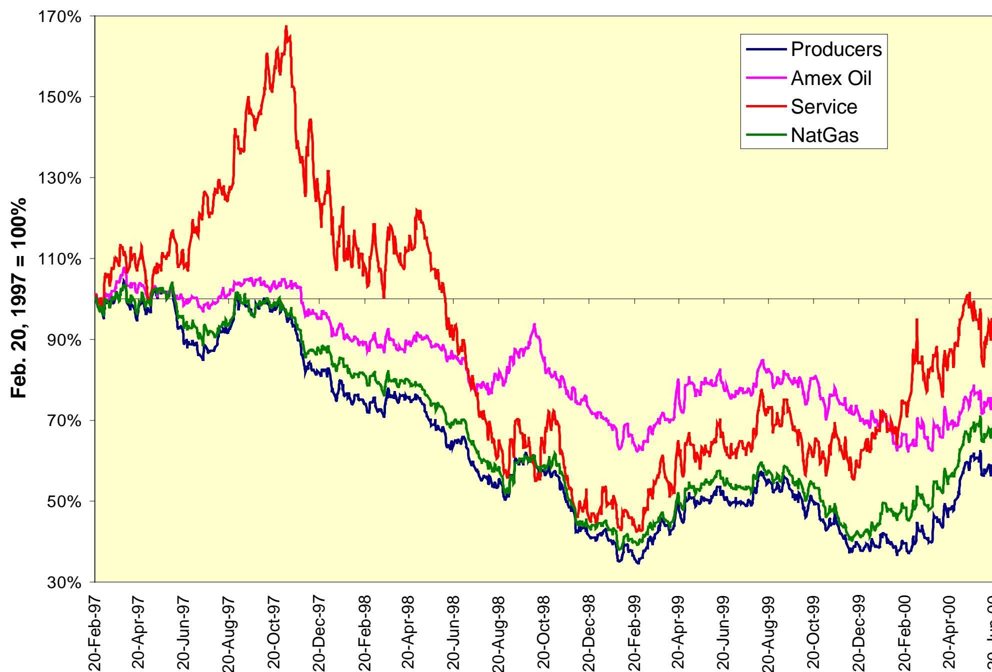
So, Where's The Bull Market In Energy Stocks?

We are blessed to live in a land where cool heads recognize price cycles are temporary phenomena self-defeating in nature. Higher prices stimulate future production and dampen present consumption, and the long-term trend in all commodity prices, as noted so often in this series, is lower. To claim otherwise is to bet against human ingenuity and productivity, which is something to think about if you are reading this on a handheld device with a wireless Internet connection.

We are in a bona fide bull market for energy commodities for the foreseeable future, but the story is different for energy-related equities. As we saw last week, the stocks of domestic refiners are a poor proxy for the increased price of gasoline and other petroleum products. Refiners have faced sharp increases in both operating expenses and higher crude oil costs. What about the firms whose profits should be tied directly to higher prices for crude oil and natural gas and to increased drilling activity?

Refining and marketing are the "downstream" side of the energy industry. Let's move "upstream" and take a look at the AMEX Natural Gas Index (XNG), the Paine Webber Oil & Gas Producers Index (OGV), and the Philadelphia Oil Service Sector Index (OSX) in addition to the more broadly based AMEX Oil Index (XOC). The OSX began on February 20, 1997, so this will restrict the history of our comparison.

Relative Performance: Selected Energy Indices Vs. S&P 500



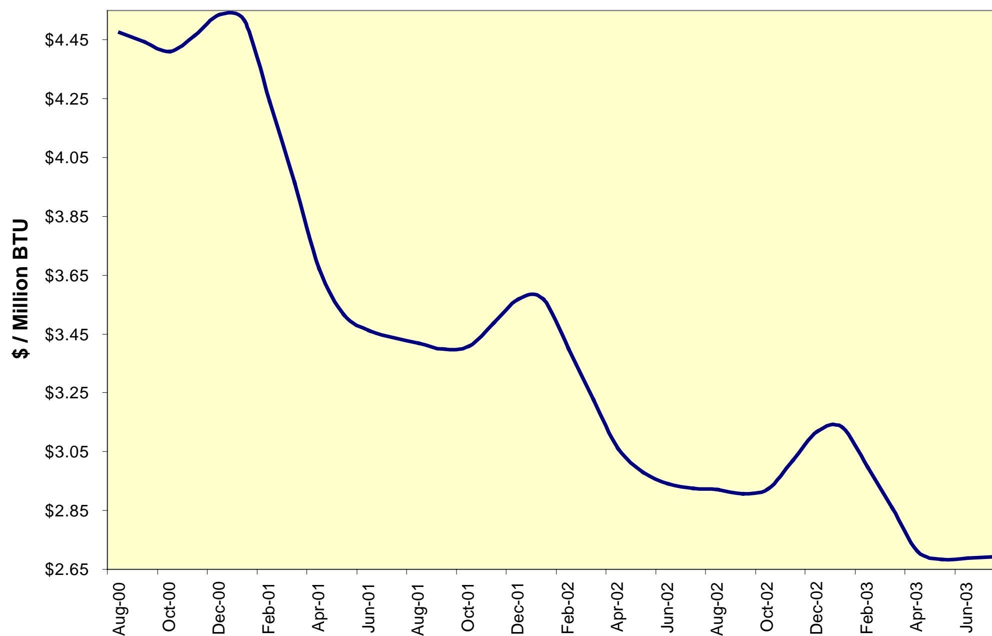
Up The Stream With Just One Paddle

Natural gas, the most bullish of the energy markets in both price action and supply/demand fundamentals, has doubled in price since the start of the year, and the XNG has jumped 52% in response -- to 65.9% of the S&P 500's gain since February 1997. While both of these gain numbers may seem muted, they actually are quite strong, and are perhaps unsustainable. How can this be?

The answer, as is so often the case in energy markets, lies in backwardation, the pattern of high current prices combined with declining price expectations. The forward curve of natural gas futures indicates

disbelief on the part of both buyers and sellers the present high price levels will endure. In fact, price expectations are declining at an astonishing 1.49% a month out to July 2003.

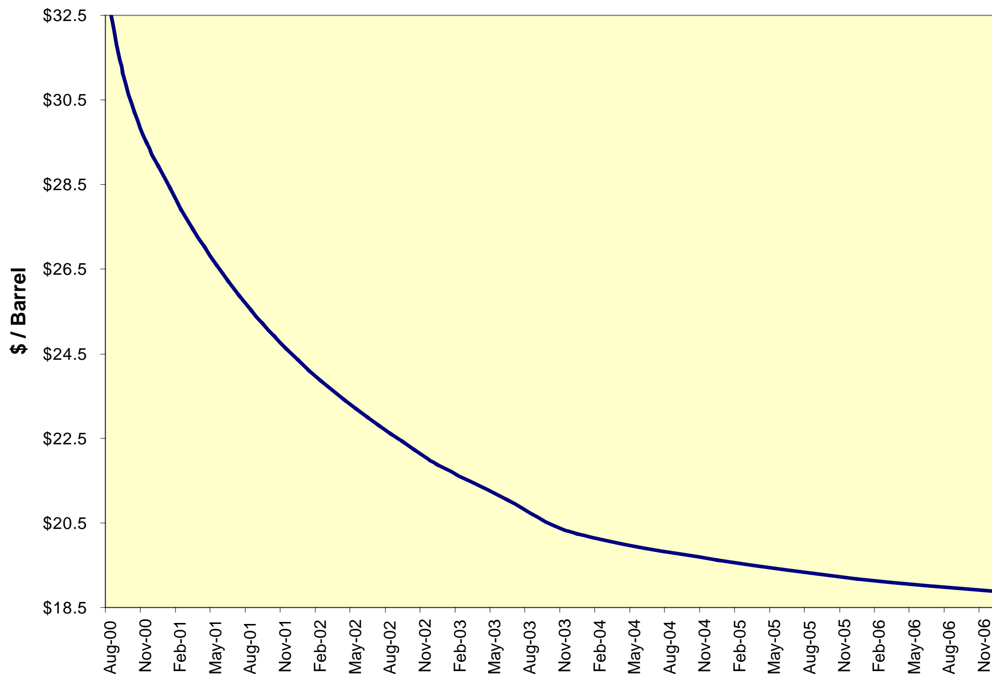
Consider the conundrum of a natural gas producer (and pretend he's considering yours): Only a small fraction of a field's reserves can be produced for delivery in any given month, and the market expects prices to fall over time. The present value of your production, the basis of your equity valuation, is lowered by the market's price expectations. In fact, the present value of one million BTU per month produced ratably out to July 2003 is approximately $53.75. A comparable figure in February 1997, when spot natural gas prices were 43% of current levels, was $29.15. As a result of backwardation, an 84% jump in natural gas price has produced only a 61% in the present value of three year's production, and a mere 18% increase in the XNG. If that's how these stocks perform with good news…



The Producers

Crude oil, like natural gas, is in steep backwardation. Here again, the commodities markets do not believe the present price regime is sustainable. As a result, the OGV is virtually unchanged from its February 1997 level, even though it has risen a very respectable 33.9% to-date in 2000. Not only do oil producers face declining price expectations, they face rising operating costs. As prices rise, oil well service and supply costs rise, percentage royalty payments rise, and governments worldwide revert to a nasty habit of increasing severance taxes. This suggests a look at the service sector.

Slip-Sliding Away: Crude Oil Futures Forward Curve June 30, 2000



Service With A Smile

The cheapest way to find and produce more oil is to service existing oil fields. Always has been, always will be. During the last big drilling boom, the early 1980s, oilfield service firms, led by Schlumberger, were the dot-coms of the day. As they exercised their pricing power and captured the economic rent of higher oil prices, they added too much capacity and as a result suffered mightily in the decade following.

The service industry, which has undergone massive consolidation since its glory days, still has pricing power, and the group enjoyed a big rally in mid-1997. The onset of the Asian crisis brought the party to an early end, however, and the group's fortunes slid with oil prices down to the February 1999 low. The OSX has rallied 40% so far in 2000, and many of its leading members are expensive. Schlumberger has a forward-looking P/E of 61.2, Halliburton 56, and Smith International 60.2. Even the Clintonesquely-named BJ Services, which provides pressure pumping, is priced at 45.1 times expected earnings.

Where's The Money Going?

The natural resources plays of the 1970s and early 1980s rewarded those who bought early when no one else wanted to get involved; later buyers fared poorly. There's little to suggest a difference this time around: The one group that can capture high prices, the service firms, is already expensive, and the other groups, refiners and producers, are (rightfully) stymied by declining price expectations.

The advice given here for how to make money is simple for all and unacceptable for most: If you want to play higher petroleum and natural gas prices, then play higher petroleum and natural gas prices. Why trade stocks in order to trade commodities?