Oil Is Falling: Another Supply Glut Looms

Description

Oil is dipping back towards US$40 as fears grow over another potential supply glut. While the curbing of North American shale and oil sands output has helped stem oversupply in recent months, these gains may prove ephemeral.

Here's what you need to know if you're invested in oil stocks such as **Canadian Natural Resources Limited** (TSX:CNQ)(NYSE:CNQ), **Encana Corporation** (TSX:ECA)(NYSE:ECA), or **Suncor Energy Inc.** (TSX:SU)(NYSE:SU)–all of which had seen renewed optimism off the back of rising oil prices.

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Supply gluts are serious events

The oil collapse originated from a supply glut provided by cheap, low-cost U.S. shale projects. After a price war broke out, most of these new suppliers continued pumping for far longer than most thought. Oil prices have rebounded towards US$50 a barrel based on recent supply dips, which have come months or even years later than most expected.

But don't get too excited; the next shale production wave could be just around the corner.

According to a report by the Bloomberg Intelligence, nearly half of the wells located in the Permian Basin and Eagle Ford can remain profitable even when crude prices fall below US$30 a barrel. A whopping 85% can maintain profitability with prices at US$50 or below. Areas such as DeWitt County and Reeves County break even at prices below US$25 a barrel. True operating costs may be even lower, warns the report.

With shale production costs consistently lower than the market expects, don't count on U.S. crude production to continue falling at current price levels. It's very possible we'll see sustainable oil production growth at or even below US$50 per barrel.

It gets worse

According to a new report this week, International Energy Agency (IEA) agrees that rebalancing the oil market will take longer than we thought.

The report shows that global oil demand is slowing at a pace faster than previously thought. “For 2016, a gain of 1.3 million barrels a day is expected,” the IEA said. That’s a downgrade of 100,000 barrels a day from its previous forecast. “Momentum eases further to 1.2 mb/d in 2017 as underlying macroeconomic conditions remain uncertain.”

Supply is certainly falling, but it may not be enough to make up for unexpected slowdowns in demand growth. Additionally, OPEC appears to be pumping at full strength, offsetting some of the declines we’re seeing in North American output. “At 96.9 mb/d, global oil output was 300,000 b/d below a year ago, but near-record OPEC supply just about offset steep non-OPEC declines,” the IEA said.

For now, it looks like a waiting game.

“When will the world oil market return to balance? That is the big question today. With the price of oil at current levels, one would expect supply to contract and demand to grow strongly. However, the opposite now seems to be happening. Demand growth is slowing and supply is rising. Consequently, stocks of oil in OECD countries are swelling to levels never seen before,” the IEA said.

“As a result, supply will continue to outpace demand at least through the first half of next year. Global inventories will continue to grow: OECD stockpiles in July smashed through the 3.1 billion barrel wall. As for the market’s return to balance–it looks like we may have to wait a while longer.”

If oil prices start to fall again, it would take the air out of stocks that have experienced big gains in recent months, including Canadian Natural Resources Limited, Encana Corporation, and Suncor Energy Inc.

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Date
2025/08/26
Date Created
2016/09/13
Author

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