Crude Oil Prices: Why the Party for the Bears May Not Last Long

Description

Goldman Sachs sees crude oil prices reaching US$125 a barrel by next year. RBC Capital Markets has given a crude oil price forecast of US$114 a barrel. Fitch Ratings also has a triple-digit price target for oil prices.

These analysts and many others see crude oil prices trading well above crucial US$100 levels for 2022 and beyond. And that's mainly because of the discomforting supply-demand imbalance.

What's behind the crude oil price decline?

However, oil is seeing immense downward pressure, dropping nearly 35% since June. Unsurprisingly, energy stocks have replicated a similar movement in this period, pushing them off from their record levels.

So, what exactly is going on? Why is there such a noticeable divergence between oil fundamentals and energy markets?

Crude oil prices gained momentum in the late first quarter of 2022 amid Russia's invasion of Ukraine. The US and Europe's rhetoric of banning most of Russia's energy commodities pushed oil prices higher then. However, even with no signs of the war waning and economic sanctions still in place, oil prices have trended lower.

Some of the major factors behind the drop are lockdowns in China. China is the biggest importer and second-largest consumer of oil in the world. The rising cases of COVID-19 have stymied its zero-COVID policy and forced it to tighten restrictions. Analyst forecasts warning of the potential for the first decline in Chinese oil demand in two decades has damaged crude oil prices.

Moreover, rising interest rates amid stubborn inflation will likely end up in a recession, according to some, ultimately denting crude oil demand.

The post-pandemic rally in oil prices was mainly driven by rising demand amid re-openings. So, if the demand vanishes once again, led by a recession, oil prices must go lower. That's what many market participants believe.

However, the supply side faces much more severe problems. And markets seem to be overlooking those to a large extent.

Supply issues

Many economists have already claimed that even if a recession hits next year, oil demand will not be significantly hit. Moreover, no new investments have been made in the last few years to increase production due to pressure from environmentalists. So, even if production needs to be increased to match the demand, it won't be possible because of the longer ramp up periods.

Plus, an oil cartel, namely OPEC (an Organization of Petroleum Exporting Countries), could cut production again to create a supply deficit. We saw a little preview of that last week when they trimmed the total output by 100,000 barrels a day for October. Although the magnitude of the cut was minuscule, it certainly sent an important signal to the energy markets. Though the demand erosion in China will most likely be interim, and re-openings will again fuel the demand soon.

Furthermore, the US Energy Information Administration in its monthly Short-Term Energy Outlook said that it expects higher demand through early 2023. The main triggers for it would be a move away from costlier natural gas to heating oil. It sees Brent crude oil averaging around US$98 a barrel in Q4 2022.

What's next for TSX energy stocks?

Energy producers have faced a paradigm shift since the pandemic. A few years back, risk management and hedging strategies were at the center stage of energy management. However, these days, energy firms are busy discussing the allocation of their flooded free cash flows.

Aggressive debt repayments and shareholder returns have been largely the theme among TSX energy producers. So far this year, TSX energy stocks at large have returned 50%, while the **TSX Composite Index** has dropped 6%.

Oil prices will likely reverse their short-term trend and move higher, given the supply constraints. We might see superior free cash flows and margins in the second half of 2022, resulting in stock price rallies and higher dividends.

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