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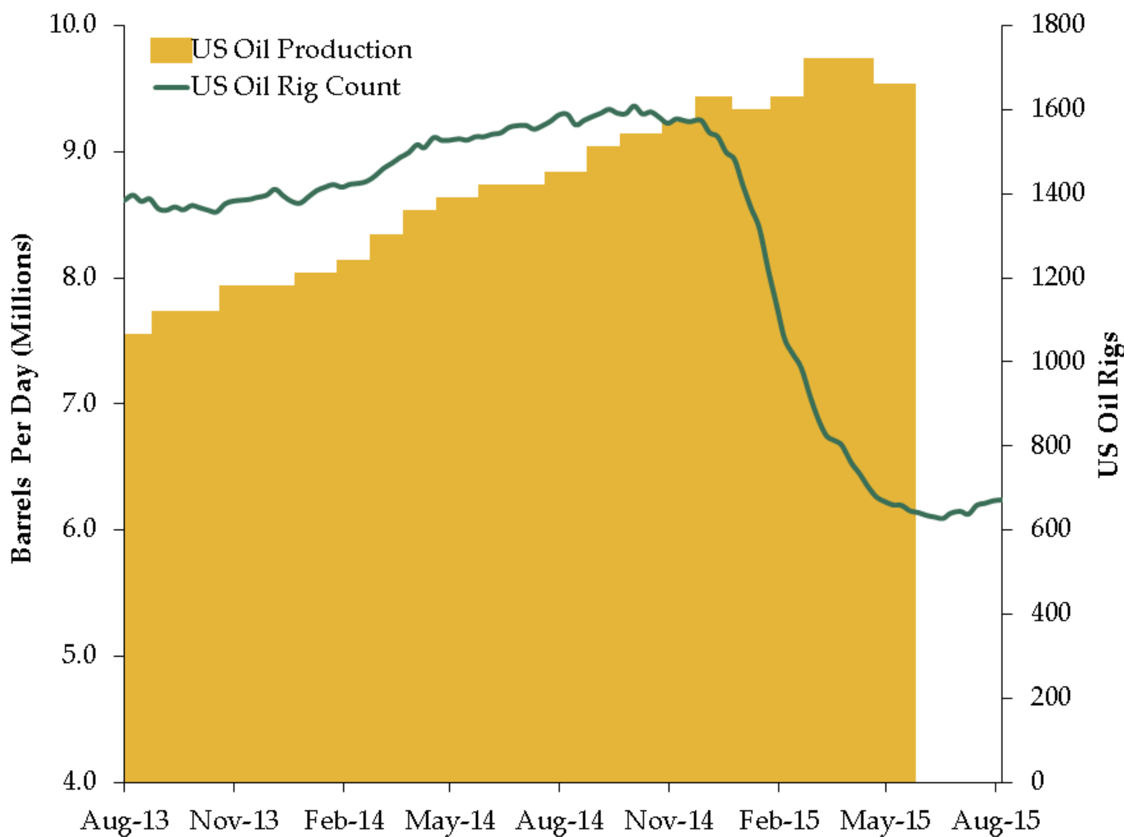
Unfavorable Climate for Energy Stocks

After rebounding to $61.43 per barrel on June 10 2015, West Texas Intermediate (WTI) crude oil began decreasing and on August 17th 2015 reached a six-year low of $41.81. Energy firms are depleting cash reserves. Their earnings and revenues are declining, and a few struggling firms are beginning to sell assets or enter bankruptcy. Despite contrary assertions, it is too early to bottom fish in Energy. With Energy stocks down double digits year-to-date amid flattish broad US markets, some suggest it is time to look for cheap value in Energy. However, fundamentals suggest bottom fishing is not a sound investment decision.

Those who are bullish towards Energy stocks primarily argue that low prices will cause firms to decrease production. Before long, they posit, growing demand will consume the excess supply, reversing the current glut, and causing prices to rise. This, they claim, is not discounted into falling Energy stock prices. Bullish oil investors cite the fact that active US oil rigs have more than halved since oil's price drop, falling from 1,573 in August 2014 to 672 currently. It is a matter of time, they claim, until oil stock prices rebound.

However, despite the declining rig count, US oil production has not dropped. According to the latest available data point, US oil output rose from 8.6 million barrels per day (mb/d) in August 2014 to 9.5 mb/d in May 2015. Production peaked at 9.7 mb/d in March and has only slightly decreased by 1.9% since.



Source: Baker Hughes, as of 8/17/2015, US oil rig count, 8/2013 – 8/2015, US Energy Information Administration, as of 8/17/2015, US oil production, 8/2013 – 5/2015

In reality, by not utilizing the least efficient rigs, Energy firms are producing more with less, maintaining high output. Though low prices caused oil production to be less profitable, firms still have an incentive to generate revenue and recoup exploration and drilling costs. Many smaller, shale drillers loaded up on debt to expand production when prices were high. These firms cannot afford to cut production and idly wait for higher oil prices.

Moreover, improvements in drilling technologies have allowed some producers to lower costs over the last year, many to below current oil prices. In McKenzie County, North Dakota, a core area of the large Bakken field, the median breakeven price is currently just over $29 per barrel, half the overall Bakken breakeven prices some estimated last fall. Moreover, as oil has fallen the last four weeks, oil rig counts have actually increased. There is little sign US shale firms are materially slowing down production.

Additionally, extra oil supply is readily available. As prices decrease, shale producers left many wells incomplete to avoid churning out more oil while prices are low. At the first sign of rebounding oil prices, producers can quickly increase production, flooding the market with new supply, putting downward pressure on prices. According to Rystad Energy, an independent oil and gas consulting and data firm, at the beginning of June the "fracklog" stood at 3,850 wells. Some estimate this adds up to about 500,000 barrels per day of output, an effective reserve supply in addition to the global supply that already exceeds demand by almost three million barrels per day.

Outside the US, production also remains high and rising. In 2015, according to the International Energy Agency, North Sea oil production is set to grow by 65,000 barrels per day. While not a large increase, it would be the second straight year of growth—the first such stretch in 15 years—in a region many believed in terminal decline. Part of this is because North Sea platforms are experiencing fewer shutdowns this year. But also, oil prices hovered above $100 per barrel for much of this expansion. In August 2014, WTI and the global benchmark, Brent, were roughly $97 and $102, respectively. Until October 2014, oil prices motivated firms to increase drilling. Firms acted on those signals and invested to boost output, which takes time to pay off, even if the payoff is roughly 60% smaller. New tax breaks in the beginning of 2015 gave UK producers another small incentive to increase production.

Production is also growing in the Middle East, a region dominated by national oil firms. Total OPEC production was 31.5 mb/d in July 2015, the highest since 2012, as cartel members (particularly Saudi Arabia) fought for market share amid dropping prices. Iraqi production reached a record high last month. Iranian production will get a boost should the US and other countries lift sanctions as part of the recent nuclear deal. Troubled countries reliant on national oil firms for revenue like Iraq, Iran, Libya and more largely cannot decrease output.

Therefore, supply will likely remain in surplus for the foreseeable future. On the other hand, it is not likely that demand will rise in tandem with supply. Some theorize that cheap energy prices will increase consumption, supporting higher prices. While consumers do respond to incentives, this force is likely incremental in the foreseeable future. Demand growth, while positive, is not likely to keep pace with all that rising output. Balancing the market will take sharply rising demand, falling production or a combination of the two. According to the International Energy Agency, global oil demand will likely grow by 1.6 mb/d in 2015 and another 1.4 mb/d in 2016. Even if this proves accurate, demand will not catch supply for over a year, presuming supply remains constant—unlikely given global oil market dynamics.

The question for Energy stocks is whether sentiment has caught up with unfavorable fundamentals. Some claim after the commodities slump over the past year investors have capitulated, believing resource prices will be "lower for longer," hence low prices are built into Energy stocks. However, market bottoms tend to occur not just when sentiment is poor, but when it is worse than fundamentals—not the case today, as illustrated by widespread calls for falling production to drive a quick rebound. A sustained Energy recovery likely will not happen until the remaining bullish investors give up on the idea that the sector represents value after a big decline.

This does not imply that owning Energy stocks is a bad investment decision. Energy is a big diverse sector globally, and eliminating it from a portfolio increases risk. Large, integrated oil and gas producers will fare better than smaller firms. They have diverse revenue streams that benefit from low oil prices (refining and chemicals for example), partially offsetting exploration and production units. These firms should also have the capabilities to acquire assets from struggling small producers—in other words, let them do the bottom-fishing.

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