Crude Oil Rides The Roller Coaster

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By Robert Rapier
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It was only a month or so ago that I began advising investors to ease up on certain energy stocks. Some had risen 20%-30% since the beginning of the year, and were starting to look fairly valued.

Fast forward a month, and the picture has changed. The front-month West Texas Intermediate (WTI) crude contract ended May over 16% lower, which marked the first monthly loss of the year. Most energy stocks have followed oil prices down. What has happened, and is this now a buying opportunity for energy stocks?

What Is Driving Oil Prices?

There are two things going on.

FIRST: The first is that it is becoming apparent that the trade war with China will be lengthy. There are fears that this will impact oil demand there as well as here.

Add to that Friday's announcement by the Trump administration of plans to impose a 5% tax on all goods imported from Mexico unless "the illegal migration crisis is alleviated." These tariffs would potentially rise to 25% by October. This sent a chill through the stock markets and the oil markets, with WTI losing more than 5% on the day.

The global oil demand picture has been mixed in recent months. The International Energy Agency (IEA) reported that oil demand numbers for the January-February period in China grew by 410,000 barrels per day (BPD) year-over-year. India's demand grew by 300,000 BPD, and U.S. demand was close behind with 295,000 BPD of growth.

But oil prices impact demand, and they have risen sharply since January. This, along with the trade war, may explain more recent reports that overall oil demand in China had declined by 0.3% year-over-year in the first quarter.

SECOND: That brings me to the second factor that I see unfolding in the oil markets. Every time demand in China slows down, there is a rush to push the narrative that it is because electric vehicles (EVs) are finally starting to take a bite out of oil demand.

This explanation promotes the fear that crude oil will soon end up like coal which, in turn, helps push oil prices lower than they should be. Bloomberg recently projected that oil demand in China will peak in 2025 as a result of EVs.

The Outlook For Investors

So, what is an investor to do? Let us consider a few things.

First, Bloomberg also recently reported that energy stocks now account for only 5.02% of the S&P 500, which is less even than in early 1999. Notably, at that time, oil prices had collapsed to $10/bbl and the tech bubble was depressing the share of all other sectors.

Consequently, a 5% energy share today seems to be a significant historical disconnect. In other words, energy stocks are likely again undervalued.

Second, we should consider the different segments of the energy sector. When oil prices fall, typically oil producers get hit the hardest. Pipeline companies usually take a milder hit, and refiners often benefit because their margins expand.

Refiners often trade out of sync with oil prices but, this time, the concerns about overall demand, and higher-priced oil from Mexico as a result of tariffs, hit the refiners hard. Trade tariffs on Mexico could be a double-whammy if the country retaliates, because U.S. refiners send large volumes of finished products back to Mexico.

Deep Bargains Among Refiners

Most segments of the energy sector are relatively more expensive than they were a month ago, considering the large drop in the price of oil. If the price remains in the current range for very long, oil producers and integrated oil companies will likely see larger declines.

The mid-streams started the year undervalued but, after a large run-up, many of them had reached fair value.

All things considered, refiners are unlikely to suffer as much as the market fears. Further, lower oil prices will help lift gasoline demand, and should help prop up margins. Right now, refiners appear to have become bigger values.

Overall, though, the broader stock market is suddenly in turmoil, thanks to slowing global growth and the escalating trade war.

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See ABOUT THE AUTHOR on the following page

ABOUT THE AUTHOR

It is hard to imagine anyone better suited to covering the energy-investment waterfront than Robert Rapier. Robert is no armchair analyst—he has two decades of in-the-trenches experience in a wide range of fossil fuel and biofuel technologies, including refining, natural gas production, gas-to-liquids, ethanol production and butanol production.
During a six-year stretch at ConocoPhillips, Robert ran a team of engineers in Scotland working on oil and gas projects in the North Sea.

For two years, Robert was an efficiency expert in a Texas petrochemical plant. The process changes he implemented saved the facility $9 million a year. He later worked as the Engineering Director for a Dutch environmental-technology company and provided engineering support for a Chinese facility the company was constructing.

Robert was also a butanol engineer in Germany for the Celanese Corporation, where he designed a novel butanol unit that cut production costs by $5 million per year.

In all, Robert has spent more than a dozen years working on liquid fuels technologies. Along the way he has picked up five patents, including one for a breakthrough way to convert ethane into ethylene (U.S. Patent 7,074,977).

Now, in addition to guiding readers to timely energy plays in his twice-monthly *Energy Strategist*, Robert travels the world evaluating start-up energy companies for deep-pocketed investors. After grilling management and assessing the technology on-site, he makes a go/no-go investment decision. His wealthy private investors and hedge fund backers trust him to make the right choice for the same reason we do: his vast real-world experience in just about every facet of the energy industry. If Robert votes thumbs-up, millions of dollars flow into these cutting-edge outfits.

Robert earned his master of science in chemical engineering and a bachelor of science in chemistry and mathematics (double major) at Texas A&M University. He tells us he was "this close" to finishing his Ph.D. before he decided he was having a lot more fun making money in energy stocks.

A prolific writer, Robert's articles have appeared in *Forbes*, *The Wall Street Journal*, *The Washington Post* and the *Christian Science Monitor* — and he has been a featured expert on *60 Minutes* and *The History Channel*. His new book, *Power Plays: Energy Options in the Age of Peak Oil* (Apress, 2012), helps investors sort through doom and gloom, hype and misinformation to understand the true costs, benefits and trade-offs for each of our major energy options.

In what little spare time he has left, Robert consults for a number of energy projects, including biodiesel, ethanol, butanol, and biomass gasification facilities.