

Debunking The 2 Biggest Reasons to Be Bearish on Oil

Description

Just a month ago, euphoria returned to the oil market — news that OPEC would be coming together to discuss a potential production cut of between 200,000 and 800,000 bpd caused money managers to amass their highest long position in oil since the record high set in May 2014. Prices spiked to US\$52 per barrel, which was very briefly the all-time high for the year.

Since then, prices have sold off dramatically, down below US\$47 per barrel. The sell-off was due mainly to speculation over the upcoming OPEC meeting. Investors are becoming more skeptical about whether OPEC can actually reach a deal to cut production, especially after some producers met on Friday and both Iran and Iraq were unwilling to cut or freeze production.

This has lead investors to reduce exposure to oil, and many of the familiar reasons to be bearish on oil have re-emerged.

1) U.S. shale production will swamp the market

This is a common concern, and it is known as the “shale band theory” which is the idea which basically says that oil will stay in a range between US\$40 and US\$60 per barrel. This is because U.S. shale production is said to fall when oil prices fall below \$40 per barrel, and rise when it goes above \$60 per barrel.

Investors are likely overestimating how much and how fast U.S. production can come online. U.S. shale production is only 5% of global production. At the same time, reserves are fairly small (tens of billions of barrels compared to hundreds of billions of barrels for the longer-lead time reserves that will be required to meet demand).

Many investors point to the fact that U.S. production was once growing at 1 million bpd annually. Companies, however, spent far beyond their cash flow and relied on debt to achieve this growth. In addition, oil prices were much higher.

Repeating this is not likely — companies in the Permian basin (known as the most economic basin in the U.S.) had an average debt to cash flow ratio of 5.4 in August 2016. According to Art Berman, this is above the bank-risk threshold of 4.1. Borrowing to grow simply isn't an option this time.

With that in mind, companies will be limited to spending within their cash flow. While companies in the Permian claim to be economic at US\$40 per barrel, the Permian is only about 2% of worldwide oil production. The rest of U.S. production needs US\$60 to break-even.

The end result is that U.S. production will only be able to grow by possibly 1.4 million bpd between 2018 and 2020 according to HFI research. This does not even cover demand growth of at least 1 million bpd for each of these years.

2) The OPEC deal may fail

This is the current concern of the market, but investors should know that the deal has a more likely chance of succeeding than many think. This is because Saudi Arabia now needs the deal to succeed, and may even consider unilateral action to cut production if necessary.

Saudi Arabia recently released their Saudi 2030 plan to reform their economy. A major part of this plan is to sell shares of their public Saudi Aramco company, and then use the proceeds to invest in other industries to diversify the economy away from oil. The country also needs to improve the government finances and reduce the deficit.

Both of these goals require higher oil prices, fast. The country's economy is growing at the slowest level since 2009, has had deficits over 10% of GDP for two consecutive years, and is implementing austerity measures. They will also require higher oil prices to get their desired value for Saudi Aramco.

This gives Saudi Arabia good incentive to take action. Other OPEC producers are in a similar boat — only Kuwait can balance their budget below US\$50 per barrel. Saudi Arabia requires US\$80, and Iran requires US\$55.

All these factors are bullish, but investors who still want to be conservative should purchase **Canadian Natural Resources Ltd.** ([TSX:CNQ](#))([NYSE:CNQ](#)) since it not only has low debt levels and large production, but also has good leverage to rising prices.

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Author

amancini

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