4 Alarming Reasons Why the Recent Oil Rally Can't Continue

Description

The recent oil rally has renewed hopes of a recovery in the energy patch, with West Texas Intermediate (WTI) up by 35% from the six-year low it hit earlier this year.

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However, there are signs that this rally will be short lived and crude prices will slide lower.

Now what?

WTI briefly rose above US$60 per barrel, creating considerable hope among investors in Canada's beleaguered energy patch because this is above the breakeven price for many producers. While the recent rally can be attributed to slowing U.S.-production growth, declining amounts of crude going into storage, and higher refinery utilization rates, there are a number of headwinds that will put further pressure on prices.

First, OPEC and Saudi Arabia in particular remain determined to continue growing market share by keeping prices low in order to drive higher-cost U.S. shale oil producers out of production.

In March the Saudi's boosted their oil production to its highest level in three decades and continue to aggressively invest in growing production even further. It has been estimated that the Saudi state-owned oil company, along with those of the U.A.E. and Kuwait, will collectively increase their investment in oil exploration and production for 2015 by 4.5% compared with 2014. This indicates that OPEC's oil production can only continue to grow over the remainder of this year and into the next.

Second, the "fracklog"—the inventory of unfinished wells in the U.S.—threatens to add an additional 330,000 barrels of daily production to current U.S. oil output.

Third, there is the growing possibility of a nuclear deal with Iran. This would mean that sanctions could be eased or even lifted, giving Iran greater access to oil markets. If this were to occur, Iran could add an additional 500,000 to one million barrels of crude daily to global supplies that already exceeds demand by around 1.5 million barrels daily.

Finally, there is the phenomenon of "oil contango" that has created an incentive for oil to be stored because of the spot price being lower than expected future prices. U.S. onshore oil storage is now close to reaching capacity, and if this occurs, there are fears it will trigger a flood of crude being sold onto an already oversupplied market.

All of these factors don't bode well for higher oil prices in the foreseeable future, at least until there is a sharp increase in demand, but now is certainly not the time to panic. Despite this ugly outlook, some institutional investors are treating it as an opportunity to take advantage of distressed asset prices and pick up bargains in the patch**.**

So what?

While I see the rout among energy stocks as a buying opportunity, the key to identifying attractively priced investment opportunities is to find companies with solid balance sheets, quality oil-weighted assets and hedging positions that protect their cash flow against lower crude prices. Three companies that stand out for those reasons are **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG), **Vermilion Energy Inc.** (TSX:VET)(NYSE:VET) and **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE). Another far more speculative play is **Pengrowth Energy Corp.** (TSX:PGF)(NYSE:PGH), with it having made significant inroads into developing its long-life, low-cost Lindbergh thermal project.

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