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AlphaWealth Monthly Brief

"Wealth isn't primarily determined by investment performance, but by investor behavior."

- Nick Murray

In this month's edition of the brief, we highlight Fed Chairman Jerome Powell's recent speech at the central bank's annual conference in Jackson Hole. We also touch on shifting perspectives in the energy sector.

Powell Sounds Off in Jackson Hole

Last week, the Federal Reserve conducted its annual conference in Jackson Hole, where Fed Chairman Jerome Powell indicated the Fed's readiness to implement further rate hikes and keep rates elevated until inflation makes substantial progress toward their 2% goal. While slower price gains within the US economy have come as a welcome sight to Powell, he cautioned that there is still work to be done. "We are prepared to raise rates further if appropriate, and intend to hold policy at a restrictive level until we are confident that inflation is moving sustainably down toward our objective," Powell said in a speech last Friday.

Nevertheless, Powell kept the possibility of holding rates steady in September on the table as policymakers continue to analyze incoming data and assess potential risks resulting from the combined impact of previous rate increases. The overall message is that The Fed is taking a more measured approach to policy making, striking a balance between the aim of bringing inflation back to the target with the potential that too much tightening could trigger unexpected shocks within the economy. At the conclusion of Powell's speech, futures traders were pricing in a roughly two-thirds chance that the central bank will raise its key interest rate by a quarter point in November after a likely pause at its September meeting.

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A New Perspective on Energy

Recently, Adam Sues, partner and portfolio manager at Yacktman Asset management discussed the firm's pivot in the energy sector. Largely avoided for the last 25 years, it's a sector where the firm now sees relative opportunity due to an existing supply/demand imbalance and shareholder friendly capital return policies. Check out a few highlights from the interview presented in question-and-answer format.

Q. What prompted you to revisit your long-standing underweight in the energy sector?

A. In general, we prefer high-quality, high-margin, stable businesses that produce significant free cash flow. Meanwhile, energy companies sell a commodity product and traditionally employ lots of financial leverage while generating cyclical earnings and poor returns on capital. So, for the first 25-plus years of our firm's history, we largely avoided the energy sector.

At the same time, we are always looking for new opportunities and ways to use flexibility to our advantage. We try to stay open-minded and reconsider our views when facts and circumstances change. In this case, the growing supply and demand imbalance in energy warranted a deeper look after years of a brutal bear market. Plus, energy is crucial to the world economy and is vital to the health and happiness of people everywhere. And we think it will remain extremely relevant for much longer than media headlines might suggest.

Q. How did underinvestment in energy supply in recent years factor into your thinking?

A. From a supply perspective, oil and gas producers have sharply curtailed investment for the past eight years. Looking back, a steep drop in oil prices in 2014 led to a wave of bankruptcies over the next several years. 2017-2018 ushered in a bit of a recovery, followed by an even more abrupt halt with the pandemic. The sudden drop in demand as the world shut down led to negative oil prices and a complete washout in the industry.

For historical perspective, consider that energy peaked at 28% of the broad market index back in the 1980s. By late 2020, it had reached an all-time trough at around 2% of the S&P 500. Such a meager weighting did not reflect the importance of the industry from a revenue or economic impact. Yet so many people—from producers to capital allocators—had been burned and remained unwilling to invest. Over the medium term, we expect a growing demand for energy. So, our question became, “If energy demand is going to persist and we've had this growing lack of investment since 2014, how does that gap get resolved?”

Q. How has the ESG movement influenced the behavior of energy companies?

A. With oil prices touching $120 a barrel in 2022, the natural expectation (and historical precedent) would be a wave of supply in response. Yet we just haven't seen that. We think that is partly due to the way the world now views energy. We have seen pressure from governments, regulatory agencies, and ESG influences dampening enthusiasm for oil and gas in favor of renewables. These pressures have suppressed the usual supply response to higher prices.

In certain cases, the compensation systems for management teams have shifted to include ESG metrics or environmental goals. During previous energy upcycles, energy companies were reinvesting more than 100% of their cash flow into new investments. Now they are reinvesting less than half. Instead, companies have shifted to returning capital to shareholders via share repurchases and dividends. The market has rewarded such capital discipline.

Q. How do you mitigate the risks when investing in energy companies in the current environment?

A. We think the risks have been mitigated somewhat by companies using this period of high prices and underinvestment to significantly deleverage balance sheets. Most of our energy investments have very little debt, are repurchasing shares, and paying attractive dividends. The dividend yield for U.S. E&Ps is now significantly higher than the broad market.

Select producers have also done a tremendous job lowering their cost structure, with many now breaking even below $40 per barrel. That lower cost structure provides a meaningful cushion from a pullback in energy prices. The combination of low-cost producers with strong balance sheets and shareholder-friendly capital return policies is a marked departure from prior cycles in energy. While this mitigates the downside, exposure to the sector does partially hedge the portfolio from the threat of spiking energy prices.

Fast Facts

"Only 11% of US household debt has an adjustable interest rate. That means many Americans are locked into existing fixed-rate mortgages/auto loans/student loans and have not been impacted by the Fed's 11 rate hikes." – The Wall Street Journal

"Pheonix recently had a record breaking 31 consecutive days of temperatures at or above 110 degrees Fahrenheit." – The Atlantic

"The number of cattle in the US is at its lowest level in nearly a decade and is on track to drop by more than 2 billion pounds in 2024 – the biggest annual decline since 1979." – The Wall Street Journal

"A recent study found that 60% of today's workers are employed in occupations that didn't exist in 1940." – USA Today

"Taylor Swift's Eras concert tour could generate some $4.6 billion in economic activity in North America alone, taking into account both stadium capacity and people's reported spending plans on things like tickets, merchandise, and travel. This would be roughly on par, adjusting for inflation, with revenues the Beijing Olympics generated in 2008." – The New York Times

Contact Us

As always, feel free to reach out to us if you have any questions regarding your investments or financial plan or would like to schedule a meeting with our advisors.

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