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Oil Prices Are Likely Headed to $80: How to Play the Bull Run

Description

By now—and after a nearly continuous rally to almost US$50 per barrel—sentiment around the oil market has turned firmly bullish, and a slew of new data has supported this sentiment. The EIA re-affirmed is fairly strong demand growth figure of 1.2 million bpd for oil in 2016, although Q1 data came in at a strong 1.4 million bpd, which the EIA stated could lead to more upward revisions.

The EIA increased its demand growth forecast for petroleum and other liquids by 300,000 bpd to 1.4 million bpd. These are very supportive demand figures, and recent data from the EIA shows that the market is slowly re-balancing; the surplus of petroleum and other liquids fell from 2.7 million barrels per day to 570,000 in April.

With U.S. production and rigs and on a steady decline, it appears that oil prices are finally rising. But does this mean you should buy today? Not necessarily. Oil prices will head higher, but not in a straight line, and they are likely to see some pressure in the short term. This could be a chance to get in on high-quality names.

Why oil prices are headed higher

Over the longer time frame (one to two years) oil will have an upward trajectory due to a few key reasons. A recent report by Rystad Energy stated that in 2015, global oil discoveries fell to the lowest levels in 63 years. This is because capital expenditures fell by 45% in 2015 from 2013 levels. This is a big problem, because, in many supply regions, it takes years to bring supply online once discovered.

The fact is, oil demand growth is set to increase by over one million barrels per day annually through to 2020, which means that significant supply will still be needed. In addition to this, global oil production in conventional fields declines by 4.5% annually, and unconventional oil, like shale oil, declines by over 50% in many cases.

Major capital cutbacks mean the investment that would have been required today to meet this demand growth isn't being made, and supply sources like the U.S. may not be able to respond quickly to demand due to balance sheet issues and poor access to capital.

How high could oil go? According to a recent article by Art Berman, most oil producers globally need $70-80 to break even, which means oil prices will need to be around this level in theory to ensure supply is maintained.

There are short-term weaknesses

Oil price growth won’t occur in a straight line, and it will likely see periods of decline as well as periods of flat trading on its way up. In the near term, there are several headwinds that could bring prices down. With oil prices nearing US$50 per barrel, they are approaching the level where U.S. production declines may slow or stop or where new rigs may be added.

As production costs decline and prices rise, U.S. producers may begin investing, which could put near-term pressure on the price of oil. In addition to this, there has been recent talk of a U.S. rate hike by July. This would lead to U.S. dollar strength, which would in turn put pressure on oil prices.

These factors could lead to a short-term drop in oil prices and a good buying opportunity.

Invest in high-quality names

Investors should watch for a pullback to buy names like **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG). Crescent Point is widely seen as a best-in-class name due to it having a large drilling inventory in some of the most economic and high-returning plays in North America.

Crescent Point has been extremely effective at reducing costs,. It achieved 30% capital cost reductions in 2015, and 4% so far in 2016, giving Crescent Point some of the deepest cost cuts in the industry according to **Bank of Nova Scotia**.

These cuts occurred as Crescent Point increased its production. Crescent Point is expecting solid production growth in 2016 from 2015 levels of about 163,630.

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