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Energy Stocks Running Out of Gas

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NEW YORK -- Energy stocks are down for the year, despite historic highs in crude oil prices, some huge profits from Exxon Mobil Corp. (XOM), and continued surging demand from China and India.

Indeed, the S&P Energy index has slipped 5.6% year-to-date through Friday, while virtually all energy subindexes are in the red.

So, why has the U.S. energy sector delivered such a lackluster performance amid such a cornucopia of blessings?

Well, to be fair, energy has significantly outperformed the broader market -- the S&P 500 index has declined 13.7% year-to-date. But with crude oil prices breaching $140 this year, one may wonder why energy equities have not done better.

Ben Halliburton, chief investment officer of Tradition Capital Management in Summit, N.J., says that long-term investors may believe that profits in the energy sector, as well as crude oil prices, have already peaked, as global demand slows and the cost of oil and gas production creeps ever-upward.

For example, Exxon just posted the largest quarterly profit figure in corporate history -- an astronomical $11.7 billion -- and its shares dropped that day. "Exxon has been underinvesting its exploration plays for many years," he said. "They just don't have the resource base to drill and increase production. Investors are well-aware that Exxon has a very low growth rate going forward and declining growth rate in production."

More importantly, with regard to the global supply/demand picture for crude oil, "we are now on the steep part of the supply curve," Halliburton added.

There may also be other factors damping the performance of energy securities -- things that have nothing to do with supply/demand or crude oil prices.

Zach Liggett, portfolio manager for Utopia Funds, explained that energy stocks now form such a large portion of the U.S. equity universe that any weakness in the overall market will hurt them too, regardless of the price of crude oil.

Energy shares now represent about 15% of the S&P 500 by market cap, up from 5% in 1998, when the current secular bull market for oil commenced.

"Whenever the stock market falls, it will be hard for energy stocks to have any positive absolute return momentum simply because they now represent a larger chunk of the market," Liggett said. "Energy stocks are still simply stocks and sometimes they follow the normal behavior of other stocks. Think of all those index funds that are geared to the S&P 500 index. If there is fear in the equity markets, oil stocks will go down in lock-step, regardless what happens to the underlying commodity."

Halliburton also pointed out that some parts of the energy industry are in abysmal shape, notably the refining and marketing segment, and they are dragging the whole sector downward. In fact, S&P's Refining & Marketing subindustry index has plunged about 53% year-to-date through Friday, reflecting weak profit growth in that business.

But for now, energy demand is intertwined with how much money people and corporations have in their pockets.

The developed world -- plagued by softening economies, credit crises and worsening consumer spending -- is actually showing decreases in crude oil consumption, somewhat offsetting robust demand from China and India.

"Going into 2009, with a sluggish economy, we'll likely see flat or even slightly declining consumption demand for crude oil," Halliburton said. "Saudi Arabia is likely to increase production and even Iraq may be pumping 1 million barrels per day in a few years."

Halliburton thinks the price of crude oil in 2009 could range from $100 to $120 barrel, reflecting flattening demand and higher supply. "If demand weakens significantly, and we have a severe recession, crude prices could go down even further," he added.

Energy stocks also look very cheap now. S&P's energy sector is trading at about 8.3 based on estimated 2008 earnings. But Liggett indicated that while the P/E for energy shares may seem modest, when one adjusts for a more normalized profit environment, they don't seem so attractive anymore.

"Profit margins for energy companies are near historic highs, but they probably peaked in 2007," he said. "It's logical to assume that as production costs climb, profit margins will begin a long steady decline in the coming years. Combine that with stalled global demand, crude oil prices are also likely to face further headwinds. Thus, energy is not a growth story."

Energy-related shares will likely continue to show lackluster returns even if oil prices remain where they are -- although Exxon and BP PLC (BP) might not care too much, already having amassed untold billions. We may even see energy stocks resume their traditional role as solid value plays -- strong dividends and moderate growth.