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Energy and oil prices in particular continue to dominate much of the current cost-of-living crisis, Westminster's Investment Strategist Peter Lucas updates his views on oil and considers the outlook for prices in the months ahead.

I first recommended energy shares as a cheap way to play the post-COVID recovery seventeen months ago ("Light at the end of the tunnel", November 2020). I then repeated that recommendation the following year, on the basis that ESG investing had led to a structural shortage of supply that would result in much higher prices ("70s redux", June 2021). The following month I added that OPEC would likely "sit on its hands", thereby removing one possible obstacle to a higher oil price ("Inflation worries on hold", July 2021). As it worked out, the US energy sector hit rock bottom (on a relative basis) on 6th November 2020 and has since outperformed the S&P 500 by 224%. Despite this impressive performance, I think there is still much to play for, subject perhaps to a short-term correction.

Let's first consider the long-term positives for oil:

1. The structural shortage in oil is unlikely to ease anytime soon. Still wedded to the Green Agenda, Western governments are clearly reluctant to do anything to encourage more production by domestic oil companies. Indeed, 'windfall taxes' on energy companies' profits and subsidies for consumers will do much to cement current shortages.
2. China is finally opening-up its economy in response to falling COVID infection rates and increasing public disquiet regarding the lockdown policy. This should lead to an increase in demand for oil and other commodities from Asia.

If the oil price continues to rise, it will eventually crush demand and incentivise the development of cheaper (and cleaner) alternatives. In short, there is a limit as to how far it can rise. History gives us a sense for where the pain threshold might be. Comparing the oil price to US consumer prices, gold, and the broader commodity index in the period since the early 80s suggest that all other things remaining equal, it should be capped around $150-$200, with an outside chance of $300. By the same token, oil is less widely used than it was decades ago, which means that the pain threshold may now be higher. Furthermore, if the prices of consumer goods, gold and other commodities continue to rise (as I expect), the oil price cap will be raised accordingly.

What are the risks to this bullish view?

1. Unwilling to promote more drilling at home, Western governments are becoming more comfortable with the idea of buying oil from hostile regimes like Iran and Venezuela.
2. Although there is little sign of a lasting cessation of hostilities in Ukraine, if there were to be such an outcome, the oil price would probably drop on hopes that Russian supply will eventually be let back into the fold.
3. With the Fed seemingly determined to get inflation down, there is a real risk that the US economy is pushed into recession, leading to a general decline in demand for commodities. This is arguably to biggest threat to the oil price right now, albeit that it would soon be met with a rapid about-turn in Fed policy.

In summary, I feel that the bullish long-term argument for oil remains compelling, but the case for a decent-sized and well overdue correction are building in the short-run.

The medium-term case for energy shares is even stronger than that for oil:

1. The historically close correlation between the oil sector relative (versus the S&P500) and the real oil price suggests that the relative is still half of what it should be. Even if one makes allowance for the fact that fossil fuels have a limited shelf life, there is still plenty of catch-up potential for energy shares versus both oil and the S&P500.

2. All the recent performance in the energy sector has been driven by rising earnings. Indeed, according to Bloomberg, the forward P/E is currently only just above 10. There is already talk of more institutional and hedge fund interest in the sector and it seems likely that this bull market will end with ratings well above their current lowly levels.

The bottom line: oil and energy shares still have plenty of upside in the next few years.

Peter Lucas

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