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The Oil Patch

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Some Christmas cheer for the oil patch:

Things heated up in the oil patch in the last month. Oil prices continued to edge higher, merger and acquisition activity stepped up a notch, and the share prices of the oil producers marched higher.

It seems the doom and gloom surrounding the oil patch since oil prices came crashing down from more than $US100 a barrel in 2014 is finally lifting.

And it is, with a veritable conga line of industry analysts and commodity experts prepared to make the call that the oil market has achieved much of its required rebalancing. Why, some are even suggesting the oil patch is returning to "normal.''

The last month has seen oil prices edge higher in response to the improved sentiment. WTI has climbed from $US55.30/bbl to $US57.55/bbl while Brent has risen from $US61.84/bbl to $US63.96/bbl, the latter helped by the recent shutdown of the crucial Forties oil pipeline in Scotland because of a hairline crack.

OPEC gives market a boost, and demand kicks in

OPEC's November 30 meeting gave the market what it wanted – an agreement for production quotas to rebalance supply/demand to remain in place until the end of 2018.

Deutsche oil analyst Michael Hsueh said that with supply "discipline'' by OPEC firmly in place until at least the June 2018 meeting of members, there was now greater certainty about markets coming in to balance in 2018, with the possibility of supply deficits in 2020.

Morgan Stanley said that OPEC's decision came against a backdrop of an oil market that had already rebalanced. The investment bank said that OECD inventories have contracted by about 100m/bbls since peaking in January 2017.

"This is partly a function of demand growing well above historical trend rates, now for the third consecutive year. With globally synchronous economic growth, and oil prices well below historical highs, we expect this to continue in 2018 and forecast another year of 1.5m barrels a day of demand growth.''

Contrarians saw this coming

Investment in exploration and new projects dried up in response to the 2014 oil price collapse, prompting the question of where is the replacement oil coming from in the years ahead?
And the way Simon Mawhinney sees it, the current prices are still not sufficient to incentivise a major step-up in exploration and development.

Mawhinney is the chief investment officer at the Sydney-based contrarian fund manager, Allan Gray, which was a notable buyer of leading oil stocks when others had turned their backs on the sector.

"All of the world's oil and gas assets are decaying assets (through natural field depletion). They deplete, some much more quickly that others, like US shale at 40% per annum and others at around 5-8% per annum,'' Mawhinney told the investment website Live Wire Markets (Livewiremarkets.com).

Oil's tentative price rise feeds into higher earnings/share prices

Investment bank UBS was one of many to recently upgrade earnings expectations in response to higher oil prices.

Based on its assumption of $US60/bbl (Brent) oil in 2018, UBS was prompted to upgrade earnings estimates for ASX-listed producers by 15-34%.

Like Mawhinney, UBS believes oil markets will need to incentivise sufficient new supply to come on stream. As a result, it expects Brent to increase to $US70/bbl over the next three years.

Share price rises posted in the last month by the producers included those by Woodside (4%), Oil Search (2.6%), and Horizon (15%).

Stepped up M & A signals were off the bottom

The last month saw stepped up merger & acquisition activity on the ASX, as sure a sign as there is that the industry itself believes better days lay ahead.

The M & A activity delivered over-sized share price gains for Santos (15%) and AWE (47%) in the last month. Both companies have been on the receiving end of takeover approaches or takeover bids.

Among other things, the potential buyers are betting that their targets are undervalued in light of the recovery underway in oil and gas markets – the major theme of the last month

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