



OPEC's Latest Move Could Be Too Little, Too Late

Description

OPEC shocked the markets by announcing that it had hammered out a deal in the cartel to reduce its oil output by just over 2% to 32.5 million barrels daily. This has been construed by investors to be great news for the beaten-down energy patch, kindling hopes of a broad-based recovery in prices.

Already, a number of heavily levered upstream producers have bounced sharply. These include **Baytex Energy Corp.** ([TSX:BTE](#))(NYSE:BTE) and **Pengrowth Energy Corp.** (TSX:PGF)(NYSE:PGH), which are up by 8% and 3%, respectively, over the last five days.

Nonetheless, the rally could be short-lived with a number of factors indicating that significantly higher crude is nothing more than wishful thinking because the cut in production is unlikely to balance supply and demand.

Now what?

The deal highlights the failure of Saudi Arabia's strategy to intentionally create a global supply glut to push higher-cost U.S. shale producers out of production to regain market share.

By relentlessly pursuing this strategy, Riyadh inflicted considerable costs on the kingdom, running a US\$98 billion 2015 budget deficit, selling assets, and drawing down currency reserves to fill the funding shortfall. While this strategy has been especially costly for the Saudis and other OPEC members who are dependent on oil exports as a key revenue earner, it has had little real impact on the U.S. shale oil industry.

U.S. oil production remains at the same level as it was in mid-2014 when West Texas Intermediate, or WTI, was trading at US\$107 per barrel—more than double where it is today.

What many pundits forget is that the oil slump was really a boon for an industry accustomed to excess.

It forced shale oil companies to rein in expenses as well as debt as they battled to shore up balance sheets, preserve cash flows, and remain profitable in a harsh operating environment. This has left them well equipped to not only keep pumping should crude remain under US\$50 per barrel but,

according to many industry insiders, make them capable of recommencing profitable exploration and drilling should oil rise to about US\$60 per barrel.

Then there is the U.S. fracklog, which the U.S. Energy Information Administration, or EIA, estimates is composed of 5,000 drilled, but uncompleted, wells. In an industry desperate to boost cash flow, those wells become attractive to frack and bring online with WTI at as little as US\$50 per barrel. This could occur quite rapidly, boosting U.S. oil production by up to 2.8 million barrels daily.

For these reasons, it is reasonable to expect a significant uptick in U.S. oil output in coming months.

When considered in conjunction with global oil demand growing at a slower pace than initially predicted by the IEA, a significant leap in prices appears to be nothing more than wishful thinking.

So what?

The issue critical to resolving the supply glut is the need for a massive increase in global demand, which isn't going to happen any time soon. The world economy is in bad shape and forecasts continue to be revised downwards. The OECD expects the global economic growth for this year and the next to be well below the long-term average.

Furthermore, weak trade, financial distortions, and a collapse in emerging market growth weighs heavily on economic growth and demand for crude.

Deteriorating demand growth coupled with the likelihood of U.S. shale oil producers rapidly ramping up production as prices rise make it unlikely that crude will bounce back as strongly as some pundits believe. This certainly isn't the good news that investors believe it to be for upstream producers such as Baytex and Pengrowth, which have WTI breakeven prices of between US\$50 to \$60 per barrel. It means that it is way too soon for investors to think that the pain of weak oil prices could be over.

CATEGORY

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TICKERS GLOBAL

1. TSX:BTE (Baytex Energy Corp.)

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Author

mattdsmith

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