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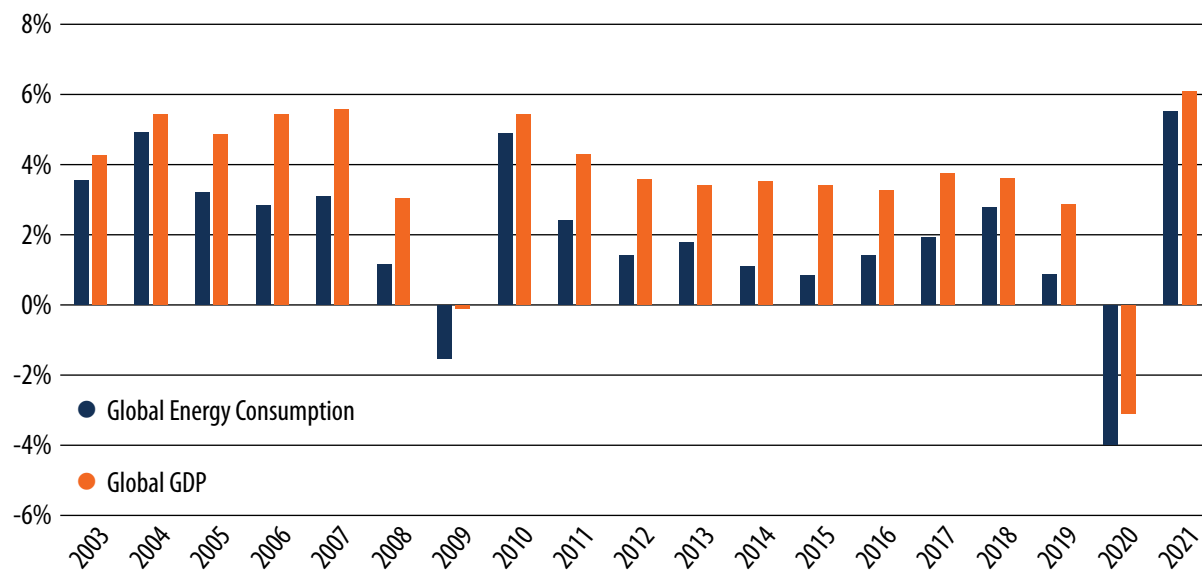
## Short-Term Weakness may Provide an Attractive Entry Point for Investors in Energy ETFs

After rallying for much of 2022, the energy sector plunged by over 20% from June 8th through July 14th as fears of a looming recession began to mount. While volatility may continue in the near term, we believe selloffs may provide more attractive entry points for investors, particularly those that remain underweight energy stocks. While we concede that a deep global recession could negatively impact demand for fossil fuels in the near term, we believe longer-term supply-demand dynamics, as well as geopolitical influences, will likely support relatively high prices for oil and natural gas, which may continue to fuel robust earnings for energy companies. Moreover, despite relatively strong performance since the Fall of 2020, energy stock valuations remain historically cheap.

### Resilient Demand for Oil & Natural Gas

Energy consumption and economic growth generally go hand in hand, as was demonstrated over the course of the last few years (Chart 1). During 2020, when the global economy faced its worst contraction in some time, energy consumption declined by 4.0% on a year-over-year basis. As the global economy recovered in 2021, demand for energy rebounded, with energy consumption rising 1.3% above 2019 levels.<sup>1</sup> While demand for energy fluctuates from one year to the next, it has generally tracked the growth of the global economy over the long term, a trend we believe will continue for the foreseeable future.

**Chart 1: Global Energy Consumption vs. Global GDP Growth (Year-over-Year % change)**



Source: Bloomberg. As of 12/31/21.

With rapid growth in renewable energy production in recent years, some have speculated about the future of fossil fuels and the traditional energy industry. While global fossil fuel consumption (oil, natural gas, and coal) returned to 2019 levels in 2021, consumption of renewable energy saw an increase of 25.7% during the same period<sup>2</sup>, accounting for the overall increase in energy consumption. In our view, greater efficiency, favorable economics, and supportive government policies will continue to drive future adoption of renewables. Even so, we believe demand for fossil fuels is unlikely to decline—and may continue to increase—over the next decade.

One key reason we expect oil demand to be resilient even with higher renewable energy production is because the two are not direct substitutes. Renewable energy is generally used in electricity production, an area that accounts for under 3% of global oil consumption<sup>3</sup>. Approximately 60% of global oil consumption is for transportation, with the majority being used in passenger vehicles. In our opinion, the adoption of electric vehicles (EVs) is a much greater competitive threat to oil demand than wind or solar power.<sup>4</sup> Indeed, EV adoption has accelerated over the past few years, and the automotive industry has made significant commitments to increase future EV production. However, the global internal combustion engine (ICE) vehicle fleet stands at nearly 1.5 billion, and the majority of these will be operating for many years. According to analysis by Energy Income Partners LLC (EIP), even if global EV sales were to grow to 50% of all passenger vehicle sales by 2030, transportation demand for oil would still be higher in 2030 than it was in 2019.<sup>5</sup> Not only is the quantity of vehicles around the world likely to continue trending higher due to population growth and economic development, it will take years for today's fleet of ICE vehicles to become obsolete and be replaced.

<sup>1</sup>bp Statistical Review of World Energy, 2022, 71st edition.

<sup>2</sup>bp Statistical Review of World Energy, 2022, 71st edition.

<sup>3</sup>IEA, World Energy Balances: Overview, 2021.

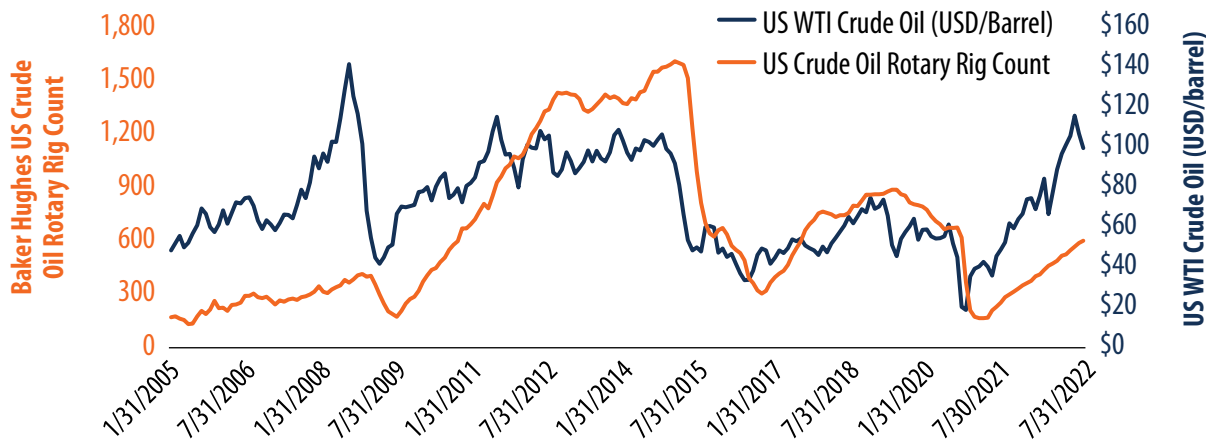
As a major source of electricity generation, we believe natural gas may be more impacted by the growth of renewable energy than oil. Nonetheless, there are several reasons we expect demand for natural gas to remain resilient over the next decade.

- First, wind and solar power are inherently intermittent—and in many areas seasonal—making fossil fuel plants a necessity to supply power when renewable sources are offline. With the passage of time, utility scale battery storage may help to address the variability of renewable output, but raw material constraints may restrict battery production, and large-scale battery storage projects may not be economically viable.<sup>6</sup>
- Second, natural gas produces significantly fewer pollutants and carbon emissions than coal,<sup>7</sup> a characteristic of natural gas that may garner greater support from policymakers and regulators. For example, the European Parliament recently agreed to include natural gas (and nuclear power) as “green” in their European Green Deal taxonomy.<sup>8</sup>
- Third, our complex energy infrastructure has been developed over many decades and isn’t well-suited for a rapid transition to renewables. [As we’ve written about before](#), trillions of dollars and decades of investment are likely needed to achieve the distributed, digital, and resilient power grid required to support large-scale renewable energy and EV adoption.<sup>9</sup>
- Finally, demand for electricity is likely to continue trending higher as the global economy grows larger. Higher electricity demand for EV charging, along with policies encouraging the “electrification of everything” —i.e., electric heat pumps, furnaces, stoves, etc.—could further increase demand for electricity. In our opinion, greater electricity demand is likely to spur growth for natural gas alongside renewables.

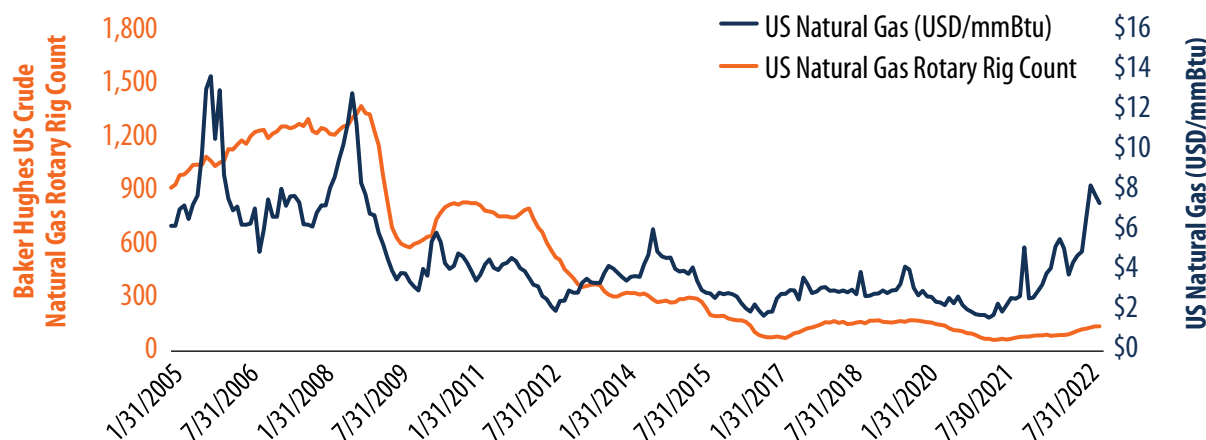
### Cautious Supply Response

Although demand for oil and natural gas has rebounded from the lows of the pandemic, energy companies have been cautious in expanding production. From 12/31/19-7/31/22, the spot price of crude oil increased by 62%, but the number of active oil rigs (11% fewer) still hasn’t fully recovered from its pandemic lows (Chart 2). Over the same period, the spot price of US natural gas increased by 224%, but the number of active natural gas rigs increased by just 26% (Chart 3). While incentives to boost output will eventually be too great to ignore, we believe supply growth may remain constrained for an extended period, creating a supportive environment for oil and natural gas prices.

**Chart 2: US Crude Oil Spot Price (WTI) and US Crude Oil Rotary Rig Count**



**Chart 3: US Natural Gas Spot Price (Henry Hub) and US Natural Gas Rotary Rig Count**



Source: Bloomberg. As of 7/31/22.

<sup>4</sup>IEA, Global Energy Review 2021.

<sup>5</sup>Energy Income Partners, *Deep Dive: The Math Regulating EV's Impact on Oil Demand*, 8/27/21.

<sup>6</sup>Bloomberg NEF, *Utilities Want More Energy Storage But Supply Remains Low*, 5/26/22.

<sup>7</sup>IEA, *The Role of Gas in Today's Energy Transitions*, 2019.

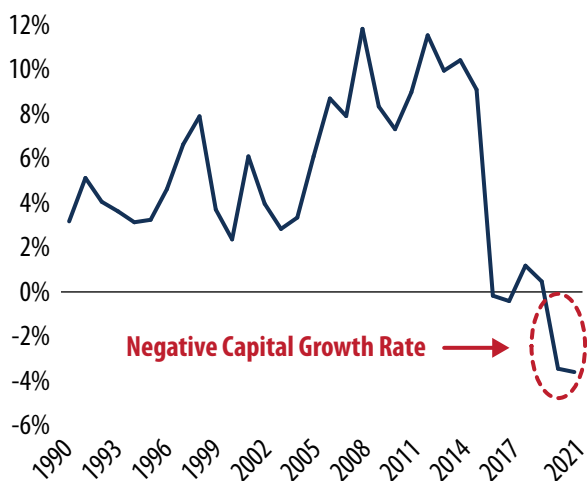
<sup>8</sup>European Parliament, *Taxonomy: MEPs do not object to inclusion of gas and nuclear activities*, 6/7/22.

<sup>9</sup>First Trust, *Rising Demand for Electric Vehicles Highlights the Need for Investments in the Power Grid: Which ETFs May Benefit?*

In our view, the existential threat posed by pandemic-related lockdowns may continue to impact how the energy sector allocates capital for many years. In 2020, 46 North American oil & gas producers filed for bankruptcy as prices fell and demand was crushed from unprecedented and unexpected lockdowns.<sup>10</sup> While much of the world has moved on from these severe restrictions, uncertainty remains in several key areas, such as China, where “zero-covid” policies have led to sudden lockdowns this year. In our opinion, the unpredictable nature of government responses to COVID cases and the potential for future lockdowns are a concerning threat that may soften investments in new energy production, leading energy companies to instead focus on strengthening their balance sheets.

We believe supply growth may also be constrained by longer-term cyclical dynamics within the energy industry. Energy production is capital intensive because it involves constantly depleting oil and natural gas reservoirs, requiring others to be developed to maintain (or grow) output. However, according to analysis by EIP, major oil and gas producers had a negative capital growth rate from 2016–2021, meaning that depreciation, depletion and amortization exceeded capital expenditures over that period (Chart 4). This reduction followed a period of strong capital growth from 2005–2015, during which energy companies employed technological breakthroughs in hydraulic fracturing and horizontal drilling to drastically expand capacity, making the US the largest producer of natural gas in 2011, and the largest producer of crude oil in 2014. With elevated prices, we expect capital spending to return, but output growth may lag demand for an extended period.

**Chart 4: Capital Growth Rate of Large Publicly Traded Oil and Gas Producers**



Finally, a focus on environmental, social and governance (ESG) factors by investors and regulators may influence investment decisions within the energy industry, in our opinion. In recent years, the European Commission has published guidelines for ESG and climate disclosures by public companies, with additional sustainability reporting requirements set to be implemented in the years ahead.<sup>11</sup> In the US, the SEC proposed climate disclosure requirements earlier this year. Increasingly, investors—particularly large institutions—are considering a company’s carbon emissions and sustainability initiatives in the investment decision-making process. In our opinion, companies making capital allocation decisions may be swayed by changing investors’ attitudes and increased scrutiny by regulators. Ironically, these new ESG considerations may have the unintended consequence of further subduing capital spending on new oil and gas production, potentially contributing to higher energy prices and earnings for the sector.

Source: EIP, 12/31/21.

### Positive Energy Sector Fundamentals

Despite recession fears impacting energy stocks in recent months, earnings expectations remain robust for the sector. According to Capital IQ as of 7/31/2022, the energy sector is expected to contribute over 60% of the earnings growth for the S&P 500 Index in 2022, by far the most of any sector.<sup>12</sup> In fact, over the 90-day period ended 7/31/2022, analysts revised 2022 S&P 500 Index energy sector earnings higher by 20.7%, also the most of any sector.<sup>13</sup>

With earnings estimates improving and stock prices moving lower, valuations within the energy sector continue to look attractive. As of 7/31/2022, the S&P 500 Energy sector was trading at 7.8x one year forward earnings estimates, below the 18.2x of the S&P 500 Index. In our opinion, today’s relatively low valuations suggest that optimism is lacking, despite intriguing developments that may spur earnings growth for the sector.

We can’t predict the future, and history tells us that recessions are a normal part of the business cycle. With the Federal Reserve and other central banks rapidly raising interest rates to curb high inflation, a recession at some point seems inevitable. While economic weakness could cause a short-term drop in energy prices, we believe energy sector valuations have largely discounted this risk, providing potential upside should it fail to materialize. But for long-term investors, especially those that are underweight the energy sector, we believe the case for increasing exposure to energy stocks may be too attractive to ignore. First Trust has several energy-focused ETFs, each providing unique and targeted exposure to areas related to the traditional energy sector. See our recently published *First Trust Traditional Energy ETF Primer* for a detailed breakdown of four such ETFs offered by First Trust.

<sup>10</sup>Haynes Boone, *Oil Patch Bankruptcy Monitor*, 1/31/22.

<sup>11</sup>Columbia SIPA, *ESG Investing and the US Oil and Gas Industry: An Analysis of Climate Disclosures*, 4/12/2022.

<sup>12,13</sup>CapitalIQ, 7/31/2022.

**You should consider a fund’s investment objectives, risks, and charges and expenses carefully before investing. Contact First Trust Portfolios L.P. at 1-800-621-1675 or visit [www.ftportfolios.com](http://www.ftportfolios.com) to obtain a prospectus or summary prospectus which contains this and other information about a fund. The prospectus or summary prospectus should be read carefully before investing.**

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