

## Current Outlook for Energy Stocks

### August 2022

Ever since oil prices traded down to the high twenty dollars per barrel level many years ago, global producers have made a conscious effort industry wide to be much more disciplined than in the past. Their new focus was not on increasing production, but on using their free cash flow to buy back their own stock, pay off their long-term debts and to increase dividends. By keeping global supply from rising, this eventually led to a shortage causing crude prices to shoot up sharply. In turn this has led to the generation of very strong operating and free cash flows that we see today.

At the same time all this was happening, there has been a global push away from fossil fuels into cleaner, renewable energy. Contrary to what many Canadians believe, the rise in energy prices was not caused principally by domestic politicians, but by pressure exerted on all global governments to stop the fast progression of global warming to save our planet.

The use of solar, wind, geothermal, hydro and nuclear is a long-term trend that is not going to be stopped by recent events. While it is very unfortunate that these alternative generators of electricity have not been able to replace the use of fossil fuels at this time, this trend to renewables is going to continue at a rapid rate. It is now obvious to everyone that this transition to renewable energy will take a lot longer than originally thought. As a society we all must strike a balance so that future shortages of any sources of energy are kept to a minimum. Currently we are clearly not there yet.

The switch to electric vehicles slowed sharply as a result of the semiconductor shortage. Hopefully in the second half of this year the shortage appears to be gradually improving.

Going back to the oil market specifically, the physical market is performing in a totally different manner than the financial market. As we all are aware, financial markets already appear to be pricing in a global economic slowdown. Global supplies remain very tight. Although drilling rigs and US shale production have been rising steadily recently, there is not a lot of extra capacity that can be added at this time. OPEC is meeting this week and has already indicated that incremental capacity is limited. A much smaller than expected increase in production of 100,000 barrels per day was announced, but that will not be sufficient to change the short supply situation. The Russian/ Ukraine war continues to cause shortages in natural gas supplies throughout Europe. The EU leaders have recently advised consumers to reduce their usage of electricity by adjusting their thermostats both in winter and summer. Higher energy prices in Europe are having much more of a negative effect on their economy than in North America.

Should the Russian / Ukraine war end tomorrow, it is likely that energy commodity prices would fall on a short-term basis. However, no one really knows when this is going to happen and in the interim chronic energy shortages persist.

Eventually the lockdowns in China will gradually end over the next six months. This is expected to increase demand for energy once this happens.

## **Possible Solutions to Current Shortages**

Increasing the usage of nuclear energy is one of the simplest remedies that should be implemented immediately. Even in Japan, that has never forgotten their nuclear disasters over the years, has come to realize that nuclear power is a viable solution to the global energy shortage. In addition, it is normally a much cleaner type of energy than oil or coal. The European utilities are seeking alternative, politically more stable energy sources than Russia. These utilities have become much more comfortable with using nuclear power than they have in the past. While it takes a long time to build new nuclear reactors, there are many globally that are still operating at a limited capacity. These ones can be reconfigured for safety relatively quickly.

Natural gas is a much cleaner hydrocarbon than crude oil. We all know how difficult it is obtaining regulatory permits for new pipelines. By liquifying natural gas in newly built LNG plants, this will enable a lot of the currently shut- in gas in North America, to be transported to foreign markets where they will be used to improve the global supply of energy sources. Unfortunately, this takes time for these plants to be built and is not a short- term solution. Historically, natural gas demand is more locally based as opposed to crude oil that is more global. These LNG plants will enable natural gas to eventually be used as a global commodity.

Although a much dirtier source of energy, demand for thermal coal to generate electricity has been sharply rising in many parts of the world and has replaced the usage of natural gas with the recent sharp rise in gas prices in Europe. In my opinion, the use of coal is only a short- term solution as it does not meet the world's long term environmental standards.

## **Factors to Consider**

Before anyone invests in Energy stocks it is important to review the following list of factors.

- The political / environmental issues remain entrenched globally.
- Assessment of Global economy – We all know that the world is in the midst of an economic slowdown. Some refuse to call it a recession yet, but it clearly is.
- The Russian / Ukraine War – How long will it last and how will sanctions continue to affect energy prices?
- China lockdowns – When will they end and how much damage has been done to the industrial sector?

Renewable Energy market and the electrification of vehicles in particular- When will the semiconductor shortage stop affecting supplies and when will electric vehicles really start to replace vehicles powered by gasoline?

## **Recommendation**

Globally we are most definitely in a major energy crisis where supply cannot possibly keep up with demand.

However, should we end up having a more severe economic downtrend that will reduce demand, energy prices may fall during this time. We must still always keep in mind that commodity stocks are highly volatile. Predicated on a weakening Chinese economy as a result of Covid lockdowns, a global economic downturn and a strong US dollar, the price of WTI has fallen from a recent high of \$125 US per barrel to the current level of \$89 per barrel. This represents a drop of 28%. Domestic producers have fallen from their 52- week highs anywhere from a drop of 24% to a drop of over 30% for the smaller companies. This week there was a much higher than forecasted inventory build in the US. causing both the commodity price and the share prices of producers to fall.

Despite all of these cross currents which make everyone dizzy, the short- term supply / demand outlook remains strong. As a result of the ongoing supply shortages, I recommend that investors maintain an overweight in this sector relative to global benchmarks and have exposure to crude oil, natural gas and uranium producers, royalty companies in addition to energy infrastructure pipelines.

*Please see our [disclaimer](#) at [mcmurtryinvestmentreport.ca](http://mcmurtryinvestmentreport.ca).*

*[Copyright](#) © McMurtry Investment Report™. All rights reserved.*

[mcmurtryinvestmentreport.ca](http://mcmurtryinvestmentreport.ca)

*Strategies for do-it-yourself investors™*