WILL OIL RISE OR FALL IN 2017?

It is essential for every serious investor and student of current events to cultivate an educated opinion of international oil market because of oil's integral role in modern life and the market's enormous size. Among the benefits of a view on oil is not least the periodic investment opportunity it presents, but also a greater understanding of geopolitical and technological forces that will exert significant influences on all markets generally, and some quite particularly. I have written twice on oil in 2016. On January 28th, I suggested that WTI had bottomed at $32 and to expect higher prices. On Jun 10th, I wrote that oil had likely exhausted its appreciation potential at circa WTI $51. Oil retraced to WTI $42 rather smartly but then rose back to circa WTI $52 on talk of an OPEC accord to cut/limit production. Oil has since fallen below WTI $50 as it has become apparent that the disparate group of nations that comprise OPEC are struggling to reach a definitive agreement. I thought it timely to update my comments on oil because we are at an important inflection point for oil at circa WTI $50. A confluence of current economic and geopolitical factors means oil has the potential to either go significantly higher or lower from current levels.

The prospect of some agreement among OPEC members is the dominant thesis for oil bulls. OPEC certainly has within its power the ability to move prices significantly higher if it can exercise discipline on production. However, OPEC is not one voice but a chorus whose members have competing interests. Saudi Arabia itself has conflicting interests. On one hand it wants to maximize price and market share, while on the other it must be concerned with generating current cash flow and maximizing the net present value of its oil reserves. Current demands for Saudi Arabia to maximize current cash flow outweigh a longer-term strategy based on higher oil prices. Saudi Arabia is incurring substantial defense costs tied to waging war in Yemen and to maintaining internal security. Saudi Arabia is not keen to incur a drop in oil revenues through a unilateral cut in production. Iran has just recently returned to selling oil on world markets and is reluctant to cut production. Iran has substantial demands for oil revenues, both for internal purposes and to fund military operations in Iraq, Syria and elsewhere in the Middle East. Nigeria and Libya initially made positive statements about OPEC production discipline, but more recently have proved reluctant to tangible changes to production. Russia, a large oil producer, contacted OPEC members this year in the hopes of developing a production agreement to raise prices. The Russian economy is suffering mightily at current oil prices. Russia, like many OPEC members, initially favoured a harder line on production but then began talking more vaguely about capping production at roughly current levels. A serious production cut by OPEC is the best bull case for oil from the supply side. OPEC certainly has the ability to raise oil prices if they could act in unison, but the tensions and conflicting interests among members make this highly unlikely.

US shale oil production will act as a cap on WTI prices at around the $50 level. Production costs for shale oil have declined substantially, through technology and better pricing given by oil service firms. Shale oil companies can be counted on to use hedging strategies to lock in a return any time WTI trades in the vicinity of $50. US shale output declined by approximately 1 million barrels a day from peak production. That production can be restored in less than a year and is already beginning to rise.

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Canadian oil sands production is profitable at current and much lower prices. Oil from tar sands is expensive oil to produce, but the bulk of the cost is a sunk cost in setting up operation. New oil sands projects are unlikely at current prices, but existing operations are profitable.

The supply side of the oil market, led by US shale and assuming no serious OPEC intervention, would appear to be more than adequate to serve current demand.

Oil demand is a function of economic activity, and that may prove problematic. The current economic expansion in the United States has lasted longer than most and a recession can be expected sooner rather than later. The economies of Europe and Japan are fragile at best. Chinese economic growth has slowed considerably. The Chinese have been large buyers of oil the past year as they built on their strategic reserve. However, much of the buying was at lower prices and the reserve target may have been met. The Chinese cannot be counted on to continue to be as large a buying presence, at least until oil prices decline considerably.

Market sentiment for oil is still very bullish. Speculative long positions in the oil futures markets at high levels is evidence of bullish expectations.

On balance, barring uncharacteristic unity on the part of OPEC or a major geopolitical event, my analysis suggests that circa WTI $50 is the current price ceiling and much lower prices could be in the offing should a recession develop.

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