Why the Next Stop for Oil Is $60

Description

With investing in general, some of the best returns are made by having a view that differs from the consensus. For example, in February 2016 investors had established record levels of short positions in oil, and many in the financial media were talking about oil headed to US$20 or even US$15 a barrel.

The minority of investors who were bullish, however, got in early on what ended up being a fairly historic 90% rally. This idea applies today. While investors are becoming more bullish on oil (long positions recently exceeded the prior highs set in April 2015), there is still plenty of caution and skepticism in the market, and many investors are likely to be surprised of the upside as Wood Mackenzie estimates $1 trillion of capex that was originally slated to be spent between 2015 and 2020 has been eliminated.

Much of this caution and skepticism surrounds the recent OPEC deal, as well as the idea that U.S. production will rise rapidly as prices increase, which will in turn put a lid on prices. Looking at both these concerns closer reveals that oil could quickly meet or even exceed US$60.

Looking closer at the recent OPEC agreement

Through to the end of 2016, the biggest driver of oil prices will be OPEC. Currently, the market remains overly skeptical of how effective an OPEC production-cut deal could be (especially given the fact that Libya and Nigeria—the largest upcoming sources of supply—will not be involved). Investors are also rightfully concerned with the idea of OPEC cheating, which is likely given that OPEC has historically beaten their production quotas by 4.8%.

Firstly, investors are right to be concerned about how effective an OPEC production cut would affect global supply and demand, but this misses the key point. OPEC is promising as much as 800,000 bpd in cuts from August 2016 levels, which would bring OPEC production down to 32.5 million bpd in 2016. When you add returning production from Libya (estimated at 600,000 bpd) and Nigeria (estimated 470,000 bpd), OPEC production actually grows by ~270,000 bpd.

While this may sound pessimistic (it isn't), it is important to keep a few things in mind. First, investors need to remember that key OPEC participants (like Saudi Arabia) now need US$60 oil, and they will do whatever it takes to ensure prices get there. Saudi Arabia has been burning through $10 billion a month in foreign exchange reserves, cut ministers' salaries by 20%, and has the highest budget deficit in the world's 20-largest economies.

Saudi Arabia also plans on launching its Saudi Aramco IPO in the coming years and will need higher oil prices to get an acceptable valuation for it. Given this, OPEC is now switching towards controlling supply once again and will make sure sentiment remains positive after OPEC's November meeting to finalize details. This will provide near-term strength to oil prices

OPEC may see rising production, but it should be easily offset by declines elsewhere. Venezuela, for example, could see declines of as much as 500,000 bpd in 2017 as recent reports show that even with recent rising prices, Venezuela's production is so weak it has to import from the U.S. and can barely afford to pay its workers.

U.S. production likely won't rise as fast as some think

Many think that U.S. production will surge online, but this is unlikely without much higher prices. Only the most economic shale areas (like the Permian) can grow production sustainably without oil above US$60. At the same time, costs are also set to increase as oil prices rise, which will affect the ability of companies to spend on growth capital.

Current drilling and servicing costs are at lows not seen since 2009; as they rise to more normal levels, the breakeven costs of oil firms will also rise. These factors are all good for oil prices, and investors should look at names with strong leverage to rising prices.

Baytex Energy Corp. (TSX:BTE)(NYSE:BTE) represents a high-risk way to gain this leverage (due to high debt levels), and **Canadian Natural Resources Limited** (TSX:CNQ)(NYSE:CNQ) represents a lower-risk way to gain this exposure thanks to low debt levels and a diversified, highly economic asset base.

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