

## INVESTMENT COMMENTARY & OUTLOOK

### January 2023

The fourth quarter started with several violent short covering rallies and helped to mark a definitive stock market bottom. Not only was October a strong month, but November also started on a positive note. The stock market temporarily lost its “mojo” in December after a hawkish FOMC statement and new interest rate fears emerged. The next Federal Open Market (FOMC) statement will be on February 1st, and we are anticipating a dovish statement due to moderating multiple inflation reports.

As you have repeatedly heard, the Fed never fights market rates, so if Treasury yields continue to moderate with better inflation reports, then the FOMC has to stop raising key interest rates. January has been characterized by weak economic news, like (1) slowing wage growth, (2) the ISM service index slipping into a contraction after expanding for 30 straight months, and (3) decelerating consumer price inflation due largely to moderating rental and housing costs (i.e., owners’ equivalent rent).

The Fed knew that by raising key interest rates it “pricked” the housing bubble. Existing home sales have fallen for several straight months and median home prices have been falling since July. Since owners’ equivalent rent is a major component in both the Consumer Price Index (CPI) and Personal Consumption Expenditure (PCE) indices, the Fed has succeeded in squelching housing related inflation.

With interest rate concerns now diminishing, the stock market can finally focus on earnings growth and there lies a problem, since outside of the Top 15% of stocks in our Dividend Grader and Stock Grader databases, positive earnings growth remains elusive due to difficult year over year comparisons as well as sputtering economic activity.

The strongest sectors remain Primary Metals (i.e., specialty steel) and Energy. Energy companies are forecast to post the strongest earnings, despite low natural gas prices due to mild winter weather. However, crude oil prices typically rise in the spring due to strong seasonal demand, so \$100 per barrel crude oil is possible and \$120 per barrel crude oil could occur if there is a disruption from Russia or OPEC.

There are several reasons that we remain bullish on crude oil. First, China is reopening its economy and approved international air travel after a 3-year hiatus from its Covid restrictions, so it just boosted the amount of crude oil refiners could import. Second, the Biden Administration released approximately 180 million barrels of crude oil from the Strategic Petroleum Reserve (SPR) in 2022, but those SPR releases of up to 1 million barrels a day of light sweet crude have abruptly ceased in 2023, since the SPR is now at a four-decade low. Third, crude oil demand always rises in the spring as people in the Northern Hemisphere get out, and worldwide demand rises in the spring and peaks in the summer months.

The lackluster guidance from some former flagship technology stocks, plus ESG being redefined after Tesla was booted from the S&P ESG indices last May has resulted in significant index realignments. Energy

companies were recently added to both the NASDAQ 100 and S&P 500 in December, so stock market indices are being changed as technology weights are reduced and energy weights are boosted. As a result, we expect persistent institutional buying pressure in our favorite energy stocks.

Mean reversion has been the favorite tool of algorithmic investors to generate trading activity post earnings announcements. Normally, we ignore the algorithmic trading activity, but they have become more annoying lately. However, we have noticed that we have had multiple companies announce their fourth-quarter earnings early, almost as if they wanted to get the good news out to make sure the algorithmic traders stopped jerking their stocks around.

Although we have had a very good start to the fourth-quarter announcement season, we remain in a 15% market, where once we leave the top 15% of the stocks screened from our Dividend Grader and Stock Grader databases, it remains slim pickings. However, the good news is the top 15% of stocks are benefitting from persistent institutional buying pressure due to leadership changes.

No matter how wonderful the fourth-quarter announcements are, it is imperative that the Fed “pivot” by acknowledging that the core rate of inflation is cooling and follow Treasury yields by hitting the “pause” button after its last key interest rate hike on February 1st. Once all the uncertainty surrounding the Fed and “how high the FOMC will go” is over, we expect a significant relief rally. The single-digit price-to-earnings (PE) ratios that now characterize both our dividend and growth portfolios are unprecedented, so we expect a significant market rebound if our PE ratios expand to the S&P 500 level.

## SUMMARY

Our fundamentally superior stocks will soon be in the midst of their fourth-quarter earnings announcement season. In the wake of several stocks preannouncing their fourth-quarter results, the upcoming announcement season is expected to be especially exciting. There is an acute shortage of companies that are still characterized by positive sales and earnings, so the top 15% of stocks are expected to benefit from persistent institutional buying pressure.

Speaking of institutional buying pressure, energy stocks are rising as a percent of major indices, while technology stocks have been trimmed. There are also major changes to ESG indices that are also adding fossil fuel companies that make “green diesel” and/or “hydrogen.” The bottom line is that fossil fuels as a percent of indices are now rising steadily and we expect that institutional accumulation to persist.

The Fed was a party pooper with a hawkish December 15th FOMC statement, but in the wake of cooling inflation, weak PMI reports, and falling key interest rates, we are expecting a dovish FOMC statement on February 1st. As soon as the stock market realizes that the Fed’s interest rate hikes are near the end, the stock market should stage an impressive relief rally.

The PE compression in our dividend and growth stocks has finally reached a ridiculous level, especially compared to the S&P 500. The fact that our dividend and growth stocks have stronger sales and earnings than the S&P 500, yet trade at much lower PE ratios, bodes well for their potential appreciation.

Many of the commodity related companies in our portfolios are considered cyclical stocks, which may explain why they have single-digit PE ratios. However, the narrative that green energy would replace fossil fuels is grossly misguided. In fact, fossil fuels accounted for approximately 84% of the world’s energy

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production in 2022, up from approximately 80% in 2020, as China, India, Germany all burned more coal. Although ESG has shunned fossil fuels, companies that make “green” fuel are now being added to major indices. Overall, we expect our energy and other commodity related stocks will continue to benefit from persistent institutional accumulation as new market leadership emerges.

We are anticipating a very prosperous 2023!

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