The Slump in Crude Means Higher Oil Prices Are on the Way

Description

Oil has once again slumped to under US$50 per barrel because of higher-than-expected U.S. oil production and a record increase in oil inventories. With fears of weakening demand growth for crude and claims that OPEC will be incapable of instituting promised production cuts, some pundits take a bearish view on crude.

These factors have triggered considerable fear that oil could once again slide under US$40 per barrel. If this were to occur it would wreak havoc across Canada's energy patch, which has only just started to become more optimistic.

You see, US$40 per barrel is close to the cost of production for many Canadian energy companies, and lower oil prices would cause their operations to become cash flow negative and trigger another round of cost cutting.

This would hit heavily levered operators such as **Baytex Energy Corp.** and **Pengrowth Energy Corp.** (TSX:PGF)(NYSE:PGH) especially hard. Not only are they struggling to become profitable in the harsh environment now being witnessed, but they are struggling to fund sufficient drilling activities to replace production lost through natural decline rates.

Nevertheless, there are signs that this bearish outlook is over-baked and that prices will move higher in the coming year.

Now what?

What some pundits are forgetting is that there has been considerable pressure building in OPEC for some time for the cartel to move to bolster prices. Many members with heavily oil-dependent economies, including Venezuela, Nigeria, Ecuador, Libya, and Algeria, have been suffering significant financial hardships because of the slump in crude.

Now there are signs that the economy of OPEC shot-caller Saudi Arabia is experiencing its own considerable financial distress. Riyadh has had to institute sweeping spending cuts because of deteriorating government revenues and large budget deficits in recent years. There are now fears that the Saudis must move to devalue their currency if crude remains below US$50 per barrel.

This has increased the motivation for the cartel to implement and enforce production cuts.

Even non-cartel member Russia, which has given confusing and ambivalent statements about whether or not it will implement the agreed production cuts, is suffering from its own significant financial distress and needs prices to rise.

Since oil collapsed in late 2014, Russia's economy has slumped into a deep recession as evidenced by 2015 GDP contracting by a worrying 4%. The IMF expects Russia's economy to contract again in 2016. It has also triggered a significant decline in the value of the ruble, causing inflation to rise sharply and living standards to fall. This is placing even greater pressure on Moscow to resolve the crisis.

Many of the world's largest non-OPEC oil producers have been battling problems similar to those being experienced by Russia.

So what?

Clearly, there is a significant economic motive for OPEC and many major non-OPEC oil producers to push for higher prices. This makes it difficult to see oil plunging to the lows witnessed earlier this year. It also brings greater credence to a range of analyst forecasts, which predict that oil will finish 2016 at over US$50 per barrel and will move closer to US$60 per barrel during 2017.

This is good news for the energy patch. Many upstream oil producers, including Pengrowth and **Vermilion Energy Inc.** (TSX:VET)(NYSE:VET), have slashed costs to the point where they are free cash flow positive and even profitable with oil at between US$50 and US$60 per barrel.

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