Why You Should Ignore Oil-Price Predictions

Description

Just yesterday on one popular U.S. financial news outlet, there were two separate articles on oil prices—one suggested that oil could possibly be heading to $10 dollars per barrel this year; the other, by French Bank Societe Generale, suggested that oil prices will rally 35% to above $40 per barrel by year end.

Analysts at **RBC** are now forecasting WTI prices of around $40 per barrel for 2016, whereas Shawn Driscoll—a prominent analyst at T Rowe Price who accurately forecasted the current rout—expects oil prices to stay under $30 and possibly fall into the teens.

Which analyst should you believe? There is good reason to ignore them all. Here is why—while it is important to understand the major forces in the oil market—it is best to simply ignore prices and focus on businesses such as **Suncor Energy Inc.** (TSX:SU)(NYSE:SU) and **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG), which are diversified, have solid balance sheets, and can withstand further pricing pressure.

There is a bullish case for oil in 2016

Currently, WTI prices are around $32 per barrel. There is a valid case for prices rising from these levels to $40 or even $50 per barrel by the end of 2016.

In this scenario, the global oil inventory build that has been going on for the past two years will begin to reduce, and the oil market will move into a more balanced state (where production and demand are roughly in line). In 2015 oil production exceeded demand by nearly two million barrels per day, followed by 600,000 barrels per day in 2014.

Two big factors would help bring the market back into balance. Firstly, strong global demand will support the market. Last year had the best demand growth since 2010, and China—a source of major concern recently—imported record amounts of oil in 2015, despite having its slowest-growing year in 25 years. This solid demand growth could continue into 2016.

At the same time, U.S. oil production would decline in this scenario and the decline could be significant. The fact is that many U.S. producers are uneconomic at current price levels, and one consulting firm estimates that U.S. producers will have a huge funding gap of $102 billion between their cash flows and their capital expenditures and interest payments. The IEA sees non-OPEC production (including U.S. production) falling by nearly 600,000 barrels in 2016.

Unfortunately, there is an equally valid bearish case for oil in 2016.

In the bearish scenario, analysts sees the oil market suffering from continued oversupply in 2016—by as much as one million barrels per day. While U.S. and non-OPEC production may fall, this could be offset by Iran coming back to the oil market when its sanctions are lifted. Iran could grow its production by as much as 500,000 barrels per day in the first part of 2016 alone.

At the same time, Saudi Arabia continues to expand its production in an effort to gain market share and put U.S. producers out of business. If demand comes in slower in 2016 (which is possible), and U.S. producers continue to be resilient, it could result in further oversupply.

In addition to this, oil storage at Cushing is currently at record highs of 64 million barrels, and this massive amount of storage could weigh on markets.

Buy producers that can withstand all price environments

It’s clear that there are good cases for oil to go in either direction this year. This is why it is important to pick producers who have strong balance sheets, good liquidity, and low breakeven costs.

Crescent Point Energy, for example, expects to be free cash flow positive at $40 per barrel. The company has a flexible capital program for 2016 (spending between $950 million and $1.3 billion), and at $40 per barrel the company would generate enough cash flow to cover $950 million in capital expenses as well as its $660 million dividend.

Suncor is in a similar position. Despite oil prices falling 66% since October 2014, Suncor shares fell only 23%. This is because Suncor has refining operations that often benefit from low prices. Suncor also has solid free cash flow and over $5 billion in cash on its balance sheet. Currently, Suncor has low operating costs of $27 per barrel, making it able to withstand the lower pricing environment.

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