Why Oil's Next Move May Surprise You (and How to Profit From it)

Description

While the oil market may technically be in bull territory, investors should take a cautious approach to adding energy stock exposure at these levels. The rationale for why can be understood by taking a closer look at why oil just rallied over 20% in well under a month.

The current oil rally has basically been driven by two familiar factors: bullish OPEC headlines and extremely aggressive short-covering by money managers. While it is true there are positives on the fundamental front (U.S. production is down over one million bpd from the peak last year), the recent surge has been primarily due to headlines and money manager positioning, which calls into question its sustainability.

Short interest in crude oil (or how many barrels are being sold short by money managers) climbed to a record high at the beginning of August, which resulted in oil briefly falling below US$40 per barrel. When investors are heavily betting against a market, it sets the stage for a violent reversal in the opposite direction, because when prices move up, these investors will need to cover (or buy back) the positions they sold short. This leads to price spikes and is exactly what has happened recently.

In the last week alone, short sellers covered (or bought) 57 million barrels worth of crude oil futures contracts, which marks the biggest decrease in short positioning since 2006. In other words, much of the recent rally has been driven by record number of investors who were short selling oil, getting out of the trade.

What caused both the rapid increase in short interest and the quick rush out of the short trade? The increase in short interest that drove prices below US$40 per barrel was primarily driven by the fact that gasoline inventories climbed to the highest seasonal levels since 1990 at a time when gasoline demand is set to drop off due to the end of the driving season. These means less demand for crude oil.

While this is certainly bearish on the fundamental front, OPEC conveniently began releasing rumours (as they did in February and March) about a potential production freeze. Such an agreement is extremely improbable, but a positive commentary around oil at the point where short interest was at a record high and prices fell below the key psychological level of US$40 was enough to lead to an explosion in short-covering.

Where are prices headed from here?

While many investors see oil rapidly moving up to US$60 in the near future, and others, like **Morgan Stanley**, seeing prices drop below US$40, the reality is that oil prices are likely to stay stuck in the mid to high US$40 range for the next several months.

Why?

Firstly, there are several bearish factors at play that could stop any increase. Many of the oil disruptions in the past few months are reversing.

The Niger Delta Avengers just agreed to a ceasefire, which means they will stop attacking Nigeria's oil production. These attacks took out 700,000 bpd of production. Similarly, tensions are fading in Iraq and Libya, and **Goldman Sachs** estimates that any one of these countries seeing returning production could lead to the supply deficit forecasted for 2017 disappearing.

At the same time, any OPEC freeze is unlikely since Saudi Arabia requires that all countries partake (Iran is unlikely to agree to any cap on their production). Even if such a freeze did occur, it would simply result in Saudi Arabia, Iran, Iraq, and Russia all producing at near-maximum capacity, and Saudi Arabia producing at an all-time high (July saw record production). In other words, little upside from these countries is expected anyway.

While these are bearish developments, they are occurring against a backdrop of a market that is close to balance. Declining U.S. production and growing global demand will require U.S. producers with breakeven prices of US$60 to increase production. The end result should be fairly flat prices for now.

Investors would be wise to purchase best-in-class names such as **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG), which has low debt and exposure to the most economic assets in North America, on dips in price.

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