Why Canadian Oil Stocks Could Still Have a Huge Rally in 2022

Description

Canadian oil and gas stocks have been strong performers in 2022. The **S&P/TSX Capped Energy Index** is up 47% so far this year. That is compared to the broader **TSX Index**, which is actually *down* 8.3% year to date.

Despite the strong performance, oil prices have declined 25% since highs made earlier in June. The good news is that many Canadian oil stocks have held up relatively well. This baseline could indicate that these stocks are ready to rally another leg further. Here is why.

Canadian oil stocks could rally again in 2022 and 2023

Firstly, Canadian oil stocks have cleaned up operationally and financially. Years of low oil prices have forced them to reduce costs and maximize operating efficiency.

With oil suddenly shooting to +US$100 per barrel, most oil stocks are earning large amounts of surplus cash. This cash has been used to reduce debt levels to long-term, sustainable levels.

Secondly, oil prices could remain elevated for some time to come. Global oil and gas production capacity has not kept up with rising demand in the past several years.

The sector has not invested in production growth as in past cycles. Consequently, a long-term supply shortage could keep prices elevated for months and even years.

Canadian oil stocks are still gushing cash

Thirdly, Canadian oil stocks are gushing cash, even when oil trades around US$80 per barrel. Rather than invest in more production, many companies are rewarding long-standing shareholders with base dividend increases, special dividends, and share buybacks. If oil prices can remain stable here, shareholders are still in for some significant rewards.

High, consistent cash returns can also mean stocks get uprated in valuation. Institutional investors have largely not yet returned to the sector. Once they start seeing huge dividends and shareholder returns, they could come rushing back.

Suncor Energy

All this means there is plenty of upside ahead. If you were looking for more stable exposure to the sector, you might want to own a large-cap stock like **Suncor Energy** (TSX:SU)(NYSE:SU). Despite being up 30% in 2022, it has underperformed most of its peers.

The company has had operational and safety issues that have been a drag on the stock. Suncor recently replaced its chief executive officer, and an activist investor is looking to shake up the business.

Suncor could eventually return to the premium Canadian oil stock that it once was. Once demonstrated, this stock could have considerable upside.

Suncor stock also pays a nice 4.6% dividend yield. With a huge windfall of cash, it recently increased its base dividend and bought back a tonne of stock. Its overall outlook remains very positive.

Vermilion Energy

For an energy stock with a little more torque, **Vermilion Energy** (TSX:VET)(NYSE:VET) is interesting. At 3.5 times earnings, it is one of the cheapest mid-cap Canadian oil and gas stocks you can find.

Its stock trades with a 36% free cash flow yield right now. That means it could essentially buy back all its public stock with its excess free cash in three years if it wished to!

Vermilion has oil and gas assets in Canada, Europe, and Australia. Its assets in Europe are benefitting from a surge in energy prices. This is creating a lot of cash, which the company is using to quickly pay down debt.

Once Vermilion hits its debt targets late this year, it is primed to return a massive excess of earnings back to shareholders. This is a riskier Canadian oil stock, but it could have huge upside if it can achieve its plans.

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Date
2025/08/13
Date Created
2022/09/20
Author
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