The Federal Reserve is committed to getting inflation under control, and it will succeed. The Fed is getting an assist from the deflationary winds that swirl in the the far corners of the globe. War-induced fuel shortages threaten Europe with industrial collapse. China's financial bubble is bursting. And the Fed plans to raise interest rates by a record 450 in less than a year. Hurricane Jerome is coming. Take cover!

Fortunately, investors can find shelter in the mailgned energy sector.

Crude Oil Prices – Set to Spike Again

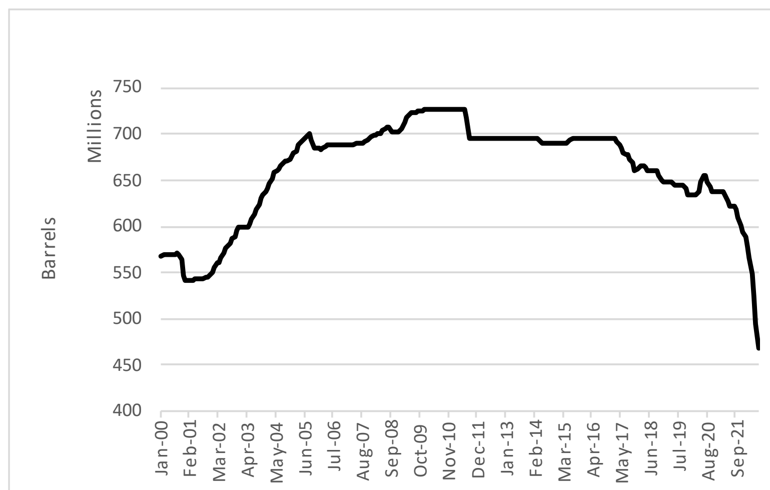
Commodity producers live for supply shortages. Substitutes are rarely available for commodities, so supply shortages usually lead to soaring prices.

In 2020, candidate Biden campaigned on a promise to "end" American oil and gas production. Upon taking office, President Biden began to deliver on that promise. His administration canceled the Keystone XL Pipeline on day number one. Soon thereafter, it canceled auctions of federal oil & gas leases. Then it doubled federal lease royalty rates, to 25%. Over time, key government agencies slowed progress on important interstate pipeline infrastructure projects. Despite rising energy consumption, oil & gas production stalled. Shortages began to develop.

The big foreign energy exporters, Saudi Arabia and Russia, also stalled their energy production. During the pandemic, for the first time, these two countries successfully coordinated production cuts. Oddly, these long-time adversaries maintained low production quotas after the pandemic ended. Could it be possible that these oil export giants found common ground as the targets of verbal assaults from the President?

Oil prices soared, prompting President Biden to release oil from the Strategic Petrolem Reserve (SPR) in November 2021. Soon thereafter, Russia invaded Ukraine. Western nations unified to boycott Russian oil. It appeared that global oil supplies would shrink, and oil prices soared. President Biden subsequently ordered two more releases from the SPR. The reserve level collapsed.

Figure 1: The U.S. Strategic Petroleum Reserve



Source: EIA

When the SPR release ends in November, the reserve will have lost 270 million barels. For the first time in 40 years, the reserve will fall below 400 million barrels.

The reserve was developed to assure supplies in case of national emergency. But this politically-motivated release was aimed at just one thing… lowering the price of gasoline before the midterm election. Unfortunately, by supressing oil prices, the release also supressed production growth. Therefore, when the release ends, prices will eventually go higher than what would have occurred without the government intervention.

The SPR release is scheduled to end next month. That will remove 1 million barrels a day from the market.

Last week, the oil supply problem intensified. OPEC-Plus announced 2 million barrels a day in quota cuts. The quota cut doesn't translate directly into lower production. OPEC has been producing less than quota for a while. But substantial production cuts will occur. Goldman Sachs expects OPEC production to decline by 1.2 million barrels per day.

Between OPEC and SPR, global supply will drop by 2.2 million barrels per day, which is more than 2% of consumption. Prices will soar…. Possibly beyond the $125 highs from earlier this year.

In response to OPEC, the Biden Administration has threatened to resume SPR releases. Indeed, that could happen, for a little while. But once the mid-term election passes, the immediate political purpose for the SPR release… to lower oil prices before the election, will end. Officials will need to preserve the (greatly dimished) SPR for the next political campaign.

Black Stone Minerals, LP (BSM)

I first learned about Black Stone Minerals from *Income Intelligence*, a publication of Stansberry Research, written by my good friend Dr. David Eifrig. Because I prefer doing my own investment research, I rarely read other investment newsletters. But I make an exception for David's newsletters. I value his insight and judgement. And his newsletters are very fun to read.

On to the featured strategy….

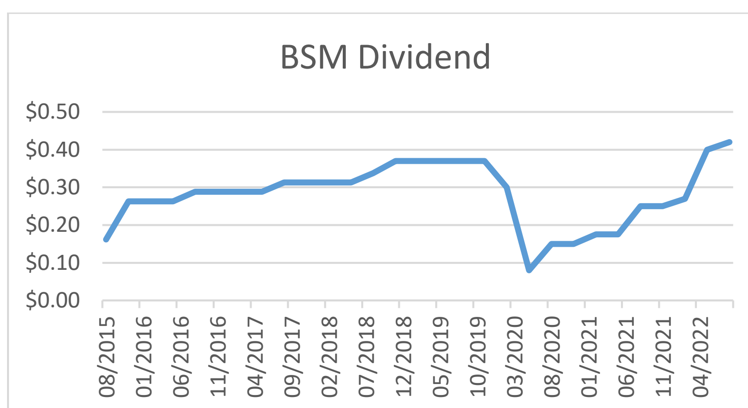
Black Stone Minerals LP (BSM) does not produce oil & gas - not a drop.

BSM holds a large portfolio of mineral resources. To monetize the resources, BSM leases mineral rights to energy producers.

BSM simply collects a 20-25% royaly share of oil & gas sales. The company reinvests a portion of revenues to replenish reserves. It pays the remaining income to investors in the form of dividends.

This company pays significant dividends.

Figure 2: Blackstone Minerals, LP - Quarterly Dividend History



Source: Yahoo Finance

Right now, BSM pays a 10% dividend. Since going public, it hasn't missed a dividend payment. Even when oil prices dropped to zero in the second quarter of 2020, BSM still paid a quarterly dividend of $0.08.

When oil and gas prices rise, the BSM dividend will also rise. Eventually, U.S. oil and gas production will increase. As BSM leases more resources for production, the dividend will rise even more.

BSM's resources are most concentrated in the Haynesville Basin of east Texas and the Permian Basin of west Texas. These basins enjoy abundant pipeline infrastructure to Gulf Coast LNG terminals. Thus, BSM is very well positioned to benefit from the expansion of LNG exports to Europe.

What happens when the fundamentals of oil and gas turn south? The energy market collapse of 2020 provides a useful example. BSM still collects royalties. Income and dividends decline. Since the company has practically no debt, it continues to operate normally, earning profits and paying dividends.

Table 1: Blackstone Minerals, LP

Ticker	BSM	**EPS**	$1.17	**Expected 5-YR Growth**	NA
Price	$17.36	**EPS Forecast**	$2.18	**Forward P/E**	7.8
Book/Share	$3.55	**Market Cap**	$3.35 B	**Credit Rating**	N/A
Dividend Yield	9.8%	**Enterprise Value**	$3.42B	**Debt/Ent Value**	2%

Sources: Finviz.com, Yahoo Finance

In summary, BSM has a low risk profile compared to production companies. It doesn't need to drill, frack, or maintain wells. It doesn't need to build gathering pipelines. It doesn't contract with midstream companies to transport oil & gas to market. BSM lets the production company manage these operating risks. BSM just collects a part of the revenues generated by the production company.

Figure 3: Blackstone Minerals, LP

Source: Finviz

<u>Investment Strategy</u>: Buy BSM at current levels.

The Economy and Markets

For the first time since the depths of the pandemic, our indicators favor contraction vs. growth, by a score of 3-to-2.

Most troubling is the Productivity measure. This indicator of societal prosperity has collapsed. When Productivity falls, real income falls. Period. When productivity declines, Americans get poorer.

Table 2: Vigilante Investor Scorecard of Economic Conditions Oct 7, 2022

Score	Positive	Neutral	Negative
Growth 2 Contraction 3	US Non-Manf PMI 56.7 Fed Signal +6.3%	US Real GDP +1.8%	US 2-10 Spread -0.44% Global Comp PMI 49.7 US Productivity -2.7%
Inflation 3 Deflation 1	CPI +8.3% YOY US Wages +5.0% YOY Gold / Euro +11.6%YOY	Gold -4.2% YOY Crude Oil +5.7% YOY	US Dollar +19.6% YOY
Positive $ 2 Negative $ 0	US-Ger2YR Spread +2.47% US-Ger10YR Spread+1.73%		

Sources: Tradingeconomics.com, St. Louis Fed, and Investing.com

Amid the decline in productivity, the Fed is trying to slow inflation. Productivity declines make production costs rise, thus raising inflationary pressures. Lower productivity will make it harder for the Fed to achieve its goals.

Fortunately, the Fed showed up for the battle against inflation. Unfortunately, it arrived a little late, and its aggressive strategy will cause collateral damage.

To cleanse the excesses from the economy, the Fed plans to set interest rates at 4.5% before year-end. Interest rates rested around 0% just a year ago. The size of the rate rise is almost unprecedented. Businesses and consumers have not been given ample time to adjust to rising rates.

For example, it takes about a year to build a custom home, and home buyers cannot lock in a mortgage rate until home construction is completed. For homes now under construction…between the time of commitment and time of completion, mortgage loan rates have doubled. The 30-year mortgage rate jumped from 3% to almost 6.75%. As a consequence, the house payment doubled compared to the expectation at the time of commitment. How many people can afford to pay double the original plan for a house payment?

Consumers and businesses will need to rely on savings and investments to cover the shortfall. But, the stock market is down 25%. The reduced pool of savings may not cover the extra interest costs. The situation is worst for Robin Hood investors who bought stocks on margins. If the margin investor failed to manage risk tightly, losses could reach 50% or more.

A global recession will exacerbate economic problems at home. China's bubble is popping. The real estate market is collapsing, literally. Some areas have such high vacancy rates that the country ha demolished skyscrapers, en masse. China's economic demise is spreading throughout the economy. Despite massive investment, the economy is stagnating. Soon, the flood of investment will end, and the Chinese economy will contract, just like Japan in the 1990s.

Europe is collapsing too. It may lack the energy supplies to heat homes this winter. Energy-dependent industries will shut down. Shrinking demand of foreign economies will intensify the U.S. economic contraction.

The Stock Market

This bear market continues. The 25% decline so far has brought the market down to historically average valuations. Before this bear market ends, stocks will fall to low valuation levels, probably between 2800 and 3300 for the S&P 500 Index.

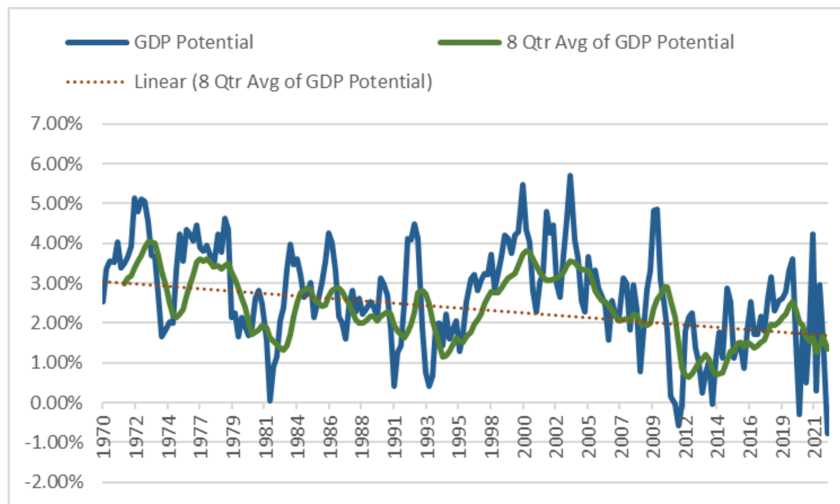
Figure 5: S&P 500 Long-Term Weekly Chart

Declining Growth Potential – What it Means to Investors

Economic growth potential depends on 1)the growth of the labor force and 2) productivity improvements. Since the 1970s, labor force growth has slowed, and productivity has swung wildly. On occasion, these two data series appear inversely correlated.

Vigilante Investor combines labor growth and productivity measures to produce an Index of Potential Economic Growth.

Figure 4: Index of Potential Economic Growth



Source: St. Louis Federal Reserve

The blue line shows the raw index, and the green line shows the 2-year average. The red line shows the linear trend.

Ominously, potential GDP is trending lower. Other than a brief, technology-inspired spike in the late 1990s, the index has trended lower for 50 years.

Demographics are partly to balme. A slowing birthrate dictates slower workforce growth. Immigration can offset the demographic trend… but only partly.

The economy can overcome a slowing workforce with higher productivity. Unfortunately, productivity is going the wrong way.

The causes of the productivity decline are many. Industrial efficiency is declining, larely due to de-globalization.

When supply chains function effectively, companies can source components from across the globe, concentrating the labor force where it adds the most value. When supply chains fail, companies must add workers to perform work that adds less value, lowering efficiency and productivity.

National security concerns will intensify de-globalization. Post pandemic, everyone wants vital supplies produced closer to home.

Other developments are likely harming efficiency and productivity. The ESG movement is forcing a reallocation of capital toward less efficient energy production. Everthing in the economy depends on energy. Less efficient, more expensive energy acts as a drag on productivity. The trend toward less efficient energy appears to be irreversible.

Finally, declining educational achievement is producing a less talented workforce. The decline in education could be reversed, but it probably won't ever happen.

Economic growth is in decline. Investors should reevaluate growth expectations. Future stock market returns will fall short of historical returns. The extremely high valuations of growth stocks cannot be logically supported anymore.

Investment Strategy

The Fed has committed to suppressing inflation, so we don't need to protect our portfolio from it any longer. Therefore, we are cutting the Vigilante "Inflation Portfolio."

High interest rates do the most damage to the real estate sector. For this reason, we are cutting real estate. Vigilante Investor recommends selling Simon Property Group (SPG) and Vanguard Real Estate ETF.

Table 3: The Vigilante Model Portfolio as of 10/7/2022

Sector	%	Selections	Symbol	Initial Price	Price Oct 7
5G	4%				
		Qualcomm Inc.	QCOM	$164.40	$120.91
Low-Tech America					
Steel	4%	Cleveland Cliffs Inc.	CLF	$16.58	$14.83
Financials	20%				
		Prudential Financial	PRU	$81.96	$91.08
		Chubb	CB	$165.98	$184.68
		Aflac	AFL	$53.38	$57.96
		AIG	AIG	$47.54	$49.71
		WR Berkley	WRB	$53.58	$66.92
Transportation	4%	Dorian LPG Ltd.	LPG	$11.86	$14.51
Energy	33%	Diamondback Energy	FANG	$61.33	$142.43
		CNX Resources	CNX	$12.21	$17.06
		Black Stone Minerals	BSM	$17.36	$17.36
		Coterra (Formerly Cabot)	CTRA	$18.69	$29.20
		Southwestern Energy	SWN	$4.06	$6.78
		Antero Resources Corporation	AR	32.67	32.32
		Nine Energy	NINE	$2.72	$3.74
		Plains All American Pipeln	PAA	$9.02	$11.12
		Cameco Corp	CCJ	$12.73	$26.20
Real Estate	4%				
		Granite Point Mortgage	GPMT	$9.87	$6.24
		Vanguard Real Estate ETF	VNQ	$109.98	$77.44
		Simon Property Group	SPG	$127.00	$92.54
Agriculture	5%	Mosaic Co	MOS	$28.67	$51.06
Emerging	0%				
Precious Metals	8%	Junior Gold Miners ETF	GDXJ	$46.02	$30.03
		Gold Miners Index	GDX	$29.30	$24.39
		Pan American Silver	PAAS	$21.13	$16.36
		Silver Miners ETF	SIL	$42.00	$24.97
Cash	18%	VG ST Infl Protected Sec ETF	VIPSX	$12.90	$11.94

The remainder of the portfolio works going forward. Energy stocks will benefit from energy supply shortages for years to come. Property-casualty stocks perform best in high interest rate environments, which will prevail for the near future. Precious metals stocks will struggle with high interest rates. However, when high interest rates produce a financial crisis, precious metals will help stabilize the portfolio.

We recommend raising cash again this quarter. If the S&P 500 Index rallies to the 4000 area, we suggest paring positions. Target 20% cash.

Table 4: Vigilante Investor ETF Model Portfolio 10/7/2022

All ETF Portfolio	%	Selections	Symbol	Initial Price	Price Oct 7
Broad Market	8%	VG Mid-Cap Value ETF	VOE	$122.88	$123.76
	8%	VG Large-Cap Value ETF	VTV	$121.81	$125.96
Financials	8%	VG Financials	VFH	$88.21	$75.97
	14%	iShares U.S. Insurance	IAK	$84.25	$81.80
Energy	32%	First Trust Revere Nat Gas	FCG	$19.01	$25.95
Real Estate	0%	Vanguard Real Estate ETF	VNQ	$109.88	$77.94
Precious Matals	5%	VanEck Vectors Gold Miners	GDX	$32.75	$24.39
	5%	Global X Silver Miners	SIL	$39.51	$24.97
Cash	20%	VG ST Infl Protected Sec ETF	VIPSX	$12.90	$11.94

Have a great quarter!

Steve Koomar

October 10, 2022

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