Why Royal Bank of Canada's Call for $70 Oil by 2018 May Be Too Low

Description

West Texas Intermediate prices have established a clear uptrend with spot prices closing near US$44 per barrel, and the general consensus is that the bottom has been put in for this cycle. At this point, analysts are debating where oil is ultimately headed over the next year or two; most seem to agree that US$55-70 is a solid balance point for the oil market.

Toronto-Dominion Bank sees oil at US$65 per barrel in 2018, and **Royal Bank of Canada** (TSX:RY)(NYSE:RY) is slightly more optimistic, seeing US$70 per barrel in 2018. This price reflects the general level that U.S. plays like the Permian Basin and the Eagle Ford need to break even.

While oil may stabilize at these prices over the long term, there is the possibility that oil can overshoot these prices for a period of time as the market finds a balance. There are several reasons why this could happen.

1. Demand growth is strong and lack of investment could lead to shortages

Analysts at the IEA see fairly steady demand growth going forward. In 2016 the IEA says that oil demand will grow by a fairly large 1.2 million barrels per day. It also sees growth of 1.3 million barrels per day in 2017 and 2018, and then 1.1 and 1.2 million barrels per day in 2019 and 2020.

This is very solid demand growth (the current oversupply in the market, for example, is about 1.5 million barrels per day). This means that by 2020, 6.1 million barrels per day of crude demand growth will occur, which also means supply growth of the same amount will be needed.

Unfortunately, there have been massive cutbacks in oil investments. In Canada, for example, oil capital spending was $81 billion in 2014; by the end of 2016 it will be $31 billion. Even if U.S. supply kicks back in at about US$50 per barrel and starts growing again, the world will need additional supply to meet the demand growth that is coming, and some of this supply will come from longer-dated projects that have not been funded for the past several years.

It is important to note that global production also declines annually (conventional fields decline by about 5% per year, but unconventional production like U.S. shale oil declines at much higher rate, sometimes as high as 70% in the first year).

This production will also need to be replaced just to keep global production even, which means that much more than 6.1 million barrels per day will be needed by 2020. With massive investment cuts, it is difficult to see how this supply will be there when it is needed.

2. Supply likely can't come online as fast as people think

Eric Nuttall—an energy fund manager at Sprott Asset Management—recently pointed out that U.S. supply will not simply restart immediately once oil prices rise into the mid-$40 or $50 range, as many think. If this were to occur, oil prices would quickly find a ceiling.

This is unlikely due to the fact that capital is simply not as available as it once was. U.S. companies regularly spent beyond their cash flow during the past five years, which allowed them to grow production at a rapid rate by drilling more wells and exploring more. This capital will no longer be available as oil companies have high debt and banks are reducing available credit.

This means that U.S. companies will not be able to ramp up production at the same rate they did in the past (about one million barrels per day annually). It is for this reason that oil prices may potentially surprise investors to the upside.

Investors looking to benefit should invest in a diversified portfolio of a few oil names, including integrated names such as **Suncor Energy Inc.** (TSX:SU)(NYSE:SU) that have refining operations, as well as smaller names.

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