EQUITY

Taking a Long-Term View on Oil

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Franklin Equity Group's Fred Fromm gives his take on global oil markets amid elevated tensions between the United States and Iran.

After a January 3 US airstrike killed Iranian General Qassem Soleimani, many investors have been asking us about the potential impact of the US-Iran conflict on oil markets. Although many market commentators have suggested that the conflict could lead to regional disruptions in oil production or push oil prices higher, we believe it is important to take a longer-term view.

As long-term investors, we've always had to consider a myriad of geopolitical issues that shift in importance over time. That's why we test a range of outcomes when analyzing oil companies and their securities.

Potential supply disruptions always exist, as we have seen firsthand in Venezuela, Libya and, at times, West Africa. Although the conflict in the Middle East has increased the potential for more significant curtailments of oil supply, we believe it is difficult to predict the timing, severity and longevity of such outcomes.

Likewise, we have found it challenging to forecast the direction of oil prices based on geopolitical events, which are ever-present. Recent examples include not only Iran's regional influence and interplay with the United States that manifests in various proxy wars and oil tanker ship attacks, but Russia's growing influence in the Middle East and increased coordination with the Organization of Petroleum Exporting Countries.

Ultimately, commodity prices are a function of supply and demand dynamics. With steady, slow-growth commodities such as oil, the marginal cost of supply serves an important role in informing our analysis.

According to our analysis, the Iran situation (or any supply disruption in the Middle East) will have a larger impact on Brent crude oil (the global benchmark), and influence West Texas Intermediate oil prices (the North American benchmark) to a lesser extent. However, the United States recently achieved record exports of oil, which may make US oil grades more susceptible to geopolitical events.

At the least, recent events should re-establish a risk premium in the price of oil, which was conspicuously absent throughout 2019 despite an increasingly volatile mix of Middle East developments. For many producers, even a small increase in the price of oil can have a significant impact on their cash flow generation.

In addition, we believe supply and demand factors need to be considered simultaneously along with equity valuations and what they imply about investors' prevailing views. During periods of heightened uncertainty, we have found any resulting equity market weakness can create investment opportunities in high-quality companies. In our view, these companies should prove to be more resilient if a more severe downturn unfolds, while still offering compelling upside potential in a recovery.

We found several such opportunities in late summer and early fall of last year, when select energy companies had sold off in response to tariff concerns and signs of slowing economic growth. They've partially recovered since then, but we think they still hold significant upside potential. Some of the companies now represent top-10 positions in our natural resources portfolios.[1]

Investment Implications

Energy stocks remain compelling in our view, as low index weightings (compared to other equity sectors), heightened uncertainty in global energy markets and three years of general underperformance led investors away from the sector. The energy sector's overall share of the S&P 500 Index was nearly 4% at the end of 2019—the lowest it has been in decades.[2] This historically light presence exists at a time when reduced spending, cost-cutting, efficiency gains by energy firms, along with rising oil prices, have created an attractive investment proposition, according to our analysis.

In other indexes commonly used for performance comparisons by growth-oriented funds, the energy sector's weightings are even smaller. The combination of reasonable equity valuations, growing cash flow and limited ownership may turn out to be a very powerful combination propelling energy stocks in 2020.

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Franklin Natural Resources Fund

All investments involve risks, including possible loss of principal. Investing in a fund concentrating in the natural resources sector involves special risks, including increased susceptibility to adverse economic and regulatory developments affecting the sector. Growth stock prices may fall dramatically if the company fails to meet projections of earnings or revenue; their prices may be more volatile than other securities, particularly over the short term. Smaller companies can be particularly sensitive to changes in economic conditions and have less certain growth prospects than larger, more established companies and can be volatile, especially over the short term. The fund may also invest in foreign companies, which involve special risks, including currency fluctuations and political uncertainty. These and other risks are described more fully in the fund's prospectus.

Investors should carefully consider a fund's investment goals, risks, sales charges and expenses before investing. Download a prospectus, which contains this and other information. Please carefully read a prospectus before you invest or send money.

1. As of December 31, 2019, shares of Concho Resources represented 4.08% of total net assets of Franklin Natural Resources Fund, Schlumberger (3.74%), EOG Resources (3.65%), Diamondback Energy (3.63%), ConocoPhillips (3.19%), Noble Energy (3.17%), Occidental Petroleum (3.1%), Pioneer Natural Resources (3.08%), Suncor Energy (2.73%) and Baker Hughes (2.62%). *Holdings subject to change.*

2. Source: S&P Dow Jones Indices. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses and sales charges. Past performance is not an indicator or guarantee of future performance. See www.franklintempletondatasources.com for additional data provider information.