



Oil Is North America's Worst-Performing Sector: Huge Upside Ahead

Description

West Texas Intermediate crude oil is down nearly 10% from the recent high of nearly US\$54 per barrel set in early April, and oil bulls are, once again, losing hope. As a result, it's no surprise that the energy sector as a whole (which includes both producers and pipelines) is sharply underperforming nearly every other sector in the United States and Canada.

This also means that for value investors, there is no better place to be. Just how badly is the energy sector doing? In Canada, the overall energy sector is down 5.7% year-to-date. This compares to the 2.4% positive gain the TSX saw. It is the only sector (other than health care) which is in the negative for the year, and the 5.7% loss for the energy sector is actually under exaggerated due to the fact that pipelines are only down 1.7%. Canadian producers are down 11% year-to-date.

The same story is true south of the border, where energy is down 9.1% for the year and is the only sector in the red. The recent under performance is the result of hedge funds and generalist investors fleeing the space due to the recent softness in the price of oil, and the generally bearish narrative that's been surrounding the market. This under performance also means that there are plenty of investors sitting on the sidelines ready to move cash into the sector at the first sign of oil price strength.

This effect could be amplified by the fact that most other sectors have been performing well and are perceived as being overvalued. However, for this to happen, oil prices will need to improve, and so will the narrative around oil. Here's why this will happen sooner than many think.

Investors are focused on U.S. oil inventories

The recent bearish sentiment around oil has everything to do with U.S. crude inventories and, to a lesser extent, rising U.S. production levels. U.S. crude inventories are just slightly off all-time highs and well above the five-year average. With oil inventories in the U.S. at all-time highs, why would oil be set to rally? There is much more to the oil market than just U.S. crude oil inventories, and U.S. inventories are imminently set to fall (and, in fact, have fallen for the past few weeks).

For example, total U.S. petroleum stocks, which includes gasoline and distillates along with crude oil, have been declining steadily since July 2016 (except for a brief spike early this year due to a surge in

OPEC imports); they're currently at the same levels they were last year at this time.

Outside the U.S., the picture is much more bullish. In the past three months alone, oil inventories globally have fallen by over 70 million barrels (which is around 25% of the total oversupply), and these inventories have been steadily declining since July 2016.

These declines in inventory began even before OPEC announced their recent cuts. Oil companies globally experienced declining production on an annual basis, and oil prices have not been high enough to generate the capital needed to grow production.

This trend will continue, and while U.S. production will continue to grow, production declines from outside the U.S. and OPEC will offset this growth and lead to under supply as the International Energy Agency sees for the remainder of the year.

In the short term, U.S. refineries coming back from maintenance, strong seasonal gasoline demand, and a potential renewal of OPEC's cuts should lead to higher prices in the coming months.

Baytex is a good way to play upside

Baytex Energy Corp. ([TSX:BTE](#))(NYSE:BTE) is unique because 51% of its production comes from the United States. This makes it immune to many of the worries of a border adjustment tax from the Trump administration. In addition, Baytex has been one of the poorest-performing Canadian names over the past few months and will respond much stronger than its peers when oil rallies.

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