From the Desk of the CIO
Marta Norton Shares What’s Top of Mind: October 2023

My Takeaways
► Rising oil prices may not upend the disinflationary trend, but they add new pressure to the economy.
► Master Limited Partnerships (MLPs) are our energy exposure of choice here in the U.S.
► Overseas, European energy has valuation and fundamental appeal and may be especially well suited for stagflation.

Interested in knowing my thoughts on a particular topic? Email us at wealth.us@morningstar.com with your ideas and feedback!

Chart of the Month
Energy prices have been on a tear this summer, ultimately showing up in a September bounce in headline inflation.

Exhibit 1: West Texas Intermediate, Brent Crude, and Headline CPI


Does this matter?

Not as much as you might think, at least as far as inflation goes. As all Fed watchers know at this point in the rate-hiking cycle, the Fed “looks through” headline inflation to core inflation, or inflation stripping out energy and food. That’s because energy and food prices bounce around quite a bit and don’t necessarily explain the trend in inflation for the economy on the whole.
But aren’t energy prices an input to other goods and services? So what about the passthrough impact of higher input costs raising the prices for goods and services more broadly?

Well, sure, research suggests that there is contemporaneous impact on inflation from rising energy prices. But even so, the impact may be less than we’d think. In fact, a working paper by the Federal Reserve of Dallas found that, even in the 2021/2022 inflation spike, the total energy impact was one quarter of the increase in total inflation. Specifically, “of the 8.1% average inflation rate in 2022 (as of August 2022), between 0.2 and 1 percentage point is explained by gasoline price shocks and between 1.1 and 1.8 percentage points by all energy price shocks combined.” (A Broader Perspective on the Inflationary Effects of Energy Price Shocks, Lutz Kilian and Xiaoqing Zhou, Federal Reserve Bank of Dallas, December 2022).

But there are economic effects of higher energy prices beyond inflation. For example, historical reviews of recessions show that, often as not, higher oil prices have preceded recessions, with research by the Federal Reserve among others suggesting at least some causal relationship. In today’s context, should energy prices continue ascending — and of course, confident predictions on the direction of energy prices have ruined many an investor — consumers will find their discretionary income shrinking while they also contend with higher interest rates and dwindling savings.

Should these headwinds result in a weakening economy, a Fed pivot earlier than the market expects could be in the cards. The operative word is “could.” Other variables matter too, like how much core inflation comes down. And even from an economic standpoint, the magnitude of economic softening is an open question, particularly given the starting strength of the consumer.

Yikes. What to do about all this uncertainty? Well, we aren’t spinning our wheels predicting precise levels of inflation and interest rates. But we are planning for the range of outcomes that are out there, assessing valuations, and thinking about how asset classes could behave in different economic regimes. The culmination of that analysis means we have some energy exposure in our portfolios. Read on.

**U.S. Energy: It’s the MLP’s for Us**

We have been longtime owners of energy. Pre-2020, in fact, which made the COVID selloff particularly painful. As we increased the position during the spring and maintained exposure through much of 2022, the added energy exposure redeemed itself in time.

Today, our models suggest broad-based U.S. energy exposure is less attractive due to relatively high expectations embedded in the stock prices of U.S. energy firms. However, one area of the U.S. energy complex still has appeal for us: oil and gas MLPs. These master limited partnerships are publicly traded partnerships that focus on energy infrastructure; generally speaking, the pipes and plumbing needed to move oil and gas. They trade like stocks, on exchanges, derive 90% of their revenue from energy activities, and pass along the bulk of their earnings through distributions.

Those distributions mean a hefty yield bolsters the total return for these companies, but we also see reasonable valuations compared with an arguably overvalued broader U.S. energy market, greater capital discipline (a big plus for an industry often subject to overbuilding), and potential upside — though arguably not as great as that of the producers — should energy prices stay higher for longer.
Relative Valuation: MLP Price to Cash Flow Relative to the U.S. Equity Market

Cash Flows Today More than Cover Dividend Payments with Midstream Energy

Source: Morningstar Investment Management, FactSet, and Bloomberg. Data as September 30, 2023. The MLP market is represented by the Alerian MLP Infrastructure Index. The U.S. equity market is represented by the MSCI USA Index.

Exhibit 3: Cash Flows Today More than Cover Dividend Payments with Midstream Energy

Source: Morningstar Investment Management and FactSet. Data as of September 30, 2023. The MLP market is defined as all companies currently held in Morningstar Investment Management’s Energy Infrastructure Sleeve within the Morningstar US Equity Fund MSTGQ. Aggregate figures are calculated by summing each firm’s value across a given time period. Historical data is calendarized and estimates are annual figures. Future dividend estimates are calculated by taking the mean dividend per share estimate times shares outstanding as of 12/31/2022.

European Energy: A Salve for Stagflation?

MLPs aren’t the only energy exposure in our portfolios. European energy stocks also look attractive to us, both from the perspective of the underlying fundamentals of the companies and considering the prevailing economic environment.

Let’s take the second topic first. In recent years, the risks of slowing growth and higher inflation have loomed large both at home and abroad, which has caused us to investigate which asset classes tend to hold help well in stagflation environments. Not surprisingly, historical reviews suggest energy companies have done quite well.

With stagflation the risk de jour in Europe, European energy companies naturally come to mind.
But the crux of the appeal for us still lies on the fundamental side. European energy companies produced stronger performance than much of the global equity market in 2022’s bloodbath, but severely lagged the tremendous gains in U.S. energy stocks.

Of course, the proximity to the Ukraine War introduced some uncertainty, no question, in recent years. However, another potential headwind for European energy companies is capital discipline. Broadly speaking, European energy companies had, in recent years, emphasized plans to transition away from oil, which not only demanded capital expenditure on initiatives with uncertain payouts, but also limited the companies’ ability to participate in traditional oil and gas markets.

2023 announcements across several companies to maintain current production and emphasize capital discipline has been met with early signs of investor enthusiasm, though valuations still lag far behind U.S. counterparts. This gives us the opportunity to invest in improving fundamentals and better valuations, a nice combination to find.

**Exhibit 4: Relative Valuation: EU Energy Price to Cash Flow Relative to EU Equities**

Source: Morningstar Investment Management, FactSet, and Bloomberg. Data as of September 30, 2023. The EU energy market is represented by the MSCI Europe Energy Index. The European equity market is represented by the MSCI Europe Index.

**Exhibit 5: European Energy Capital Discipline: Capex to Cash Flow from Operations**

Source: Morningstar Investment Management and FactSet. Data as of September 30, 2023. This chart shows CapEx / Cash Flow from Operations for all 11 current MSCI Europe Energy Index constituents. Index level figures are calculated by summing each
firm's value across a given time period. Historical data is calendarized and estimates are annual figures. Index constituents are not adjusted going back in time.

Of course, there is potential downside to both our MLP and our European energy positions. Falling energy prices, due either to a recession or to a change in supply and demand dynamics, tend to work against those positions, just as higher energy prices help their fundamentals. But decent starting valuations afford us some margin of safety. For example, our analysis suggests that European energy companies are poised to deliver solid returns even in an environment in which oil prices fall from today’s levels to $65 per barrel of crude oil by the end of the decade. In other words, one does not need to make heroic assumptions around the future direction of oil prices to conclude that European energy is reasonably priced today.

**Happy Halloween!**

Given the push-pull between expectations for one more hike and expectations for a pivot at some point in the first half of 2024, economic data continue to loom large for us in the coming month, as I imagine is true for many other investors. But earnings season will take center stage; we’ll be paying close attention to margins as companies aim to manage costs with unrelenting labor costs and some measure of inflation still in play. And let’s not forget America’s favorite holiday at month end. Like all normal, good parents, my favorite part of Halloween is pilfering through my kids’ candy for a late-night snack. I imagine I’m not alone in this.

Between now and then, enjoy the fall color.

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