2 Reasons Oil Is About to Start its Next Explosive Leg up

Description

Only one year ago, oil was in the process of bottoming below US$30 per barrel. Over the following 12 months, investors who were able to ignore the slew of headlines calling for US$10 per barrel saw oil prices rise over 100%, and many oil stocks — like **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) — rise well over 200%.

Oil is currently trading around US$52 per barrel, and while very few analysts are calling for another 100% oil-price increase in 2017, there is very good reason to think that oil is about to stage a move up to US$60 per barrel and possibly even US$70 per barrel (or higher) by the year's end.

Investors who missed 2016's huge rally have a chance to get in on the next major phase of what should be a multi-year bull market in oil prices. There are two good reasons to think that this next leg-up in oil prices could start very shortly.

Seasonality

Last year on January 20, oil formed a short-term bottom at about US$27 per barrel before rallying up to US$35 and then crashing to the final bottom of US$26 per barrel. From there, the trend was up for the remainder of 2016.

Investors who understand oil seasonality would know that the fact oil bottomed in January and February and rallied afterwards was not entirely a coincidence. Oil has fairly predictable periods of strength and weakness depending on the month of the year, and this is because demand for oil typically shows seasonal patterns.

For example, a look at average oil prices over the past 10 years reveals that oil prices typically see weakness in December, January, and February, followed by a rally that typically lasts until the late summer, followed by weakness in the fall. This pattern exists whether looking at oil prices over the past five, 10, or 15 years.

This is because oil demand largely comes from refineries, and gasoline demand is typically lowest in the first two months of the year. Refineries often use this time to perform maintenance (which even further reduces gasoline demand). From there, gasoline demand rises every year and peaks in August.

These seasonal factors work in oil’s favour, and if oil follows seasonal trends, the next leg up should start in February or March.

OPEC agreement compliance

Late in 2016, OPEC and non-OPEC nations agreed to cut a combined 1.8 million barrels per day of production to reduce global inventories closer to average levels and bring up oil prices.

If OPEC and non-OPEC actually comply with these cuts, it would be extremely bullish for oil prices. While OPEC typically doesn’t comply 100% with cuts, early reports show that OPEC nations are playing by the rules. Not only that, but OPEC nations have little choice but to play by the rules. During previous weak-oil-price periods, OPEC had nearly 15 million bpd of spare production capacity (meaning they could grow production substantially if they wanted).

Today, that capacity is basically nothing, and the largest producing nations, like Saudi Arabia and Iraq, were maxed out before the cuts. These nations have massive budget deficits and need oil prices to increase.

Early reports indicate that cuts are occurring. Saudi Arabia, which is expected to cut close to 500,000 bpd of the 1.8 million total, has already cut between 300,000 and 700,000, according to Open Square Capital. Non-OPEC producers like Russia have also delivered half of their promised cuts so far.

OPEC and non-OPEC producers need higher oil prices and have limited ability to raise production, which should lead to high compliance. This will help the next leg up in oil.

Baytex is a good way to play the rally

Baytex has strong leverage to rising oil prices, which means that as oil prices rise, Baytex can expect to rise significantly more. More importantly, the stock has recently sold off substantially (from $7.40 to $5.42), which makes this an excellent time to get in.

Baytex has made major progress in reducing debt levels, and a recent acquisition in Alberta increases Baytex’s heavy oil exposure and gives it even more leverage to rising oil prices.

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Date
2025/08/24
Date Created
2017/01/23
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