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Americas CIO View

Oil near normal, Energy profits still below, but limited upside

Oil is back to its average historic price when adjusted for USD FX rates and inflation

The surge in oil prices in 2004-2008 was exacerbated by falling USD foreign exchange (FX) rates. Similarly the 2014-2016 plunge in oil prices was aggravated by U.S. dollar strength. Inside, we present a history of oil prices adjusted for both inflation and broad-based USD FX variation. After such inflation and USD FX rate adjustments, the average price of oil since 1973 is $64/barrel (bbl). The West Texas Intermediate (WTI) oil price has recovered from its 2015-16 slump and averaged $63/(bbl) during 1Q18. Right now, the spot price is above its historic average on our inflation and USD adjusted basis. We expect the dollar to appreciate 3-5% from now as the Fed continues to hike over the coming year. We also think broad based inflation will stay tame. So we see some dollar headwind and only a small broad inflation boost to oil prices, which should leave prices driven by fundamentals. We think the ability of global supply to meet global demand over intermediate and longer-term periods is ample and we think geopolitical supply-side disruptions are unlikely to be large.

S&P Energy is earning close to normal mid-cycle profits with WTI back to ~$65

Our 2018 whole year S&P 500 Energy sector earnings estimate is $69bn based on a $60-65/bbl average WTI oil price assumption. S&P 500 Energy companies made $15.2bn net profits in 1Q18 on an average $63/bbl WTI, which is ~$61bn annualized profits. As oil prices recovered to essentially normal in 1Q18, we think Energy earnings are not substantially depressed any more. A little, but no longer a lot depressed. There is probably some further operating leverage left at Energy companies to help their earnings rise more than any increase in oil prices, but this leverage appears to have been diminishing in recent sequential quarters. Also, as profits improve some maintenance-capital-expenditure (capex) spending has resumed, causing less free-cash-flow (FCF) upside leverage. Also, some companies should be paying down some debt upon their improved profitability, which curtails the ability to increase dividends or share buybacks.

Energy consensus forward earnings have been revised up in-step with rising 1-year forward WTI oil price consensus forecasts. The current Energy forward earnings estimate is at a level that is consistent with the usual relationship to the 1-year forward WTI consensus of $61/bbl. Thus, there should not be further 2018E upside revisions to Energy earnings unless the spot WTI oil price stays at the current $71/bbl or above. Our March 2019 global CIO View oil-price forecast of $60/bbl is currently under review.

In a nutshell

- Oil is back to its average historic price when adjusted for USD FX rates and inflation
- S&P Energy is earning close to normal mid-cycle profits with WTI back to ~$65
- The relationship of Energy earnings growth vs. oil-price increases is 1.2-1.5x to 1
- S&P EPS sensitivity to oil prices ~$1 for every $5/bbl of WTI
- Energy sector is pricing in a $75-80/bbl WTI oil and is still expensive
- We still prefer Banks over Energy within U.S. Value

The relationship of Energy earnings growth vs. oil price increases is 1.2-1.5x to 1

Since 1982, S&P 500 Energy sector earnings rise by about 1.2x the y/y increase in WTI oil prices. Between 2010 and 2017, this sensitivity is greater at about 1.5x given strong U.S. investment in horizontal drilling and the improved efficiency in extracting crude oil at lower costs. These breakthroughs caused some excess capacity over the last few years, but as this capacity was absorbed by taking global share, the associated recovery in oil prices came with stronger upside leverage of profits to the oil price vs. the very long-term 1.2x relationship. That said, the leverage was less than the 2x or more that many were expecting. When oil prices are falling there is usually a 1.5x or more leverage in profits to percentage oil price decline, as companies aren't able to cut costs as quickly as the oil price declines.

S&P EPS sensitivity to oil prices

The impact of oil prices on Energy and overall S&P earnings depends on the levels of oil prices and the share of Energy sector earnings in the S&P 500. Energy earnings are now 5% of S&P, which is significantly lower than the 10%+ weight back in 2010-14. With WTI oil at $60-70/bbl, our analysis shows that every $5/bbl higher in WTI oil from current levels adds ~$1 to S&P 500 earnings per share (EPS).

Energy sector is pricing in a $75-80/bbl WTI oil and is still expensive

Energy is the second best performing sector year to date with WTI oil prices surprising to the upside. We think the crude oil price is probably a little ahead of itself, elevated by recent geopolitical tension. If we assume WTI averages $60-65/bbl in 2018, we are comfortable with our 2018E S&P Energy sector earnings of $69bn. At that earnings estimate for the Energy sector, it is trading at 20.3x our 2018 EPS estimate, which is still the most expensive among all sectors other than Consumer Discretionary. S&P Energy sector market cap is $1.47bn, if we apply a 15x fair price-to-earnings (PE) ratio to whatever its normalized 2018 earnings should be, then Energy earnings should be near $100bn, which we think requires sustained $75-80/bbl WTI oil.

We still prefer Banks over Energy within U.S. Value

Big Banks are our favorite U.S. Value plays. Other than Banks, we see some relatively decent opportunities in Airlines and Machinery. We prefer these industries over Energy. We encourage investors to look for more Value opportunities outside the U.S., especially in Europe.

Glossary

Capital expenditures (capex)

Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

Earnings per share (EPS)

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Foreign exchange

FX or foreign exchange is the currency — literally foreign money — used in the settlement of international trade between countries.

Free Cash Flow (FCF)

Free Cash Flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. It shows how much cash a company is able to generate after deducting the money required to maintain or expand its asset base.

Inflation

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Price-to-earnings (P/E) ratio or multiple

The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

U.S. Federal Reserve Board (the Fed)

The **U.S. Federal Reserve Board**, often referred to as "**the Fed**", is the central bank of the United States.

West Texas Intermediate (WTI)

West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing.

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