

The Energy Sector: Powered Returns

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Standard & Poor's Sam Stovall, MSSB's Eric Applewhite and Pinnacle Advisory Group's Rick Vollaro explain why energy remains an attractive sector—and which industries may be market leaders going forward

The energy sector has been buoyed over the last year by a host of forces ranging from spikes in oil prices to growing demand for commodities in developing nations. Light crude oil prices are up 4.4%, to more than \$95, in the six months ended June 30, according to Bloomberg. Though uncertainty over the outlook for the global economy, as well as inflationary pressures in China and the end of aggressive stimulus in the U.S., will determine whether strong returns posted by energy stocks continue or dissipate.

Sam Stovall, chief investment strategist for Standard & Poor's Equity Research Services; Eric Applewhite, senior portfolio manager and Financial Advisor at Morgan Stanley Smith Barney; and Rick Vollaro, partner at Pinnacle Advisory Group, discussed how energy stocks fit in with their investment strategy during a recent S&P webinar. The energy sector has posted high returns recently—the S&P 500 Energy Sector Index is up more than 40% for the year ended June 30, according to Bloomberg. That is a well observed pattern in past bull markets says S&P's Stovall, with the group agreeing that energy stocks should remain a core holding. "From an earnings-growth perspective, as well as a valuation perspective, energy looks fairly attractive," Stovall says. Applewhite agrees but also notes that, as the business cycle continues, defensive holdings such as consumer staples are good plays. Vollaro points out that the energy sector may soon face headwinds in the form of a tighter monetary policy in the U.S. An edited version of the discussion follows.

Question: What is the typical pattern for performance of the energy sector at different phases of a bull market?

Sam Stovall: Keep in mind that three of the last 10 bull markets have died an early death—meaning they petered out sometime during the third year. But assuming this bull market does last for three years we can look back at previous patterns to see which sectors typically outperform during each of those years. As most people know, energy tends to be a late-cycle performer so you don't want to be in [those stocks] right out of the gate in a bull market. The frequency of that sector's outperforming the market improves as we head into year three. The energy sector has beaten the market about 50% of the time in the third year of a bull market, going back to 1970.*

Q: How is the energy sector positioned right now in terms of projected earnings growth?

Stovall: Looking at the 10 sectors within the S&P 500, energy is expected to show the greatest increase in 2011 earnings—at 38% vs. a 17% projected increase in operating results for the S&P 500. But it's not just a large-cap story. Mid-cap energy stocks are likely to see a 44% increase in operating results, the strongest [operating results] of the 10 sectors. And when we scoot out to the small-cap category we see a projected increase of 66%, compared with 44% for the overall small-cap market.

Q: Have energy stock prices been bid up, or are they still at attractive levels?

Stovall: The energy sector in the S&P 500 is trading at 11.4 times projected 2011 estimates as of May 19—the lowest of all the 10 sectors in the S&P 500. For the [energy] mid caps, the P/E ratio based on projected 2011 earnings is 18.6, just a shade below the P/E for the mid-cap S&P 400 index. And looking at the S&P 600 small-cap index, [we see that] the P/E ratio of 17.3 for the energy sector is also below the ratio estimated for the S&P 600 as a whole. From an earnings-growth perspective, as well as a valuation perspective, energy looks fairly attractive.

Q: What areas within energy have a robust outlook?

Stovall: [We think] earnings increases are likely to be fairly strong for coal and consumable fuels in 2011—along with oil and gas drilling equipment and services. For 2012, again we are likely to see above-average growth for coal and consumable fuels as well as [for] drilling equipment and services, exploration and production, refining and marketing and, finally, storage and transportation.

Q: How has the market for ETFs changed?

Eric Applewhite: The proliferation of exchange traded funds has opened up myriad opportunities for us. With the thousands of ETFs out there, there is nothing we can't invest in. We make investment decisions according to a "relative-strength" discipline that analyzes stock performance of a sector relative to some other benchmark. We also use both fundamental analysis and technical analysis to make our decisions.

Q: What is your analysis of the relative strength of the energy sector?

Applewhite: Early on in this bull market we identified technology, consumer discretionary and materials as areas to be in. Those areas were our heaviest investments with a bent toward small caps. As the bull market moved along [we added] energy and [are now adding] telecom.

Q: Are there other sectors that are interesting now?

Applewhite: The work I'm doing now is identifying positive trends in terms of relative strength of health care, consumer staples and utilities. We are still very heavy in technology, materials, industrials and energy, but these other defensive areas do seem to be emerging as attractive.

Q: How do you determine when to rotate in and out of sectors within the market?

Rick Vollaro: We are big believers that if you follow the business cycle that will point you in the right direction. Usually at this point in the cycle, inflationary pressures are building. At that point you are looking at things like energy, industrials and materials to be the outperformers.

Q: Where do you think we now are in the business cycle?

Vollaro: The business cycle right now is showing signs of slowing—the question is how much. Initial jobless claims are beginning to perk up a bit. The sector leadership in the market, as we've said, is beginning to change. At the same time, China is tightening. China's growth rates, as well as its demand for commodities like oil, have major economic implications. Now energy has performed well in a lot of poor periods for equity markets, and I think it would do well in an inflationary world. A deflationary world, however, would be bad news for energy.

Q: Do you look at relative-strength measures in determining which sectors of the market may be attractive?

Vollaro: We do look at relative strength and think it helps identify leadership in the market. But we marry that with other things, including mean reversion—so the idea [is] that things will typically return to their averages. Look at the broad energy sector. It was up about 16% in the first quarter. But we've had a correction more recently that is based a bit on mean reversion.

Q: Which factors are important to assess when determining the outlook for the energy sector?

Vollaro: The dollar's [weakness or strength] will make a big difference in terms of what happens with commodities prices. That's because commodities, including oil, are largely traded in dollars. I think part of the story behind the strength in energy over the last few quarters has been a weak-dollar play. As you well know, the Federal Reserve has been very loose in terms of monetary policy, and that's been a de facto weak-dollar policy. The weak dollar has helped the entire commodity complex, and it's helped the energy stocks. Now [with] the [Fed's] quantitative easing program ending, and that creates some real uncertainty about the impact that will have on the dollar and, by extension, on commodities.

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