StoneX Intelligent Quant

May 2025

Famous Last Words: “I Like Energy”

1 – The oil curve is backwardated, the market is tight, and energy stocks are absurdly cheap
2 – US producers have learned from their shale boom excesses: they are lean, profitable, and shareholder-friendly
3 – Oil is the only commodity to price a 2025 recession, but global growth should surprise to the upside
4 – OPEC’s quota increase is a temporary internal adjustment, not the start of a price war or a grand geopolitical deal

"Smile at all the beatings
All the punches and the greetings
All the blows and the bleeding
Until you like it.” – Exodus, The Beatings Will Continue (Until Morale Improves), 2021

Investors always find a reason to sell energy. If the Democrats are in power, sell because of climate change and ESG. If the Republicans are in power, sell because shale will over-produce. If shale does not over-produce, sell because OPEC will. If growth is strong, sell because the Fed will hike. If growth is weak, sell because of recessionary risks.

This report will make **the contrarian bet that energy should be the best-performing US sector in 2025**.

The first part will review the fundamental case for the sector. First, a backwardated curve pays investors to hold barrels and indicates that the physical market is tight, as confirmed by low global inventories.

Second, energy companies return 7.2% of their capitalisation in buybacks and dividends every year, three times the shareholder yield of the S&P 500 index. The companies that overdrilled, overacquired, and overinvested during the shale boom years have become **lean, profitable, and shareholder friendly.**

The second part will discuss the macro case. First, **energy is the only commodity that prices a 2025 recession**. As I argued last month, IMF and most sell-side economists have overreacted to the Trump tariffs and the March-April bear market. The world economy will get used to moderate tariffs, and global growth will benefit from the boost of a weak US dollar, lower energy prices, higher European investment, and the Chinese stimulus. **East Asia’s “reverse currency crisis” is especially bullish for energy**, as it will boost the consumption of energy-dependent nations. State buyers usually refill China’s reserves when prices fall in the low 60s. The timing of this Chinese put could not be better: China does not want to recycle its trade surplus in US Treasuries, gold is too expensive, and higher gasoline prices pressure Trump to end the trade war quickly.

The third part will discuss the case against oil. First, the US economy’s surprising resilience in April could be a mirage that will dissipate in the summer. Maybe. But **oil prices and energy stocks’ valuations already price a recession** when non-energy US stocks trade for 25 times earnings. Second, OPEC’s recent quota increase could start another price war or indicate a grand geopolitical bargain between the US, Russia, and Saudi Arabia. Or it could just be a temporary increase to formally recognise Iraq and Kazakhstan’s higher output, which will be needed for the *haj* pilgrimage in June.

Contents

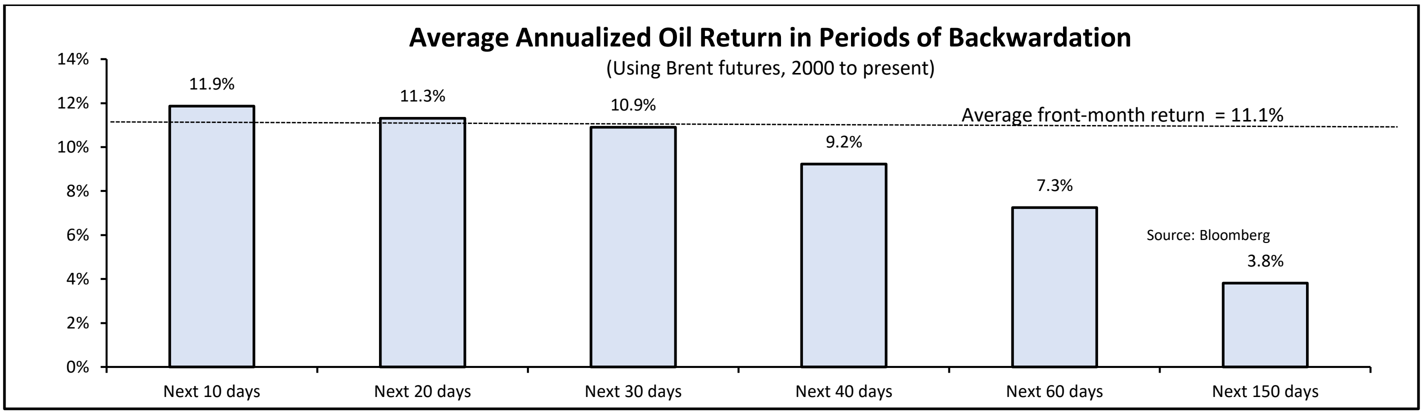
Vincent Deluard, CFA | Vincent.Deluard@StoneX.com | (+1) 415-713-5205 | StoneX Market Intelligence

The Fundamental Case for Energy

Backwardation

The first reason to own oil is simple: investors get paid to own barrels. 6-month Brent futures trade at a 2% discount to the June contract. If spot prices stay constant, investors in longer-dated futures will collect a nice roll yield when their contracts mature.

As shown in the chart below, the roll return is usually partially offset by weaker spot returns following periods of backwardation. However, this effect is not observed immediately, allowing futures investors to collect a short-term roll yield during periods of backwardation.

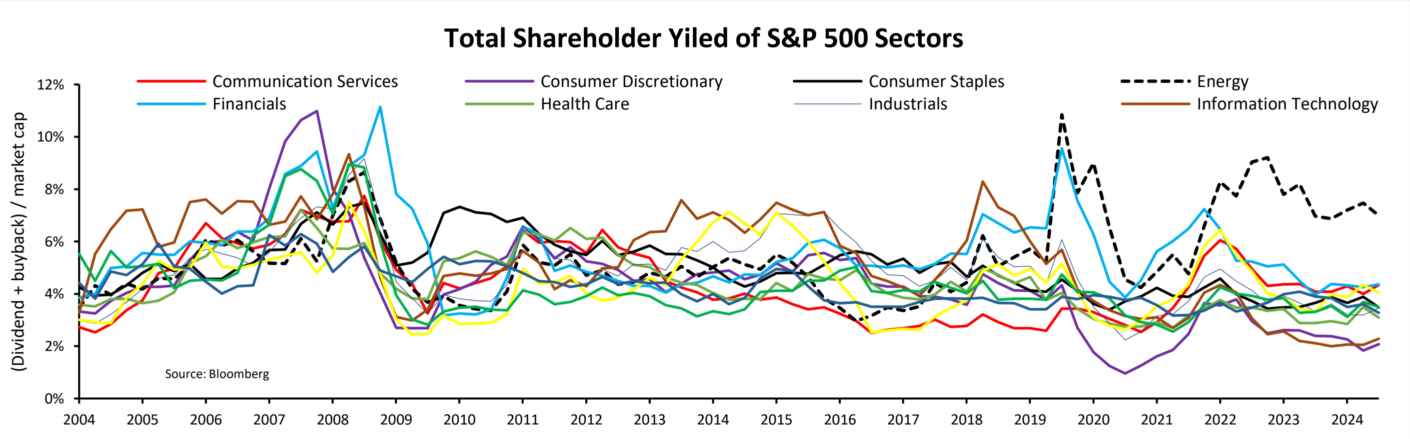


Many complex strategies can exploit time spreads, but generalists should stick to the basics:

- It is generally better to receive a yield than to pay it
- A premium in the spot market indicates strong physical demand, which is consistent with my [bullish view on global growth]
- Backwardation discourages storage. EIA inventories are at a historically low level, so any upside surprise in summer demand will have to be met by new production

Valuations

With a total shareholder yield of 7.2%, energy stands out as the cheapest sector in the S&P 500 index. Unloved oil majors are a rare example of US stocks that can compete with the value offered by international stocks.



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At $1.5 trillion, **the market value of the energy sector has fallen to less than 3% of the S&P 500 index, versus a long-term average of 8%**. The market capitalization of the energy sector is essentially unchanged from the 2016-2020 period, when the average oil price was also in the high 50s.

The similarities stop there. As shown in the table below, S&P 500 energy companies have earned almost twice as much in the past four years as they did during the four years ended in December 2019. **They also returned more than half of their operating profits to investors via buybacks, dividends, and debt repayments**.

In other words, the industry (over) corrected from its past sins. The shale boom was characterised by over-investment, excessive leverage, and uneconomic acquisitions. Today, **energy companies' sole focus is to return as much capital as possible** – even if it means sacrificing future growth. Energy companies are more profitable and more shareholder friendly.

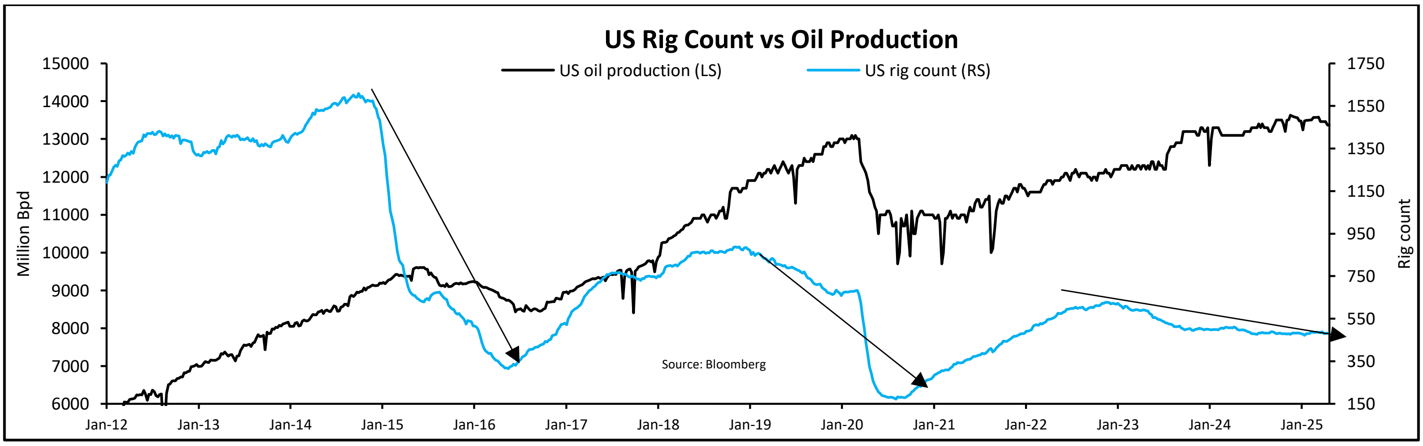
S&P 500 Energy Uses of Cash

Apr 2021 to Mar 2025

	Operating Cash Flow	Investment	Dividend	Debt repayment	Buyback	Net capital returned	*Capital Return rate*
Exxon Mobil Corp	165,390	51,080	43,432	15,747	51,350	110,529	*66.8%*
Chevron Corp	146,883	46,196	44,800	18,409	39,067	102,276	*69.6%*
Conocophillips	89,434	41,566	17,724	1,378	24,528	43,630	*48.8%*
Williams Cos Inc	20,338	14,507	8,670	-2,977	49	5,742	*28.2%*
Kinder Morgan Inc	22,841	13,579	10,078	-756	897	10,219	*44.7%*
Eog Resources Inc	43,786	21,523	13,624	419	5,150	19,193	*43.8%*
Oneok Inc	15,132	15,344	7,718	-8,464	489	-258	*-1.7%*
Schlumberger Ltd	21,841	8,878	4,609	2,094	4,188	10,891	*49.9%*
Marathon Petroleum Corp	42,985	-13,203	5,084	2,440	37,958	45,482	*105.8%*
Phillips 66	27,966	5,555	7,217	613	8,884	16,714	*59.8%*
Occidental Petroleum Corp	52,229	28,144	5,003	11,586	5,528	22,117	*42.3%*
Hess Corp	17,186	13,555	1,971	-345	192	1,818	*10.6%*
Diamondback Energy Inc	24,333	20,479	5,128	-8,459	2,989	-342	*-1.4%*
Valero Energy Corp	35,349	8,865	5,956	4,520	12,875	23,351	*66.1%*
Baker Hughes Co	10,686	3,998	3,039	1,706	2,474	7,219	*67.6%*
Targa Resources Corp	11,820	10,768	1,729	-9,944	3,562	-4,652	*-39.4%*
Eqt Corp	12,475	9,674	853	631	623	2,107	*16.9%*
Texas Pacific Land Corp	1,726	580	796	0	179	975	*56.5%*
Expand Energy Corp	10,566	6,116	2,348	-526	1,375	3,197	*30.3%*
Devon Energy Corp	27,923	18,643	7,449	-1,763	3,695	9,381	*33.6%*
Coterra Energy Inc	14,431	8,787	4,425	-1,177	2,293	5,542	*38.4%*
Halliburton Co	11,650	5,536	1,879	2,159	1,756	5,794	*49.7%*
Apa Corp	15,613	5,925	1,002	5,163	2,945	9,110	*58.3%*
Total - April 2021 to Mar 2025	**842,583**	**346,095**	**204,534**	**32,454**	**213,047**	**450,035**	***53.4%***
Total - Jan 2016 to Dec 2019	**447,505**	**309,421**	**147,795**	**-9,381**	**13,515**	**151,928**	***34.0%***
Growth since 2016-2019	***88%***	***12%***	***38%***	***-446%***	***1476%***	***196%***	***57%***

Source: Stonex, Bloomberg

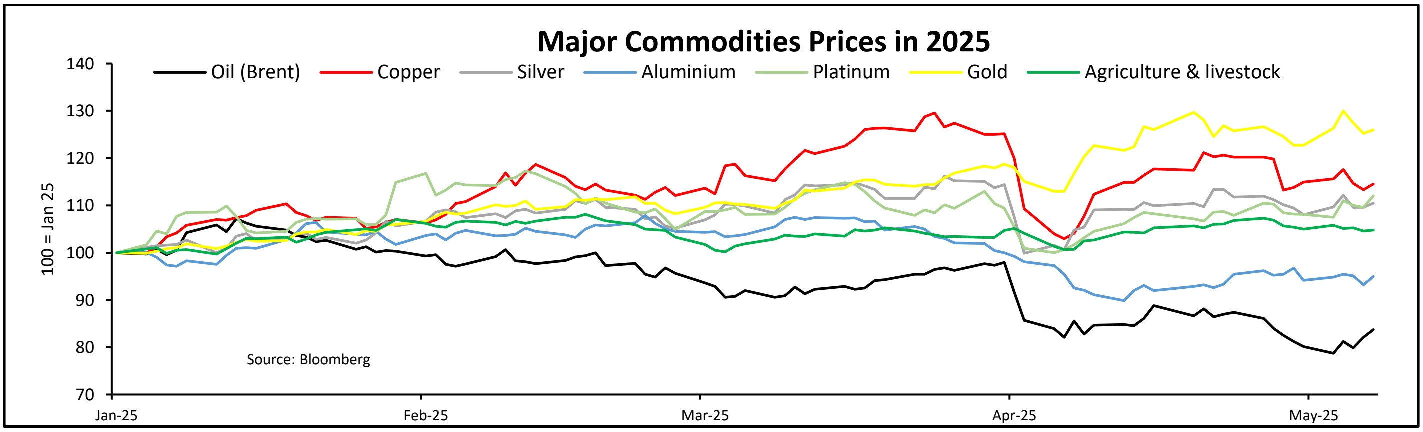
As shown in the chart below, Trump's promise to "drill, baby drill" did not stop **the decline of the US rig count to a three-year low**. Production has held up as drillers focused on the most productive wells, but shale fields' output eventually declines. As shown in the chart below, all prior declines in the rig count led to production declines a year later. Markets work, nature is healing, and low prices cure low prices: the oil selloff of 2025 will rebalance the market by discouraging supply and boosting demand. To which we shall turn.



Vincent Deluard, CFA | Vincent.Deluard@StoneX.com | (+1) 415-713-5205 | StoneX Market Intelligence

The Macro Case for Energy

Oil's precipitous decline since January 15 has been blamed on recession fears. However, other commodities did not get the memo. Gold's rally has surely benefited from central buying and uncertainties about the new monetary order, but the rally in growth-sensitive metals, such as copper, silver, and platinum, does not suggest an imminent global recession.



Oil prices may not have participated in this rally because **investors worry about the OPEC overhang**, i.e., the risk that Saudi Arabia will flood the market if prices rebound. The conclusion will discuss this risk and OPEC's recent output hikes. In the meantime, investors seem so focused on OPEC's hypothetical cap on oil prices that they ignore **the Chinese put**.

Chinese state-controlled buyers have emerged every time oil prices have dipped under $70 in the past five years. Chinese exports rose 1% in April despite the tariffs, so China still needs to recycle a monthly trade surplus of about $100 billion: Treasuries are out of the question, and gold's parabolic rise this year shows that it cannot accommodate China's surpluses. The oil market is ten times larger.

By re-filling its strategic oil reserve at a five-year low price of $50-$60 a barrel, China contains upside pressure on the Yuan, gains competitiveness against the soaring currencies of its neighbours, and enhances its strategic autonomy. Furthermore, keeping Brent prices above $60 reduces the odds of a Fed cut in July and raises gasoline prices ahead of the summer driving season. Higher borrowing costs and sticky inflation pressure Trump to get a quick trade deal with China. In the words of *The Art of the Deal*, "he who wants a deal badly gets a bad deal".

Second, banks and official institutions' **revisions to global growth are likely excessively negative** because most economists hate tariffs (and most IMF economists hate D. Trump even more).

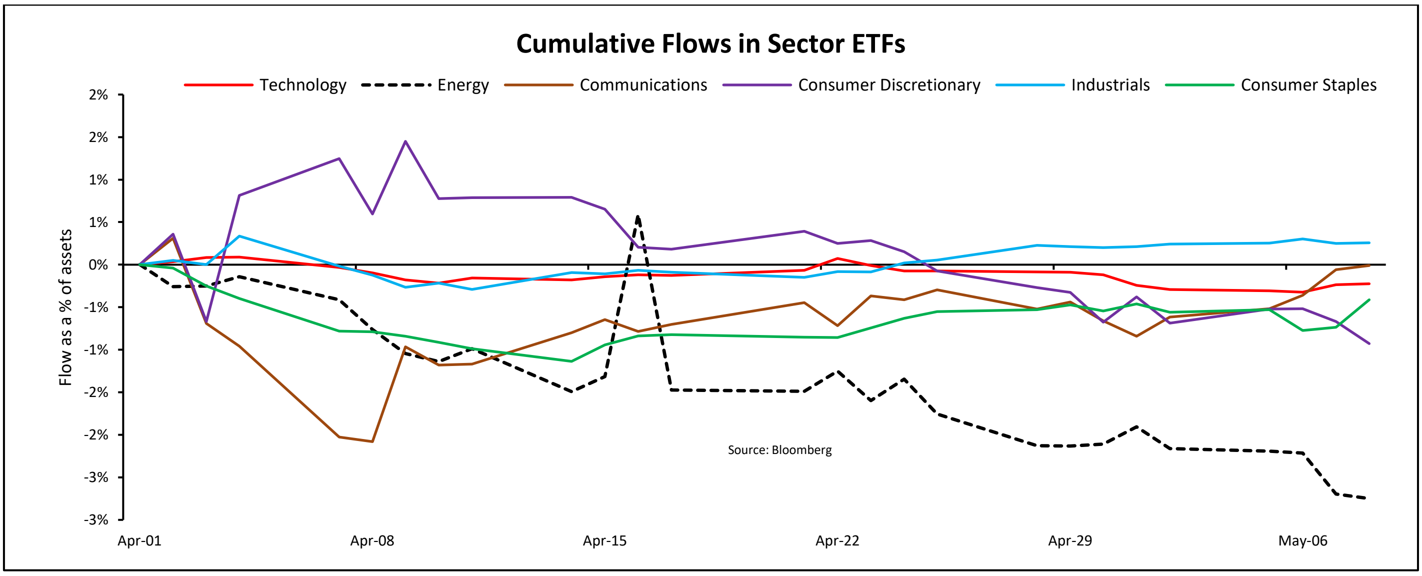
As discussed last week, the IMF knocked down its global growth estimate by $1 trillion, or twice the estimated value of the highest possible tariffs! The IMF also failed to acknowledge the boost to global growth created by the fall of the US dollar, lower energy prices, higher deficits in Europe, and the Chinese stimulus.

Furthermore, **East Asian nations, which import almost all the energy they consume, are on the verge of a "reverse currency crisis"**. The Taiwanese Dollar soared 10% in the past month. The Yen and the Korean Won are also breaking out. The world is healing: global growth was excessively reliant on the US twin deficits, its overleveraged consumer, its overpriced assets, and the overvalued US dollar. New engines of growth are emerging: European investment, Chinese consumption, soaring Asian currencies, and, unfortunately, a global push towards higher military spending.

Marginal energy demand was met with hard-to-export shale gas when the US economy was the sole engine of global growth. On the other hand, the **rebalancing of global growth towards Asian consumers and European investment will boost energy imports**.

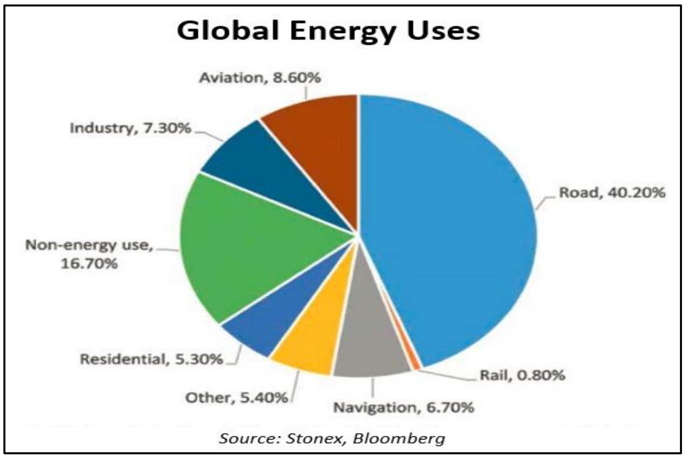
Vincent Deluard, CFA | Vincent.Deluard@StoneX.com | (+1) 415-713-5205 | StoneX Market Intelligence

Last, investors have treated oil as collateral damage from the trade wars, according to the theory that tariffs hurt global growth, which leads to lower energy prices. As shown in the chart below, **ETF investors have dumped energy funds since Liberation Day**. Industrials funds have benefited from hopes that the sector would benefit from tariffs and re-shoring. Finally, investors held to technology and communication funds, presumably because service platforms and the Mag 7 stocks would be mostly immune to goods tariffs.



The ultimate effect of trade wars may be the opposite. First, **energy commodities are excluded from tariffs, while the trade wars will probably expand to services**. D. Trump already promised to "[Make Hollywood Great Again]" by applying a 100% tariff on a rare sector where the US has a large surplus. Europeans' immediate response to Trump's tariffs on goods is to point out the US's large surplus on services, crack down on tech platforms' tax optimisation strategies, and impose tariffs on digital services.

Second, **de-globalisation and the regionalisation of trade may paradoxically increase energy consumption**. Navigation consumes just 6.7% of global energy, compared to 40% for road transportation and 7.3% for industry.



According to Google's Gemini, sending one pear from Argentina to New York consumes about 0.0033 gallons of gas. By contrast, sending it by truck from Oregon to New York consumes 0.009 gallons, or three times more. In the words of the large language model, "shipping the pear from Argentina would likely consume less oil per pear than trucking it from Oregon. This is due to the immense economies of scale and superior fuel efficiency (per ton-mile) of ocean freight, which more than offsets the significantly longer distance."

Vincent Deluard, CFA | Vincent.Deluard@StoneX.com | (+1) 415-713-5205 | StoneX Market Intelligence

Conclusion
The Bearish Case

In conclusion, investors should consider the bearish case for oil - and its weaknesses.

First, last month's economic rebound may be a mirage: efforts to front-run tariffs may have caused a temporary spike in activity, but **growth could plummet in the coming months**. This was essentially the playbook discussed in the March 25 report, Spring Rebound, Summer Lull, and a Fall Correction. The rebound phase may be over, but investors should wait for the summer lull before pricing another imaginary recession. Consumption is robust, and the deficit is still growing: it will take time for the economy to slow, and Trump will do everything he can to avoid a recession ahead of the 2016 midterms. The debt ceiling and budget bills will surely come with "big, beautiful tax cuts" in the fall.

The 2022 precedent of a stagflationary environment with a shallow and non-significant recession may be a better template for the second half of this year. For reference, energy was the only positive sector in 2022.

Last, **energy stocks' valuations already discount the risk of a severe 2025 recession**. *Recessionistas* may want to place their bearish bets against the margins and rosy EPS expectations of tech and consumer discretionary stocks.

Second, **oil and energy stocks' prices are tainted by a rare "geopolitical discount".** Prices were artificially sustained by low OPEC quotas and Saudi Arabia's voluntary cuts this past year. This era ended last week when the cartel announced output increases of 411,000 barrels a day in May, triple the market's expectations. Geopolitical tea-leaf readers suggested that Gulf States are helping Trump's inflation problem to earn goodwill ahead of a regional security deal over Gaza and Iran. Or that Saudi Arabia started another price war to break the back of shale producers and punish the cartel's cheaters. Or that Trump is pushing for lower oil prices to force Iran and Russia back to the negotiation table.

These claims are often contradictory and always unverifiable. Oil and energy bulls can also come up with grand geopolitical theories to justify their priors: India and Pakistan are on the verge of a nuclear war, China could boost its reserves before making a move on Taiwan, Netanyahu could have a secret agreement with Trump to bomb Iran's nuclear facilities, *etc*

Investors should consider more prosaic explanations for OPEC+'s production increase.

First, Iraq and Kazakhstan were already overproducing: the May 3 announcement simply adjusted the cartel's quotas to this existing reality.

Second, the *haj* pilgrimage to Mecca in June will lead to a spike in travel in the Middle East when demand for AC is highest.

Finally, the May 3 OPEC meeting communique stressed that "*gradual increases may be paused or reversed subject to evolving market conditions*". This caution dismisses the theory that Saudi Arabia wants a protracted price war.

When bullish energy analysts get over-excited with grand geopolitical theories ("petroyuan!", "de-dollarization!", "closure of the strait of Hormuz!"), I remind them that **friends don't let friends trade based on geopolitics**. Those who sold energy stocks because of the Trump tariffs or shorted oil after the OPEC announcement should listen to this advice.

Vincent Deluard, CFA | Vincent.Deluard@StoneX.com | (+1) 415-713-5205 | StoneX Market Intelligence

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Vincent Deluard, CFA | Vincent.Deluard@StoneX.com | (+1) 415-713-5205 | StoneX Market Intelligence