Is the Oil Rally Over?

Description

Oil rallied solidly in recent days to see the North American benchmark West Texas Intermediate (WTI) break through the US$65-per-barrel mark, only to sharply retreat, as conflicting data causes energy markets to swing wildly. This is making it increasingly difficult for pundits to predict the direction of oil, but one factor that indicates that weaker oil could be on its way is the failure of energy stocks to rally on the back of firmer oil.

While WTI has gained almost 6% since the start of 2018, **SPDR S&P Oil & Gas Exploration & Production ETF** (NYSE:XOP) has dropped by over 10% in value. That highlights that the outlook for crude might not be as positive as some pundits would have investors believe.

Now what?

The good news that drove the latest rally in oil was a statement from the Saudi energy minister that the OPEC production caps will likely remain in place into 2019, and that the Kingdom was seeking to map out a deal for long-term cooperation with the world's largest oil producer, Russia. That pushed WTI to over US$65 per barrel — its highest point since late January 2018.

Nonetheless, WTI has retreated sharply in recent days, mainly because of a surprise inventory build on Tuesday when data from the American Petroleum Institute (API) showed a 5.3-million-barrel build in U.S. oil stocks.

The optimism surrounding the outlook for crude continues to wane, as a range of fundamentals indicate that global oil production, notably from the U.S., is poised to swamp to higher demand growth. The U.S. rig count last week came in at 995 active rigs is at its highest level since April 2015.

Meanwhile, U.S. production continues to rise at a rapid clip, reaching almost 10.5 million barrels daily — its highest level since the U.S. Energy Information Administration (EIA) started providing data. Investment in the U.S. energy patch continues to climb, as energy majors such as **Exxon Mobil Corporation** (NYSE:XOM) and **Chevron Corporation** (NYSE:CVX) pivot their upstream operations to make shale oil an ever-greater proportion of their portfolios.

In fact, the EIA expects U.S. production to top 11 million barrels daily by the end of 2019, seeing it overtake Saudi Arabia and Russia to become the world's top oil-producing nation. Then there is additional production to come online from non-OPEC producers such as Brazil, Colombia, and Argentina, which are all focused on boosting investment in their respective energy patches and in oil production. This indicates that global oil output will overtake demand growth regardless of the sharp deterioration in Venezuela's production and the growing likelihood that Trump will end the nuclear deal with Iran.

So what?

While the outlook for crude may not be as optimistic as some pundits would have us believe, it won't collapse any time soon. It appears likely that it will remain range bound, with WTI between US$55 and US$65 per barrel for the foreseeable future. That may not be the ideal scenario for energy stocks.

Nevertheless, many stocks, like **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE), **Pengrowth Energy Corp.** (TSX:PGF)(NYSE:PGH), and **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG) are free cash flow positive with WTI at US$55 per barrel, despite the differentials applied to Canadian crude blends. That makes it likely that, once WTI demonstrates it has settled in this range, their stocks will appreciate.

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Author
mattdsmith