Crude Oil Prices Resume Decline, Could Hit $20 a Barrel

Coming in just hours apart on Friday, two reports confirm that oil prices are likely to resume their decline and stay low well into 2016. In a note to its clients, Goldman Sachs said that supplies remained robust despite the decline in rig count, while demand increases failed to materialize as expected:

> In fact, the oil market is even more oversupplied than we had expected.… We now forecast [that] this surplus [will] persist into 2016 [based] on further OPEC production growth, resilient non-OPEC [i.e., U.S.] supply and slowing demand.…
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> Risks [are] skewed to even weaker demand given China's slowdown.

In its worst-case scenario, Goldman Sachs said oil prices could drop as low as $20 a barrel before finding a bottom. Although unlikely, Goldman Sachs reported that the chances of $20 oil are "becoming greater as storage [tanks and offshore tankers] continue to fill." It announced severe cuts to its own forecasts reflecting its negative outlook, knocking the price of oil one month out from $45 to $38 a barrel, and its 12-month forecast down from $60 to $45.

Goldman Sachs remains firm in its conviction that low prices will eventually result in lower production from the United States, sufficient "to start rebalancing the market."

Friday's report from the International Energy Agency (IEA) expressed the same view, that U.S. production would drop by more than 400,000 barrels a day next year, the largest decline in almost 25 years. But with OPEC countries continuing to pump oil at record levels in order, it is said, to maintain their share of the world market, the overall decline in world production will remain modest, keeping prices low well into next year.

The IEA says that the real purpose behind OPEC's decision, led by its primary producer Saudi Arabia, was to squeeze American producers to the point where they would be forced to shut down, and that such a strategy seems to be working:

> The lower price environment is forcing the market to behave as it should, by shutting in output and coaxing demand.
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> On the face of it, the Saudi-led OPEC strategy to defend market share regardless of price appears to be having the intended effect of driving out costly, "inefficient" production.

But because of the resiliency of American oil and natural gas producers, the supply has not fallen nearly as much, or as quickly, as OPEC hoped. With the rig count down by half, production is only now starting to slow. Fracking wells have enjoyed enormous technological advances whereby an existing well's production can be extended greatly with relatively little additional investment. Translation: The marginal cost of lifting one additional barrel of oil from an existing well is significantly below current market prices, and so, despite those lower prices, wells have remained profitable.

And also weighing on the market is that many wells that have been temporarily shut down can be restarted within weeks at relatively modest cost as price rises make them profitable once again. In addition, some producers are continuing to drill wells but capping them temporarily, treating those reserves as "temporary storage" that is less costly than pumping them out only to have them be stored away in tanks on land or tankers at sea.

But it isn't all about oil, oil prices, oil supplies, and demand for oil. It's the overall state of the world economy that is driving the pricing equation, an understanding that made Doug King and his clients in his Merchant Commodity Fund 59 percent returns last year. The Merchant Fund, at King's direction, deals in rubber, cotton, coffee, sugar, fertilizer, and other commodities, which gives him a rare insight into just how the world economy is doing.

And it isn't doing well. King said: "Rubber is a big proxy [for world gross domestic product]. Our rubber deliveries globally, whether in the U.S. or in China, were just lackluster and declining." In early 2014 King began to notice the softening of demand and decided to place massive bets that the price of oil would drop. His well-informed guess might have exceeded his expectations.

Despite the recent three-day rebound in oil prices, King says that nothing has changed his outlook, that the price action all across the commodities markets are now "telling the same tale" they told him in early 2014. And until there is a substantial decline in supply, oil prices will continue to move lower:

> I don't see capacity being taken out of the commodity world today. Until we see some proper supply-side reaction, I don't think you can call the bottom [in oil prices]….
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> My bias is still that the world economy is struggling.

A graduate of an Ivy League school and a former investment advisor, Bob is a regular contributor to The New American *magazine and blogs frequently at www.LightFromTheRight.com, primarily on economics and politics.*