROWN
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Chestnuts roasting on an open (natural gas) fire

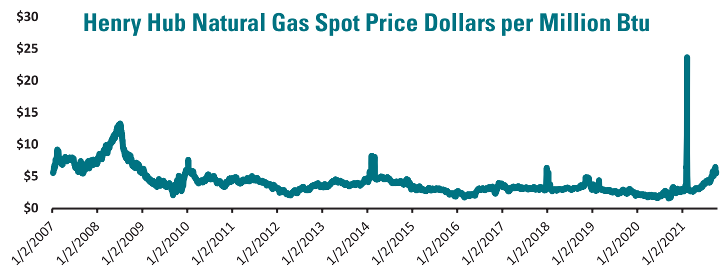
It feels as if polarizing topics are the soup du jour these days, and as such, I feel compelled to throw my hat in the ring with an admission: I start listening to Christmas music **immediately** after Thanksgiving.

I am not ashamed of this, but I've come across enough Scrooge McDucks (a.k.a. a certain someone in my house) to know that being clandestine around this time of year is in my best interest.

In the office, I keep my door closed so as to not offend my colleagues' sensibilities with my festive tunes, but you can usually find me listening to Nat King Cole's "The Christmas Song" (also known as "Chestnuts Roasting on an Open Fire") on repeat from now until December 25. Back when Nat was performing this live, most people were doing their chestnut roasting over a wood fire. Nowadays, you may have your open fire hooked up to your home's gas. Once again, this got me thinking about investments; namely, with gas prices trending upwards in a serious fashion, are we going to be roasting as many chestnuts this year?

Natural Gas – How did we get here?

To understand how we got to this point, it's worth going back to 2015/16. I've focused on North America, but the trends discussed below are applicable globally as well. After a pricing collapse in 2008, persistently low prices for natural gas for almost a decade afterwards (denoted in \$/mmBtu: dollars per million British thermal units) and an oversupplied market due to shale plays in the U.S., the market had finally had enough.

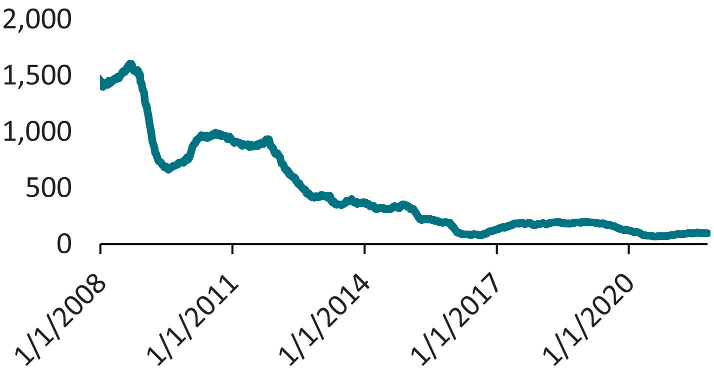


Source: EIA

From 2016 to 2018, natural gas was range bound between \$1.80 and \$3.20 mmBtu: an uneconomical price for a lot of players in the business. With little incentive to develop new projects or maintain existing ones, new businesses left, and established businesses curtailed their spend in this space. If you think back to Economics 101, this process is to be expected; when there is over/undersupply relative to demand, pricing will change in a way that incentivizes businesses to ramp up supply or exit. There was also the compounding issue of increasing social distaste for fossil fuels, and a subsequent regulatory response that further disincentivized production in favour of purely renewable resources. The idea centered around a quick transition away from fossil fuels entirely, instead of a multi-step transition using lower carbon intensive alternatives (like natural gas) as the renewable technology developed. We will revisit this point, as it represents (in my opinion) the crux of why we're at this juncture.

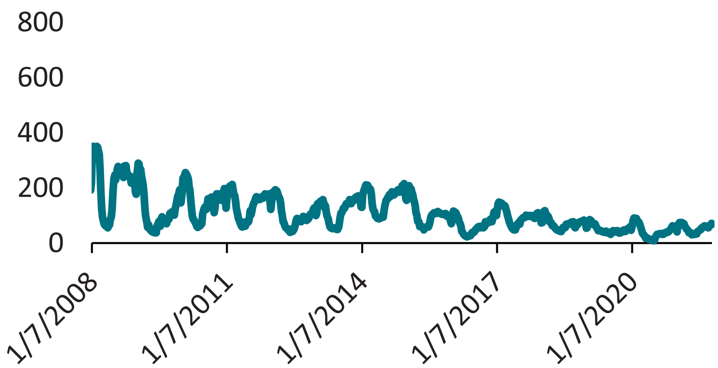
By the time COVID-19 hit in early 2020, the economic woes of many in this space had already worsened to such a point that there was barely a noticeable impact on pricing. Many had left the industry altogether, and those who were still players had focused on cutting costs in order to maximize the sliver of margins that they had left. Below are two charts showing gas drilling activity in the U.S. and Canada that illustrate the point.

Gas Rig Count (U.S.)



Source: Baker Hughes

Gas Rig Count (Canada)



Source: Baker Hughes

Moving through the end of 2020 and beginning of 2021, a series of unfortunate events (several hurricanes and a very cold winter in the South) brought more capacity offline, at the same time that there was increased demand. We all know what happens then (refer to chart on page 1 for a recap).

We are now in an environment where demand for gas is only going to increase, especially into the colder months, while the capacity to supply gas has been severely constrained.

The Energy Debate

The energy debate has taken on a renewed fervor in recent years, both environmentally and politically. Developed and developing nations have made pledges to curb their share of emissions (The Paris Agreement | UNFCCC) and large multinational energy businesses have followed suit with their own initiatives to lower their carbon intensity. In the boardrooms of sovereign wealth funds and pension funds, significant effort is being made to decarbonize portfolios in favour of renewable investments. All of this is a move towards the greater good, in my opinion. However, the fact remains: as a society, we are still heavily reliant on carbon-intensive resources for energy. So long as that is the case, the persistent underinvestment in this space, coupled with the consistently increasing demand for energy, will result in higher prices. Eventually, these alternative technologies will provide the solution we're hoping for, but that time has not come yet. I don't know about you, but between binge-watching *Squid Game* and keeping my home warm for our cat, I cannot see my energy intensity diminishing.

Closing Thoughts – Portfolio Stock(ing) Stuffers

We have been able to participate nicely in the natural gas/energy rally in recent months, and I suspect that trend will continue so long as the factors mentioned above persist. However, this is just a portion of the total investment universe, and unique opportunities like these exist in different areas. As always, our objective is to buy and own businesses that make sense and generate cash flow in multiple scenarios at a reasonable price. So long as we're able to execute on that, every month might feel like it has a little Christmas in it.

As always, I'm happy to chat anytime and can be reached by phone or email if you have any questions or concerns regarding the markets or your investments.

Sincerely,

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