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MARKET NEWSLETTER

Views from the Patch – Oil Update May 23, 2016

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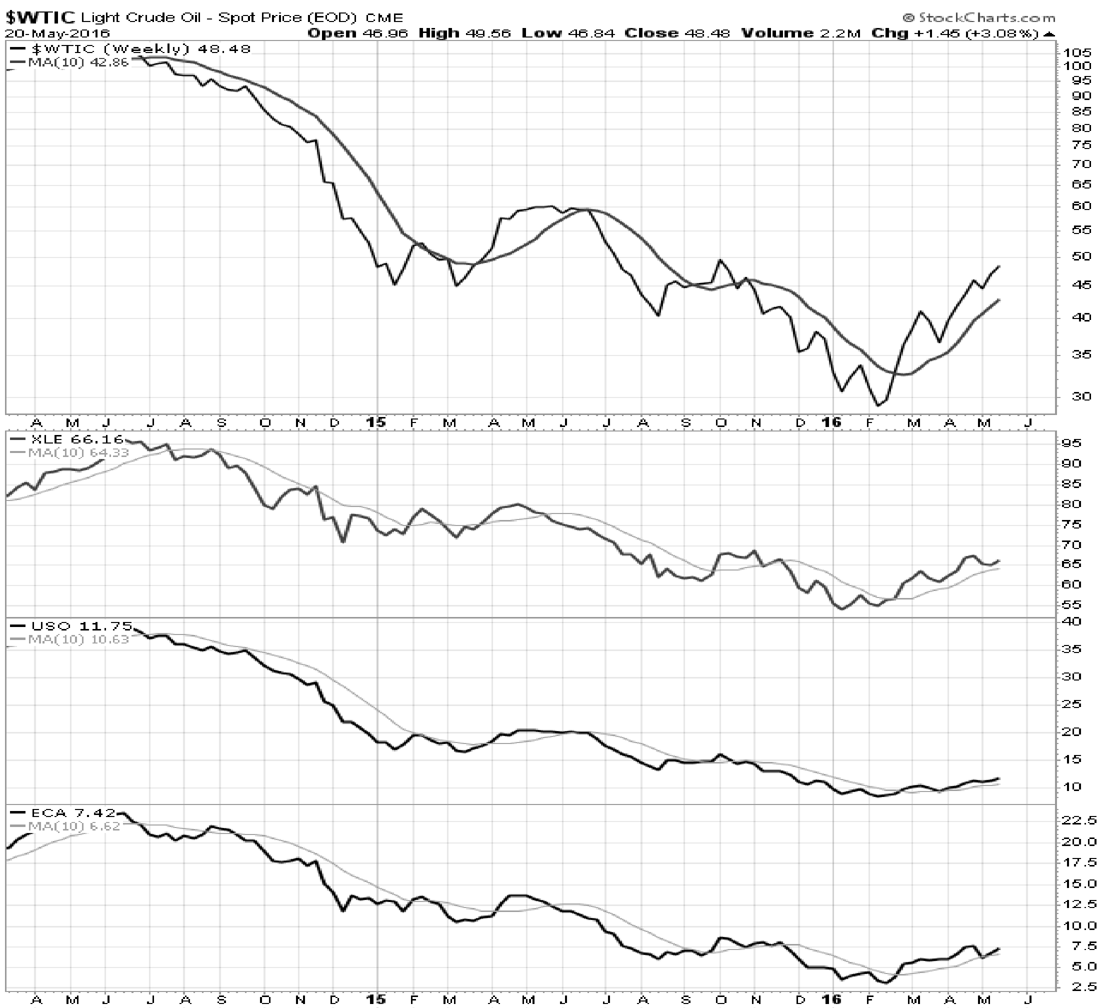
It's been six months since the inaugural commentary on crude oil and the author's view of the WTI oil price not seeing north of US$ 60/bbl in the near to mid-term (at least 5 years) has not changed. However, a few "Black Swan" events, world economic recovery timing, and OPEC issues have lengthened the oil demand/supply balance point and created some near term opportunities. Additionally, oil business cycles events are indicating that we have seen bottom and oil price recovery is starting to take place, namely, industry bankruptcies and consolidation in both the US and Canada.

The premise that WTI oil price is unlikely to crest $ 60/bbl in the mid-term is evidenced by forward curve oil pricing which still shows a mid-$50 oil price in 2020. In fact, the demand / supply balance point has been pushed to Q1 2017 due to Saudi Arabia defending its market share, Iranian oil production returning to pre-sanction levels, and further moderation in Asian, European, and North American economic recovery rates. On the bright side, US oil production has fallen by approximately 800,000 bopd since its peak in April 2015, reversing its annual growth rate of 1,000,000 bopd over the previous four years in response to the current low oil price environment. This reduction for the most part has offset the increase in OPEC production. The current oversupply of approximately of 1,300,000 bopd should be offset by the increase in global oil demand by year end. The question will be how much "new", US shale oil production and Saudi Arabian, to a lesser extent, Iranian, excess capacity will commence production as the world approaches balance and oil shows price stability around US$ 50/bbl in Q4 2016. These production additions will try to maintain balance with increases in worldwide demand post 2016, causing oil price volatility as they oscillated around balance, exacerbated by geopolitical and other "Black Swan" events.

It's the author's opinion that in the near term there is significant potential that crude oil could touch US$ 60/bbl then back off to the $ 50 level due to current supply disruptions (due to Black Swan events) mainly in Canada (Fort MacMurray wild fire shutting in oil sands production), Nigeria (civil unrest curtailing production), Brazil (unplanned facility outage), and Libya (again civil unrest curtailing production). The combined disruptions are approximately 2,500,000+ bopd in total which easily offsets the 1,300,000 bopd of world oversupply. These disruptions are temporary in nature (1-3 months) and likely will not attract capital expenditure that would increase world supply significantly, but may encourage "shut-in" oil production that requires minimal effort / capital to bring on, i.e. starting up a pump or turning a valve to start up / increase production. The question is how much of this "easy" additional oil is available and where is it located. The author believes that most of this "easy" production mainly exists in OPEC, namely, Saudi Arabia / Iran and not in North America. It is the author's contention that this could cause a temporary supply / demand imbalance in North America lasting 1-3 months while these disruptions are resolved, causing oil to spike to US$ 60/bbl at its peak followed a rapid drop back to $ 50 when majority of the disruptions are resolved. The peak should occur by mid-June when the maximum effect of the shut-in of Fort McMurray oil sand production is first felt at PADD 2, specifically Cushing (It takes about 35 days to move oil from Fort McMurray to Cushing.). This effect should benefit oil traders and producers of oil over the next quarter.

Additional good news for the oil and gas industry is confirmation that world oil price has bottomed. We have seen both WTI and Brent oil prices increase from sub $26/bbl in January to nearly $ 50/bbl in May due to the overall reduction in oil production worldwide from non-OPEC countries, the increasing worldwide demand (approximately 94,000,000 bopd, currently) and short term oil disruptions starting in April / May. We have also seen business cycle effects of oil company bankruptcies and consolidations taking place in both the US and lately, in Canada, indicating the beginning of the end of the down cycle in the WTI and world oil price. This has been reflected in the stock market by the recovery of oil and gas company stock. If one looks at Energy Select Sector SPDR ETF (XLE), it has increased from the low of $ 52 /share in the beginning of February to currently, $ 66 /share, approximately, in May. We see similar increases when we examine United States Oil Fund (USO) and Encana (ECA).



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