Did You Miss the Oil-Price Rally?

Description

Investors who were bearish on energy early in the year likely find themselves increasingly discouraged over oil's steady climb higher. It seems that each day oil continues to make new highs and overall sentiment for oil in the financial media and among investors seems to have turned positive.

Just today, the IEA released its March report. The major headline was that the IEA sees signs that oil prices have finally bottomed. The IEA cites many factors, such as news that major OPEC producers as well as Russia are ready to sit down and have constructive talks on production later this month.

The report is also bullish due to the fact that it now expects non-OPEC producers (mainly the U.S.) to see production fall by 750,000 bpd in 2016 compared to their previous estimate of 600,000 bpd. With demand still coming in strong, it is starting to look like investors may have missed their opportunity.

Fortunately, the window may not be closed yet. While oil may not plunge to $25 per barrel again, it is very likely oil will pull back from current levels over the next few months. Investors can use such a pullback as an opportunity to get in on some of the high-quality names in the sector before a more sustainable rally into the $40-per-barrel range takes hold.

It is likely oil will pull back from current levels

Many have said recently that the massive rally currently underway is not supported by market fundamentals, and there is some truth to this. **Goldman Sachs** supports this position and has said that the current price rally is ultimately unsustainable and is largely based on improving sentiment (partially due to news of OPEC talks).

Last week, U.S. crude stockpiles surged another 3.9 million barrels, bringing inventories up to 521.9 billion barrels, which the IEA describes as being "historically high." The fact that oil storage volumes are still growing substantially shows that the major problem (a global oversupply) that caused the oil-price collapse is still in place.

While there are encouraging signs that high-cost U.S. production is coming offline, the IEA estimates that a global oversupply of about 1.5 million barrels per day still exists. Ultimately, for a sustainable rally in oil to occur, this oversupply will need to be significantly reduced until demand exceeds supply and withdrawals from storage occur.

This will be the sign that the market is truly undersupplied on a fundamental level and will be the source of a sustainable rally in oil prices. Estimates vary as to when this will occur, but most analysts seem to agree Q3 2016 is a reasonable point to begin looking for this.

It is for this reason why Goldman Sachs described the recent rally in oil prices as a “false start.” It is important to remember that the oversupply will ultimately be cured by falling U.S. production combined with global demand growth. If oil prices remain at current levels or increase even more, the rally will become self-defeating in many ways, since it will slow the reduction of higher-cost U.S. production or even encourage new production to come online.

Oil prices will need to remain low for a longer period in order to help the market rebalance properly.

Buy names such as Baytex and Crescent Point on a pullback

If oil prices do pull back, it will be an excellent opportunity to buy high-quality names such as **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) or **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG).

Why are these names high quality? They both have production in some of the most economic areas in North America (areas such as the Viewfield Bakken for Crescent Point and Eagle Ford for Baytex). Baytex’s Eagle Ford wells can break even and earn a 10% return at US$35/bbl oil, and Crescent Point’s Viewfield wells can earn an impressive 41% return at US$35/bbl oil. These stocks should outperform when oil recovers, and they already have during the current rally.

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Author
amancini