3 Reasons Why the Rally in Oil Is Unsustainable

Description

The last year was a painful one for Canada's energy patch and energy investors. Sharply weak oil prices triggered an avalanche of spending cuts across the industry as oil companies struggled to remain cash flow positive and meet their financial obligations.

However, the recent production-freeze agreement between OPEC members Saudi Arabia, Kuwait, UAE, Qatar, and Venezuela as well as non-member Russia has given the oil industry considerable hope. As a result, crude has rallied substantially in recent days to now be about 37% higher than its one-year low reached in early February of this year.

As a result, the share price of a range of troubled energy companies, such as **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) and **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE) rose substantially by 96% and 61%, respectively, over the last month.

Nonetheless, there are signs that the recent rally may be unsustainable as industry fundamentals indicate that the supply glut will continue.

Now what?

Firstly, OPEC's oil production is set to grow despite the production freeze.

You see, OPEC member Iran has described the production freeze as a joke and remains on a mission to boost output. Teheran is desperate to kick-start an ailing Iranian economy, which has been in decline because of international trade sanctions that were imposed in response to its nuclear program.

However, these sanctions were recently lifted, and Iran remains determined to boost its oil production by up to one million barrels daily because oil is an important driver of economic growth and a producer of government revenue.

Then there is OPEC's second-largest producer of crude, Iraq, which is seeking to lift its output by 600,000 barrels daily by mid-2016.

These factors will cause an even greater of volume of crude to flood an already saturated global market, and there are no signs of demand substantially picking up any time soon.

Secondly, U.S. oil stocks remain at record levels and continue to grow.

Analysts now estimate that about 80% of total U.S. storage capacity is now filled and U.S. oil inventories continue to grow, increasing by 3% since the start of 2016. This is placing considerable pressure on oil prices, and it is feared that as soon as prices rise, the stored crude will flood the market as producers and traders seek to cash in.

Finally, despite a sharp decline in the U.S. rig count, U.S. oil production is still higher than it was when West Texas Intermediate was trading at over US$100 per barrel.

These indicators are what continues to push oil stocks ever higher; production has yet to decline sufficiently to make a difference to the price of crude.

So what?

These fundamental indicators highlight that the recent rally in crude is unsustainable and that prices can only fall over the short term. This makes oil companies that are heavily levered and have high variable costs relative to their U.S. peers, such as Penn West Petroleum and Baytex, unattractive investments.

Any renewed decline in crude could make it difficult for these companies to meet their financial commitments and increases the risk of insolvency. If this were to occur, the share price for both stocks would depreciate sharply from recent highs.

CATEGORY

1. Energy Stocks
2. Investing

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1. Editor's Choice

TICKERS GLOBAL

1. TSX:BTE (Baytex Energy Corp.)

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Date
2025/09/21

Date Created
2016/03/08
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