Has the Next Oil Price Collapse Arrived?

Description

Oil has fallen sharply since the start of 2020 to see the international benchmark Brent down by around 10% to be trading at under US$59 per barrel. This is despite OPEC and Russia agreeing to shave an additional 500,000 barrels daily off their collective output during the first three months of the year.

A key driver of oil's latest collapse is the coronavirus pandemic, which has led to fears of a significant decline in economic activity in China, the world's second-largest economy, and the potential for a global recession. There are signs that crude will fall further, which doesn't bode well for energy stocks and Canada's beaten-down energy patch, which has suffered from the prolonged slump in crude since late 2014.

Worsening outlook

The growing size of the coronavirus pandemic has seen analysts trim their growth forecasts for China's 2020 gross domestic product (GDP), which comes on the back of the nation's 2019 GDP growth declining by 0.5% year over year to 6.1%. Some analysts have predicted that GDP growth during 2020 could fall to as low as 4.9%, which would be blow for the world economy and oil.

You see, China, which is the world's largest consumer of petroleum after the U.S., is the single largest driver of demand growth for crude globally; therefore, any marked decline in economic activity will lead to a notable drop in the consumption of fuels.

For these reasons, the International Energy Agency (IEA) has again cut its 2020 demand growth forecast for crude, shaving 378,000 barrels daily off its earlier estimate, primarily because of the coronavirus outbreak. That has applied considerable pressure to prices, as are growing concerns that a sharp decline of GDP growth in China could trigger a major global slump.

The world's third-largest economy, Japan, appears have entered a recession, and there are indications that the fourth-largest economy, Germany, is teetering on the brink. A sharp decline in China's economy would cause demand for products and services from Japan and Germany to plunge, causing their economic malaise to deepen. That would further impact demand for crude, pushing the price even lower.

There are also supply-side pressures with U.S. oil production continuing to grow, as it is in many other non-OPEC nations, leading to growing global inventories, further weighing on prices.

There is speculation that Brent could fall to as low as US$50 per barrel. Leading investment bank **Goldman Sachs** has slashed its 2020 price forecast by US$10 to US$53 per barrel. That would cause the North American benchmark West Texas Intermediate (WTI) to fall to around $48 per barrel or even lower, because it trades at a discount to Brent, which is currently around US$5 per barrel.

Bad news for the energy patch

This would be a disaster for many Canadian oil companies, because of the discount applied to domestic crude blends, notably the heavy oil benchmark Western Canadian Select (WCS), which sells for a whopping US$18 per barrel less than WTI.

Among the hardest hit will be heavily indebted intermediate oil producers, such as **Baytex Energy** (TSX:BTE)(NYSE:BTE). It finished 2019 with long-term debt of a whopping $2.1 billion, which balloons to over $3 billion once asset retirement and deferred tax obligations are included.

Baytex based its 2020 guidance on WTI averaging US$55 during the year, and that it will be cash flow neutral if WTI averages US$50 per barrel. There is considerable urgency surrounding Baytex's need to generate significant free cash flow, because it has substantial near-term debt maturities totalling around $833 million by 2022.

Since the start of 2020, WTI has averaged around US$56 per barrel, but that could fall below US$50 per barrel if oil continues weaken because of a sharp reduction in demand coupled with growing supply. This explains why Baytex has lost a whopping 22% in the little over six weeks since the start of 2020 with signs of further downside ahead, making it a stock to avoid.

Looking ahead

Rising geopolitical and economic risks are weighing heavily on oil and applying considerable pressure to prices. There is every indication that prices will fall further, as demand growth for crude falls, leading to the potential for another oil price collapse, particularly if global supplies continue to grow.

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