EQUITY STRATEGY INSIGHTS

Energy Sector Offers a Combination of Solid Fundamentals and Favorable Technicals

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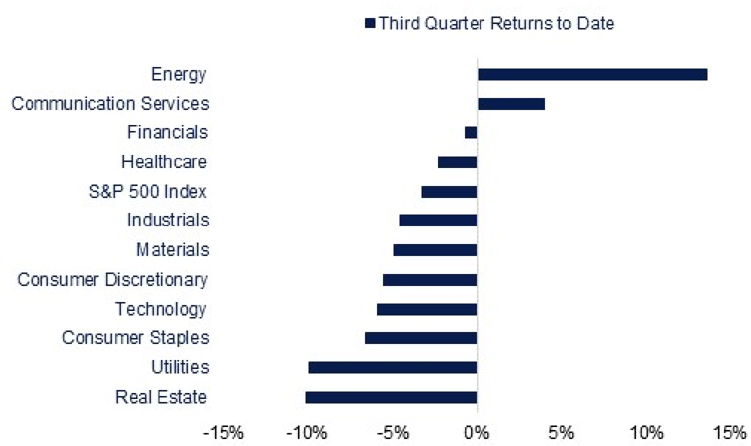
EXECUTIVE SUMMARY

- The energy sector has made an impressive comeback to lead all sectors in Q3 returns. Energy stocks have gotten a boost from oil prices, which is more of a supply story than one of demand.
- LPL Research believes the energy sector continues to offer an attractive risk-reward trade-off, bolstered by supportive commodity prices, attractive valuations, generous dividend yields and a seemingly unified group of shareholder friendly companies.
- Risks include softening global growth, a strong U.S. dollar, and the clean energy movement.

The energy sector has made an impressive comeback and will end up as the top performer for the third quarter after underperforming during the first half of the year. As of September 27, the sector has returned 13.6% quarter to date, followed by the communication services sector in second place at 4%, while the S&P 500 is down 3.2% (**Figure 1**). Investors have clearly responded to the latest rally in oil prices, with some help from natural gas, while also recognizing the sector still has value at current prices. Perhaps less obvious, there are several sector narratives that we believe make the sector more investable and position energy stocks for attractive returns over the next year or so, and potentially beyond.

1 Energy Sector Sits Atop Third Quarter Sector Rankings



Source: LPL Research, Bloomberg data as of 09/27/23
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Tighter Supply Driving Oil Prices Higher, Despite Tepid Demand

Any assessment of the attractiveness of the energy sector has to start with oil. ESG-related production curbs were a big story last year, while OPEC+ curbing supply and U.S. producers' increasing discipline with regard to production (profitable production, not production at any cost) have perhaps been the biggest stories for oil this year. The Saudis wanted oil in the $90-$100 range and they got it there. In our mind, that makes the oil price outlook more about supply than demand.

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In the near-term, Saudi led production cuts have done the work to keep the supply and demand dynamic tight and supportive of higher prices. Domestically, US crude inventories at the Cushing, OK hub (key determinant in WTI oil futures contracts) have drawn down for seven straight weeks and are at the lowest levels since July 2022. This domestic supply dynamic has driven WTI futures market into backwardation (more on that later), implying a tight market and a near-term need for supply. Moreover, oil rig counts are down 19% since peaking late last year, to levels last seen in February 2022. This all implies a tight market that is constructive for oil prices in the near term.

On the demand side, the picture has firmed some in the U.S. this year as the domestic economy has strongly outpaced expectations (leisure travel surge, positive economic surprises, Atlanta Fed GDP tracking over 4% for the third quarter, and recession probably pushed out to 2024). But at the same time, a lackluster reopening in China, slowing growth in Europe where recession risk in late-2023 is high, and an overall slow global growth outlook for 2024 (Bloomberg consensus forecast is +2.6%, down from an estimated 2.7% this year), will all keep demand generally in check in the year ahead.

In essence, we would expect upside to oil prices to come from an upside economic surprise in global growth (oil demand), additional unanticipated OPEC+ supply cuts, or unanticipated supply disruptions. In terms of downside risk, we have seen OPEC+ (i.e., Saudi Arabia) reassert its influence on the market to provide a floor on prices. But oil doesn’t have to go much higher, in our view, for the sector to move higher and continue to outperform the S&P 500 for the rest of the year.

Technicals Have Turned Bullish

The next major area of overhead resistance for WTI sets up near the $94 to $97 range, which traces back to the August-November 2022 highs.

In the commodity space, West Texas Intermediate (WTI) oil has broken out from nearly a year-long bottom formation after clearing key resistance at $83.25. Momentum is confirming the breakout, including a recent bullish crossover between the 50- and 200-day moving averages (dma) and a Moving Average Convergence/Divergence (MACD) indicator buy signal. In terms of upside, the next major area of overhead resistance for WTI sets up near the $94 to $97 range, which traces back to the August-November 2022 highs and a key Fibonacci retracement level of last year’s bear market in oil.

Tightening oil market conditions have also shown up on the futures curve. WTI time spreads between front-month and second-month futures contracts have been climbing higher in positive territory (technically switching from contango to backwardation in July), pointing to an uptick in near-term demand for oil.

Natural gas also continues to make technical progress after finding support near $2.00 back in January. Since then, short positions have been covering as prices advance within a rising price channel. The next major resistance hurdles for natural gas to clear set up at $2.84 (declining 200-dma) and $3.00.

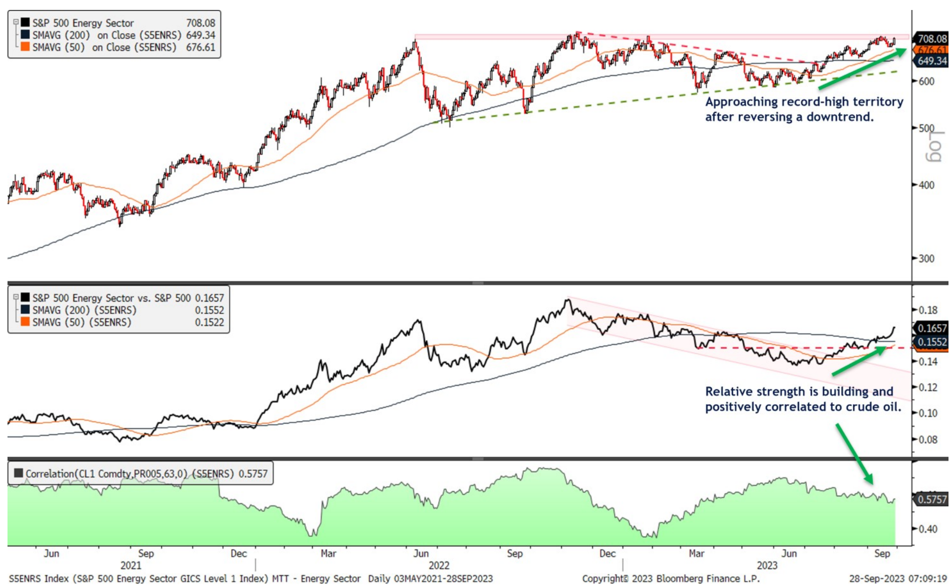
Turning to equities, after an impressive 59% rally last year, the energy sector took a bit of a breather during the first half of 2023. However, with oil and natural gas prices climbing out of major bottoms, from a technical analysis perspective, the consolidation phase for the sector appears to be over.

The energy sector is approaching record-high territory after reversing a downtrend back in July. Bullish momentum and widespread buying pressure are confirming the reversal. Over 90% of energy sector stocks are trading above their 200-dmas), marking the highest reading among sector peers.

Overall, the technical evidence of bullish momentum, broad participation, and building relative strength suggests the path of least resistance remains higher.

Relative strength is also improving. The S&P 500 Energy Sector vs. S&P 500 ratio chart has broken out from a declining price channel. Consistent higher highs and higher lows and the recent recapture of the 50- and 200-dmas imply a new uptrend of energy outperformance likely lies ahead. As shown in the bottom panel in **Figure 2** below, the ratio chart between the energy sector and S&P 500 is positively correlated to the price of crude oil, which has also entered a new uptrend. Overall, the technical evidence of bullish momentum, broad participation, and building relative strength suggests the path of least resistance remains higher.

2 Energy Sector Approaching Record Territory As Relative Strength Improves



Source: LPL

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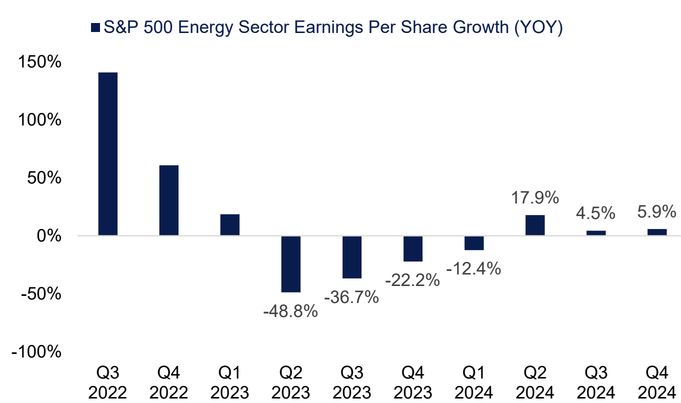
We expect earnings growth to potentially return to the sector in the second quarter of 2024, but Q1 is a possibility.

Earnings on the Mend

A casual observer might look at the sharp earnings decline for energy last quarter and steer clear of the sector. Earnings for the S&P 500 Energy sector fell nearly 50% year over year during the second quarter and are expected to drop another 37% in the third quarter (**Figure 3**). We think that would be a mistake for several reasons. First, when pessimism is extreme and fundamentals start to improve coming off a trough, it is typically a good time to invest in

3 Energy Earnings Growth Likely To Trough In Early 2024



Source: LPL Research, FactSet, as of 09/28/23
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Estimates may not develop as predicted and are subject to change.

the sector. Now that the anniversary of the oil price peak in spring 2022 when Russia invaded Ukraine has passed, the earnings declines are going to get smaller over the next several quarters. We expect earnings growth to potentially return to the sector in the second quarter of 2024, but Q1 is a possibility. Regardless, investors

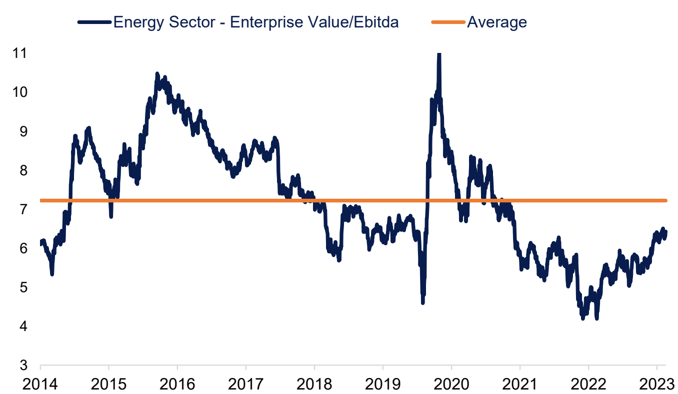
The sector is also starting to see positive earnings revisions, a trend we expect to continue. We believe analysts' estimates for 2024 for the sector calling for just 3% earnings growth over 2023 are too low, setting up more positive revisions in the future. Over the past month, the sector has seen the second strongest 2023 and 2024 earnings revisions among all sectors—a good sign as earnings season approaches.

Valuations Remain Attractive Despite Recent Strength

As profits improve and allow for more dividends, share buybacks, and debt reduction, we would expect sector valuations to adjust higher.

Despite a strong third quarter rally, the sector still looks attractively valued and we do not believe the higher floor for oil prices and increasingly shareholder friendly producers are being fully appreciated by the markets. As profits improve and allow for more dividends, share buybacks, and debt reduction, we would expect sector valuations to adjust higher. **Figure 4** illustrates energy sector valuation on an enterprise value to EBITDA basis (earnings before interest, taxes, and depreciation). This measure adjusts for the capital intensive nature of the sector to provide a better valuation assessment. You can see that despite depressed earnings currently, and the sector's strong recent advance, valuations remain comfortably below recent averages.

4 Energy Sector Valuations Remain Attractive



Source: LPL Research, Bloomberg, as of 09/28/23
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If earnings and cash flow estimates are too low, as we suspect they are based on producers' increased efficiency and higher energy prices, then already low valuations may be cheaper than they appear. Add on a 3.6% dividend yield, more than double that of the S&P 500, and it looks like a formula for solid returns.

Deeper Dive Into Reformed Industry

Getting constructive on the energy sector requires a positive outlook for the commodities, given that the sector's returns have a high correlation to oil prices (correlation over last 30 years > 0.5). We see a lot to like with the sector's fundamentals as well. Focusing on the Oil & Gas Exploration & Production sub-industry (E&P's), we have seen the companies shift strategy toward creating value for shareholders, via improved capital efficiency and returning excess capital to shareholders, and away from growth at any cost to capture market share.

We have seen E&P companies shift strategy toward creating value for shareholders, via improved capital efficiency and returning excess capital to shareholders, and away from growth at any cost to capture market share.

There are various explanations for what has driven the change in mindset; from the existential (capital has fled the sector due to ESG investment mandates), to new shareholder friendly management teams coming in after the bust in the mid-2010s. We are less concerned with the narrative. We saw the headlines last year (prominent examples here and here) claiming the wildcatters are no longer profligate, that they have a new-found appreciation for creating shareholder value rather than destroying it. Investors have certainly bought into the shift based on U.S. energy stock performance over the last 10 years (**Figure 5**).

5 Investors Have Bought Into New Energy Company Mindset

Source: LPL Research, Bloomberg 09/28/23
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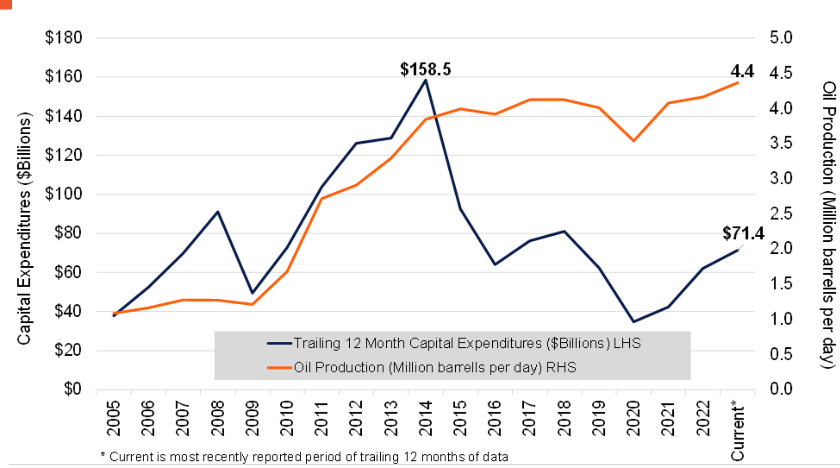
The narrative has been in place for a few years now, and we have experienced steadily rising oil prices coming out of the pandemic, including the March 2022 spike due to the Russian invasion of Ukraine, despite the pullbacks in the commodity witnessed earlier this year. This means we now have data to analyze whether energy producers are “walking the walk” after “talking the talk”.

Annual energy sector capex has fallen 55% from peak levels in 2014 to current levels, on a trailing 12 months basis.

The first place to look for confirmation of the behavioral shift among E&Ps is annual capital expenditure (capex) trends. In our analysis, we isolate the Oil & Gas Exploration and Production sub-industry of the Russell 3000 index to serve as our proxy for U.S. based producers. Excluding large integrated oil and gas companies, such as Exxon (XOM) and Chevron (CVX), ensures we are analyzing companies whose sole business is that of extracting oil & gas from the earth, primarily in the U.S. In **Figure 6** we see that annual capex has fallen 55% from peak levels in 2014 to current levels, on a trailing 12 months basis.

6 Energy Capex Has Fallen Precipitously Since the Mid-2010s



Source: LPL Research, Bloomberg 09/27/23
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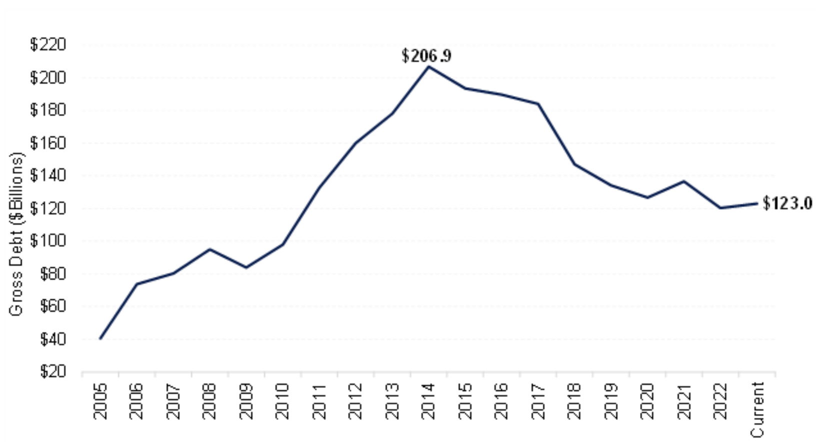
We note that we have seen spending react to rising oil prices in recent years, as one would expect; however the incremental spend has not matched the price reaction seen during the prior up-cycle (oils bottom in 2009 through the peak in 2014). One could argue E&Ps will relapse to their old ways if oil prices hold above $90 for four years as they did years as they did at the beginning of the 2010s, which is valid. Yet company guidance and analysts' estimates for 2024 capex is flat to down year over year. We will continue to monitor company results for any signs of producer profligacy.

Commentary from company management teams during second quarter 2023 earnings season suggested that E&Ps can deliver on their projected muted but still positive oil production growth in 2024 at lower costs.

The other metric we compare capex trends to is overall oil production, the orange line in Figure 6. Innovation in drilling and completion technology has created efficiencies in the production of oil and gas, as shown by the sustained oil production levels by domestic E&Ps despite the reductions in capex. Commentary from company management teams during second quarter 2023 earnings season suggested that E&Ps can deliver on their projected oil production growth (albeit muted) in 2024 at lower costs, highlighting continued improvement in production efficiency, as well as deflationary pressures in service costs. On the service cost side of the equation, we note that during 2Q 2023 earnings calls management teams specifically referred to North American service costs coming down in 2024. E&Ps that have rigs and crews on term contracts that are expiring soon were especially vocal on cost deflation, as they will be able to re-hire in the softer (i.e., cheaper) spot market. On this note, we favor diversified, internationally exposed companies on the oil services side of the sector due to the weakening activity and pricing the pure play domestic providers face.

We have seen that energy producers have reduced capex while sustaining production levels. So, what have they done with the excess cash flow? For one thing, E&Ps have taken steps to clean up their balance sheets, i.e., reducing debt levels (**Figure 7**). Debt levels have come down over 40% since the peak in 2014.

7 Exploration & Production Companies Have Paid Down a Lot of Debt



Source: LPL Research, Bloomberg 09/15/23
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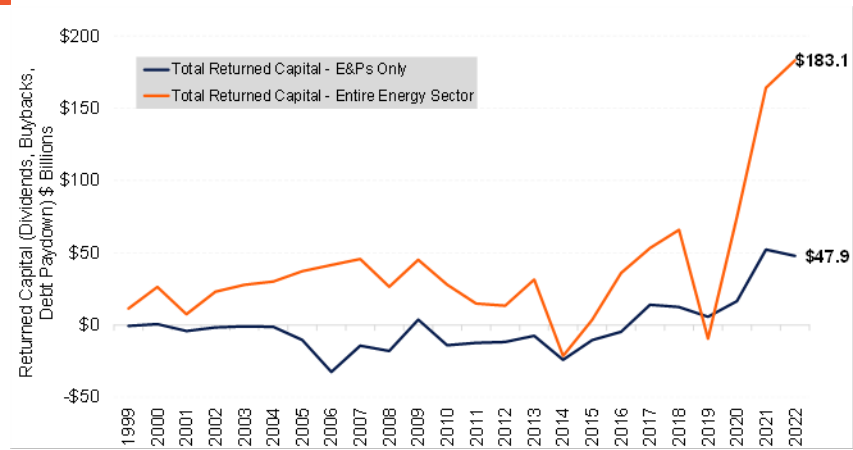
Returned capital among the E&Ps is as high as it has ever been.

Even with more manageable debt levels, companies have remained committed to not overspending to grow production and take market share, and instead have rewarded shareholders with increased dividends, variable dividend policies (where a company commits to paying out a certain percentage of free cash flow via a special, incremental dividend), and increased share buyback authorizations. We can see in **Figure 8** that returned capital among the E&Ps is as high as it has ever been. Add in the rest of the sector, and the capital returned to shareholders by energy companies in the last three years exceeds the total amount returned in the prior 15 years.

8 Energy Companies Returning Record Capital to Shareholders



Source: LPL Research, Bloomberg 09/27/23
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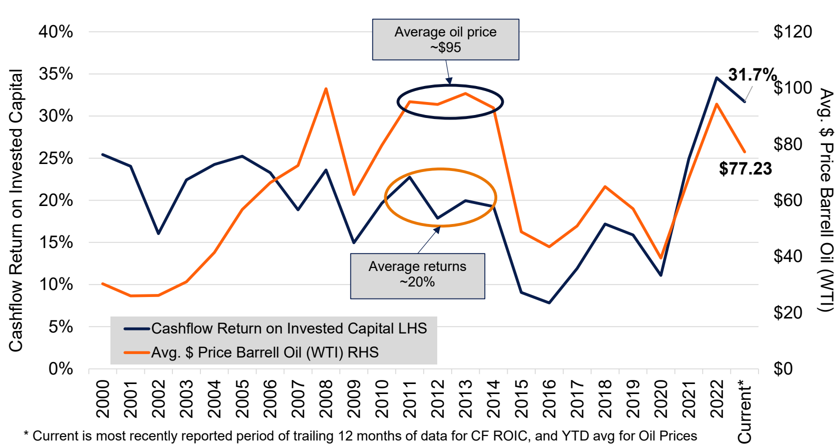
There is an additional positive impact these shareholder friendly policies create, at least in the near to medium term; they increase the marginal cost to produce a barrel of oil, which ultimately dis-incentivizes increasing production at value destroying oil prices. While improvements in drilling efficiency have reduced costs and improved capex yields relative to the early 2010's, once you add in corporate level costs of increased dividend payouts and share buybacks, as well as increases in the cost of equity given corners of the capital markets are closed to energy producers, you are left with few producers who are willing to increase production at oil prices below $75-80/bbl.

Cash flow returns on invested capital have broken above levels seen in the last 20 years.

Finally, we analyzed returns metrics to validate that the strategy of not overspending and returning excess cash flow to shareholders is indeed the most productive use of capital by the E&Ps. In **Figure 9** we see that cash flow returns on invested capital have also broken above levels seen in the last 20 years. What is compelling in this chart is the fact that even when oil prices averaged more than $90 for about four years, cash flow returns on invested capital averaged just 20%, compared to the 30% average E&Ps have put up in since 2021, in a slightly weaker oil price environment.

9 Improved Cash Flow Returns on Investment



* Current is most recently reported period of trailing 12 months of data for CF ROIC, and YTD avg for Oil Prices

Source: LPL Research, Bloomberg 09/28/23
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While we do not possess a crystal ball to tell us whether oil market participants from West Texas to Saudi Arabia will remain disciplined to keep the market at current tight supply levels, or what may ultimately happen with oil demand in the coming years, we do see that right now the market is giving E&Ps an attractive oil price to generate returns for shareholders.

Risks to Bullish View

We recognize there are risks to our bullish energy sector outlook. First, the aforementioned lackluster growth in Europe and China may pressure demand, particularly if U.S. demand falls in coming months as the U.S. economy likely slows from its current solid pace of growth. A mild, short-lived recession in the U.S. in early 2024 remains a very real possibility, which is not currently priced into the energy markets.

The strong U.S. dollar is another risk to consider. Historically, the U.S. dollar and oil prices have been inversely correlated. However, since mid-July, oil prices and the dollar have been moving higher together. It’s hard to say how much longer that can continue, though we do expect the impending end of the Federal Reserve’s rate hiking campaign, and potentially cuts starting in 2024, to eventually put downward pressure on the dollar.

The clean energy movement is a risk to the oil producers and service companies that make up the sector, but we see that risk as well beyond the time horizon for most investors.

The clean energy movement is a risk to the oil producers and service companies that make up the sector, but we see that risk as well beyond the time horizon for most investors. New EV sales are expected to reach 18% of total car sales in 2023, based on the latest IEA projections, up from 14% in 2022. However, keep in mind there are only about 26 million EVs on the road today, compared to more than 1.4 billion total cars on the road. In other words, this headwind won’t slow oil demand in any meaningful way any time soon.

Conclusion

Bottom line, we believe the energy sector continues to offer an attractive risk-reward trade-off. For those investors who are concentrated in the mega-cap growth corners of the U.S. equity market, this could be a good time to consider re-allocating your sector positioning to the energy sector. Supportive commodity prices, attractive valuations and returns, generous dividend yields and a seemingly unified group of shareholder friendly companies make the sector an attractive investment currently in our view.

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This material is for general information only and is not intended to provide specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors or will yield positive outcomes. Investing involves risks including possible loss of principal. Any economic forecasts set forth may not develop as predicted and are subject to change.

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The fast price swings in commodities will result in significant volatility in an investor's holdings. Commodities include increased risks, such as political, economic, and currency instability, and may not be suitable for all investors.

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Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet and Bloomberg.

This research material has been prepared by LPL Financial LLC.

For a list of descriptions of the indexes and economic terms referenced in this publication, please visit our website at lplresearch.com/definitions.