



Has Crude Slipped Into a New Bear Market?

Description

After rallying unexpectedly since the start of 2018 to see the international benchmark Brent reach a high of US\$86 per barrel in early October, crude has pulled back sharply to now be trading at around US\$59 a barrel. Because of the wide spread between Brent and the North American benchmark West Texas Intermediate (WTI), there is every indication that WTI could tumble below US\$50 a barrel at any moment. This is generating considerable pessimism in energy markets, particularly because many of the factors that were expected to have a bullish effect on the price of crude have had no positive effect at all.

Now what?

If the North American benchmark drops below US\$50 a barrel, it will have a noticeable impact on Canada's energy patch. This will be magnified by the [steep discount](#) applied to Canadian heavy crude known as Western Canadian Select (WCS). While many of the larger integrated energy majors like **Suncor Energy** will experience little fallout, it will have a sharp impact on smaller oil sands companies like **MEG Energy** ([TSX:MEG](#)) that have no refining capability.

Earlier this month, the spread between WCS and WTI reached a record high, which saw Canadian heavy crude selling for less than US\$13 a barrel, despite WTI trading at US\$55 per barrel. There are fears that a new oil glut has emerged, which is weighing heavily on prices.

While the reinstatement of U.S. sanctions against Iran were expected to significantly crimp global supply, the impact has been far less than anticipated by oil bulls. OPEC production, including oil exports from Saudi Arabia, continues to grow, and Iraq is determined to increase its oil output as Baghdad desperately seeks additional sources of revenue to repair the conflict-torn nation.

Meanwhile, U.S. shale oil production is growing at an unexpected clip to see the U.S. now pumping 11.6 million barrels daily, causing inventories to rise, further fueling fears of a new glut.

Increasingly negative forecasts regarding the global economic outlook are creating additional concerns that demand for crude and other forms of energy will diminish significantly. In October, the International

Monetary Fund (IMF) shaved 20 basis points off its original 2019 GDP forecast for the world economy expected it to expand by 3.7% rather than the 3.9% originally projected.

It is feared that in order to curtail the latest supply glut for crude that new production cuts from OPEC and Russia will be required. While Saudi Arabia has flagged that these could eventuate, there are signs that Moscow is not interested in another deal to cap oil output at a time when production has reached a post-Soviet high of 11.4 million barrels daily.

So what?

When this pessimistic perspective is coupled with the substantial differential between WCS and WTI, it doesn't bode well for the [oil sands](#), despite the discount applied to WCS declining in recent days. Because of that discount, many oil sands operators need WTI at US\$55 or more to break even. That means many that are reliant on the production of bitumen as a key source of revenue are operating at a loss in the current harsh environment.

This becomes clear when reviewing MEG's third-quarter 2018 results. For the period, it realized an average price of around US\$33 per barrel of bitumen sold when WTI averaged US\$66.75 to generate net earnings of \$80 million. Because of the wide differential between WCS and WTI — along with sharply weaker oil over the last two months — it is likely that MEG will incur a loss for the fourth quarter 2018. That trend will continue into 2019, unless oil recovers and the spread between WCS and WTI eases significantly.

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Date

2025/08/19

Date Created

2018/11/23

Author

mattdsmith

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