What Low Oil Prices Could Mean for Investors

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Look for potential opportunities in energy, consumer discretionary, and industrials.

Oil prices fall

1. *Rising supplies and falling demand have led oil prices to fall dramatically.*
2. *Energy stocks have suffered, but some may have reached attractive prices.*
3. *Consumers should benefit from lower fuel costs.*

After four years when oil prices routinely ran more than $100 per barrel, it seemed like high energy prices might never go away. It was getting harder to find and develop new oil fields, and the dramatic growth of China and other emerging-market countries was driving demand, or so the thinking went. But this year, the picture looks dramatically different. The prices for Brent crude fell more than 35%, from a high above $110 a barrel in June to less than $70 by early December.

The drop in prices came in part because supply was surprisingly strong, thanks to surging production from the U.S. and an increase in production in Libya. At the same time, an economic slowdown in Europe and China has hurt demand, and a stronger dollar raised the price of gas outside the U.S.

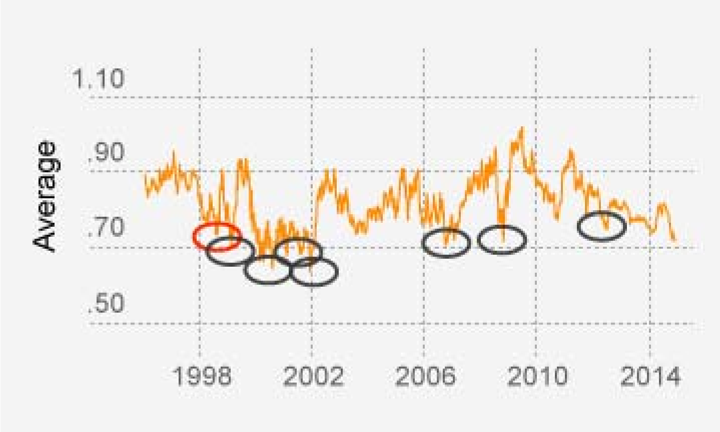
"Nothing focuses companies and organizations like lower commodity prices," says John Dowd, manager of Fidelity Advisor Energy Fund (FANAX). "The market has been oversupplied with crude oil for the past six to seven months, but, historically, when profitability per barrel has been this low across the industry, it usually has been an opportunity for investors. Given the current environment, I expect to see production growth slow, which may eventually lead to higher oil prices and profit recovery, and eventually see demand bounce back."

The slide in oil has implications in many corners of the stock market. Stocks in the energy sector have sold off, and everything from retail holiday sales to the competitiveness of U.S. chemical producers may be affected. Here is a look at what low oil may mean for different sectors of the economy.

Opportunities in energy

Energy stocks look relatively cheap.

Average of price-to-earnings (P/E), price-to-free-cash-flow (P/FCF), and price-to-book ratios (P/BK) relative to the S&P 500® Index.



The price-to-earnings (P/E) ratio compares a company's current share price with its reported earnings. The price-to-free-cash-flow (P/FCF) ratio compares current share price with the amount of cash a company has remaining after paying expenses, debt service, capital expenditures, and dividends. The price-to-book (P/BK) ratio reflects the ratio of a company's share price to reported accumulated profits and capital. Source: Haver Analytics, Fidelity Investments, as of Nov. 19, 2014.

Over the past few months, energy stocks have sold off to a point that the sector as a group is currently relatively cheap compared with its history (see chart), which could make this a rewarding time to invest in promising companies, according to Dowd. Selection is very important, however. Dowd thinks a key is to invest in quality companies that have been driving production growth and lower prices, not the companies with no production growth that will be forced to respond to declining prices.

A handful of U.S. exploration and production (E&P) companies with strategic advantages, such as prime drilling locations and well-controlled costs, are in a position to outperform even in an environment of flat-to-weak oil prices, according to Dowd.

"Natural gas producers in the Marcellus region (areas of Ohio, New York, and Pennsylvania) provided the blueprint: Even as natural gas prices declined in 2010–2013, a handful of companies operating the Marcellus shale region managed to survive and outperform the broader equity market while increasing production," says Dowd. "I believe this success could be repeated by high-quality E&P companies in the Bakken, Permian Basin, and Eagle Ford shale areas."

Dowd also noted that valuation have reached a point that has historically indicated opportunity for investors. "Energy has rarely been this cheap relative to the S&P 500, and when the sector reached these relative valuations in the past, it has usually outperformed the market during the following 12 months," he says. "You want to buy energy when the outlook is dark and rainy—and recently it has been pouring."

Impact on the consumer

While lower oil prices have hurt profitability for many energy companies this year, the story is flipped for consumers. Lower-priced oil means cheaper gas and energy prices, and that means more income that can be used for other purchases.

In fact, Peter Dixon, manager of Fidelity Advisor Consumer Discretionary Fund (FCNAX), estimates that when gas prices dropped from $3.60 to $3 it translated to approximately $40 per month of additional discretionary income for each American household or a total of 10 billion–$15 billion of freed-up money per quarter could be used for discretionary purchases.

"The greatest impact would likely be small-ticket impulse purchases," says Dixon. "It may also encourage consumers to drive more, which tends to support restaurants and convenience stores."

Industrials and materials

Lower crude oil prices may help some industrials companies but hurt others. For instance, fuel prices are among the largest expenses for airlines, so lower oil prices tend to benefit these companies, according to Tobias Welo, manager of Fidelity Advisor Industrials (FCLAX) and Fidelity Advisor Materials (FMFAX) funds.

On the other hand, industrial companies with upstream exposure to the oil industry, such as those that provide equipment to energy exploration and production companies, could suffer as companies look to limit investment in response to lower prices. Industrials with downstream exposure, such as those supporting refineries, may be less affected.

A sustained decline in oil prices could also hurt a portion of the U.S. chemical industry that has invested heavily in making petrochemical products, such as polyethylene, from relatively cheap domestic natural gas. But Welo says stocks prices have already moved to reflect that new reality.

"The advantage cheap natural gas provided over higher-priced crude oil fades as the price of oil falls," says Welo. "But stocks prices have reacted quickly; in some cases, the market has punished stocks disproportionately to the move in oil. So some chemical companies remain attractive."

The bottom line

Oil prices have fallen sharply in recent months. It is possible that oil producing countries could decide to reduce production to raise prices, or events in Iraq or Libya could decrease output there. Or lower prices could at some point cause companies to invest less in production and bring supply down. In the meantime, low oil prices may continue to shake things up in the markets and for consumers, and that could create opportunities for investors.

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