The Rise of Canadian Energy Stocks

Description

Rising inflation and geopolitical tensions have notably weighed on financial markets this year. However, very few sectors have emerged stronger amid the challenges, and energy has been one of them. Canadian energy stocks continued their stupendous bull run this year as well, remarkably beating the **TSX Composite Index**.

So far this year, TSX energy stocks at large have gained 35%, while the broader markets have added a mere 4%. In comparison, U.S. energy stocks have soared 40% in the same period.

TSX energy stocks outperform

Crude oil prices were already rising higher amid the supply woes. Crude oil has surged from US$76 a barrel at the end of last year to US$112 levels this week.

The Russia-Ukraine war only aggravated the situation, boosting oil prices to record levels. But instead of profiting from the higher prices by boosting production, Canadian energy focused on improving the balance sheet strength. So, a significant portion of their incremental free cash flows went towards debt repayments.

Canada's largest oil sands player **Suncor Energy** (TSX:SU)(NYSE:SU) repaid almost $3.6 billion of debt last year. This lowered its leverage from uncomfortably high levels in 2020 to 1.3 times as of December 31, 2021. And it's not just Suncor; debt repayment has been the theme across the board since last year.

Since last year, TSX small-cap stock **Baytex Energy** (TSX:BTE)(NYSE:BTE) has also seen a meaningful recovery. Its free cash flows last year surged to $396 million from $70 million in 2020. As a result, Baytex stock zoomed 330% in the last 12 months, notably beating its large-cap peers.

The crude oil demand-supply equation could remain skewed

Interestingly, even if the energy commodity prices fall from current levels, there might not be an equivalent fall in TSX energy stocks. That's because Canadian energy companies see superior financial growth at much lower forecasted crude oil prices. For example, Baytex sees free cash flows of $2.8 billion through 2025 at US$75-a-barrel WTI oil.

Moreover, sustained free cash flows will likely allow companies to spend more on dividends. Suncor Energy doubled its dividends late last year, while **Vermilion Energy** reinstated its shareholder payouts in Q1 2022.

We might see this trend gaining ground with continued strength in oil prices. Many Canadian energy companies still have room to grow their dividends, which are backed by their improving balance sheets.

Eric Nuttall, a partner and a senior portfolio manager at Ninepoint Partners, sees Canadian energy representing a generational opportunity. He thinks oil will see a multi-year rally, and TSX energy stocks are still trading at a discount.

What's next?

Although Russia-Ukraine tensions resolve soon, crude oil prices will likely remain high. The supply constraints have been mainly pushing it higher, coupled with demand rising even faster.

On the flip side, crude oil could see a setback if the mutating COVID-19 virus raises its ugly head again. That could lower the global oil demand, ultimately pushing stocks lower in the short to medium term.

Despite the strong rally since last year, Canadian energy stocks still look discounted. Appealing valuations, improving balance sheet strength, and a supporting macro picture make TSX energy stocks some of the attractive bets in today's market.

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