



2 Oil Stocks to Buy on an Upcoming Pullback in Oil Prices

Description

In an interview on *BNN* earlier in the year, Sprott Energy Fund manager Eric Nuttall stated that with oil equity investing, the primary concern is getting the call on prices right; the selection of specific stocks is secondary. This is why it is important to involve some analysis of oil prices in the purchase of oil stocks.

There is very good reason to think that after a massive 22% rally in 12 days, oil prices will likely experience some sort of pullback, potentially followed by range-bound price action for several months before a more sustainable rally occurs in 2017 and 2018 in the US\$50 barrel range and beyond.

If this is correct, it means investors looking to add oil-stock exposure should be very patient and avoid joining the euphoria currently present in oil markets by buying at the temporary highs (especially in names that follow the price of oil closely). Investors should instead wait for oil prices to pull back to the mid-US\$40 range or below and carefully add exposure to high-quality names on weakness.

Why prices are due for a pullback

While it is impossible to say what level prices will pull back to, there is good reason to suggest they will. Firstly, it is important to look at what caused the current rally: extreme short positioning and OPEC rumours.

Prior to the decline that saw prices dip below US\$40, investors had acquired extreme short interest in oil prices, and the timely release of OPEC rumours led to these investors having to buy back (or cover) their short positions, leading to extreme buying. In fact, in the last two weeks hedge funds cut their total short positions in oil by a massive 123 million barrels, which would be the biggest reduction on record during such a short time frame. This drove prices higher.

This cycle of short selling is now likely over. There have been four major cycles of short selling and covering since 2015, and these cycles all typically ended when the total short position falls to between 50 and 100 million barrels (it well exceeded 200 million at the peak in early August). With short positions now falling into the 50-100 million range (96 million), the upward pressure should dissipate.

In addition to this, rumours of an OPEC freeze (which ignited the short-covering rally) are likely set to

lose their effectiveness. While OPEC stated an end-of-September meeting could result in some sort of freeze, few think such a deal will materialize. After all, the Saudi Arabian energy minister recently stated that with the market moving in the right direction, the forces of supply and demand should be enough to balance the market and intervention should not be necessary.

On top of this, Iran—a key part of any deal—has stated they would only co-operate in such a deal once they regain their previous market share before sanctions (about four million bpd; they are currently at 3.6). This makes any freeze not only unlikely, but useless, since Iran has a large chunk of OPEC's spare capacity.

With global oil inventories still significantly above the five-year average, some weakness is due.

Use this as a buying opportunity

Oil may be due for a pullback followed by some flat prices, but prices are likely headed upwards over the next few years due to strong demand growth and falling supply after two years of underinvestment.

One name to buy on weakness is **Canadian Natural Resources Limited** ([TSX:CNQ](#))([NYSE:CNQ](#)). Canadian Natural owns the lowest-cost oil sands operation in Canada (the Horizon mine, which is currently under construction), and once construction completes in 2018, Canadian Natural will see expansion capital drop off to sustaining levels, which are expected to be only 21% of cash flow at US\$60 barrel oil. With production unhedged, Canadian Natural has big leverage to rising prices.

Crescent Point Energy Corp. (TSX:CPG)(NYSE:CPG) offers similar leverage, but in the light oil rather than oil sands space. Crescent Point's current 160,000 bpd of production can be supported by only \$950 million of capex, which the company can earn at US\$35 barrel. At US\$50 or US\$60 oil, this gives Crescent Point plenty of options for production growth and acquisitions.

CATEGORY

1. Energy Stocks
2. Investing

POST TAG

1. Editor's Choice

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1. NYSE:CNQ (Canadian Natural Resources)
2. NYSE:VRN (Veren)
3. TSX:CNQ (Canadian Natural Resources Limited)
4. TSX:VRN (Veren Inc.)

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