



1 Threat to Oil Prices Many Investors Have Ignored

Description

In a move that surprised some investors and the energy patch, oil has given up all the gains made since last November's historic agreement between OPEC and key non-producing nations to reduce production in an attempt to bolster prices.

Crude has dropped to under US\$46 per barrel in recent days, and there are fears that it could fall further, dashing the hopes of many industry insiders and investors that higher prices were on their way.

This has had a sharp impact on the price of many energy stocks, especially heavily indebted upstream producers such as **Baytex Energy Corp.** ([TSX:BTE](#))(NYSE:BTE), which is down 14% over the last month.

There are signs that oil may not bounce back as predicted by a number of pundits and that sub-US\$50 crude may be the new normal for the remainder of 2017.

Now what?

The sharp decline in oil prices is being blamed on the usual suspects; the key suspect is higher than expected oil inventories caused by the latest drawn-down being less than half of what was originally anticipated.

Another cause is fears that non-OPEC oil production is growing faster than expected. U.S. oil output continues to rise at a rapid rate and is now at its highest level in almost two years. It can only continue to grow.

As the latest rig count shows, the tempo of activity in the U.S. energy patch is growing at a rapid rate. By the end of April 2017, the number of active rigs had grown by 46 month over month to 870 which is almost double the same period in 2016. Such a marked uptick in drilling activity means there can only be one result — U.S. oil production will keep growing.

While these oft-quoted reasons are important, they aren't the only reason for oil's latest decline.

There is one important factor that many analysts continue to neglect: Saudi Arabia's political and economic bearing.

The primary reason for the kingdom's decision to support production cuts was the sharp decline in government revenue caused by oil's prolonged weakness.

In a recent interview, an important government figure, Deputy Crown Prince Mohammed bin Salman, voiced some interesting observations regarding the kingdom's state of affairs. These included statements to the effect that the budget deficit had narrowed, non-oil government revenue had exceeded expectations, and government debt won't exceed 30% of GDP.

This tells us that Riyadh's financial health is stronger than many analysts believed, and with such a low debt-to-GDP ratio the kingdom can borrow at will to plug funding gaps.

More significantly, it hints at the fact that the incentive for the Saudis to continue propping up oil prices is waning significantly, making an extension of the existing OPEC deal not as certain as once thought. If the deal is not renewed and expires in June 2017, there is every sign that oil prices will plummet precipitously once again, especially when rising North American production is considered.

So what?

This is bad news for those heavily indebted oil companies that have bet their survival on higher oil prices. This includes a popular contrarian pick, Baytex.

While there may be some time to go before Baytex's massive pile of debt falls due, the company has predicated its ability to replace declining production by ramping up drilling activity over the course of 2017. This is dependent on one very important condition: that oil (more specifically, the price of West Texas Intermediate) remains above US\$50 per barrel.

If crude stays at below US\$50 per barrel, the company will have to slash exploration and development funding, which will cause production to decline further, threatening its ability to generate sufficient cash flow to meet its operational and financial commitments.

CATEGORY

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