Energy sector seems to be on the rise, so why are share prices low?

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One sector we continue to remain bullish on is the Energy sector, although sometimes it feels like our enthusiasm is to no avail. Indeed, the S&P 500 Energy sector is down 8.2 per cent year to date compared with the 0.1 per cent gain for the overall index.

The story is no different over the past 12 months as the sector continues to lag the performance of the index (minus 7.6 per cent compared with a 11.8 per cent gain for the market). In fact, if one were to go back to the beginning of the decline in oil prices back in mid 2014, the energy sector has declined 32.7 per cent versus a 35.7 per cent gain for the S%P 500 - a whopping 68.4 per cent underperformance. However, we do recognize that making an investment case simply because it has underperformed the broader market is not a sound argument. Let's take a look at the fundamentals.

The cause for the steep decline in the price of oil started with global supply and demand imbalances. From 2013 to 2015, the world went from an excess demand position of nearly one million barrels a day (b/d) to an excess supply position of 1.4 million b/d in response to an oil price that had reached US$100 a barrel. The result of more oil than needed flooding the market was the dramatic collapse in global crude prices - classic Economics 101.

Since then the narrative surrounding oil prices and the energy sector has been constantly shifting between the bulls and bears. The bulls will point to the supply-cut response by the Organization of Petroleum Exporting Countries and Russia that helped bring balance between supply and demand, in addition to an increase in organic demand from an improving global economy. The bears will point to the U.S. shale industry and nimble cost structure that allows for a rapid response to price changes. So which argument is right? Both sides have valid points, but the reality is that the answer is somewhere in the middle.

OPEC and Russia will eventually wind down their supply cut agreement as global stockpiles slowly return to their historical averages amid an improved demand backdrop - indeed, the International Energy Agency is projecting a return to a balanced market in 2018 and 2019. In practice, the Saudis are currently bearing the lion share of these production cuts and have been very vocal in their desire for higher sustained prices. So even though the agreement will expire at the end of 2018, it would be reasonable to expect a more orderly return of supply to the market.

On the flip side, the U.S. shale industry is not going to be able to achieve unlimited growth into the future. Years of supply chain cuts in response to the initial collapse in prices has begun to demonstrate that exploration and production companies are bumping up against capacity constraints. These constraints are materializing through inflationary pressures and potentially diminishing productivity. For instance, EOG Resources Inc., the premium shale oil producer, increased its capital spending guidance by 10 per cent in order to achieve its production expectations and the market responded with a 5 per cent decline in the share price. Investor focus has shifted from an emphasis on capital expenditure and growth spending to capital discipline and distribution to shareholders - this is an important pivot in sentiment.

The final cherry on top may be the return of the futures market to backwardation - meaning the spot price of oil is higher than the price in the future. This is true in both West Texas intermediate and Brent crude, and is indicative of a market in tight supply.

By now we have focused on why we are constructive on the price of oil itself, but what about the stocks? This is the part where we really get bullish on the energy sector. The stocks of exploration and production companies in Canada and the Unites States are priced as if oil itself was as much as US$10 a barrel cheaper than it actually is. In the case of Canada, producers are priced for US$50 a barrel on WTI and about US$55 a barrel in the United States.

Valuations continue to compress (in some cases to financial crisis levels, no less) as some of these stocks have seen their largest monthly price declines in 10 years. Not to mention that we are about to enter the seasonally strongest part of the year as refiners increase oil consumption after their scheduled maintenance shutdowns.

Earnings are expected to grow by 74 percent this year and 11 per cent in 2019. Sure, the comparable may be coming off a low base but where else can you get those kind of growth numbers for a forward P/E ratio of nine? Technology trades at a very similar 18.5 times forward P/E and is only expected to grow 11 percent in 2018 and 2019.

The fundamentals surrounding the price of oil itself appear fine, the profitability of energy producers are fine, management focus is increasingly shifting to capital discipline and return of capital to shareholders and valuations are cheap - someone please tell us why these stocks are showing no response?

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