MEDALLION WEALTH MANAGEMENT

March 2024 Market Commentary

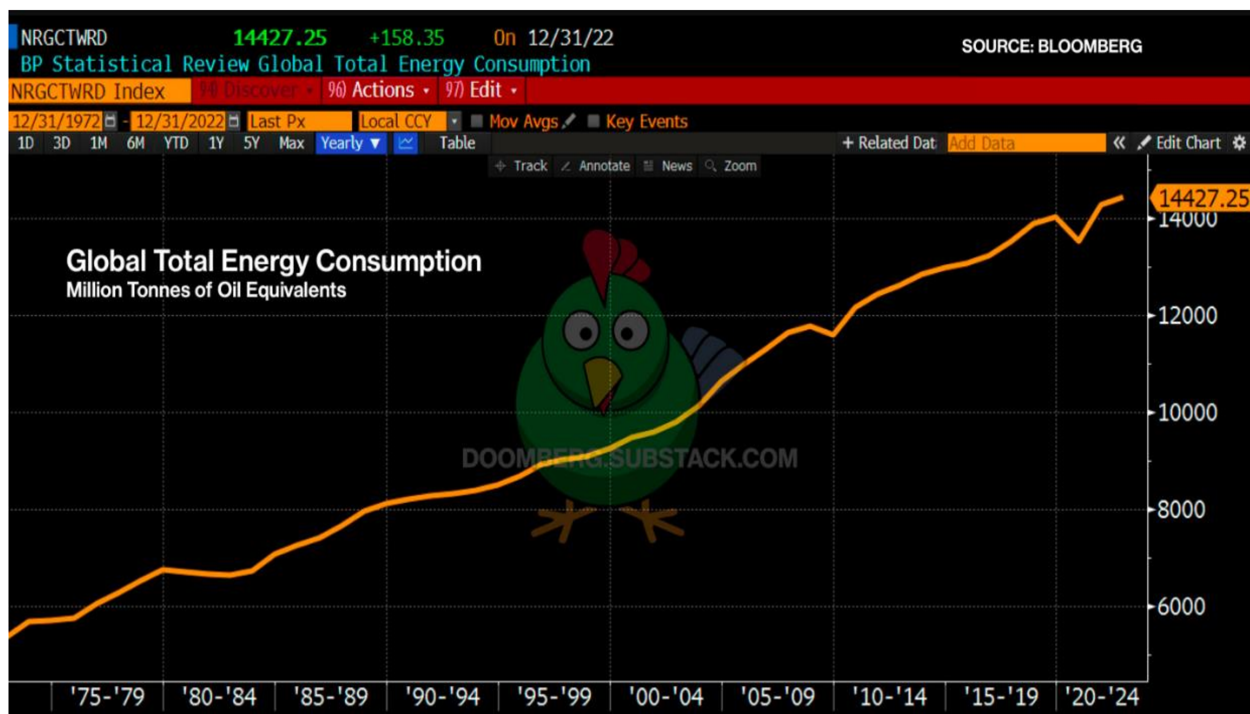
<u>Bubblin Crude</u>

***"Come and listen to a story about a man named Jed
A poor mountaineer, barely kept his family fed,
And then one day he was shootin at some food,
And up through the ground came a bubblin crude.
Oil that is, black gold, Texas tea."
-The Ballad of Jed Clampett by Paul Henning***

On August 9, 1971, President Richard Nixon closed the gold window, setting off 50 years of relentless debasement of the US dollar. A debasement that continues today with the Fed's stated goal of devaluing the dollar by 2% per year (aka. inflation target). In 1973, war broke out in the Middle East, triggering the Organization of the Petroleum Exporting Countries (OPEC) to place an unprecedented embargo on oil exports to the West. The Shah of Iran was overthrown in 1979, an event that eventually led to war raging between Iran and Iraq during most of the 1980s. On August 2, 1990, Saddam Hussein invaded Kuwait. By January of the next year, the US military led a coalition force of over one million soldiers into battle, ejecting the Iraqi army from its neighbor in a matter of weeks. The late 1990s saw a series of financial crises strike the global economic system, including the Asian currency crisis of 1997, the Russian Ruble default in August of 1998, and the collapse of Long-Term Capital Management a month later.

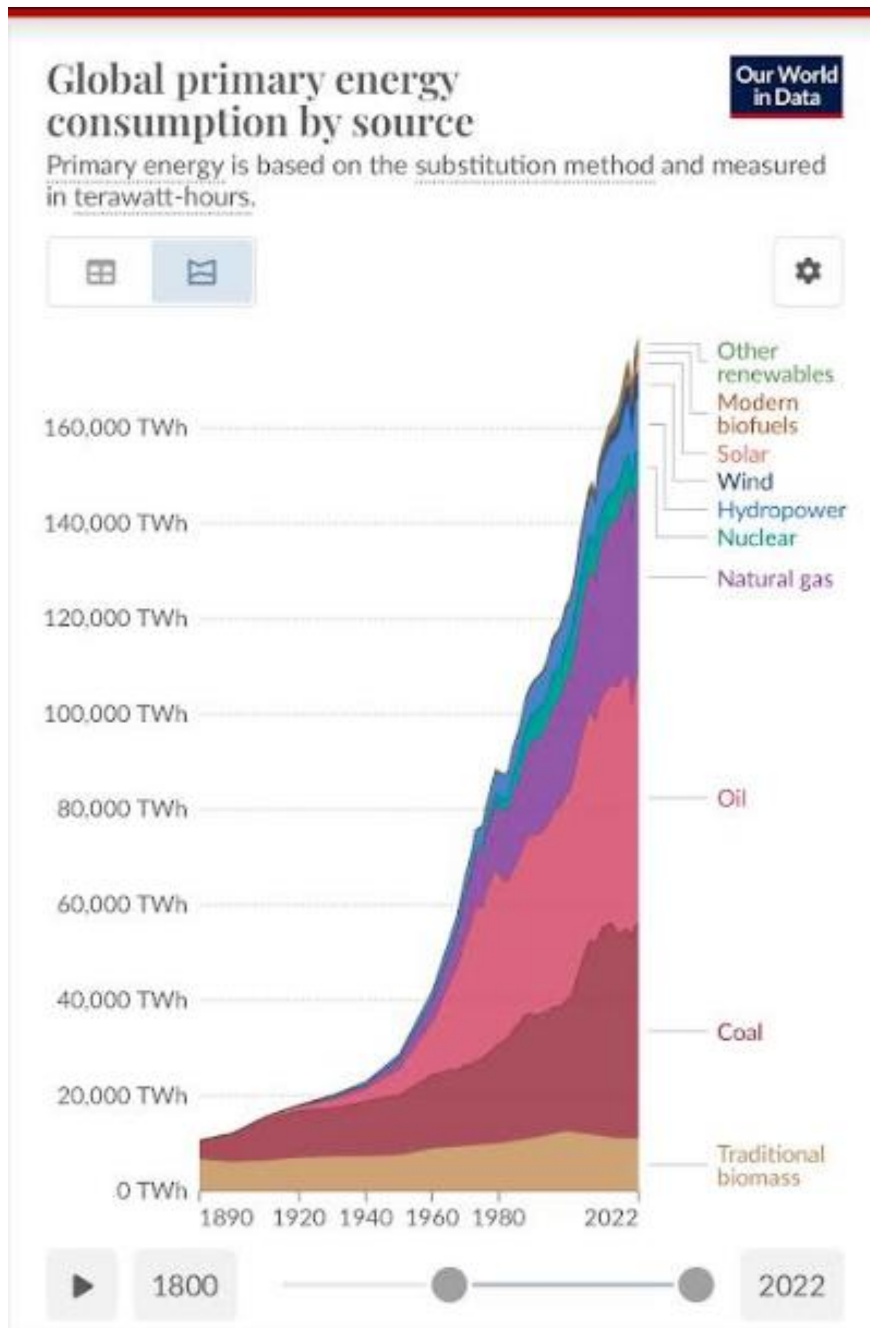
The turn of a new century brought with it a continuation of this parade of catastrophes. The terrorist attacks of September 11, 2001, triggered a recession, a major war in Afghanistan, a second go at Saddam Hussein's Iraq, and a perpetual "war on terror" that has destabilized Libya, Syria, and several other regimes the world over. The global financial crisis of 2007-2009 nearly brought the world's economy to its knees. In the mid-2010s, Venezuela—a founding member of OPEC and major oil exporter to the US—crumpled into a hyperinflationary tailspin. The world descended into the depths of the Covid crisis in early 2020, Russia invaded Ukraine in February of 2022, and yet another war broke out in the Middle East in October of 2023, a conflict that risks creating a direct confrontation between the US and Iran.

Throughout those decades of turmoil how did the world's appetite for energy react to all of these events? It mostly ignored them, marching consistently higher.



What Jed Clampett taught us way back in 1962 is that energy is not just an input into the economy, it is the economy. ***"So they loaded up the truck and moved to Beverly. Hills, that is. Swimmin pools, movie stars."*** One irrefutable fact of mankind is that all humans everywhere seek a higher standard of living, we want to grow and we want our offspring to have a better life than we had. And throughout history, energy is life, the ability to access energy is inextricably linked to economic growth and standard of living.

As the citizens of the world continue to seek a better life for themselves and their offspring, the fuels of choice continue to be oil, coal, and natural gas. Yes, the world is electrifying, but the fuels to generate that electricity continue to be the tried and true, incredibly efficient, fossil fuels. This is especially true in countries looking to raise massive populations out of poverty, like India and China.



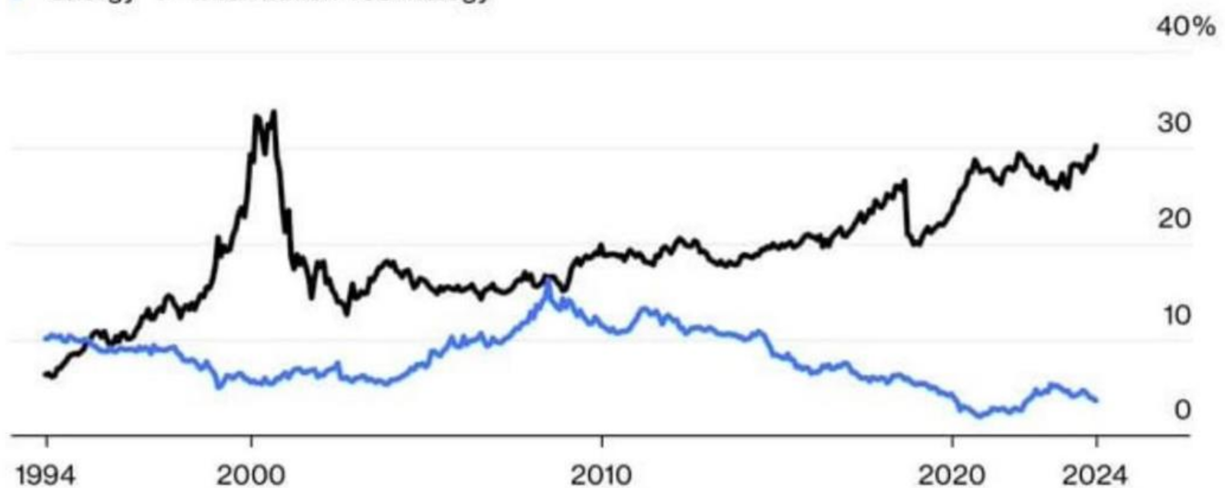
Raw energy resources are just the first step though, next is turning that natural resource into usable electricity. That's where utility companies come in. All of this oil, coal, and natural gas is burnt and turned into electricity, that is then distributed to consumers. Of course, in the more developed (rich) countries we seek to generate electricity with more environmentally friendly fuel sources like wind, solar, and hydropower. This isn't very efficient, and has negligible impact on the climate, but hey it makes us feel better, and its only money.

You may be wondering where I'm going with this newsletter, especially when one AI (artificial intelligence) company named NVIDIA is worth more than the entire S&P 500 Energy sector.

Well, AI is pretty exciting stuff and it will dramatically change the way we work and live, but it has a dirty little secret…it consumes massive amounts of energy. Alex de Vries, a researcher at the School of Business and Economics at the Vrije Universiteit Amsterdam, projected that based on current and future sales of microchips built by NVIDIA, global power usage for AI systems could ratchet up to 15 gigawatts of continuous demand. That's about the power consumption of the Netherlands, and would require the entire output of about 15 average-size nuclear power plants.

The Wall Street Journal also reported that Microsoft is working on using its own AI to speed up the approval process for new nuclear power plants—to power that same AI. It is projected that the amount of energy needed to power the world's data centers could jump by 50% by 2027, thanks to AI alone.

So, while the Tech sector's weight in the S&P 500 is about 30%, the Energy sector's weight is hovering around an all-time low. But you can't have technology without energy!



In Warren Buffett's most recent Berkshire Hathaway shareholder letter, he laments the fact that Berkshire is now so large that ***"there remain only a handful of companies in this country capable of truly moving the needle at Berkshire, and they have been endlessly picked over by us and others…All in all, we have no possibility of eye-popping performance."***

This doesn't mean that Warren has stopped investing, he goes on to talk about their 27.8% ownership of Occidental Petroleum, as well as their Berkshire Hathaway Energy (BHE) which includes power generators as well as transmission. Mr. Buffett understands that none of our country's growth ambitions will happen without reliable sources of energy.

While this continually growing need for reliable energy would make it seem like a layup long-term investment thesis, it's not without risks. As Buffett explains in his letter, the Berkshire Hathaway Energy division had very disappointing earnings as, ***"the regulatory climate in a few states has raised the specter of zero profitability or even bankruptcy (an actual outcome at California's largest utility and a current threat in Hawaii). In such jurisdictions, it is difficult to project both earnings and asset values in what was once regarded as among the most stable industries in America."***

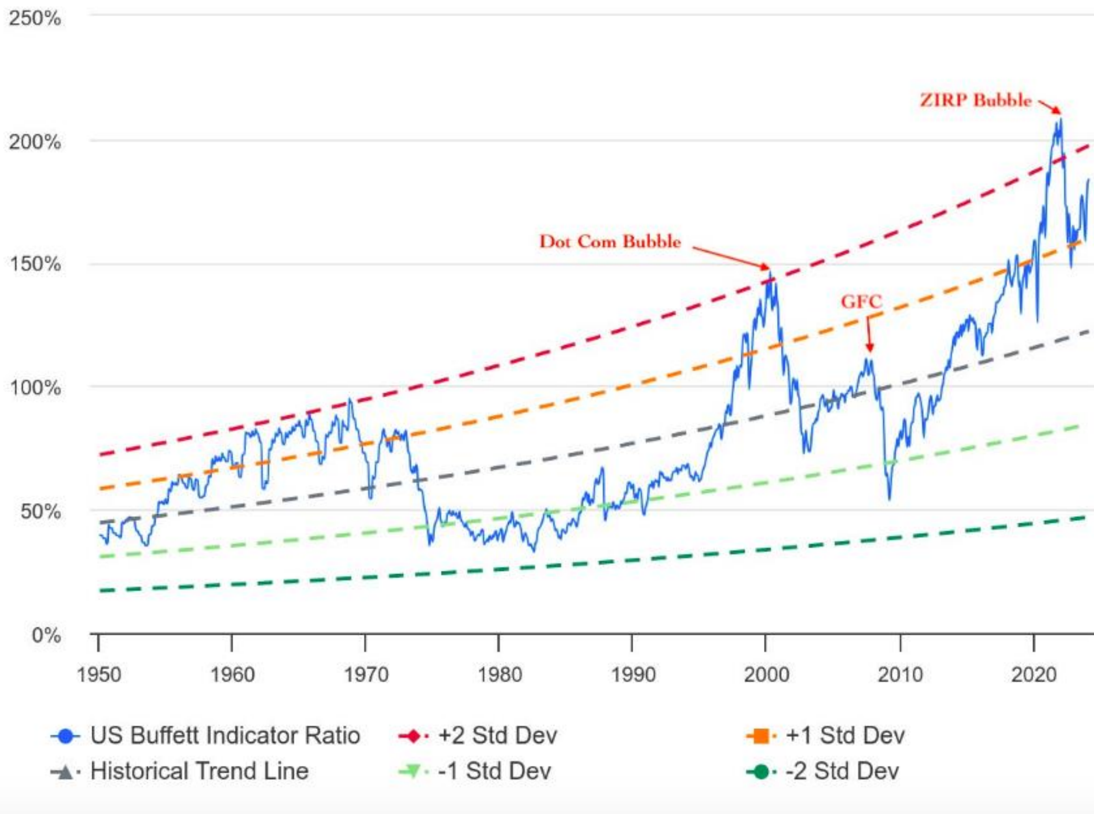
He continues, ***"Whatever the case at Berkshire, the final result for the utility industry may be ominous: Certain utilities might no longer attract the savings of American citizens and will be forced to adopt the public-power model. Nebraska made this choice in the 1930s and there are many public-power operations throughout the country. Eventually, voters, taxpayers and users will decide which model they prefer.***
When the dust settles, America's power needs and the consequent capital expenditure will be staggering. I did not anticipate or even consider the adverse developments in regulatory returns and, along with Berkshire's two partners at BHE, I made a costly mistake in not doing so."

As an old Utility Fund manager, I totally agree with Warren Buffett's succinct analysis regarding the current state of both the energy resource and energy production markets. There is enormous demand and potential for investors, but there is also a growing minefield of risks. There is some hope that capitalist solutions will "eventually" win out, as we've seen a major backlash from citizens in Europe who are tired of skyrocketing energy bills as well as unreliable power. Here in the United States, the battle between corporate versus government control of our energy resources will rage on, but one thing I'm fairly certain of, demand for a reliable supply will eventually win out. Here at Medallion we maintain a slight overweight to Energy and a market weight to Utilities in our equity portfolios.

The Buffett Indicator:

Since we're talking about Warren Buffett I thought it would be good to take an updated look at the Buffett Indicator. In a famous speech back in 1999, Warren Buffett introduced his method of looking at market valuations. He stated that, ***"probably the best single measure of where valuations stand at any given moment is a country's market value of equity divided by the country's Gross Domestic Product (GDP)."***

This is a classic mean reversion chart, when things get too extended on the upside or downside, they eventually revert to historic norms. The chart below shows that currently equity values are about 184% above GDP (pointing towards overvaluation), versus their historic average of about 122%.



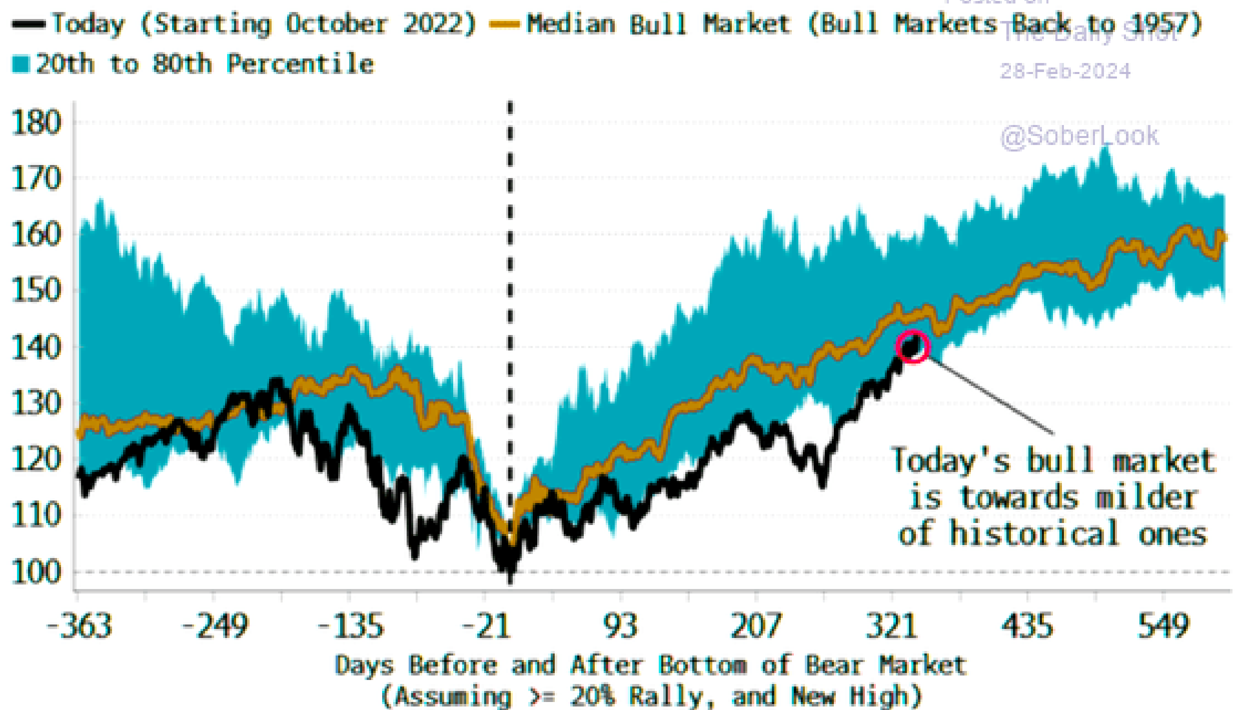
I used to be a pretty big fan of this valuation tool, and it's not bad for getting a general idea of over or under valuation, but like all valuation tools it's got some flaws. First, it's basically a Price-to-Sales tool, and it assumes that profit margins will always revert back to historic averages. The upward sloping of the above graph shows that isn't necessarily the case. Corporations have seen a fairly steady increase in margins due to improved efficiencies, which may actually accelerate with the adoption of AI.

Secondly, this analysis assumes that market forces dictate the cost of capital (aka. Interest rates). Unfortunately, the Fed has gone from a light thumb on the scale approach to rates to a full heavy hand. The decade of zero interest rate policy (ZIRP) as well as quantitative easing, has thrown a rather large monkey wrench into the workings of any valuation models that look for things to return to "normal".

In summary, the Buffett Indicator is currently showing that we are in a bull market. We may, or may not, be overvalued versus history. We'd know if you could only tell me what profit margins are going to be and whether or not the Fed is going to have a heavy or light touch on interest rates. Glad I could help!

Our Current Bull Market:

Our last Bear Market ended on October 12, 2022, with a decline of about 25% from its previous high. This also marks the beginning of our new Bull Market which has now seen the S&P 500 rise about 43%. As the chart below shows, this is so far a historically mild bull.



While it might be a mild bull so far, that doesn't mean it's not going to experience some pull-backs. There are some clear signs that we are getting extended, complacency and greed are growing, while caution and fear are hard to find.

CNN's Fear & Greed index is in the Extreme Greed range.

Fear & Greed Index

What emotion is driving the market now?
Learn more about the index

Last updated Mar 1 at 6:59:59 PM EST

We all love to participate in bull markets, they make us feel sooo smart, but we also have to beware of traps. As Jed Clampett was fond of saying, ***"Us old foxes is trap-shy; especially when the bait comes lookin for us!"***

As always, be careful out there.

Chris Wiles, CFA

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