Sector report

Global Energy & Materials sectors – Riding on the reflation theme

Research Team

Global | Energy, Materials

The Path to a New Normal

Investment summary

With Democrats having unified control of the U.S. government, the prospects of more aggressive fiscal stimulus, greater infrastructure and renewable energy spending, as well as stronger economic growth are brighter. The Energy and Materials sectors, which we have **Overweight** ratings on, are expected to be beneficiaries.

We had earlier issued a 2021 outlook for the Energy sector and various sub-segments, "More favourable macro environment to aid in energy transition" on 4 December 2020, and what has changed over a month is a continued rise in share prices, as seen from the outperformance of the MSCI ACWI Energy Index compared to the MSCI All-Country World Index. Still, we see undervalued opportunities in the sector. We continue to prefer companies which have **struck a balance between the focus on shareholder returns and the transition to renewable energy**, as well as companies with **strong balance sheet strength** and **solid operating cashflow generation**. **Total SE* [FP FP; BUY; FV: EUR 49.00]** satisfies the above-mentioned requirements, while **Chevron* [CVX US; BUY; FV: USD 111.00]** offers one of the strongest balance sheets among the integrateds. Within refiners, **Phillips 66* [PSX US; BUY; FV: USD 88.00]** has a more diversified portfolio and relatively stronger balance sheet.

As for the Materials sector, we see it as a beneficiary of a weaker dollar, higher commodity prices, an upswing in global manufacturing and a restocking cycle. Opportunities in this sector include **Johnson Matthey* [JMAT LN; BUY; FV: GBp3,200.00], Anhui Conch Cement [914 HK; BUY; FV: HKD68.00]** and **Nutrien* [NTR US; HOLD; FV: USD61.00]** which still has a 12% upside.

- **Countries are regaining their footing; new U.S. administration should usher in greater stimulus**
- **Energy and Materials are beneficiaries of reflation theme though road may be bumpy**
- **Still see undervalued opportunities despite earlier rallies**

Beneficiaries of a weaker dollar, higher commodity prices, more stimulus and upswing in global manufacturing

Our bank has recently upgraded US equities to Overweight on the back of a unified government catalysing a more aggressive path for US fiscal stimulus, amongst other factors. We believe that Biden would likely pass a substantial relief aid package in 1Q 2021 via the reconciliation process that is around USD1 trillion or more, and that later in his first term, Biden will successfully implement major spending initiatives on infrastructure, renewable energy, the environment and healthcare.

Due to the prospects of more aggressive fiscal stimulus and stronger economic growth, US inflation expectations have broadly risen and this should spur reflation trades going ahead. The Energy and Materials sectors, which we have **Overweight** ratings on, are expected to be beneficiaries, and we still see a number of undervalued opportunities for the investor going forward.

We had earlier issued a 2021 outlook for the Energy sector and various sub-segments, "More favourable macro environment to aid in energy transition" on 4 December 2020, and **what has changed over a month is a continued rise in share prices** - the MSCI ACWI Energy Index rose 8% since the report compared to about 5% for the MSCI All-Country World Index. This was supported by improving market sentiment, as well as higher oil prices – Brent and WTI crude prices rose about 13% since then, catalysed by Saudi Arabia's unilateral cut on its output following the OPEC+ meeting in January.

Despite the more positive macro outlook, 4Q results could see further impairments. However, we believe the market is forward looking, and in this sector report, we re-look at the upside potential of stocks in the sector for undervalued opportunities for the investor.

Meanwhile, we continue to prefer companies which have **struck a balance between the focus on shareholder returns and the transition to renewable energy**, as well as companies with **strong balance sheet strength** and **solid operating cashflow generation**. **Total SE* [FP FP; BUY; FV: EUR 49.00]** satisfies the above-mentioned requirements, while **Chevron* [CVX US; BUY; FV: USD 111.00]** offers one of the strongest balance sheets among the integrateds, a reasonably low breakeven and an attractive and low -risk growth outlook of short-cycle investment opportunities anchored by its massive legacy position in the Permian Basin once oil prices improve. A recovery in refined products demand should also support the recovery thesis for refiners, though we need to see higher utilization levels first before refining margins recover in a sustainable fashion. We prefer **Phillips 66* [PSX US; BUY; FV: USD 88.00]** with its more diversified portfolio and relatively stronger balance sheet.

Opportunities along the Energy value chain

1. **Exploration & Production (E&P) companies**
2. **Independent Refiners**
3. **Integrateds**
4. **Oilfield Services**
5. **Midstream, pipelines**

Exhibit 5: Ratings and dividend yields of E&P Companies

					BOS/BOS-Morningstar			12m fwd	12m fwd
	Company Name	Ticker	Crncy	Price	Rating	Fair Value	Upside	Div Yield (%)	ROE (%)
Exploration and Production	CNOOC LTD	883 HK	HKD	7.30	Buy	10.00	37%	7.3	8.0
(E&P)	WOODSIDE PETROLEUM LTD	WPL AU	AUD	25.32	Buy	44.60	76%	2.9	5.3
	SANTOS LTD	STO AU	AUD	7.23	Buy	10.30	42%	1.1	6.9
	HESS CORP	HES US	USD	63.84	Sell	46.00	-28%	1.6	na
	EOG RESOURCES INC	EOG US	USD	62.44	Hold	64.00	2%	2.4	6.8
	MARATHON OIL CORP	MRO US	USD	8.39	Buy	13.00	55%	1.5	na
	DIAMONDBACK ENERGY INC	FANG US	USD	62.87	Buy	86.00	37%	2.4	7.7
	CONTINENTAL RESOURCES INC/OK	CLR US	USD	20.66	Hold	18.00	-13%	0.1	1.6
	PIONEER NATURAL RESOURCES CO	PXD US	USD	135.12	Buy	159.00	18%	1.6	9.6

Source: Bloomberg, Internal estimates and BOS-Morningstar estimates

Exhibit 6: Ratings and dividend yields of U.S. Refiners

					BOS/BOS-Morningstar			12m fwd	12m fwd
	Company Name	Ticker	Crncy	Price	Rating	Fair Value	Upside	Div Yield (%)	ROE (%)
Refiners	MARATHON PETROLEUM CORP	MPC US	USD	45.58	Buy	57.00	25%	4.8	na
	PHILLIPS 66	PSX US	USD	73.74	Buy	88.00	19%	4.9	4.9
	VALERO ENERGY CORP	VLO US	USD	59.51	Buy	79.00	33%	6.6	0.0
	HOLLYFRONTIER CORP	HFC US	USD	27.35	Buy	41.00	50%	5.1	1.8

Source: Bloomberg, BOS-Morningstar estimates

Exhibit 7: Ratings and dividend yields of the Integrateds

						BOS/BOS-Morningstar			12m fwd	12m fwd
		Company Name	Ticker	Crncy	Price	Rating	Fair Value	Upside	Div Yield (%)	ROE (%)
Integrateds	**HK**	CHINA PETROLEUM & CHEMICAL-H	386 HK	HKD	3.78	Buy	4.20	11%	7.1	4.8
		PETROCHINA CO LTD-H	857 HK	HKD	2.48	Hold	2.37	-4%	4.3	1.8
	China	CHINA PETROLEUM & CHEMICAL-A	600028 CH	CNY	4.15	Hold	4.08	-2%	5.3	5.3
		PETROCHINA CO LTD-A	601857 CH	CNY	4.31	Sell	3.60	-16%	2.2	2.3
	US	CONOCOPHILLIPS	COP US	USD	47.42	Buy	62.00	31%	3.7	2.5
		EXXON MOBIL CORP	XOM US	USD	47.88	Buy	74.00	55%	7.3	4.3
		CHEVRON CORP	CVX US	USD	93.34	Buy	111.00	19%	5.6	4.2
	EU	TOTAL SE	FP FP	EUR	37.05	Buy	49.00	32%	7.0	6.5
		ROYAL DUTCH SHELL PLC-A SHS	RDSA NA	EUR	16.84	Buy	24.50	45%	3.5	6.0
		BP PLC	BP/ LN	GBp	305.00	Buy	445.00	46%	5.1	7.3
		ENI SPA	ENI IM	EUR	9.05	Buy	13.80	52%	5.1	3.3
		REPSOL SA	REP SM	EUR	8.82	Buy	12.00	36%	6.9	4.5

Source: Bloomberg, Internal estimates and BOS-Morningstar estimates

Exhibit 8: Ratings and dividend yields of Oilfield Services companies

						BOS/BOS-Morningstar			12m fwd	12m fwd
		Company Name	Ticker	Crncy	Price	Rating	Fair Value	Upside	Div Yield (%)	ROE (%)
Oilfield Services	**Large Cap OFS**	HALLIBURTON CO	HAL US	USD	22.13	Buy	26.00	17%	1.0	8.9
		SCHLUMBERGER LTD	SLB US	USD	26.14	Buy	48.00	84%	2.0	9.4
		BAKER HUGHES CO	BKR US	USD	23.04	Hold	26.00	13%	3.1	11.6
	E&C, Eqpt providers	NOV INC	NOV US	USD	16.00	Buy	28.00	75%	0.2	na
		TECHNIPFMC PLC	FTI FP	EUR	10.27	Buy	25.00	143%	1.2	5.0

Source: Bloomberg, Internal estimates and BOS-Morningstar estimates

Exhibit 9: Ratings and dividend yields of Midstream firms

					BOS/BOS-Morningstar			12m fwd	12m fwd
	Company Name	Ticker	Crncy	Price	Rating	Fair Value	Upside	Div Yield (%)	ROE (%)
Midstream, pipelines	KINDER MORGAN INC	KMI US	USD	15.21	Buy	21.00	38%	7.1	6.3
	PEMBINA PIPELINE CORP	PBA US	USD	26.91	Hold	27.00	0%	7.4	8.9
	ENBRIDGE INC	ENB US	USD	33.72	Buy	45.00	33%	7.8	9.0
	TC ENERGY CORP	TRP US	USD	42.41	Buy	51.00	20%	6.5	13.2
	ONEOK INC	OKE US	USD	43.51	Hold	41.00	-6%	8.5	19.6
	ENTERPRISE PRODUCTS PARTNERS	EPD US	USD	22.41	Buy	25.50	14%	8.1	17.8

Source: Bloomberg, BOS-Morningstar estimates

Exhibit 10: Ratings and dividend yields of Singapore Asset Fabricators

					BOS/BOS-Morningstar			12m fwd	12m fwd
	Company Name	Ticker	Crncy	Price	Rating	Fair Value	Upside	Div Yield (%)	ROE (%)
Asset fabricators	KEPPEL CORP LTD	KEP SP	SGD	5.67	Hold	6	6%	3.6	4.9
	SEMBCORP MARINE LTD	SMM SP	SGD	0.17	Sell	0.14	-16%	na	na

Source: Bloomberg, Internal estimates

Please refer to the company reports for more details.

Confluence of factors benefitting the Materials sector

As for the Materials sector, we see it as a beneficiary of a **weaker dollar**, **higher commodity prices**, an **upswing in global manufacturing and a restocking cycle**. The combination of subdued bond yields and negative real interest rates have been a perfect tailwind for the materials sector but it has also come alongside other coinciding forces.

First**, China's Fixed Asset Investment** (FAI) trends remain healthy. Second, the record drawdown in US home and auto inventories is producing a **strong replenishment cycle**. Third, governments are stepping up their initiatives to combat climate change and to become carbon neutral. The **switch to renewables** is gathering pace at a time when the supply of copper, nickel, cobalt, lithium etc has not been able to keep up with demand.

In **Agriculture**, potash demand is expected to grow over the next several years. As the fertilizer helps plants grow in stressed weather conditions, including mild drought and flooding, farmers globally should continue to apply potash in greater quantities to maximize crop yields.

In **Chemicals**, producers saw demand continue to recover during 2H20 following Covid-19-driven closures. We expect a continued sequential volume recovery in 2021. This should bode well for specialty chemicals producers, whose differentiated products command premium pricing, driving profit recovery as volumes return.

It's a Blue Wave after all… more stimulus ahead

Last Thursday's confirmation of a Blue Wave in the upcoming US administration was also a significant development. Now that the Democrats have unified control of the government, this widens the scope of further stimulus spending, and increases the likelihood of a larger infrastructure bill and spending on renewables. This development favours the industrials and materials sectors, which was also touched upon in our earlier Industrials sector report, "Global Industrials – Building its way out of the pandemic" on 11 January 2021.

This was evident in the jump in share prices following the news that the Democrats have gained control of the Senate for related stocks, such as those we identified in our earlier reports like **Vulcan Materials* [VMC US; SELL; FV: USD 135.00]** and **Martin Marietta* [MLM US; SELL; FV: USD 235.00]**.

In addition, **Dupont de Nemours* [DD US; HOLD; FV: USD85.00]** which is in our Equity Focus List jumped 5.4% that day. It has just turned Hold-rated after appreciating more than 55% since we added it to the list in July (as of 8 January close). **BASF* [BAS GY; HOLD; FV: EUR63.00],** another materials stock in our Equity Focus List for months previously till it turned Hold rated and was removed, was also up about 5% that same day.

At current levels, we think the positive news have been priced in for these stocks. The natural question then is, where are the investment opportunities currently in the Materials sector?

Opportunities in the Materials sector

<u>United States</u>

In the U.S., **Nutrien* [NTR US; HOLD; FV: USD61.00]**, **Air Products* [APD US; HOLD; FV: USD305.00], Mosaic Co* [MOS US; HOLD; FV: USD30.00], Westrock* [WRK US; BUY; FV: USD49.00],** though HOLD rated, still have some upside**.**

Nutrien* (NTR US)

Nutrien will be a beneficiary of recovering potash fertilizer prices. The company's cost advantage stems from its low potash and nitrogen production. Created in 2018 as a result of the merger between PotashCorp and Agrium, Nutrien is the world's largest fertilizer producer by capacity. Nutrien produces the three main crop nutrients--nitrogen, potash, and phosphate--although the company's main focus is potash, where it is the global leader in installed capacity with roughly 20% share. The company is also the largest agricultural retailer in the United States, selling fertilizers, crop chemicals, seeds, and services directly to farm customers through both its physical stores and online platforms.

We think the market assumes lower-for-longer fertilizer prices, but we see potash and nitrogen prices rising in 2021 due to increased fertilizer demand. A key driver of fertilizer demand is crop prices. Farmers tend to apply more fertilizer when crop prices are higher in hopes of boosting crop yields and maximizing profits while applying less fertilizer to reduce costs when crop prices are lower. Crop prices are currently at multi-year highs, due to a sharp rebound in Chinese demand for grains and weather-related lower production in some regions. As a result, we expect increased fertilizer demand in 2021.

<u>Europe</u>

In Europe, **Johnson Matthey* [JMAT LN; BUY; FV: GBp3,200.00]** is BUY-rated while **Akzo Nobel* [AKZA NA; HOLD; FV: EUR95.00]** and **Linde Plc* [LIN US; HOLD; FV: USD275.00]** are HOLD-rated with upside.

Johnson Matthey* (JMAT LN)

Johnson Matthey is a U.K.-based specialty chemical company with unique expertise in catalysts, chemicals, and manufactured products derived from platinum group metals, or PGMs. Sales are fairly concentrated in developed markets, particularly Europe and North America. China, growing fast, now accounts for 15% of sales. Roughly 60% of sales are targeted at the automobile sector. The clean air segment is the company's largest (51% of EBIT) and manufactures autocatalysts for cars and heavy-duty trucks that reduce emissions and improve air quality. The group is preparing for a post-autocatalyst world by developing a cathode materials business electric vehicle batteries.

<u>Asia</u>

In Asia (including Australia), **Anhui Conch Cement [914 HK; BUY; FV: HKD68.00]** is BUY-rated while HOLD-rated **Orica Ltd* [ORI AU; HOLD; FV: AUD 17.50]** and **Amcor* [AMC AU; HOLD; FV: AUD 16.30]** have upside potential of 9-18%.

Anhui Conch Cement (914 HK)

Anhui Conch is expected to see continued profitability, supported by its leading position in eastern and southern China. While a slowing domestic economy may affect cement demand, this may be mitigated by the government's increase in infrastructure spending although a large scale stimulus is not expected. Anhui has a track record of managing its costs well in the past, which should help in supporting margins during downturns. Given its strong capital position (in net cash), the company is also positioned to make strategic acquisitions. Near term risks to monitor include regulatory risks following recent anti-trust meetings between the government and major cement players on the topic of rising cement prices. Overall, Anhui's supportive dividend yield and strong balance sheet (in net cash) position makes it a relatively more defensive play.

** Stock under BOS-Morningstar coverage*

ANALYST DECLARATION:

For analysts' shareholding disclosure on individual companies, please refer to the latest reports of these companies.

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Co.Reg.no.: 198301152E
Published by OCBC Investment Research Private Limited