Oil and Natural Gas Stocks Both Have Double-Digit Upside: Which Should You Buy?

Description

After a brief retreat into bear-market territory, oil prices are now firmly back in bull-market territory after a 20% climb from August 2nd lows. The retreat into bear-market territory (which saw prices briefly dip below US$40) was driven largely by concerns about elevated gasoline inventories and extreme short positioning by money managers, as managers amassed gross short positions that were only 13 million barrels shy of the all-time record of 261 million set in February.

While the move up for oil was largely driven by OPEC production freeze rumours, the fact that oil prices were unable to stay below US$40 for long despite such a historic build in short positions reveals that investors are also betting heavily on a price recovery. This could mean sub-US$40 oil is gone for good.

Oil is not the only bullish energy commodity, however, and investors buying natural gas–weighted Canadian names would have actually outperformed investors buying oil-weighted names by a fairly substantial margin so far in 2016 (the average gas-weighted producer is up 35% compared to 13% for the average oil producer).

Why?

Because Henry Hub natural gas prices are up nearly 70% from March lows and, like with oil prices, a prolonged period of low prices have reduced rig activity to the point where future supply shortages are likely.

Which of these two commodities should investors have the most exposure to?

The case for natural gas exposure

Gas prices were over US$6/mmBtu in January 2014 and, after falling below US$2/mmBtu, are now sitting at about US$2.60. Current prices are low historically; the average price from 1976 was US$4.61/mmBtu, and since 2009 the average price has been US$3.81.

According to energy analyst Art Berman, even prices of US$3.81/mmBtu are below the breakeven prices of most U.S. shale gas plays. A fairly conservative estimate is that over the long term gas prices of US$3.50-4.00/mmBtu will be required to encourage enough investment and drilling to offset natural declines and grow production adequately to meet demand.

Clearly, current prices aren't working; total rigs are sitting at only 81, down 60% from last year, and well off the 1,600 that were present in 2008. Production is also falling, and in Q1 2016 the average U.S. shale producer outspent their cash flow by two to one.

Going into winter, natural gas inventories are expected to be around the five-year average, which will be very bullish, especially if winter is colder than usual.

The case for oil exposure

While oil may be at US$48 per barrel now, prices of at least US$60 are required for the U.S. oil industry to drill enough wells to both offset declines and to meet the over one million bpd of demand growth that will be needed each year through to 2020.

Like natural gas, the oil rig count is way down and is currently sitting at 396. This is well below the highs of 1,238 in 2014 and below the approximately 600 rigs that are required just to keep U.S. production flat and prevent declines. In order to bring the rig count up and beyond 600, higher and more stable oil prices will be required. Energy fund manager Eric Nuttall of Sprott Energy Fund thinks US$60 oil is the price that will be required to encourage this kind of investment.

Which to choose?

Both commodities have decent upside going forward, and the best approach is buy quality names that have a solid mix of oil and natural gas production. **Birchcliff Energy Ltd.** (TSX:BIR) is one of these names.

Birchcliff is sitting at about 82% natural gas production for 2016, and the company just made an excellent acquisition from **Encana** that not only reduced its leverage, but also gave it a solid production-growth runway.

Investors looking for more oil exposure may also consider **Vermilion Energy Inc.** (TSX:VET)(NYSE:VET). Vermilion not only has a dividend yield over 5%, but it is one of the few names not to cut the yield at all during the oil rout. Vermilion currently has about 50% gas production, which makes it a well-balanced way to play both commodities.

CATEGORY

1. Energy Stocks
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1. NYSE:VET (Vermilion Energy)
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