



Could Oil Really Fall to \$20 Per Barrel?

Description

It was just over a month ago when investment bank Goldman Sachs predicted that crude could fall as low as US\$20 per barrel in coming months because the global supply glut was far larger than originally thought. This appears to be a somewhat extreme prediction that stands in stark contrast to some of the indicators about the state of the global oil market, but if it were to occur it would be a devastating blow for Canada's energy patch.

Let's take a closer look to determine whether or not this is a possibility.

Now what?

Pessimism surrounding the outlook for oil continues to grow. Even the previously optimistic CEO of the world's largest oilfield services company, **Schlumberger Ltd.**, recently stated that he now believes that the worst is yet to come for the oil industry. This is in stark contrast to statements he made three months ago when he said the industry had seen the worst and a recovery was in sight.

Much of the pessimism surrounds the growing global supply surplus, which has now reached 1.4 million barrels per day and continues to grow. This supply surplus is rising because U.S. oil output has not fallen as sharply as initially predicted, despite the U.S. rig count now at its lowest level in over a decade.

In fact, U.S. oil production is still roughly at the same level it was prior to OPEC commencing its strategy aimed at boosting production as a means of driving prices lower in order to force higher-cost U.S. shale oil producers out of the market.

Meanwhile, U.S. oil inventories, after declining in recent months, are now back to their highest level since early June. This is a clear sign that supply is outstripping demand, leaving a considerable amount of oil in storage that will enter the market when prices rise.

Even the International Energy Agency or IEA recently adjusted its outlook. It now believes the oil glut will persist throughout 2016 due to declining global demand caused by weak economic growth in those countries dependent on commodities revenues.

Then you have OPEC member Iran, which many analysts expect to boost production by up to one million barrels daily in 2016 once sanctions are lifted.

So what?

On top of the possibility of US\$20 oil, there is the potential for the Fed to raise interest rates before the end of the year. If this occurs it would increase borrowing costs across the oil industry, further impacting companies that are already cash flow negative.

When these factors are considered in conjunction with the looming industry-wide credit crunch, where lenders will refuse to extend further credit to companies that are already financially stretched, there will be a considerable number of bankruptcies.

The most vulnerable are those companies such as **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE), **Pacific Exploration and Production Corp.** (TSX:PRE), and **Pengrowth Energy Corp.** (TSX:PGF)(NYSE:PGH), which are cash flow negative with mountains of debt and highly levered balance sheets.

Nonetheless, while the risk of US\$20 oil is a possibility, it does appear to be likely that oil will rebound somewhat over the coming year. Most significant is the forecast 500,000 barrels per day reduction in global non-OPEC oil output, while the threat of Iran increasing production is not as real as it appears because it will take a considerable amount of time as well as outside investment and expertise for that to occur.

CATEGORY

1. Energy Stocks
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TICKERS GLOBAL

1. TSX:FEC (Frontera Energy Corporation)

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