
Weekly Global Market Commentary

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Energy Stocks for Income and Growth

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Energy stocks have lagged behind this year's upward-trending equity markets. Year-to-date, the MSCI World Energy Sector Index has returned just 8.25% including dividends, compared to the broader MSCI Index's total return of 18.09% as of September 23. In recent months, the energy sector has followed oil prices downward, with the spot price of West Texas Intermediate (WTI) crude dropping more than 20%, from \$87 per barrel in April to a low of \$66 earlier this month.

Despite efforts by the OPEC+ cartel to stabilize prices by reducing output, oil and gas prices have declined in recent months due to concerns over excess supply and weakening demand. China, one of the world's largest energy consumers, is grappling with a troubled real estate sector and slowing economic growth. Meanwhile, in the U.S. and Europe, fuel consumption is decreasing as a result of higher domestic production, improved energy efficiency, and shifts toward alternative energy sources. Seasonally, fuel demand has also declined with the end of the summer driving season.

While lower energy prices may be impacting the profitability of exploration and production for major oil companies, the relatively flat performance of energy stocks combined with rising dividends has led to higher dividend yields. The current dividend yield on the iShares Energy Select ETF (XLE) stands at 3.28%, more than double the S&P 500's yield of 1.23%.

Energy stocks are also trading at attractive valuations. The S&P Energy Index is priced at just 13.9 times next year's earnings, compared to a multiple of 23.9 for the broader market. Historically, the energy subsector has traded at a median price-to-earnings ratio of 19.1 times over the past decade. Major integrated energy companies like ExxonMobil, currently trading at around half the market multiple, have often traded in line with the broader market.

While global demand for fossil fuels may have softened at the margin, supply-demand dynamics in the energy sector are delicate and can shift rapidly due to various factors. Last week, the Federal Reserve cut interest rates by half a percentage point and signaled more cuts ahead, which could spark a resurgence in U.S. economic growth and strengthen energy demand. Internationally, India has been steadily overtaking China as the most critical developing economy and marginal energy consumer, reducing the impact of China's economic slowdown on global energy markets.

A significant strategic shift for many energy companies has been a focus on returning capital to shareholders through dividends and share buybacks. Unlike previous cycles, the majors have committed to disciplined capital management, including reducing debt and avoiding riskier projects. Increased regulation from the U.S. government has also led to a more conservative approach to new projects.

According to Bloomberg, ExxonMobil, Chevron, Shell, TotalEnergies, and BP spent a record \$113.8 billion on dividends and share repurchases in 2023, despite lower crude prices. This represents a more than 10% increase from 2022, a year marked by the global energy market upheaval following Russia's invasion of Ukraine. Notably, the 2023 cash return to shareholders was 76% higher than the average payout during the industry's peak in 2011-2014, when oil prices topped \$100 per barrel.

Some of the leading players in the industry currently offer robust dividend yields, including Chevron (4.4%), ExxonMobil (3.2%), ConocoPhillips (2.8%), and Shell (3.9%). Energy stock dividends are strong and expected to continue growing. The iShares Energy Select ETF (XLE) has posted an annual dividend growth rate of 6.43% over the past five years, with an even more impressive 11.26% annual growth over the past three years.

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A key source of growth for the energy majors has been increased investment in the highly productive Permian Basin. In late 2023, ExxonMobil acquired Pioneer Natural Resources for \$59.5 billion, and Chevron purchased Hess Corporation for \$53 billion. These acquisitions reflect a strategic focus on increasing low-cost oil and gas production, positioning these companies for long-term profitability.

While some economists predict that peak oil demand could arrive within five years, others believe fossil fuels will remain in high demand for decades, particularly in emerging economies that will continue to rely on conventional fuels. Additionally, the push towards vehicle electrification has faced some resistance, further extending the lifespan of fossil fuel demand.

Commodities, including oil, are well-positioned to benefit from the ongoing devaluation of fiat currencies as governments continue to run large budget deficits. These deficits are likely to be monetized, leading to inflation and currency erosion over time. Gold, for example, has surged 27% this year in U.S. dollars, reaching new highs. For this and a variety of other reasons, investing in “black gold” has a place in most diversified portfolios.