October 2024

Fourth Quarter 2024 Analysis

For the first time in many quarters, mega cap tech stocks, or the so called Magnificent 7, did not lead the market in the third quarter. Instead, the broader market, represented by the equal weight S&P 500 Index and the Russell 2000 Index, outperformed for the first time in quite a while. I view this as a constructive development. Perhaps all the good news regarding artificial intelligence is getting priced into the large cap tech stocks. Investors are examining the massive investments many of those companies are making in AI and questioning when any monetization or payoff from those investments will be forthcoming. Expectations remain extraordinarily high, and it is very difficult to continually exceed expectations as the laws of large numbers become problematic. These remain excellent companies, but most are priced at very high valuations.

As the equity advance has broadened beyond technology and AI, I anticipate investors will explore those areas of the markets that offer relative value or might be perceived as cheap compared to technology. I would argue that energy could be considered the cheapest sector relative to technology. Energy is the worst performing sector so far this year and sentiment has fallen to its lowest level in fifteen years. In the early 1970s, the

blaircapitalmgt.com blair-capital-management (914) 413-9904 johnblair@blaircapitalmgt.com

energy sector weight in the S&P 500 bottomed out at 15% before reaching an all-time high at 35% in 1981. In 1999, the energy share of the S&P 500 bottomed out at 6% before reaching a high of 15% in 2008. Today, the energy weighting of the S&P 500 is 3.5%, the lowest share on record.

The energy sector historically was thought to be quite cyclical with oil and gas explorers reinvesting every dollar of profit back into further exploration and development. This created booms as well as busts. There has been a massive change in how energy company managements now view their resources. Rather than reinvest and grow at all costs, energy companies are now focused on shareholder returns. They are paying down debt and returning capital to shareholders in the form of increased dividends and share buybacks. Capital expenditure in inflation adjusted terms has been flat for almost a decade. Reinvestment rates for oil producers are at multi decade lows. Balance sheets and debt levels are now very conservative.

Natural resource investment firm, Goehring and Rozencwajg, contends that the major domestic shale fields have reached their production peaks and are on the cusp of decline. This is certainly the case for the Bakken field in Montana and the Eagle Ford play in Texas. The Permian basin in west Texas is the largest domestic field in the country and might be nearing peak production. Tier 1 oil wells are finite and going forward, companies will be forced to drill less optimal wells.

Since 2010, U.S. shale oil has accounted for nearly 90% of global non-OPEC oil supply growth. If domestic oil and gas production growth is slowing, a new era in energy may be ahead. Similar to the 1970s when conventional oil production peaked and rolled over, OPEC gained market share and pricing power. A similar set up could be developing today, which would pass more power to the oil cartel. The U.S. shale revolution engendered an enormous increase in supply, but no one is forecasting any new meaningful supply growth. From trough to peak, crude prices rose ten-fold from 1970 to 1980. By 2003, when North Sea oil production began to wane, again shifting market share and pricing power to OPEC, prices rose from $14 in 1999 to $145 in 2008. Bearish sentiment pervades the energy sector as many are focusing on the move towards cleaner energy and renewables. But I contend that even ardent clean energy advocates are accepting that fossil fuels are required for the foreseeable future.

More broadly than just energy, commodities in general have never been cheaper relative to financial assets. The commodities to equity ratio, as defined by the

Goldman Sachs Commodity Index versus the S&P 500 index is the cheapest it has ever been. Goerhring and Rozencwajg point out that over the past 100 years, commodities have reached points of extreme undervaluation relative to stocks on four occasions; 1929, 1969, 1999 and presently. At the conclusion of the first three lows, commodities and natural resource equities saw dramatic outperformance compared to the broader market. These periods of commodity despair coincided with equity mania. The 1920s saw broad market euphoria. The 1960s saw the rise of the Nifty Fifty stocks. The 1990s witnessed the dot-com bubble and presently we observe the dominance of technology. Moreover, each such period was preceded by a period of easy money. The 1920s could be seen as the first experiment in quantitative easing. The 1960s was noteworthy for Johnson's expansionary fiscal policies. The Greenspan era of the 1990s marked ever looser monetary policy culminating in the housing bust and the Great Financial Crisis. Since that disaster, central banks around the world embarked on the fastest period of money printing ever seen, expanding their balance sheets to unprecedented levels.

Investor capital has fled the commodity sector and capital expenditures remain at record lows. Investor interest in the natural resource space is meager as the AI frenzy continues to dominate the market, and capital continues to flow into technology. Commodities and natural resource equities likely have never been a lower portion of investor portfolios than they are today.

President
Blair Capital Management

Fourth Quarter 2024 Analysis Disclosures