



3 Big Reasons to Reduce Your Oil Exposure

Description

Earlier in the week WTI prices collapsed by nearly 8%, culminating in a total 15% drop from WTI's nearly US\$62.00 high at the end of June 2015.

The drop in oil prices can be attributed to a variety of factors, including a potential lifting of an export ban in Iran, oversupply, and slowing growth in China. While these all have varying degrees of long-term implications on the price of oil, oil prices face several even more daunting long-term headwinds—namely, the gradual loss in market share to natural gas and renewables, as both offer less carbon-intensive and increasingly more effective alternatives.

As usual, the prudent response is proper diversification. The overall TSX is currently weighted 20% towards energy, and investors should bring their energy exposure much closer to the 7.9% weighting present in the much better diversified S&P 500 index. By reducing energy exposure and holding only the highest-quality names, like **Suncor Energy Inc.** ([TSX:SU](#))([NYSE:SU](#)), it is possible to maintain low-risk exposure to the commodity. Here are three major reasons to diversify.

1. The lifting of the Iranian export ban could flood the market with supply.

Iran and the west are currently in negotiations over Iran's nuclear program, and most agree that an agreement would result in the lifting of sanctions on the country, which would allow the country's oil supply to access global markets.

With 158 billion barrels of reserves, it is estimated that Iran could potentially contribute up to one million barrels a day to an already oversupplied market, which would contribute significant downwards pressure to the price of oil. There is already a global oversupply of nearly two million barrels per day, and with Iran looking to quickly double their current exports of 1.2 million barrels a day, the situation could be exacerbated.

2. Low prices may not reduce supply as anticipated

The standard economic logic is that low oil prices will work to reduce production due to the fact that

American frackers have total breakeven costs often above US\$60 per barrel. This is due to the fact that fracked wells have rapid decline rates—that is to say, after a well is drilled it produces rapidly and production quickly declines.

As a result, these companies need to invest constantly to find new wells and maintain production. Low oil prices discourage this. It appears though, that these costs are rapidly coming down, thanks to rapid improvements in data and simulation technology, which allows drillers to drill more productive wells, thereby reducing costs.

Energy expert Mark Mills suggests this new technology will yield breakeven costs of as low as \$5-20 per barrel, which would keep supply abundant and prices low.

3. Long-term demand for oil will be threatened

While the first two concerns are supply oriented, the third is demand oriented. Canada recently made a commitment to end fossil fuel use by 2100, and this is part of a greater movement towards less carbon-intensive forms of energy.

Coal prices faced rapid declines due to policy-induced shifts from coal to natural gas-fired power plants as well as rapid reduction in coal use from China; oil is likely to face similar pressures. In fact, by 2035 oil's market share will decline by 12%, whereas natural gas will have its market share grow by 13%, and renewables will have their market share triple or more.

Natural gas is currently cheaper than oil on an energy-equivalent basis, and more vehicles are expected to be powered by natural gas going forward. Renewables will also have their costs drop rapidly, as they quickly become more competitive with oil.

Hold high-quality names only

By reducing your exposure and holding high-quality names like Suncor, you can still retain exposure to any upside in oil prices, while reducing downside risk. Suncor's refining and upgrading assets, combined with its strong market access initiatives, allow the company to ensure it receives higher Brent-based prices on all its production, which means Suncor is receiving the highest possible value per barrel at any given time.

With industry leading low costs and a well-capitalized balance sheet, Suncor is able to remain profitable in all pricing environments.

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1. Editor's Choice

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Date

2025/08/26

Date Created

2015/07/10

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