# The Sizemore Income Letter

September 2021


## Nasty End to a Nasty Month

By Charles Lewis Sizemore, CFA

I can tell you I'm not sad to see September come to a close. The stock market spent essentially the entire month trending lower, and we saw some of the worst volatility of the past six months.

That's not necessarily unusual for a September. This is, historically, the weakest month of the calendar, and the September – October stretch is historically when some of the worst market declines have come. The 1929 and 1987 crashes were both in that window, as was the bulk of the 2008 meltdown.

Most of our positions held up well, though we did take a few casualties. We got stopped out of all of our inflation-sensitive mining plays.

It's always disappointing to get stopped out, but all of that is water under the bridge. I'm more concerned about what is coming next rather than what has already passed. So, let's take a look at the world circa September 2021to see what's driving the market's movement and what's likely to happen next.

### It Starts With China

As I mentioned briefly last week, China is in a real mess right now.

After the 2008 meltdown and the "Great Recession" that followed, China's leaders realized that they had an unacceptable amount of risk in their export-driven economy.

The recovery from 2008 was slow for the U.S. and Europe, and a slow recovery in the West meant a slow recovery for China's manufacturing sector.

*Figure 1*

Furthermore, with the great exodus from the countryside already complete – and with China's population now aging rapidly after 30 years of having the One Child Policy in place – Chinese labor was no longer the ridiculously cheap bargain it was just a decade earlier. The low-cost export model simply wasn't going to be sustainable over the long haul.

So, China nudged its policy towards domestic investment, building out infrastructure and buildings.

But while this lessened China's dependence on the West, it ended up creating an entirely new set of problems. China's coastal cities were overbuilt, and its property developers overleveraged.

China tried to nip this problem in the bud by forcing property developers to deleverage… but that exposed the weakness in companies like Evergrande, which is struggling to meet its debt payments.

The risk now is that China's banking system comes under stress and the country suffers a "Lehman Brothers moment" in which a single big corporate failure starts a domino effect that brings the entire system down.

I don't see that happening. China has enough top-down control to prevent a classic bank run. But that doesn't mean the ccountry is in the clear.

China's society at virtually all levels is overleveraged. Chinese households now have debts totaling 62% of GDP. That's not far from the 69% we see in the United States, but remember that China is a less developed country.

Debt pulls future consumption into the present. And if used responsibly, there's

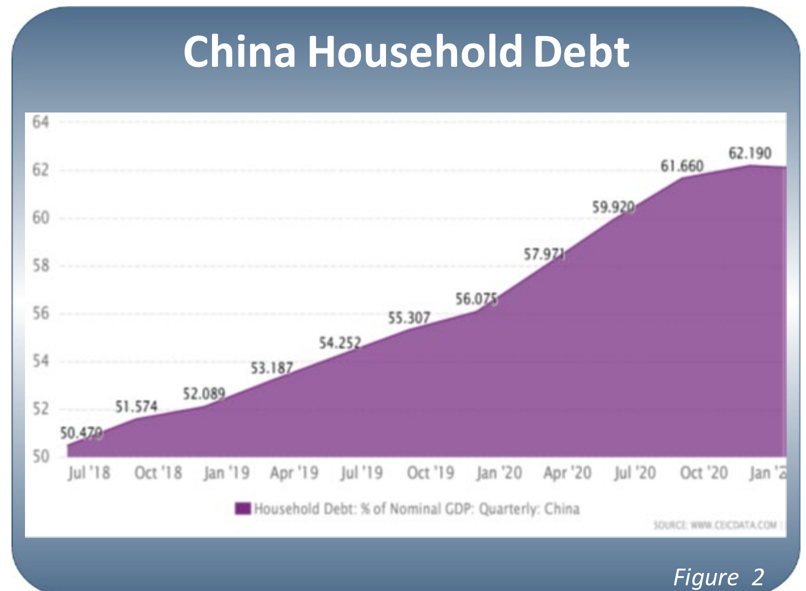



Figure 2

nothing wrong with that. I want to enjoy my house *today*. I don't want to save for 30 years in order to buy it in cash with no mortgage. But every dollar borrowed to be spent today is a dollar that won't be spent tomorrow.

Now, as the United States has proven over the decades, you can always borrow more and go deeper in debt. But eventually, the banks have to pull back. And when they do, you get a recession.

China may or may not fall into outright recession. But it's hard to see a scenario in which growth doesn't drop off precipitously. And that's a big problem for American Big Business because China has been a major driver of growth here. Slower growth in China means fewer Nike shoes, Apple iPhones and McDonald's Big Macs sold.

With U.S. stock prices as expensive as they are, you can see analysts pricing in a slowdown in China… and we know what that means for earnings closer to home.

## And Then There's the Fed…

Let's not forget the Fed. I've argued for months that current stock prices make

sense if – and only if – short-term interest rates and long-term bond yields remain absurdly low.

Well, the Fed hasn't raised rates yet… and almost certainly won't for a while. But Chairman Powell is laying the foundations for significant changes.

Powell made it clear in his September comments that the Fed would be scaling back its bond buying sooner rather than later, with reductions happening as soon as November. And rate hikes won't be too far behind.

**Fed "Dot Plot"**

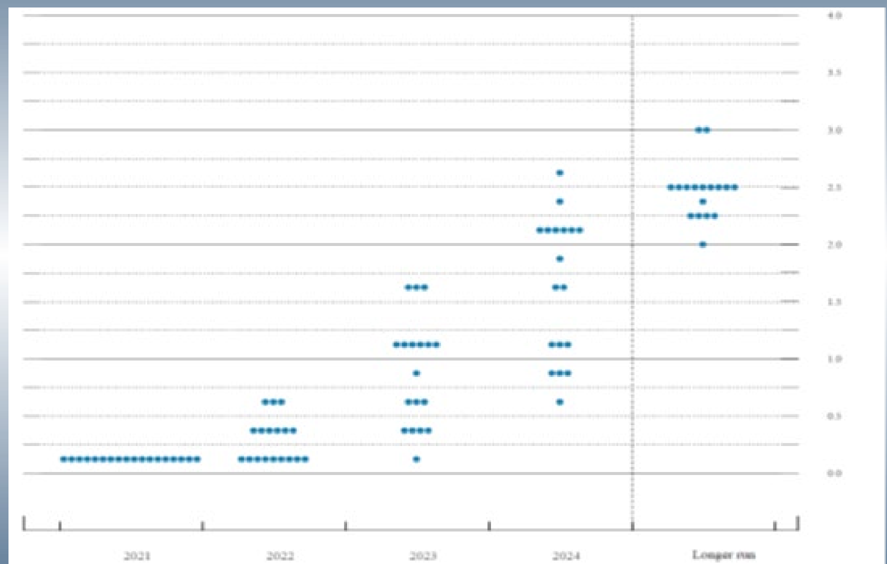


*Figure 3*

You've probably heard of the Fed's "dot plot." This is a survey in which the Fed Open Market Committee members essentially handicap their best guess of where rates "should" be at various points. As you can see in Figure 3, not a single member sees rates rising this year, but more than half now see rates rising to something between 0.25% to 0.75% in 2022. And about half see rates being above 1% in 2023.

Now, these aren't earth-shattering, dramatic moves by any stretch of the imagination. But to a market that is addicted to free money – and lots of it – it's enough to sow seeds of doubt, particularly for growth and tech stocks.

I'll try to avoid getting lost in wonky industry speak, but's here's why in a nutshell. When you buy a growth stock, you're prepared to pay up for *future* earnings. And to price those future earnings in today's dollars, you use a discount rate (which is the Treasury risk-free rate plus a "risk premium" for stocks). Well, the higher market interest rates go, the less those future earnings are worth. That's the way the math works. And it's why tech stock in the Nasdaq got slammed particularly hard in late September.

Powell and his colleagues at the Fed aren't idiots. But that doesn't mean they're going to get this process of normalization right. The most brilliant minds at the world's best investment banks could screw this up. It's hard and it's never really been done before… and that's why Wall Street is getting jittery.

### …and the Debt Ceiling

Where do we find these people?

There are only 535 members of Congress across both houses. That's 535 people out of a population of about 330 million.

These are supposed to be the best of us – the top 0.0002% of the population to represent and lead us. And yet these idiots are toying with the very real

possibility of a debt default or, at the very least, of a government shutdown.

Why?

I struggle to answer that question.

It's not about fiscal responsibility. Neither party can claim that. The Republicans spent like drunken sailors for the entirety of the Trump presidency, and the Democrats now seem determined to spend us into oblivion even faster.

It appears that hot dogging in front of the camera to impress the voters back home – or at least the true believers that vote in primaries – is more important than actually governing the country or setting anything resembling an example.

Perhaps we'll get lucky and a new COVID variant will emerge that only kills politicians and wipes out every single one of them. We can only hope.

Barring that, we'll just have to suffer with these buffoons and hope they don't break things too badly.

I don't expect a debt default. None of these people want to be remembered in history as "the guy that ruined the country." But until they raise the debt ceiling (or somehow magically discover fiscal responsibility and decide to live within our national means) this looming threat is going to be yet one more thing to keep the market preoccupied.

It's tempting sometimes to just sell everything, turn off all media, and just go live in a cave for a few months to let things blow over. It's tragic that's not an option, but alas we have to live and work in the real world and make real decisions with our money.

The good news is that I've found a great opportunity for us in a staid old blue chip dividend stock.

## It's Going to be a Cold Winter

I love renewable energy. I think it would be fantastic to live in a zero-emissions world.

You probably know that I spend a lot of time in Lima, Peru. And I really fear the time I spend here will materially shorten my life. The air quality is hellish. Just walking around the city for an hour is like smoking a pack of unfiltered Marlboros.

Even back home in Dallas, the air quality isn't great… though it's better than it was when I was a kid. And a big part of that was the transition from dirty coal to cleaner natural gas, as well as better pollution standards for cars. My kids enjoy bluer skies than I ever did,

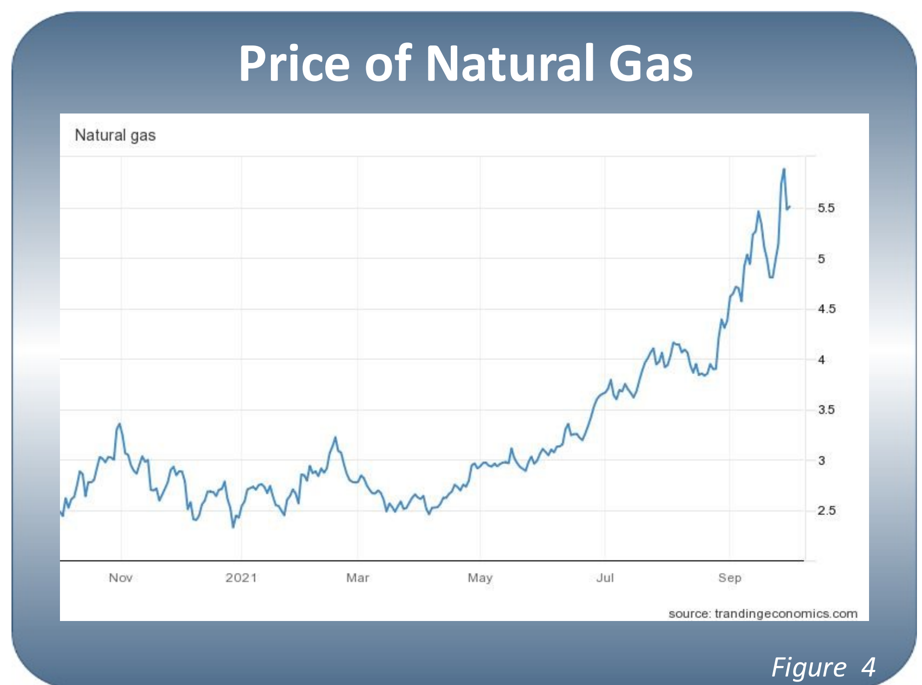



*Figure 4*

and this despite the fact that Dallas is a vasty larger city today.

But while we'd all love cleaner air, renewables aren't anywhere near ready to do the heavy lifting. And we're seeing a potential disaster unfolding in Europe.

Europe really made an effort to decarbonize its energy grid. And they did a great job. Except that the spring ended up being colder than usual, which meant they burned through their natural gas stockpiles quicker than planned. And then, for whatever reason, the wind blew a lot less than usual over the summer, which forced Europe to resort to more fossil fuel usage. So today, as the weather is starting to cool off for the fall, natural gas prices are spiking because the gas Europe needs to stay warm isn't there.

Will Russia increase production and pipe it into Europe? Probably. But if you were Vladimir Putin and you had the opportunity to strongarm them into paying more for gas… wouldn't you?

The U.S. will likely fill some of the gap with liquified natural gas. But this too takes time, and winter will be here soon.

I think it's highly likely that a major spike in energy prices this winter causes investors to rethink the energy sector. Wind, solar and other renewables are still the future. I believe that. But there is no escaping the need for oil and gas in the here and now.

An energy spike would be just one more risk for the broader market. But it would be a fantastic opportunity within the energy sector.

We could go crazy and buy exploration and production companies and likely make a fortune. But you know me. Slow and steady wins the race here, and I think the opportunity is good enough in the supermajors.

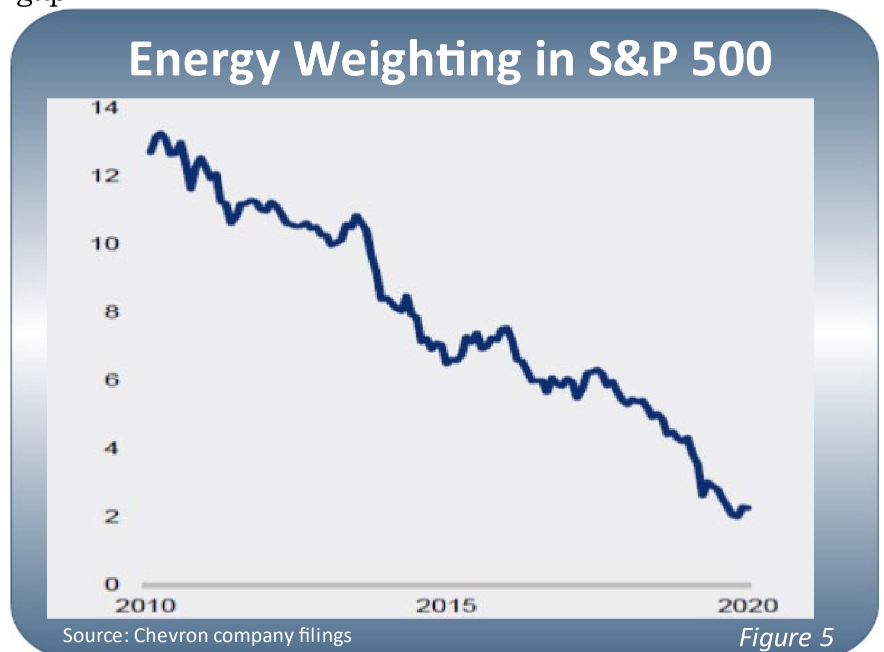
So, with no further ado, let's take a look at **Chevron Corporation (NYSE: CVX)**.

Chevron really needs very little in the way of introduction. It's one of the oldest publicly traded companies in America with roots going back to John D. Rockefeller's Standard Oil.

The bullish case here is straightforward. The overall market is expensive at the moment, but energy stocks are comparatively cheap.

And importantly, they're also massively under-owned. As recently as 10 years ago, energy stocks made up 13% of the S&P 500. Today, they make up about 2%.

Some of this is due to divestments from investors with green mandates or from changing preferences from younger




Source: Chevron company filings *Figure 5*

investors. But let's face it. Most of this is due to the fact that energy has been in a truly awful bear market for most of the past decade. Massive new supplies of crude oil and natural gas coming out of U.S. shale producers flooded the market, driving prices lower.

## Chevron Corp (NYSE: CVX)

*Figure 6*

## Chevron Dividend Yield

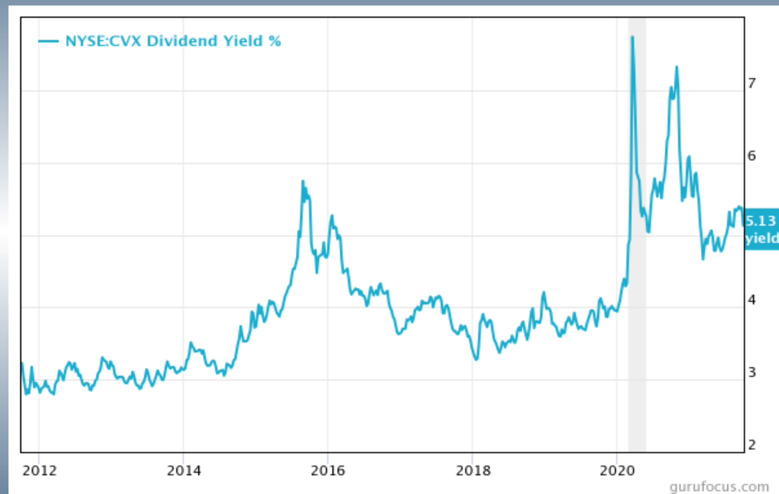



*Figure 7*

Just think back to last year to remember how truly bad things got. Crude oil prices briefly went *negative*. You literally couldn't give it away.

Negative oil prices were the cherry on top of the sundae. That was the moment when the industry washout was complete. But conditions were rough long before that. The energy bear market started in earnest in late 2014, massively accelerated in 2016 and then reached its epic conclusion in 2020.

107 North American oil and gas companies went bankrupt last year, bringing the total since 2015 to over 500.

All of this had to happen to return the industry to something resembling balance. And the companies that survived the ordeal of the past six years should be considered pretty close to indestructible. They survived the apocalypse.

Chevron not only survived the energy apocalypse, it managed to do so with its dividend intact. More on that in a minute.

But the key takeaway here is that the energy sector is the healthiest it's been in years. The oversupply that has plagued the industry has been worked off, and the major players have massively scaled back new investment.

Energy is volatile, of course. But the supply/demand dynamics look healthy for the foreseeable future. And as I alluded earlier, I believe Europe's energy woes this winter will cause investors to reexamine their aversion to traditional

oil and gas. At the same time, I expect value investors to continue to rotate into the few corners of the market that still look reasonably undervalued.

September was a volatile month in the market, but Chevron's shares actually broke higher (Figure 6).

That's a good sign. And the shares are still trading at a dividend yield of 5.2%. Stripping out the panic spikes in 2016 and 2020, that's the highest the yield has been in well over a decade.

Chevron continued to pay its dividends throughout last year's carnage, and earlier this year the company actually raised its dividend. That's a major show of confidence.

That's also not the only way the company has been rewarding its shareholders. After a pause of a couple years during the pits of the energy crisis, Chevron has been buying back shares again. The company announced in July that it would be buying back $2 billion to $3 billion per year for the foreseeable future, or roughly 2% to 3% of Chevron's market cap each and every year.

I cannot say for sure whether this little spate of volatility is wrapping up or just getting started. This is a volatile time of year, and there are more potential destabilizers than usual. But whether the S&P 500 goes up, down or sideways, Chevron is cheap, under-owned, and trending higher. And it pays a nice 5.2% dividend to boot.

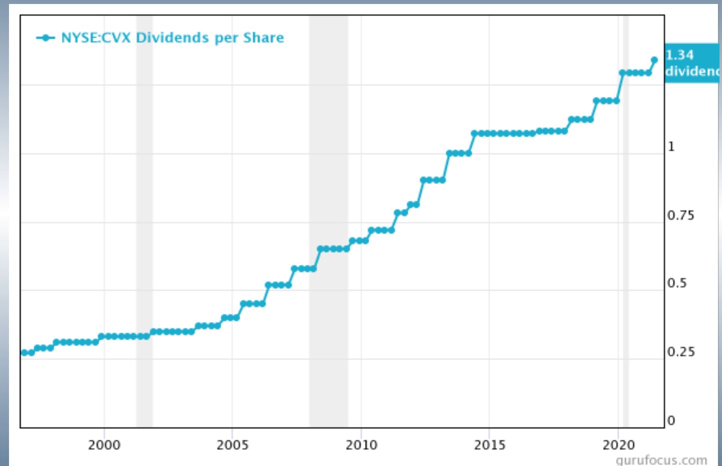
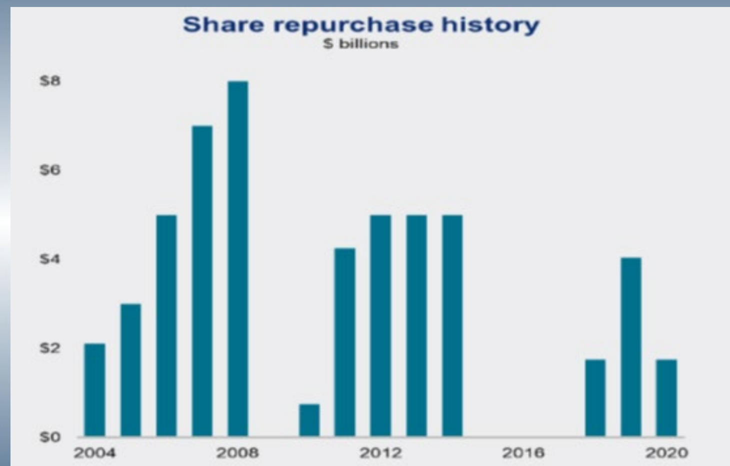



Figure 8




Source: Chevron company filings

Figure 9

As for expected returns, let's look at it this way. Chevron might not see its old 2014 highs any time soon. But simply return to its pre-COVID price would represent a gain of about 20%. Adding in the dividend, and we're looking at potential returns of 25%… in a traditional dividend payer… at a time when the market may be spinning its wheels for a while.

That seems like a pretty good deal to me. So, let's do the following:

**Action to take: Buy shares of Chevron Corporation at market. Set an initial stop loss at $76.24 based on closing prices.**

We're out of all of our commodities and materials plays, though we still have healthy exposure to energy and energy infrastructure.

I'm good with that. I expect us to do fantastically well in the sector over the next several months.

That's going to wrap it up for now. We'll pick this up next month.

Until then, stay safe out there, and keep cashing those dividend checks!

P.S.: Apart from writing this newsletter, I run a full-service wealth management firm along with my colleagues. At **Sizemore Capital Management**, we build income portfolios like those I write about in the *Sizemore Income Letter*.

But we also do a lot more than that. We manage a suite of low-volatility strategies offering low correlation to the S&P 500. If you think your portfolio is a little too exposed to the stock market right now, let's talk. I may have some alternatives that can offer competitive returns without the heartburn.

If you'd like for me to take a look at your portfolio and offer some recommendations, contact me at info@sizemorecapital.com.

## The Sizemore Income Letter Portfolio

| Stock | Ticker | Entry Date | Buy Price | Recent Price | Stop Loss | Yield | Cumulative Dividends | Total Return | IRA Friendly? | Action |
|---|---|---|---|---|---|---|---|---|---|---|
| Chevron Corporation | CVX | 9/30/2021 | $103.33 | $ 103.33 | $ 76.24 | 5.19% | $ - | 0.00% | Yes | Buy |
| AGNC Investment Corp. | AGNC | 8/30/3031 | $16.23 | $ 15.97 | $ 13.52 | 8.71% | $ - | -1.60% | Yes | Buy |
| Morgan Stanley Emerging Markets Domestic Debt | EDD | 7/30/2021 | $6.15 | $ 5.85 | $ 5.50 | 6.60% | $ - | -4.88% | Yes | Buy |
| Nuveen Real Estate Income | JRS | 6/25/2021 | $10.77 | $ 10.60 | $ 9.27 | 6.68% | $ - | -1.58% | Yes | Buy |
| ClearBridge Energy Midstream Opportunity | EMO | 5/26/2021 | $21.94 | $ 22.11 | $ 17.30 | 7.10% | $ 0.38 | 2.51% | Yes | Buy |
| First Trust Dynamic Europe Equity Income | FDEU | 5/26/2021 | $13.68 | $ 12.90 | $ 11.76 | 5.29% | $ 0.18 | -4.39% | Yes | Buy |
| Magellan Midstream Partners | MMP | 1/29/2021 | $44.41 | $ 46.30 | $ 41.78 | 8.65% | $ 2.06 | 8.89% | No | Buy |
| WisdomTree Emerging Markets High Dividend Fund | DEM | 12/31/2020 | $41.22 | $ 43.34 | $ 40.42 | 4.48% | $ 0.82 | 7.12% | Yes | Buy |
| Healthcare Trust of America | HTA | 11/20/2020 | $26.80 | $ 30.48 | $ 23.45 | 4.61% | $ 0.96 | 17.31% | Yes | Buy |
| Physicians Realty Trust | DOC | 11/20/2020 | $17.80 | $ 18.11 | $ 15.30 | 4.49% | $ 0.69 | 5.62% | Yes | Buy |
| AllianceBernstein Holding, | AB | 11/6/2020 | $30.85 | $ 49.80 | $ 36.20 | 6.77% | $ 1.78 | 67.20% | No | Hold |
| Main Street Capital | MAIN | 9/25/2020 | $29.74 | $ 41.52 | $ 32.96 | 5.93% | $ 1.85 | 45.81% | Yes | Buy |
| Iron Mountain | IRM | 8/25/2020 | $30.22 | $ 44.31 | $ 35.76 | 5.30% | $ 2.48 | 54.82% | Yes | Hold |
| Starwood Property Trust | STWD | 8/25/2020 | $15.70 | $ 24.94 | $ 18.15 | 7.38% | $ 1.92 | 71.08% | Yes | Buy |
| Dow Inc. | DOW | 6/24/2020 | $38.45 | $ 58.82 | $ 47.25 | 4.53% | $ 2.80 | 60.26% | Yes | Buy |
| Ecofin Sustainable and Social Impact Term Fund | TEAF | 6/24/2020 | $10.73 | $ 13.85 | $ 12.19 | 6.14% | $ 0.98 | 38.16% | Yes | Buy |
| LyondellBasell Industries | LYB | 5/22/2020 | $60.39 | $ 95.86 | $ 79.23 | 4.27% | $ 5.33 | 67.56% | Yes | Buy |
| Invesco Adv. Municipal Income Trust II | VKI | 4/23/2020 | $10.12 | $ 12.57 | $ 11.46 | 4.70% | $ 0.75 | 31.62% | No | Hold |
| Ares Capital Corporation | ARCC | 4/23/2020 | $11.35 | $ 20.43 | $ 16.45 | 8.20% | $ 2.00 | 97.62% | Yes | Buy |

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