5 Undervalued Stocks to Buy as Their Stories Play Out

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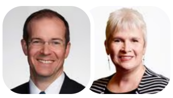

David Sekera, CFA and Susan Dziubinski • Jun 10, 2024

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Susan Dziubinski: Hello, and welcome to *The Morning Filter.* I'm Susan Dziubinski with Morningstar. Every Monday morning, I sit down with Morningstar Research Services Chief US Market Strategist Dave Sekera to discuss what's on his radar this week, some new Morningstar research, and a few stock picks or pans for the week ahead. So, good morning, Dave. We have a good deal of economic news coming out this week.

Let's start with the Fed meeting. I'm assuming the market is pricing in about a 0% chance of a rate cut. Is that about right?

David Sekera: Hey, good morning Susan. That is right. So right now, the market implied probability of a cut is essentially zero. And in fact, when we look to the July meeting, I think the market implied probability's only about a 10% chance that they cut at that point in time. But the probability does increase up to 50% at the September meeting.

And of course, that's still our base case scenario as far as what we expect the Fed to start cutting interest rates.

Dziubinski: So then what are you going to be listening for during Fed Chair Powell's remarks? And from the Fed statement?

Sekera: I think this is going to be actually a pretty boring, uneventful Fed meeting. I expect the commentary from Chair Powell to essentially be unchanged from his prior meetings. And I think he's probably likely to say that they still need additional data in order to make sure that inflation is on that study downward path that they're looking for.

I think he'll acknowledge that the rate of economic growth is slowing but not necessarily to the point that it's really all that concerning to them. And I don't expect to hear really any commentary surrounding when the Fed is going to talk about timing for cutting the Federal-funds rate. So really, it's going to be the July meeting, I think, is going to be the one that's going to be much more important.

And we'll be listening for a lot more indications of the Fed looking to start cutting rates in September. So to start doing that at the July meeting, I think he'll probably start to remark that the Fed is getting that confidence in inflation being on that study downward path. Plus, I think at that point they probably highlight that restrictive monetary policy has been leading to much more slowing economic growth.

Dziubinski: Now we also have CPI and PPI numbers coming out this week. What's the market expecting on that front?

Sekera: To some degree it depends a little bit on which source you're looking at for consensus estimates. So what I saw is two different areas that I watch—the consensus for headline CPI is either decrease of one tenth of a percent or 2/10 of a percent as far as a month-over-month basis. So the either way, whether it increases 0.1% or 0.2%, that is a slowdown from what was reported last month, which was up 0.3%.

But even more importantly is the consensus for core CPI. Right now, both of those areas that I look for show that consensus being up 3/10 of a percent on a month-over-month basis, which is the same as what we saw last month. And then on a year-over-year basis, headline CPI consensus is that 3.4% and for core CPI at 3.5%.

Dziubinski: Now, Dave, given that we have both the Fed meeting and some key inflation figures coming out this week, should investors be bracing themselves for some market volatility? Or do you think at this point the market has readjusted its expectations about inflation and rate cuts enough that volatility won't be much of an issue?

Sekera: Based on our expectations, I really don't see any reason why there should be any greater than historical volatility. Really, the only things I'd be listening for that could drive volatility higher would be if Chair Powell was to say something unexpected. I think that's a very low probability.

He's always very measured in his commentary. Or conversely, if CPI and we also have PPI numbers coming out this week, if those were just significantly different than what's expected. So thinking about those inflation metrics, if they come in line or better than expected, that probably provides some positive market sentiment. But based on where valuations are in the market right now, we just don't think that there's that much of a short-term upside left.

But if inflation metrics, do come out much higher than expected that could lead to a small selloff. And of course how much it sells off would be just depending on how much above consensus inflation is running.

Dziubinski: And we also have earnings season starting to wind down. But there is a company reporting this week whose stock you've been kind of pounding the table about. And that's Adobe. So what are you going to be listening for? What could management say to turn sentiment for the stock. It's down more than 20% this year.

Sekera: Yeah. It's currently rated 4 stars at. Trades at a 24% discount to our fair value. And it is a company we do rate with a wide economic moat. Now as you mentioned, there has been some negative sentiment surrounding that stock. Specifically, it sold off in March after the last earnings report. And our analysts noted that the numbers in and of themselves really weren't all that bad.

But the stock sold off because the company did what he considered to be a pretty poor job conveying its outlook for the year to the marketplace. Now, we did leave our fair value unchanged at that point in time, because we didn't hear anything specific that would have caused us to change our projections. So I do think there is some potential for some upside here.

Not only because we think the stock is undervalued here, but if the management team was able to come out and provide better clarity as to their outlook that may ease some of the investor concerns and allow that stock to start moving up again.

Dziubinski: Any other companies reporting this week that you're keeping an eye on?

Sekera: First one is going to be Broadcom. We did raise our fair value estimate there pretty dramatically very recently, I think by about 24%. So that fair value increase was due to some changes in our long-term growth assumptions to factor in even higher generative AI opportunities for Broadcom. We now forecast that I will approach about half of their overall chip sales over the course of the next five years.

Specifically generative AI, it's going to be about 70% of their custom accelerator sales and 30% of merchant networking chips. And the other one I'm going to keep an eye on is Kroger. Now, I don't think we've ever talked about Kroger before. And to be honest, Kroger in and of itself really isn't a very interesting stock. Supermarkets in and of themselves are pretty low growth, very low margin businesses.

Stock is currently rated 3 stars. Only pays a 2.2% dividend yield. We don't rate the company with an economic moat. Now having said all that, the reason to pay attention this quarter is I want to see if they provide any commentary about what they're seeing among middle-income consumers. I think you and I have talked a couple times over the past few shows about this, but low-income consumers, of course, they were hit pretty hard immediately by high inflation, whereas the middle-income consumers were able to hold up for a while. They had their excess savings from the pandemic.

Their savings rate was higher. But now at this point, excess savings from the pandemic appear to be pretty much largely used up. And saving rates have actually been coming down. And they're down to the point where they're actually below where prepandemic levels are. So I just don't see a way of lowering those any further here.

And this past quarter there's just a number of different anecdotes that we're hearing where we are starting to see early indications just how much now, two years of compounded high inflation, it's really starting to impair the middle-income consumer.

Dziubinski: Now Tesla holds its annual meeting this week. Now given that the stock's down about 28% this year, do you think anything might come out of this meeting that could be a catalyst for the stock?

Sekera: Yeah I don't think there's going to be anything new at the annual meeting. But of course we're talking Elon Musk, so we can always be surprised by what he may say. But right now Tesla the stock is rated 3 stars. But it is a very volatile stock. And when I look at the price movement here, over the past year, it was briefly in 4-star territory in mid-April.

It was a 2-star stock as recently as last July. So again very volatile. Can certainly swing your back and forth, but pretty much fairly valued in our view today. I think some of the things investors would be listening for would be any updates as to the status of the rollout of their low-priced electric vehicles, which is expected to be, I think, in early 2025, maybe even as soon as later this year, as well as if they give any other updates on their full self-driving capabilities.

Dziubinski: So let's pivot over to some new research about a few companies that reported earnings since our last show. And let's start with Bath & Body Works. Now this stock got hammered after earnings, so explain what happened and what Morningstar thinks of the stock after earnings.

Sekera: Yeah, I don't know about hammered there, Susan. It definitely it definitely took a hit. It was down I think 10% by the end of the week compared to where it was pre-earnings report. But really the takeaway here: The results were really not necessarily all that bad. In fact I think they even made a slight increase for their fiscal-year guidance.

We have reaffirmed our fair value estimate. We think the market to some degree is overreacting here. In the short term, it seems like traders are focused on the near-term profit pressure on the company. They had some higher marketing costs in the second quarter. That may lead to some year-over-year operating margin contraction in the second half of the year.

But sales were only down 1% in the first quarter, which is pretty in line with our expectations. The operating margin did expand 60 basis points to 13.5%. So I know Jamie thinks the business is still holding up pretty well in an environment where consumers are very judicious now about where they're spending their money and how they're spending their money. Now long term, she just didn't see anything that changed her mind regarding the company over the longer term. We do still think that the company will be able to start moving its historical operating margins back up toward its longer-term historical averages, which was, I think slightly over 20%. So in this case, maybe this is just a little bit of some profit-selling, or profit-taking at this point.

The stock, it's still up 50% from when we first recommended it on our Nov. 27 show, even after the selloff. So to be honest, I'm just really not all that worried about this one at this point.

Dziubinski: Got it. Now we also saw CrowdStrike report last week. Results were good, and the stock soared as a result. Morningstar maintained its fair value estimate of $300 though. So what did we think of earnings, and what do we think of the stock today?

Sekera: Yeah, stock popped. It was up 14% after the earnings report. To some degree it also might just be a bit of a relief rally here. This only brings the stock back to where it was trading before it sold off at the end of May. We saw a number of the cybersecurity stocks sell off at the end of May.

There were some other security vendors, a couple of companies that we don't cover, but those companies had noted a tougher macroeconomic environment and a longer sales cycle. So all of those cyber companies we saw maybe dip at that point. Now, the results here are slightly better than what we expected, but not to the degree that we revised any of our longer-term assumptions.

Thus, the fair value was unchanged. It's a 3-star-rated stock, but I'd note it is pretty close to the top of that 3-star range. It's close to moving into that 2-star territory. So for cybersecurity, which of course as you know, we do like this area, we think the fundamentals in the long term had some good long-term secular trends.

I would look at two other stocks: 4-star-rated Fortinet and 4-star-rated Palo Alto.

Dziubinski: Now Dollar Tree stock is having an ugly year, and Morningstar's analyst called the company's earnings report last week "uninspiring." And the company also announced that it's planning to sell its Family Dollar business. So unpack the story here for viewers, Dave. First, how were the results?

Sekera: Yeah, it's a bit of the same story we've been seeing in the retail sector this past quarter. Consumers now trading down to discounters from full-price retailers. So that actually led to an increase in foot traffic of 2.8%. However, their comparable store sales were only up 1.7%. So, what they're seeing is that consumers are buying less while they're there, and specifically they're buying less discretionary products.

Now, discretionary products are those purchases that can be delayed. But unfortunately for the company, those products are also the same that have much higher operating margins on them. So as people are buying less of that, we did see a decrease in the operating margin this past quarter. And they also announced that they're exploring strategic alternatives for Family Dollar.

So strategic alternatives—really that's just code word for they're just looking to figure out what to do with this business. So it could result in a sale or a spinoff or a disposition of assets. So we'll see what they announce. And when I read our note here our analyst noted that he thinks that actually makes sense to us.

There's just very little overlap between the merchandise. And he thinks there's just unclear real estate synergies between it and Dollar Tree.

Dziubinski: So do we think the stock's attractive?

Sekera: Yeah. I don't think anything really gets me all that interested in the stock here. It's a 3-star-rated stock. They don't pay a dividend. We don't rate the company with an economic moat. It's got a high uncertainty. And net-net we just don't think the company would get very much if it does end up selling Family Dollar.

So it's not a sell. It's not a buy. Or if you're involved in it, we think that you'll get kind of that cost of equity over the longer term, but not anything that I'd put new money into today.

Dziubinski: Got it. So now we had some nonearnings news from a few companies we've talked about on the show before. For starters, Illumina revealed the details of its plan to spin off its Grail business to shareholders at the end of June. So before we get into the details of the spin off, briefly recap for viewers why Illumina is required to spin off its Grail business.

Sekera: Yeah, so the synopsis here is Illumina heard by Grail, and they closed the acquisition in 2021, but they closed the acquisition before regulators completed their antitrust reviews. And then subsequently both the US and the EU regulators have determined that the acquisition would be anticompetitive. So they ordered Illumina to divest Grail. Illumina tried appealing this, but those appeals were unsuccessful, which has now led to them now having to spin that business off.

Dziubinski: So what's Morningstar think of Illumina spinning off the business directly to Illumina's shareholders? What are the benefits here?

Sekera: We think this is really going to be the best outcome of an unfortunate situation. It does preserve the economic value. Still think it preserves the upside potential for the existing shareholders in that Grail business. And as a reminder what Grail is doing is they're developing a liquid biopsy test that can test for up to 50 different types of cancer in one blood draw.

If that were to get approved, we think there's a huge total addressable market potential for this test, as it can catch cancer much earlier than most people typically detect that they have cancer, so before symptoms emerge. And of course if you can start treating cancer much earlier that typically leads to better outcomes over time.

So if they had ended up selling Grail as opposed to spinning it off to existing shareholders, we don't think the existing shareholders would have gotten its net worth out of the economic value and the upside of that company. So again, we do think that, of the different options, this is probably the best one.

Dziubinski: And then what impact will the spinoff have on Morningstar's fair value estimate of the stock? And second question: Is there any benefit for investors who aren't already Illumina shareholders to buy the stock ahead of the spinoff?

Sekera: So when the spinoff is completed, Julie, who covers the stock, she noted that she expects to lower the fair value to $188 per share. That's coming down from $228. So what that does is that leaves $180 worth of value on the legacy sequencing business of Illumina. And then she added $8 of value based on her value for Grail, which I think they'll continue to own about 14.5% of that company.

Now, the Illumina stock—that's been under a lot of pressure while this process has been being drawn out. So I'm hoping that after the spinoff here, this might allow a better valuation on the existing Illumina business. This is really geared more toward a value-oriented investors, specifically those kind of investors that may not have wanted to invest in the risk of Grail getting those approvals on this test.

But then for Grail as a stand-alone they might get better valuation from more growth-oriented investors. Those who are comfortable taking on that kind of risk, but looking for that upside. And the type of investors that probably wouldn't want to own the legacy business of Illumina.

Dziubinski: Got it. So now Waste Management announced plans to acquire Stericycle last week, and I think we've talked about Stericycle on the show before. So what's Morningstar think of the deal, both from the perspective of Stericycle shareholders and Waste Management shareholders?

Sekera: We first highlighted Stericycle as a stock pick on our Jan. 29 show earlier this year. I think the stock was trading around $49 a share. And then we also then rehighlighted it on our April 1 show. Stock was at $52 a share at that point. From the perspective of Stericycle shareholders, we think it's a pretty fair deal.

Our fair value estimate was $60 a share. So the acquisition here really just allows existing shareholders to immediately recognize what we consider to be the full economic value of the company. And then from the perspective of Waste Management shareholders, we do think that it'll be a modestly value-accretive transaction where we're only increasing our fair value to $164 a share from $161.

That leaves that stock still in that 2-star category.

Dziubinski: And then one of your previous picks, Dave, GSK, was also in the news last week. The Delaware state court Daubert ruling allows Zantac plaintiff experts in future litigation. And our analyst, I think, thinks this opens the door to increased litigation risk for the firm. So what's Morningstar's take on the news? Any changes to the fair value? And do we think the stock looks attractive?

Sekera: Yeah, that's a mouthful there Susan. GSK, it was a stock pick actually almost a year ago exactly. We highlighted that one on our June 26 show. It was a 5-star-rated stock at $36 a share. And then we reiterated it again on our Oct. 9 show last year when it was at 37. Stock is close to $41 a share right now, but we still think there's upside here.

Trades at a 24% discount. Puts it in the 4-star territory. As you noted, our $54 fair value estimate is unchanged. I talked to Damien Conover. He's the equity analyst that covers GSK. In fact, he's also the sector director for healthcare. He thinks that they'll be successful in their appeal of this ruling.

There's a number of different reasons that he's highlighted here. I'm not going to go over all of them on today's show. But they are available on Morningstar.com if you look this stock up and look at the most recent note. And for those of you that aren't familiar: GSK is the old GlaxoSmithKline. It's a UK company.

One of the largest global pharmaceuticals. And we just think that they have a strong portfolio of drugs across several different therapeutic classes: respiratory, cancer, antiviral, vaccines, and so forth. Although I would note they were not involved in the mRNA covid vaccines. And I think part of the catalyst that we're looking for here is launching a traditional RSV vaccine, which we think has some multibillion-dollar potential addressable markets.

Dziubinski: Now, Morningstar's chief US markets—*you're* the chief US market strategist. Morningstar's chief US *economist*, Preston Caldwell, published an updated economic forecast last week. So let's walk through some of the updates, starting with Morningstar's expectations for inflation.

Sekera: Yeah, not much of a change here. We're still looking for inflation to moderate over the course of this year and going into next year. Essentially, we increased our estimate for PCE, the personal consumption expenditures, which is the Fed's measure for inflation. Just tick that up to 2.4% from 2.3%. Essentially that just takes into account the slightly higher inflation that we've had over the past month or two.

Dziubinski: So then where does Morningstar expect the fed-funds rate to finish this year, given that interest-rate cuts will be happening later than our original forecast?

Sekera: Yeah. So our base case right now is that we forecast the Fed's going to cut the federal-funds rate at the September meeting, probably skip the November meeting, and then cut again in the December meeting. So that takes the fed-funds rate down to that 4.75% to 5% range at the end of this year.

We do expect ongoing cuts in 2025. So that would take the fed-funds rate all the way down to 3.00% to 3.25% by the end of next year.

Dziubinski: Now let's talk about Morningstar's expectations for GDP growth. Looks like we're expecting slowed growth, but no recession.

Sekera: Exactly. So base case forecast is still: no recession soft landing, but that slowing rate of economic growth. Now I get to note what's interesting here, having talked to Preston, he actually thinks that the first-quarter economy was stronger than the 1.3% that was actually reported. And the reason for that is there's a number of different GDP categories that he thinks or what he calls as "noisy."

So essentially what that means is that these measurements they can swing from quarter to quarter more than what we think the actual underlying activity had changed. But over time they will average out. So for example, one area that he called out this past quarter was the imports and exports measurement number. So in our opinion, we think these components will actually give a slight boost to the reported GDP in the second quarter.

But we think the actual underlying activity in the second quarter is actually going to be slower than our current 2.2% forecast. So you may want to average out that first-quarter and second-quarter number. But looking forward, we're looking for GDP of 1.8% in the third quarter, slowing to 1%, essentially a little bit above stall speed, in the fourth quarter.

And then looking at 2025, we think it's going to be a pretty sluggish year, averaging 1.4% for the full year.

Dziubinski: So then, Dave, what might be a reasonable expectation for stocks for the remainder of this year, given these GDP and earnings expectations?

Sekera: Well, as a long-term investor, I try not to get too caught up into short-term movements. There's always too many exogenous variables that can come up in the short term that can swing the market around. So really, from our perspective it's really always about valuations more than it is about, maybe, some short-term swings in the economy. Now having said that, the market is pretty fully valued here. There could be some risks to the stock market in the short term if the economy were to disappoint to the downside, which of course could lower earnings growth estimates, maybe dampen investor sentiment.

Plus, we do have the US elections coming up this fall. That certainly could drive some downward volatility just based on the unknown variables that could come up there. But, when I look at the overall market, broadly maybe just a percent or two above our fair value. I do think that investors should be at that market weight position within their own portfolios today.

So whatever your target allocation is to equity based on your risk tolerance, I'd be pretty close to that number today. And then that way if we do get any kind of market selloff this fall that gives you then room to move to more of an overweight position.

Dziubinski: And then let's pan out a little bit, Dave, based on the economic forecast, if it pans out that Morningstar has, what might that mean for stocks during, let's say, the next couple or few years?

Sekera: Stock market right now overall trading at just a bit above our fair value I think a 1% or 2% premium. So for long-term investors over the course of several years, we would expect they'll earn kind of that historical average cost of equity over time. Somewhere in that 8% to 9% area.

Dziubinski: Let's talk quickly about bonds. During the next couple of years, what might investors expect on that front?

Sekera: Well, based on our expectations for the Fed and the economy, Preston is forecasting that the entire yield curve will probably start shifting down over the next few years. In the shorter end of the curve, we expect rates to decline as the Fed cuts the federal-funds rate. In the longer end of the curve, Preston currently forecasts an average 10-year US Treasury this year of 4.25%. The US Treasury's a little bit above that right now. But then expecting the 10-year to continue decreasing in that low growth economic environment next year with inflation moderating. So we're looking for the

10-year to average 3.75% next year. So I think, looking forward, returns to some degree will depend a lot on the duration of your portfolio.

So in the short end of the curve you'll see less price appreciation. And I think that when you reinvest money as bonds mature, you'll be reinvesting in those lower rates. Whereas in the longer end of the curve, you'll see higher returns because you'll get that price appreciation as yields decline. Having said all that, while I do think that in the fixed-income market I prefer being in longer duration assets, I'd still steer clear of corporate bonds. I still think that that would be an area to underweight based on where corporate credit spreads are right now, I just don't think that you're getting paid enough for that additional risk.

Dziubinski: All right. Well, time to move on to the stock picks portion of the program. In your June stock market outlook, which viewers can access via a link beneath this video, you suggest that investors who want some sort of performance edge to the market, that they should consider what you're calling "story stocks." So today, you've brought viewers five story stocks you like whose stories are starting to play out.

Where We See Opportunities in June as Stocks Recover Losses

And your first pick this week is FMC. Tell us about the story here.

Sekera: Yeah. So FMC was actually a top pick by our equity analyst team in the first quarter. And really there have been two issues that have been plaguing the stock over the past couple of years. So during 2021 and 2022, the agricultural industry, they just overordered too much crop-protection chemicals. That was really in response to shipping bottlenecks and supply constraints.

So the users really just wanted to make sure that they were going to have that supply for when they needed it in order to protect their crops and their fields. Now, in 2023, we used up those excess inventories. So we had that big pull forward in 2021. And then you saw a decrease in demand in 2023.

So the investment thesis in 2024, we think that this is shaping up to be a much more normalized year just for the demand and the supply characteristics. And we are forecasting recovery in crop-protection products this year and going into next year. And then specific and this is specific to FMC in and of itself: It is losing patent protection in 2026 on the manufacturing process for Diomedes. That is one of their more important products. But we think the market is underestimating their strong research and development pipeline. We think that new products will offset the loss of that patent protection. And you'll just taking a look at reported earnings, I think the key takeaway here is we're starting to see the beginning to the end of that inventory destocking that should lead to improved results through this year and into next year.

Stock is currently rated at 5 stars. Trades it only about half of our fair value estimate, provides a 4.1% dividend yield. And it is a company we rate with a narrow economic moat.

Dziubinski: Now your next story stock is Chewy. The stock's been an awful performer during the past year or so but has shown some signs of life during the past week or two. So what's the story here?

Sekera: Yeah there's been some volatility here. So this stock we actually first recommended on our Nov. 27 show. Now from that show the stock is up 24%. But we think that it's still got further to go. So those of you that don't know Chewy: It is the largest e-commerce pet care retailer in the US. And I think this is just another good example of how the pandemic skewed corporate growth trajectories.

So following the emergence of the pandemic, early on we had the lockdowns, the social distancing and so forth. We saw a big increase in the number of households with a new pet. So we had a huge amount of growth. Growth initially soared. Those new pet owners turned to Chewy to feed their pets.

Plus as a online retailer, you didn't have to go to the store. You got it delivered to your house. Plus, when you've got a new pet, especially for people that weren't pet owners, you ended up buying your crates, toys, and other accessories. So a big pull forward in that kind of demand.

Now, Chewy's revenue is 75% subscription. We think that's a very good business model for this company, really provides that steady revenue growth. But the sales growth rate has slowed over the past year. We are seeing fewer households buying new pets. But we think that we're starting to get to that point where the growth rate should start to get back to normalized levels after that early pandemic pull forward, the sales growth slowdown. And so we'll get back toward more normalized adoption levels, more normalized new pets. So in our view, we still think that overall it's a growth business. Probably not necessarily being recognized by the market as one. And we think it will continue to benefit as the pet category moves increasingly to online sales.

Net net, 4-star-rated stock. Company that we rate with a narrow economic moat. Still trading at a 22% discount.

Dziubinski: Now, your third stock pick this week is an undervalued stock in an industry that we talk about quite a bit on the show. Actually we already talked about it today, and that's cybersecurity. The stock is Fortinet. Now how does this qualify as a story stock? And why do you like the stock in particular?

Sekera: Yeah, I mean, maybe this one is more of a thematic stock then necessarily a story stock, but definitely within a similar vein. So cybersecurity is an area that I just see having a long-term secular growth, very attractive industry dynamics. Corporations need to protect themselves against geopolitical events, growth in ransomware attacks, hacking and so forth.

And the thing that I like about cybersecurity: The spending itself on cybersecurity is a pretty small percent of your overall IT budget. But, of course the cost of succumbing to any kind of cyber event has just huge monetary and reputational costs. So an area that I don't think that management is going to try to cut even in a recessionary environment.

So this stock is rated 4 stars, trades at a 22% discount, and does have a wide economic moat.

Dziubinski: Now another story stock that has maybe a little bit more of a thematic flavor to it that you like is WEC Energy. Why?

Sekera: So I've actually seen over like the past month or two, an increase in the number of stories about how utilities are going to benefit from higher demand in electricity. AI computing, of course, requires multiple times more electricity than traditional computing. And we agree that is true. The only thing I would note with utilities is that if you're just buying into utilities today to try and play that theme or that story, I think you're already eight months too late to the game.

So in our fourth quarter 2023 US market outlook, we highlighted that the utility sector was trading at some of its lowest valuation levels as compared to our fair values, really near some of their lowest levels over the past decade. And at that point, we noted that, fundamentally, we thought the outlook for the sector was as strong as we'd ever seen it.

And since then, I think when the market hit its low for the Morningstar US Utility Index, it's up about 32%. So very strong growth already in the utilities sector. Utility sector overall starting to get to be pretty fully valued. Now as far as the amount of additional demand growth for electricity from these data centers, we actually have already incorporated that into our forecast last fall. We're looking for a cumulative 46% growth in data center demand through 2032. Now, the reason I've picked WEC here as a pick for the utility play is that there are a number of data centers under construction right now in Wisconsin. So we do think that they will be a beneficiary from that additional demand growth.

And of course, being in a northern state, a lot of the year it's going to be a colder environment up there. So it just makes sense to build those data centers up there, because it will cost less to cool those data centers in the northern environment. But even besides that, we just think WEC combines some of what we consider to be best-in-class management with above-average growth opportunities, a constructive regulatory environment.

So a lot of things to like regarding this story. It's a 4-star-rated stock at a 17% discount, currently yielding about 4.2%.

Dziubinski: And then your final story stock pick this week is one we talked about several times last year. And that's International Flavors & Fragrances. The stock had a tough run in 2023, but it's up more than 20% this year. So what's the story here?

Sekera: Yeah it looks like we first recommended this stock on our Sept. 18 show. Stocks up 46% now since then but we do think it's still undervalued. Now over the past few years IFF has suffered from both what I consider to be self-inflicted wounds as well as a lot of industry volatility from the pandemic. So from the perspective of self-inflicted issues, IFF had made a number of acquisitions over the years, a lot of these acquisitions just haven't turned out as planned.

That then led to management turnover as they were holding people responsible for those acquisitions. They're now in the midst of divesting a number of these different business lines, getting back to focusing on their core competencies. And they're going to use the proceeds to repay debt in order to help fix their balance sheet, which was getting to be overleveraged.

Now, from an industry perspective, the pandemic did lead to a lot of volatility in customer ordering patterns. The consumer food packaging companies, they overordered in 2021 and 2022 due to excess demand, as people were, if you remember back then, you still had a lot of pantry-loading at that point in time, a big shift into goods and away from services.

Plus, we also had the supply in the shipping chain bottlenecks. Then in 2023, there was really a large reduction in demand from those same consumer product companies. People used up what was in their pantry, consumption patterns normalized, people went back out to restaurants. So really, we expect that, at this point, this destocking is coming to an end this year.

We're looking for more modest growth patterns coming forth this year and into next. So there's no change to our fair value at this point. Taking a look at the earnings guidance from last quarter, came in line with our expectations. It's a 4-star-rated stock. We rate the company with a wide economic moat.

Currently trades at a 24% discount to our fair value.

Dziubinski: Well, Dave, thanks for your time this morning. Viewers interested in researching any of the stocks that Dave talked about today can visit Morningstar.com for more analysis. We hope you'll join us for *The Morning Filter* again next Monday at 9 a.m. Eastern, 8 a.m. Central. In the meantime, please like this video and subscribe to Morningstar's channel. Have a great week!

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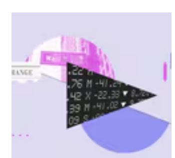

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