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ARE ENERGY STOCKS HEADED FOR A FIFTH YEAR OF UNDERPERFORMANCE?

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"Outperformance of energy stocks in 2016 will require an earlier than expected oil price recovery."

Four years and counting

Energy stocks have underperformed the broader market for a fourth consecutive year. They have also posted the lowest returns among the 10 S&P 500 sectors over both a three- and five-year time horizon, and rank second lowest (above only financials) over the past 10 years.

Oil prices are only part of the problem

The long-term relative performance of energy stocks vs. the broader market typically correlates with the price of oil. Energy stocks performed very well during both the 1970s and 2000s when oil prices rose and underperformed during most of the 1980s when oil prices declined.

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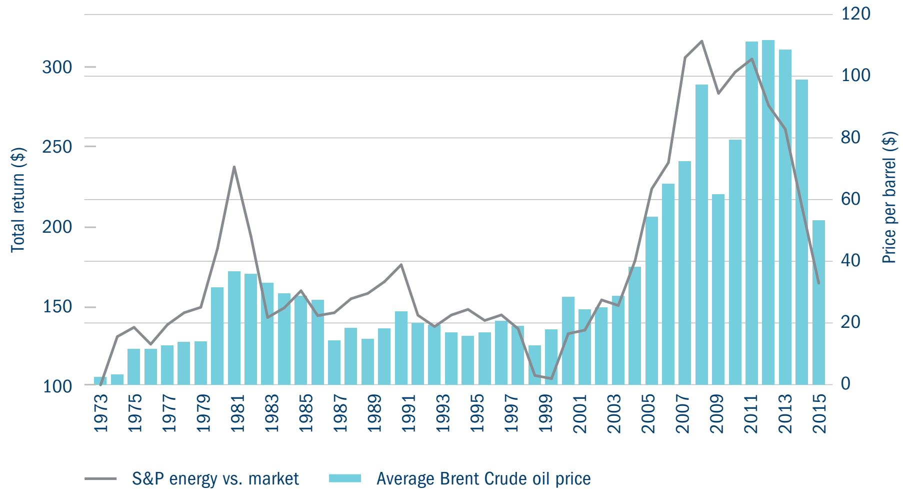
The close correlation between energy stocks' relative performance and oil prices



Source: Bloomberg, 12/09/15
Data for 2015 is year-to-date average up to December 9.

The sharp contraction in oil prices is largely responsible for energy's weak recent performance, although many other factors are to blame, some of which have been in place for several years.

Corporate returns have been steadily deteriorating since the middle of the last decade as a result of record levels of capital spending and easy access to capital. With oil prices recently below $40 per barrel, the energy sector is being forced to focus on lowering its cost structure, improving operational and capital efficiencies and spending within its means.

Can the underperformance continue? Statistically speaking, a losing run of five or more years for any sector is par for the course and has occurred on numerous occasions over the past 50 years.

Reversing energy's losing streak

For energy shares to outperform the broader market, higher oil prices and a more disciplined business model must emerge. Sentiment toward oil prices remains negative. The lower-for-longer view is widely accepted throughout the investment community, and the prospect for an oil price recovery before late 2016 or early 2017 seems unlikely. Equity investors, however, appear to be an optimistic group. Valuations today look beyond the current downturn to a time when oil prices, earnings and cash flows will all be higher.

The timing of oil's recovery will likely dictate how energy stocks will fare versus the broader market in 2016:

- **Early surprise.** An oil price recovery in early to mid-2016 will likely catch the market off guard, providing a positive catalyst, especially if the higher prices are perceived to be sustainable.
- **A 2017 recovery.** Expectations for a gradual recovery in 2017 will likely not be enough of a catalyst to move the stocks higher during 2016.
- **Lower for even longer.** Should oil market imbalances persist throughout 2016, pushing out the recovery out beyond 2017, energy stocks will most likely face another difficult year.

Oil markets will likely remain oversupplied for most of 2016, although signs of the next oil cycle are already starting to emerge. Declining U.S. shale activity (a positive) and the continued market-share war within OPEC (a negative) are only two parts of the supply equation. Sharp declines in capital spending outside of these two regions have been underway for almost two years and should continue in 2016, further delaying future supplies to accommodate modest demand growth and natural decline rates. While it is difficult to predict exactly when the supply/demand imbalance will reverse, a gradual recovery in 2017 remains the most probable outcome — one that is unlikely to provide enough of a catalyst for energy stocks to outperform the broader market during 2016.

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** Source: ICI as of September 30, 2015 for Columbia Management Investment Advisers, LLC.
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