US Value Equities

Energy tops our list of 2019 opportunities

Kevin Holt
CIO, US Value Equities

Key takeaways

- Equity markets have been negatively impacted by global trade war concerns, and investors are also worried about the prospects of slowing economic growth given tighter monetary conditions.
- In particular, opportunities exist in select cyclical sectors as many are discounting a sizable economic slowdown commensurate with a recession.
- In our view, historically low volatility sectors are expensive, and in some cases structurally challenged versus history.

Equity markets have moved meaningfully higher with little disruption since the presidential election in 2016. Absent an unexpected downturn, I believe the US economic backdrop is relatively strong and supportive of higher equity prices in certain sectors as we transition into 2019. The benefits of fiscal stimulus combined with aggressive deregulation should continue to be felt in the coming year, in my view. That said, this outlook is not without risk and investors have no shortage of issues to worry about – trade tensions (most notably between the US and China) and concerns about the current level and trajectory of interest rates have both cast a shadow on the stock market.

Trade wars have historically been a lose-lose scenario, which makes a timely resolution even more important. The longer the conflict continues, the greater the potential for higher inflation, slower economic growth and disruption in the stock market. While the bottom-line effects are hard to accurately quantify, companies have been commenting more frequently that ongoing trade wars are negatively affecting corporate profits as 2018 comes to a close. A global power management company is anticipating US$110 million in tariff-related costs in 2019, which could likely be passed through to consumers in the form of higher prices. A large industrial company noted in October that higher input costs, while not all trade-related, outstripped price increases by US$50 million in the third quarter. I believe that a favorable trade-related outcome should help alleviate many of the concerns surrounding more economically sensitive companies.

We're optimistic about energy

In our view, energy stocks represent the largest opportunity for fundamental improvement in the market today. Following the largest downturn in oil prices in decades, major energy companies cut capital expenditures about 50% since 2014.[1] The cuts had a significant impact on future production as many of the oil projects are long-tailed and can take three to five years to bring on.

The combination of underinvestment and growing world consumption has resulted in a supply-demand deficit environment with the lowest spare oil capacity on record. Absent a material decline in demand, global consumption should continue to outstrip supply for the foreseeable future.

It's also important to note that energy companies have been changing the way that CEOs are compensated. Corporate energy boards are now prioritizing profitability over production, and are funding only those projects that generate an acceptable return on investment capital. This recent shift has led to healthier balance sheets, more attractive free cash flow generation and, in many instances, stock repurchases of shares that are at historically inexpensive valuations.

And yet, these improved fundamentals have done little to convince investors that energy companies represent a compelling opportunity. The question is: Will companies revert to their bad habits of overspending, or will capital discipline remain? In our view, the market entered November with energy stocks reflecting an oil price of US$50 per barrel, and long-term price expectations averaging US$60 to US$70. This indicates the potential for substantial upside for energy stock prices, in our view.

We're cautious about consumer staples

Conversely, we remain cautious of those traditionally defensive segments of the market that were used as bond proxies and perceived "safe havens" over the course of the past decade. Flat to negative revenue growth in consumer staples, combined with historically unattractive valuations, warrants additional caution, in our view. We expect this to be further exacerbated by price-cutting activities from big-box retailers as competition heats up.

1 Source: Bain & Company, "Accelerating Capital: 2018 Oil & Gas Industry Planning Outlook," Nov. 22, 2017. Oil majors cut capex spending from $215 billion in 2013 to $118 billion in 2016.

We believe many of the food and consumer products companies have driven operating margins to unsustainable levels by underinvesting in their businesses. Many of these companies are also highly correlated with bond prices, which could make them a risky bet in a rising interest rate environment. That said, if the trade fears persist, I would expect these stocks may outperform as investors seek out more conservative alternatives relative to cyclical stocks in the short-term.

Conclusion

Looking ahead into 2019, we find ourselves in an environment where valuations have taken a back seat to growth stocks and low volatility stocks. Instead of growth versus value, stock market moves have been largely characterized as risk on/risk off due to the proliferation of factor and quantitative-oriented strategies. I believe that a meaningful shift to value, which includes areas that are more sensitive to the macro environment, may take place once investors begin to feel comfortable with the key issues highlighted above.

Important information

This document has been prepared only for those persons to whom Invesco has provided it for informational purposes only. This document is not an offering of a financial product and is not intended for and should not be distributed to retail clients who are resident in jurisdiction where its distribution is not authorized or is unlawful. Circulation, disclosure, or dissemination of all or any part of this document to any person without the consent of Invesco is prohibited.

This document may contain statements that are not purely historical in nature but are forward-looking statements, which are based on certain assumptions of future events. Forward-looking statements are based on information available on the date hereof, and Invesco does not assume any duty to update any forward-looking statement. Actual events may differ from those assumed. There can be no assurance that forward-looking statements, including any projected returns, will materialize or that actual market conditions and/or performance results will not be materially different or worse than those presented.

The information in this document has been prepared without taking into account any investor's investment objectives, financial situation or particular needs.

Before acting on the information the investor should consider its appropriateness having regard to their investment objectives, financial situation and needs.

You should note that this information:

- may contain references to amounts which are not in local currencies;
- may contain financial information which is not prepared in accordance with the laws or practices of your country of residence;
- may not address risks associated with investment in foreign currency denominated investments; and
- does not address local tax issues.

All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. Investment involves risk. Please review all financial material carefully before investing. The opinions expressed are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

The distribution and offering of this document in certain jurisdictions may be restricted by law. Persons into whose possession this marketing material may come are required to inform themselves about and to comply with any relevant restrictions. This does not constitute an offer or solicitation by anyone in any jurisdiction in which such an offer is not authorised or to any person to whom it is unlawful to make such an offer or solicitation.