Is it Time to Buy Oil Stocks?

Description

The price of crude has collapsed once again, despite OPEC and its allies agreeing to cut their combined oil output by 1.2 million barrels daily commencing in January 2019 to rebalance global energy markets. After reaching a multi-year high of over US$76 per barrel in early October 2018, the North American benchmark West Texas Intermediate (WTI) has plummeted to around US$45 a barrel.

Regardless of OPEC's promised cuts, there are signs that crude could soften further in coming weeks, because of a sluggish global economic outlook and growing oil production. This is bad news for Canada's beaten-down energy patch, which — after a brief glimmer of hope — has been weighed down by the deep discounts applied to Canadian oil and natural gas benchmark prices and sharply weaker crude.

U.S. oil production is expanding rapidly

Activity in the U.S. energy patch continues to grow at a frenetic pace, despite oil's latest collapse. The latest U.S. rig count for the week ending December 21 shows that the number of active rigs grew by nine compared to a week earlier to 1,080. This is 149 rigs greater than for the same period in 2017 when WTI was trading at US$58 a barrel compared to US$45 when the data was released.

That is the largest volume of active rigs since early March 2015, indicating that even oil's latest weakness is not deterring shale oil companies from investing in developing further productive capacity.

While the latest data from the U.S. Energy Information Administration (EIA) for the week ending December 14 shows that U.S. commercial oil inventories decreased by 500,000 barrels compared to a week earlier, they are still 7% greater than the five-year average for that time of year.

For that period, the agency estimated that U.S. oil production had reached 11.6 million barrels daily, which is three million barrels a day greater than in August 2014 when the oil price crash began. The executive director of the EIA recently stated that by 2025 U.S. oil output will be almost equal to the combined totals of Saudi Arabia and Russia.

Non-OPEC oil production is growing

There are also several non-OPEC nations in the process of expanding production. Canada is targeting production growth of 33% by 2035, which will add 1.4 million barrels daily to its total output. The government of Alberta's mandated production cuts of 325,000 barrels daily won't reduce global supply. This is because they are solely designed to drain record local inventories that have materialised because of growing oil production in Western Canada and a lack of the required pipeline capacity to transport that crude to U.S. refining markets.

South America's largest oil producer Brazil is in the midst of a tremendous push aimed at significantly lifting its oil output. Far-right president-elect Bolsonaro aims to attract a substantial volume of foreign investment through asset sales and implementing favourable legislation to significantly bolster Brazil's burgeoning oil industry. This, according to a story from *Bloomberg*, would give foreign oil companies access to more crude than all of Mexico's proved oil reserves.

The International Energy Agency (IEA) reported earlier this year that production growth in the U.S., Canada, Brazil, and Norway alone would more than meet global demand growth for crude.

A stronger U.S. dollar is also weighing on oil and other commodity prices because oil is priced in U.S. dollars, and as the dollar firms it costs more in other currencies to buy crude, thereby causing demand to fall. Fears of a global economic downturn are also weighing on oil prices because of the direct correlation between energy consumption and economic growth.

Weaker crude bodes poorly for Canada's oil industry

If crude falls further, it will have dire consequences for the energy patch. Among the hardest hit will be oil sands companies like **Cenovus** and **MEG Energy** because of high breakeven costs. Cenovus needs WTI at around US$40 a barrel to break even, while for MEG the magic number is US$45.

It is even worse for **Athabasca Oil** (TSX:ATH) and **Pengrowth Energy** (TSX:PGF), both of which, according to analysts, need WTI at over US$50 a barrel to break even. This means in the current operating environment they are losing money on every barrel they produce, although both have hedging strategies in place aimed at minimizing the financial impact of sharply weaker oil. Athabasca and Pengrowth have tremendous piles of debt totalling $582 million and $672 million, respectively, which makes them vulnerable to any prolonged downturn in the price of crude.

If oil prices slump further for a prolonged period, Canada's smaller oil sands producers will be particularly unattractive investments.

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mattdsmith