The 3 Biggest Reasons to Be Optimistic About Oil Prices

Description

As oil prices continue to languish, many analysts believe that a rebound is inevitable. This would certainly be great news for energy producers such as **Suncor Energy Inc.** (TSX:SU)(NYSE:SU) and **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG).

Below are the top three reasons why so many analysts are optimistic.

1. U.S. shale producers are in trouble

Thus far, production from the American shale drillers has held up far better than most people predicted. And that's one of the main reasons why oil is trading near the US$30 mark. There are a few reasons why shale production has been so stubborn.

First of all, costs have come down significantly partly due to lower rates for labour and equipment, but also due to technological improvements. Drillers have also been more selective about where they drill for oil.

Secondly, many producers had strong hedges heading in to the downturn, which helped protect cash flow. And finally, oil companies by their very nature are determined to maintain production; no one wants to work at a shrinking company.

But sooner or later, the music has to stop. Costs can only go down so far, and only so much oil can be drilled from the best fields. And hedges are rolling over, which will put many producers under serious pressure.

It gets worse for these producers. Shale wells tend to have steep decline rates, meaning that producers must keep drilling new wells just to maintain production. With oil prices this low, these wells simply don't generate sufficient returns. And if that wasn't enough, many of these producers have terrible balance sheets. So when the funding dries up, it simply doesn't matter how determined these companies are.

2. There could be a short squeeze

Short bets against oil prices are at all-time highs, and this makes the prospect of a short squeeze very realistic. In fact, we've already seen some mini short squeezes. For example, the WTI oil price surged by 20% in just two days last week partly due to short covering.

So if there are any positive signs for the oil price–perhaps due to conflict in the Middle East or a fall in U.S. production–then a modest rally could turn into a major spike.

3. There has been a lack of investment

Back in 1998 oil prices crashed mainly due to the Asian financial crisis. As a result, oil producers decided to hunker down, deferring major capital projects.

This had a profound impact over the next 15 years. As China grew rapidly, oil producers were constantly playing catch up, which is why (with the exception of the 2008 financial crisis) oil prices marched upwards for so long.

We are arguably in a similar situation now. Approximately US$170 billion in capex spending between 2016 and 2020 has been scrapped, and that could create shortages in the next few years. At this time last year, one oil executive even predicted that prices could reach $200 per barrel precisely due to this dynamic. We've also recently heard OPEC comment on the lack of investment.

The oil bears still have their arguments. But if you're investing in Suncor or Crescent Point, there are certainly reasons to be very optimistic.

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