



## 3 Big Reasons Oil Is About to Stage its Next Leg up

### Description

There is a strong case to be made that oil is finally setting up for a sustainable break of the US\$50 level in the coming weeks, and the source of this upside will be the sentiment change from the recent OPEC meeting combined with plenty of evidence that fundamentals are improving.

It is important to note that analysts, for the most part, are largely skeptical of OPEC's recent agreement to cut oil production by as much as 800,000 bpd. These analysts, using data since 1994, cite the fact that OPEC has always produced above agreed-upon quotas (not that since late 2014, there has been no quota).

The OPEC deal is also being criticized for not including Nigeria, Libya, and Iran, who are the largest sources of growing supply and will almost certainly result in the offsetting of OPEC's 800,000 bpd in cuts, leading to OPEC production growing from both January 2016 and August 2016 levels.

Despite this, there are some major silver linings, and combining these with recent market fundamentals could stage the next leg up in oil prices.

### The real value of the OPEC deal isn't the fundamental impact

With Iranian, Libyan, and Nigerian production poised to come back online, and concerns over compliance, the actual effect of the OPEC deal on OPEC's production versus what production would have been without a deal is likely to be minimal.

This is not necessarily a bad thing. A recent report by oil consulting firm Rystad indicates that even if OPEC produces 33.6 million bpd in 2016 (well above OPEC's August 2016 levels of 33.2 million bpd, and above their production cut target of 32.5 million bpd), the global market will still be undersupplied in 2017. This undersupply could be around 400,000 bpd.

This means that if anything positive at all comes from the OPEC deal, it will help the global markets, but if OPEC produces as it would have without the agreement, the markets are still set to be undersupplied, which is good news for prices.

In the short term, however, oil prices have rallied on news of the OPEC agreement, which shows that the market sees it as being bullish.

This view of the agreement is not unfounded; this agreement would be the first production cut since 2008, and it is basically Saudi Arabia admitting that their strategy of not intervening in markets has failed. Saudi Arabia has been burning through \$10 billion per month, and it is now clear that OPEC and Saudi Arabia need to return to some form of production control in order to support markets.

Sprott Energy Fund manager Eric Nuttall recently called this “the biggest development in oil markets in the previous two years,” and he is not incorrect.

### **Supply is falling apart globally**

The biggest thing holding back oil prices is the fact that U.S. inventories, being at about 500 million barrels, are still 45 million barrels higher than last year. The trend is going in the right direction, however. September saw the largest drop in U.S. inventories since 1920, which is a positive sign, especially since September usually sees seasonally weak demand due to refineries shutting down.

U.S. inventories hit a seven-month low recently, and production is down by about 1.2 million bpd since April of last year. Outside the U.S., Chinese production fell by 400,000 bpd, and **Petrobras** in Brazil recently cut its future capital spending plans by 25%. Brazil was supposed to be a large source of supply growth going forward.

### **Once refinery-shutdown season ends, prices should move up**

Refinery outages typically peak in October, which makes it a seasonally weak month (September is usually the worst month of the year), but shut downs are expected to be over by early December, which means refineries will want crude again.

This will provide a good backdrop to oil prices, and investors should focus on investing in names that have good leverage to oil-price increases. This means companies that see a relatively large increase in cash flow for each dollar that oil increases.

According to Eric Nuttall, **Baytex Energy Corp.** ([TSX:BTE](#))(NYSE:BTE) ranks first in this regard, and **Enerplus Corp.** ([TSX:ERF](#))(NYSE:ERF) ranks third. Both of these names are smart ways to play the rally.

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### Date

2025/08/24

### Date Created

2016/10/05

### Author

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