OIL AND NATURAL GAS PRICE OUTLOOK

The short-term outlook for oil prices is very challenging given simultaneous supply and demand shocks. After failing to reach an agreement to deepen production cuts, Saudi Arabia and Russia have entered into a price war and are threatening to flood the market with additional oil supplies. This is an unexpected and dramatic turn of events for the oil market, which was already suffering from sharply reduced demand due to the coronavirus. Oil prices have plummeted and are at levels that are uneconomic for many North American oil producers. How long oil prices remain at these levels will depend on when and if Saudi Arabia and Russia come back to the negotiating table and agree on much-needed production cuts to stabilize the oil market. We expect significant price volatility in the near term.

Longer-term, we expect U.S. oil prices to range between $45 to $65 per barrel, reflecting the volatile nature of the commodity, as large price swings are common. The pace of oil demand growth over the long term is uncertain given the global economy’s transition to a lower-carbon future. In the short term, we expect oil prices to be below this range; however, a sharp increase in prices could occur if Saudi Arabia and Russia reach an agreement to cut production.

We see natural gas prices in the U.S. ranging from $2.00 to $3.50 per thousand cubic feet over the long term. Natural gas prices can swing significantly based on changes in weather. We expect prices to be near the lower end of our expected range in 2020 as supply growth continues to outpace demand growth. Demand growth has been strong, driven by liquefied natural gas (LNG) exports and increasing usage for power generation. Hotter summers and colder winters tend to drive higher demand and prices in the shorter term. In coming years, we expect that growing LNG exports and further usage growth for power generation should help support prices in our long-term range.

GUIDANCE

Despite stocks trading at wide discounts to historic valuation levels, broad negative sentiment towards the energy sector is likely to remain a headwind until there is less oversupply of oil. Energy stocks can be very volatile given the commodity-sensitive nature of cash flows. In looking through these short-term movements, we see long-term upside potential in our Buy-rated stocks. We prefer energy stocks in the integrated oil & gas, storage & transportation, and refining & marketing subsectors, where companies have strong balance sheets that allow them to weather commodity-price weakness and support dividends.
What Is Our Outlook for Oil Prices?

The short-term outlook for oil prices is very challenging. After failing to reach an agreement to deepen production cuts, Saudi Arabia and Russia have entered into a price war and are threatening to flood the market with additional oil. This is an unexpected and dramatic turn of events for the oil market, which was already suffering from sharply reduced demand due to the coronavirus. Oil prices have plummeted to levels that are uneconomic for many North American producers. How long oil prices remain at these levels will depend on when and if Saudi Arabia and Russia agree on much-needed production cuts to stabilize the oil market. We expect significant price volatility in the near term. Long-term, we expect oil prices in the U.S. to be between $45 to $65 per barrel, reflecting the volatile nature of the commodity (see Figure 1). In the short term, we expect oil prices to be below this range; however, a sharp increase in prices could occur if Saudi Arabia and Russia reach an agreement to cut production.

Figure 1

What Is the Status of the Global Oil Supply?

United States

Since the discovery of fracking technology that made vast amounts of crude oil resources economic to develop, U.S. oil production has risen from 5 million barrels per day a decade ago to over 13 million barrels per day (see Figure 2). U.S. oil production grew 1.6 million barrels per day in 2018 and 1.3 million barrels per day in 2019. The vast majority of U.S. production growth has come from three main areas: the Permian basin in West Texas, the Eagle Ford shale in south Texas, and the Bakken area in North Dakota. Collectively, these three areas account for over 80% of U.S. oil production growth. The Permian basin alone accounts for nearly one-third of total U.S. oil production. Before the severe drop in oil prices in early 2020, U.S. oil production was expected to grow by nearly 1 million barrels per day in 2020. As producers drastically curtail drilling activity in the near term in response to low oil prices, we expect U.S. production to slow and potentially decline in 2020 depending on how long the oil price downturn lasts.

Figure 2

Canada

In Canada, oil sands growth is expected to slow significantly. Over the past decade, oil sands production grew at an average annual rate of around 9.5%. Over the next decade, oil sands production is estimated to grow at an average annual rate of around 2%, according to the Canadian Association of Petroleum Producers, as existing projects see small incremental capacity expansions (see Figure 3). While the oil sands will help satisfy global demand growth over the next decade, it will remain challenged to compete with low-cost areas with a smaller environmental impact.

Figure 3
The vast majority of oil sands output is exported by pipeline to the U.S. where it is refined into finished products such as gasoline, diesel and heating oil. With the start-up of new oil sands production at the end of 2017, there is currently not enough pipeline capacity to transport all the oil production coming out of western Canada. However, there are three large pipeline projects in the works (see Figure 4), but environmental and regulatory headwinds have resulted in significant delays in moving these projects forward. Until new pipeline capacity is added, incremental production will need to move to market via rail. This is a much more expensive and less efficient option than pipelines.

Figure 4 - Projected Pipeline Capacity

[Graph showing projected pipeline capacity with various projects listed, including Keystone XL, Trans Mountain Expansion, Line 3 Expansion, rail volumes, West Coast Canada refineries, and export markets of Western Canada pipeline capacity.]

To address the issue of oil production exceeding pipeline capacity, in late 2018 the government of Alberta announced a mandated reduction in oil production. Alberta’s move to mandate production cuts is aimed at improving the price of Western Canadian Select (WCS). Beginning in 2019, Alberta reduced production by 325,000 barrels per day, or approximately 9%. This amount has been gradually lowered to a decrease in production of 75,000 barrels per day. The production reduction has been extended to the end of 2020, with possible earlier termination.

OPEC

In a drastic turn of events for the oil market, OPEC (Organization of the Petroleum Exporting Countries) and Russia failed to reach agreement to increase production cuts in light of sharply reduced demand due to coronavirus. OPEC was pushing for an additional cut of 1.5 million barrels per day, on top of the 2.1 million barrels of oil per day cut that has been in place since the beginning of 2020, which is set to expire at the end of March 2020. Russia was not on board with the additional cuts, and Saudi Arabia (the de facto head of OPEC) is unwilling to shoulder the burden of additional cuts. With the sharp reduction in oil demand due to the coronavirus, production cuts are needed to avoid a large buildup of global oil inventories.

By way of background, in order to offset the growth in U.S. oil production, OPEC, along with Russia and 10 other non-OPEC countries (collectively referred to as OPEC+), have been curtailing oil production since early 2017. Combined, OPEC+ accounts for nearly half of the world’s oil production. Iran, Libya, and Venezuela are exempt from the OPEC production cuts because these countries are suffering from sanctions, civil unrest and economic turmoil, respectively. Production from these countries combined are down by over 2.5 million barrels per day since 2017, far outpacing the decline in production from the rest of the OPEC+ members.

Despite the production cuts by OPEC+ and the declines elsewhere, global oil supply has outpaced oil demand in 2018 and 2019. This is because oil production in the U.S. continues to grow at impressive rates. Without further actions by OPEC to lower production volumes further, we expect global oil supplies to outpace global oil demand in 2020, which will likely keep oil prices below the low end of our long-term forecasted range in 2020.

What Is the Status of Global Oil Demand?

Global oil demand reached 100 million barrels per day in 2019, up just under 1% from 2018, according to the International Energy Agency (see Figure 6). The majority of oil demand growth comes from China and India. In 2019, China accounted for nearly 80% of global oil demand growth. Given the significant disruptions to travel and trade from the coronavirus, Chinese oil demand is expected to contract significantly in 2020. Before the coronavirus outbreak, global demand growth was forecasted to be around 1.3%. In light of reduced demand around the world as containment measures result in drastic reductions in international and domestic transportation, oil consumption is currently projected to decline in 2020. If these estimates prove to be
true, it would be the first negative demand growth year since 2009.

In the long term, we believe oil demand will continue to grow, reflecting rising needs in the developing world from a growing middle class. We see this more than offsetting declining or flat demand in developed economies. In addition, demand for byproducts, like chemicals and plastics, will likely continue to grow with the global economy. However, we expect global oil demand will eventually peak, potentially in the next decade or two.

While electric vehicles (EVs) get most of the headlines for reducing oil demand in coming years, it will likely be more due to improved internal combustion engines (ICEs). ICEs will materially outnumber EVs for the foreseeable future, but will use much less fuel in the future for every mile driven in our view. EVs will likely see significant growth, but face several barriers to widespread global acceptance despite growing interest and government moves to encourage them. These barriers are numerous but include strong competition from more efficient and cheaper ICEs, the need for government subsidies and mandates to incentivize buyers, and limited battery lives and expensive replacement. While some factors may be improved upon, it is difficult to see them all being mitigated in the near term.

**Figure 6**

![Global Oil Demand](chart)

Source: International Energy Agency

**What About Natural Gas Prices?**

We see U.S. natural gas prices ranging from $2.00 to $3.50 per thousand cubic feet over the long term. Natural gas prices can swing significantly based on changes in weather. We expect prices to be near the lower end of our range in 2020 as supply growth continues to outpace demand growth. Demand growth has been strong, driven by liquefied natural gas (LNG) exports and increasing usage for power generation. Hotter summers and colder winters tend to drive higher demand and prices in the shorter term. In coming years, we expect that growing LNG exports and further usage growth for power generation should help support prices.

**Figure 7**

![U.S. Natural Gas Price](chart)

Source: FactSet, data as of 3/12/2020. Past performance is no guarantee of future results.

**How Do Energy Stocks Fit Into a Diversified Portfolio?**

Despite stocks trading at wide discounts to historic valuation levels, broad negative sentiment towards the energy sector is likely to remain a headwind until there is less oversupply of oil. We expect oil prices in the U.S. to range between $45 to $65 per barrel over the long term, reflecting the volatile nature of oil prices. Energy stocks can be very volatile given the commodity-sensitive nature of cash flows. In looking through these short-term movements, we see long-term upside potential in our Buy-rated stocks. We prefer energy stocks in the integrated oil & gas, storage & transportation, and refining & marketing subsectors, where companies have strong balance sheets that allow them to weather commodity-price weakness and support dividends. We recommend a 5% weighting in the energy sector in a well-diversified portfolio. See the list on page 1 for all of our Buy-recommended energy stocks.

**Valuation** -- We believe the current valuation of the energy stocks listed on page 1 are attractive. Methods used to evaluate the attractiveness of energy stocks include the price-to-operating cash flow (P/CF) ratio; enterprise value (market capitalization plus debt) to earnings before interest, taxes, depreciation and amortization (EV/EBITDA); along with a discounted cash flow analysis in certain situations. Some traditional measures like price-to-earnings (P/E), price-to-book value (P/B), and price-to-earnings to earnings plus growth (PEGY) are not applicable to the energy sector.
Risks -- Some of the primary risks of the energy sector: volatile commodity prices, which are cyclical and will affect earnings and the stock price; reduced company growth expectations; cash liquidity; demand being difficult to predict and which could change at unexpected rates; foreign operations being affected by political uncertainties and currency fluctuations; regulatory changes affecting company operations; and adverse legal decisions.

Please see the full opinions of the individual companies mentioned in this report for additional information, including valuation and risks.

Required Research Disclosures

Analyst Certification

I certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers; and no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.

Jennifer Rowland, CFA

Analysts receive compensation that is derived from revenues of the firm as a whole which include, but are not limited to, investment banking revenue.

Other Disclosures

This report does not take into account your particular investment profile and is not intended as an express recommendation to purchase, hold or sell particular securities, financial instruments or strategies. You should contact your Edward Jones Financial Advisor before acting upon any Edward Jones Research Rating referenced.

All investment decisions need to take into consideration individuals’ unique circumstances such as risk tolerance, taxes, asset allocation and diversification.

It is the policy of Edward Jones that analysts or their associates are not permitted to have an ownership position in the companies they follow directly or through derivatives.

This opinion is based on information believed reliable but not guaranteed. The foregoing is for INFORMATION ONLY. Additional information is available on request. Past performance is no guarantee of future results.

In general, Edward Jones analysts do not view the material operations of the issuer.

Diversification does not guarantee a profit or protect against loss in declining markets.

Special risks are inherent to international investing including those related to currency fluctuations, foreign political and economic events.

Dividends can be increased, decreased or eliminated at any time without notice.

An index is not managed and is unavailable for direct investment.

Edward Jones - Member SIPC