The IEA's Latest Report Says the Oil Glut Is Far From Over: What it Means for Your Portfolio

Description

After an irrational bout of euphoria in the oil market in August, which saw oil prices surge 24% in half a month on OPEC-meeting optimism, the markets are finally coming back to reality, erasing most of the August gain.

While the market was already selling off due to skepticism over an OPEC deal, the IEA's recent monthly oil report was a firm reminder to the market that higher oil prices (and a sustainable break of the US$50 mark) is still months away. The trajectory for the next several months will likely be flat at best with a firm possibility of downside.

What were the key takeaways of the report?

Global oil demand is slowing. Originally, 1.4 million bpd of growth was expected for 2016, and this will now be revised down to 1.3 million bpd. And 2017 will see demand further erode to 1.2 million barrels per day. Q3 2016 will be particularly weak with demand plunging to a two-year low of 0.8 million bpd from 1.4 million bpd in Q2.

The trajectory for demand growth has been steadily down. Year-over-year demand growth hit a high of 2.3 million bpd in Q3 2015, but only 1.2 million bpd is expected for Q3 2016. The IEA links this to several factors—from plunging U.S. refinery demand to weakening emerging market demand.

The end result? Thanks to a decline in demand, the IEA does not expect the market to rebalance until Q4 2017.

The most concerning part of the report

While the fact that oil supply and demand will not balance until Q4 2017 is concerning, it is not the most worrisome aspect of the report.

According to oil analyst Art Berman, it is not the supply/demand balance that is necessarily the issue, but rather huge inventories. The current oversupply of about 0.5 million bpd is actually closer to balance than most of the time during the past decade.

One of the main issues is that oil inventories continue to grow rapidly, and that demand growth doesn't seem strong enough to draw down these extreme inventory levels. Crude inventories are currently at 510 million barrels, which is 12% higher than last year at this time. Between 2011 and 2014, oil inventories stayed in a range between 300 and 400 million barrels.

Current levels need to come down in order to reduce inventories, but the latest IEA report's weakening demand shows this may be a slower process. Oil prices may even need to fall further or stay lower for longer for it to occur. The fact that oil consumption has declined steadily as oil prices have risen from US$30 per barrel implies the world economy is simply too weak to support current prices, according to Berman.

What this all means for your portfolio

The key takeaway is to expect weakness in oil prices for the next few months, possibly until early 2017. September is historically the weakest month for oil prices, and the back half of the year is usually weak as well due to the fact that refinery maintenance season is fully underway and refinery demand declines during this period before rebounding later in the year.

As oil stays weak for the next few months, many high-quality oil names may start to break down. These names have actually remained surprisingly resilient, holding their value despite weak prices. One name that has broken down significantly is **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG). The stock is down 30% off June highs and 25% since August 17.

This is due to oil weakness and because management decided to issue equity to fund production growth (an unpopular move with shareholders). Despite this, Crescent Point is one of the highest-quality names in the industry. As oil prices recover into 2017, Crescent Point will show strong production growth and good leverage to rising prices.

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