



3 Reasons Why Oil Is Close to Bottoming

Description

It has been interesting to follow the crude market over the last year and a half.

When the commodity peaked back in June 2014, everyone was bullish. As the price declined, investors were convinced crude's decline would be short-lived, citing what happened in 2009, increasing demand from the developing world, and the belief that OPEC would cut production to help stabilize the market.

In fact, the exact opposite happened. OPEC kept pumping; so did U.S. and Canadian producers. Beleaguered North American producers don't have much of a choice, since many are in so much debt that they depend on the meagre cash flow obtained from selling crude at today's low prices to stay alive.

This is the main reason why we haven't seen supply leave the market. Many upcoming large-scale projects in the oil sands have been shelved, which helps but does little to alleviate supply issues today. Most producers are pressing on, since most of the cost of a project comes up front. And fracking producers are loving the lower cost of labour and drills, which has helped bring costs down significantly.

All of this sounds very bearish for oil, and it's the main reason why crude has gotten absolutely hammered thus far in 2016. Crude is down nearly 30% in 2016 alone with the commodity trading at \$26.50 per barrel as I write this. It's at a low not seen since before the Iraq war.

Amid all of this darkness it might sound insane, but I'm beginning to think we don't have much lower to go with the price of crude. Here are three reasons why it's close to bottoming.

Sentiment

I'm a big believer in sentiment. I think it's an incredibly undervalued investing tool.

Essentially, it goes like this: when everybody crowds into a trade, an idea, or an opinion, that's exactly the time to take the other side of the bet. When it seems like everyone is calling for oil to continue to fall, that's the opportune time to be contrarian.

The issue becomes how investors can bet on crude. One example is **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE), a company that needs to continue to sell off assets or it'll be forced to declare bankruptcy. Even if crude rallies from \$26.50 to \$40 per barrel, Penn West still isn't out of the woods. It needs much higher prices to not breach its debt covenants.

Perhaps a somewhat healthier producer such as **Baytex Energy Inc.** ([TSX:BTE](#))(NYSE:BTE) and its lack of upcoming debt maturities would be a better choice.

If crude doesn't rally hard from these lows, the only real hope for Penn West shareholders is for a bigger producer to recognize the value there and buy the whole company. But is there really any value with crude so low?

Production cuts

Last year didn't see much in the way of production cuts, but 2016 will be different, especially among North American producers. There are dozens of different producers that will go bankrupt barring a miraculous recovery in crude.

One Canadian company I think that is in particularly rough shape is **Lightstream Resources Ltd.** (TSX:LTS). The company owes more than \$1.6 billion in total debt, and it likely won't crack \$150 million in funds flow from operations in 2016 unless crude heads much higher. Sure, the company has low-cost production, but it's just too far in debt to really take advantage. Like Penn West, Lightstream looks to need help to survive.

These production cuts will take time. But they are coming.

Futures prices

The final reason why I think oil has bottomed is because that's what future contracts are telling us.

Going out just a few months, the May 2016 crude oil contract trades at \$30.23 per barrel, an increase of more than 14% compared to today's quoted price, which is for the February contract. July contracts are trading at \$32 per barrel, and the January 2017 contracts are nearly \$35 each.

What that tells me is short-term traders are dominating the market and reacting on fear. It explains why there's such a spread between prices of contracts just a few months apart. Even if these future contracts don't move much, it's very possible the short-term futures will rally simply as a reversion to the mean.

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1. TSX:BTE (Baytex Energy Corp.)

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