Oil Market Update: Looking Beyond Weekly Noise

ScotiaMcLeod Portfolio Advisory Group

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Don't miss the forest for the trees!

- Crude oil prices remain highly volatile due to concerns about global growth and continuing high production levels by OPEC and non-OPEC producers.
- While we believe it will take more time for the global oil market to return to equilibrium, evidence has started to emerge that low oil prices are beginning to impact U.S. oil production.
- On a day-to-day basis, oil prices are being whipsawed by U.S. data that show occasionally larger than expected increases in oil inventories. Unfortunately, the market appears to be missing the forest for the trees as overall U.S. oil inventories are now trending lower after peaking in April (Exhibit 1).
- Low oil prices have resulted in a dramatic drop in capital spending by oil producers that is finally starting to impact overall U.S. oil production, which has declined by almost 400,000 barrels/day since early June (Exhibit 2).
- A decline in refinery utilization coupled with increased oil imports to the U.S. has also dampened weekly inventory data (Exhibit 3).
- We don't expect oil prices to recover to mid-2014 levels in the near- or medium-term, but we also don't expect prices to languish for an extended period in the current mid-US$40s either. Should current industry trends prevail (i.e. lower spending, lower drilling activity), we believe oil prices could recover to the US$55-US$60 range over the next 12 months.
- Investors should review energy holdings within portfolios with an aim of focusing exposure on high quality companies with low balance sheet leverage as a shallow oil price recovery could overwhelm producers carrying high levels of debt.

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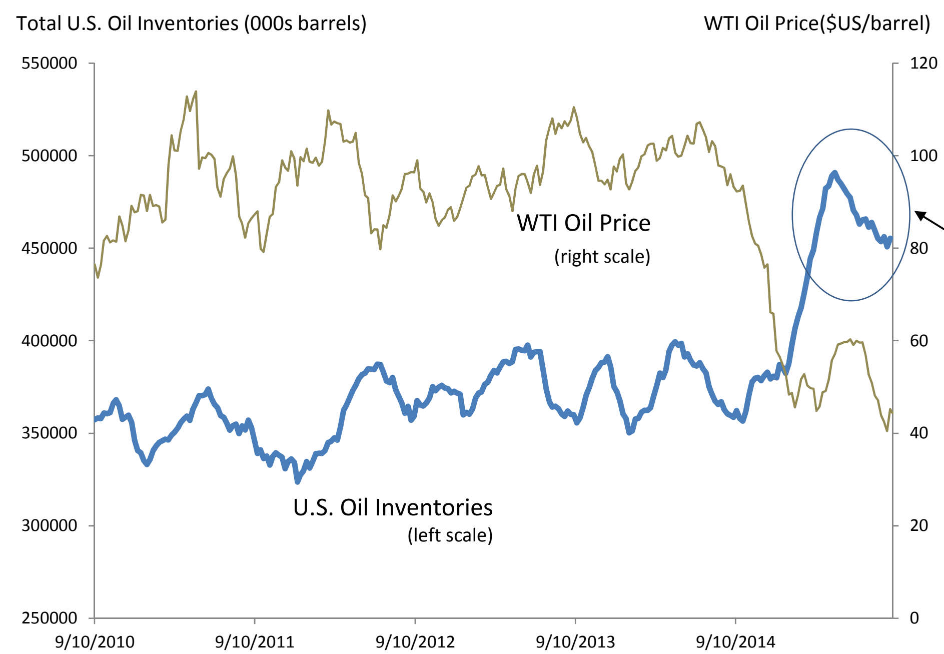
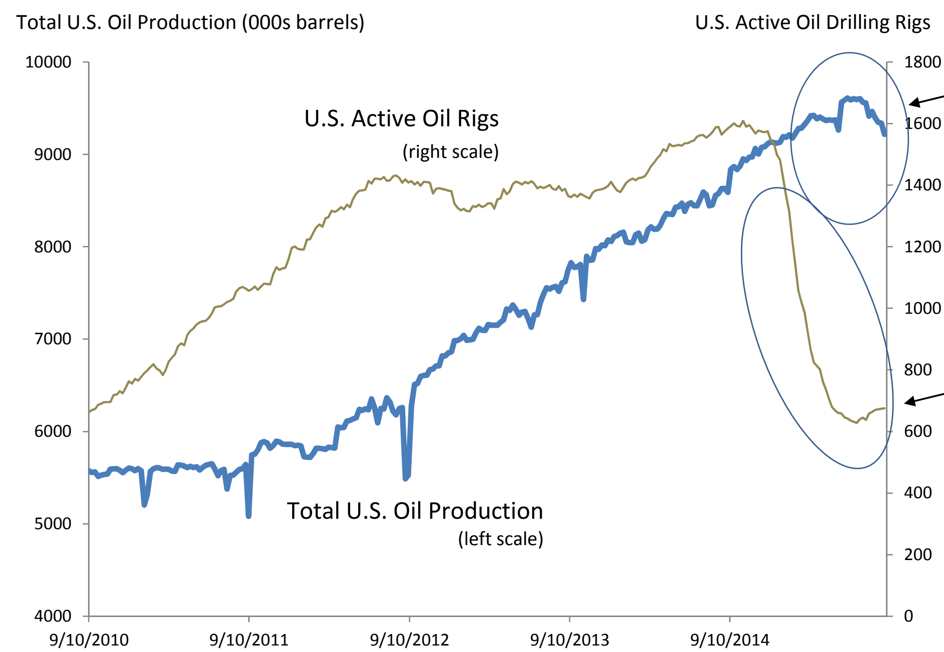
Exhibit 1: U.S. Oil Inventories Remain High, But Have Starter to Decline



Source: Bloomberg

Headlines pointing to high U.S. crude oil inventories are accurate, but the bigger picture is that the absolute inventory level has started to decline and is now 7.2% below the April peak. Some of the recent spikes in weekly inventory data can be attributed to planned and unplanned refinery outages, namely BP's Whiting Refinery in Indiana which restarted on August 25. Meanwhile, YTD U.S. gasoline demand is running 4.2% higher than the same period in 2014.

Exhibit 2: Decline in Drilling Activity Resulting in Lower Production

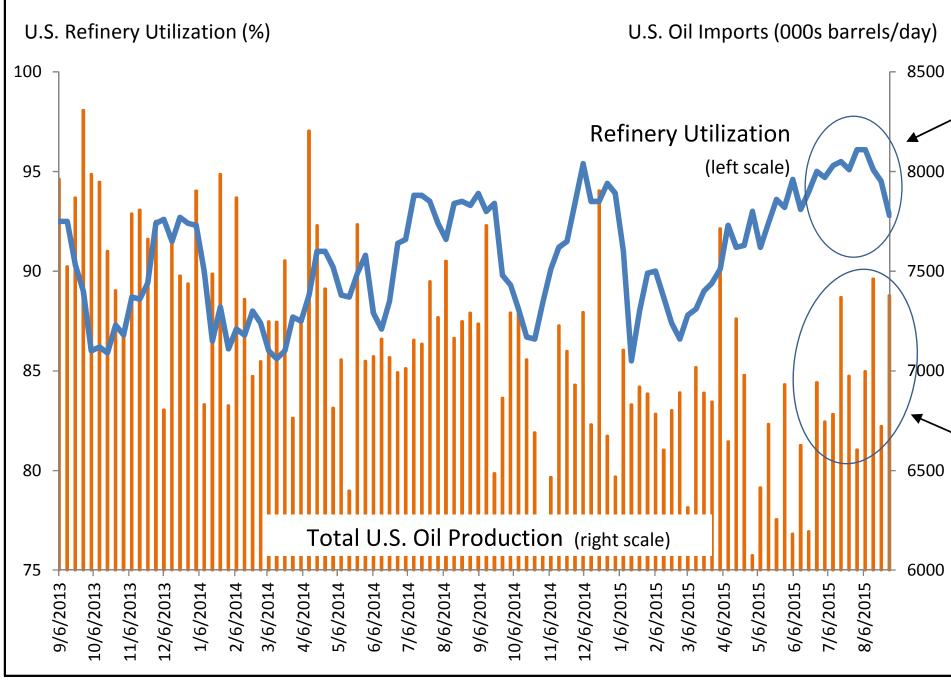


Source: Bloomberg

After an expected lag between drilling activity and production, total U.S. oil production has finally started to decline. Since peaking in early June 2015 at 9.61 million barrels/day, U.S. production has declined to 9.22 million barrels/day as of Aug 28, a 4% decline. Should this trend continue, OPEC could eventually achieve its goal of recapturing market share that was lost to rapid U.S. production growth.

30%-50% declines in capital spending by North American oil producers has translated into a 57% reduction in oil drilling activity since Oct 2014 as low oil prices deter producers. Drilling activity at current levels is seen as insufficient to replace natural declines in production, suggesting that overall oil production could moderate further in coming

Exhibit 3: Refinery Utilization and Imports Also Weighing on Inventories



Source: Bloomberg

Refinery utilization has dropped 3.3 percentage points in recent weeks as refineries undergo planned and unplanned maintenance outages. As refineries are the primary users of crude oil, declines in utilization tend to result in increased inventory levels. With high gasoline demand and wide refining margins, refineries try to maintain high utilization rates.

Recent increase in crude oil imports has also exasperated short-term inventory levels.

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