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The Oil Patch

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The heady days of 2011-2014 when oil was fetching more than $US100/bbl are not expected to return anytime soon.

But there is no doubting that confidence has returned to the oil patch in response to global oil benchmark prices recovering to three-year highs in the case of Brent ($US63.16/bbl), and two-year highs in the case of WTI ($56.69/bbl).

The price recovery has yet to be fully reflected in equity values on the basis that for most of the producers at least, their share prices were already factoring in higher prices. Investors are likely to wait for proof of a sustained period of higher prices before marching back in to the sector.

As is always the case with oil, the price recovery reflects the complex interplay between supply/demand fundamentals, and geopolitics.

On the supply/demand side, oil prices have been underpinned by slowing growth in US shale oil production, and by crude output cuts from OPEC and Russia. Critically, OPEC meets on November 30 to discuss cuts beyond the current agreement which expires in March 2018.

On the geopolitical side of things, political drama in Saudi Arabia, the world's biggest oil exporter, has recently emerged as another factor in oil's bounce back.

Stronger oil prompts increased M & A activity

The confidence boost that has flowed from the stronger oil price is being reflected in increased acquisition activity in the local oil patch. There have been two acquisition deals of note in recent weeks:

November 1: Oil Search (ASX:OSH) announced the $US400m acquisition of 25.5% to 37.5% interests in Alaska North Slope permits said to contain 500m barrels of oil (gross).

November 6: Horizon Oil (ASX:HZN) agreed to acquire an additional interest in two producing oilfields in New Zealand for $US17.6m.

Market talk

Morgan Stanley said in October that geopolitical risk has returned as a factor in driving oil prices. "Oil markets have priced in little for geopolitical risk in recent years. With high inventories and ample supply, this made sense. However, as the market is tightening, it is becoming more sensitive to such risks too. With several 'hot spots' on the horizon, this can provide ongoing price support.''

The investment bank said that oil markets have been undersupplied by about 0.3m bopd, according to IEA figures, and OECD inventories are currently just 190m bbls above their five-year average.

“We expect this to tighten further into 2018, driven by healthy demand growth, slowing US shale growth and continuing OPEC restraints. As the market has tightened, the amount of 'buffer' in the system has shrunk. Geopolitical risks and supply shocks have become more relevant again.”

“At the moment, we estimate that oil prices incorporate $1-2/bbl for geopolitical risk, or a supply disruption of about 40-60m bbls. This is still modest, in our view. With several 'hot spots' around the world, and markets tighter than they used to be, this could become an ongoing feature of the market once again.’’

Morgan Stanley was on the mark as early in November, political instability arrived in Saudi Arabia after dozens of government officials were arrested in a corruption crackdown. ANZ’s commodities desk takes up the story:

“Crown Prince Mohammed bin Salman has staked his claim on restructuring the economy to be less reliant on the oil industry. However, the kingdom is faced with significant challenges as its fiscal position has continued to deteriorate since the era of $US100/bbl oil ended in 2014. This means the prospect of prices falling back below $US50/bbl is just too big a risk. We believe Saudi Arabia would rather over-tighten the oil market than risk prices falling again.”

“While the likelihood of a disruption to supply remains low, we believe the events raise the probability of Saudi Arabia taking a more aggressive stance on production curbs. In fact, the risks now lie towards curbs remaining in place longer than expected. As such, we see oil prices remaining well supported in the short term,’’ ANZ said.

OPEC said in its latest monthly report that oil use would grow faster than previously thought due to a stronger-than-expected world economy. It expects the world will need an extra 360,000 bopd from OPEC sources next year. It was the fourth consecutive time the monthly report has increased the projection.

Deutsche Bank estimates that the enterprise value of global oil producers on a 2P barrel of oil equivalent basis on October 26 was $US6.80/bbl. Its oil analyst said the bank expects that falling estimates for 2018 US production growth have contributed to higher oil prices. But the bank is worried that reversal may be in store for the fourth quarter, helping to act as a downside catalyst.

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