



Is the Market Overvalued?

Description

With the TSX showing an impressive one-year return of 18% and a five-year return of 26%, investors may be feeling nervous. Are valuations getting ahead of themselves, or is there room to go higher?

I prefer to answer this question by looking into the different segments of the market, making a case-by-case conclusion, and hopefully finding the areas with the most value. Let's start with the energy sector and delve a little deeper. The energy sector has a one-year return of 27% and a five-year return of -15%. This makes sense because five years ago, oil was trading at over \$100, and last year it was under \$40 versus yesterday's close of \$56.83.

We certainly have to compare these returns against economic fundamentals and stock valuations to formulate an opinion on whether or not the market is overvalued. From a macroeconomic perspective, the energy sector has been strengthening, as supply and demand forces have started to work themselves out, and we are starting to see strengthening in drilling activity in Canada due to higher commodity prices. Expectations have been rising from very low expectations last year.

Suncor Energy Inc. ([TSX:SU](#))([NYSE:SU](#)) shares have a five-year return of 16% and a one-year return of 23%. It trades at a price-to-cash flow ratio of 10.5 times. Suncor has been a stellar performer and has beat expectations in the last two quarters. The company has plans to increase production by over 10% in 2017 and sees a corresponding increase in cash flow and reduction in debt. In the latest quarter, the dividend was increased by 10% to \$1.28 per share, which represents a 3.1% dividend yield.

Husky Energy Inc. (TSX:HSE) has taken strides to improve its business. Dispositions have improved the balance sheet, and the company reported better than expected fourth-quarter 2016 results. The 2017 cash flow will reflect higher commodity prices and lower interest expense. The shares trade at an attractive valuation of 7.6 times 2016 cash flow.

Mullen Group Ltd. ([TSX:MTL](#)) is a name that investors can be patient with and which represents good value. Its balance sheet is strong with \$273 million in cash and \$75 million in unused credit facility. The company will continue to make acquisitions to strengthen its foothold in the industry, and its diversified

business means that it is somewhat buffered from the cyclicalities of the oilfield-services industry. It also means it has a greater ability to generate free cash flow, even in hard times. Investors can expect a very interesting and successful year for this company.

Assuming the price of oil will at least remain in the current range, I think the energy sector will continue to do well and represents good value. Companies in the sector have been forced to look very closely at costs and efficiencies, and many have come out of it with improved businesses.

CATEGORY

1. Energy Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:SU (Suncor Energy Inc.)
2. TSX:MTL (Mullen Group Ltd.)
3. TSX:SU (Suncor Energy Inc.)

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