



Has Oil Really Bottomed?

Description

The recent rally in crude that now sees West Texas Intermediate (WTI), the North American benchmark price, trading at over US\$40 has given energy companies and investors alike hope that the bottom in crude is finally in. A number of notable institutions, such as the International Energy Agency and asset managers including Fidelity, T.Rowe Price, and Merrill Lynch have even stated that it is the case.

This idea isn't relatively new. Industry insiders and asset managers have been making similar claims since the precipitous slide in crude began in late 2014. Even if these claims are correct, there are reasons for investors to continue viewing energy stocks with caution.

Now what?

Claims that the price of crude has bottomed rest on Iran's less than spectacular re-entry to global energy markets. Its oil output hasn't increased as rapidly as it initially claimed. Then there are the production caps that have been proposed by OPEC, which, along with an expected substantial decline in U.S. oil production, will cause global supplies to fall.

Nonetheless, there are signs that this may not be the case.

While Iran's re-entry to global energy markets has not been as spectacular as it claimed it would be, the country is still resisting OPEC's proposed production caps and is focused on boosting its crude output by up to 500,000 barrels daily.

U.S. oil output also remains not far off record highs, and the shale oil industry has demonstrated a considerable resilience to weak crude prices by slashing costs and shuttering uneconomic production. Many companies are now operating with cash costs of less than US\$20 per barrel, meaning that their production remains cash flow positive, even with WTI hovering at about US\$40 per barrel.

For this reason alone, there is no incentive at this time for them to cease pumping crude. This coupled with debt restructuring and equity raising across the industry, the majority of shale oil companies are capable of meeting their financial commitments and won't fall into bankruptcy any time soon.

Even if the claims made by consulting firm Deloitte are true, that up to a third of North American oil companies will file for bankruptcy this year, it is unlikely that this will cause them to cease production. You see, when filing for bankruptcy, companies typically continue to operate, and many emerge as a going concern after undergoing a debt restructuring.

These factors certainly don't bode well for any marked decline in U.S. oil output, as some analysts have claimed will occur. This means that any concerted recovery in the price of crude is still some way off.

As a result, the financial pressures being applied to heavily indebted companies with deteriorating cash flows and high cash costs, such as **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE) and **Baytex Energy Corp.** ([TSX:BTE](#))(NYSE:BTE), won't cease any time soon.

In fact, the majority of heavily indebted oil producers such as Penn West and Baytex need crude to be at over US\$60 per barrel if they are to become profitable once again. This is unlikely to occur until there is either a steep increase in demand or a sharp decline in supply, neither of which appears likely at this time.

So what?

With a market rebalance hinging on U.S. shale oil production, it is unlikely that there will be a sustained rally. There are signs that shale oil companies are capable of continuing to pump crude at close to current levels. This makes it likely that even if oil has bottomed, the top isn't far off and sharply weak prices will remain for the duration of 2016.

CATEGORY

1. Energy Stocks
2. Investing

TICKERS GLOBAL

1. TSX:BTE (Baytex Energy Corp.)

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Date

2025/07/02

Date Created

2016/04/25

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