Why Eric Nuttall of Sprott Asset Management Thinks Oil Is Going to $55 This Year

Description

It seems that sentiment around the oil market is finally becoming more positive, even though the fundamentals have changed little. Since mid-February, West Texas Intermediate (WTI) prices have rallied 30% off the 13-year low of $26 per barrel.

Much of this rally was due to the news that three OPEC producers and Russia have agreed to freeze production at January levels under the condition that Iran and Iraq (the major sources of new OPEC supply this year) also agree to the deal.

While many are skeptical this will happen, well-known fund manager Eric Nuttall—manager of Sprott's $50 million energy fund—says that it ultimately doesn't matter. He is forecasting that WTI oil prices will return to $55 this year, and this price increase will likely occur regardless of what happens with OPEC in 2016.

If he is right, this could mean major upside for oil stocks, and there are several names that could benefit significantly.

The oversupply of oil can be eliminated by the end of the year

While it is difficult to pinpoint the exact amount of oversupply that exists in the market today, the general consensus is that the market is oversupplied by about 1-1.6 million barrels per day. While this sounds large, the world consumes about 95 million barrels of oil per day, meaning a 1.6 million oversupply is only 1.6% of global demand (this compares to the oversupply during the 1980's crash, which was a gigantic 14 million barrels per day).

Nuttall says that because this oversupply is small, it can be worked off by a year or so of demand growth. Demand growth is still healthy, growing by 1.8 million barrels per day in 2015 (which is the fastest rate since 2010). Demand growth in 2016 should slow but still remain strong. Nuttall uses IEA and EIA predictions to estimate that oil demand should grow by about 1.2 million barrels per day in 2016.

This demand growth would largely work off the current oversupply. This assumes though that supply will not grow overall during 2016, and Nuttall believes this to be the case. He views Iran as being the only source of global supply growth in 2016, which is estimated to be adding about 500,000 barrels per day. While Iran could add more (up to one million barrels per day over time) this amount is very questionable and is almost certain not to come online in 2016.

While Iran will add to supply, Nuttall thinks this won't create a net increase in supply due to the fact that U.S. production will be coming offline. In fact, it is estimated that U.S. production will come offline by about 600,000 barrels per day in 2016, which would fully offset the amount coming from Iran and actually cause an overall reduction in supply year over year.

Combining a reduction of supply with demand growth of 1.2 million barrels means that the current oversupply of 1-1.6 million barrels per day could be eliminated or close to being eliminated by year end.

Nuttall thinks that as soon as there is an undersupply and there are withdrawals from storage (a reduction of inventories) rather than additions, oil prices should rally to levels around $50. Nuttall sees this as the level that U.S. producers will need to start ramping production back up.

Names like Crescent Point and Baytex will perform well

Crescent Point Energy Corp. (TSX:CPG)(NYSE:CPG) and **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) should both see huge upside if oil prices actually increase to $55 per barrel.

Crescent Point is the less risky of the two and is seen as a best-in-class name because it owns assets in some of the most economic plays in North America with fairly low breakeven costs, it has 34% of its production hedged at higher prices, and it will be able to grow its production in 2016.

Baytex is a higher-risk name due to its high debt levels, but Nuttall sees Baytex as having huge upside if oil prices improve and has it at as a top holding in his energy fund.

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