



Taming of the Crude

Market Commentary

February 2, 2009

It is difficult to fathom that since our last Commentary, oil prices have retreated further. Is the end of price decrease in sight, or have we already seen it? Are these current low prices sustainable? These are critical questions for society, but more importantly for energy investors. There are causal commonalities between the rise in oil prices in the summer of 2008, the sharp descent since then and the increase in pricing volatility. This key link has been decades of under-investment in basic infrastructure to produce, deliver, store and distribute energy⁽¹⁾. Global oil markets have moved from a focus on shortages in production, to a focus on shortages in storage and transportation. Had storage and transportation capacity kept pace with increases in demand, we would be much better equipped to use stored oil to reduce price spikes when demand increased and store oil in times of demand softness. These activities would help to smooth out prices and reduce overall volatility.

As it was, the price of oil moved up swiftly to the point where we were able to balance demand and supply by reducing demand, most notably for transportation fuels. Today, the financial crisis has reduced demand and the excess supply cannot be adequately stored, causing prices to fall low enough to compel producers, such as OPEC, to curtail production. The deficit in available storage capacity, by definition, increases volatility:

... "Specifically, global "working" storage capacity for oil is currently less than 10 days of demand, meaning less than 10 days of use separates demand destruction from supply destruction. In 1980 that number was more than 20 days, which suppressed price volatility to a fraction of today's volatility... Even with the current weakness in demand, capacity utilization for global oil production is still 94.4%. To put this into context, the utilization rate for the US manufacturing sector is 70.2%. The bottom-line is that the energy industry runs near capacity even during a global recession" ⁽¹⁾...

OIL DEMAND

Currently, the world is focused on the weakening demand for crude oil as a result of the economic recession triggered by the credit crisis. This demand has a base, as energy is as essential as air for modern life. Add to this that now there is a large, relatively new, contingent of energy users based in Asia, where large populations can translate small increases into huge incremental demand.

When we focus on the growth in this global demand, the International Energy Agency (IEA) is forecasting a small increase in global oil demand in 2009 (Figure 1 depicts the drivers of this demand - Asia and the Middle East). The reduction in oil demand from OECD⁽²⁾ Europe and North America is compensated for by other global regions.

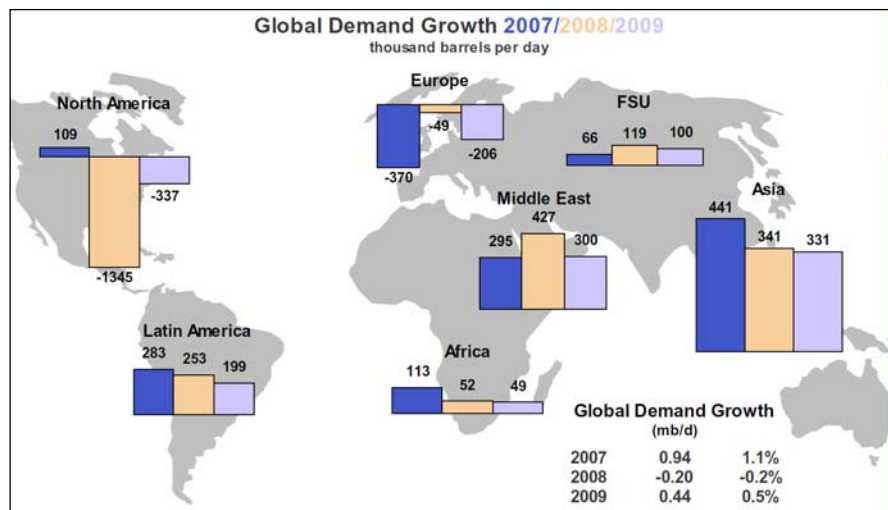


Figure 1 - Source: IEA Oil Market Report, 11 December 2008

The U.S. Energy Information Administration (EIA) has forecast a decrease in the demand for crude oil in 2009, as seen in Figures 2a and 2b. This difference in view may be related to the expected timing of a global economic recovery, or the EIA's view may be impacted by their proximity to the US economy, as compared to the IEA which is located in Paris. Regardless, 2009 looks to be a year of excess oil inventories as supply outstrips demand. This will cause oil prices to remain weak, until we start to see improvement in demand (expected to be mid to late 2009), at which time excess oil inventories will be quickly depleted and prices will strengthen. Then it will become very interesting, as described further in the Oil Supply section of this commentary.

Reported numbers show there are currently approximately 80 million barrels of crude oil in storage. This has pushed down current prices and exacerbated the existing contango⁽³⁾ in crude oil pricing. When demand recovers, the 80 million barrels will disappear quickly, as even today it represents only about 22.5 hours of global demand!

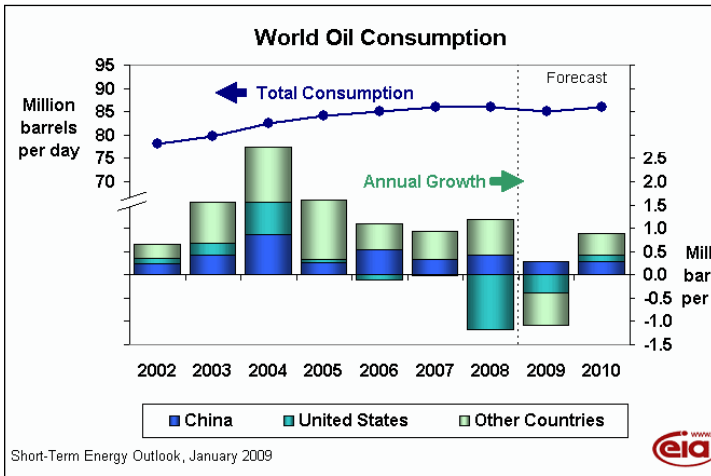


Figure 2a - Source: EIA, Short-Term Energy Outlook

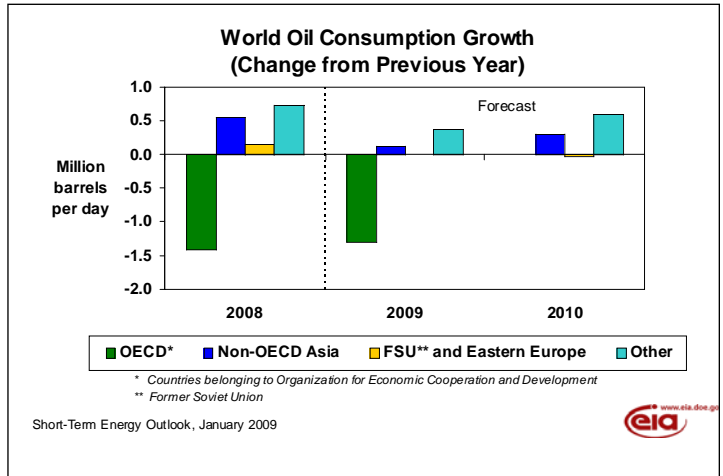


Figure 2b - Source: EIA, Short-Term Energy Outlook

The 1980's was the last time we experienced a rapid ascent in the price of oil, followed by a collapse, as depicted on Figure 3. To highlight the shift in importance of demand concentration from the OECD countries to the non-OECD countries, consider Figure 4 on the following page. In the 1980's, according to the comprehensive study prepared by BMO Capital Markets (Figure 4), the OECD represented 68% of global demand and 41% of demand growth. Now, the OECD accounts for just 55% of global demand and is a -19% (yes, negative!) component of demand growth.

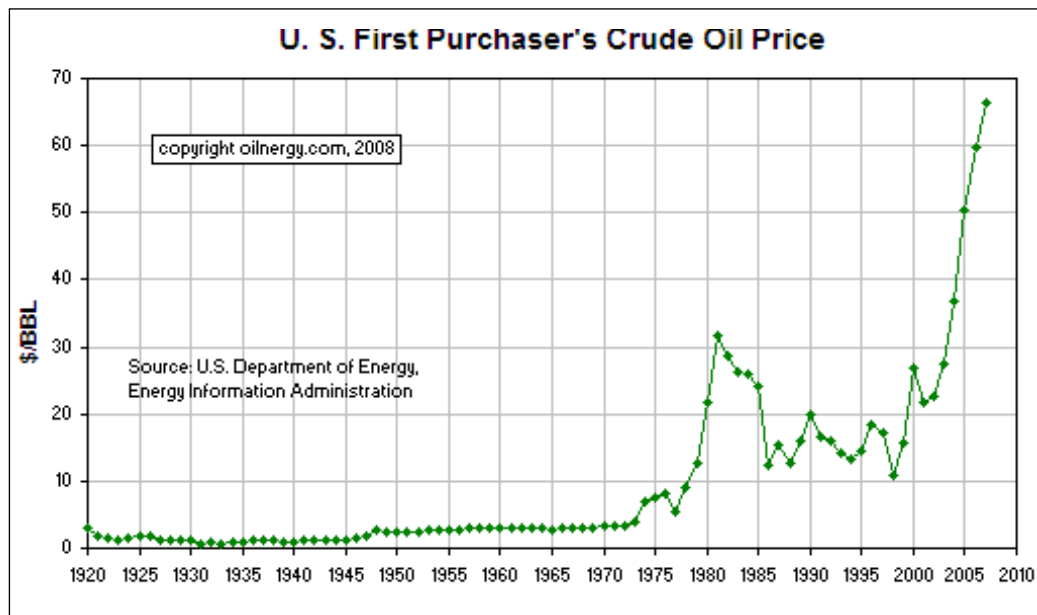


Figure 3 - Source: Energy Information Administration (EIA)

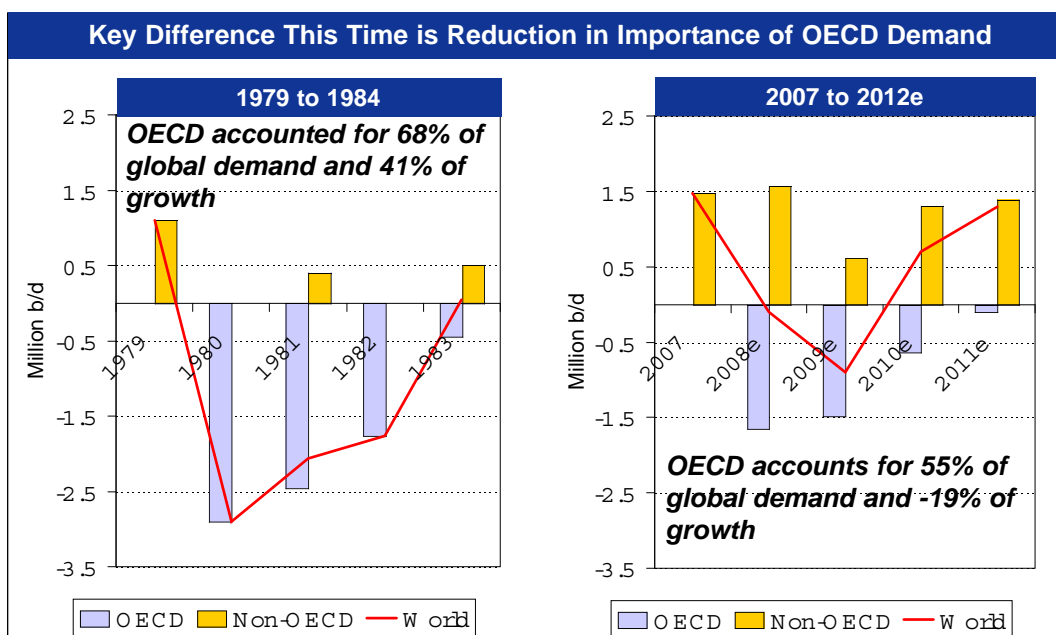


Figure 4 - Source: BMO Capital Markets

So, at the risk of repeating myself over time, it is not about us. The mature economies of the OECD countries are large consumers of oil, but that consumption is not growing, and really wasn't even before the recession. The developing world, led by China, is the source of oil demand growth. In this time of every headline you read being negative, we are bombarded with news like "China's economic slump is worsening". True, China has put in place its own stimulus plan, but this is designed to increase its growth from the "slumped" 6.8%, back up towards double digits. The OECD countries pale by comparison, even in robust growth times. As the world's third largest economy (behind the US and Japan), China's continuing impressive growth rate fuels large demand for oil, and this 6.8% growth rate is during a global recession! What happens when the recession wanes and demand starts to increase? The answer is the other half of the supply - demand equation that is being ignored by the market: Supply.

"A third of humanity doesn't want to ride bikes anymore; that has profound geopolitical implications." Anne Korin, the co-director of the Institute for the Analysis of Global Security (May 1, 2005).

OIL SUPPLY

Now that oil prices are "cheap" again, the market is very comfortable and complacent with the availability, at current prices, of sufficient oil supply. The market is mistaken! When prices ran up in 2008, it was the result of both supplies and the delivery infrastructure struggling to keep up with the pace of demand increases. On the infrastructure front, Matthew Simmons, of Simmons & Company International in Houston, believes that 80-90% of global infrastructure is beyond its original design life and the fact that 99% of it is made of steel means that it continues to rust away. None of the announced global government stimulus programs have addressed energy processing and transportation infrastructure, as they are often in private sector hands.

Current prices are not sustainable, because most future energy projects do not generate an economic return at today's prices as shown in Figure 5 (see following page) which depicts the 2009 US dollar oil prices required for oil producing countries to break-even. This means that many oil-rich oil producing countries are facing deficit spending if they aim to maintain their social programs and prevent unrest!

What this means is that current economics are preventing many countries and companies from committing to future large scale capital projects. Remember that the oil price rise in 2008 was with the full expectation that there would be impressive oil supply gains in the future. A great deal of this forecast growth in world oil supply came from the Canadian oil sands. In the past few months alone, we have seen over one million barrels of future daily production cancellations or postponements from the Canadian oil sands and this represents about two-thirds of the expected global supply growth over the next

five to ten years. Recently published reports, from a variety of independent sources, puts the finding and development cost of a new barrel of oil sands production at between US \$80-\$90 per barrel. Similar reports put the global cost of finding a new barrel of oil at about US \$65 per barrel. IEA data showing where the future global oil supply growth is projected to come from, is highlighted in Figure 6.

Jeff Rubin, the noted CIBC economist, further examines the projected production capacity change from the oil prices in place in the Spring of 2008 to today, post the price collapse, and determines that we have moved from the forecast of adding two million barrels per day of productive capacity, to losing one millions barrels per day - see Figure 7.

Mr. Rubin goes on to say, *"and that's only the tip of the iceberg since the vast majority of cancellations have been on projects whose first flow dates are well after 2010. If oil prices were to stay at current levels, production, instead of plateauing around 88 million barrels per day in 2012, as we had originally forecast, would decline at an accelerating pace between now and 2015. By 2015 production would decline to around 76 million barrels per day, a level roughly 10% lower than last year's level. Unlike past oil shocks, there is no longer any newly discovered \$10 per barrel North Sea oil to meet a rebound in demand"*. The world today, in recession, consumes about 85 million barrels of oil per day.

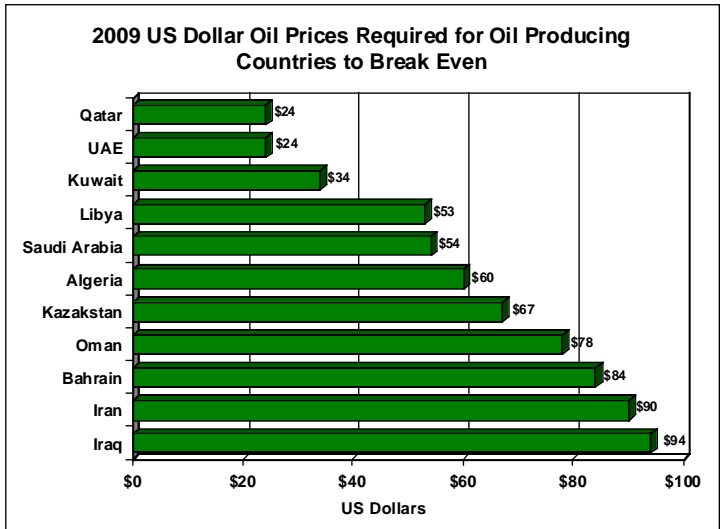


Figure 5 - Source: CNBC, October 24, 2008

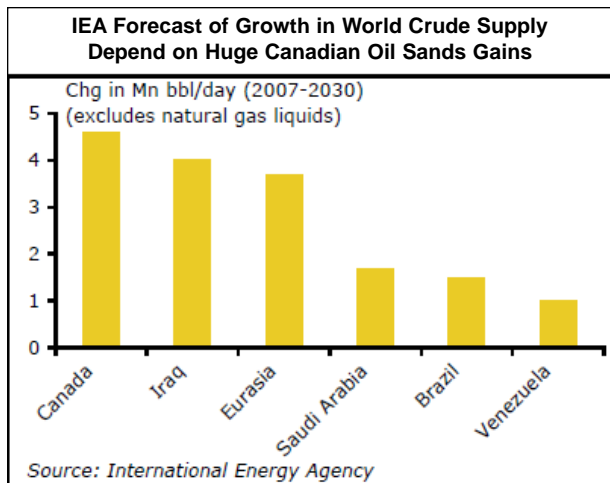


Figure 6 - CIBC World Markets Inc. StragEcon Jan 23, 2009

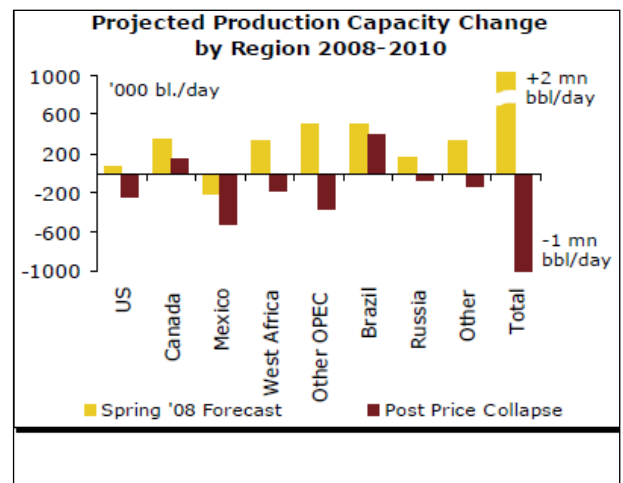


Figure 7 - CIBC World Markets Inc. StragEcon Jan 23, 2009

GLOBAL COST OF OIL

Examining the cost of oil is a means of recognizing that these low oil prices are a short-term phenomenon. Current global costs are, as mentioned above, in the order of US\$65 per barrel. This is generally comprised of the cost of exploration, operating costs, royalties (to the mineral owner, often governments), taxes and a return on the capital employed, ideally commensurate with the risk. Figure 8 (following page) shows that current oil prices around US\$40 certainly do not promote long term investment in the sector in most jurisdictions!

Figure 9 (following page) shows the trend over time of supply costs compared to the price of crude and clearly evidences that today's prices do not support ongoing investment and will result in lower supply which will in turn strengthen prices, even in a recessionary environment, let alone when the economy starts to strengthen and demand improves. Low prices are not an ongoing phenomenon and the forward curve bears this out. Figure 10 (following page) shows how, even in today's current environment, the forward price is dramatically higher than today's price.

As an energy investor, it is important to remain focused on the fundamentals and not become drawn into the pervasive economic negativity that is in the media. The fundamentals speak to an industry that requires higher prices in order to provide the investment that creates the supply. This supply is necessary, even in a recessionary environment and costs cannot, and will not, come down to the extent that fosters investment at the US\$40 oil price level. This is very positive for investment at today's prices in specific companies that have strong balance sheets, experienced management and the ability to grow their production within a cash flow budget, as they will be able to benefit by multiples from the strengthening crude oil price and may make acquisitions along the way.

The significant supply reductions underway by OPEC, coupled with unprecedented global stimulus programs in the form of credit liquidity and infrastructure spending will, we expect, have a positive impact on crude oil prices, pushing them up to higher levels in 2009. Investors who remain in high-quality oil names or who put new money to work now, will be rewarded. Qwest's funds are focused in oil, gold and high-quality hedged natural gas names, so we are well positioned.

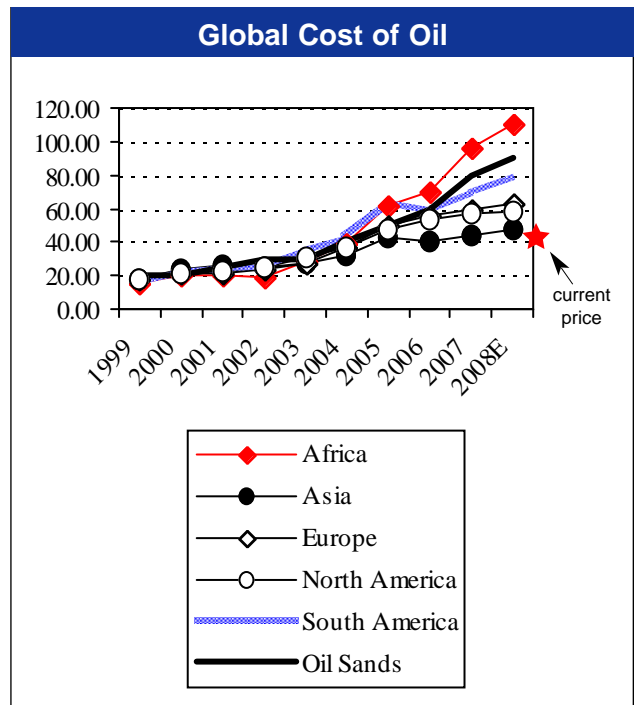


Figure 8 - Source: BMO Capital Markets.

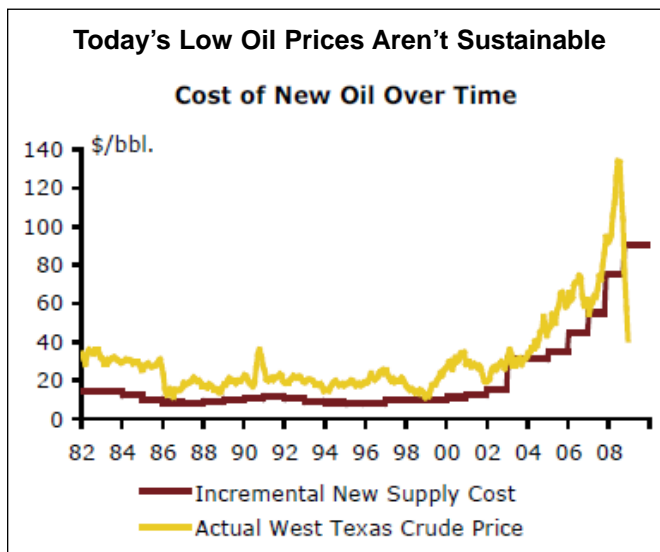


Figure 9 - Source: Energy Information Administration, Total, CIBC WM

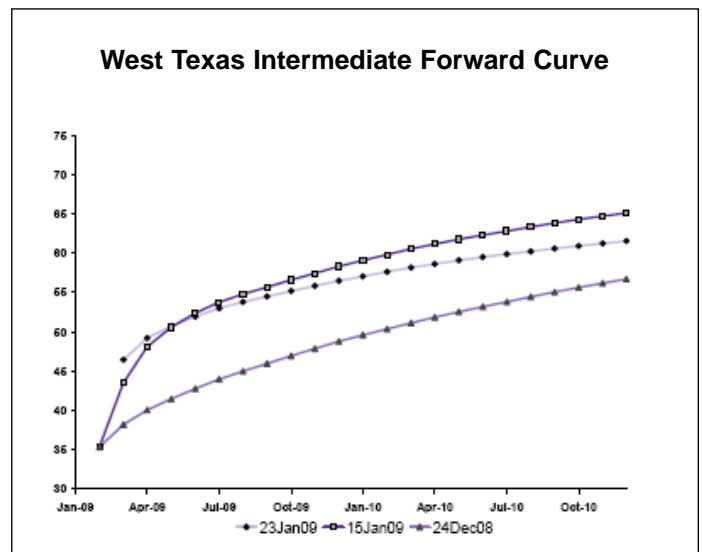


Figure 10 - Source: Goldman Sachs

NATURAL GAS

Our natural gas positioning is smaller and more defensive than oil for 2009, as we see the timeframe for investor reward as longer than that for crude oil. No discussion of the Canadian energy sector would be complete without a discussion of natural gas "gas", as it is a key commodity from the Western Canadian Sedimentary Basin.

Our investment thesis on gas is one of short-term conservatism, as North American markets are currently oversupplied and we expect this situation to persist into an economic recovery, as supply continues to be strong. The United States has historically been a market that relies on imports from Canada and LNG (liquefied natural gas) to fulfill its total demand requirements. In the past few years, the success of horizontal wells, drilled into shale plays, has helped the US dramatically

increase their supply as depicted in Figure 11. This success has, through 2008, all but pushed out the need for LNG, which went elsewhere globally as prices in the US significantly lagged global prices. Canadian gas was still required and was shipped to the US, with prices in alignment.

Despite cold winter weather (which increases demand for space heating), natural gas demand from the industrial sector has fallen with the recession and has been large enough to reduce overall gas demand. This reduced demand comes at a time that supply from the US continues to be strong, as the economics associated with many of the shale plays are still attractive, even at low gas prices. Conventional, vertical well economics are impacted much more by these low gas prices and producers across North America have "high-graded" their drilling programs to drill only the best-return-projects and to live within cash flow. The productivity of the horizontal wells from the US shale plays (such as the Haynesville, Marcellus and Barnett) continues to be enough to offset the decline in conventional well drilling and keep US gas supply strong. This caused gas prices to decline in 2008 and they have stayed weak through the cold winter of 2009.

We are not expecting an immediate up turn in gas prices in 2009 as we believe that global softness in LNG prices, combined with additional LNG supply from several new liquefaction projects, most notably Qatar, which could outstrip demand and arrive in US storage and add to the US supply, just as demand is increasing as we start to pull out of the recession.

As with oil, it is important not to lose sight of the fundamentals for natural gas. The natural gas market in North America has been through massive swings in pricing and profitability in the past and one message rings true: "the best cure for low prices is low prices". We are currently in a short term era of oversupply, but these low prices have curtailed conventional drilling already. This is evident in the reduced Alberta gas production numbers, where shale resource plays are much less of a factor and the production is principally conventional. With respect to the horizontal shale wells in the US, the rate of

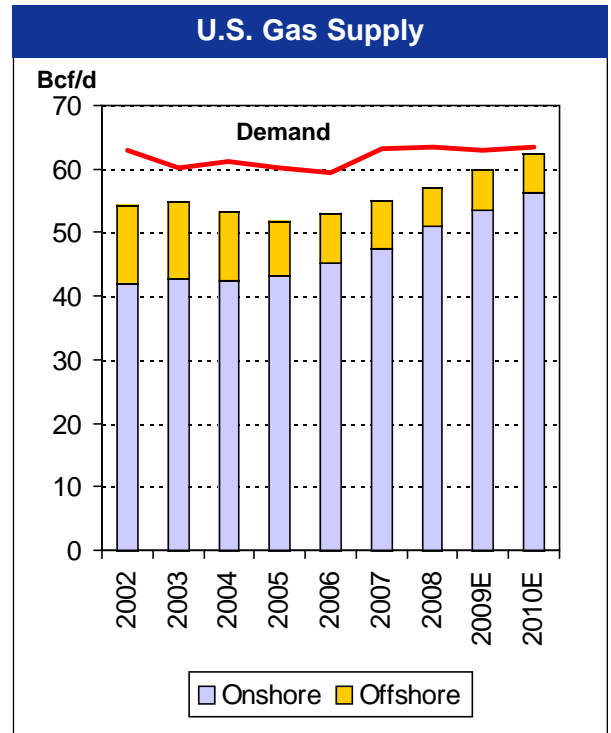


Figure 11 - Source: BMO Capital Markets

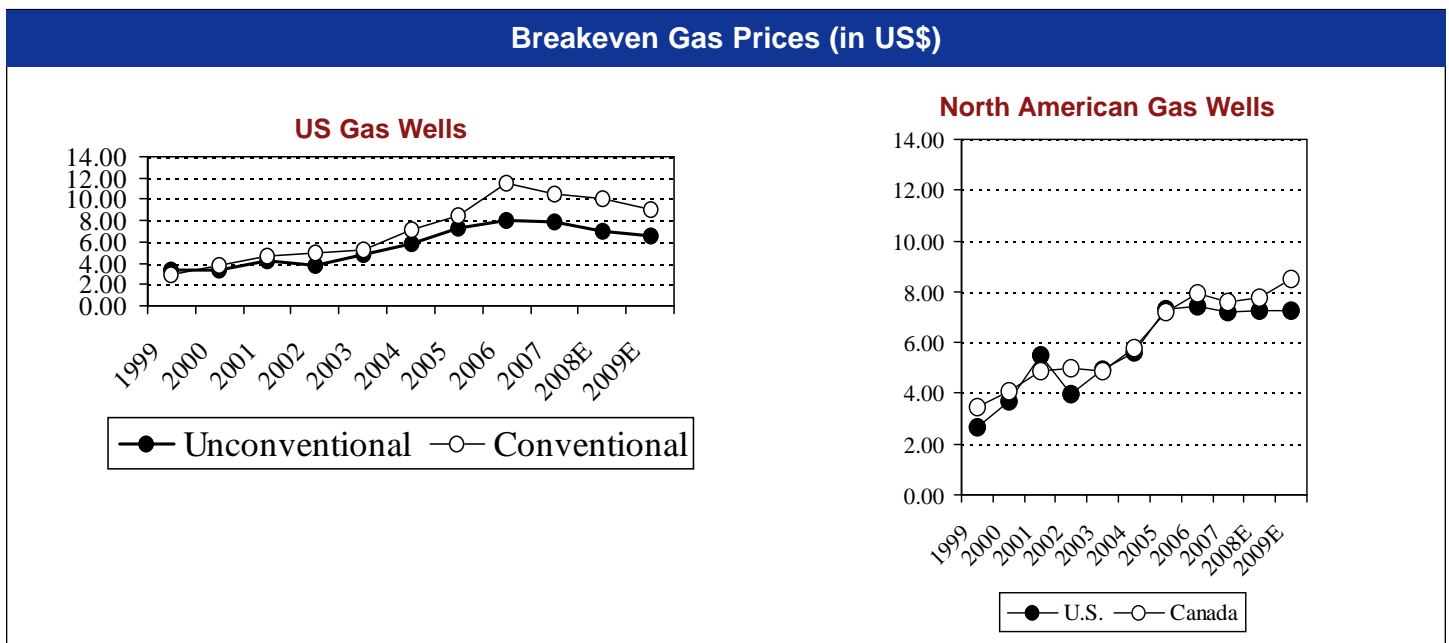


Figure 12 - Source: BMO Capital Markets

production increases from drilling has thus far been able to outstrip the declines, allowing gas production to grow. The decline rate, however, on new horizontal wells is at least double the underlying average decline rate for natural gas wells in the US. As US production becomes more and more skewed towards horizontal wells, the decline rate will increase, and before long, even a strong drilling rate will have trouble overcoming these declines and show any growth. Across the US, the average break-even gas prices vary within unconventional plays (shale/resource/horizontal), from US\$3, to an average of about US\$6 per thousand cubic feet (Mcf). Conventional plays have higher average break-even prices at US \$8-\$10 per Mcf (see Figure 12 on previous page).

Natural gas prices in our view will remain weak through most of 2009, and strengthen into 2010, becoming range-bound when supported by costs and oil prices and constrained by available LNG supply and global gas prices. A range of US\$6 to \$9 for gas though, provides strong returns and will keep the industry vibrant.

In preparation for these weaker gas prices, we increased our oil and gold weights and focused our gas holdings into larger, defensive names, such as those larger companies who have hedged production, have clean balance sheets or pay a dividend/distribution.

THE MARKET AND GOLD

The overlay to any fundamental review is "what is the market going to do to these stocks?". The fundamentals on natural gas point to a quality focus with an eye on 2010. On crude oil, they point to a focus on the dire supply picture and a more near term recovery. In the middle is gold, the store of wealth for the fearful, the antidote to inflation, or the hedge against a weaker US dollar, or all or none, depending upon the sentiment of the day. Our focus is on gold producers with strong margins. Our gold positions have been a compliment to our energy positions in the past few months, so we are pleased with their contributions to the portfolios.

With the fundamentals pointing to this being an opportune time to invest in energy, with stocks individually selected to suit this environment and the outlook, we need to step back and look at the overall market, to determine its bias. If you are of the mindset that we are heading into the great depression, you are likely not reading this as you have already liquidated your portfolio, sold your house and are eating beef jerky deep in the mountains. Alternatively, we can review the market for signs of stability. In a previous commentary I outlined one indicator of perceived credit risk called the TED Spread. It is the difference between interest rates on inter-bank loans and the US three month treasury bill yields. Immediately after the collapse of Lehman Brothers, the TED Spread spiked to unprecedented levels, evidencing the extreme lack of liquidity in the market. The TED Spread is now back at pre-Lehman levels, as seen in Figure 13, which is a very good sign of the thaw in credit market sentiment and the liquidity injections from central governments having a positive effect. The VIX, or Volatility Index, has also dropped down significantly from its post-Lehman highs, although has room to decrease further to reach the lows of the late spring of 2008.

In the last month many banks have been able to add significant amounts of capital to their balance sheets from investors in the form of the new issue of preferred stock and debentures. In the past two weeks, we have seen several high quality energy and gold companies come to the market for equity, including Kinross Gold, Crescent Point Energy Trust, ARC Energy Trust, AltaGas Income Trust, Progress

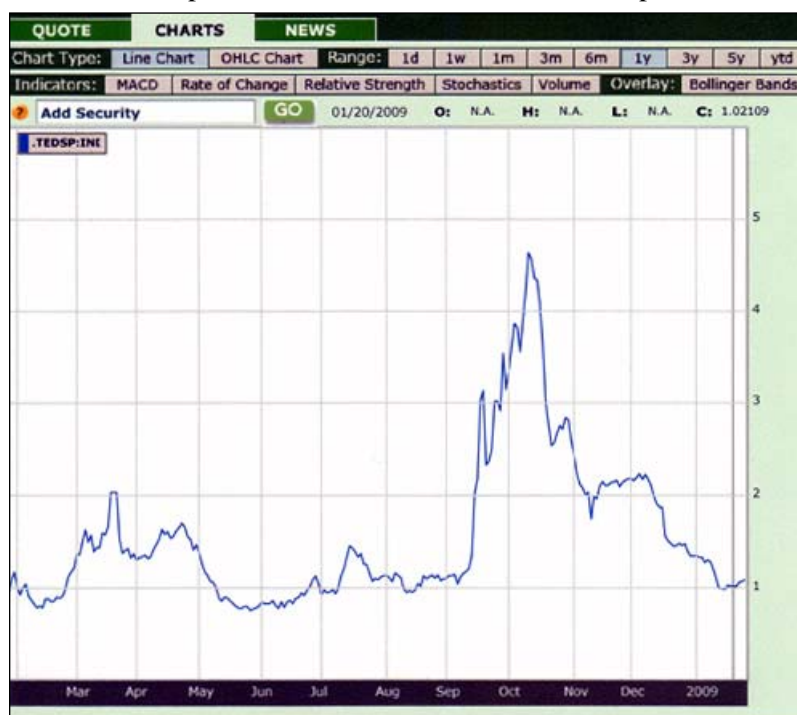


Figure 13 - Source: Bloomberg.com

Energy, Penn West Energy Trust and Breaker Energy. CP rail also completed a large, successful equity offering. All of this new equity (some of it provided by Qwest!) speaks well to investor sentiment on current value and future performance. Total Energy has also just made an unsolicited offer for UTS energy, whose asset is a 20% working interest in the Fort Hills oil sands project, with partners Teck Cominco and Petro-Canada. UTS Energy's stock closed the day before the bid at \$0.83 and the day of the bid at \$1.73, especially interesting when Total's bid is cash of Cdn\$1.30. Are oil assets undervalued? Total Energy and the market seem to think so!

Just about every stock chart you look at falls off a cliff at the time of the Lehman Brothers bankruptcy date. What you did next was important! We had large cash balances (over 20%) in our funds, which we have now started to reinvest. When the market is valuing all companies alike, it is an opportune time to align the portfolio in the best companies that lead their sectors out of the bottom. Many economists project a start to an economic recovery in late 2009 or 2010 and the stock market usually anticipates this and starts moving higher about six months before. Selectively buying the best companies now, or moving from weaker names to stronger names is a strategy that not only allows your, and our, portfolios to be defensive in the near term, but also benefit immediately when the sector rises. We continually analyze our holdings and make adjustments, but we are confidently positioned for the turn in oil prices and sentiment that we expect.

As always, our website contains a great deal of information on our portfolios and the energy market and we are always available to answer any questions that you may have.

Jennifer Stevenson

Executive Vice-President, Portfolio Management
Qwest Investment Fund Management Ltd.
Registered Portfolio Manager

Notes:

1. *Goldman Sachs Global Economics, Commodities and Strategy Research, January 26, 2009.*
2. *OECD: the Organization of Economic Cooperation and Development; a group of 30 "wealthy" countries committed to democracy and the market economy.*
3. *Contango: describes a condition when the price of a commodity contract is higher in the future than today. The opposite condition is known as backwardation.*

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