

# US Equity Investment Outlook



## Market review

The US equity market experienced significant turbulence in May. A steep downturn late in the month was attributable mainly to anxiety regarding the ongoing fiscal crisis in the Eurozone linked to Greece's credit problems, as well as deteriorating financial situations in Portugal and Spain. The sharp decline offset optimism earlier in the month as Greece agreed to drastic austerity measures in exchange for a US\$136 billion bailout package from European Union leaders. Additionally, shares of energy exploration and production companies and energy services providers with US offshore drilling exposure declined sharply in May following British Petroleum's largely unsuccessful efforts to contain a massive oil spill following the explosion of a rig that the company operated in the Gulf of Mexico off the coast of Louisiana.

It appears that the US market has benefited from the problems in Europe. The S&P 500® Index is the best-performing major global stock market benchmark year-to-date and the dollar has strengthened against the euro as investors have been seeking a "safe haven" from the crisis in the European market. Yet the US economy, while displaying signs of recovery, shares the same problems as Europe—large fiscal deficits that will take years and much pain to resolve. However, the federal monetary system is preventing the US from experiencing the same currency problems as Europe and is more able to provide the required coordinated policy response and structural reforms.

## Economic and market outlook

The oil spill most likely has created a "ripple effect" that runs through the Gulf region and deep into the wider oil and gas industry. There is growing uncertainty regarding the future of oil and natural gas exploration and production (E&P) in the US and, consequently, the implications of the disaster for E&P companies and related industries. While the causes of the oil rig explosion are being investigated and the oil spill clean-up and containment efforts are underway, the Obama administration has already extended the moratorium on new offshore drilling and has proposed increased regulation and restrictions going forward. It is likely that the debate over offshore and deep-sea oil and natural gas exploration will persist. In our view, however, it seems impractical in the longer term to halt deep sea exploration altogether. According to the Department of Energy, the US imports 11.5 million barrels of oil each day—more than 60% of its daily oil requirements.

The near-term issues with the Gulf of Mexico oil spill notwithstanding, we feel that the US must continue to find other sources of energy. If the government closes the Gulf and other currently open areas in the US to offshore drilling, the country will face further dependence on imports. We believe that this would lead to more serious issues such as a weaker dollar and increased vulnerability to the unstable political and economic environments in the Middle East, from which the US obtains more than one-half of its oil imports.

Because global economies are just beginning to recover from the financial crisis of 2008-2009, the US is susceptible to higher energy costs as these nations' economies grow, driving increased demand and rising prices for oil. In our view, higher energy costs—most notably for gasoline—are tantamount to a tax on the US economy, which most likely is not in a good position to absorb any substantial spikes in energy prices. Should we revisit the high gasoline prices of 2008, we believe that consumers would reduce their broader consumption levels yet again.

What does this all mean for investors? While the energy sector has taken a hit to its image (and stock values) recently, the search for oil and energy sources will continue, as there currently are very few alternative choices, and US oil consumption is still outpacing production. We feel that the recent downturn in the energy sector presents an opportunity to invest in select high-quality companies at relatively attractive valuations. Therefore, we remain comfortable with the longer-term prospects for our portfolios' holdings in what we believe are solid companies in oil and gas exploration and production, integrated oil and gas, and energy equipment and services.

## Sources of concern

The recent oil spill in the Gulf of Mexico has again shed light on the need for the US to reduce its dependence on fossil fuels (coal, crude oil and natural gas) and turn to more alternative energy sources such as nuclear, hydroelectric and solar power. According to the most recent data from the Energy Information Administration of the Department of Energy, between 1973—the year

**Anxiety about the fiscal crisis in the Eurozone and the Gulf of Mexico oil spill contributed to the US equity market's downturn in May.**

**US stocks have outperformed their European counterparts for the year to date as risk-averse investors seek to avoid the problems in the Eurozone.**

**The oil spill has led to uncertainty regarding the future of oil and natural gas exploration, as well as companies in the industry.**

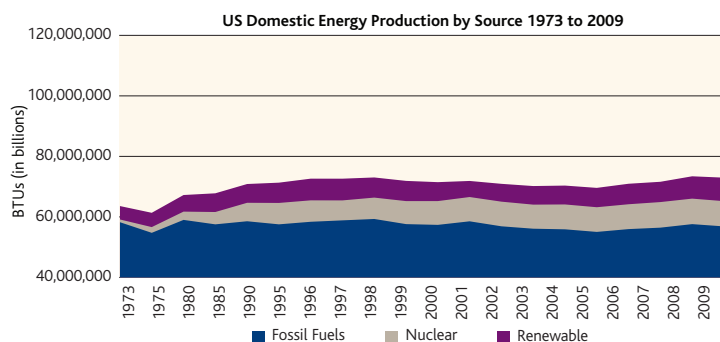
**We believe that that the US must find other sources of energy, as increased global demand for oil ultimately will lead to higher prices.**

**In our view, there are still opportunities to invest in select high-quality energy companies with attractive valuations.**

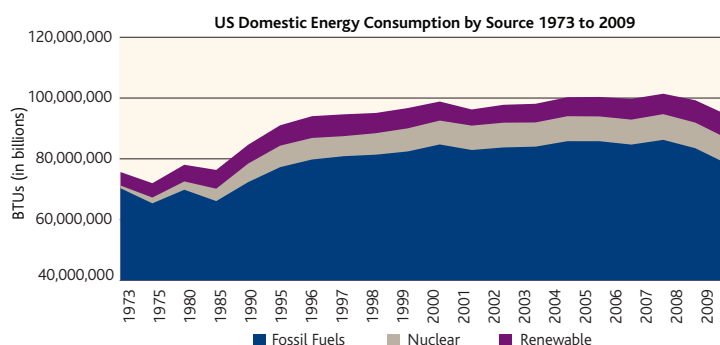
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of the first "energy crisis" in the US - and 2009, domestic oil production fell roughly 45%, while consumption rose modestly. Consequently, US oil imports nearly doubled. The supply/demand gap most likely would have been even greater if there had not been a substantial increase in coal and renewable energy production during the period. We feel that the expansion of offshore oil and natural gas exploration and production in the US is vital to the country's economic and fiscal health, given the lack of sufficient alternative energy sources for the foreseeable future.

### US domestic energy production continues to decline...



### ...while consumption expands.



Source: US Department of Energy, Energy Information Administration, June 2010

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