Will Oil Rally Higher During 2018?

Description

There is considerable speculation over the direction that oil will take over 2018 with some market pundits remaining bearish, saying that a reversal is due, while others have gone as far as to state that US$80 or US$100-per-barrel oil is on the way. While it has proven difficult to predict the direction that oil will take, it is increasingly clear that the positive catalysts now outweigh the negative ones. This means that oil could easily jump to as high as US$70 or even US$80 per barrel in coming months, which would be a boon for energy stocks.

Now what?

A key consideration that many pundits appear to be ignoring is that global economy has finally hit its growth phase. There has been a significant upswing in global GDP growth, notably as emerging markets continue their economic recovery. That means demand growth for ever-vital oil and petroleum products, which are the lifeblood of almost all economic activity, will keep expanding.

At its recent World Economic Outlook Update, the International Monetary Fund (IMF) once again revised its global economic projections upward to GDP growth of 3.9% for 2018 and 2019. This represents a 20-basis-point increase over 2017 and highlights the strength of the world economy.

A stronger economy will translate into greater demand growth for oil, with many analysts revising their forecasts upwards by up to ~400,000 barrels daily for 2018.

Higher demand will push prices higher, especially once supply-side issues constrain global oil supplies. Many of these are centred on geopolitical factors, including Trump's tough stance on Iran and the potential of additional sanctions, which could take up to one million barrels of oil from world markets if they are re-imposed.

Then there is Venezuela's failing oil industry, which has seen its production decline by 752,000 barrels daily since the end of 2016 to be 1.6 million barrels daily for December 2017. There are signs that this precipitous decline will continue as infrastructure fails and a lack of investment field development and exploration drives depletion rates higher.

Libya and Nigeria are also experiencing production outages due to labour disputes and internal conflict causing attacks on oil infrastructure.

Despite the solid rally witnessed over the last two months, there are no signs of OPEC seeking to end its production cuts; the Saudi and Russian energy ministers reiterated their support for the cuts. One reason for this is that despite the surge in crude, global oil inventories have not fallen as much as predicted, while exploration spending and investment in developing new oil assets has failed to grow.

Furthermore, U.S. oil production has not grown as significantly as initially anticipated, indicating considerable restraint on the part of the shale oil industry.

So what?

For these reasons, we could be entering a period of balanced energy markets. Any supply disruption or marked increase in demand could give prices a healthy bump, possibly sending the international benchmark Brent to US$80 per barrel.

This is all good news for Canada's beleaguered energy patch.

Even oil's latest rise failed to trigger a rally among energy stocks. That leaves **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) attractively valued. Its stock is down by 28% over the last year, despite oil being ~22% higher than it was a year ago. Baytex has forecast that with West Texas Intermediate (WTI) at US$50 per barrel it will be free cash flow positive. With WTI at US$64, Baytex is on track to generate considerable free cash flow. That leaves it well positioned to invest further in expanding production while paying down its net debt totaling $1.7 billion.

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