PETROLEUM SECTOR HARD TO NAVIGATE IN SEA OF OIL

BY CHUCK FREEDMAN, CFA®, CAIA

The glut continues, and global oil prices are likely to remain weak as excess crude looking for a home sloshes around in storage tanks on land and sea.

The oil patch has been among the worst-performing investments of 2020, with the S&P energy sector down over 40% YTD, as the pandemic has caused a continuing global collapse in oil consumption. Earlier this month, U.S. oil prices fell 7% to $36.84 a barrel — petroleum's worst day and lowest closing price in nearly three months.

The drastic imbalance in supply and demand causing this price weakness is not expected to be resolved anytime soon. The world's major crude oil suppliers have cut back production as demand remains muted for petroleum products across the board, including the jet fuel that powers the staggered airline industry and the industrial lubricants that drive manufacturing plants recovering from the economic shutdown.

The Organization of Petroleum Exporting Countries (OPEC) has cut its forecast for oil demand growth this year and next year, citing a weaker-than-expected recovery in India and other Asian countries, and warned risks remain "elevated and skewed to the downside" for the first half of next year. OPEC downwardly revised its outlook for global oil demand to an average of 90.2 million barrels per day in 2020. That's down 400,000 barrels per day from the previous month's estimate and reflects a contraction of 9.5 million barrels per day year-over-year.[1]

The United States, which only recently assumed its role as the world's No. 1 oil producer largely due to the fracking industry, has been heavily impacted by the slowdown. Operating oil rig counts have dropped dramatically, some oil refineries may come offline, and normal supply chain logistics are likely to be disrupted. It will become increasingly difficult the longer this lull lasts to put everything back online quickly if demand suddenly resurfaced.

To put matters in perspective, Texas, the largest oil-producing state in the United States, had 440 land oil rigs at the end of August last year.[2] That number has fallen to 104 this year. A similar trend is unfolding in prime U.S. oil-producing states from Alaska to North Dakota and Wyoming to Louisiana. Besides the hit oil production takes, the industry suffers as well as many high-paying jobs disappear.

A harbinger of the precarious nature of fluctuating oil prices during the pandemic was evident earlier this year when West Texas Intermediate went briefly into negative territory on April 20th before snapping back to close in positive territory on April 21st. This brief move into negative pricing was unprecedented and dominated financial market headlines for much of that week as a result.

In short, oil prices (WTI) have fallen almost 33% YTD to their current level of about $41 per barrel.

There are some forces out there that may help oil recover down the road. The economic reopening after the global economic shutdown should eventually boost oil consumption. While OPEC's report was skewed toward the downside in the first half of 2021, it was a little more upbeat for the second half. OPEC now expects global oil demand to grow by 6.6 million barrels per day to an average of 96.9 million barrels per day next year. But the updated forecast was also 400,000 barrels per day lower than its previous estimate.[3]

What should investors do? The year-to-date decline in both the commodity and stocks within the Energy sector is still warranted in our view. The eventual recovery for Energy stocks is likely to be a long and arduous one, with several casualties along the way, including many dividend cuts and more than just a few bankruptcies. For investors considering stocks in the Energy sector, we recommend focusing on companies with diversified operations, strong balance sheets, and proven management teams. These are the companies in our view most likely to maintain their dividends, pick up the pieces and move the industry forward in the years to come.

1. OPEC September Monthly Report
2. Baker Hughes' weekly rig count.
3. OPEC September Monthly Report

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Chuck is a senior vice president and senior portfolio manager within the family office services group of Commerce Trust Company. Upon gaining a thorough understanding of a client's needs and goals as well as assessing the client's entire financial situation, he works with our investment research team to construct a portfolio to help clients achieve their long-term goals. Chuck comprehensively represents our research- and goals-based investment process, starting with the initial assessment and creation of an investment objective to ongoing evaluation and adjustments based on changing market and life circumstances. With a deep knowledge of the market and experience in investment management, he serves clients with thought leadership, insight, and consulting services. Prior to joining Commerce in October 2011, he was a senior vice president and the lead senior portfolio manager in Atlanta. In that role, Chuck was responsible for managing investment portfolios for high net worth individuals and for families, trusts, foundations, and other tax-exempt entities. In total, he has more than 30 years of financial and investment experience, developing creative solutions for complex financial situations. More recently, he has specialized in managing significant individual equity portfolios as well as implementing complex financial strategies that included the use of alternative investments. Chuck holds the Chartered Financial Analyst® and Chartered Alternative Investment Analyst designations. He has also successfully completed the Certified Public Accountant exam. He earned his master of business administration degree from the Kenan-Flagler Business School at University of North Carolina.

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