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Investment Strategy

"I'll Go Along With the Rest of the Boys!"

You might think institutions with their large staffs of highly-paid and experienced investment professionals would be a force for stability and reason in financial markets. They are not; stocks heavily owned, and constantly monitored by institutions, have often been among the most inappropriately valued. A perfect example of this is the Consumer Staples sector. Last year, the Staples were heavily owned by the institutions believing they were a "defensive bet" in what they considered to be an expensive stock market that was trading at peak earnings. We, however, thought such concentration, and money flows into the sector, had driven valuations to historically extremely expensive levels. Further, we did not believe we were at peak earnings! As we quoted Alkeon Capital in last Thursday's Morning Tack: "At the same time, and in stark contrast to the gathering tailwinds we currently see for high quality growth sectors, we view defensive, low-growth and interest-rate sensitive sectors, such as utilities, consumer staples and REITs, to be overvalued and vulnerable to the downside, exhibiting elevated valuations with little to no earnings growth."

Currently, we think the Energy sector is under-owned and is undervalued relative to the overall stock market. Ben Graham told a story more than 60 years ago that illustrates why many investment professionals behave as they do:

> An oil prospector, moving to his heavenly reward, was met by Saint Peter with bad news. "You qualify for residence," said Saint Peter, "But as you can see, the compound reserved for oil men is packed and there's no way to squeeze you in." After thinking a moment the prospector asked if he might say just four words to the present occupants. That seemed harmless to Saint Peter, so the prospector cupped his hands and yelled, "Oil discovered in hell!" Immediately the gate to the compound opened and all the oil men marched out to head for the nether regions. Impressed, Saint Peter invited prospector to move in and make himself comfortable. The prospector paused and then said, "No, I think I'll go along with the rest of the boys because there might be some truth to that rumor after all."

We have often commented that there is a large disconnect in the energy space. To wit, many of the energy stocks are trading at the same valuation levels they were when crude oil was at $26 per barrel. Now, however, crude oil changes hands around $66/bbl. This disconnect is likely due to the belief that the rising U.S. oil production is going to cause the price to come back down. Adding to that belief was last week's pleas to have Saudi Arabia produce 1,000,000 more barrels a day. What we think the markets are missing is the fact that worldwide demand is outpacing production. As Cornerstone's Mike Rothman writes:

> While our figure is preliminary and subject to revision (and we caution, as usual, that one month does not a quarter make), our estimate of global oil demand for April suggests a year/year jump of 2.41 million b/d which is literally more than double the growth rate in our working forecast. The high frequency data for demand (the US and China) did show April numbers to have come in much higher than generally expected. You may recall that the 1Q 2018 global demand figure we generated came in higher than forecast even after allowing for the fact that the respective 2017 level seemed suspiciously weak.

Concurring with Mike's bullish view is a recent report by Jan van Eck (founder of VanEck) titled "It's Now or Never for Energy Stocks." Jan writes:

> Since the beginning of 2018, oil prices have continued to march towards $80 a barrel, but energy stocks have lagged behind. Our recent research in the space shows that the returns of unconventional oil & gas equities, or exploration and production (E&P) companies, can mostly be explained by the performance of three independent variables: oil, natural gas, and the U.S. stock market. Meanwhile, similar research has shown that oil service equity returns are predominately driven by oil prices and the U.S. stock market.
>
> The performance variance between E&P companies and the three key independent variables has recently narrowed significantly from widths not seen for nearly a decade. However, oil servicers still appear to be trading at a discount when we compare actual performance of oil servicers with their predicted performance based on oil and U.S. stock

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market returns. These levels are close to some of the lowest historical values since 2001, and we believe that this trade in energy stocks constitutes one of the most exciting currently available.

Raymond James has arguably the best energy team in the country, and they tend to agree with the aforementioned quips. Accordingly, we screened three recommended lists (Analysts Best Picks, Analysts Current Favorites, and The Equity Income Report) looking for favorably rated energy stocks from our fundamental energy research team that look good using our proprietary algorithm. The names that surfaced included: Continental Resources (CLR/$65.84/Strong Buy), Marathon (MPC/$78.99/Strong Buy), Nextera Energy (NEP/$44.03/Outperform), Phillips 66 (PSX/$116.84/Outperform), Plains GP Holdings (PAGP/$24.76/Strong Buy), Targa Resources (TRGP/$49.31/Strong Buy), and Viper Energy (VNOM/$27.52/Strong Buy).

The call for this week: As we wrote in Friday's *Morning Tack*:

> There is a little flat spell in the short-term energy model arriving today and extending into early next week. Yet, it is difficult to see much downside coming in right here, but we could get a big stall. Over the intermediate term we don't see much to stop the S& P 500 (SPX) from making new all-time highs. . . . However, on a very short-term basis, the upside breakout by the SPX used up a lot of trading energy. After four consecutive up sessions, a respite was due. Often after breakouts, retrenchments occur because stocks are usually overbought on the surge and that is what is happening this morning with the S&P 500 futures off some 15 points on the headline, "G7 leaders set to clash with a combative President Trump over tariffs and trade."

That said, Friday's early upside reversal, where the S&P 500 (SPX/2779.03) went from down 15 points to close up 8.66 points, is a "tell" in that, barring unexpected news, there should not be much to push prices down in the near term. Moreover, there remains plenty of internal energy over the intermediate term to cause stocks to continue to grind higher. This morning, however, all is quiet on the western front as participants await the summit.

Source: Eikon

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