2 Reasons Why Energy Stocks Are a Risky Buy Right Now

Description

The **S&P/TSX Capped Energy Index** has grown about 248% since its crash valuation. That's an unprecedented growth run for the sector and many individual energy stocks that experienced similar three-digit growth. And the momentum doesn't seem to be waning.

Has the sector grown as much as it was supposed to, or is there still time to tap into the powerful growth run? That's the question investors were asking a while ago. Right now, many are wondering whether it's even safe to buy energy stocks right now.

And even though the future pattern is difficult to predict, the reasonable answer to this question would be "no." Energy stocks might not be a safe buy right now, and the risk grows the longer the current momentum carries the sector ahead.

Still, before you make a buying and selling decision based on the perception of the risk alone, it's important to understand *why* energy stocks are risky in the first place.

Risk # 1: Unrealistic optimism-fuelled growth

The demand slump during the pandemic pushed most energy stocks way below the fair valuation line. The current demand hike and supply crunch is creating the opposite effect: A high demand has pushed many energy stocks way higher than their fair price. And it's not about the financial fundamentals of these stocks: The overvaluation is tied to the general long-term outlook of the sector.

Fueling the growth is the fact that OPEC missed production targets at least three months in a row. And the timing couldn't have been better for the energy stocks since it's also the time of the year when natural gas demand (and prices) are usually at their highest. All of these factors combined have made energy stocks appear more attractive than they actually are. And it's unlikely to last for more than a couple of months.

The first to get hit might be exploration stocks like **Canadian Natural Resources** (TSX:CNQ)(NYSE:CNQ). While the stock has a very stable history, even when the rest of the sector was suffering, it isn't immune to the current "optimism-fuelled" momentum of the sector. The usually slow growth stock has risen over 145% in the last 12 months alone, pushing the yield down to 3.5%.

The valuation is solid, but if the sector sees a correction, the stock might fall even below its pre-pandemic levels.

Risk # 2: Slow correction

The rise of the sector has been relatively sharp, but the correction might not be. It's both good and bad. Good because it will give investors more time to unload their growth stocks and bad because it will push the eventual recovery and future growth months or even years into the future. And the further it goes, the shakier the chances of the energy sector reclaiming its glory days would become thanks to variables like green energy bills and mainstream EV adaption.

This might be bad news for oil-heavy stocks like **Suncor** (TSX:SU)(NYSE:SU). The company has lost a lot of investor love after it slashed its dividends in 2020, and its reliance on oil sands might count against it in a market where the demand is slowly shrinking. Investors might concentrate more on "easy and relatively clean" oil production compared to the "costly and relatively dangerous" one associated with oil sands.

Foolish takeaway

The silver lining here is that when the energy stocks finally start moving downwards, you will get many generous dividend stocks in the energy sectors with very attractive yields. The growth of the energy sector might be in question, but if the demand and supply don't fluctuate too far ahead on either side of normal, the financials of energy stocks might stay stable, and the dividends will remain sustainable.

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