



Don't Miss Out on the Next Bull Run in These 2 Commodities

Description

The **Bank of Nova Scotia** commodity index—which measures the performance of a basket of commodities—has finally ended its massive downtrend which began in 2015 (although some could argue it started in 2011), and commodity prices plunged to 12-year lows.

The rally in commodities was broad-based; spot WTI prices led the way with a 71% appreciation in price from lows set in February. Does this mean a new commodity bull market is starting? It's hard to say. The previous bull market in commodities—known as the commodity super-cycle—began in the late 90s and saw prices of many commodities grow by triple and (in the case of oil) even quadruple percentages before markets crashed in 2008.

These gains were driven by a combination of years of under investment coupled with massive investments from China, which saw China's annual GDP growth stay above 10% between 2003 and 2007 (peaking at 14.2% in 2007).

It's almost certain that demand growth for commodities won't reach the historic levels of the 2000s, but major under investment in certain commodities over the past few years coupled with steady demand growth going forward could lead to significant rallies in key commodities.

1. Oil

Oil has led the commodity complex over the past several months and, with prices now hovering around US\$45 per barrel, the current rally—at least over the next several months—may be due for a pause or pullback as the current financial-activity-fueled rally begins to refocus on the much slower moving fundamentals.

Towards the end of 2016 and beyond, however, oil will likely continue its uptrend into the US\$60 range. Some are suggesting the price could go much higher over the short term if the market proves unable to bring production up to speed in short order.

This is a likely possibility.

Firstly, the rapid one million bpd of annual growth that the U.S. shale industry has had over the past five years was driven heavily by credit as companies exceeded their annual cash flow by about 1.44 times according to Eric Nuttall of Sprott. Going forward, with companies having debt levels well above average and banks being less willing (and less able) to lend, the ability of the U.S. to respond quickly to demand growth will be limited as companies focus on de-leveraging and living within their balance sheets.

Couple this with the fact that there have been massive layoffs in the oil sector, and the oil sector may have difficulty recruiting the labour needed to ramp production up quickly without being subject to the kind of cost inflation that was typical during the mid 2000s.

With longer-cycle projects (like oil sands) seeing little investment over the past two years, oil could be in for large upside. **Baytex Energy Corp.** ([TSX:BTE](#))(NYSE:BTE) is a smart way to play this trend as it is heavily exposed to the highly economic Eagle Ford region, and the company has plenty of room for valuation expansion as the market becomes less concerned about debt levels.

2. Natural gas

While natural gas has not received nearly as much attention as oil, top investors like T Boone Pickens and David Einhorn have been increasing exposure to the commodity. The idea behind natural gas is similar to oil—current prices of about US\$2 per mmBtu (which are slightly off multi-decade lows) are simply too low to justify drilling.

In the Marcellus region, the best players need at least US\$3.50 per mmBtu to break even, and other plays (like Utica) require over US\$5 per mmBtu. A simple look at the rig count shows that prices are too low to justify drilling—there are currently 87 natural gas rigs that are active. This is down from over 900 in 2011; the previous record-low rig count in 1992 was 242.

One way to play the natural gas trend is through low-cost natural gas producer **Tourmaline Oil Corp.** ([TSX:TOU](#)). Tourmaline has some of the lowest costs in the industry, is one of the largest natural gas producers, and has exposure to oil for diversification.

CATEGORY

1. Energy Stocks
2. Investing

TICKERS GLOBAL

1. TSX:BTE (Baytex Energy Corp.)
2. TSX:TOU (Tourmaline Oil Corp.)

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