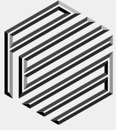

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Weekly Commentary

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FED Chair Powell Changes the Rules

Sorting through Federal Reserve Policy statements can often be a cure for insomnia, and Mr. Powell's speech on Thursday was no different. I guess economists just aren't particularly engaging speakers. Nonetheless, it was worth staying awake for this one. Here is what we think you need to know.

1) The FED is adjusting the way it manages the economy. This **revised strategy puts less emphasis on inflation and more emphasis on its full employment goal**.

2) They are introducing **average inflation targeting**. The official inflation target remains at 2%, but after periods of inflation running below 2%, **they will now be more willing to allow inflation to exceed the target at times**, such that inflation averages 2% over long periods of time.

The bond market was not particularly pleased. **Long-term bond holders have their returns eroded by inflation, and the market quickly began to adjust long rates higher (bond prices lower) in response.** How far this adjustment goes is anybody's guess, but the Fed can't allow it to go too far, or it could threaten the pending recovery.

What Powell's speech clearly says is that the FED intends to keep rates very low for a very long time. If that sounds incongruous with the paragraph above, you are correct and this is precisely why many on Wall St. are expecting the FED to be forced to implement yield curve control (which we mentioned in our comments last week). The intention here would be to keep long term rates low despite the markets desire for more inflation protection due to the change in policy. **This could get very messy.**

From a long-term perspective, this is an admission that the plan implemented to address the Housing crisis, can't work, and they need to find another way out. **We view this as an admission by Fed that there is no possibility of unwinding the massive asset purchases made from 2010 through 2019, as they originally intended. Historically, there has rarely been a lot of money made fighting the Fed, but we can't help but feel that they are boxing themselves into a corner.** The bottom line is that debt problems cannot be solved with more debt.

Exxon, Pfizer and Raytheon are replaced in the Dow Industrial Average. What happened?

In reality, not much. The probable spark for this action was the 4-for-1 stock split that Apple announced. This affects the Dow Indexes because the Dow averages are price weighted, which is different than most other stock indexes. In a price weighted index, the higher the stock price, the greater the weight in the average. Most indexes are value weighted, that is the index weight is a function of the price per share times the number of shares. So, a 4-for-1 split will reduce the weight of Apple in the Dow by 75%, but it has no impact on a value weighted index.

If that sounds odd, it's because **a stock split does not change the value of the company. Here is an example, if I split a $1 dollar bill 4-for-1, I get four quarters for each dollar. The value has not changed.** This is why the positive market reaction to the Apple and Tesla stock splits makes absolutely no sense.

However, the Apple split did force Dow Jones to re-jigger the Industrial Index components and they took the opportunity to make several changes. Here is how we see it.

1) **Amgen replaces Pfizer.** Merck and Johnson and Johnson are already in the index, adding Amgen adds an increasingly important biotech component to the healthcare portion of the index. This is a logical change.

2) **Honeywell replaces Raytheon.** Raytheon only joined the index earlier this year, when it merged with United Technologies, which was already part of the Dow. The removal reduces the weight of defense and government contractors. Honeywell has a meaningful defense/government business, but it is a broader based industrial company, much like United Technologies was before the merger with Raytheon. This is a logical change.

3) **Salesfore.com replaces Exxon.** Salesforce is the leader in SAAS (Software as a Service) sector and this addition replaces the lost technology exposure created by the Apple stock split. The elimination of Exxon, a part of the Dow average since 1928, is a function of the diminished role of energy in stock indexes as the energy sector has massively underperformed the overall market for three years. Although Exxon is larger, Chevron, another Dow component, has a higher price, so the elimination of Exxon actually reduces the energy weighting less than if Chevron had been removed. **This change simply recognizes the currently decreased role of energy and increased role of technology in market indexes**.

Dow Industrial Stocks		
Added	**Unchanged**	
Amgen	3M Company	JPMorgan Chase
Salesforce.com	American Express	McDonald's
Honeywell	Apple Inc.	Merck
	Boeing	Microsoft
Removed	Caterpillar	Nike
Pfizer	Chevron	Procter & Gamble
Exxon Mobil	Cisco Systems	The Travelers Cos.
Raytheon	Coca-Cola Co.	UnitedHealth Group
	Dow Chemical	Verizon
	Goldman Sachs	Visa
	Home Depot	Walgreens Boots All.
	Intel Corp.	Walmart
	IBM	The Walt Disney Co.
Source PWM Research	Johnson & Johnson	

Ironically, stocks removed from the index have generally outperformed their replacements, according to Dow Jones Market Data. Over the last ten years, stocks that have been added to the Dow have gained 0.3%, while those removed rose 10.37%.

Is Exxon, and the Energy Sector, Dead?

There is an old saying on Wall Street, that **'nobody rings a bell at the top'. We would add that no one rings a bell at the bottom either, but often, there are hints. One of the most famous is the "Death of Equities" cover of BusinessWeek in August of 1979, when the Dow Industrial Average was a bit over 800. You read that correctly… 800… It is now over 28,000!**

Signals like this are rare, but we can't help but get the feeling that after three horrific years for energy stocks, things just might be on the cusp of

getting better and removing Exxon, just might be the signal that a change in fortunes is near, so we decided to take a closer look.

Crude oil markets have suffered from a double whammy – chronic oversupply combined with a COVID induced demand shock. This combination briefly sent crude futures well into negative territory earlier this year. The demand shock is fairly obvious, when you close the economy, demand for oil plummets and although it has recovered some, full recovery won't arrive until the pandemic is behind us and we can get back to some semblance of normal again. Obviously, there is no precise time line on that, but all indications are that sometime next year, the pandemic should be behind us. **As the economy gets moving again, oil demand should also pick up**.

The green movement plays a role here, but for now, it is a minor role. **We do believe that we will continue to move toward cleaner fuels, but there is still a lot that needs to be understood to fully replace fossil fuels.**

The biggest culprit to the decline of the energy sector has been the massive increases in U.S. crude and natural gas production. Some historical perspective is necessary here. Back on the old days, a well was drilled based on finding evidence of a geologic structure that could potentially hold oil or gas. An exploratory well was then drilled, which produced one of three results:

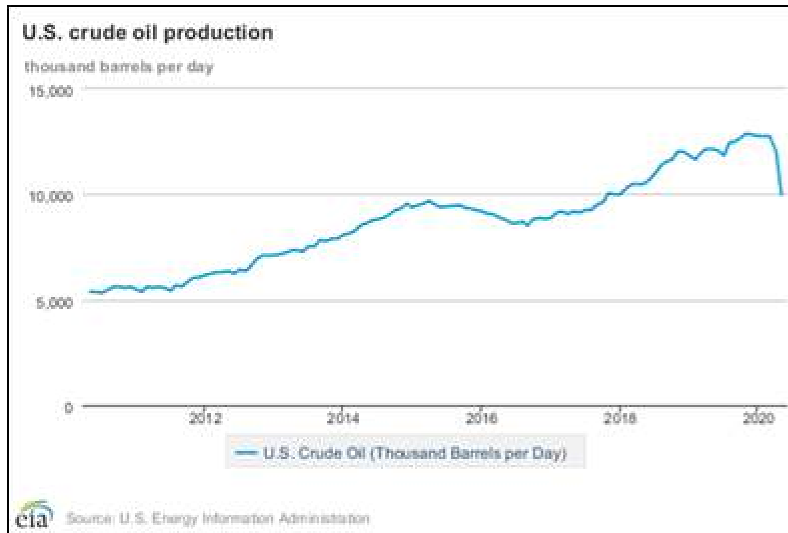
1) a dry hole – no oil or gas;
2) a 'tight' formation – oil or gas present, but unable to economically extract it due to the characteristics of the rock it is embedded in, i.e. a 'tight' formation;
3) a successful, producing well.

Wildcatters took the risk of drilling these wells and more often than not, they came up empty. It was a very risky game that made some, like T. Boone Pickens, very wealthy.

What we produced over a long period of time is an inventory of tight formations and eventually new technology came along to extract that oil and gas (Hydraulic Fracturing, or fracking).

This fundamentally changed the oil and gas business as now we could drill wells with almost a 100% success rate. The downside was that these fracked wells only produced for a relatively short period of time, which required more drilling to maintain or grow a production level. To make a long story short, **the industry got a bit drunk with success and drilled like crazy, using the cheap money that has been available for many years now.** The industry tended to lose all perspective on investment returns and focused only on production growth. So, **when prices collapsed earlier this year, the industry came to a screeching halt. Too many companies were over levered (too much debt) and many went bankrupt** and production has been falling apart ever since.

The chart below shows **US Crude oil production for the last 10 years**. Back in mid-2010, we were producing a bit over 5 million barrels per day (bbls/d). By the beginning of this year, that had **more than doubled to almost 13 million bbls/d, briefly making us the largest oil producing country in the world, exceeding even Saudi Arabia!**



Due to this recent rash of bankruptcies, obtaining financing for drilling activity has become significantly more difficult. In addition, **the experience has left survivors substantially more focused on returns on capital, as opposed to production growth. That has and should continue to sharply curtail US production, which has already declined almost 3 million bbls/d in a matter of months. We view this shift as more permanent than not.** As this surge in US production played a substantial role in creating the oil glut, **we suspect that this could go a long way to stabilizing oil markets and supporting higher prices over the next several years**. The risks to that forecast would be that the economic recovery from COVID remains tepid or we have a double dip recession. In our view, that would not change the long-term outlook, it would merely delay its arrival.
The reason that the rejects from the Dow Index often outperform their replacements is that contrarian investing often works. It is the same reason that Warren Buffet advises "be fearful when others are greedy, and greedy when others are fearful." A case-in-point is the rally in the stock market since the trough on March 23rd. At that moment in time, it felt that we were sliding into the abyss. Well, since March 23rd, the S&P 500 is up approximately 56% and hitting all-time highs. We believe in staying well-balanced, disciplined and staying on track with our diversified investment process.

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