**Investment Strategy**
**October 2023**

The tone and behavior of the market has noticeably changed over the past quarter. The mega-sized tech stocks have lost momentum while oil prices and interest rates have surged sharply higher. Over the last three months the S&P 500 Index is down 3.7%, the tech-heavy Nasdaq is off 4.1%, corporate bonds fell 3.9%, while oil prices are up 28.5%. This improved the relative performance of our portfolios due to our large energy holdings and avoidance of the tech sector. We also continue to largely sidestep the bond losses by purchasing short-term treasuries. Unfortunately, higher interest rates and oil prices will strangle consumers and businesses. Mortgage applications to purchase a home have already fallen to the lowest levels since 1995 and corporate bankruptcies are becoming more frequent and larger in size. We should also recognize these two forces are even more potent for most of the rest of the world. As a result, Europe is already in a recession and China has stopped reporting economic statistics because of their deteriorating growth outlook. For clients, we are keeping portfolios very conservative with a healthy allocation of short-term U.S. treasury bonds. We also believe there are interesting investments in energy stocks and gold mining companies.

The past quarter has behaved much like all of 2022. Stocks and bonds have both struggled in the face of surging interest rates and higher oil prices. In retrospect, these two factors have been driving the market since the beginning of 2022. As you can see from the charts enclosed with this letter **(Page 4)**, the stock market, interest rates, and oil prices have been highly correlated over the past two years.

**Please reference charts on bottom of letter**

The charts show the performance of the S&P 500 Index, 10-year interest rates, and oil prices since before the emergence of COVID-19. The top chart shows the incredible performance of the S&P 500 Index over this period with an overall gain of 28%.[1] You can see the market made an all-time peak on 1/2/22 (red line) and recently came within 4.3% of that high on 7/31/23 (green line). The second chart is the interest rate on a 10-year U.S. Treasury bond over the same period. The "10-year" is important because it sets mortgage rates as well as most other long-term business lending. Back in early 2020, rates were at roughly 1.9% before plunging to all-time lows during the health crisis. Interest rates stayed below these pre-COVID levels until early 2022. They shifted higher during the surge of inflation and now sit at almost 5%. In the last graphic, oil prices[2] were trading for about $63 a barrel prior to COVID. Once again, prices plummeted initially and continued to trade for the pre-pandemic price as late as December 2021.

[1] Are giant international U.S. companies worth 28% more since COVID happened?
[2] Brent Crude (European terminal price)

It was probably around this time that Russia and China began stockpiling resources in anticipation of the Russian aggression on Ukraine. Following this hostility, prices increased dramatically to over $120 before settling down late last year.

Focusing on the market rally from last November (blue line) to July (green line), you can see this advance coincided with a softening of interest rates as well as a relatively stable period of declining oil prices. Interest rates eased twice during this period. First, central banks provided stimulus following the UK pension crisis and, subsequently, they eased again after the U.S. regional bank blowups back in March. Meanwhile, oil prices weakened following the outbreak of war after the U.S. rapidly drained the Strategic Petroleum Reserve to the lowest levels since the early 1980s[3]. In contrast, the correction over the last quarter has been triggered by the 10-year jumping to the highest level since 2007 while oil prices have surged as the energy market tightened up.

Oil prices and U.S. interest rates are the two most critical economic factors in the economy. One is the most important long-term interest rate benchmark in the world, feeding into countless types of financing arrangements. The other is the lifeblood of modern society. Unfortunately, we believe both will have large tailwinds to go higher in the medium-to-long term. Long-term treasury prices are facing a situation where the U.S. government needs to rollover roughly **$7.6 trillion**[4] dollars of debt over the next year that is maturing. On top of that, the U.S. government is expected to run a **$2 trillion** deficit in 2024. This shortfall is equal to about 8% of GDP[5], a ratio not seen in U.S. history outside of deep recessions[6] and major wars. Government finances will certainly deteriorate during the next economic downturn, forcing the sale of trillions in additional treasuries. As you can see, the enormous issuance of government bonds that will be required over the next many years will undoubtedly put upward pressure on interest rates.

Oil is a story that began 15 years ago in the shale patches of the United States. Shale fracking was perfected and quickly became an enormous speculative bubble over the next decade as small drilling companies could put a hole in the ground relatively cheaply. Thanks to their eagerness, U.S. oil production grew by over 8 million barrels a day and the world enjoyed a period of cheap energy prices. Incredibly, U.S. shale generated over 90% of all the global oil production growth during this period, but the companies that focused on this resource collectively lost over $600 billion in capital during this era. While shale was exploding, more

[3] The release from the SPR was largely completed by December
[4] 31% of U.S. debt matures in next year as estimated by Apollo Global Management, Inc.
[5] Gross Domestic Product (essentially the size of the US economy on an annual basis)
[6] Currently we have labor shortages with unemployment at 3.5%

conventional oil fields were starved of capital. The industry is only recently coming out of the largest investment downturn in history (100+ years). The problem is that shale oil wells rapidly deplete over two years. The only replacement for these swiftly declining fields are deep water oil reserves that take years to develop[7]. Once again, you can see why oil prices will have an upward bias over the next 5+ years with periodic shortages that are likely to lead to price spikes.

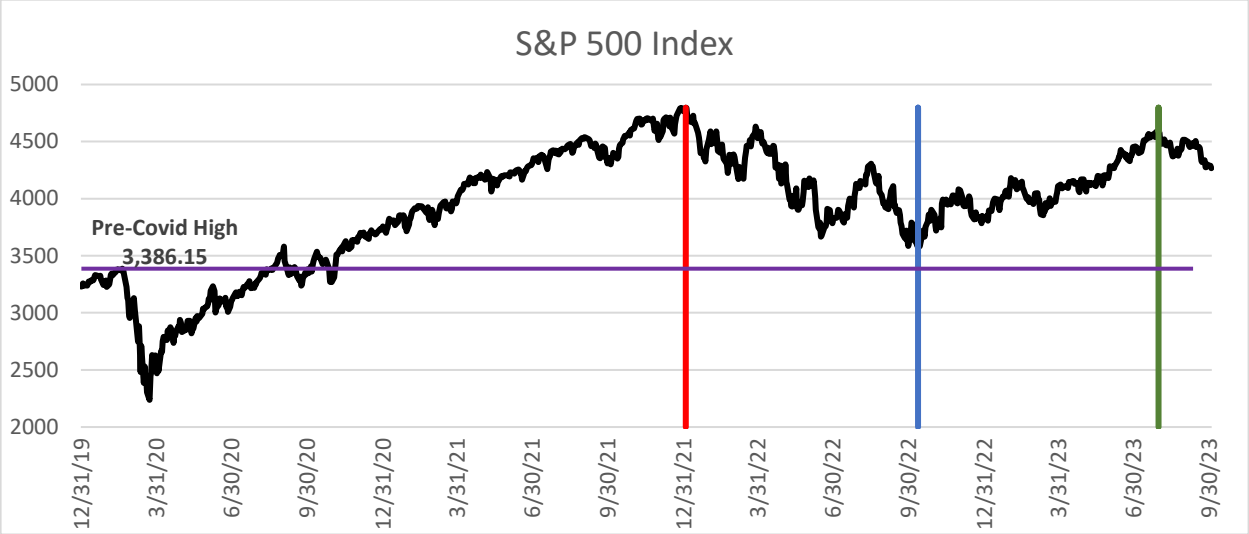
The global economy may be heading into a dark place. Higher interest rates and oil prices are likely to pressure the economy for years to come. We also face the reality that the greatest housing bubble in history is likely imploding as we speak (China, Canada, Australia, etc.). To add insult to injury, global demographics are rolling over, reducing the amount of natural economic growth in the years ahead. This combination of factors could lead to a very weak economic environment for years to come. As a result, we should not expect a strong recovery after the next recession like we have enjoyed for the past 40 years. All these factors are huge structural changes that will be difficult to avoid, making the currently high stock market valuations seem particularly inappropriate.

Given these circumstances, **investors need a much different portfolio than what has prospered over the past 40 years.** Two areas we highlight are a large allocation to energy stocks as well as other resource companies, including gold miners. Energy companies are the most attractive area to invest in the current market. Oil stocks are the best protection against inflation, oil prices are likely to remain elevated, and the companies themselves are selling for very attractive valuations. As an example, our large holding in Equinor has provided us with a roughly 10.9% dividend[8] over the past 12 months. Meanwhile, the gold mining industry has been in an investment downturn since 2013 with no major discoveries reported. Global gold production is in decline while central bank demand has jumped to the highest levels since the 1950s[9]. Ironically, the energy and resource stocks are likely to benefit from high interest rates because it will slow the development of new sources of these materials. Additionally, these companies have already gone through long downturns and during this period they significantly trimmed their own debt levels. In combination, these could be very attractive investments over a 3-5 year period. Nevertheless, the largest allocation in client portfolios continues to be short-term Treasuries. With a treacherous road ahead, generating a risk-free return of 5% is an extremely compelling investment option.

Sincerely,

Keating Investment Counselors, Inc

[7] Nuclear plants making hydrogen for transportation fuel would be nice too
[8] $3.40 in dividends since last November compared to a stock price of roughly $31
[9] Central Bank gold purchases doubled after the western banking system seized Russian assets after the war began


S&P 500 Index
5000
4500
4000
3500
3000
2500
2000
Pre-Covid High
3,386.15
12/31/19
3/31/20
6/30/20
9/30/20
12/31/20
3/31/21
6/30/21
9/30/21
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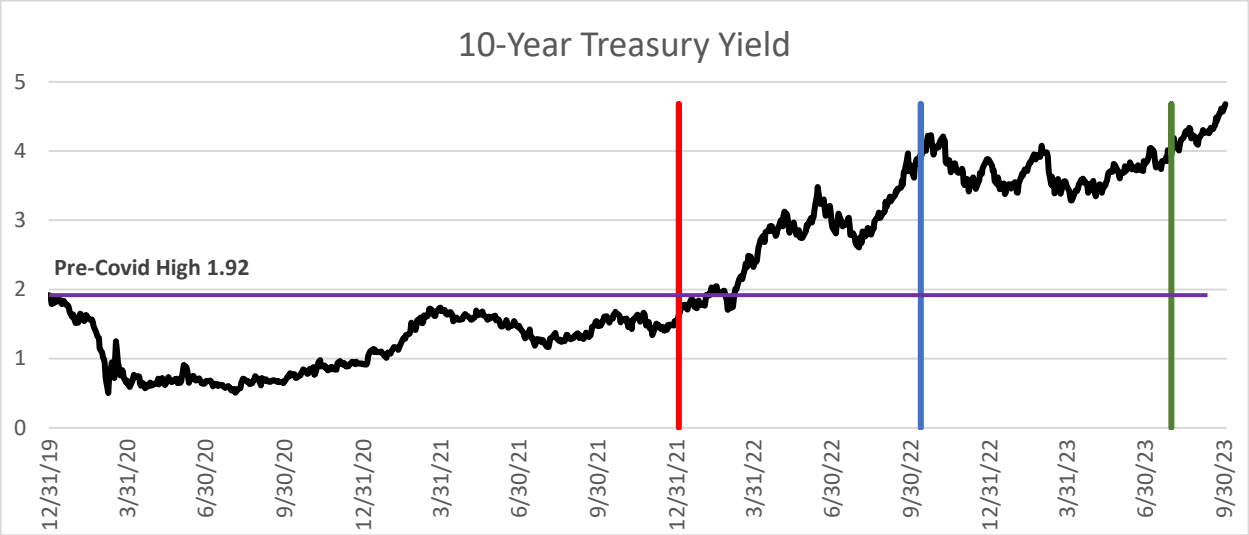
10-Year Treasury Yield
5
4
3
2
1
0
Pre-Covid High 1.92
12/31/19
3/31/20
6/30/20
9/30/20
12/31/20
3/31/21
6/30/21
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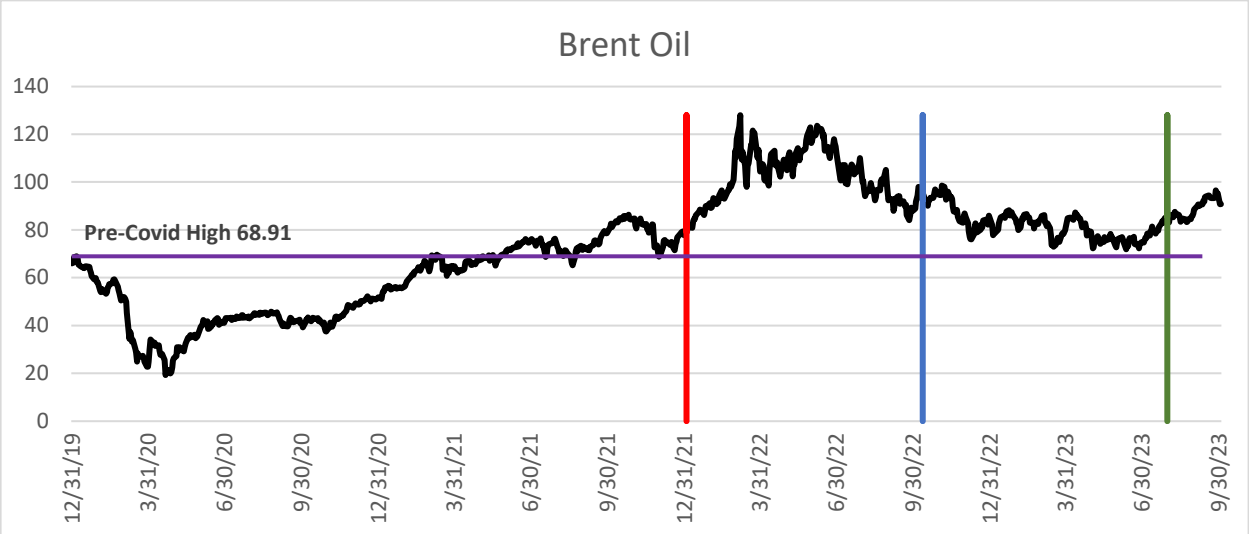
Brent Oil
140
120
100
80
60
40
20
0
Pre-Covid High 68.91
12/31/19
3/31/20
6/30/20
9/30/20
12/31/20
3/31/21
6/30/21
9/30/21
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