Oil Stocks Remain a Risky Investment

Description

The energy patch continues to attract considerable attention from bargain hunters. The prolonged oil slump has savaged energy stocks, causing many one-time darlings to come crashing to Earth and trade at a third or less of their pre-slump value. Even long-time stalwart **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG), which again and again proved it was capable of consistently unlocking value, is now trading at less than a fifth of its 2014 high.

Many pundits believe oil will recover, fueling a belief that beaten-down energy stocks will rally strongly. Recent developments, such as OPEC production cuts, growing inventory draws, and stronger economic growth, are encouraging investors to believe that a recovery is not far away.

Despite the increased optimism surrounding the outlook for crude, there are signs that weak oil is here to stay, making oil stocks unattractive investments.

Now what?

When OPEC and key oil-producing non-member states**,** including Russia and Kazakhstan, announced production cuts in November 2016, a burst of optimism swept through the industry. Industry insiders and analysts believed that the 1.2 million barrels per day of production these cuts would remove would eliminate the supply glut and rebalance energy markets, catapulting crude to as high as US$60 per barrel by the end of 2017.

Even with cuts being extended earlier this year, and the increasing likelihood that they will stay in place beyond March 2018, the much-hyped rally has failed to materialize. Indeed, even larger than forecast inventory draws, which have caused U.S. commercial oil stocks to fall to their lowest levels since the start of 2016, have failed to bolster prices.

There are a range of reasons for this — key being growing OPEC production and fears that the deal will progressively unravel the longer it remains in place.

OPEC members exempt from the cuts**,** notably Libya and Nigeria**,** have been pumping crude at a furious pace, causing July OPEC oil production to reach a 2017 record high. Impoverished South

American member Ecuador elected to exit the agreement altogether, citing the need to boost oil output to bolster urgently needed export income and government revenues.

Kazakhstan, the world's 12th-largest oil exporter has also said it intends to bow out of the agreement to focus on expanding its oil production to generate much-needed export income. There is also the risk of Iran and Iraq failing to comply because they have both made it clear that they intend to grow oil production, because it's the only means of earning the revenue desperately needed to rebuild their shattered economies.

The bad news for the energy patch isn't solely restricted to OPEC.

U.S. shale oil has demonstrated it is quite adept at profitably boosting output, despite a weaker price, and is willing to fill the supply gap left by the production cuts. U.S. oil production rose to its highest level since July 2015 by the end of August.

Demand growth also remains slack and continues to be impacted by slowing economic growth in China, the world's second-largest consumer of oil.

The battle against climate change is also weighing on demand. It has triggered a fundamental shift in energy use globally, leading to an ever-growing proportion being derived from renewable sources. The aim as stated in the Paris Agreement is to keep global temperature increases below two degrees Celsius above pre-industrial levels.

According to data from the Carbon Tracker Initiative, between 60% and 80% of fossil fuel reserves owned by publicly listed companies are unrecoverable if that target is to be met. Along with the rapid uptake of electric vehicles, that will cause demand growth for oil to peak sooner than expected. This has been recognized within the oil industry. Integrated energy major **Royal Dutch Shell plc** (NYSE:RDS.A)(NYSE:RDS.B) believes it could happen as early as 2021. Once that point is reached, demand for oil will fall into terminal decline.

So what?

The oil industry is under considerable pressure on many fronts, and oil prices are unlikely to recover to profitable levels for most producers any time soon. That makes any investment in oil stocks a risky proposition, especially for those that have considerable debt and have budgeted for crude to be higher, such as **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) and **Pengrowth Energy Corp.** (TSX:PGF)(NYSE:PGH). Both based their 2017 forecasts on crude averaging US$55 per barrel over the course of the year, while even the venerable Crescent Point needs it to average US$52 per barrel.

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Author
mattdsmith