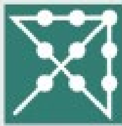

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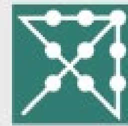

May 30, 2024

Morning Briefing

Oil, MegaCaps & Beating Inflammation

Check out the accompanying chart collection.

Executive Summary: OPEC+'s power over the oil market isn't what it used to be. As non-OPEC producers from various countries drive up global production, the cartel must decide whether or not to extend the production cuts it started implementing two years ago. Jackie looks at the dynamics of an industry that we've considered a hedge against the uncertainties of war. … Also: Joe has isolated the top seven highest-capitalization companies of the S&P 500 Pure Growth and S&P 500 Pure Value indexes, creating MegaCap-7 Pure Growth and MegaCap-7 Pure Value. He compares the groups' capitalizations and ytd performances. … And: Might a new drug for a rare lung disease have much wider applications?

Energy: OPEC's Catch-22. With war raging between Israel and Hamas and between Russia and Ukraine, we've looked at the oil industry as a hedge against stock market disruptions brought about by war. Investors appear to be doing so as well, with oil industry stock prices and the price of the underlying commodity gaining ground this year.

The S&P 500 Energy sector's 9.6% gain ytd through Tuesday's close trails only the AI-boosted S&P 500 sectors of Communication Services (21.7%), Information Technology (20.3), and Utilities (12.2) (*Fig. 1*). The price of Brent crude oil futures has also had a strong start to 2024, climbing 9.3% ytd (*Fig. 2*).

That said, the price of a barrel of Brent crude oil, at $84, is less than the $93 it fetched in October 2022, when OPEC+ first announced the production cuts of roughly two million barrels per day (mbd) that have remained in effect since. That's because non-OPEC producers have continued to ramp up production. Concurrently, demand has grown slowly, hampered by the rollout of hybrid and electric vehicles and sluggish Chinese and European economies.

The leaders of OPEC—slated to meet on Sunday—find themselves caught in a Catch-22: Extend the production cuts, and non-OPEC producers like the US and Canada will benefit

from artificially inflated prices. End the production cuts, and the price of oil could fall sharply, hurting everyone. For now, OPEC+ is widely expected to kick the can down the road and extend the production cuts.

Here's a look at some of the oil industry dynamics OPEC is trying to manage:

(1) *Production growing.* Global oil production continues to grow notwithstanding OPEC+'s cuts. Here's the total world production of petroleum and other liquid fuels according to data from the US Energy Information Administration (EIA): April 2024 (102.1 million barrels per day [mbd]), April 2023 (101.5), April 2022 (98.8), April 2021 (94.0), and April 2021 (99.4).

Production increases are coming primarily from outside of OPEC+ countries. The US is the largest producer of oil products, adding 22.2mbd in April. That's up from 21.5mbd in the same month last year, 20.4mbd in April 2022, 19.0mbd in April 2021, and 18.5mbd in April 2020.

Over time, US crude oil wells have grown more productive. The amount of crude oil produced remains near record-high levels, even as the number of active US oil rigs has dropped sharply in recent years (*Fig. 3*). This bounty of black gold has allowed US producers to export far more oil than ever before. US exports have jumped to 11.0mbd in mid-May, up from 7.3mbd in June 2020 and 1.7mbd in 2010 (*Fig. 4*).

Countries outside of the US and OPEC+ also are boosting production of petroleum and other liquid fuels. This cohort produced 37.3mbd in April, up from 35.1mbd a year ago and 32.2mbd in April 2020.

Canada is among the overachievers. Our northern neighbor contributed 5.8mbd of petroleum and other liquid fuels to the market last month, up from 5.0mbd in April 2020. And production increases are expected to continue now that the Trans Mountain pipeline has been completed. The pipeline can carry 590,000 barrels of oil per day from Alberta to the Pacific Coast, where it can be exported by ship to the US and Asian markets, a May 21 Reuters *article* reported.

Guyana's offshore wells are also notable for the 645,000 bpd of crude oil production they've added to the market since deposits were discovered in 2015. The South American nation's production is expected to continue to grow.

And then there are the cheaters. An excellent *article* in *The Economist* noted that since

January, OPEC+ has overshot its production targets every month, most recently in April by almost 500,000bpd.

(3) *Demand slowly improving.* The good news for producers is that demand is slowly growing closer to the supply of crude oil and other products. In April, demand was only 680,000 barrels per day less than supply. That's a vast improvement from 2020, when Covid decimated demand.

Here are EIA data on global supply and consumption of petroleum and other liquid fuels for the past five Aprils: 2024 (102.1mbd production, 101.4mbd consumption), 2023 (101.5, 100.3), 2022 (98.8, 98.1), 2021 (94.0, 96.0), and 2020 (94.4, 83.9).

Demand may be growing more slowly than it has historically because cars have grown increasingly efficient thanks to the rollout of hybrids and electric vehicles. After tumbling briefly during Covid, vehicle miles driven has rebounded to 3.3 trillion miles, matching the miles traveled in January 2020 before Covid hit. Yet gasoline usage, at 8.8mbd, remains below its January 2020 level of 9.3 million barrels (*Fig. 5*).

(4) *What could go wrong?* Mother Nature could quickly eliminate the excess supply of oil and send prices sharply higher. The National Weather Service *reports* that there's an 85% chance that this year's hurricane season will see above-normal activity, with a 10% chance of a near-normal season and 5% chance of a below-normal one.

Tensions in the Middle East could flare up. Most recently, missile attacks damaged a Marshall Islands-flagged, Greek-owned ship in the Red Sea off the coast of Yemen, a May 28 AP *article* reported. No one claimed responsibility, but Yemen's Houthi rebels were the suspected attackers.

(5) *Merger mania strikes.* Oil industry executives have been acquisitive over the past year. The latest deal was announced yesterday: ConocoPhillips is acquiring Marathon Oil, a US shale producer, in a $17.1 billion stock-funded deal. The news follows Exxon Mobil's $60 billion purchase of US shale producer Pioneer Natural Resources, Chevron's $53 billion pending acquisition of Hess Corporation, and Occidental's $12 billion acquisition of US shale producer CrownRock.

Acquisitions often put a short-term lid on the acquiror's stock price. So it's not surprising that the S&P 500 Integrated Oil & Gas stock price index—which includes Chevron, Occidental, and Exxon—has been stuck near record-high levels for the past few years (*Fig. 6*).

The forward earnings of the industry's companies collectively has been declining since October 2022, which was four months after the price of Brent crude oil futures peaked near a high of $123 in June 2022 (*Fig. 7*). (FYI: "Forward earnings" is the time-weighted average of analysts' consensus operating earnings per share for the current and following years.) Analysts are a bit more optimistic about earnings in 2025. Their consensus estimates imply resumed earnings growth of 8.4% next year, up from the 3.3% decline expected this year (*Fig. 8*). With a forward P/E of 12.2 the industry's stock price index is reasonably valued relative to its history (*Fig. 9*).

Analysts are more optimistic about earnings growth prospects for the S&P 500 Oil & Gas Exploration & Production industry's companies, anticipating 2.2% this year and 14.1% in 2025 (*Fig. 10*). However, that industry's stock price index has been range-bound for the past two years (*Fig. 11*). At a recent 11.4, its forward P/E is modest as well (*Fig. 12*).

Strategy: Winds of Change for MegaCaps. Today's mega-capitalization stocks have outperformed substantially relative to the S&P 500 for much of the past decade. It's a well deserved outperformance, though, as their revenues and earnings have grown at faster rates than many other companies'. Whether the companies' capitalizations will remain mega-sized is the trillion-dollar question. Company-specific slip-ups by Alphabet, Amazon, Meta, and Tesla in recent years have caused them to suffer big share price declines. Amazon returned to the trillion-dollar club in March 2023 after dropping out temporarily during the months surrounding the start of 2023. But Tesla has been broken down in the pitstop since April 2022. Its stock would need to rise over 75% from current levels to get back into the trillion-dollar club.

If investors get a whiff that the lofty growth expectations for secular AI spending need to be lowered, they'll inflict swift punishment. Two S&P 500 sectors specifically would bear the brunt of the resultant price declines: Information Technology and Communication Services.

So to prepare for that possibility, Joe sniffed out some alternative investment candidates. Since the biggest of the mega-capitalization stocks are in the S&P 500 Pure Growth index, he looked at the other end of the investment-style spectrum for candidates within the S&P 500 Pure Value index. Here's what he found:

(1) *Introducing the MegaCap-7 Pure Style members.* We've taken the top seven market-cap companies in the S&P 500 Pure Growth index to create the MegaCap-7 Pure Growth group, with an aggregate capitalization of $14.4 trillion (*Fig. 13*). Six of the seven are in the trillion-dollar club. Here are the companies in order of their market capitalizations (as of Friday's

close): Microsoft ($3.2 trillion), Apple ($2.9 trillion), Nvidia ($2.8 trillion), Alphabet ($2.0 trillion), Amazon ($1.9 trillion), Meta ($1.1 trillion), and Eli Lilly ($0.8 trillion).

Likewise, our MegaCap-7 Pure Value group was created from the top seven market-cap companies in the S&P 500 Pure Value index. The MegaCap-7 Pure Value, with a total capitalization of $2.1 trillion, is just one seventh the size of its Growth counterpart. Most of these seven companies have a long way to go before reaching the trillion-dollar club: Berkshire Hathaway ($0.87 trillion), Bank of America ($0.31 trillion), Chevron ($0.29 trillion), Wells Fargo ($0.21 trillion), Verizon Communications ($0.17 trillion), Goldman Sachs ($0.15 trillion), and AT&T ($0.12 trillion).

(2) *Both pure-style MegaCap indexes are outperforming ytd.* Having the largest companies as members has helped the MegaCap-7 Pure Growth and MegaCap-7 Pure Value groups outperform the two broader S&P 500 style indexes from which they came so far this year. The MegaCap-7 Pure Growth leads the way, with its 25.0% ytd gain more than double the 12.1% rise logged by the S&P 500 Pure Growth index. It's also more than double the 11.0% ytd rise of the MegaCap-7 Pure Value, which in turn is way ahead of the 2.0% ytd rise of the S&P 500 Pure Value index.

(3) *Valuations slightly higher too.* The seven MegaCap-7 Pure Growth companies have an aggregate forward P/E of 24.4. That's above the 21.5 of the S&P 500 Pure Growth index. It's also more than double the MegaCap-7 Pure Value's 11.9 forward P/E, which in turn is above the 9.9 for the S&P 500 Pure Value index (*Fig. 14*).

On a relative P/E basis—i.e., the forward valuations of our MegaCap-7 style groups compared to their parent S&P 500 style indexes—viewed over time, we see no cause for alarm. The MegaCap-7 Pure Value is valued 22% higher, near the top of the range seen since 2015 (*Fig. 15*). Its Pure Growth companion is at a 10% premium, in the middle of the range since 2020.

(4) *Mixed margin comparisons.* The forward profit margin of MegaCap-7 Pure Growth is at a record-high 24.6%. It has improved steadily since early 2023 and is now more than 100bps higher than the 14.5% of the S&P 500 Pure Growth index (*Fig. 16*). The MegaCap-7 Pure Value is very profitable too, with its forward margin of 12.6% less than 2ppts below that of the S&P 500 Pure Growth index and nearly triple the 4.7% of the S&P 500 Pure Value index.

Disruptive Technologies: Targeting Inflammation. Biotech company Insmed announced

positive results in a Phase 3 trial of brensocatib, a drug used to treat patients with bronchiectasis. In this rare lung disease, bronchi in the lungs become permanently dilated, making patients vulnerable to serious lung infections that may result in increased coughing, shortness of breath, and an acute decrease in lung function. Insmed plans to file a New Drug Application with the Food and Drug Administration for the drug in Q4-2024.

Insmed shares more than doubled on news of the trial results because investors are also excited about the possibility that the drug can be used to treat other inflammatory diseases like arthritis, lupus, and dermatologic conditions.

In the Phase 3 trial, brensocatib showed the benefit of blocking dipeptidyl peptidase 1, a.k.a. DPP1. DPP1 “activates key enzymes in a type of white blood cell called a neutrophil. These enzymes are associated with a range of inflammatory diseases. When neutrophils accumulate in the airways, the result can be excessive activity from the enzymes, leading to lung damage and inflammation. By blocking DPP1, brensocatib is intended to stop activation of those enzymes,” a May 28 MedCity News *article* explained.

Insmed is conducting trials that look at the use of brensocatib to treat chronic rhinosinusitis without nasal polyps and plans to conduct trials on its use to treat the inflammatory skin disorder hidradentis suppurativa. Insmed purchased the drug from AstraZeneca in 2016 and will owe the drug giant payments based on hitting specific hurdles. It also announced plans to do a secondary stock offering.

Calendars

US: Thurs: GDP & GDP Price Index 1.3%/3.1%; Headline & Core PCED 3.4%/3.8% q/q; Corporate Profits 3.9%; Goods Trade Balance -$91.8b; Jobless Claims 218k; Pending Home Sales 0.1%; Wholesale Inventories -0.1%; Natural Gas Storage & Gasoline Production; Fed’s Balance Sheet; Williams; Bailey; Logan. **Fri:** Personal Income & Spending 0.3%/0.3%; Core PCED 0.2%; Atlanta Fed GDPNow 3.5%; Chicago PMI 40.8; Baker-Hughes Rig Count. (FXStreet estimates)

Global: Thurs: Eurozone Business & Consumer Survey 96.0; Eurozone Consumer Confidence -14.3; Eurozone Unemployment Rate 6.5%; Eurogroup Meeting; Spain CPI 3.7y/y; Italy Unemployment Rate 7.3%; Japan Unemployment Rate 2.6%; Japan Industrial Production 1.5%; Japan Retail Sales 1.8%; China M-PMI & NM-PMI 50.5/51.5. **Fri:** Eurozone Headline & Core CPI 2.5%/2.7%y/y; Germany Retail Sales -0.2%; Germany

Import Price Index 0.5%; France GDP 0.2%q/q/1.1%y/y; France CPI 0.2%; Italy GDP 0.3%q/q/0.6%y/y; Italy CPI 0.2%; UK Nationwide HPI 0.1%; Japan Housing Starts -0.2%. (FXStreet estimates)

Strategy Indicators

Stock Market Sentiment Indicators (***link***): The Bull-Bear Ratio fell to 3.25 this week after climbing the prior four weeks (to 3.45 from 2.15). It was at 4.43 eight weeks ago—which was the highest reading since February 5, 2018. Bullish sentiment fell to 58.2% this week; the drop followed a four-week rise of 13.2ppts to 59.4% from 46.2%—which was the lowest percentage since late October. Meanwhile, bearish sentiment edged up to 17.9% this week after falling the prior four weeks by 4.3ppts (to 17.2% from 21.5%). It was at 14.1% in early April—which was the fewest bears since 12.6% in late January 2018. The correction count edged up to 23.9% this week after falling the prior three weeks by 9.9ppts, to 23.4% from 33.3%—which was the highest since early October 2023. Turning to the AAII Sentiment Survey (as of May 23), both optimism and pessimism rose during the latest reporting week, while neutral sentiment posted a large decline. The percentage expecting stock prices to rise over the next six months jumped 6.2ppts to 47.0%—remaining above its historical average of 37.5% for the 28th time in the past 29 weeks—while the percentage expecting stocks to fall over the next six months rose 3.1ppts to 23.3%, with pessimism below its historical average of 31.0% for the third time in six weeks. The percentage expecting stock prices will stay essentially unchanged over the next six months sank 9.2ppts to 26.6%, with neutral sentiment below its historical average of 31.5% for the third time in seven weeks.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin remained steady w/w at an 18-month high of 13.1% during the May 23 week. That's up from a 24-month low of 12.3% during the March 30, 2023 week and just 0.3pt below its record high of 13.4% achieved intermittently in 2022 from March to June. It's now 2.8pts above its seven-year low of 10.3% during April 2020. Forward revenues rose less than 0.1% w/w to a new record high for the first time in three weeks. Forward earnings rose 0.2% w/w to a record high too. It had hit that mark during the September 21 week for the first time since the June 16, 2022 week. Revenues and earnings had been steadily making new highs from the beginning of March 2021 to June 2022; prior to that, they peaked just before Covid-19 in February 2020. The consensus expectations for forward revenues growth rose to a 19-month high of 5.3%. It has gained 3.0pts from its 33-month low of 2.3% during the February 23, 2023 week. That's down from a record high of 9.6% growth at the end of May 2021 and compares to 0.2% forward revenues growth during April 2020, which was the

lowest reading since June 2009. The forward earnings growth forecast rose 0.1pt w/w to a 31-month high of 12.3%. It's now 9.0pts above its 31-month low of 3.3% during the February 16, 2023 week. That's down from its 23.9% reading at the end of April 2021, which was at its highest since June 2010 and up substantially from its record low of -5.6% at the end of April 2020. Analysts expect revenues to rise 4.7% in 2024 (unchanged w/w) and 5.6% in 2025 (unchanged w/w) compared to a revenues gain of 2.2% in 2023. They expect an earnings gain of 10.6% in 2024 (up 0.2pt w/w) and a 14.2% rise in 2025 (up 0.1pt w/w) compared to an earnings gain of 2.4% in 2023. Analysts expect the profit margin to rise 0.7ppt y/y to 12.6% in 2024 (unchanged w/w), compared to 11.9% in 2023, and to rise 1.0ppt y/y to 13.6% in 2025 (unchanged w/w). The S&P 500's weekly reading of its forward P/E ticked down 0.1pt w/w to 20.7 from a seven-week high of 20.8, and remains below its 26-month high of 21.1 at the end of March. That's up from a 30-month low of 15.3 in October of 2022. It also compares to 23.1 in early September 2020, which was the highest level since July 2000, and to a 77-month low of 14.0 in March 2020. The S&P 500 weekly price-to-sales ratio was unchanged w/w at a 28-month high of 2.72. That's up from a six-month low of 2.22 during the October 26 week and compares to a 31-month low of 1.98 in October 2022. That also compares to a record high of 2.88 at the end of 2021 and a 49-month low of 1.65 in March 2020.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Looking at the 11 S&P 500 sectors during the May 23 week, six had forward revenues that rose w/w and six had forward earnings that moved higher. This led to a gain in forward profit margins too, as five sectors moved higher w/w on that measure. Health Care and Information Technology were the only sectors with forward revenues at a record high this week as these six sectors remained less than 1.3% below their recent records: Communication Services, Consumer Discretionary, Consumer Staples, Industrials, Real Estate, and Utilities. The three remaining sectors have forward revenues more than 5.0% below their post-pandemic highs: Energy, Financials, and Materials. When adjusted for the incoming transfer of five former Tech sector firms in March 2023, Financials' forward revenues would be at a record high. Three sectors have record-high forward earnings this week: Consumer Staples, Information Technology, and Utilities. Communication Services, Consumer Discretionary, and Industrials were in that camp in very recent weeks, and Financials would be too when adjusted for GICS changes in March 2023. Among the remaining four sectors, two still have forward earnings down more than 20.0% from their post-pandemic highs: Energy and Materials. Looking at the forward profit margin, nearly all of the sectors are showing signs of recovering from their early 2023 forward profit margin lows. Information Technology is the only sector with a forward profit margin at a record high this week. In recent weeks, Communication Services, Consumer Discretionary, and Industrials were in that camp as

well. Energy's forward margin is improving now from its 23-month low of 10.4% in February, while those of Consumer Staples and Health Care remain at or close to their record lows. The annual profit margin is expected to fall y/y in 2024 for Energy, Materials, and Real Estate and improve for the other eight sectors. Here's how the S&P 500 and its 11 sectors rank based on their current forward profit margin forecasts along with their record highs: Information Technology (26.9%, up 0.2pt to a new record high this week), Financials (19.0, down from its 19.8 record high in August 2021), Communication Services (17.7, unchanged w/w down from its 17.8 record high several weeks earlier), Real Estate (16.9, unchanged w/w and down from its 19.2 record high in 2016), Utilities (13.8, unchanged w/w a d down from its 14.8 record high in April 2021), S&P 500 (13.1, unchanged at a 90-week high, but down from its record high of 13.4 achieved intermittently in 2022 from March to June), Materials (11.0, unchanged w/w at a 31-week high, but down from its 13.6 record high in June 2022), Energy (10.9, unchanged w/w and down from its 12.8 record high in November 2022), Industrials (10.7, unchanged w/w and down from its 10.8 record high in early April), Consumer Discretionary (9.1, unchanged w/w at a record high), Health Care (8.6, unchanged w/w at 0.1pt above its record low at the end of April and down from its 11.5 record high in February 2022), and Consumer Staples (6.9, unchanged w/w and down from its 7.7 record high in June 2020).

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