

fat-LITE

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5

A Monthly Investment Publication from Fat Prophets

The inexorable rise of Oil



STOCK OF THE MONTH EnCana

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Where Wealth Creation is Our Mission

A Monthly Investment Publication from Fat Prophets

Oil

The inexorable rise

There have been some interesting developments occurring in the resources sector recently. Despite fears about US economic growth and whether the country has entered recession, many commodity prices continue to make all-time highs. Two in particular, gold and oil, have been gaining most of the headlines.

At Fat Prophets, we have been deeply invested in both of these commodities for years and maintain our position that each are still firmly in the midst of a long term bull market. In this month's Fat-Lite, we will be taking a closer look at the oil sector and some of the reasons behind that market's current strength.

At the start of the year, our target for oil was \$110 per barrel with a run to \$120 seen as possible. Less than three months later and the first of these targets has already been achieved. Whilst the next few months are typically a period of slower demand and lower prices, we still believe that oil will be well supported throughout the year. Yet oil's biggest market, the US, is experiencing real difficulty.



About Fat Prophets

Fat Prophets is an independent international research house providing clear unbiased advice, covering international financial markets. Our independence is maintained by virtue of the fact that we do not provide share execution or investment banking services.

Our investment philosophy follows a value based, typically contrarian approach that combines both fundamental and charting analysis. Our long term bias towards the resources sector and bottom up stock picking ideas have resulted in consistent outperformance against the market since inception seven years ago.

This monthly Fat-Lite publication contains some of our market insights and stock ideas. If you wish to learn more about Fat Prophets, go to

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There is little question now that economic growth in America has slowed significantly. In fact, there is a strong argument to be made in our opinion that a recession is underway. The latest evidence being disappointing employment figures showing a rise in those out of work. Add in the continuing deterioration in the housing market and credit meltdown and the outlook is somewhat less than inspiring.

Yet the policy response to these problems has underpinned an acceleration in the price of oil. Interest rate cuts by the Federal Reserve have been, in our view, rightly interpreted as inflationary and detrimental to the strength of the US dollar. With more weakness on the horizon, the Fed in our opinion will continue stoking inflation and undermining the greenback with further cuts.

Internationally, the Bank of England is also lowering rates though in a much more measured pace. And despite representations to the contrary, displeasure with the strength of the euro should mean that the ECB is not far behind in cutting official rates too.

What this all means is that fiat (i.e. paper) currencies will be the ultimate loser. In an era of floating currencies, inflation generally wins out. (When currencies were fixed to gold deflation usually carried the day.) In the end, these policies will ultimately continue to be beneficial for oil prices in 2008.

Meanwhile, the primary engines of *growing* demand for crude are the Asian powerhouses of China and India. Both of these countries continue to grow at exceptionally strong rates and we do not see any substantial drop off as a result of a US slow down.

For instance, much of China's growth comes from investment and with the country in the midst of an historic industrialisation phase, we would expect these elevated levels of investment and therefore economic growth to continue.

Tangible evidence of the country's resilience to slowing export markets is provided by an examination of the impact that 2001's technology-led slump had on China's GDP. From the peak of 2000, China's export growth rate fell by a hefty 35 percent. Nevertheless, the impact to GDP was a slowdown in growth of less than 1 percentage point.

This is due to the fact that China's business investment and domestic demand is the major component of GDP growth. Indeed, estimates suggest that even if net exports were removed entirely, the country would still achieve high single digit growth.

And recent retail sales data from China showing a 20 percent increase in January and February is encouraging. We believe this supports the case that domestically led consumption, complemented by infrastructure investment, should help sustain economic growth even if export demand weakens.

This in turn will underpin fast growing demand for energy to fuel the economic growth. Oil is playing a major part in satisfying this demand, which we believe will continue for years to come.

The fundamental outlook for oil is also robust in our view as supply in the years ahead will have to run hard to stay in touch with demand. This is borne out by the International Energy Agency (IEA) who believe a drop in demand in developed countries will be largely offset by increases in emerging markets.

Estimates from the IEA are for demand in 2008 to be 87.5 million barrels per day (mb/d) or 2 percent higher than last year. Total world production last month was also 87.5 mb/d, demonstrating the tight match between supply and demand.

And raising output to provide a buffer and alleviate upward pressure on prices is, in the current environment, a difficult task. Most large and easy to exploit fields have been discovered. This leaves the oil companies in a position where unconventional (oil sands) and expensive (deepwater drilling) resources are the new targets.

This situation creates a floor for oil prices as development will not occur if a weaker oil price makes resources uneconomic. It also means that new discoveries take longer to bring into production. So, although vast amounts of money are being invested, supply simply cannot respond as quickly as demand is rising.

Furthermore, the geo-political risk premium will likely continue to support higher oil prices in the year ahead. From disruption in the Niger Delta, to the rise of resource nationalism and unrest in the Middle East, we believe the location of the world's energy reserves fully justifies such premiums.

Taken together we believe these are all compelling reasons to remain bullish on oil as we enter 2008. Whilst the strong gains made so far this year opens the door to a correction in the coming months, such pull backs will in our view be temporary as oil continues its inexorable rise higher.

To this end our strategy remains the same. We favor resource related stocks over the financials and will remain overweight to the energy sector.

Encana

Delivering solid growth

Market Cap \$57.27 billion

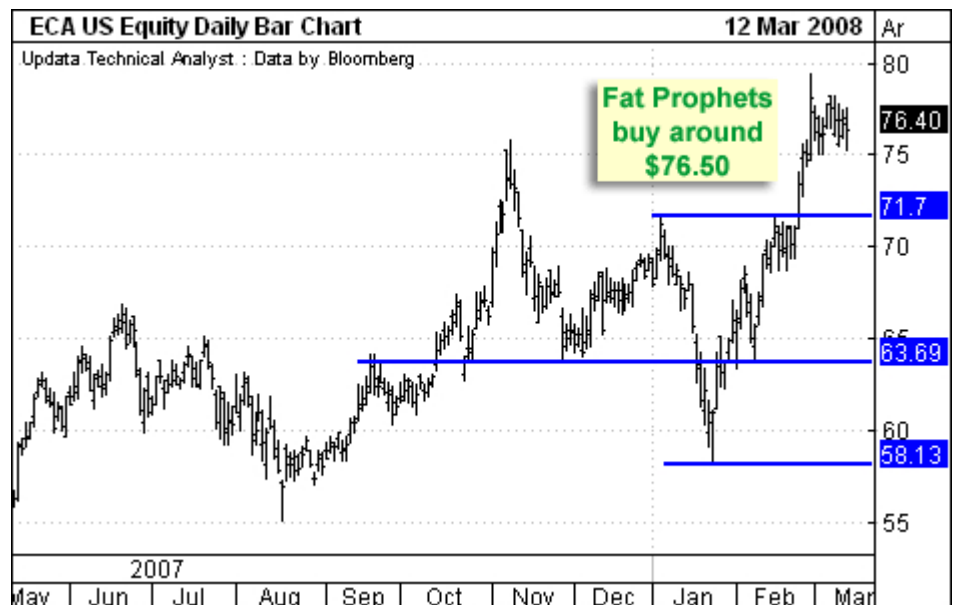
Buy around \$76.40

"In the late nineties when oil was trading below \$20 per barrel, prohibitive development costs made vast hydrocarbon deposits such as the Canadian oil sands uneconomical. This however all changed as that price climbed in subsequent years."

A common problem for many large integrated oil and gas companies today is finding a way to not only increase production year over year but also to find new reserves to replace this output. In the case of EnCana (NYSE, ECA) however, full year results confirm the company is anything but common.

Today's large energy companies have a serious challenge to grapple with. Large, mature hydrocarbon reservoirs discovered years ago are going into natural decline, meanwhile access to new exploration acreage is becoming more limited. This is largely due to the desire of governments around the world wanting to maintain control of, and to profit from, the respective nations' natural resources.

While this has always been the case, the rise in the price of oil has exacerbated the issue. Take for instance the politicization of oil in Russia and Venezuela to name but two countries to have made recent headlines. The result is



that the search for new reserves (and future production) must expand to areas less exploited in the past for one reason or another.

One reason this may have been the case is technological know how, cost of development is another. In the late nineties when oil was trading below \$20 per barrel, prohibitive development costs made vast hydrocarbon deposits such as the Canadian oil sands uneconomical. This however, all changed as the price climbed in subsequent years.

EnCana recognized the changes facing the industry and chose to focus on unconventional natural gas and oil plays. Significantly, the company has also maintained primary operations in the politically stable North American region. Recent sales of assets in Chad, Australia and Brazil highlight this point.

Despite this strategy of staying close to 'home', EnCana's production and reserve replacement are very encouraging. Last year's total production from continuing operations was 4.4 billion cubic feet equivalent per day (Bcfe/d), a 5 percent increase on 2006. Leading the way were solid results from what the group refers to as 'key plays'.

These fields are all located in the US and Canada. The natural gas key plays grew production by 25 percent to 3.6 Bcfe/d while integrated oil production from oil sands projects rose 25 percent to 26,814 barrels per day. In particular, US production stood out with strong growth from the East Texas, Fort Worth and Jonah plays.

Looking ahead, production in 2008 is forecast to rise again to 4.6 Bcfe/d. Given our view that energy markets will remain buoyant this year, we believe the rising production profile bodes very well for earnings growth.

The company's success in building reserves was truly outstanding. Total proved reserves at the end of last year stood at 18.9 trillion cfe! This represents a 12 percent increase, and a reserve replacement ratio of over 200 percent. Major natural gas additions to the build up came from Cutbank Ridge, Jonah and Piceance, and oil contributions from Foster Creek and Christina Lake.

A final impressive feature of this build in reserves is the low finding and development cost of only \$1.65 per million cfe. Although this is higher than the \$1.59 three year average, it is encouragingly less than 2006 - indicating to us that EnCana are keeping a firm grip on costs.

Going forward we are confident that the company has several projects in the pipeline that will maintain production growth beyond this year. For instance, there is the \$5.4 billion project to increase bitumen output from Foster Creek and Christina Lake to 400,000 bopd by 2015. There is also Borealis in Fort McMurray, which when fully operational in 2010 will add 100,000 bopd.

Also by 2010, the \$700 million Deep Panuke natural gas project offshore Nova Scotia will begin delivering between 200 and 300 million cubic feet of gas per day.

Downstream projects associated with refining and part of a joint venture agreed with ConocoPhillips at the start of last year are also set to grow rapidly. At present, plans involve investing \$5.3 billion in expanding heavy oil processing capacity at the Wood River and Borger refineries from 60,000 to 550,000 barrels a day by 2015.

EnCana, however, will not have to wait that long to notice the positive impact of the JV. Already this year, cash flow from operations at the refineries of \$1.3 billion was twice the amount management originally expected. Contributing to this performance was a robust crude utilization rate of 96 percent.

Altogether, the rising production, solid downstream business, high oil price and favorable gas hedges added up to a 25 percent increase in group operating earnings to \$4.1 billion.

We already know that solid refining operations boosted cash flows in that segment, but overall EnCana was also impressive. For the year, cash flows were 18 percent higher at \$8.5 billion. Hardly surprising then that the company

was able to fund a healthy capital investment program while also making \$2.3 billion in acquisitions, re-purchasing over \$2 billion in stock and doubling the fourth quarter dividend.

Companies that generate large amounts of cash like EnCana are often faced with the dilemma of how best to use it. We believe the company has struck a sensible balance between investment in operations and shareholder returns.

From a charting perspective, the longer-term outlook for EnCana remains positive. As evident on the weekly chart below, a strong upward trend has been in place since the initial listing of the stock in 2001.

More recently, following a corrective low of \$58.13 in January, the stock has rebounded strongly to reach a new all time high of \$79.38 last month. In our opinion, this move reflects the strength of underlying investor support for the stock.

Currently, prices are consolidating at the highs, which is not surprising given the strength of recent gains. In the near term, we anticipate additional consolidation with support in the region of \$71.70 limiting downside risks. Once the current short-term consolidative phase is complete, we anticipate a continuation of the resilient long-term upward trend, with further gains achievable in the months ahead.



Given EnCana's potential to increase production, ramp up refining capacity and success in replacing output with new reserves, we believe the stock trades on an undemanding prospective price earnings ratio of 14.5 times with a dividend yield of around 2 percent.

As such, and with the long term energy bull market still intact, we recommend EnCana as Buy around \$76.40.

Chart of the Month

Oil

As evident on the daily chart, the price of Crude Oil was contained to a relatively broad range between October and February, with support at \$85.82 and resistance in the region of \$100. However, a decisive break through the upper end of this range has since seen prices reach an all-time high of \$110.20.

From the January 2007 low of \$49.90, prices have risen by as much as 120 percent. However, after the four-month pause for consolidation between October and February, there has been a clear rejuvenation of upward momentum and we believe that further gains are achievable in the months ahead. While we cannot rule out corrective dips in price, we believe that the \$100 level now provides a substantial area of support.



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For Fat Lite readers who are interested in a way to play this inexorable rise in oil, we have published a full story on how to do this in our full US report. [Click here](#) to subscribe to the full Fat Prophets USA report.

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