



Why Investors Can't Ignore the Geopolitics of Oil

Description

Claims by industry insiders, traders, and fund managers that oil can only move higher over the course of 2016 are inopportune at this time.

You see, while higher inventory drawdowns, declining U.S. oil production, and lower rig counts all contribute to setting higher prices for crude, the majority of analysts continue to ignore crucial geopolitical drivers. These are responsible for the growing oil output from the Middle East, which continues to disrupt oil markets by creating a significant supply overhang.

Now what?

One of the most important drivers of the current supply glut is Saudi Arabia's use of oil as a weapon to further their national interest as well as to protect their economy and regional influence. This is easy to see when considering the degree of alarm expressed by Saudi Arabia over the U.S. shale oil boom, which saw the U.S. become the world's leading producer of crude.

By 2013, the Saudis were eyeing this boom with suspicion because it represented a direct threat to their oil-dependent economy.

After all, crude is responsible for generating over 70% of government revenues—roughly half of the kingdom's GDP and around 90% of all export earnings. And the threat became very real when key OPEC customers started limiting oil imports.

The boom also saw the U.S., once one of OPEC's important customers, cut its importation of crude from OPEC by just over 40% between 2010 and 2013. This meant that it was no longer dependent on the cartel, sending a collective shiver down Saudi Arabia's spine.

It was then that the Saudis realized they were losing control of their position as the world's largest producer of crude and that if they slashed production in order to boost prices, the gap would be filled by non-OPEC producers. This forced their hand; they had to boost production and let prices fall in order to test how long and at what levels shale oil producers could keep pumping.

Even with no sign of success in sight, their foreign currency reserves down by 18%, and a budget deficit amounting to 16% of GDP because of weak oil prices, the Saudis remain married to the strategy.

In fact, they are determined to grow oil production even further; industry insiders estimate that they will lift their oil output by as much as 3%, or 350,000 barrels daily, over the remainder of 2016. This certainly doesn't bode well for higher oil prices or for the survival of heavily indebted North American oil companies such as **Baytex Energy Corp.** ([TSX:BTE](#))(NYSE:BTE) or **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE).

And now it's just not the shale oil industry that is viewed as a threat.

Iran, the Saudi's regional nemesis, has made it clear that it intends to boost oil production now that sanctions have been lifted, as it seeks to boost government revenue in order to fund initiatives aimed at expanding regional influence and reinvigorating its fragile economy. This has triggered considerable concern in Riyadh because the Saudis are locked in a battle for regional influence and leadership with Iran.

You see, both nations are engaged in costly proxy wars in Syria and Yemen and heavily involved in funding-aid programs that are designed to extend their influence in the region. The cost of these policies, which are critical to furthering their regional ambitions, are appreciable, making Iran's rising capability to resuscitate its lagging oil industry and economy of considerable concern to Saudi Arabia.

So what?

The overarching geopolitical and economic concerns of Saudi Arabia coupled with Iran's deep-seated need to revive its lagging economy means that neither country is interested in cutting or capping production at this time. This certainly doesn't bode well for any reduction in the global supply surplus, meaning that prices will remain under pressure for some time.

For these reasons, investors are urged to approach the energy patch with caution and stick to companies with low levels of debt and high-quality oil assets such as **Vermilion Energy Inc.** ([TSX:VET](#))(NYSE:VET) and **Gran Tierra Energy Inc.** ([TSX:GTE](#))(NYSE:GTE).

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