2016's Last Good Opportunity to Buy Oil Stocks May Be Approaching

Description

After a brief trip down to US$35/bbl, oil has once again rallied back to the US$40/bbl level. The source of the rally? Among other things, the EIA released inventory data that showed a U.S. inventory draw of 4.94 million barrels for the week ending April 1.

This is somewhat significant. Analysts were estimating a consensus inventory build of 2.85 million barrels, and this inventory draw represents the first significant draw since the week ended December 18 (where inventories declined by 5.9 million barrels).

Inventory draws are a sign that the market may be potentially be under supplied, and the market responded accordingly. Many investors who missed the initial rally are waiting for oil to pull back to US$35 or below once again to gain entry. Fortunately, these investors may get another opportunity to enter below the US$40 range, but it may be their last chance.

A sustainable rally in oil prices is approaching

Analyst forecasts for oil vary widely, but the general consensus is that oil prices are headed higher. There is a strong case for why this is true, and the main question now is timing.

The fundamental case for a sustainable rally in oil prices is based on the fact that production (in particular, U.S. production) seems to be responding to low oil prices. Currently, U.S. oil production is down about 600,000 barrels per day from the high set in June 2015 (about 9.6 million barrels per day), and production fell last week to 9.008 million barrels per day—the lowest in 17 months and close to dropping below the psychologically important nine million mark.

At the same time, rig counts are also falling. The week ended April 8 saw total U.S. rigs of 354, and this compares to 760 one year ago. Fewer rigs means fewer new wells being drilled, and a low rate of well additions means that U.S. producers are not effectively replacing declining production from current wells (shale wells decline by up to 70% a year).

Overall, U.S. production is estimated to fall by 600,000-700,000 barrels per day in 2016 (and it is tracking well towards this target based on the decline noted in the first quarter). If the current global oil oversupply is 1-1.6 million barrels per day, these U.S. production declines combined with estimated demand growth of about 1.1 million barrels per day should easily take care of the oversupply.

The 500,000 barrels per day of production coming online from Iran is also not a concern as this will be offset by production declines elsewhere (China just recently announced it is expecting a 600,000-barrel-per-day decline).

Prices will not head upwards in a straight line

Fortunately for investors, oil is volatile, and this is an opportunity for investors to buy oil stocks on dips in the price of oil. There are several factors that could add some downside pressure to oil prices over the coming weeks.

Firstly, the upcoming OPEC meeting has added upward pressure to prices, but without Iran's participation (Iran is the only meaningful source of production growth from OPEC in 2016), the meeting will do little to fix the global oversupply. Analysts at **Goldman Sachs** recently reiterated this view, stating such an agreement without Iran is insignificant.

In addition to this, last week's inventory build was just one week—a steady pattern of declines will be necessary to convince the market that oil is under supplied. It is important to note that last week's decline was also driven by a drop in imports and higher refinery runs. This was followed by an increase in gasoline inventories, which shows that the decline may have been driven by higher refinery activity rather than actual end product demand.

The oil market will still take time to re-balance, and investors can use the near-term volatility to pick up high-quality names as they decline with the price of oil.

Crescent Point Energy Corp. (TSX:CPG)(NYSE:CPG) is an excellent choice for investors deciding how to play energy. It has a strong balance sheet, a hedging program that locks in higher prices on a large portion of its production in the event of price weakness, and the ability to ramp up production at a low cost as prices rise.

CATEGORY

1. Energy Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:VRN (Veren)
2. TSX:VRN (Veren Inc.)

Category

1. Energy Stocks
2. Investing

Date
2025/09/04
Date Created
2016/04/11

Author
amancini