Oil at $40, and Below, Gaining Traction on Wall Street

By Grant Smith - Jan 13, 2015

Brace for $40-a-barrel oil.

The U.S. benchmark crude price, down more than $60 since June to below $45 yesterday, is on the way to this next threshold, said Societe Generale SA and Bank of America Corp. And Goldman Sachs Group Inc. says that West Texas Intermediate needs to remain near $40 during the first half to deter investment in new supplies that would add to the glut.

“The markets are continuing to price in huge oversupply in the first half of 2015,” Mike Wittner, head of research at Societe Generale SA in New York, said by phone on Jan. 12. “We’re going to go below $40.”

Oil is seeking a “new equilibrium” as the Organization of Petroleum Exporting Countries abandons its role of keeping supply and demand aligned, according to Goldman. Prices are poised to drop further, testing the ability of U.S. shale drillers to keep pumping.

WTI fell as low as $44.20 a barrel on the New York Mercantile Exchange yesterday and traded at $45.56 at 12:11 p.m. Singapore time. The U.S. benchmark has dropped 14 percent this month, extending a 46 percent plunge last year that was the worst since the 2008 financial crisis.

OPEC Strategy

OPEC is trying to maintain its share of the global oil market against the rise of U.S. output. United Arab Emirates Energy Minister Suhail Al Mazrouei reiterated yesterday that shale producers will capitulate before OPEC to lower prices, the latest in more than a dozen comments from Gulf members aimed at hastening oil’s slide and lowering non-OPEC supply. The group upheld its target of 30 million barrels a day at a meeting in Vienna on Nov. 27.

The rout may continue to $35 a barrel in the “near term” because both oil supply and demand will have a delayed reaction to falling prices, Francisco Blanch, head of commodities research at Bank of America in New York, said in a report on Jan. 6.

The U.S. is pumping oil at the fastest pace in more than three decades, helped by a drilling boom that’s unlocked supplies from shale formations including the Eagle Ford in Texas and the Bakken in North Dakota. U.S. output expanded to 9.14 million barrels a day in the week ended Dec. 12, the
most since at least 1983, according to the U.S. Energy Information Administration.

Reducing Investment

With Saudi Arabia and other OPEC nations no longer fine-tuning supply, reductions in investment in new production will be the instrument for removing excess output, Jeffrey Currie, head of commodities research in New York at Goldman said in a report on Jan. 11. This means the collapse will be deeper and the recovery slower than in previous slumps, he said.

Reducing Investment

Operating cash costs for many non-OPEC projects are below $40 a barrel and some producers will be able to keep going because they have locked in forward prices, or are supported by tax breaks or weaker domestic currencies, said Blanch, who on Nov. 27 predicted that WTI, then above $70 a barrel, could plunge to $50. An increase in demand in response to lower prices will take about six months, he said.

“An impatient oil market, wanting to see production adjustments as soon as possible, could push WTI oil prices to $40 a barrel,” Giovanni Staunovo, an analyst at UBS AG in Zurich, said by e-mail yesterday. Investment “cutbacks and less drilling activity are required to see a stall in North American supply growth. This is unlikely to happen in a meaningful way before the second half,” he said.

Cutting Supply

While U.S. drilling activity has slowed down in response to the price plunge, it will take months for that to translate into lower supplies, according to Societe Generale’s Wittner. Rigs seeking oil in the U.S. decreased by 61 to 1,421, Baker Hughes Inc. said Jan. 9. That’s the largest drop since February 1991.

“Rig counts are coming down, so it is happening the way it’s supposed to happen,” Wittner said. “But it’s going to take a while to see an impact on shale oil.”

A seasonal lull in demand this quarter will add to the downward pressure from brimming inventories, pushing down prices as much as another $10 a barrel, Amrita Sen, chief analyst at London-based consultant Energy Aspects Ltd. said in an interview on Bloomberg Radio’s “Surveillance” on Jan. 12.

“There is likely to be another leg lower for prices,” said Sen. “I wouldn’t rule out a peek into the $30s.”

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