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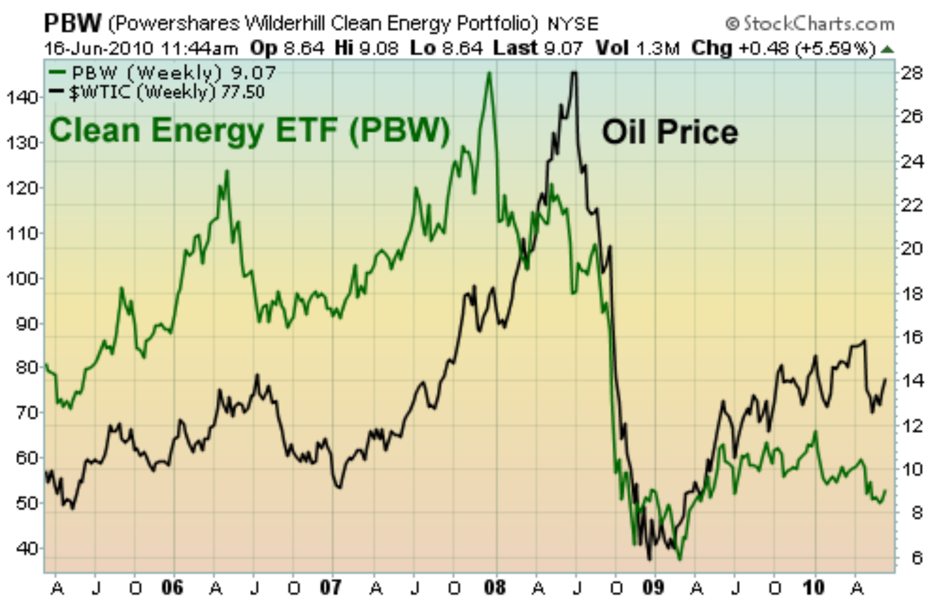
Why Alternative Energy Sector Underperformance Is About to End

Alternative energy being a sub-segment of the energy market, it is no surprise to find a strong link to oil prices. Some forms of alternative energy, such as ethanol for instance, are direct substitutes for oil products and therefore are very directly impacted by the vagaries of oil prices. In fact, the ups and downs of oil prices have driven the boom and bust cycles of the renewable fuel industry even more than government subsidies.

Most other forms of alternative energy which produce electricity are not direct substitutes for oil today, but are they affected by the price of oil as well?

We use the oldest and largest clean energy ETF, the PowerShares WilderHill Clean Energy Portfolio (PBW), as a proxy for the green industry and plotted its price history (green line) against the price of oil (black line) in the chart below.



As evidenced by the chart, since its inception in March 2005 the clean energy index ETF has been highly correlated with the price of oil, which means they tend to move together. Just to be sure it is not an optical illusion, we computed the coefficient of correlation between oil and PBW. The result, 0.90, is indeed very high, with 1.00 marking perfect positive correlation.

We also checked the correlation between oil and PBD, the PowerShares Global Clean Energy Portfolio, which we feel is a better proxy for the green industry for being global, and it came out even higher at 0.93.

The price of oil has been in a solid uptrend for a decade with the only significant declines coming during the 2001 and 2008 recessions. All evidence points to a long-term bull market in energy, with global demand growth driven largely by emerging countries. Oil prices will continue to be volatile with economic cycles and threats to supply/demand, but are widely expected to continue their long-term uptrend for years to come due to higher demand and ever higher costs. Increased regulation and oversight for the oil industry and fewer permits for new offshore drilling, the direct consequences of the ongoing environmental disaster in the Gulf of Mexico, will only serve to hike prices further for years to come.

With this in mind we strongly believe that the recent underperformance of the alternative energy sector is about to end.