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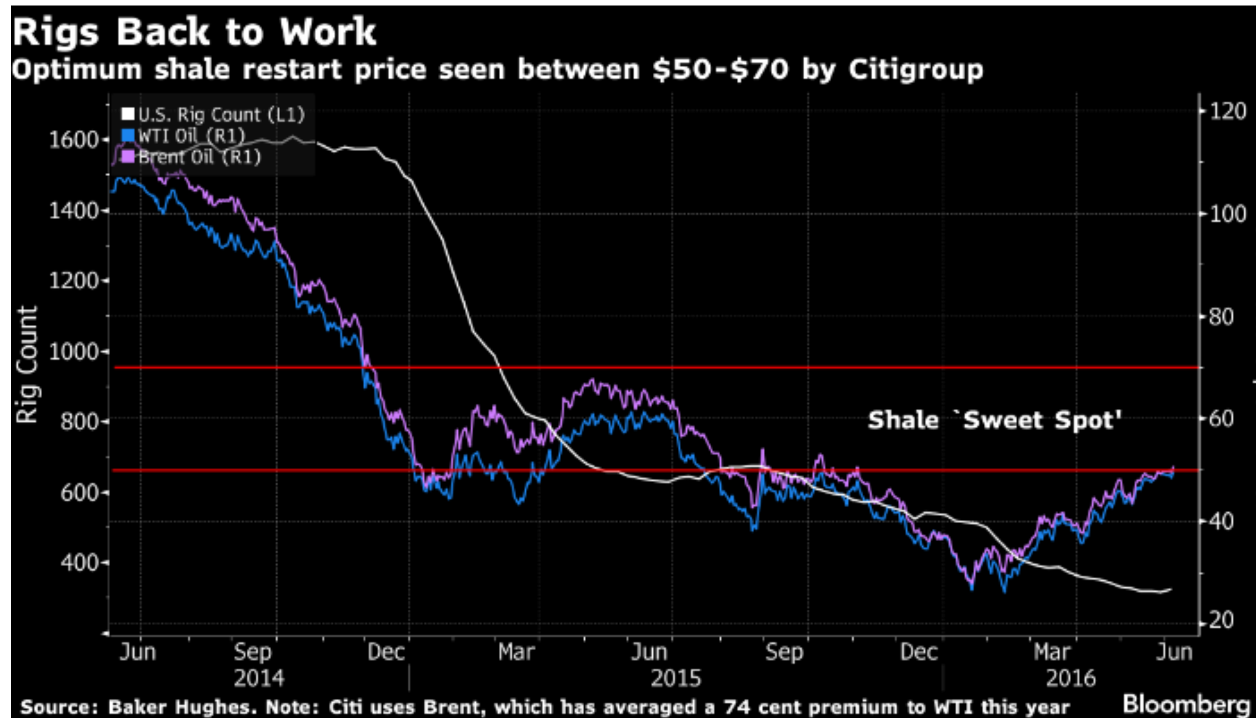
TIME TO SELL OIL?



The price of oil has staged an impressive rally in 2016, rising approximately 60% since my post of January 28th, suggesting that the low had been seen. Fundamental factors as well as extraordinary events have played a role in pushing oil to the current circa $50 per barrel price. Can we expect the rally to continue or is another decline in the cards?

One of the longstanding precepts of oil trading is "the cure for low oil prices is low oil prices," with lower oil prices translating into reduced drilling and falling production. A reduction in drilling was a key component of my belief in January that a low in the price of oil had been reached and supply/demand could be restored to a reasonable balance. The chart above illustrates the relationship between drilling and price and makes the point that we are now on the cusp of a price level that may prompt a rebound in drilling and shale production. Indeed, there is evidence that we may have seen at least a temporary bottom in rig counts in the United States.

The major factor that will determine the extent of a rebound in drilling will be the level of optimism by oil companies that a circa $50 or higher price can be maintained. Obviously higher prices make the economics of drilling more compelling and thus companies that are confident of a $50 price will be tempted to drill.

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In addition, the economics of shale drilling have improved as day rates have declined and casing and tubular costs are lower. Shale oil companies under financial pressure (there are more than a few) will welcome any activity that can generate positive cash flow.

Lower costs appear to be coinciding with growing comfort that oil prices can maintain current levels. A large share issue by Suncor in Canada is said to be twice oversubscribed. In addition, the CBOE Crude Oil Volatility Index has recently declined to its lowest level in a year, which suggests that traders view the environment for oil prices as essentially benign.

Oil prices have always been subject to geopolitical influence given the geographic dispersion of supply. This has certainly been the case in the past few months, with Nigerian production being reduced to its lowest levels in a year as a result of militant attacks. In addition, serious wildfires in Alberta have served to reduce Canadian tar sands production of late, although production can be expected to rebound as the year progresses. The Nigerian situation is more of a wildcard, with a restoration of lost production dependant on the actions of the Nigerian military or some arrangement with the militant groups.

In the middle east, recently restored Iranian oil sales to the world market have been a material addition to world supplies. Iran, an historic hawk on prices, seems more concerned with generating cash flow than maximizing price, at least for the time being. Saudi Arabia continues to produce near capacity, requiring revenue to fund military actions and maintain domestic tranquility.

On the demand side, world oil demand has been, to my mind, surprisingly strong given the sluggish nature of the global economy. Moving forward, demand growth will likely prove to be muted for some time and may stall on weakening of the world economy.

In conclusion, it appears that the sharp rally in oil prices has been due to a sharp decline in US drilling activity combined with supply disruptions in Nigeria and Canada. Moving forward, oil price sentiment appears sufficiently positive to result in at least a partial rebound in shale drilling. While it is uncertain whether, when, or if Nigeria can restore full production, one can anticipate that Canadian heavy oil production will rebound. At the same time, major producers such as Iran and Saudi Arabia seem intent on maximizing production to protect market share and generate revenues. Thus, supply should not continue to be a positive for oil prices, barring an unforeseen geopolitical development. The prospect of improving oil supplies, positive and perhaps complacent sentiment and subdued demand growth suggest that a pullback in the price of oil is likely. A reduction in exposure to oil seems warranted. The risk/reward of the oil trade does not justify an aggressive long position.

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