

A closer look at the energy sector

Global Equity Pulse

As of the end of the quarter, West Texas Intermediate (WTI) oil prices topped US\$100 per barrel, driven by ongoing uncertainty over the conflict in the Middle East. Energy stocks were among the top performers in global equity markets so far this year but were relatively weak in 2025. How to navigate a sector so tied to geopolitics and external events?

We believe staying focused on individual company fundamentals, while being mindful of the shifting dynamics in which they operate, provides the most rational framework for investments in the sector. We see opportunities in European integrated oil majors. These companies have diversified business models that enable them to potentially capture upside across different products and different geographies, which can offer resilience throughout the market cycle.

Short-term oil shocks and long-term investing

We look at energy stocks over a longer-term horizon than the market, which typically focuses on short-term moves in oil prices. Energy markets react quickly to events. Long-term value, however, is still determined by cost structure, capital discipline and durable demand instead of temporary surges in geopolitical risk.

Our approach to long-term investing in the sector is not dependent on near-term oil prices. Rather than trying to estimate global oil prices and their impact on companies through a top-down approach, we model what we consider to be a normalized medium-term oil price and focus on the factors that we believe will likely affect the equity performance of specific companies, including where they are located and where they are finding their growth. We believe opportunities can typically be found in the two situations below:

Underappreciated growth stories—companies experiencing an investment phase that depresses cash flow today but that could lead to higher production in the future. As an example, a US-based exploration and production holding is currently spending on long-dated projects that are depressing free cash flow, but we believe this will likely inflect over the next five years. In our analysis, the market has underestimated the value of this inflection.

Restructuring opportunities—as a sector with limited organic growth opportunities, business restructuring can offer an opportunity to increase shareholder value over time. A UK-based major integrated oil company is a good example. The company is cutting costs, appointing a new chairman and chief executive officer, and raising free cash-flow generation. Taken together, we expect these measures to create value and thus hold a strong conviction in the stock.

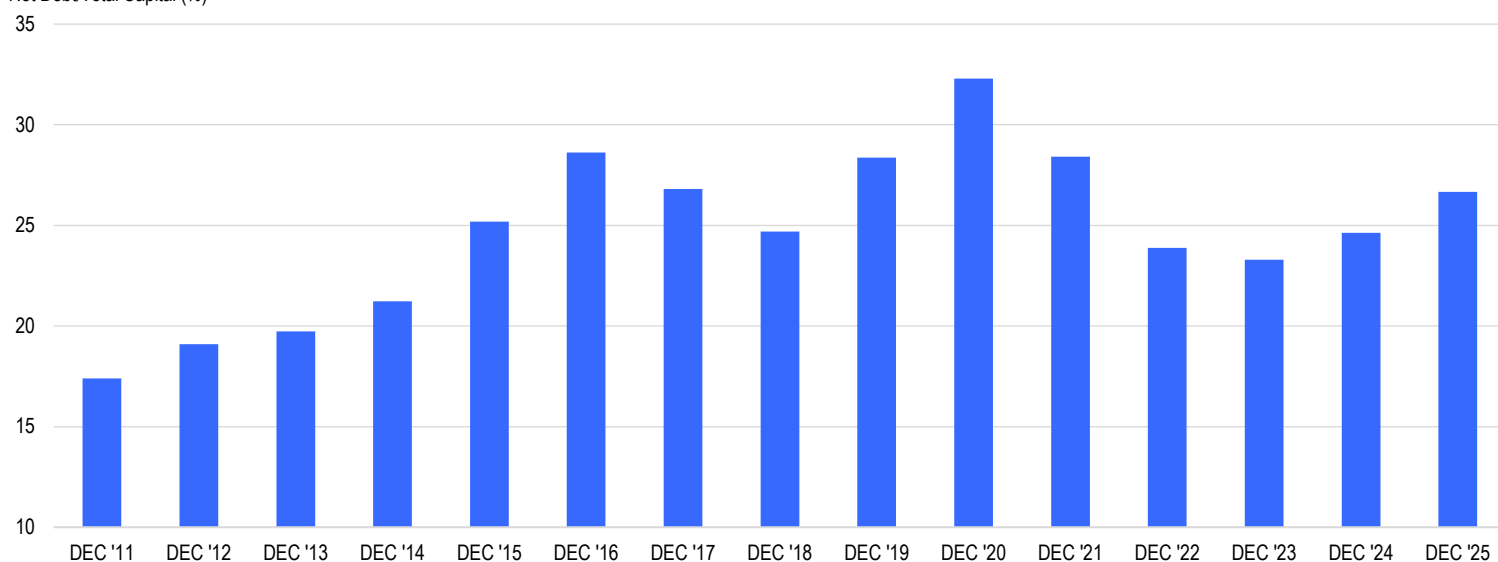
What both these examples have in common is that our thesis around value creation is, to some extent, independent of shifts in the commodity price.

Overall improvements in the sector

The energy sector has seen considerable improvements in its ability to generate free cash flow over the past decade. Currently, the sector stands out with one of the highest free cash flow yields—free cash flow relative to share price—in the market. With ample cash flows, the sector continues to reward shareholders with what we consider attractive dividends. For example, stocks in the MSCI AC World Energy Index had a dividend yield of 3.4% as of February 27, 2026. In contrast, the global benchmark yielded dividends at around 1.6% as of the same date.¹

Deleveraging: Energy Company Debt Has Decreased Significantly since 2020

Net Debt/Total Capital (%)



Sources: FactSet, MSCI. Energy companies represented by the MSCI ACWI Energy Index, which includes large- and mid-cap securities across 3 developed market (DM) and 24 emerging market (EM) countries. All securities in the index are classified in the energy sector as per the Global Industry Classification Standard (GICS®). Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** See www.franklintempletondatasources.com for additional data provider information.

The sector has also improved its resilience by reducing leverage from the peak reached during the COVID crisis in 2020. Stronger balance sheets mean that the sector will likely be able to sustain dividends at lower oil prices.

More broadly, the current supply-side constraints relative to demand growth are positive for the sector's outlook. While slowing, oil demand growth is still expected until at least 2030. However, the number of drilling projects has been declining steadily over the past decade, and production at existing oil fields continues to decline. This disparity will likely keep oil prices at or above marginal cost, which should help sustain cash flow generation in the energy sector.

As always, bottom-up stock selection, primarily in underappreciated growth stories and restructuring opportunities, will continue to drive our exposure to the sector.

Market review

Global equities declined over the first quarter of 2026, with the MSCI All Country World Index (ACWI) falling,² as a sharp drawdown in March more than offset gains earlier in the period. Market performance experienced a significant rotation in leadership, with value stocks, as measured by the MSCI ACWI Value Index, declining modestly over the quarter and materially outperforming growth stocks, as measured by the MSCI ACWI Growth Index, which experienced a pronounced selloff. Additionally, smaller-capitalization stocks proved more resilient and held up better than large caps.³ This shift reflected a sustained move away from US mega-cap concentration and long-duration growth assets.

Outlook

In the United States, longer-lasting high oil prices and inflationary pressures could pressure sectors such as consumer discretionary and industrials. The Asia-Pacific (APAC) region is also vulnerable to the oil shock, with the risks of higher-for-longer energy prices potentially hurting regional economic and corporate earnings growth in 2026. We will stay selective in APAC, focusing on sectors that are more resilient despite external shocks. In our opinion, the technology and artificial intelligence theme remains compelling. Within European equities, we maintain a constructive but selective outlook for the rest of 2026. Following a 2025 marked by asymmetric market reactions, we believe improving policy momentum, including competitiveness reforms, German fiscal support and coordinated defense spending should support Germany's medium-term growth. Geopolitical risks may increase volatility, but disciplined stock selection should remain the primary driver of returns.

ENDNOTES

1. Source: MSCI. As of February 2026. Energy companies represented by the MSCI ACWI Energy Index, which includes large- and mid-cap securities across 23 developed market (DM) and 24 emerging market (EM) countries. All securities in the index are classified in the energy sector as per the Global Industry Classification Standard (GICS®). Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** See www.franklintempletondatasources.com for additional data provider information.
2. Source: MSCI. As of March 2026. The MSCI ACWI captures large- and mid-cap representation across 23 DM and 24 EM countries. With 2,514 constituents, the index covers approximately 85% of the global investable equity opportunity set. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** See www.franklintempletondatasources.com for additional data provider information.
3. Source: MSCI. As of March 2026. The MSCI ACWI Value Index captures large- and mid-cap securities exhibiting overall value style characteristics across 23 DM and 24 EM countries. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield. The MSCI ACWI Growth Index captures large- and mid-cap securities exhibiting overall growth style characteristics across 23 DM and 24 EM countries. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate, long-term historical EPS growth trend and long-term historical sales per share growth trend. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** See www.franklintempletondatasources.com for additional data provider information.

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All investments involve risks, including possible loss of principal.

Commodity-related investments are subject to additional risks such as commodity index volatility, investor speculation, interest rates, weather, tax and regulatory developments.

Equity securities are subject to price fluctuation and possible loss of principal.

Dividends may fluctuate and are not guaranteed, and a company may reduce or eliminate its dividend at any time.

The **investment style** may become out of favor, which may have a negative impact on performance.

Large-capitalization companies may fall out of favor with investors based on market and economic conditions. **Small- and mid-cap stocks** involve greater risks and volatility than large-cap stocks.

International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in **emerging markets**.

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