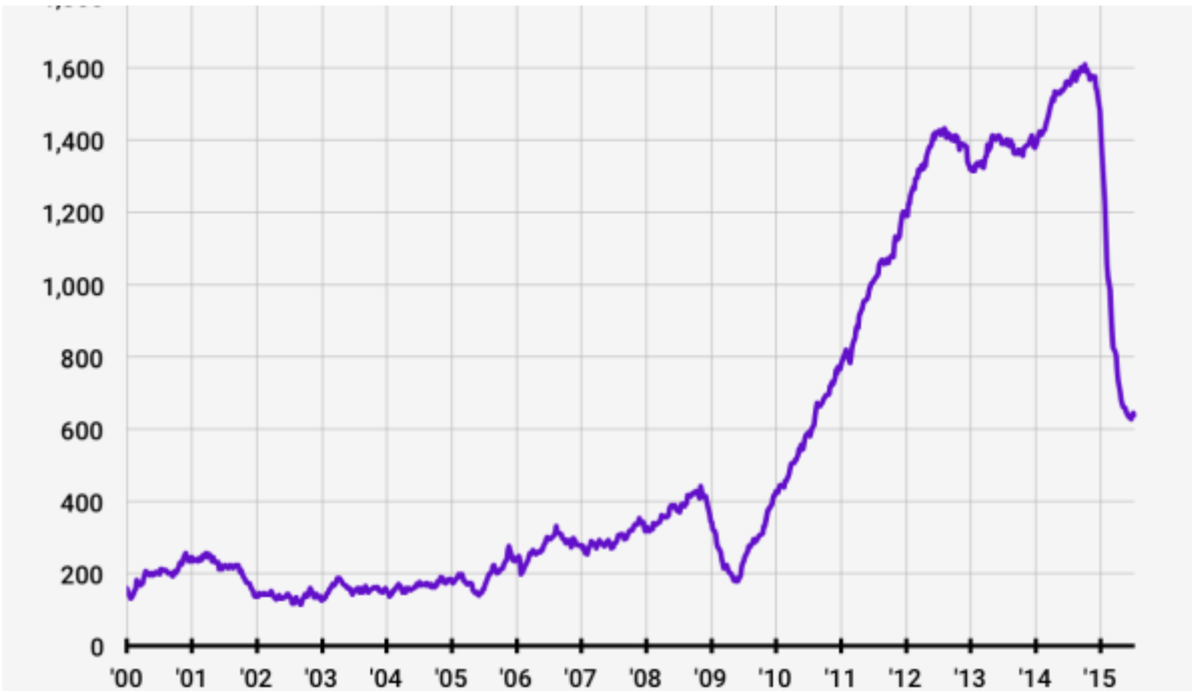
WILL OIL PRICES RISE OR FALL?



US RIG COUNT COURTESY BAKER HUGHES

Oil is the most important commodity because of its dominant role in all but the least developed economies. The price of oil is a major input into many nations' current account and inflation measures and influences currency markets, not least the Canadian dollar. The oil market also has more potential catalysts to significantly affect price than ever before. Oil's importance and recent price volatility suggest it's time for an evaluation. While a complete analysis is beyond the scope of this piece, I'll touch on what, in my opinion, are key considerations.

Two macro factors have historically affected the price of oil, geopolitics and demand/supply. The dawn of the modern oil market commenced with the first oil price shock of the early 1970s, which was a geopolitical event. Geopolitics has continued to periodically influence oil prices, though not as dramatically as the first event. Oil will continue to have a political dimension, and be subject to price shocks, because a significant portion of world supplies reside in politically tenuous jurisdictions such as the Middle East, Russia and Venezuela.

Basic supply/demand considerations drive oil prices in the absence of geopolitical turmoil, and it is a surge in supply that is currently weighing on the oil price. The biggest factor on the supply side has been the advent of shale oil production in the United States over the past 5 or so years. Shale or "tight" oil production has transformed the United States from a large net importer of oil to a potential net exporter. Shale oil has two major characteristics, it is expensive to drill and the wells have much steeper decline rates than traditional oil wells. Thus, new wells have to be drilled at a brisk pace to maintain or grow shale production. Shale oil drilling is thus among the most price sensitive of petroleum extraction methods. Current oil prices will reduce activity in this sector.

Oil sands production has been growing steadily over the past two decades. This technology is more akin to mining for oil than drilling for it. It is not as price sensitive as many people suppose. Operating costs are quite reasonable once the huge initial costs have been incurred. Current oil prices will likely not significantly impact oil sands production though it will certainly put off the addition of new production capacity.

Saudi Arabia and most of its Persian Gulf neighbours continue to produce oil at capacity. We can anticipate this trend to continue as the Saudis et al require hard currency to fund domestic projects and increased defence spending. An interesting wildcard in the oil market is the total secrecy surrounding the large Saudi fields. It has been speculated that the fields have been water flooded or otherwise stimulated for some time to maintain production. If such speculation is true, then Saudi production will begin a significant decline at some point, dramatically affecting demand/supply. However, there is no current evidence to support the notion that Saudi production is nearing a peak.

Oil supply is also currently being supported by increased production from Iraq. Moreover, Iran will add supply to the market in 2016 as a result of the recent agreement over its nuclear program.

The bullish case for oil is based on the fact that despite the development of shale oil and the oil sands, there has not been a truly significant discovery of oil since the 1970s. Many major oil fields are in decline, e.g. the North Sea, Alaska and Mexico. Chinese domestic production is apparently beginning to decline.

The notion of "Peak Oil" has always been a flawed concept. There is no shortage of oil, but there will be shortages of oil available at a certain price. The sources of low cost oil have been exhausted. Oil production must be replaced in future through higher cost methods, whether shale oil or deep offshore etc.

There is an old maxim about oil that states that "the cure for low oil prices is low oil prices." Lower prices, particularly below the cost of marginal production, will curtail oil drilling and exploration until demand/supply is reset and oil prices rise.

Drilling activity has been a useful indicator of the state of the oil business in North America. Drilling activity predictably rises as prices rise and declines as oil declines. The magnitude of changes in drilling activity is a measurement of sentiment in the industry about future prices. Drilling will be at its lowest levels when expectation about oil prices is most negative.

The chart above suggests that while drilling activity is down it must still decline significantly before North American production and sentiment suggest an investable bottom to the oil price. Expectations remain for higher prices. This notion is reinforced by the action of oil shares, which remain valued to reflect much higher than current prices.

Oil demand can certainly be affected by economic recession and other factors, but is less elastic than most commodities given its consumption for transportation and heating. Oil demand will continue to rise over time with population growth and the increase in use of automobiles in nations such as China.

Therefore, the current price of oil represents a bargain for long term investors, given the limited capacity of the market to add meaningful production at current prices. However, overly optimistic sentiment is maintaining drilling activity at elevated levels that will forestall a quick recovery in the price. In addition, in my opinion, the lack of compelling bargains in oil equities suggests that prospects in the short to medium term are less than compelling.

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