Sector Strategy Update from the Investment Advisory Group

Energy sector pullback represents a buying opportunity

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Sector Strategy Team

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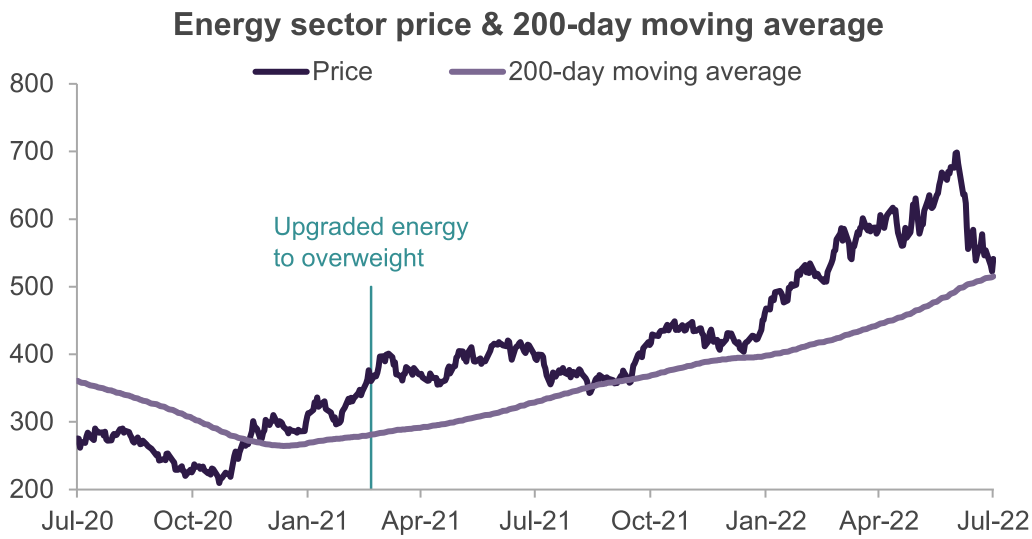
What happened

After strong outperformance, the energy sector has come under pressure recently. It is down more than 20% from its June peak on the heels of rising recession concerns and the accompanying plummet in oil prices.



Data source: Truist IAG, FactSet. Energy = S&P 500 Energy.

Our take – Pullback represents a buying opportunity

We view this pullback as a buying opportunity and reiterate our overweight rating for the sector. The sector strategy team upgraded our view on the energy sector to overweight in February 2021. Since then, the energy sector is still up nearly 50%, even when accounting for the recent pullback, versus the S&P 500's return of about 3% over the same period.

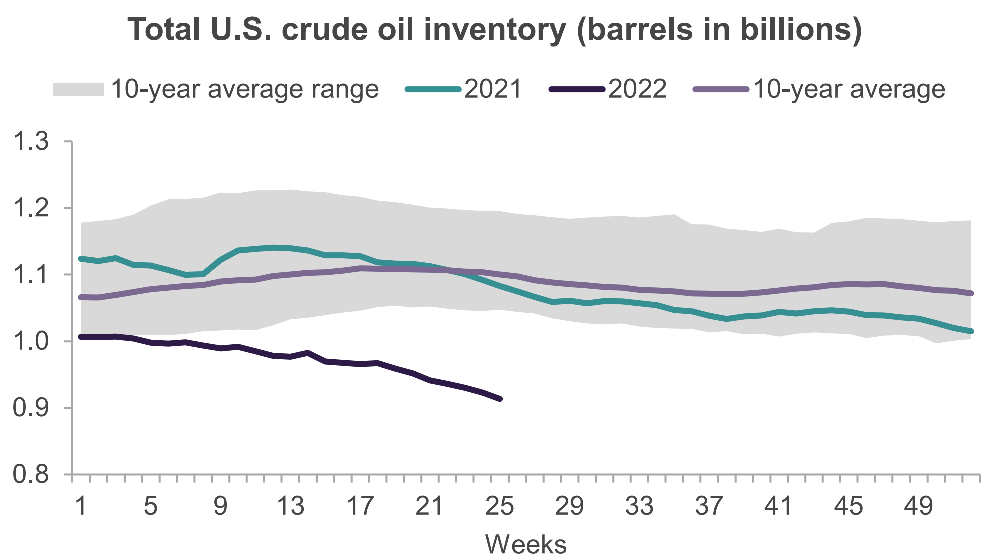
That the sector is still outperforming over this period despite such a sharp recent pullback goes to show how extreme the outperformance of the sector had become. **The good news is a lot of the excess has now been corrected and the macro and fundamental backdrop remains supportive.**

Macro view – Supply deficit and tight inventories are key supports

Our senior U.S. macro strategist, Mike Skordeles, continues to expect the price of oil to remain elevated, which is a positive for the energy sector. This view is underscored by continued supply constraints and tight inventories. Indeed, the supply deficit is expected to get worse as we move through the third quarter, and our team anticipates the deficit to grow to two million barrels per day by the fourth quarter.

Additionally, a Russian court ordered a 30-day suspension of operations for the Caspian Pipeline Consortium, which exports Kazakh crude oil from a key terminal in the Black Sea – which is an additional flow that averages 1.2 million barrels per day.

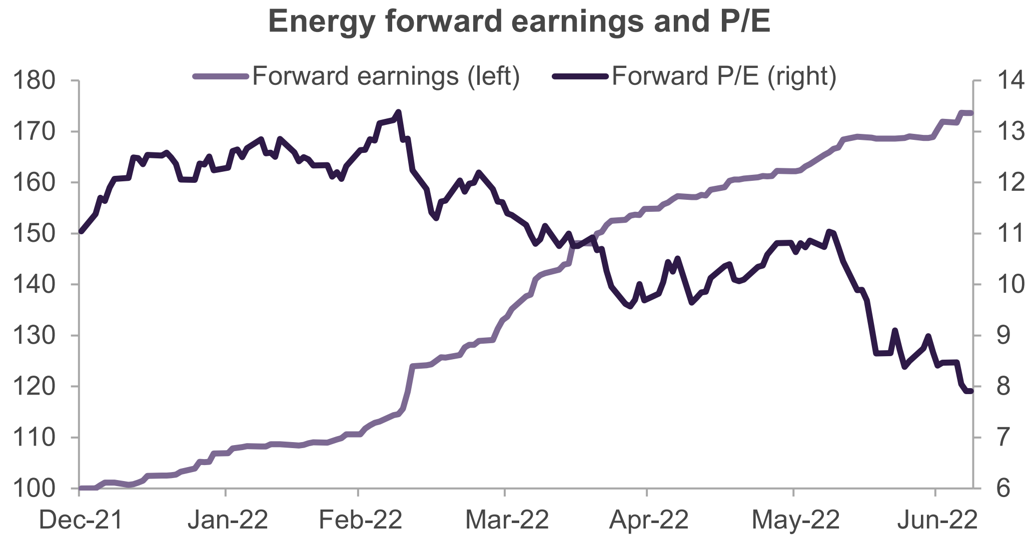
Inventories are well below the pre-pandemic 10-year average range. Additionally, a recession generally doesn't impact crude oil consumption that greatly, especially over the shorter term. In fact, consumption change was minimal during three of the past eight recessions. The 1980/81 double dip recessions, the global financial crisis, and the pandemic were the exceptions.



Data source: Truist IAG, Bloomberg, EIA. Inventory data includes Strategic Petroleum Reserve. Weekly data through 6/24/22.

Fundamentals remain supportive

Energy fundamentals have been a key support for the sector. Year to date, **forward earnings estimates for the sector have been revised higher by 74%** compared to the S&P 500's 7%. This has pushed **the sector's forward P/E down from 11x at the beginning of the year to 8x currently**, despite being the best performing sector this year.



Data source: Truist IAG, FactSet. Energy = S&P 500 Energy. Earnings indexed to 100 as of 12/31/21.

In addition to strong earnings**, elevated free cash flow generation has enabled sizable recent debt reduction and higher capital returns to shareholders**. Our energy equity analyst, Charles Redding, expects more substantial share repurchases for many companies over the coming quarters. Importantly, Charles expects exploration & production companies to generally remain disciplined on future production increases given labor and raw material constraints as well as a renewed focus on capital return. This production discipline is also likely to keep oil prices elevated.

What could change our view

Our sector strategy's process is heavily quantitative and technically based and generally has a three to 12 month outlook. Therefore, it's important to understand that our sector views can shift quickly. If the sector starts to deteriorate in our quantitative work or technical trends breakdown, our process could lead us to downgrade the sector.

Additionally, a resolution to the Russia-Ukraine conflict could allow for the reintroduction of Russian oil to global markets and a rapid change in the outlook for oil and the energy sector.

Bottom line

The weight of the evidence in our work points to the recent pullback in the energy sector as a buying opportunity. This is supported by our quantitative work, where energy continues to screen as attractive, our macro team's view of a favorable supply/inventory backdrop, as well as our equity team's expectation for continued positive fundamentals given discounted valuations, strong earnings and free cash flow generation.

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S&P 500 Index is comprised of 500 widely-held securities considered to be representative of the stock market in general.

S&P 500 Energy Index – a capitalization weighted index that is composed of those companies included in the S&P 500 that are classified as members of the energy sector based on GICS® classification.

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