How Bleak Is the Outlook for Crude?

Description

Oil prices are whipsawing wildly in response to a mix of events that see markets oscillating between wild optimism and deep pessimism over the outlook for crude. It was only two months ago that pundits were proclaiming US$100 a barrel oil was on the way, yet West Texas Intermediate (WTI) recently slipped below the psychologically important US$65-a-barrel mark. There are signs that oil could fall further in coming weeks.

This is bad news for a Canadian energy patch laboring under weaker oil and an increasingly deeper discount for heavy crude known as Western Canadian Select (WCS), which makes up almost half of Canada's oil production.

Now what?

The latest dip in oil was sparked by fears of OPEC and Russia boosting their output, record U.S. oil production, and a firmer U.S. dollar. Even Venezuela's deteriorating production, the end of the Iran nuclear deal, and outages in Libya due to armed conflict have failed to support oil prices. That is because there are significant concerns about whether OPEC and Russia will continue to support production caps as a means of balancing global oil markets.

Analysts believe that Saudi Arabia has spare capacity of up to 2.5 million barrels daily, making it relatively quick and easy for Riyadh to open the spigots and boost the nation's oil output. In the case of Russia, analysts estimate that around 400,000 barrels daily of oil production is lying idle.

This means there is the potential for the more than the one million barrels required to meet growing world oil demand to be brought back to global energy markets, which could trigger another supply glut, depressing prices further.

Activity in the U.S. shale oil industry is also growing at a frenzied pace. Despite the latest U.S. rig count dipping slightly, it is still close to its highest point since March 2015. The pace at which U.S. drilling activity is growing is highlighted by new well oil production per rig expanding to 690 barrels daily, supported by a material increase in productivity in the Eagle Ford and Bakken.

Meanwhile, the Permian has been assessed by analysts to have excess capacity that is second only to Saudi Arabia. This continues to grow, as highlighted by the rising number of drilled but uncompleted wells (DUCs). By the end of April 2018, there were 7,677 DUCs across the major shale basins with the largest increase occurring in the Permian, which also has the greatest volume.

The Canadian rig count last week expanded significantly, increasing by 29 rigs compared to a week earlier to now see 129 active rigs in the energy patch.

This means that North American and, more specifically, U.S. shale oil production is primed to grow significantly over coming months. The reason for this is clear, the breakeven price for the majority of shale oil companies is estimated by analysts to be at around US$50 a barrel, or almost US$15 lower than the current market price. Expanding oil production in North America will continue to apply pressure to oil prices, indicating that unless a positive catalyst emerges from the OPEC meeting later this week, oil could fall further.

So what?

While it could have a significant impact on Canada's heavy oil producers such as **MEG Energy Corp.** (TSX:MEG), it shouldn't deter investors from Canadian energy stocks. Light oil producers with solid balance sheets and quality assets, such as **Raging River Exploration Inc.** (TSX:RRX) and **Surge Energy Inc.** (TSX:SGY), are attractive investments. They aren't affected by the significant discount applied to WCS, are steadily expanding production, and have relatively low operating costs. Because they possess quality assets and remain undervalued relative to the net asset value of their oil reserves, they offer considerable potential upside.

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Author
mattdsmith