4 Things Every Oil Investor Needs to Know About the Current Plunge in Prices

Description

With WTI prices down over 20% since its peak near US$52 per barrel in early June, sentiment in the oil market has taken a serious turn for the worst; oil officially entered a bear market (which is technically defined as a 20% decline in prices) on June 28.

Both market commentators and participants have turned firmly bearish. **Goldman Sachs** now says US$45-50 will be the range for the next year; **Morgan Stanley** stated that oil prices still have much more downside, calling for prices as low as US$35 per barrel for the second half of 2016.

Here are four things every oil investor needs know about the recent plunge in prices.

The sell-off is being led by hedge funds

Hedge funds have turned significantly bearish since late May. In mid-May, hedge funds had 408 million barrels worth of net long positions in crude (bets on prices going up minus bets on prices going down). This has declined to 327 million barrels as of last week, which means that hedge funds are selling their long positions after steady builds since the start of the year.

They are replacing these long positions with short positions, and short positions have tripled since the end of May when prices reversed off their highs. The combination of short selling and the liquidation of long positions is a sign of an underlying shift in sentiment among money managers, whose positioning on oil is strongly correlated with its price.

A recovery is unlikely until the shift towards short selling begins to reverse.

Huge gasoline stockpiles are the main economic driver of the sell-off

Currently, gasoline inventories in the U.S. are climbing steadily. The average inventory size since 2011 has been 220 million barrels, and inventories are currently sitting at 241 million barrels. With the exception of a brief spike in inventories up to 258 million barrels earlier in the year, the last time prices were above current levels was in 1990.

The excess gasoline demand is due to the fact that refiners have been producing plenty of gasoline due to low oil prices. Refineries are a key source of crude oil demand, and while they have been strong buyers of crude as of late, the fact that gasoline inventories remain so high means that end product demand is not as high as one would hope, which leads to gasoline building in storage.

Refiners are seeing declining margins as a result, and with inventories being high and margins being low, it is likely that refineries will start to cut back on crude oil purchases. Crude demand is now lower than refined product demand, which is a sign that demand is waning.

To make matters worse, refinery shutdown season is coming, which causes a usual seasonal drop in demand as refineries enter into maintenance as the summer driving season ends. This will only worsen the demand situation.

The price decline is temporary

While there are some headwinds to crude demand going forward, the oil industry is still facing a declining supply issue, and the longer prices stay at current levels (which are well below what most producers need to start drilling new wells to replace depleting wells), the worse this issue will get.

While inventories may be high, the entire supply chain that is required to generate the oil needed to meet future demand is severely impaired. U.S. production is now down one million bpd from its peak, and while the U.S. rig count has risen by about 50 (to 371) since oil climbed above US$45 per barrel, this is still down from over 1,600 in 2014.

U.S. production will need to grow to meet the expected one million bpd annually of demand growth, and much higher oil prices will be required to do so.

Baytex is a good way to play a rebound

Many oil names have actually remained fairly stable even with oil prices plunging. One name that hasn’t though (and a name that also led the market during the upswing) is **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE).

Baytex is sensitive to oil prices due to its relatively high debt load and higher proportion of costlier heavy oil production. With shares down 35% since June, at least as much upside can be expected when oil prices recover.

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1. TSX:BTE (Baytex Energy Corp.)

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Date
2025/08/25
Date Created
2016/07/29
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