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Guest Contributor: Is the Oil Sector in the Recovery Phase, and is Now the Time to Invest?

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By Dan Steffens, President of Energy Prospectus Group

The Oil Price Recovery

With four decades working in the oil and gas industry, I've lived through several oil price cycles. Over the last six years, oil traders have had to deal with Saudi Arabia's attempts to regain market share, the U.S. vs. China trade war, and a global pandemic. Plus, we have an ongoing cold war with Iran.

Three Cycles in One:

The shale boom that took U.S. oil production from under four million barrels of oil per day (BOPD) in late 2008 to more than 9 million BOPD in 2014 over-supplied the global market. Saudi Arabia's failed attempt to regain market share in 2014 caused the oil price to decline from over $100 per barrel to under $30 per barrel. The double bottom in early 2016 appeared to be the end of this cycle, and oil prices moved back over $70 per barrel in the summer of 2018.

Then the U.S. vs. China trade war took oil back under $50 per barrel. The signing of phase one of the trade agreement had oil back on track to the $70s. In the first week of this year, oil was trading over $62 per barrel, and everyone thought the price was heading higher.

Then along comes the COVID-19 pandemic and the oil price crash in April.

The good news is that humanity and the oil and gas industry will survive. Barring another round of pandemic shutdowns, oil, natural gas, and natural gas liquids (NGL) prices are all heading higher. I now believe the price of oil will be back to $65 per barrel by June 2021. Add in a large helping of inflation created by global pandemic stimulus packages, and $75 per barrel is easily within range.

Paradigm Shifts Move Markets: The global oil market is tightening much faster than the belief held by most money managers today.

After the sharp decline in demand for transportation fuels in April, demand bounced back quickly, and global oil inventories began to decline in May.

Oil demand exceeds oil production today by more than two million bpd, and the difference is coming from above-ground inventories.

Non-OPEC spending for exploration and development has been cut dramatically. We are not completing enough oil or gas wells to keep production from falling.

Restoring April/May shut-ins has temporarily slowed the rate of U.S. oil production decline, but the rate of decline will accelerate in September.

The bottom line is that the U.S. needs at least 600 rigs drilling for oil to stabilize oil production, and today only 180 rigs are drilling for oil.

Sources: https://www.iea.org/, https://www.eia.gov/

U.S. Oil Production: Since peaking in November 2019, U.S. oil production declined 2.4 million BOPD through June 2020 (U.S. Energy Information Administration). I forecast that U.S. oil production will decrease another million BOPD in the second half of 2020 to an exit rate of 9.4 million BOPD or less.

The US Energy Information Administration only has actual U.S. oil production data through June. It shows that U.S. oil production peaked in November 2019. Due to the sharp decline in oil prices in April and lack of storage capacity, shut-ins caused a 2.0 million BOPD decline in U.S. production from April to May. Most shut-ins have been placed back on production in June and July.

I believe U.S. production stabilized in July because of more shut-ins coming back online. Production will go on a steady decline in August (which will include Hurricane Laura shut-ins), and natural declines will accelerate September to November. We could see a slight increase in December because some companies will complete more drilled but uncompleted wells in November and December to get them into their year-end reserve reports.

Production declines typically occur in the first quarter because of winter weather.

The U.S. and all non-OPEC oil production will keep declining in 2021 until the active rig count more than triples. Horizontal shale wells come on strong, but their production declines rapidly. We need at least 600 rigs drilling for oil in the U.S. to hold production flat. There will not be a significant increase in drilling activity until oil prices are much higher than they are today. I believe the "right price" for oil is $65 per barrel. Adjust the inflation price, and we may need $75 per barrel West Texas Intermediate (WTI) a year from now before upstream companies significantly increase their drilling programs.

Note: My pricing forecast is based on the assumption that there is not an unforeseen recession (U.S. or globally), a new outbreak of the coronavirus causing widespread shutdowns, any other anomaly significantly impacting the global markets this year or in 2021.

Demand Side of the Equation

Global demand for hydrocarbon-based liquids, primarily transportation fuels refined from crude oil, was 101 million barrels per day in 2019. Demand is seasonal, and it declined to approximately 94 million barrels per day in the first quarter of 2020 before the pandemic travel restrictions caused the largest demand drop-off in history to approximately 83 million barrels per day.

Key point: The demand decline in the second quarter was not as bad as some dire predictions, and the demand rebound in the third quarter was much better than expected. Oil demand in Asia and Europe is almost back to pre-pandemic levels. The price of oil is still in the $40s because it will take time to draw down inventories to normal levels.

"The oil market rebalancing slowed sharply this summer as we expected. Demand gains stalled as the virus continued to spread with Chinese imports, also slowing. In turn, shut-in production restarted in North America alongside higher OPEC+ quotas. This left only modest draw in inventories since early July." – Goldman Sachs Commodities Research August 30th, 2020

Despite some remaining headwinds, the global oil market will be balanced early in 2021. If demand increases back to 100 million barrels per day as expected, the market will be under-supplied next summer. Only much higher oil prices than we have today will cause upstream companies to expand their drilling programs. I forecast that WTI will be trading for $75 per barrel a year from now, and natural gas prices will average close to $3.00/MMBtu in 2021. Smart investors should be adding more energy to their portfolios.

They call them "cycles" for a reason.

To get a full energy market update and investment ideas, register for the upcoming webinar with Dan Steffens, president of Energy Prospectus Group, as the featured speaker scheduled for Wednesday, October 14th, at 3:30 pm CST.

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