

WHAT MAKES THE ENERGY SECTOR THE ULTIMATE HEDGE TODAY?

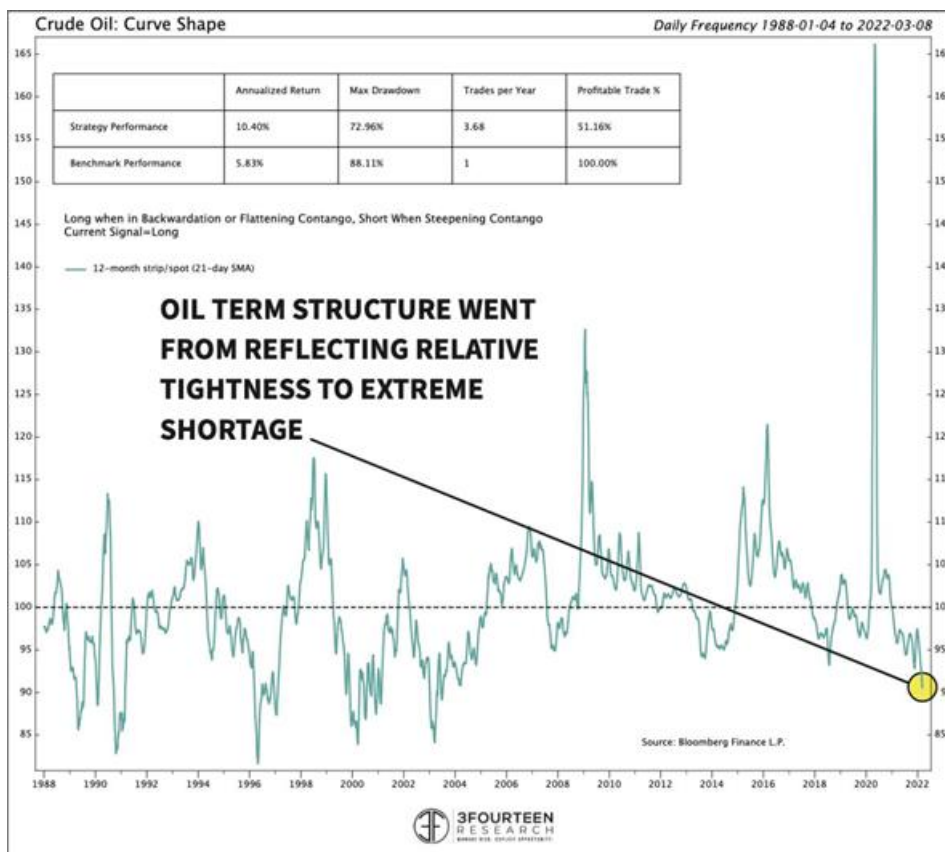
Warren Pies – Founder, Strategist at 3Fourteen Research
03/31/2022

We believe the events of the past two weeks will mark a historic change for investors and for the world.

Russia opened Pandora’s Box when it invaded Ukraine in February. Even the most optimistic resolution scenario will not get us back to the way the world was before. Geopolitically, the subsequent dominoes have brought us to the brink of world war III.

Coming into this crisis, the oil market was already relatively tight. By most estimates, global demand was outstripping supply by approximately 1.5 to 2 million barrels per day (mmbpd).

As a result, oil’s [term structure](#) remained [backwardated](#) as viewed by our curve indicator throughout this time. With the effective removal of Russian crude from the supply-side of the equation, however, the oil market has gone from tight to a generational crisis.



3Fourteen Research estimates the removal of Russian crude will expand the gap between supply and demand by roughly 2 million additional barrels per day with favorable assumptions (bringing the total gap to between 3.5 and 4.5 mmbpd).

We get to this rough calculation by assuming Russia exports approximately 6.5 mmbpd of

crude. At the right price, post-sanctioning, China and India could sop up about 3.5 mmbpd (up about 1 million barrels, but held back by logistical and political constraints).

On the supply side, Saudi Arabia and the UAE are likely to boost production by another 1 million bpd. That leaves a two-million-barrel gap. U.S. and Iranian production could arrive in the coming months as well.

But, no matter how you run the numbers, there will be a massive gap and virtually no spare capacity on the other side of this.

With little relief coming from the supply side, demand destruction will balance the market. At what price does this begin? Right around the highs we have recently observed (~\$130/bbl). At these levels, oil's cost to the American economy balloons to 4%.

Persistent pricing between \$130 and \$150/bbl will bring the nation's cost of crude oil up to around 4% to 5% and sap demand.

Globally, oil costs 6% of global gross domestic product, so oil is currently an even bigger drag on the global economy than it is for the U.S.

If prices persist at these levels (\$130-\$150), demand will stall and then fall. Put simply, an economic slowdown will materialize. However, a typical recession may not be enough to kill off sufficient demand to balance the market.

Recall, we estimate that a gap of approximately 4 million bpd will open between supply and demand without Russian oil flowing to the Western coalition. Going back to the 1970s, the average U.S. recession has reduced U.S. oil demand by about 1.5 million bpd.

Globally, the world lost just over 3 million bpd of demand during the Great Recession. Even this magnitude of demand softening would not be enough to close the projected deficit.

Only the COVID-19 crisis—and its attendant lockdowns—managed to destroy more than 4 million barrels of oil demand (around 11 million, peak to trough).

Bottom line: without Russian crude oil, [stagflation](#) is likely.

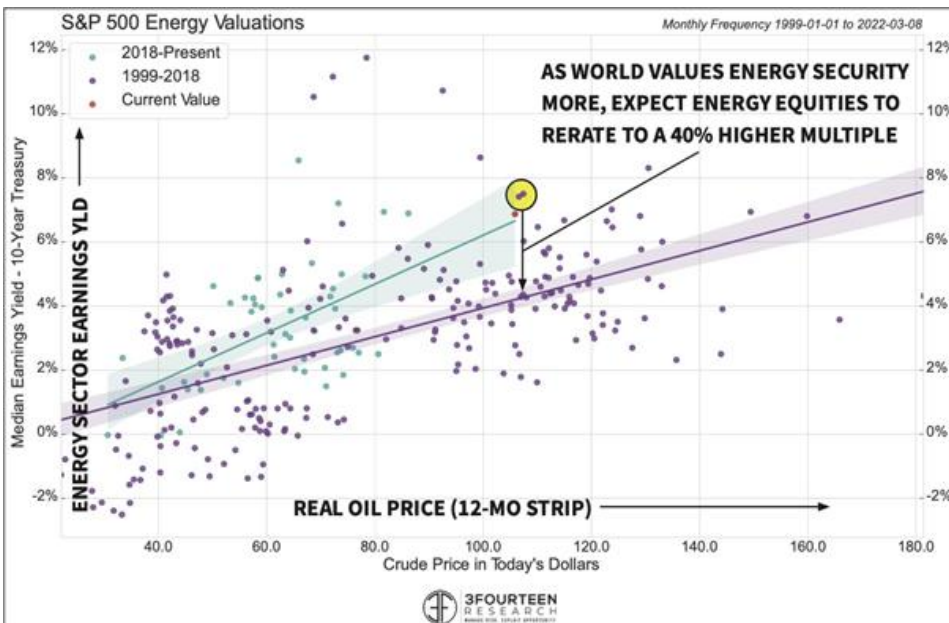
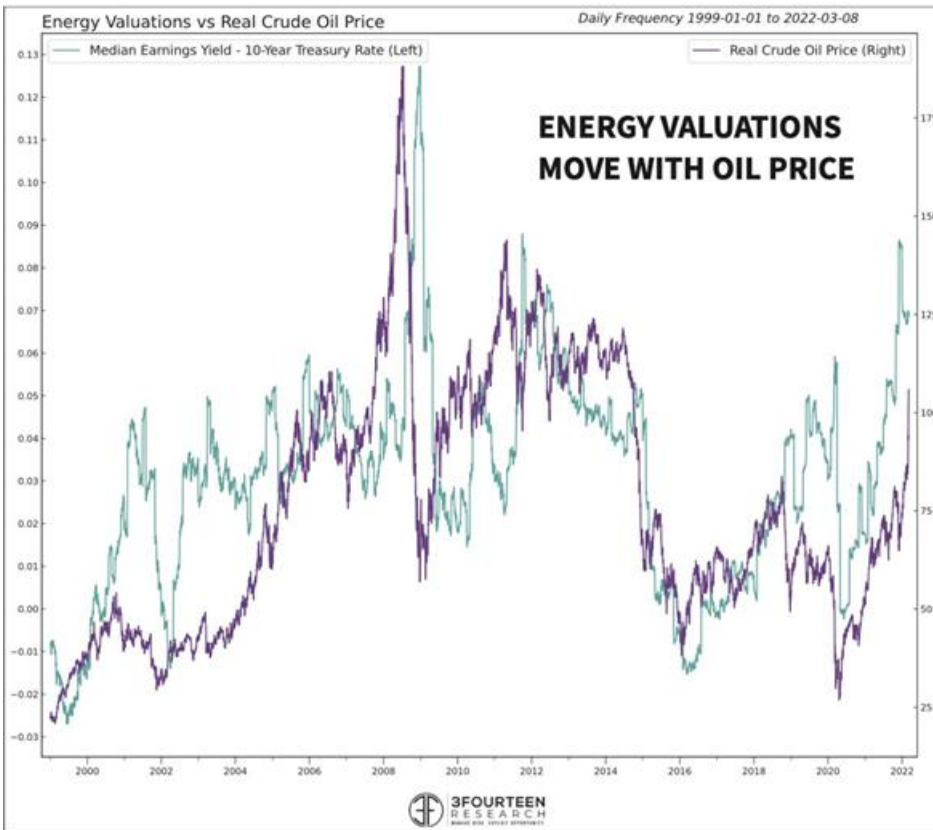
Implications for the Energy sector

In the fog of war, conclusions are scarce. But we do have one conviction: a new appreciation for energy security will emerge from the conflict. For investors, this may translate into better [valuations](#) for traditional energy stocks.

We can attempt to quantify an Energy sector rerating. Energy is the quintessential “top-down” sector. In order to get the Energy call “right” you must first establish a view on oil and the assorted energy commodity prices that dictate the operating environment (i.e., “top down”).

On a long enough timeline, oil is a mean-reverting asset. The market accounts for this tendency by assigning a high valuation to the Energy sector at oil troughs and a low valuation at oil peaks.

We compare the Energy sector's [earnings yield](#) to the price of oil. The dynamic is apparent.



Given the market’s tendency to adjust Energy sector valuations based on oil price, we must control for crude before determining whether current valuations offer anything compelling.

We compare the forward earnings yield for the sector (less the risk-free rate) to the real price of crude. The red dot is where we stand at present.

The conclusion: after adjusting for oil, the Energy sector’s earnings yield is elevated (i.e., its valuation depressed) by about 40%, compared to historic norms.

Since 2018, capital has fled traditional energy. Poor returns, questionable

terminal values, and an anti-fossil fuel zeitgeist have coalesced to push down Energy sector valuations (blue dots/regression trendline).

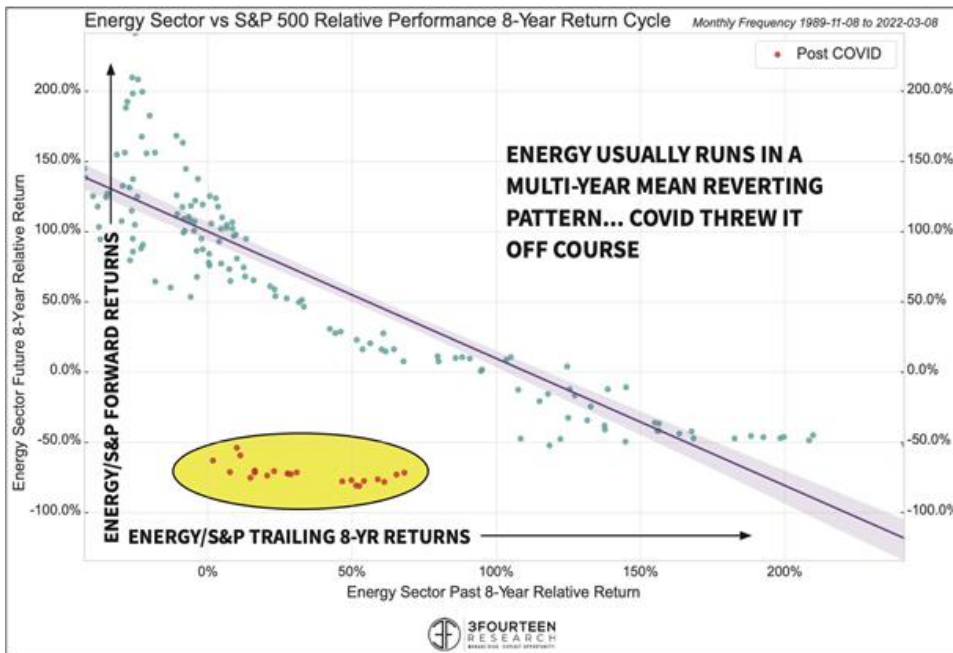
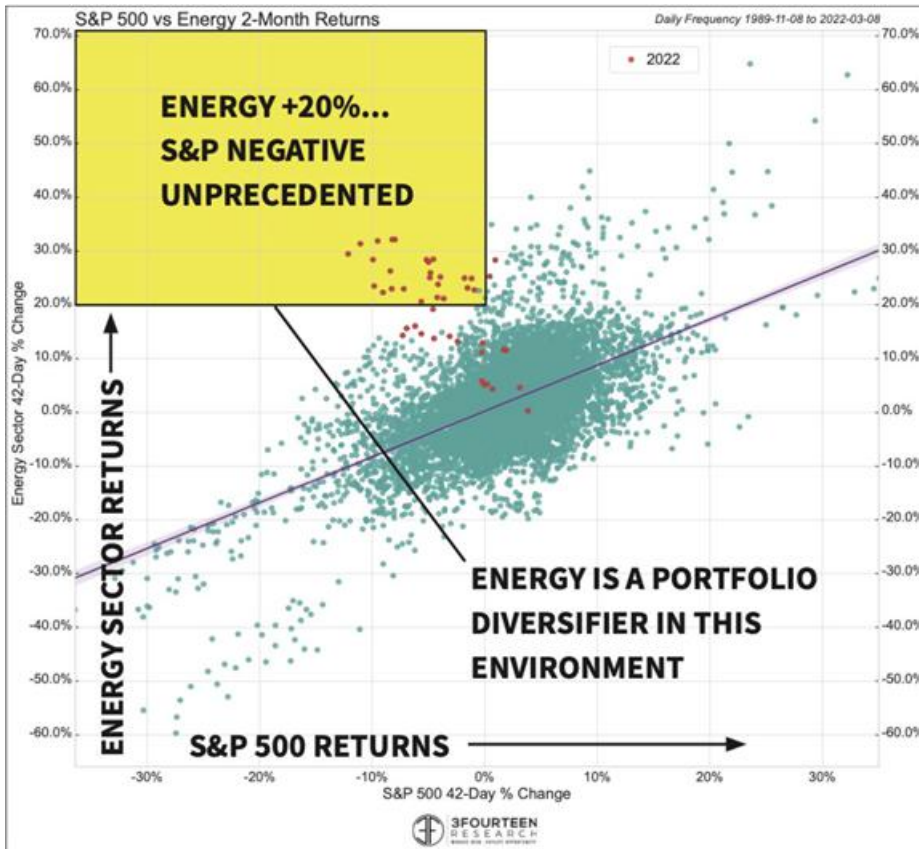
We believe the pendulum has swung too far. The Russia-Ukraine conflict will catalyze a new appreciation for energy security and traditional energy companies. Over the next few years, we expect Energy sector valuations to move closer to their historic multiple when adjusted for crude oil (purple line).

Based on this analysis, we should see multiples expand by about 40% (Energy earnings yield moves from 6.5% to 4.25%). Additional upside to the sector will come from expanding analyst estimates (this is a forward earnings yield analysis) and the shift higher in oil prices.

Finally, Energy’s negative [correlation](#) to the market offers attractive diversifying potential to quantitative analysts. Throughout 2022, the Energy sector has traded with a negative correlation to every other sector in the market. There are no other sectors with negative correlations to each other.



In effect, Energy equities are [hedging](#) two of the most acute risks facing the rest of the market: 1) an escalation between Russia and the West, and 2) persistent [inflation](#) driven by energy commodities.



Past performance is not indicative of future results. You cannot invest direct in an index. S&P 500: market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the U.S. economy.

Important Risks Related to this Article

This material contains the opinions of the author, which are subject to change, and should not be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product, and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment

of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Unless expressly stated otherwise, the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

WisdomTree and Foreside Fund Services, LLC, are not affiliated with the entities mentioned.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

view the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only. You cannot invest directly in an index.

DEFINITIONS

Term structure: The term structure refers to the relationship between short-term and long-term interest rates.

Backwardation: A scenario when the futures price is below the spot price.

Stagflation: a situation in which the inflation rate is high, the economic growth rate slows.

Valuation: Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Earnings yield: The earnings per share for the most recent 12-month period divided by the current market price per share. The earnings yield (which is the inverse of the P/E ratio) shows the percentage of each dollar invested in the stock that was earned by the company.

Correlation: Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Hedge: Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Inflation: Characterized by rising price levels.