Energy stocks have been struggling the past two months, reflecting a steady weakening of oil prices. When oil prices fall, that generally has indicated that supply is outweighing demand. But the factors that are driving oversupply may not be sustainable, which likely means that prices could soon return to the previous higher levels.

During the recent oil slump, West Texas Intermediate (WTI), a leading oil price benchmark, slid by more than 30%, from about $76 per barrel on October 3, 2018 to about $47 per barrel in December (Exhibit 1). Many stocks in the energy sector have followed suit, with the S&P 500® Energy sector posting double-digit losses over that time frame.

These dramatic declines broadly reflect a number of recent changes in supply and demand trends. For example, in early November, the Trump administration issued waivers that eased sanctions against Iranian oil sales, which had the effect of enhancing global supply.

But the bigger story around supply stems from the U.S., where domestic producers have boosted production significantly in recent years. A decade of investments and increased oilfield activity has resulted in significantly higher oil and gas output. The U.S. is likely to become a net oil and petroleum products exporter by 2020 – a remarkable change after decades of oil dependence. In fact, the U.S. has recently regained the lead as the world’s leading oil producer at about 11.6 million barrels per day.

This expansion of supply comes at a time when the global economy appears to be slowing. Although we believe demand for oil will continue to increase in 2019, it could be at a slower pace than 2018. The combination of rising supply and average demand growth explains a lot regarding the current downward pressure on energy prices.

But one thing we have noticed about energy prices is that they can move dramatically, and quickly, in response to even modest changes in supply and demand trends because supply and demand are tightly balanced. Forecast changes of just 200,000 to 300,000 barrels per day on a 100 million barrel-per-day base have historically moved markets. Moves are often compounded by investment flows – from large institutional buyers and speculators – that can play into the movement of day-to-day prices. In recent weeks, oil speculators have been shorting energy (essentially betting that oil prices will decline) in response to supply and demand news, which puts further downward pressure on the price.
Broader Realities May Push Prices Higher

Short-term supply and demand movements typically have had a direct impact on energy prices. But we think it is valuable to look beyond the day-to-day fluctuations and evaluate the bigger picture. What we see are a number of factors that may drive energy prices higher over the longer term.

One of the biggest signals that the current price downturn is likely to be temporary is that current oil inventories have dwindled to a relatively low level. Ordinarily, prices come down because there is a backlog of unsold oil that needs to be worked through. That is not the case today. In fact, inventories are currently below normal – as they have been throughout most of 2018, as Exhibit 2 illustrates.

What’s more, the capacity to produce more oil is tightly restrained. For example, production in Saudi Arabia has recently reached an all-time high of just over 11 million barrels per day, which is about 1.4 million barrels per day below the country’s claimed capacity of 12.5 million barrels. This 1.4-million-barrel difference represents the vast majority of the world’s spare capacity. In an environment where excess capacity is so limited, there is little room for production or geopolitical hiccups.

It is also true that the energy-producing countries have moved quickly to try to address the current supply-demand imbalance. At the recent December OPEC meeting, the OPEC nations, along with Russia, agreed to restrict production in order to bring supply and demand more into balance. Canada, separately, is cutting output by over 300,000 barrels per day.

Of course, it is possible that these countries won’t stick to their pledged targets, as has sometimes been the case in the past. But the evidence suggests they may not have much choice. Many energy-producing companies and nations simply cannot achieve a viable return on invested capital at the current depressed price levels.

One other crucial factor that could affect oil supplies in the future is the fact that oil is a depleting resource. There are very few untapped oil sources at this time, and those that are known would require higher oil prices in order to be economical. Existing oil fields – even recently developed ones – have produced less oil, less efficiently each year. These realities suggest that, over the long-term, the WTI price is more likely to move toward $70 or $80 per barrel to incentivize investment rather than to stay at around $50 or below.

While a return to higher prices may be unwelcome news to U.S. consumers, rising prices may be considered a positive for the overall economy. This is a change versus historical perceptions since the U.S. has evolved from being dependent on oil imports to becoming a net exporter of oil and petroleum products. The positive impact includes hundreds of thousands of U.S. workers employed in the sector, a tax and royalty income stream to state and federal coffers, and the potential for favorable changes in the geopolitical landscape.

The Advantage of Fundamentals

It’s our view that chasing the latest trends or trying to anticipate short-term price movements only increases the risks and undermines the opportunity to benefit from the investment potential of the sector.

Instead, we take what we learn about everyday market dynamics and use that to evaluate energy companies in context. We try to identify the best firms within each industry segment – with the best financial fundamentals, the best management, and the best products or technologies. Our goal is to invest in these best-in-class firms across a diversified array of industries because we believe that superior companies typically are best able to position themselves for success, regardless of current market dynamics. We believe that strong fundamentals are the most reliable indicator of sustained long-term earnings and growth potential.
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All information and representations herein are as of December 20, 2018, unless otherwise noted.

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