Don’t Expect $100 Oil Anytime Soon

Description

Only two months ago, analysts and energy traders were talking about oil reaching triple figures before the end of 2018. There was every sign that with U.S. sanctions against Iran being reinstated, Venezuela’s deteriorating oil output, growing bottlenecks in the U.S. oil patch, and stronger-than-expected demand growth that crude would surge to US$100 per barrel.

Nonetheless, the emerging consensus among analysts is that oil will decline sharply in 2019. This supports earlier claims by the Russian Finance Ministry and Citibank commodities analyst Ed Morse that oil prices will collapse in 2019. While the outlook for crude does appear more bearish than it did two months ago, it may not be as bleak some pundits believe.

Why did oil pull back sharply?

A key reason for the latest pullback is that the impact of U.S. sanctions on Iranian oil exports may not be as severe as initially believed. Many pundits were originally predicting that once sanctions came back into force earlier this month that it would clip around one million barrels daily off global oil supplies, but that appears increasingly unlikely.

You see, the U.S. has elected to grant waivers to eight nations, allowing them to continue importing Iran crude, including China and India, which are two of Teheran’s largest customers. The growing consensus among analysts is that the reinstatement of sanctions on Iran at worst will only shave around 600,000 barrels daily off global supply.

U.S. oil production is also expanding at a rapid clip. For August 2018, the U.S. Energy Information Administration (EIA) data showed that oil output expanded by an unexpected 416,000 barrels compared to a month earlier to reach a record 11.3 million barrels daily. There are signs that as transportation and other bottlenecks in the Permian Basin ease, U.S. oil production will keep expanding at a solid rate.

OPEC also continues to grow supply, despite deteriorating output from Venezuela and ongoing production outages in Libya. For the third quarter 2018, OPEC data shows that the cartel produced 32.6 million barrels daily, which was 1.1% greater than the previous quarter. September 2018 production volumes swelled by 0.5% month over month to 32.8 million barrels daily.

Even after the application of sanctions against Iran, OPEC can continue to grow production. Analysts estimate that Saudi Arabia has around 1.2 million barrels daily of spare capacity, giving it considerable flexibility to dial up production as required to keep oil prices lower. A non-OPEC member and key party to the oil production cap deal, Russia can add up to an additional 500,000 barrels daily to global supply, according to energy analysts.

Refinery maintenance season and reduced winter demand for crude is also weighing on prices, but when this cycle ends, demand for oil could spike significantly, pushing Brent to over US$80 a barrel over the short term. This will likely only be for a brief period because global economic growth, weighed down by Trump's trade policies, is expected to slow during 2019, causing demand for crude to wane.

What does it all mean?

It is likely that unless there is a major geopolitical or economic event that significantly reduces supply or lifts demand that oil will remain range bound for the foreseeable future. This means that the international benchmark Brent will trade in the US$70-80-a-barrel band, while West Texas Intermediate (WTI) will average around US$10 a barrel less, because analysts believe that the differential between the two benchmarks will remain in play for the foreseeable future.

Even if WTI remains range bound between US$60 and US$70 a barrel, it won't crimp U.S. production growth. Many shale plays have breakeven prices of US$50 a barrel or less, and many light tight oil producers, like **Baytex Energy** (TSX:BTE)(NYSE:BTE), are free cash flow positive with WTI at US$60 a barrel. The largest proportion of Baytex's oil production comes from the Eagle Ford shale, and it anticipates funding its 2019 exploration and development program from operating cash flow.

If the wide differential between Brent and WTI remains in play, it makes Canadian drillers operating internationally, like **Gran Tierra** (TSX:GTE)(NYSE:GTE), attractive investments. This is because the differential gives them a handy financial advantage over their North American peers and sees driller's like Gran Tierra reporting an impressive operating netback in excess of US$45 a barrel.

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