



Mitch on the Markets

Portfolio Manager Investing Insights

WEEKLY CLIENT COMMENTARY

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What the Energy Market's Wild Ride Means for Your Investment Strategy

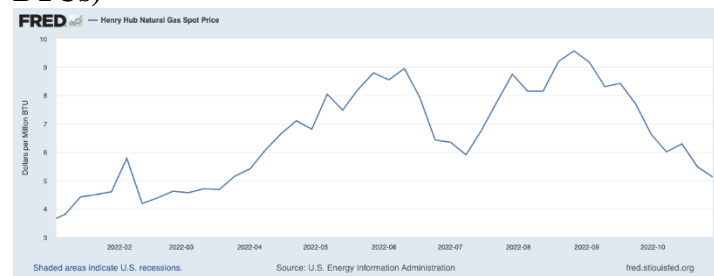
The last few years offer a case study of how quickly energy markets can shift.

In 2020, the pandemic and ensuing shutdowns and restrictions saw oil demand plummet, sending prices into negative territory for a brief period. Margins for oil producers fell to multi-decade lows, and S&P 500 energy stocks fell by a third that year as earnings plummeted.¹

Prices rebounded in 2021, however, and then shifted into overdrive in 2022 due to supply constraints tied to the war in Ukraine, which sent the price of a barrel of crude oil above \$100 a barrel. S&P 500 Energy stocks rebounded +54.6% in 2021 and are up +34.9% in the first three quarters of 2022.

Natural gas prices have endured even more wild swings than oil. In April and May alone, prices soared over +60%, but then plummeted in June to finish the three months down -3.9%. Prices rebounded quickly over the summer, but as I write, natural gas prices have fallen again – down over -40% since late August²:

Natural Gas Prices (Dollars per Million BTUs)



Source: Federal Reserve Bank of St. Louis³

Along the way, investors have likely heard all manner of predictions and forecasts for where oil, natural gas, and other commodity prices are headed. Most of them have painted a dire picture for energy markets, one in which oil could rise above \$200 a barrel and/or where many Americans would struggle to pay heating bills this winter.

Most of these predictions have been, and continue to be, wrong.

Though not widely reported, overall U.S. oil production is currently closing in on all-time highs. In August, U.S. oil output rose to 12-

million barrels per day, which is just one million barrels a day shy of a record. Natural gas prices have also moved in unexpected ways. Warmer-than-expected weather in September meant less gas was consumed for air conditioning, which happened at the same time as record domestic production (100 billion cubic feet a day) in the U.S. The result has been gas-storage facilities filling up quickly ahead of winter.

Most warnings dealing with energy have said that a crisis is looming, but markets have been moving in the opposite direction. Oil and gas supplies have been growing, not dwindling.

For investors, rapid shifts in the energy markets should be expected, but they should not mean rapid shifts in your portfolio positioning. Since earnings for oil and gas companies are impacted by price more than anything else, and since we know prices can be wildly volatile and largely unpredictable, I think it's wise not to have Energy exposure too much higher or too much lower than your benchmark. There is simply too much risk that prices will move in a direction that runs counter to your wager.

Bottom Line for Investors

The Energy sector's earnings are on track to grow +142.6% this year, which makes the sector responsible for the S&P 500 earnings growth we've seen in 2022 year-to-date. In Q3 2022, total S&P 500 earnings are currently expected to be up +2.0% from the same period last year on +10.7% higher revenues. But excluding contributions from the Energy sector, Q3 earnings for the rest of the index would be -5.6% below the year-earlier level.

A rational investor might wonder: if the Energy sector is the only area of the market generating positive earnings growth – and huge positive earnings growth at that – then why not substantially increase portfolio exposure to the sector while the earnings outperformance persists? The reason is that we cannot assume oil and gas prices are going to remain stable or rise going forward from here. Current trends

indicate the opposite – elevated prices incentivize more production, as we're seeing now with near-record oil and gas production in the U.S. Bringing on more supply is good from a consumption and manufacturing standpoint, but it also moves global supply and demands back into balance – which could ultimately pressure prices lower. Being heavily overweight to Energy when oil and gas prices are falling is not where an investor wants to be.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

¹ Wall Street Journal. October 27, 2022.
<https://www.wsj.com/articles/us-gdp-economic-growth-third-quarter-2022-11666830253>

² Conference Board. October 20, 2022.
<https://www.conference-board.org/topics/us-leading-indicators#:~:text=The%20Conference%20Board%20Leading%20Economic,over%20the%20previous%20six%20months>

³ Fred Economic Data. October 31, 2022.
<https://fred.stlouisfed.org/series/T10Y3M#>

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- The rise in consumer prices
- The midterm elections are still undecided
- More signs of slowing in China's economy
- The U.S. job market remains strong

Stocks and Bonds Rally on Better-Than-Expected Inflation Data

The stock and bond market surged on Thursday as inflation data showed signs of falling further from its June peak. The Labor Department announced on Thursday that the consumer price index (CPI) increased 7.7% year-over-year in October, which while still elevated marks a meaningful decline from June's peak 9.1% rate and the 8.2% print in September. When the volatile food and energy categories are stripped out, the 'core CPI' was seen rising 6.3% year-over-year in October, down from the 6.6% rate in September. The stock and bond markets responded very positively to the news, with the S&P 500 index climbing a stout 5.54% on the day and the tech-heavy Nasdaq posting a sharp 7.35% rally. Small-cap stocks also fared well, with the Russell 2000 rising 6.11%. In the fixed-income markets, the yields on 2- and 10-year U.S. Treasury bonds both retreated sharply, which meant that the underlying prices of those bonds went up. The 2-year U.S. Treasury tends to shift alongside expectations of future Fed policy, so the sharp decline in yield showed investors anticipating that the pace of Fed increases may moderate with the favorable inflation reading. Traders are betting that the Fed will raise the benchmark fed-funds rate by

50 basis points at the December meeting, easing concerns of another aggressive 75 bp rate hike.¹

Midterm Elections Still Undecided, Which May Drive Short-Term Market Volatility

Stocks tend to do well in the year following a midterm election. In fact, since 1950, the stock market has risen 100% of the time in the year following a midterm election. And not only do stocks tend to go up, but they also tend to go up by a lot. The average annualized forward total return for the S&P 500 index in the year following a midterm election is +18.6% (data from 1950 – 2018). A good argument for why stocks tend to outperform is that the president's party historically loses seats in a midterm election, which recalibrates the balance of power and often leads to gridlock – which markets like. But it is also true that markets do not like uncertainty, and with many races yet to be called and the actual balance of power still in question, there are still many unknowns. In our view, we would not be surprised if markets exhibited volatility in the short term until final results become a certainty.²

China Shows More Signs of Slowing

Economic data from China continues to show signs of weakness. This week, factory gate prices – which represent the prices charged by Chinese companies – fell for the first time in two years. High inventories in the United States and other export partners combined with an anticipated decline in demand have led Chinese companies to pull back on pricing. According to China's National Bureau of Statistics, Chinese producer prices fell by 1.3% year-over-year. China's exports also fell in October which surprised economists, signaling that the softening across the global economy is hitting

trade as well. Economists were expecting 4% export growth and instead got -0.3%. Meanwhile, China continues to grapple with balancing its zero-Covid policy with efforts to revamp growth. By mid-November, China had locked down the manufacturing hub of Guangzhou, which has 4 million residents and is known as an export powerhouse. Major companies in China are signaling that China's policies and slowing economic growth are having an impact. Apple Inc. warned investors that shipments of high-end iPhones would be lower-than-expected, and Foxconn Technology said plant disruptions and closed factories were hurting production.³

The U.S. Jobs Market Remains Strong Even as Tech Layoffs Rise

Headlines last week focused a lot of attention on sizable layoffs at some of the U.S.'s biggest technology firms, including Twitter and Facebook's parent Meta. Of particular note was Facebook's plans to lay off about 11,000 workers, or about 13% of its workforce. Salesforce also made waves by announcing it too planned to start laying off workers this week. While these layoff announcements seem at first glance like the beginning of a tidal wave of job losses, it's important to note that tech layoffs so far account for a very small percentage of overall activity in the employment market. These recently announced layoffs will show up in the Labor Department's November data, which we will not see until December. In October, the U.S. economy added 261,000 jobs, which still puts this job market in line with where it was before the pandemic.⁴

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¹ Wall Street Journal. November 10, 2022. https://www.wsj.com/articles/us-inflation-october-2022-consumer-price-index-11668050497?mod=hp_trending_now_article_pos1

² Wall Street Journal. November 7, 2022. https://www.wsj.com/articles/midterm-elections-2022-results-house-congress-11667973242?mod=djemRTE_h

³ Wall Street Journal. November 9, 2022. https://www.wsj.com/articles/china-producer-prices-turn-negative-in-warning-sign-for-global-economy-11667981170?mod=djemRTE_h

⁴ Wall Street Journal. November 10, 2022. https://www.wsj.com/articles/jobless-claims-ticked-up-but-remained-historically-low-11668088210?mod=economy_lead_pos4

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Nasdaq Composite Index is the market capitalization-weighted index of over 3,300 common equities listed on the Nasdaq stock exchange. The types of securities in the index include American depositary receipts, common stocks, real estate investment trusts (REITs) and tracking stocks, as well as limited partnership interests. The index includes all Nasdaq-listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds (ETFs) or debenture securities. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

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The Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and

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