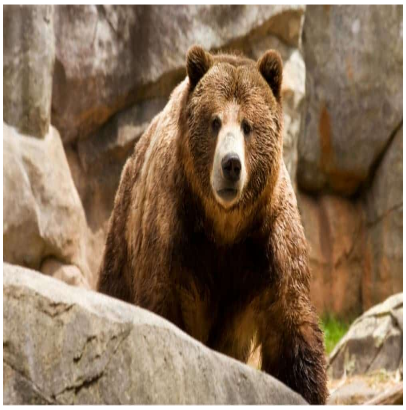

# Has Oil's Next Bear Market Finally Arrived?

## Description

There are fears that crude's latest pullback, which saw the North American benchmark West Texas Intermediate (WTI) plunge to below US$55 a barrel, has pundits worried that the long-awaited next oil price collapse has arrived. Even after recovering marginally in recent days, WTI is still trading at around US$57 per barrel, which leaves it down by roughly 3% for the year to date. This has seen many analysts claim that oil is now officially in a bear market.



That has triggered a sharp sell-off of oil stocks, causing the largest industry exchanged traded fund (ETF), the **Energy Select Sector SPDR ETF,** to plummet by a whopping 12% for the same period. Some of Canada's biggest names, such as the third largest oil sands operator, **Cenovus Energy Inc.** (TSX:CVE)(NYSE:CVE), which is down by a whopping 17%, have been sharply negatively affected.

The outlook for Canada's energy patch is certainly not as bullish as it was in early October when WTI was trading at a multi-year high of over US$76 a barrel.

**Now what?**

For some time the Russian Finance Ministry as well as renowned Citibank commodities analyst Ed Morse have been predicting that oil prices would once again collapse. In July 2018, the Russian Finance Ministry warned that oil was trading above its equilibrium price, which it believed was somewhere between US$50 and US$60 a barrel and that Brent would fall to that level. Whereas, Morse claimed that crude was headed somewhere between US$45 and US$65 per barrel on the basis that supply constraints were not as severe as many analysts believed.

It is worth noting that despite U.S. sanctions against Iran being reinstated at the start of this month, which analysts claimed would shave up to one million barrels daily off global oil supplies, prices plunged to a one-year low. That occurred because of a greater than expected expansion of U.S. oil production in August 2018 combined with rising OPEC supply and diminished demand growth amid fears that global economic growth will slow during 2019.

Oil inventories also continue to build, with the American Petroleum Institute stating that crude stocks for the week ending November 9, 2018 had gained 8.8 million barrels, more than double the 3.2 million barrels forecast by analysts.

That's being driven by lower refinery utilization rates, as many have commenced their maintenance cycles and declining seasonal demand for gasoline. The expectation among industry analysts is that inventories will continue expanding at a solid clip.

Weaker oil will have a far greater impact on Canada's energy patch than it does on U.S. oil producers. This is because the spread between Canadian oil blends and WTI have widened noticeably in recent months. By the end of October 2018, the discount applied to Western Canadian Select (WCS) was trading at a record high of 61% compared to 39% at the end of December 2017. Canadian light crude was trading at a 38% discount, more than triple the 10% discount that existed at the end of 2017.

There are indications that these substantial discounts will continue for some time because of a massive localized supply glut that has emerged in Western Canada created by the serious pipeline constraints that are preventing Canadian oil producers from getting their oil to crucial U.S. refining markets.

This is weighing heavily on the outlook for Canada's energy patch and makes some oil stocks highly unattractive investments. The financial impact on Canadian heavy oil producers is severe. For the third quarter 2018, despite WTI averaging US$66.75 per barrel, Cenovus only realized an average sale price of around US$35 a barrel.



As a result, the oil sands giant only reported an operating netback before accounting for the impact of hedging contracts of US$20 per barrel, highlighting the considerable negative effect that the discount applied to WCS is having on the profitability of Cenovus' operations. This can only worsen as WTI declines in value while that deep-discount continues.

**So what?**

The recent sharp decline in oil prices has caught many analysts by surprise. The consensus was that the international benchmark Brent would reach US$80 before the end of 2018, but this appears to be increasingly unlikely. Greater than anticipated supply growth, rising inventories and deteriorating demand growth are all contributing factors in the suppression of oil prices.

Along with the considerable discount applied to Canadian crude, this will significantly impact the performance of oil sands operators over the remainder of 2018 and into the first half of 2019.

**CATEGORY**

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