The Positives Behind Exxon Mobil’s Earnings

The sharp drop in equities since Friday is notable for missing any obvious catalyst. Interest rates have been headed higher, but they’re far too low to offer value and the Equity Risk Premium continues to strongly favor stocks over bonds. A sharp move higher in interest rates could shift relative valuations away from bonds, but we’d need to see rates 1-2% above where they are today.

Earnings have generally been good, but Exxon Mobil (XOM) disappointed with their report on Friday morning and duly dropped 10% over the following two trading sessions. They missed expectations across each segment. They have failed to make money in U.S. oil and gas production for over two years, and their refining margins were also squeezed.

However, XOM’s travails shouldn’t tarnish the outlook for energy infrastructure. First, they announced plans to invest $50BN in the U.S. over the next five years. CEO Darren Woods singled out the Permian Basin in West Texas and New Mexico as an important target for some of this capital investment. This is exactly what energy infrastructure investors should be excited about. It’s evidence that the world’s biggest energy companies recognize the value in the Shale Revolution. Unconventional “tight” oil and gas formations offer rapid payback for a small initial investment. Capital invested is often returned within two years, allowing price risk to be hedged in the futures market. In Why Shale Upends Conventional Thinking , we noted last year that XOM’s CEO expected a third of their capex to be devoted to such opportunities. In response to a question on their recent earnings call, VP Jeff Woodbury replied, “…While we continue to invest across all segments, this increase compared to 2017 is primarily driven by higher investment in short-cycle Upstream opportunities, notably U.S. unconventional activity and conventional work programs, both of which yield attractive returns at $40 per barrel.” Woodbury continued, “As I indicated before when we were talking about the five-year projection of $50 billion, that is a very attractive investment. We’ve got – at a low price forecast we’ve got returns in excess of 10% with a $40 per barrel…”

Other multinational energy companies reported good earnings, including Royal Dutch Shell (RDS) and BP.

In addition to positive fundamental developments such as XOM’s future investments focused in the U.S., energy infrastructure was completely bypassed by last year’s strong equity rally. Few investors in this sector can be guilty of irrational exuberance, and there’s unlikely to be many panic sellers. We continue to see investors allocating new money, including yesterday in spite of the sharp drop in the market. This reflects the value that investors increasingly see in the sector. Energy infrastructure companies are valued at a 9% Free Cash Flow yield based on 2018 earnings, and 10% based on 2019.

By contrast, the S&P 500 Energy Corporate Bond Index yields only 3.8%. The truly overvalued sector is the bond market, especially long term government and high grade bonds whose yields remain too low to provide a reasonable return and show overvaluation compared with stocks (see Down’s A Long Way for Bonds). Fixed income investors should consider switching into energy infrastructure equities.