3 Reasons Why US$20 Oil Is Now a Real Possibility

Description

The last year has been a tough one for the energy patch with crude falling to its lowest level in 13 years and dipping under US$30 per barrel in recent days before recovering. The ongoing weakness of oil prices has been a harbinger of doom for the patch, forcing companies such as **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG) and **Canadian Oil Sands Ltd.** (TSX:COS) to slash costs and cut dividends.

The impact of weak crude is not limited to the patch–it also continues to have a marked impact on Canada's economy and the value of the loonie.

Now what?

Despite the optimism of some industry insiders that 2016 will be the year that crude finally starts on the path to recovery, there are growing signs that it has further to fall.

Firstly, a rapidly appreciating U.S. dollar will drive the price of crude lower.

In a recent research note, analysts from investment bank **Morgan Stanley** noted that the sudden appreciation of the U.S. dollar has the potential to push the price for Brent–the international benchmark oil price–to US$20 per barrel. This they believe will be from currency movements alone with little to no influence from industry fundamentals.

Secondly, despite the latest U.S. rig count now being at its lowest level in over 16 years, U.S. output grew for the last five straight weeks.

Contrary to the claims of industry insiders and analysts that weak prices would force U.S. shale oil producers to slash output, many are keeping the spigots open and pumping crude. This is because for many it is better to keep pumping and generating some cash flow that allows them to meet a portion of their financial obligations than shuttering operations altogether.

With many now operating with substantially lower operating costs, the breakeven price per barrel for many oil companies has fallen significantly. As a result, companies such as **Baytex Energy Corp.** (TSX:BTE

)(NYSE:BTE) and **Vermilion Energy Inc.** (TSX:VET)(NYSE:VET), which have relatively low breakeven prices, can become profitable with only a moderate rebound in oil prices. This provides an additional incentive to keep pumping even if prices dip lower.

Finally, global crude inventories have swelled to a record level of about three billion barrels and continue to grow.

This is weighing heavily on crude prices, and with U.S. oil inventories now soaring to record levels, there are fears that storage space in the U.S. will soon be exhausted. The storage hub at Cushing, Oklahoma, the largest U.S. oil storage hub, is close to 90% capacity. Once that is exhausted oil producers could be forced to dump excess crude on global markets that are already suffering from significant oversupply.

It is feared that this will trigger a violent correction that will result in prices plunging to a level that is necessary to force an immediate halt to some production. As long as U.S. oil production remains close to all-time highs, there is a strong likelihood of this occurring.

So what?

Growing global supplies, decreasing storage capacity and declining demand are creating the perfect storm that could see oil fall to as low as US$20 per barrel. This will be disastrous for the energy patch, forcing further cost cutting and damaging Alberta's already distressed economy.

US$20 oil would also push heavily indebted energy companies such as **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE) to the wall, while triggering the end of a number of dividend payments. Canadian Oil Sands and Crescent Point's dividends are already at risk.

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1. Energy Stocks
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Author

mattdsmith