ROCKMAN CAPITAL

12th August 2022

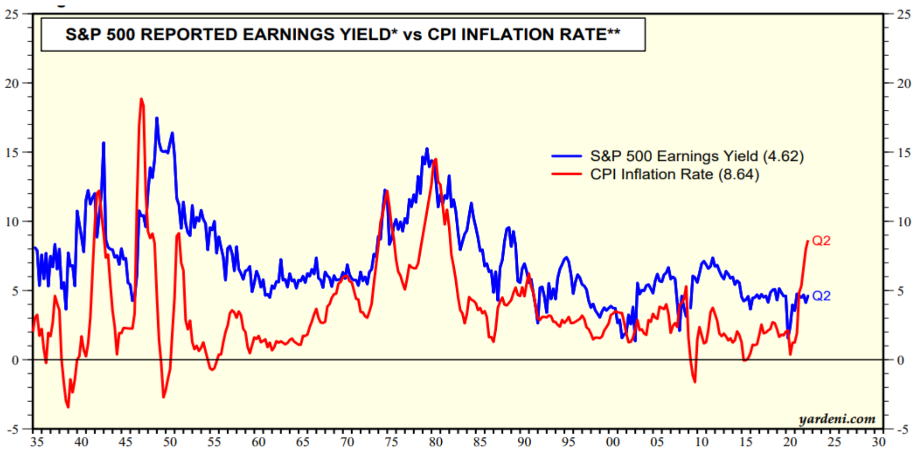
Time and timing

S&P 500

The earnings yield (*E/Y*) measures a stock's expected return relative to its value. I.e. If a company has an earnings yield of 10%, the company is expected to earn 10 USD for every 100 USD worth of shares owned. The E/Y is also the inverse of the price earnings (P/E) ratio. For example:

- *If Stock A is trading at USD10 and its earnings per share (EPS) for the year was 50c, it has a P/E of 20x (USD10/0,50c) and an E/Y of 5% (0,50/USD10).*
- *If Stock B is trading at USD20 and its EPS was USD2, it will have a P/E of 10x and an E/Y of 10%.*

The present E/Y of the S&P 500 (refer to the graph blow) is 4,62%. However, with US inflation rate at 9.1% and the S&P 500 dividend yield at 1,69%, the real expected return will be negative, at -2,79% (Real return = Earnings Yield – CPI Inflation Rate).



A bear market has usually coincided with negative real returns (A bear market is where the market witnesses a prolonged drop of more than 20%). The S&P 500 touched 3666.77 points or -23.5% on the 17th of June and has since climbed back to 4199 points or -12.5% year-to-date. However, as mentioned in our previous update, entitled *Continued Trouble* (per the graph below), bear markets do not last as bull markets (the average length of a bear market is 289 days, or about 9.6 months versus the average length of a bull market, of 991 days or 2.7 years).

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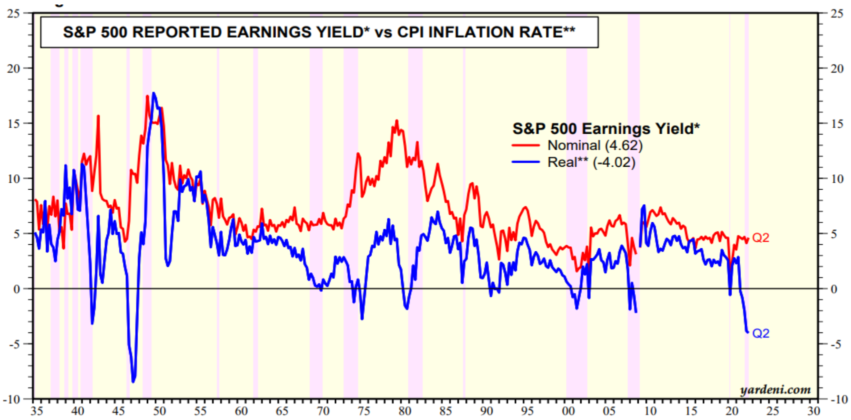
The S&P 500 P/E ratio is another important indicator: Presently the current S&P500 10-year P/E Ratio is 28.8. This is 80% above the modern-era market average of 15.98, putting the current P/E 1.28 standard deviations above the modern-era average. For the market to return to its average P/E, the S&P 500 would need to fall back to 2,700 points.



The E/Y can be used to compare different stocks and/or fixed income instruments, indicating investor sentiment. A company with a high E/Y, could indicate that its outlook is poor, and earnings are expected to fall. Or it could indicate a possible dislocation in the market or mispricing of a counter, which may present a favorable time for buying a quality business. E.g.

- *Motor companies during 2021 were priced on a E/Y of between 21-25%. Presently their E/Y's are 18.5-35%: All major motor companies have indicated strong earnings outlooks.*
- *Alphabet in 2018 had an E/Y 1.71% versus its current E/Y 4.9%. This is whilst Alphabet's various business franchises indicate no significant stress, or slowdown in its business model.*
- *The S&P 500 has fallen 16% year-to-date, whilst the dividend aristocrats index has declined only 2.8% and is on yield of 5.9%. This indicates the quality of the constituents making up the aristocrats' index and how highly investors value their defensive and consistent earnings streams.*

Whilst average mean P/E ratios have trended historically upwards, especially considering high technology valuations (refer below), Rockman Capital's view remains: Due to the rising cost of capital and pressures mounting on US consumers, the overall market is still overvalued.

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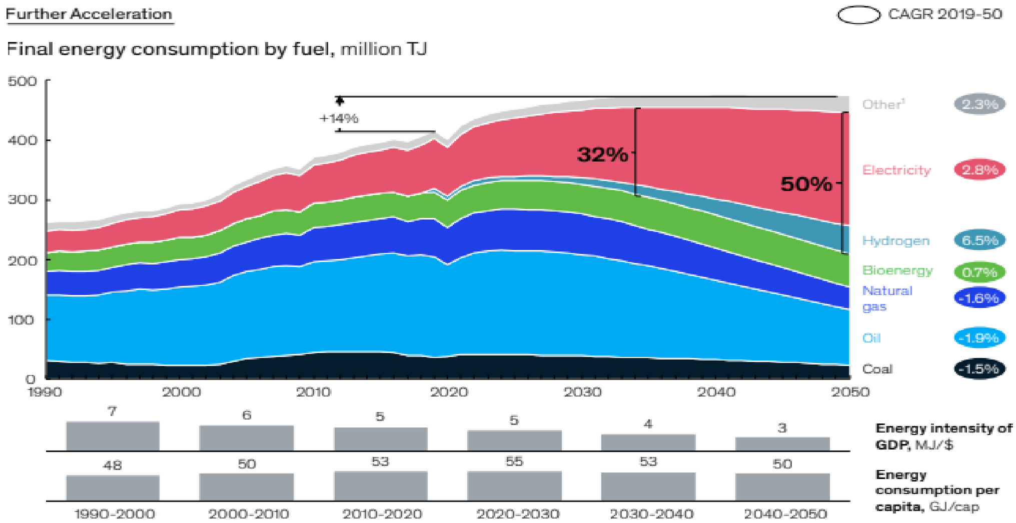
The Global Energy Shortage

The economic recovery from the effects of the COVID-19 pandemic has resulted in a rebound in global energy demand. Whilst gas prices hit a 30-year low at the start of the COVID-19 pandemic, they have since reached a nearly two-decade-high in 2022. Power prices have shown similar volatility, impacting energy costs for many businesses and households.

In the medium-term (refer below), global energy consumption is projected to flatten, owing to advancements in energy technology, as a result of greater end-use efficiencies in buildings, transport, and industry.

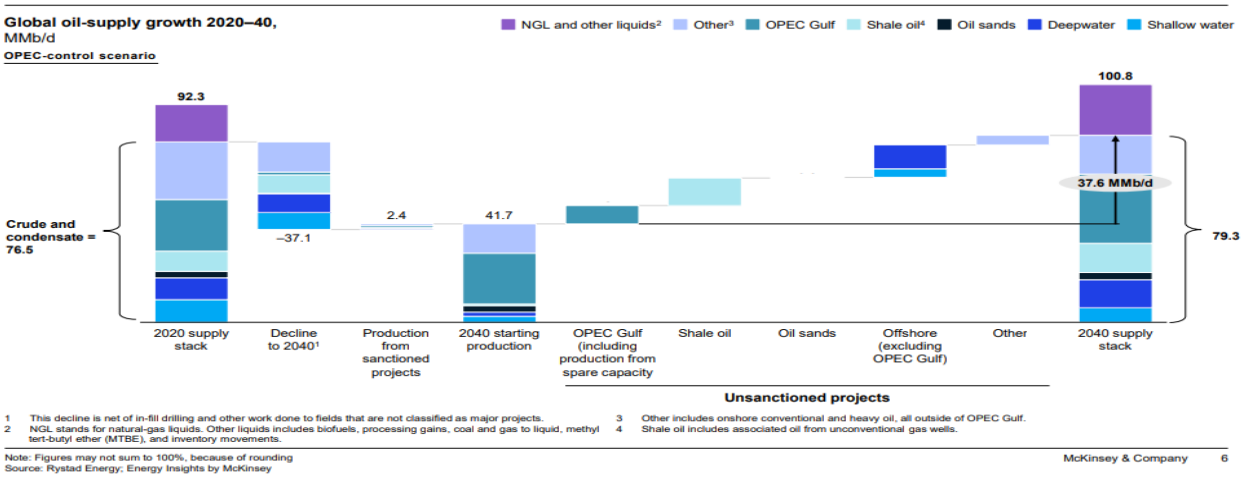


However, present oil supply remains constrained. Both demand and supply, appears to be hostage to world politics and economic events, including:

- The ongoing war in Ukraine,
- Lower demand, underpinned by high inflation and higher interest rates,
- Under investment in new supply.

Through 2022, global crude oil prices have averaged well above the USD100 per barrel (*/bbl*) mark. Minor supply-side disruptions, including the release of strategic reserves, have not had any major downside effects on the oil price. Furthermore, OPEC and non-OPEC members alike (including US shale gas and oil producers), have not been able to significantly increase supply. This is whilst Russian supply, as of July 2022, has also almost recovered to pre-conflict levels.

By 2040 (refer below), exploration and production companies need to add 38 million barrels per day (*MMb/d)* of new crude production, in order to meet existing energy demands of 98 mmb/d. With supply constrained, market sentiment supports the short-to-medium term view, that the oil prices will remain elevated, at between USD100/bbl – USD150/bbl.



As a result of continuing supply constraints, Rockman Capital has placed the energy and resource sector under review. Our oil and petroleum sector watchlist includes the following counters Chevron, ExxonMobil, Occidental Petroleum, Eni, Conoco Philips, and Royal Dutch Shell.

Current client energy sector exposures, have included Brookfield Renewable Partners, SSE PLC. We favour these counters owing to their low volatility, strong cashflows and dividends.

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