Should You Buy Oil Stocks on the Dip?

Description

The price of oil has plunged from the 2022 highs. Contrarian investors are now wondering if the recent drop in oil stocks is a good opportunity to buy.

Oil market outlook

Oil bulls say the drop in the price of West Texas Intermediate (WTI) oil from more than US$120 to the current price near US$75 per barrel is overdone. Industry leaders suggest there is limited opportunity or willingness to raise production to meet rising demand. Energy companies around the world slashed capital spending by hundreds of billions of dollars during the pandemic. This means it will take longer to replace depleting resources. At the same time, large, new production projects are unlikely to get the green light, as producers seek to meet stringent net-zero emissions targets.

On the demand side, airlines are ramping up orders for new planes to meet surging travel bookings. This means fuel usage will continue to rebound. Commuters are also heading back to the office, and that trend is expected to pick up speed, as COVID-19 risks decrease.

In 2023, a reopening of the Chinese economy amid a reduction in COVID-19 restrictions could drive a surge in oil demand. This, along with sanctions on Russian oil, could potentially send WTI back above US$100 per barrel.

Oil bears say a potential global recession in 2023 or 2024 could hit oil consumption. They also point to the long-term trend of reduced gasoline demand as automakers shift to electric vehicles. At the same time, the recent developments in nuclear fusion hint at further progress in green energy. Meanwhile, hydrogen and the expansion of renewables are expected to slowly replace the use of fossil fuels.

What will actually happen in the market in 2023 and beyond is anyone’s guess, but there is probably more upside potential in the near term than downward risks for oil prices from the current level. Some of Canada’s top oil stocks now appear undervalued.

Suncor

Suncor (TSX:SU) fell out of favour with investors during the pandemic when it slashed the dividend by 55% to protect cash flow. The board has since raised the payout significantly, and the current dividend is at an all-time high. The stock, however, still isn't getting much love. Suncor trades near $42 per share at the time of writing. That's roughly where it was before the pandemic.

Management is selling non-core assets and making acquisitions that fit a narrower production focus. Suncor's integrated business that includes production, refining, and retail operations will remain in place and should deliver solid results, as the rebound in fuel demand continues.

Investors who buy the stock at the current price can get a 4.9% dividend yield. It wouldn't be a surprise to see Suncor move back toward the 2022 high around $53 if the price of oil trends higher in the first part of 2023.

In the meantime, investors get paid well to wait for a rebound, and there should be additional dividend increases on the way, even if oil holds in a US$70-$80 range. Suncor is using excess cash to reduce debt and buy back stock. As net debt drops, and the aggressive share-repurchase program reduces the outstanding common share float, more cash should become available for dividend increases or bonus payouts.

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