



## **Global Securities Market Bulletin**

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### **COMMENTARY – Modest to marked downside in 2012 predicted by pundits at CFA Vancouver's 34<sup>th</sup> Forecast Dinner**

*Shilling's targets of 800 for the S&P 500 and 80 US cents for the C\$ were the most extreme views*  
**Elvis Picardo, CFA**

Investors should brace themselves for another turbulent year in 2012, going by the forecasts of the pundits at CFA Vancouver's 34<sup>th</sup> Annual Forecast Dinner yesterday. The three presenters were Hanif Mamdani, Head of Alternative Investments at RBC Global Asset Management; David Fisher, Executive Vice President at PIMCO; and economic consultant Dr. Gary Shilling. All three speakers made some cogent arguments to support their outlook for the year ahead. Key points are summarized below, while specific one-year forecasts are shown in the Table –

**Hanif Mamdani**, relatively the least bearish of the three, offered two specific investment picks and one pan.

- He recommends the Goldman Sachs C\$ 5.2% 2017 subordinated notes, which are trading at approximately 88 cents on the dollar and yield 650 basis points over Government of Canada bonds of comparable maturity. Including the coupon, he projects returns of 11.7% per annum.
- Mamdani's second pick, which he stressed was a totally contrarian play (that was nevertheless greeted with hoots of derision from some attendees) is Yellow Media's 6.25% 2036 senior notes, currently trading at 36 cents on the dollar. He expects a recovery rate of 72 cents on the dollar in the event the company defaults, and is looking for two-year returns of 188%. (Readers are cautioned that this is an aggressive investment that may only be suitable for high-risk accounts).
- Mamdani's pan is the US REITs sector, which he believes is overvalued, given that it is trading at 1.9x the valuation of the S&P 500 (i.e. adjusted funds from operations for the US REIT sector / S&P 500 Price-to-Earnings = 1.9).

**David Fisher** noted that PIMCO is bearish on the global economy. The world's biggest bond investor estimates 2012 global growth at 1.5%, which is well below consensus.

- PIMCO ranks its base-case scenario for the global economy at D+ (where A is the best and D is the worst), with some risk of a D scenario.
- It expects the European Union to re-enter recession in 2012. PIMCO's forecasts for the world's two most important economies are also below consensus – the US is forecast to only grow at 0.5%, with inflation at 1.75%, while China is forecast to grow at 7.0% (with inflation at 4.5%).
- Secular forces at play are – balance sheet de-leveraging, financial de-globalization (given that EU bank assets are 3x those of US banks), and government re-regulation. Cyclical challenges include – fiscal austerity, European bank recapitalization, and insecurity & uncertainty.
- Specific probabilities for the various scenarios are pegged at – Upside 20%, Baseline 50% and Downside 30%. The Upside scenario would prevail if the European debt issue is resolved favourably, while the Downside scenario would arise in the case of a break-up of the European Monetary Union. The Baseline case is the “muddle through” scenario where things continue on their present course.
- Specific investment classes recommended for each scenario include – (i) “Left tail” or Downside: Go long gold, go short on risky assets; (ii) Baseline case: overweight duration, underweight euro and commodity-linked currencies; (iii) “Right tail” or Upside: overweight equities and long “carry” currencies.

**Dr. Gary Shilling** said that the US economy is about one-third to one-half through the deleveraging process that began in 2007 (a subject he examines at length in his latest book, “The Age of Deleveraging”). He noted that US Treasuries, and particularly zero-coupon Treasuries, have been the best performing asset class over the past 30 years. Since 1981, US zero-coupon Treasuries have outperformed the S&P 500 by a factor of 9.3.

- Dr. Shilling’s “Buy” Investment Themes for 2012 include – Treasury Bonds, rental apartments, North American energy producers (especially renewables), the US dollar (versus commodity currencies), consumer staples, and productivity enhancers (such as logistics companies).
- His “Sell” investment themes for 2012 include – developed country stocks, homebuilders, medium / smaller banks, developing country stocks and bonds, selected commodities (such as copper), junk securities, and old technology capital equipment providers.
- Dr. Shilling also had an extremely bearish forecast for the S&P 500, based on his view that index earnings this year will come in at US\$80, well below strategists’ average estimate of US\$105. Assigning a 10x multiple to that EPS number, his forecast for the S&P 500 is 800, which is almost 40% below current levels. He also expects the TSX Composite to decline 33% over the year ahead, reaching a level of 8,400.
- Dr. Shilling obviously expects massive risk aversion to be the norm this year, given his forecast for the C\$ to trade at 80 US cents, and 10-year Treasury yields to reach 1.5%.

**One-year forecasts by the presenters at the CFA Forecast Dinner**

	Levels(Jan.26)	Mamdani	Fisher	Shilling
<b>TSX Composite</b>	12,464.32	12,000	11,500	8,400
<b>S&amp;P 500</b>	1,318.43	1,250	1,200	800
<b>10-year yields – GoC</b>	2.01%	2.25%	–	1.5%
<b>US Treas.</b>	1.93%	2.00%		1.5%
<b>Crude Oil</b>	US\$ 99.70	US\$ 85	US\$ 85	US\$ 80
<b>Gold</b>	US\$ 1,720.65	US\$ 1,850	US\$ 1,650	Flat
<b>C\$</b>	US\$ 0.9982	US\$ 1.00	US\$ 0.92	US\$ 0.80

**Implications of the Fed’s pledge to hold rates low until 2014**

On Wednesday, the Federal Reserve, while leaving its target rate for the federal funds rate at 0% - 0.25%, extended the time horizon for leaving rates at these low levels from mid-2013 to late-2014. Specifically, the Fed said that economic conditions – including low rates of resource utilization and a subdued medium-term outlook for inflation – are “likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.” Here are some quick thoughts on the implications of the Fed’s move –

- **USD may come under renewed pressure:** The greenback may encounter downward pressure over the long term, assuming that the global economy continues on its path to normalcy, with no major shocks such as a deterioration in the European situation. The US dollar has depreciated against all 10 major currencies this week, but the adverse interest rate differentials that are currently weighing it down would not be much of a consideration in the event of a global shock, as the greenback benefits from the flight-to-safety appeal of US Treasuries in periods of turmoil.
- **Gold may reach or breach the US\$ 2k mark:** Gold surged in the moments after the Fed’s announcement, and has added to its gains since then. In an environment of steady dollar decline, it is not inconceivable that gold could reach – or even breach – the US\$2,000 / oz barrier. Interestingly, gold stocks have regained favour with investors this week, with the TSX Global Gold Index up 8.5% over the past three days, compared with a gain of 3.3% for gold (in C\$ terms).
- **Commodity prices could find support:** Global growth expectations have a bigger impact on commodity prices than just the level of the US dollar. But as long as the global economy remains on even keel (without encountering any of the problems mentioned in the previous section), commodity prices may find support from dollar depreciation.
- **Is there more upside in US Treasuries?** While we have completely missed the boat on US Treasuries in recent years, the risk-reward payoff does not strike us as particularly appealing at the present time, with Treasury yields at or near record lows.

**(New Trade) Add Nexen to diversified portfolios – target \$25**

We recommend adding energy giant **Nexen Inc (TSX: NXY, \$18.41)** to diversified portfolios, based on its attractive valuations and long-term growth potential. **We rate Nexen as a Buy, with a price target of \$25.**

**Nexen** is an upstream oil and gas company that is developing energy resources in some of the world's most significant basins, including the UK North Sea, offshore West Africa, the Gulf of Mexico and Western Canada. It has a strategic focus on three businesses – conventional oil and gas, oil sands, and shale gas. Nexen is the majority owner (65%) and operator of the Long Lake oils sands project, and also has a 7.23% stake in the giant Syncrude oil sands operation.

The stock has been an abysmal performer over the past year with a 25% decline, ranking it No. 47 on the 65-member TSX Energy index and No. 48 on the TSX 60 in terms of performance over this period. By mid-December, it had retraced almost 50% from a 52-week high of \$27.11 reached on March 7, 2011.

That precipitous decline could be attributed to a whole host of problems that plagued the company over this period. While the stock was weighed down by continued production issues at the Long Lake project – the core cause of the valuation gap to its peers, according to management – it was also hit by a constant barrage of negative news, including substantial changes to UK tax rates, the non-renewal of the Masila production sharing agreement in Yemen, and operational problems at the Buzzard oil field.

But the company and the stock may be turning around. Earlier this month, the stock rose on news that CEO Marvin Romanow would be leaving Nexen. The news was interpreted in some quarters as a sign that Nexen's board is on a mission to restore shareholder confidence and close the valuation gap that has persisted for years.

Improving performance at Long Lake would be a big start in this regard. Long Lake was planned as a fully integrated project (SAGD, Upgrader and Gasifier) that was the first of its kind, but first-time use of new upgrading technology caused difficulties in start-up and a prolonged ramp-up period. The project was expected to generate 70,000 barrels of oil per day, but will only average about 22,000 barrels though 2012.

While the project is expected to continue ramping up, investors will need to be in for the long haul. Nexen said at its "Investor Day" on December 1 that it would take 3-5 years to produce enough bitumen to fill the upgrader; the company also needs to spend \$900 million on 60 additional wells at Long Lake. But the wait may be worth it for investors, as Long lake is expected to generate an operating cost advantage of \$10 per barrel due to its unique integrated process. As well, the project is expected to generate \$750-\$850 million in annual cash flow once the ramp-up is complete (Figure 2), up from expected cash flow of over \$100 million in 2012.

In late-November, Nexen said that its Production Sharing Agreement (PSA) on the Masila block would not be extended by the government of Yemen, and would expire on December 17, 2011. While total field production at Masila peaked at 225,000 barrels of oil per day (bbls/d) in 2003, Nexen's share of production in 2011 was about 24,000 – 28,000 bbls/d. Nexen said that the loss of this production would be mitigated by the expected start-up of production in the second half of 2012 from the Usan project. In fact, with Usan's netback about twice that available from the Yemen project at current prices, Nexen expects higher cash flow from operations in 2012 (see Figure 3).

Nexen's 2012 guidance, which it released on November 29, calls for production of 185,000 to 220,000 barrels of oil equivalent per day (boe/d), reflecting a partial year of production from Usan and the Masila contract expiry. With Usan (offshore West Africa) expected to contribute about \$600 million to cash flow this year, price-neutral cash flow is forecast to increase about 15%. Overall, cash flow from operations is forecast at between \$2.8 billion and \$3.3 billion, or \$5.30 to \$6.30 per share. Nexen projects capital expenditure of \$2.7-\$3.2 billion in 2012 to advance development projects and production capacity from Usan, Long Lake and Golden Eagle in the North Sea.

With a market capitalization of a little less than \$10 billion – making it the 13<sup>th</sup> largest energy company in the TSX Energy sub-index – and a diversified, high-potential asset base, Nexen would seem like a likely acquisition candidate. However, that looks quite unlikely in the near to medium-term. Former CEO Romanow said that management had seriously considered selling assets and / or the company, but shelved the idea because it was unable to get a fair price.

In any case, the company has made some progress in addressing its huge capital requirements. On November 29, Nexen said it would receive \$350 million from Tokyo-based energy companies Inpex and JGC for a 40% stake in a joint venture targeting the Horn River, Cordova and Liard shale basins, with an additional \$350 million to be paid by Inpex and JGC for drilling costs. On November 30, Nexen said that it had concluded a joint venture with Chinese energy major CNOOC in the Gulf of Mexico, under which CNOOC will have a 20% working interest in three wells and may also participate in three additional exploration wells with a 10%-25% working interest.

Analysts' average cash flow per share (CFPS) estimate for 2012 is currently at about \$5.01 per share, which represents growth of 12% from an estimated \$4.48 in FY11, but is well below the company's guidance. Analysts' EPS forecast for 2012 is at \$2.24, up 33% from \$1.68 in FY11. On that basis, the stock trades at attractive forward multiples of 3.7x FY12 CFPS and 8.2x FY12 EPS.

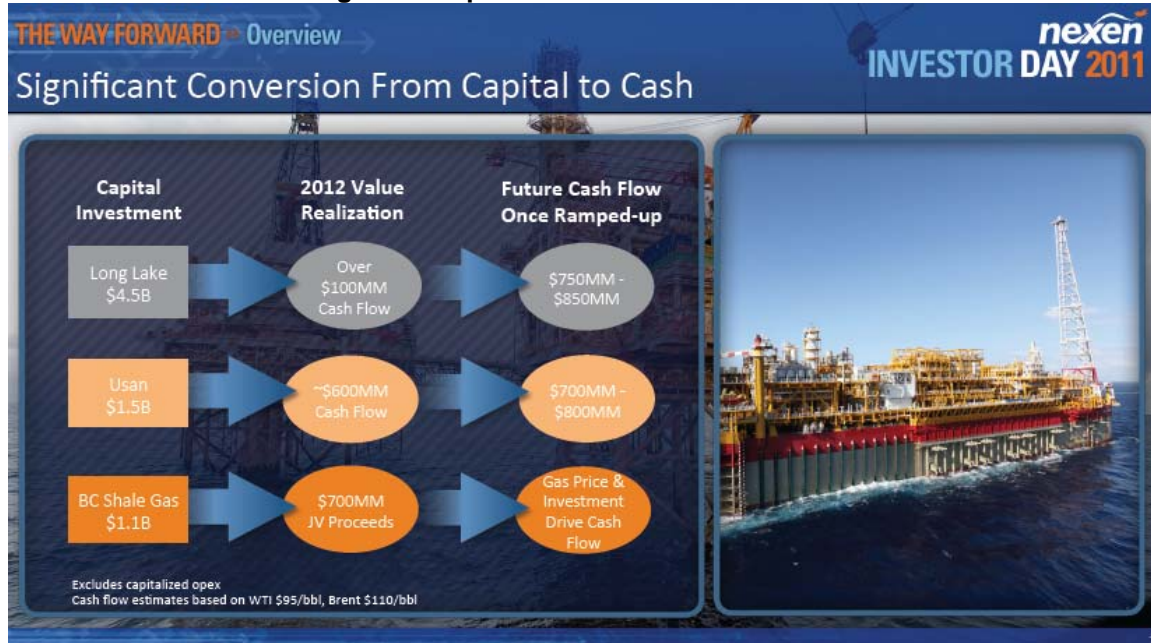
Our target price for Nexen is \$25, on the basis of a 4.5x multiple applied to our 2012 CFPS estimate of \$5.50. The stock pays a quarterly dividend of 5 cents per share, for an indicated yield of 1.1%.

Figure 1: Nexen Inc (five years – weekly)



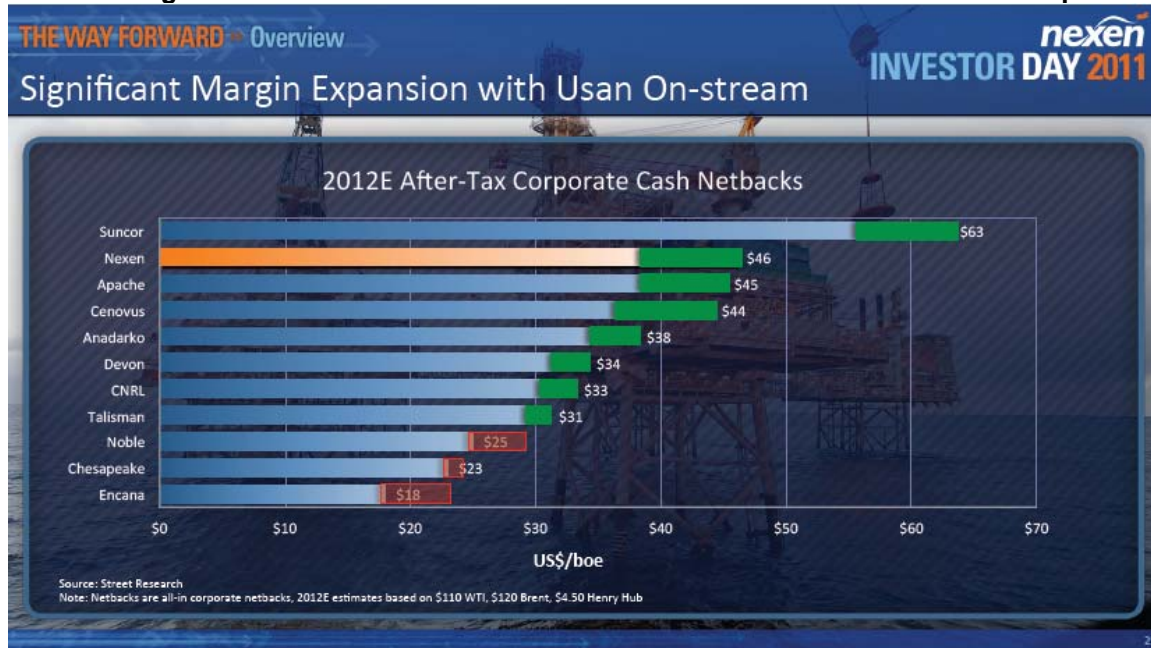
Source: Bloomberg

Figure 2: Capital Investments and Future Cash Flow



Source: Nexen Investor Day 2011 Presentation

Figure 3: Estimated 2012 after-tax netbacks for North American E&P companies



Source: Nexen Investor Day 2011 Presentation

Market Snapshot at Close

S&P TSX	12466.50	+2.18	Commodities		Yields (%)		Can.	US
TSX Venture	1628.92	+14.15	Canadian \$	99.90	+0.08	90 Day T-Bill	0.85	0.05
DJIA	12660.46	-74.17	Gold (Spot)-US\$	1739.80	+19.15	2-Year Bond	0.99	0.21
S&P 500	1316.33	-2.10	Oil (WTI-March)	99.66	-0.04	10-Yr. Bond	1.98	1.89
NASDAQ	2816.55	+11.27	CRB Index	317.81	+0.39	30-Yr. Bond	2.60	3.06

### **Thought for the Day**

**“The first rule of any technology used in a business is that automation applied to an efficient operation will magnify the efficiency. The second is that automation applied to an inefficient operation will magnify the inefficiency.” – Bill Gates**

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