These 3 Stocks Are Cheap But Dangerous

Description

The Canadian energy sector has been hit with a double-whammy of epic proportions in recent weeks. The global COVID-19 pandemic has become a much larger demand-side shock than many investors initially expected. A slew of previous discussions around a V-shaped recovery and comparisons to previous short-lived outbreaks like SARS had many investors less concerned than they should have been. This has turned out to be a very serious pandemic. We are all now doing our part to stop this serious virus.

Supply issues

On the supply side, a global commodities glut is start to form. This is particularly true in the energy sector. The U.S., Russia, and Saudi Arabia are continuing to produce oil at or near record levels. This is driving oil and gas prices to lows we haven't seen in more than a decade.

Canada remains a price taker and has zero influence on global oil prices. Therefore, the choice for many producers has shifted from how much to cut capital expenditures or dividends to how much they should cut production in the short term to merely survive.

Three dangerously cheap examples

Many companies in Canada's oil patch are in survival mode. There are many examples of Canadian energy companies that I could have selected to highlight the dangers of investing in deep value energy right now. The three that I have chosen for discussion purposes are **Cenovus Energy**, **Baytex Energy** and **MEG Energy**.

These three companies have all seen their stock prices plummet on a year-to-date basis amid balance sheet concerns and unfavourable production economics right now. I have previously written about the dangers of investing in Baytex Energy. I called for all but the "most risk-loving investors out there" to avoid Baytex. However, I now predict an even more dire future for the company than I did previously.

These three companies are currently demonstrating that they are at risk of insolvency. The market is now pricing in this significant downside potential at the current stock price levels.

Balance sheet issues

These three companies are indeed examples of firms that had higher-than-average debt levels prior to this recent oil price plunge. This balance sheet weakness is a double-edged sword in that it increases the beta of each company and their respective leverage to commodity prices compared to peers.

When oil prices are rising, higher leverage can actually be good for stock prices. These sorts of plays get a boost from increased optimism around debt repayment, credit upgrades, etc.

In a persistently low oil price environment, however, the stock market tends to punish such companies. We've seen this happen lately. This reality means investing in these high-leverage names has really become a bet on oil prices. In my opinion, that's too dangerous of a game for true long-term investors to play. If you're a trader, trade away. But I'll be on the sidelines with these companies.

Stay Foolish, my friends.

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