What Happens If Oil Falls Below US$50 a Barrel?

Description

The optimism expressed two months ago about the outlook for oil and the belief that it could even reach US$100 a barrel by the end of 2018 has been replaced by much pessimism. While the North American benchmark West Texas Intermediate (WTI) bounced back recently, there are indications that it could again fall to below US$50 a barrel after already briefly dipping below that psychologically important price.

This would be disastrous for Canada's energy patch because many oil producers, especially those in the oil sands, have breakeven prices of US$50 a barrel or even higher. Bitumen producers such as **MEG Energy Corp.** (TSX:MEG) and **Cenovus Energy Inc.** (TSX:CVE)(NYSE:CVE) are particularly vulnerable because of their high breakeven costs and the deep-discount applied to Canadian heavy oil known as Western Canadian Select (WCS).

Why did oil collapse?

Many energy industry analysts were caught off-guard by oil's latest price collapse, which began in late October over concerns that a new global supply glut had begun to develop. Those fears arose despite Trump reinstating sanctions on Iran, the deterioration of Venezuela's oil output and the risk of further outages in Libya.

While the reinstated sanctions against Iran were expected to crimp global supply by up to 1.7 million barrels this reduction has not occurred because Trump granted waivers to eight nations, including key customers India, South Korea and China, which will allow them to continue importing oil from Iran. For this reason, it is now believed that only around 1 million barrels daily will be shaved from global supplies because of sanctions against Iran.

Furthermore, Saudi Arabia took the opportunity to expand its oil output in November 2018. Industry sources claim that by the end of that month production had reached 11.2 million barrels daily, or around 300,000 more barrels than it was at the start of the period.

The rapid growth of U.S. oil production is primarily driven by the shale oil industry. By August 2018, U.S. oil output had expanded to a record 11.3 million barrels daily as it overtook Saudi Arabia to become the world's largest oil producer. That represents a 416,000 barrels increase over the previous month and is a massive 23% higher than a year earlier.

This stunning growth was largely unexpected by the market, and there is every sign that it will continue at a solid clip. The U.S. Energy Information Administration (EIA) anticipates that U.S. oil production could expand by up to an additional 1 million barrels daily by this time next year. This would weigh heavily on oil prices, particularly in an environment where demand growth is believed to be slowing.

The emerging consensus among economists is that the global economy will slow as we head into 2019 because of the impact of Trump's trade war, the developing crisis in emerging markets, and slower than predicted growth in Europe. This is a poor portent for oil because there is a direct correlation between energy consumption and the level of economic activity.

In fact, OPEC anticipates that oil demand will rise by around 1.4 million barrels daily during 2019, which is significantly less than the roughly 2 million barrels daily that many analysts believe will be added to global supply. It is for these reasons that fears of another global supply glut have emerged and the only action that could prevent it is if OPEC decides to cut production at its December 2018, although there is no guarantee of this occurring.

What does it mean for the energy patch?

Sharply weaker oil would be a disaster for the energy patch, where many producers are already being sharply impacted by the considerable discounts applied to Canadian oil blends. Such oil sands producers as MEG and Cenovus are among the most vulnerable despite having forecast breakeven costs of around US$45 and US$40 per barrel, respectively. That is because those break even prices were calculated at a time when the discount applied to WCS was roughly a third of what it is now.

There is every indication that the wide differential will continue for the foreseeable future, as the massive oil glut in Western Canada is caused by a lack of sufficient pipeline capacity to transport Canadian heavy crude to crucial U.S. refining markets. For these reasons, investors should avoid MEG or Cenovus for as long as WTI remains weak. Both companies are heavily reliant upon heavy oil production to generate earnings, and weaker WTI combined with the deep-discount applied to WCS means they will likely operate at a loss.

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