This article is an RIA PRO exclusive for subscribers. If you are reading this article, this is a good example of the insights our subscribers read every day. Try it RISK-FREE for 30-days.

In this edition of the Value Seeker Report, we provide some initial high level thoughts on the energy sector. We plan to follow up on this report with an analysis of a few companies that we see value in.

Overview

- The Energy sector lies among those most battered and bruised by the pandemic. To further complicate matters, the United States is approaching a Presidential election between two candidates with starkly different views on Energy.
- While the S&P 500 has climbed back to positive territory year-to-date, XLE remains down nearly 50% since January 1st.
- While there are many headwinds for the energy sector, the valuations of some energy stocks are well below fair value.

Why The Cold Shoulder?

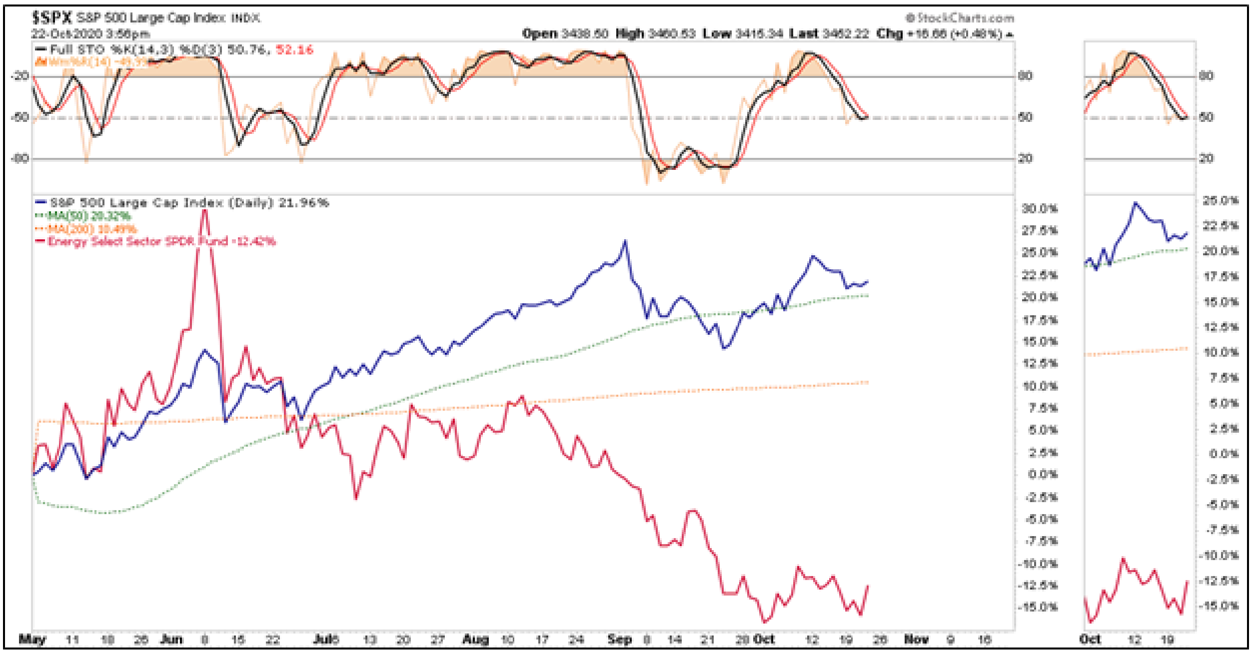
- We think there are four major factors that may help explain investors' apathy toward energy stocks. Two of them are related to weak demand for oil and gas, one related to market forces, and one related to politics.
- Quite obviously, regional lockdowns and associated limitations on travel are a big problem for stocks in the energy sector. The collapse in worldwide demand is wreaking havoc on crude oil and natural gas prices, which directly affects revenue and profits. As much as we would like to be winning the fight against COVID, winter is quickly approaching in the US, and we see limited signs of demand recovery.
- There is also the issue of whether the US will receive additional stimulus in the coming months. The economic recovery is slowing, and further delay of stimulus will only make things worse. Stimulus will play a key role in the demand for crude products in the fourth quarter. Making this factor tough to game, it appears that both parties are playing political football without regard to the Americans suffering as a result.
- A delay in demand recovery is a valid concern, but if it justifies the recent performance of XLE, then we should also see it reflected in the price of crude oil. Since May when economic recovery took hold and oil prices recovered, the price of XLE as a ratio to crude oil prices has been cut in half.
- It is important to point out a negative for that sector that will be a long term positive. As a result of weakened demand and teetering balance sheets, many wells have been shut-in. **As of September, the Baker Hughes Worldwide Rig Count stands at 1019. Not only is that**

lower than in the spring and summer, but the lowest since at least 1975. The U.S. rig count is also at 45-year lows.

- Further hurting energy stocks are popular investment trends. The rise of passive investing and demand for index ETFs create imbalances, leading to market inefficiencies over time. As our portfolio manager, Michael Lebowitz, recently wrote in [The Market?s Invisible Guardrails Are Missing](), ?*The massive surge in passive strategies? popularity has pushed the market to the brink of instability. Instability can result in price surges to unprecedented valuations*?. Consider this. For every $100 invested in SPY, $25 goes to technology, $14 goes to health care, but only $2 is invested in energy. Imagine this effect on a market being led higher by passive investors. Still, is this significant enough to explain the troubles of XLE?
- A significant factor to consider is the policy implications that this election may have in store for the energy sector.

Energy Stocks and The Election

- The outcome of this election carries important implications for stocks in the energy sector. The two candidates, President Trump and former Vice President Joe Biden possess diverging views on the issue of climate change.
- Mr. Biden is making his campaign based, in part, on laying the groundwork for the United States? push towards green energy. While Biden plans to roll out a $2T plan of action, President Trump would likely maintain the status quo in the energy sector.
- Whether you believe the polls or not, they suggest that Biden has held a lead for quite some time, and it seems that the stock market is taking this into consideration. As shown below, the returns on XLE began to diverge from those of the overall market in late June. Then, on August 11th, Biden announced Senator Kamala Harris as his running mate. That same day, XLE entered a bearish price channel and the divergence widened to where it is today.



What Would a Biden Administration Really Mean for Energy Stocks?

- We cannot definitively say what a Biden administration would mean for energy stocks, as there are a multitude of factors at play. Although we do have an idea based on what we see in the futures market for WTI crude.
- According to Joebiden.com, ?*Biden will make a $2 trillion accelerated investment, with a plan to deploy those resources over his first term, setting us on an irreversible course to meet the ambitious climate progress that science demands*?. Further, in last night?s debate, Biden openly acknowledged his intention to move away from fossil fuels. What Biden?s campaign site leaves unmentioned is that this will likely include regulations that create headwinds for the US shale industry. US shale oil makes up roughly 8% of global production. If onerous policies are implemented in the current economic environment, resulting headwinds will raise breakeven prices for US shale drillers and lead to increased bankruptcies. Incentives to transition to clean energy could result in bankrupt drillers? reserves being ?left on the table?. This combined with the previously mentioned worldwide rig count could lead to a lower long-term supply of crude, even as demand recovers. While certain drillers may struggle, reducing global supply by 8% would have a massive positive effect on the price of oil, thereby benefiting low cost producers in the sector.
- What some investors fail to consider is how many of the everyday products that the world consumes are derived from crude oil and its byproducts. A Biden policy which results in less US shale production, and consequently a higher crude price, could create significant inflation for the working-class. Not the ?good kind?, fueled by demand, that the Fed prefers. The US could see cost-push inflation, which would be especially destructive in a fragile post-COVID economy.
- Thus, because of inflationary and economic implications, we do not believe it is feasible for Biden to implement the type of policies that investors appear to expect in a first four-year

term.

- Finally, we still lack the technology necessary to make the transition to green energy that Biden envisions. We require more efficient storage and long-distance transmission before new technologies will get moving at scale, but that does not curb Biden?s belief in ?spend and the breakthrough innovation will come?.
- In the end, it is impossible to know whether a Biden victory would be good or bad for the Energy sector, but we think the stock market is overreacting to this prospect. The futures market for WTI crude may be calling Biden's bluff, or it could be picking up on something else, but it is telling a different tale than XLE.
- It is worth adding that many of the major oil companies are making significant investments in green energy. In the long run, some of these companies are well-positioned for a transition to green energy.

Latest Report Date	Ticker	Last Close Price	Intrinsic Value	Forecast Upside Remaining	Original Conviction Rating	Current Conviction Rating	Currently Held in RIA Pro Portfolio?
8/6/2020	T	$ 28.28	$ 38.09	34.7%	3-Star	2-Star	No
8/13/2020	XOM	$ 34.86	$ 55.42	59.0%	3-Star	2-Star	No
8/28/2020	VIAC	$ 29.10	$ 36.70	26.1%	4-Star	2-Star	No
9/3/2020	DOX	$ 57.29	$ 76.76	34.0%	3-Star	3-Star	Yes
9/11/2020	CVS	$ 59.48	$ 85.35	43.5%	3-Star	3-Star	Yes
9/18/2020	PETS	$ 29.99	$ 41.14	37.2%	3-Star	3-Star	No
9/24/2020	SPB	$ 61.33	$ 61.18	-0.2%	4-Star	4-Star	No
10/2/2020	DKS	$ 59.53	$ 68.76	15.5%	4-Star	4-Star	No
10/9/2020	WCC	$ 44.98	$ 61.42	36.5%	4-Star	4-Star	No

For the Value Seeker Report, we utilize RIA Advisors? Discounted Cash Flow (DCF) valuation model to evaluate the investment merits of selected stocks. Our model is based on our forecasts of free cash flow over the next ten years.