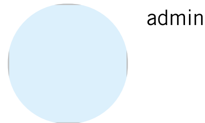
EQUITY

Is the Energy Sector Starting to Turn?

November 30, 2017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Recalling the shocks of the sharp oil-price downturn back in 2014-2015, many investors have remained wary of energy stocks even as prices began to rebound this year. Here, Franklin Equity Group's Fred Fromm, vice president and portfolio manager, Franklin Natural Resources Fund, says they shouldn't be. Short-term volatility aside, he digs deeper into industry fundamentals that he thinks make for an attractive longer-term investment case for oilfield services stocks.

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Global oil prices rose to two-year highs in early November of this year after booking monthly gains in September and October. Oil prices have benefited from strong demand growth in many parts of the world—emerging markets in particular—and output restraint that has tightened supply-and-demand fundamentals.

Despite the recent oil-price rally, many investors have remained reluctant to buy energy stocks, as evidenced by the sector's general underperformance this year.[1] Oilfield services stocks have been particularly weak.

Why Investors Are Reluctant to Buy Energy Stocks

Many investors remain wary of energy stocks following a three-year slump in oil prices. Prices began to fall in 2014 when global supply started to rapidly outpace demand, largely due to the US shale oil revolution. By 2016, benchmark West Texas Intermediate (WTI) and Brent oil prices fell below $30 a barrel, leading many companies to either go bankrupt or slash exploration and production spending.

An initial decline in US production combined with coordinated supply cuts by major suppliers in the Organization of Petroleum Exporting Countries (OPEC) and partners have helped bring oil back up to $50-$60 a barrel this year. However, prices are still far below the $100+ peak we saw four years ago.

Given the current lower-price environment, market volatility and future uncertainty, many investors have perceived oilfield services stocks as too risky. That, in turn, has led to more attractive valuations for these stocks that we believe could be creating attractive investment opportunities.

In our view, there is a common misconception that energy stocks require higher oil prices to realize upside potential. We have found that it's price stability that can provide a fertile environment for growth-oriented companies to thrive. Also, spending by producers is largely a function of their cash flow, which can benefit from declining costs and efficiency gains.

Of course, producers would benefit from a rise in prices, but it is not a necessary ingredient. In particular, we see many oil-and-gas exploration and production firms today have ample opportunities for growth at historically low levels of risk given the factory model that is being followed to develop unconventional resources.

It seems to us many investors are cautious about energy stocks for other reasons too. Some believe increased US oil production will cause prices and spending to weaken, despite multiple reports that have suggested otherwise. And, in fact, the only way production is likely to continue growing is through increased spending and drilling activity, which will benefit service companies.

We do see production growing at a quicker pace over the coming quarters, but we do not think it will be overly problematic for oil-market fundamentals and, at some point, will be required to offset the natural decline in rates elsewhere in the world. Based on our analysis, we think a higher level of spending will be required to maintain market balance over the long term.

Many investors also question when widespread electric vehicle (EV) adoption will likely curb the demand for oil. Although we do not dismiss the risk posed by EVs, most rational expectations do not call for a meaningful impact until perhaps the middle of the next decade.

Even then, we believe the impact to oil demand from EV adoption will likely be much smaller than high-level assumptions have suggested. We have seen that even the most pro-EV advocates see growth in sales of gas-powered cars in coming decades.

In the near term, we believe oil prices should continue to benefit from output restraint that has tightened supply-and-demand fundamentals.

Outlook for Oilfield Services Stocks

We believe the oilfield services industry has suffered from investor intransigence. In our view, soft US production trends, declining inventories and rising oil prices should have been seen as supportive of future spending patterns.

For the reasons above, we see opportunities in select oilfield services stocks. The estimates of future revenue and earnings for these stocks have been reduced as analysts perceived that this year's sharp increase in activity simply pulled spending forward.

In our view, estimates now appear not only reasonable, but possibly overly conservative as well. For many companies, 2018 estimates can be reached by annualizing expected fourth-quarter results. This signals that estimates can be achieved with flat activity levels. We think this is an unlikely outcome with oil prices at two-year highs.

We believe valuations appear attractive based on these more conservative estimates. That could lead to renewed upside for oilfield services shares as expectations recalibrate.

Oilfield service stocks with high levels of exposure to the US onshore market, such as Halliburton, are particularly attractive to us.[2] We also see several smaller companies experiencing rapid growth in the strongest market—pressure pumping or hydraulic fracturing in the Permian Basin of Texas.

However, we also believe spending will broaden in other markets over the next year. In our view, this spending may favor companies providing other services in the US and those that have been out of favor due to exposure to offshore and non-US markets, such as TechnipFMC and Schlumberger.[3]

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What Are the Risks?

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. 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.

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1. Source: Bloomberg LP. Data from January 2017 to November 2017. See www.franklintempletondatasources.com for additional data provider information.

2. As of October 31, 2017, Halliburton common stock represented 3.43% of total net assets of Franklin Natural Resources Fund. Holdings are subject to change.

3. As of October 31, 2017, TechnipFMC and Schlumberger represented 2.03% and 4.20% of total net assets of Franklin Natural Resources Fund. Holdings are subject to change.

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