Yardeni Research

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Morning Briefing

On Crude Oil, Valuation & AI

Check out the accompanying chart collection.

Executive Summary: The Q4 earnings of Occidental Petroleum provides a case study in how an oil producer can grow earnings at a time when global production is outpacing consumption and oil prices are weak. … Also: It's not just the richly valued Information Technology sector that has propelled the S&P 500's forward P/E well above its historical average. Multiples have expanded over the past year for nearly all S&P 500 sectors. Today, Jackie examines valuation inflation among non-tech sectors. … And: A look at the upgrades to AI LLMs and AI agents that serve as personal assistants—smart enough to get on your computer and do errands from shopping to posting.

Energy: OXY & Oil. Perhaps now we know why Warren Buffett's Berkshire Hathaway has built a 28.2% equity stake in Occidental Petroleum that's worth more than $13.5 billion. Occidental managed to increase production, increase its dividend, and pay down debt last quarter even though the price of crude oil slid, bringing its y/y decline to 9.2% (*Fig. 1*).

The company benefitted from the production it acquired through a $38 billion purchase of Anadarko in 2019 and a $12 billion purchase of CrownRock last summer. Last year's deal helped increase Occidental's worldwide production to 1,463 million barrels of oil equivalent per day (MBOE/D), up from 1,230 MBOE/D in Q4-2023.

Let's drill down for a deeper look:

(1) *Adjusted earnings rise.* Despite the oil price weakness, Occidental reported higher Q4 adjusted net income than a year ago: $792 million (80 cents a share) versus $710 million (74 cents). The adjusted figures exclude a long-term environmental liability the company had to recognize after a federal court ruling that's being appealed.

On the earnings *conference call*, CEO Vicki Hollub noted that the company has been replacing higher-cost production with a higher volume of lower-cost new reserves, and its annual capital spend for oil and gas development is less than its annual depreciation, depletion, and amortization cost. “This is driving increased earnings per barrel and increased earnings per share,” she explained.

Earnings also benefit as the company reduces its debt and related interest expense. It plans $1.2 billion of divestitures in Q1, and the proceeds will be used to reduce debt. As debt is paid down, the cash that was used to meet interest payments can instead be returned to investors.

One major Occidental project launching this year removes carbon dioxide from the atmosphere. The project received funding under the Biden administration, as it would reduce greenhouse gasses. Hollub has been talking to President Trump about the need to continue the funding because the nation will need carbon dioxide pumped into depleted oil wells to increase the oil ultimately recovered. Enhanced oil recovery will add 50 billion to 70 billion barrels of oil to US reserves, which would increase US energy independence by more than 10 years—a business case she believes will resonate with Trump.

Occidental shares rose 4.4% on Wednesday to $50.99, an improvement from the slide off their recent peak of $69.26 on April 11.

(2) *Producers keep producing.* Having flexibility is important in an era when global oil production continues to outpace consumption, even as OPEC+ keeps 2.2 mbd of production off the market. According to a US Energy Information Administration *report*, global consumption of petroleum and other liquid fuels was less than production last year, which should continue: 2024 (102.77 mbd consumption, 102.84 mbd production), 2025 (104.14, 104.56), and 2026 (105.18, 106.16).

What could buoy consumption? If the aggressive fiscal actions taken by Trump 2.0 and the Chinese government improve global economic growth, that might increase business and consumer confidence and spending. We’ve been watching for signs of this in copper prices, which have popped 14.9% ytd (*Fig. 2*).

Strategy: Rising P/Es Outside of Tech. There’s much handwringing about the S&P 500’s forward P/E of 22.4, which is up two points from a year ago and well above its long-term average of 15.8 (*Fig. 3*). Is it precariously high, too high to be sustained? (FYI: The forward P/E is the multiple based on forward earnings, i.e., the time-weighted average of analysts’ consensus estimates for the current year and following one.)

The S&P 500 Information Technology sector is often blamed for pulling the broad index's valuation skyward. It sports a forward P/E of 28.8, up modestly from 27.7 a year ago (*Fig. 4*). And the sector has industries with very lofty forward P/Es, including Application Software (34.7) Systems Software (30.4), Semiconductors (28.7), and Technology Hardware, Storage & Peripherals (28.2) (*Table 1*).

But the Information Technology sector isn't solely responsible for the S&P 500's recent multiple expansion. A forward multiple in the high 20s has been the sector's norm during most of the post-pandemic era. And the sector has experienced only about one point of multiple expansion over the past year, whereas the S&P 500's forward P/E is up two points.

Multiple expansion has been broad based, affecting 10 of the S&P 500's 11 sectors: Real Estate (forward P/E of 37.2 currently, 36.5 year ago), Information Technology (28.8, 27.7), Consumer Discretionary (28.5, 24.5), Industrials (22.9, 20.2), S&P 500 (22.4, 20.4), Consumer Staples (22.0, 19.4), Materials (20.7, 19.4), Communication Services (20.5, 18.2), Utilities (17.9, 15.1), Financials (17.4, 15.1), Health Care (17.3, 18.9), and Energy (14.5, 11.8).

The Consumer Discretionary sector's forward P/E jumped the most dramatically, boosted by the P/E multiple increases in stocks of companies that make autos, movies, and sneakers. Let's take a look at the changes in these and other notable industries:

(1) *Rocketing retail.* The S&P 500 Consumer Discretionary sector's forward P/E has jumped to 28.4 from 24.5 a year ago (*Fig. 5*). Except for the period just after the pandemic, when its forward P/E soared to 40.5, the sector's earnings multiple is as high as it has been at previous peaks in 2021 and 2009. But at those prior P/E peaks, the sector's earnings were depressed, unlike today when they are at record levels (*Fig. 6*).

Some of the multiple expansion is due to the Automobile Manufacturers industry, which has a forward P/E of 41.2, almost double the 22.9 of a year ago. Tesla's shares have jumped 77.1% over the past year to $354.11 as of Tuesday's close, while its earnings per share is expected to decline from $4.30 in 2023 to $2.93 in 2025. The rise in share price and decline in expected earnings have pushed its forward P/E up to 126.7 (*Fig. 7*).

Other Consumer Discretionary industries rocking high forward P/Es: Broadline Retail (33.8 currently, 37.5 last year), Movies & Entertainment (32.0, 28.4), Footwear (30.5, 25.4), and Restaurants (27.9, 24.3).

The Consumer Staples Merchandise Retail industry, in the Consumer Staples sector, stands out with a forward multiple that has climbed to a record high of 36.8, up from 27.9 (*Fig. 8*). Blame the share price surges of Costco Wholesale, up 45.9% y/y, and Walmart, up a whopping 82.8% y/y—boosting their forward P/Es to 55.7 and 37.6.

(2) *Defense & Meta.* Another standout is the Aerospace & Defense industry, with a forward P/E of 27.7, near its record high and up from 21.1 a year ago (*Fig. 9*). This Industrials sector's industry has some standout stocks, like GE Aerospace, and some clunkers like Boeing.

Given the 20-day record rally in Meta shares, it's surprising that its industry, the S&P 500 Interactive Media Services industry, has such a reasonable forward P/E. The industry, which also includes Alphabet, has a such strong collective earnings growth outlook—45.8% in 2024 and 9.3% projected this year—that its forward P/E remains a reasonable 22.8 (*Fig. 10* and *Fig. 11*).

(3) *P/E compression hurts Health Care.* The only sector in the S&P 500 to see its forward P/E drop y/y is Health Care, from 18.9 a year ago to 17.3 today (*Fig. 12*). The industry has been buffeted by rising costs, drug development misses, and uncertainty around how the Trump administration will address health care costs and insurance.

Here are some of the industries whose forward P/Es have fallen y/y: Life Sciences Tools & Services (24.0 currently, 27.8 one year ago), Health Care Supplies (18.1, 25.9), Biotechnology (16.5, 16.8), Health Care Distributors (15.6, 15.8), Pharmaceuticals (15.4, 18.4), Managed Health Care (14.5, 15.7), and Health Care Facilities (12.0, 14.6).

Disruptive Technology: AI Programs Improving. The number of artificial intelligence (AI) programs continues to multiply, and the programs themselves continue to grow ever more sophisticated. Large language models (LLMs), like ChatGPT and others, are being rapidly updated in a bid to avoid commoditization. Developers have also created AI agents that are like apps. They use LLMs and control the user's computer or other device to execute a command—e.g., make a restaurant reservation or buy a product.

Here's a look at some of the latest advancements:

(1) *Something to honk about.* Block—formerly known as "Square"—has introduced a free, open-source framework, dubbed "Goose," that developers can use to develop AI agents that embed the LLMs of their choice. The program was originally developed to help

programmers write and fix code. But it has the potential to execute numerous tasks, like organizing calendars and sending emails. It runs locally, allowing users to retain control over their information.

OpenAI also has developed an AI agent dubbed "Operator." It was used by a *NYT* reporter to order a new ice cream scoop on Amazon and book a Valentine's Day reservation, according to the February 1 *article*. Operator occasionally asked questions to clarify the task at hand. The reporter compared it to having an AI driver for one's computer.

Operator has its limitations, however. It requires a human to actually execute a purchase; it isn't allowed to gamble, so can't play online poker; and it is prevented from entering websites that require users to prove they're not robots. Operator is available to ChatGPT Pro subscribers for $200 a month.

(2) *Grok aces the test.* xAI's Grok-3 is the best AI LLM based on testing in math science and coding. It outscored OpenAI's GPT-4o, Claude 3.5, DeepSeek-V3, and Google's Gemini-2 Pro, according to data reported by Elon Musk and the folks at xAI in an X *video*. The team expects Grok's results to continue to improve as it undergoes additional training. The LLM also outperformed the competition on a crowdsourced platform, Chatbot Arena.

Additionally, Grok is developing a reasoning model that takes a bit longer to respond as it "thinks," working its way through a question to offer higher-quality results. Grok can be creative and combine two games upon request. "We're seeing the beginnings of creativity," says Musk. To achieve this, xAI built a ginormous data center with 200,000 GPUs.

(3) *ChatGPT's still evolving*. Sam Altman laid out the roadmap for ChatGPT in a recent *post* on X. OpenAI plans to roll out GPT-4.5, its last non-chain-of-thought model. It then will introduce GPT-5, which will be able to determine whether an inquiry can be answered simply or requires its chain-of-thought reasoning capabilities. In the latter case, ChatGPT will break down the problem into steps that are displayed and can be checked. GPT-5 at "standard intelligence" will be free to users, and smarter versions will require a subscription.

(4) *Lots of new guys.* At the heels of the large established LLM companies are a slew of startups hoping to replicate, if not exceed, their success. Earlier this week, OpenAI's former chief technology officer Mira Murati launched Thinking Machines Lab, which aims to build AI systems that "encode human values and aim at a broader number applications than rivals," a February 18 Reuters *article* reported.

Another OpenAI alum, co-founder Ilya Sutskever, has started Safe SuperIntelligence with Daniel Levy and Daniel Gross, a February 18 *Fast Company* article reported. The company, which aims to create a safe superintelligent AI system, has no product on the market but is in the midst of raising $1 billion of capital at a valuation north of $30 billion.

(5) *China's LLMs improving too.* China's tech gurus also aren't sitting on their laurels. In the January 23 *Morning Briefing*, we highlighted a number of Chinese tech developers creating LLMs, including Moonshot AI. It has developed a LLM and popular chatbot, both called "Kimi." Moonshot recently updated Kimi, the LLM, with version 1.5, which can recognize text, images, and code as well as conduct advanced chain-of-thought reasoning. Founded in 2023, Moonshot is backed by Alibaba and valued at $3.3 billion, a February 2 *article* in *The Guardian* reported. Kimi 1.5 is free to use and has reportedly performed well in benchmark testing.

Calendars

US: Thurs: Leading Indicators -0.1%; Jobless Claims 215k; Philadelphia Fed Manufacturing Index 16.3; Barr; Golsbee; Musalem. **Fri:** University of Michigan Consumer Sentiment 67.8; M-PMI & NM-PMI Flash Estimates 51.2 & 53.0; Existing Home Sales 4.13mu; Jefferson. (FXStreet estimates)

Global: Thurs: Eurozone Consumer Confidence Flash -13.9; Germany PPI 0.6%m/m,1.3%y/y; UK Gfk Consumer Confidence -24; Japan M-PMI Flash Estimates 49.0. **Fri:** Eurozone, Germany, France C-PMI Flash Estimates 50.5, 50.8, 48.0; Eurozone, Germany, France M-PMIs Flash Estimates 47.0, 45.5, 45.5; Eurozone, Germany, France NM-PMI Flash Estimates 51.5, 52.5, 48.9; Italy CPI 0.6%m/m, 1.5%y/y; UK C-PMI, M-PMI, NM-PMI Flash Estimates 50.5, 48.4, 50.8; UK Retail Sales 0.3%m/m, 0.6%y/y. (FXStreet estimates)

Strategy Indicators

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward revenues ticked down 0.1% w/w during the February 13 week from its record high a week earlier. Forward earnings dropped 0.2% w/w, also from a record high. The forward profit margin dropped 0.1ppt w/w to 13.5% from a record high of 13.6%. It is now 3.2ppts above its seven-year low of 10.3% during April 2020. The consensus expectation for forward revenues growth was steady w/w at 5.5%, and is now 0.3ppt below its 23-month high of 5.8% during the August 1 week. It has gained 3.2ppts 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 was steady w/w at a 36-week low of 12.6%, and is now 1.7ppts below its 38-month high of 14.3% during the December 12 week and 9.3ppts 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 boosted by the recovery from the pandemic to its highest reading since June 2010 and up substantially from its record low of -5.6% at the end of April 2020. Analysts expect revenues to rise 5.2% in 2025 (down 0.1ppt w/w) and 6.3% in 2026 (unchanged w/w), an acceleration from 2024's forecasted 4.9% (unchanged w/w). They expect an earnings gain of 12.2% in 2025 (unchanged w/w) and a 14.1% rise in 2025 (unchanged w/w) compared to 2024's forecasted earnings gain of 10.8% (down 0.3ppt w/w). Analysts expect the profit margin to rise 0.8ppt y/y to 13.3% in 2025 (unchanged w/w) and 1.0ppt y/y in 2026 to 14.3% (unchanged w/w), compared to 2024's forecasted 12.5% (unchanged w/w). The S&P 500's weekly reading of its forward P/E rose 0.4pt w/w to a 10-week high of 22.2, and is just 0.2pt below its 43-month high of 22.4 during the December 12 week. It's up 2.5pts from a 14-week low of 19.7 during the August 8 week and 6.9pts 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 rose 0.02pt w/w to 3.02 and is just 0.01pt below its January 23 record high. That's up from a six-month low of 2.22 during the October 26, 2023 week and compares to a 49-month low of 1.65 in March 2020.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): During the February 13 week, forward revenues rose for four of the 11 S&P 500 sectors and forward earnings rose for one. This led to rising forward profit margins for two of the 11 sectors. Three sectors posted record-high forward revenues this week: Financials, Health Care, and Utilities. These five sectors are less than 0.4% from their recent record highs: Communication Services, Consumer Discretionary, Consumer Staples, Information Technology, and Real Estate. Industrials' forward revenues has weakened to 3.4% below its early September record. Materials and Energy are struggling to improve, and remain the biggest laggards at 6.1% and 15.1% below, respectively. Communication Services and Utilities were the only sectors with record-high forward earnings this week. These three sectors are less than 0.3% from their recent record highs: Consumer Discretionary, Financials, and Information Technology. Industrials and Consumer Staples are 1.6% and

1.3% below their respective record highs in early January. Improving now is Real Estate at 1.7% below its record high in August 2022 and Health Care at just 0.7% below its February 2022 record. Among the remaining two sectors, forward earnings remains depressed for Energy and Materials, which are 34.5% and 26.2% below their respective highs during 2022. Looking at the record-high forward profit margin club, Financials' was steady w/w after entering the club during the January 16 week for the first time since August 2021. Also at a record high this week are Communication Services and Consumer Discretionary. In recent weeks, the Industrials and Information Technology sectors were in that club. Among the laggards, Energy's forward margin fell 0.1ppt w/w to a 36-month low of 9.3% and has tumbled 1.6ppts since its six-month high of 10.9% in mid-June; Consumer Staples' 6.8% is just 0.1ppt above its seven-year low in March 2023; Health Care's 8.6% is only 0.1ppt above its record low in April; and Real Estate's 16.9% is up from a low of 12.4% in December 2020. 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 (27.0%, down from its 27.6% record high in September prior to low-margin Dell's index addition, which lowered the margin 1.3ppts then to 26.3%), Financials (20.0, a record high for a fifth week, the first since August 2021), Communication Services (18.6, a record high this week), Real Estate (16.9, down from its 19.2 record high in 2016), Utilities (14.5, down from its 14.8 record high in April 2021), S&P 500 (13.5, down 0.1ppt w/w from its 13.6 record high during 22 of the past 24 weeks), Materials (10.6, down to a 12-month low and from a 20-month high of 11.6 in July 2023 and a 13.6 record high in June 2022), Energy (9.3, down 0.1ppt w/w to a 36-month low and from its 12.8 record high in November 2022), Industrials (11.1, down 0.1ppt w/w and from its 11.3 record high in early January), Consumer Discretionary (9.4, a record high this week), Health Care (8.6, only 0.1ppt above its 8.5 record low at the end of April and down from its 11.5 record high in February 2022), and Consumer Staples (6.8, down from its 7.7 record high in June 2020).

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Eric Wallerstein, Chief Markets Strategist, 201-661-3575
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-241-6502
Melissa Tagg, Senior Global Investment Strategist, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102