

ANALYST(S)

Jennifer Rowland, CFA

Buy-rated energy stocks:**Integrated Oil & Gas:**

- **Chevron** (CVX - US\$86.39)
- **Suncor** (SU.TO - \$21.87)
- **Total SA** (TOT - US\$39.09)

Refining & Marketing:

- **Marathon Petroleum** (MPC - US\$37.18)
- **Valero Energy** (VLO - US\$54.26)

Storage & Transportation:

- **Enbridge** (ENB.TO - \$43.32)
- **ONEOK** (OKE - \$27.86)
- **Pembina** (PPL.TO - \$35.41)
- **TC Energy** (TRP.TO - \$65.22)

Prices and opinion ratings as of market close on 8/19/2020; subject to change. Source: Reuters.

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OIL AND NATURAL GAS PRICE OUTLOOK

Oil prices suffered a severe decline in early 2020, with the Canadian benchmark Western Canadian Select (WCS) declining from US\$40 per barrel at the beginning of the year to under US \$5 per barrel in April and partially recovering since then. Oil prices were hit by the drastic loss in demand from the COVID-19 pandemic combined with an increase in oil supply following the collapse of the OPEC+ alliance in March 2020. Although the OPEC+ alliance was able to reach agreement on a historic production cut in terms of size and duration, the near-term outlook for oil prices remains challenging. Oil inventories have built rapidly around the world and will likely remain bloated well into 2021, which will keep a lid on oil prices in the near-term.

Longer-term, we expect WCS to range from US\$30 to US\$50 per barrel. The discount to U.S. prices reflects differences in the quality of the crude as well as the cost of transportation, which has increased because there is not enough pipeline capacity to meet Canadian production. Assuming OPEC+ adheres to its production-cut agreement and oil demand begins to recover in the second half of 2020, we expect global oil inventories to return to more normal levels by the end of 2021. A key risk to our long-term outlook is the pace of oil demand growth, which is less certain given the global economy's transition towards a lower-carbon future. In the short term, we expect oil prices to remain below this range, and we expect significant price volatility to continue.

For Canadian natural gas, we expect prices to range from US \$1.00 to US\$1.75 per thousand cubic feet. Prices can swing significantly based on changes in weather. We expect prices to be near the low end of this range in 2020 as supply growth outpaces demand growth. In coming years, we expect that growing liquefied natural gas (LNG) exports from North America and further usage for power generation should help support prices in our long-term range.

GUIDANCE

Despite stocks trading at discounts to historic valuation levels, broad negative sentiment towards the energy sector is likely to remain a headwind until there is less oversupply of oil. Energy stocks can be very volatile given the commodity-sensitive nature of cash flows. In looking through these short-term movements, we see long-term upside potential in our Buy-rated stocks. We prefer energy stocks in the integrated oil & gas, storage & transportation, and refining & marketing subsectors, where companies have strong balance sheets that allow them to weather commodity-price weakness and support dividends.

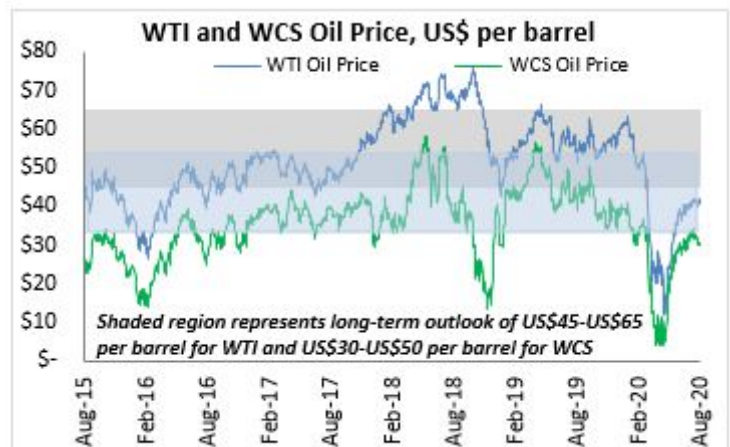
What Is Our Outlook for Oil Prices?

Oil prices suffered a severe decline in early 2020, with the Canadian benchmark Western Canadian Select (WCS) declining from US\$40 per barrel at the beginning of the year to under US\$5 per barrel in April and partially recovering since then. Oil prices were hit by the drastic loss in demand from the COVID-19 pandemic combined with an increase in oil supply following the collapse of the OPEC+ alliance in March 2020. Although the OPEC+ alliance was able to reach agreement on a historic production cut in terms of size and duration, the near-term outlook for oil prices remains challenging. Oil inventories have built rapidly around the world and will likely remain bloated well into 2021, which will keep a lid on oil prices in the near-term.

Longer-term, we expect WCS to range from US\$30 to US\$50 per barrel, below our forecast for the U.S. oil benchmark West Texas Intermediate (WTI) of US\$45 to US\$65 per barrel (see **Figure 1**). The discount to U.S. prices reflects differences in the quality of the crude as well as the cost of transportation, which has increased because there is not enough pipeline capacity to meet Canadian production. Assuming OPEC+ adheres to its production-cut agreement and oil demand begins to recover in the second half of 2020, we expect global oil inventories to return to more normal levels by the end of 2021. A key risk to our long-term outlook is the pace of oil demand growth, which is less certain given the global economy's transition towards a lower-carbon future. In the short term, we expect oil prices to remain below this range, and we expect significant price volatility to continue.

Historically, WCS has traded at 70%-80% of WTI, with the discount between the two crudes reflecting differences in quality (WTI is a light crude while WCS is a heavy crude that is harder to refine into products such as gasoline) as well as the cost of transportation. At times, the differential between WCS and WTI has widened out significantly, with WCS trading as low as 25% of the WTI price, because of the lack of adequate pipeline capacity to move Canadian oil to demand markets in the U.S. In the long term as new pipeline capacity comes online to transport Canadian crude, we expect WCS to return to its normal relationship with WTI and trade at 70% to 80% of the WTI price, which equates to a discount of US\$15 per barrel at the midpoint of our estimated range.

Figure 1



Source: Factset and Edward Jones Securities Research. Data as of 8/18/2020.

What Is the Status of the Global Oil Supply?

OPEC

The Organization of the Petroleum Exporting Countries (OPEC), along with Russia and 10 other non-OPEC countries (collectively referred to as OPEC+), have been curtailing oil production since early 2017 to offset the growth in U.S. oil production in order to keep supply balanced with oil demand. Combined, OPEC+ accounts for nearly half of the world's oil production. In March 2020, OPEC+ failed to reach an agreement to increase production cuts in response to reduced demand due to the COVID-19 pandemic. Russia was not on board with additional cuts, and Saudi Arabia (the de facto head of OPEC) was unwilling to shoulder the burden of additional cuts. With no agreement in place, Saudi Arabia responded by starting a price war with Russia. This was an unexpected and drastic turn of events for the oil market, which was already suffering from reduced demand due to COVID-19. As a result, oil prices fell precipitously.

A month later in April 2020, OPEC+ met again to address the rapidly deteriorating oil market. This time the group was able to agree to a historic production cut. The alliance agreed to reduce its oil production by 9.7 million barrels of oil per day in May, June and July, followed by a 7.7 million barrels of oil per day cut from August through December 2020. This will be followed by a 5.8 million barrels of oil per day cut for 16 months, from January 2021 to April 30, 2022.

While the production cut agreement is historic in terms of its size and duration, it unfortunately was not

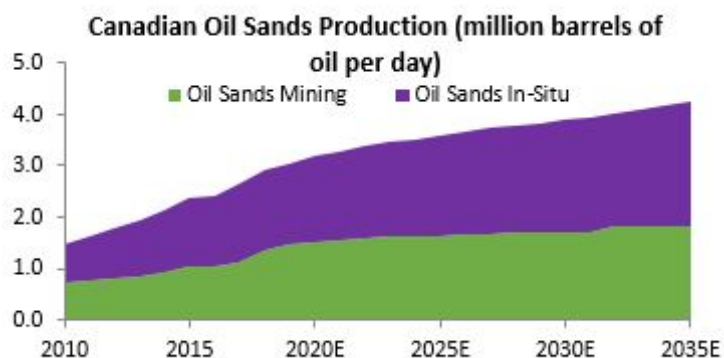
enough to balance the oil market given the drastic loss in demand from the COVID-19 containment measures. On the positive side, the production cuts helped reduce the large build in oil inventories that occurred around the world. On the negative side, stabilization in oil prices at sub-US\$45 per barrel would still be a devastating blow to the North American oil sector because most companies are not profitable at those levels.

Canada

In Canada, oil sands growth is expected to slow significantly. Over the past decade, oil sands production grew at an average annual rate of around 9.5%. Over the next decade, oil sands production is estimated to grow at an average annual rate of around 2%, according to the Canadian Association of Petroleum Producers, as existing projects see small incremental capacity expansions (see **Figure 2**). While the oil sands will help satisfy global demand growth over the next decade, it will remain challenged to compete with low-cost areas with a smaller environmental impact. As producers drastically curtail drilling activity in response to low oil prices, we expect Canadian production to decline in 2020 and likely in 2021, depending on how long the oil-price downturn lasts.

The vast majority of oil sands output is exported by pipeline to the U.S. where it is refined into finished products such as gasoline, diesel and heating oil. There is currently not enough pipeline capacity to transport all the oil production coming out of western Canada. However, there are three large pipeline projects in the works, but environmental and regulatory headwinds have resulted in significant delays in moving these projects forward. Until new pipeline capacity is added in 2021 and 2022, incremental production will need to move to market via rail. This is a much more expensive and less efficient option than pipelines.

Figure 2

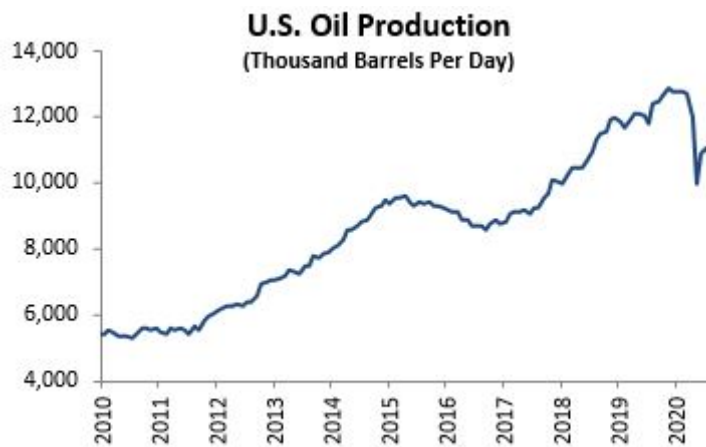


Source: Canadian Association of Petroleum Producers

United States

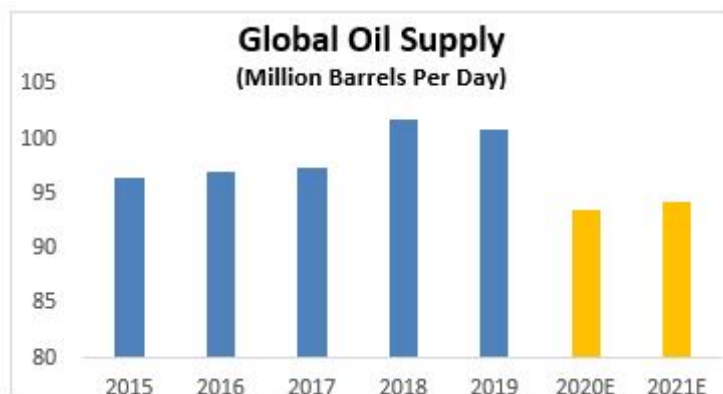
Since the discovery of fracking technology that made vast amounts of crude oil resources economic to develop, U.S. oil production had risen from 5 million barrels per day in 2010 to 13 million barrels per day at the end of 2019 (see **Figure 3**). U.S. oil production grew 1.6 million barrels per day in 2018 and 1.3 million barrels per day in 2019. The vast majority of U.S. growth has come from three main areas: the Permian basin in West Texas, the Eagle Ford shale in south Texas, and the Bakken area in North Dakota. Collectively, these three areas account for over 80% of U.S. oil production growth. The Permian basin alone accounts for nearly one-third of total U.S. oil production. Before the severe drop in oil prices in early 2020, U.S. oil production was expected to grow by nearly 1 million barrels per day in 2020. As producers drastically curtailed drilling activity in response to low oil prices, U.S. oil production has fallen to under 11 million barrels per day. We expect U.S. production to decline in 2020 and likely in 2021, depending on how long the oil-price downturn lasts.

Figure 3



Source: Energy Information Administration

Figure 4



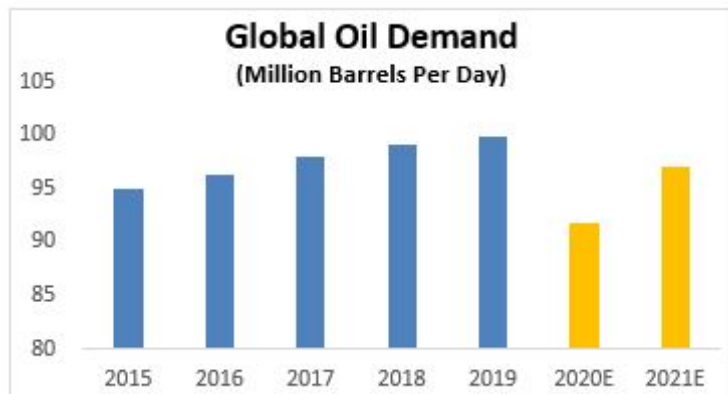
Source: International Energy Agency

What Is the Status of Global Oil Demand?

Global oil demand was 100 million barrels per day in 2019 according to the International Energy Agency (IEA). The majority of demand growth comes from China and India, with China alone accounting for nearly 50% of global demand growth over the past five years. Given the significant disruptions to travel and trade from the COVID-19 pandemic, global oil demand is expected to fall by approximately 8 million barrels of oil per day in 2020, according to the IEA. This would be the largest decline in annual oil demand and the first negative-demand-growth year in over a decade. Global oil demand is expected to rebound in 2021, although still be below 2019 levels (see **Figure 5**).

In the long term, we think oil demand will continue to grow, reflecting rising needs in the developing world from a growing middle class offsetting declining or flat demand in developed economies. In addition, demand for byproducts like chemicals and plastics will likely continue to grow with the global economy. However, we expect global oil demand to eventually peak, potentially in the next two decades. While electric vehicles (EVs) get most of the headlines for reducing oil demand in the future, it will likely be more from improved internal combustion engines (ICEs). ICEs will outnumber EVs for the foreseeable future, but will use less fuel in the future. EVs will likely see significant growth, but face several barriers to widespread acceptance despite growing interest and government incentives. These barriers include strong competition from more efficient and cheaper ICEs, the need for government subsidies and mandates to incentivize buyers, and limited battery lives and expensive replacement.

Figure 5



Source: International Energy Agency

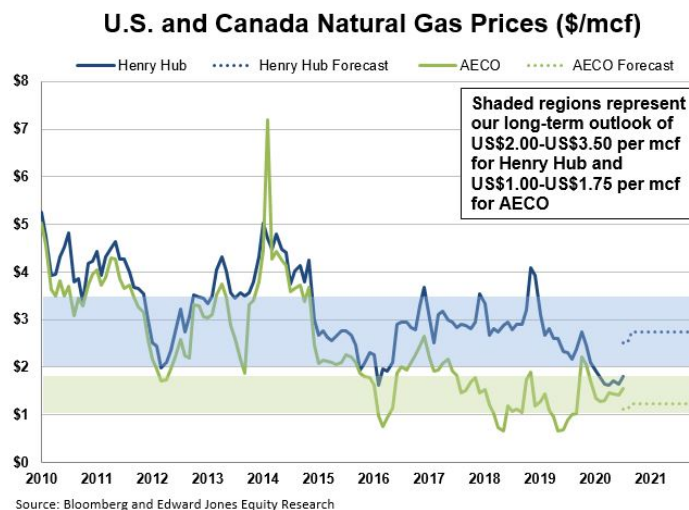
What Is Our Outlook for Natural Gas Prices?

For Canadian natural gas, we see the benchmark natural gas price of AECO ranging from US\$1.00

to US\$1.75 per thousand cubic feet (mcf) over the long term (see **Figure 6**). In the U.S., we see natural gas prices ranging from \$2.00 to \$3.50 per thousand cubic feet over the long term. Natural gas prices can swing significantly based on changes in weather. We expect prices to be near the lower end of our range in 2020 as supply growth continues to outpace demand growth. Demand growth has been strong, driven by liquefied natural gas (LNG) exports and increasing usage for power generation. Hotter summers and colder winters tend to drive higher demand and prices in the shorter term. In coming years, we expect that growing LNG exports and further usage growth for power generation should help support prices in our long-term range.

In the long term, new pipeline capacity should improve AECO prices. Until new pipeline expansion projects are completed in the early part of the next decade, we expect the price differential between AECO and the U.S. benchmark of Henry Hub to remain wider than historical levels.

Figure 6



How Do Energy Stocks Fit Into a Diversified Portfolio?

Despite stocks trading at wide discounts to historic valuation levels, broad negative sentiment towards the energy sector is likely to remain a headwind until there is less oversupply of oil. We expect oil prices in Canada to range between US\$30 to US\$50 per barrel over the long term, reflecting the volatile nature of oil prices. Energy stocks can be very volatile given the commodity-sensitive nature of cash flows. In looking through these short-term movements, we see long-term upside potential in our Buy-rated stocks. We prefer energy stocks in the integrated oil & gas,

storage & transportation, and refining & marketing subsectors, where companies have strong balance sheets that allow them to weather commodity-price weakness and support dividends. We recommend a 7% weighting in the energy sector in a well-diversified portfolio. See the list on page 1 for all of our Buy-recommended energy stocks

Valuation - We believe the current valuation of the energy stocks that we recommend with a Buy rating remain attractive relative to our longer-term commodity-price expectations. We use mid-cycle prices to value energy stocks. Methods used to evaluate energy stocks include price-to-operating cash flow (PCF); enterprise value to earnings before interest, taxes, depreciation and amortization (EV/EBITDA); and discounted cash flow analysis. Some traditional measures like price-to-earnings (P/E), price-to-book value (P/B), and price-to-earnings to earnings plus growth (PEGY) are not applicable to the energy sector at this time.

Risks -- Some of the primary risks of the energy sector: volatile commodity prices, which are cyclical and will affect earnings and the stock price; reduced company growth expectations; cash liquidity; demand being difficult to predict and which could change at unexpected rates; foreign operations being affected by political uncertainties and currency fluctuations; regulatory changes affecting company operations; and adverse legal decisions.

Please see the full opinions of the individual companies mentioned in this report for additional information, including valuation and risks.

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