Will Renewed Geopolitical Tensions Lead to $100 Oil?

Description

The deadline for President Trump's re-certification of the Iran nuclear deal is less than two weeks away, and there are signs that the current U.S. administration will tear up the deal. That would certainly drive tensions in the Middle East higher, leading to a renewed period of confrontation between Washington and Teheran. This combined with conflict in the Middle East, the deterioration of Venezuela's oil industry, and civil conflict in Libya have the potential to disrupt global oil supplies causing prices to rise further.

As a result, some analysts believe that the international benchmark price for oil, Brent, could rise to as high as US$100 a barrel during 2018, which will be a boon for Canada's beaten-down energy patch.

Nevertheless, predicting the outlook for crude is extremely difficult in the current volatile environment, and there are a range of factors on the supply as well as demand side that need to be accounted for.

Now what?

Geopolitical tensions predominantly in the Middle East, including the ongoing proxy war between Saudi Arabia and Iran, have been the key driver of the latest rally. These have caused Brent to rise by 10% for the year to date to trade at US$73 per barrel. While there is every sign that higher prices are here to stay, notably because of firmer demand growth for energy, it is doubtful that oil can rise to as high as US$100 per barrel.

U.S. oil production is growing at a rapid clip, so fast, in fact, that the U.S. is predicted to overtake Russia and become the largest producer of crude globally by 2020. Along with the U.S. rig count rising to 1,021 rigs, its highest level since early April 2015, and a surge in drilled but uncompleted wells known as DUCs, this means that U.S. shale oil production will continue to grow.

Those trends will continue for as long as the North American benchmark price, West Texas Intermediate (WTI), trades at over US$60 a barrel, because the breakeven prices for shale oil producers have been estimated to average roughly US$50 per barrel.

These poor fundamental factors and higher oil prices have attracted considerable interest from short sellers. This includes commodities guru Dennis Gartman, who is shorting oil primarily because of the large number of DUCs and spare capacity that exists predominantly in the Permian basin. He believes that this will cause U.S. output to expand exponentially, driving prices lower.

This may occur, but because of higher-than-expected global demand growth for oil and ongoing geopolitical tensions, it is difficult to see the price falling below US$55 per barrel, which is the magic number for many of Canada's upstream oil companies.

You see, companies such as **Pengrowth Energy Corp.** (TSX:PGF)(NYSE:PGH), **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG), **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE), and **Obsidian Energy Ltd.** (TSX:OBE)(NYSE:OBE) are cash flow positive when WTI is at over US$55 a barrel. Even if WTI weakens, it will have little impact because they have not enjoyed the same rally as oil or kept pace with U.S. shale oil producers, which have recovered strongly since the start of 2018. These drillers have also mitigated much of the potential impact of lower prices by reducing costs and implementing hedging programs, which will help to protect earnings should oil fall as sharply as some pundits believe.

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