Oil Drops Below $100: What Now?

Description

The oil market has finally turned. Crude oil prices have dropped below $100 in recent days. This has significant consequences for the global economy and for Canadian oil investors. Here's a closer look at this trend in the energy market and what could lie ahead.

Oil prices dropping

At the time of writing, West Texas Intermediate (WTI) is trading at US$95.7 per barrel. That's 21% lower than last month. Meanwhile, Brent crude has dropped from US$123 to US$99 over the same period.

This dip has come as a surprise to many. Some experts believe the dip is temporary. Global supply and production of oil are still remarkably tight and oil prices could rebound soon. Others believe there's demand destruction from a potential recession that could put the market into balance sooner than expected.

What comes next?

Oil prices have dropped in every previous recession. If we face another recession now, there's a chance oil could remain under pressure. This means several oil stocks could see lower earnings ahead. However, there is a chance that some oil stocks have already priced in these risks.

Oil stocks

The sudden dip in oil prices has put pressure on oil stocks. **Canadian Natural Resources** (TSX:CNQ)(NYSE:CNQ), for instance, has lost 28% of its value since late May. However, this drop seems unjustified.

CNQ stock was already undervalued before the recent dip in oil prices. Now, after the 28% correction, it's trading at just 7.86 times earnings per share. That could mean that the upcoming recession and a deeper dive in energy prices may already be *priced in*.

Analysis by Eric Nutall indicates that CNQ would earn a free cash flow yield of roughly 15%, even if WTI drops to US$70. If oil remains at current levels, free cash flow could be much higher!

CNQ expects to use much of this excess cash flow to pay down debt. Management expects to reduce net debt from $13 billion to $8 billion by early 2023. After that, most of the cash flow will be returned to shareholders in the form of dividends or share buybacks. The stock already offers an attractive 4.8% dividend yield.

Other major oil producers are in a similar position. They should see significant cash flows, even if the price of oil drops further. The industry is set to reduce debt significantly this year and reward shareholders handsomely next year. These rewards could be higher than expected if the energy crisis persists *despite the economic downturn.*

Put simply, oil stocks should be on your radar if you're looking for a safe haven.

Bottom line

Energy prices are off their peak and could be heading lower. However, the downturn and recession seem to be priced in already. Oil stocks are undervalued even in the worst-case scenario. Keep an eye on this sector.

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