



What OPEC's Historic Agreement Means for Canadian Energy Shareholders

Description

Back in early August, OPEC shocked markets by announcing an unscheduled meeting in Algiers on September 26 to discuss a potential production cut. Prior to the announcement, short-sellers established a near-record position size, and news of the OPEC meeting caused a 25% rally in oil prices in less than a month.

The market subsequently sold off as market participants began pricing in the fact that the odds of an agreement between OPEC members was next to none. The market was wrong—on Wednesday OPEC announced that they had agreed to limit output, marking the first time since 2008 such an agreement has occurred.

OPEC did agree on production targets, deciding that output would be reduced from August 2016 levels of 33.2 million bpd down to between 32.5 and 33 million bpd. They did not, however, agree on the details of how the cuts will be allocated or timelines, and these details will not be determined until November.

While this does mean that from a fundamental perspective, not much will change until November, the sheer fact that OPEC agreed to cuts is significant and suggests a bullish shift in markets. OPEC has traditionally used production cuts to support markets, but 2014 saw OPEC fail to agree to cut production largely in an attempt to drive prices down and put high-cost U.S. frackers out of business.

The fact that OPEC and Saudi Arabia (its largest producer) in particular are now talking about cuts means that they have been victims of their own free-market strategy to gain market share and can no longer tolerate lower prices. The numbers seem to agree—Saudi Arabia has burned through \$150 billion of foreign exchange reserves and has a large deficit (13.5% of GDP); this is the largest deficit of the world's 20-largest economies.

Saudi Arabia can't sustain itself with persistent oil prices below US\$50. The agreement to freeze an eight-year free-market strategy is a sign that OPEC producers are now desperate enough to actively intervene in the market once again to support prices. This means that the days of sub-US\$40 per barrel oil are likely over.

Investors shouldn't get overly excited

While the recent news does probably limit the downside in oil prices, it isn't nearly as bullish as some would think. Firstly, if OPEC cuts production from 33.2 million bpd to 32.5 billion bpd (the specific number given was 796,000 bpd), this would be the most bullish and also the most unlikely scenario.

Nigeria and Libya were exempted from any production-cut deal due to the circumstances in the region. Analysts at **Bank of Nova Scotia**, however, see the return of production in these two countries as actually increasing OPEC's total production levels from August 2016's 33.2 million bpd to 33.5 million bpd—an increase of 282,000 bpd, specifically.

More importantly, while Iran, under the proposed agreement, would need to basically freeze production (a small increase was permitted to allow for production growth up to historical norms), it is still about 400,000 bpd shy of where Iran's oil minister recently stated he wants to end up. This could add even more risk to the price forecast.

Assuming the more likely case where OPEC production grows by only 282,000 from the August 2016 levels, the oil market would see a 2017 deficit of around 500,000 bpd, according to Bank of Nova Scotia, with most of the deficit occurring in the back half of the year.

While this would certainly work to support prices, there are several issues. Firstly, there is no guarantee OPEC will be able to agree on specifics in November. Secondly, even if details are agreed on, there is no guarantee the deal will be implemented properly. **Goldman Sachs** recently stated that OPEC has historically beat production quotas by 4.6%.

The end result for Canadian investors is that while the news may support oil prices over the short term and even into 2017 if OPEC can agree, the market will likely start to see cracks in the agreement, which should give investors a further opportunity to buy names such as **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG) and **Baytex Energy Corp.** ([TSX:BTE](#))(NYSE:BTE).

Both these names have sold off more than their peers recently (Baytex due to the recent plunge in prices and Crescent Point due to an equity issue), and this is a good buying opportunity.

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