Energy Market Turmoil: Further Carnage Ahead for Oil Stocks

Description

Oil has plummeted to prices not seen since early 2016. A combination of coronavirus fears, the growing likelihood of a global recession and the price war between Saudi Arabia and Russia are weighing heavily on energy prices. The world's second- and third-largest oil producers, respectively, intend to flood global energy markets with more crude, despite already being awash with oil.

That caused the international Brent price to plunge by a whopping 54% since the start of 2020, seeing it trade at around US$32 per barrel. Energy stocks have been hit hard. One of the largest industry ETFs, the **SPDR S&P Oil & Gas Exploration & Production ETF**, has plunged by 63%, and there are signs of further losses to come.

Poor outlook

The sharp reduction in activity caused by the coronavirus and government attempts to prevent it from spreading has sparked a market reduction in the consumption of fuels. This means even the latest price crash won't boost demand, which typically occurs when prices fall substantially, despite significantly lower energy prices.

Even worse for oil prices is that Saudi Arabia and Russia, as part of their price war, claim they can add up to 3.2 million barrels daily to global supply in an already saturated market. That will only deepen the existing supply glut, leading to higher global oil inventories, meaning it will take longer for the oversupply, which is applying considerable pressure to prices to end.

As a result, many industry analysts substantially reduced their oil price forecasts. Some are predicting that oil could fall to as low as US$10 per barrel. This would be a disaster for energy stocks, which have already been ravaged by a multi-year price slump.

Oil stocks to fall further

It would certainly spark a new round of bankruptcies across the energy sector with many, particularly

U.S. shale oil companies, having dangerously leveraged balance sheets. That makes oil stocks such as **Baytex** (TSX:BTE)(NYSE:BTE) unappealing investments. The driller, which has lost 77% since the start of the year, has net debt of almost $1.9 billion and several medium-term maturities.

Baytex was expecting the North American West Texas Intermediate (WTI) benchmark to average US$50 per barrel during 2020, allowing it to generate enough free cash flow to substantially reduce that massive debt pile. That forecast is almost double the US$29 a barrel price for WTI, meaning that Baytex will fail to earn the planned free cash flow, impacting its ability to reduce debt.

It will also force Baytex to significantly dial down spending on exploration and well development, causing its oil output to fall. Boosting low-cost production is key to increasing earnings to make up the revenue shortfall caused by significantly lower oil. Latest developments could further reduce Baytex's oil reserves and production, because it will be forced to make asset sales to reduce debt.

If oil prices remain sharply lower for a sustained period, that could lead to a marked decline in cash flow, meaning that Baytex may never be able to fully recover.

Foolish takeaway

Energy markets will be in turmoil for some time to come, even if the fallout from the coronavirus is not as severe as anticipated. That means investors shouldn't count on energy stocks rallying any time soon. They should also consider avoiding investing in the energy patch, unless it is a driller with a robust balance sheet and strong fundamentals, allowing it to weather the current difficult operating environment unscathed.

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