



Will the Latest Middle East Tensions Sustain Higher Oil?

Description

A sharp increase in tension in the Middle East has propelled oil higher, witnessing the international benchmark Brent trading at over US\$68 per barrel and representing a gain of 20% over the last year.

A key driver aside from OPEC and Russia deciding to shave a further 500,000 barrels daily off their collective output is increased hostility between Iran and the U.S.

There are fears that recent U.S. airstrikes in Iraq, which led to the unexpected death of one of the most important figures in the Iranian government, have the potential to ignite another Middle East conflict.

This has sparked considerable bullishness regarding the outlook for oil and energy stocks in 2020, although many Canadian upstream oil producers have yet to experience any solid gains.

Beaten-down **Baytex** ([TSX:BTE](#))(NYSE:BTE), which gained a stunning 32% over the last month, is still down by 20% over the last year. Unless crude rises further, it will struggle to deliver value.

Higher oil will be short-lived

While the short-term outlook for crude appears positive with another geopolitical crisis in the Middle East buoying prices, the long-term outlook is not as optimistic as believed.

Prior to the latest series of OPEC production cuts, oil's short-term outlook was weak. A combination of growing U.S. oil production, with the EIA expecting U.S. oil production to increase by 7% over to an average of 13.2 million barrels daily, and weak demand growth were applying pressure to oil prices.

Several industry analysts even predicted another oil [price collapse](#) during 2020 because global supply growth would eclipse demand.

It appears that even the latest geopolitical ructions in the Middle East may not be enough to sustain higher prices for the long-term. There is increasing speculation that Iran's response to the U.S. airstrikes won't be sufficient to trigger a general war or major disruptions to oil supplies.

While Iran is committed to retaliating and will be forced to do so on a meaningful scale if Teheran is to maintain credibility in a region fractured by conflict and religious differences, an all-out war appears highly unlikely, as domestic politics in Iran and the U.S. will act as a brake policy on decisions in both nations.

A general war with the U.S. would also end Iran's regime, because the Middle Eastern nation's military is incapable of matching U.S. military might.

Clearly, Iran's current leadership wishes to avoid any loss of domestic power in an environment where there is already substantial domestic dissent. Those factors will temper Teheran temper response appropriately.

Oil is trading at a substantial premium, reflecting the possibility of war and major supply disruptions, meaning that unless they occur, oil will fall significantly once Iran has retaliated and tensions ease. Energy markets have also already priced in a sharp decline in Middle

East oil supply after the Trump Administration withdrew from the Iran nuclear deal in 2018 and reinstated all sanctions against Teheran, which means that the fallout from Iran's retaliation may not bolster oil prices as significantly as believed.

It's difficult to see a general war occurring in the Middle East or any other outcome that could trigger an appreciable supply disruption. With such an event already priced in, oil can only fall once the threat of war wanes and tensions ease. OPEC and Russia can also ratchet-up production, thereby softening the impact of outages caused by an escalation of conflict.

Foolish takeaway

For these reasons, appreciably higher oil for a sustained period appears unlikely, highlighting why it is important for energy investors to focus on fundamentals such as asset quality, balance sheet strength and cash flow when investing in oil stocks.

For the aforementioned reasons, Baytex, which is weighed down by net debt of \$2 billion and facing near-term maturities of \$819 million by 2022 remains an unattractive investment.

If oil plunges Baytex's drilling program and ability to meet near-term maturities would be under threat, impacting its ability to grow production while potentially forcing asset sales.

The driller's heavy oil production, which sees 25% of all crude sold exposed to Canadian heavy crude pricing, increases Baytex's financial vulnerability, particularly as Alberta winds down mandatory production cuts, causing heavy oil to weaken. Baytex is therefore an [unappealing play](#) on higher oil.

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