4 Risky Stocks to Sell and 4 Picks to Buy Instead

Plus, our take on regional banks heading into earnings and overvalued sectors to avoid.

David Sekera, CFA and Susan Dziubinski • Oct 14, 2024 Share

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Susan Dziubinski: Hello, and welcome to *The Morning Filter*. I'm Susan Dziubinski with Morningstar. Every Monday morning, I talk with Morningstar Research Services Chief US Market Strategist Dave Sekera about what investors should have on their radars, some new Morningstar research, and a few stock picks or pans for the week ahead. So, good morning, Dave.

We saw higher than expected CPI numbers last week after higher than expected jobs numbers the week before that. So given this new data, what's Morningstar think the Fed will do during its meetings in November and December?

David Sekera: Hey, good morning, Susan. Well, first of all, I just got to admit, I was wrong on both of these. Considering the Fed cut by 50 basis points instead of 25, I expected that if payrolls were going to miss the consensus estimates, it actually would have been to the downside, not surprising people by coming in much higher than anybody expected. And then same thing with inflation. I thought that if that was going to miss expectations, it would have been slower or more moderate than consensus expectations, not hotter than what was expected. So I guess that's why I'm not an economist.

Now, having said all that, one month does not necessarily make a trend. Our US Morningstar US economics team still expecting a 25-basis-point cut both here at the November and the December meeting. But even more importantly, they're still looking for those ongoing cuts in 2025 to take the federal-funds rate down to that 3.00% to 3.25% range by the end of next year.

However, they did throw in one caveat this past month. They noted that if payrolls and inflation continue at these types of levels, the Fed just really wouldn't end up having the ability to cut the fed-funds rate as much as we currently forecast over the course of next year.

Dziubinski: Now, even though you're not an economist, Dave, you've made that clear, anything on the economic front that you're going to be watching this week?

Sekera: No, and actually, fortunately for me, it's all going to be about fundamentals this week, getting back to stocks and earnings and guidance. So, I mean, yeah, I'll probably keep an eye on retail sales. That's coming out this week. If that were to come in higher than expected, that could indicate that the economy is still doing better than what people expect. And conversely, if it's slower than expected, that could indicate a slower than expected economy. But no, I'm very happy to be able to focus my attention on earnings this week instead.

Dziubinski: Well, then let's talk about earnings, Dave. We have a whole slew of regional banks reporting earnings this week. And regional banks have staged really quite a comeback since Silicon Valley Bank collapsed a year and a half ago. Update viewers a little bit on what's been going on with these stocks and how valuations on the regional banks look today.

Sekera: Yeah, it feels like it was so long ago, but it was actually in spring of 2023 that Silicon Valley Bank failed. All the US regional banks just got hammered at that point in time and sold off very dramatically. Now, we did reduce our fair values across that part of the sector a bit, but we think the market had sold off way too much back then. In fact, I think all the US regional banks were either rated 4 or 5 stars at that point in time.

Now, when I look at the charts here over the past 52 weeks, yeah, it's been a huge rally. Regional banks are all up quite a bit. For example, it looked like PNC is up 54%, Truist up 48%, Fifth Third up 75%, and U.S. Bank is up 42%. So at this point only U.S. Bank really is still rated 4 stars. Most of these other are 3 stars. So we still see some value there. But it's been a huge rally since then.

Dziubinski: So then what are you going to want to hear about this week from the regional banks during their earnings calls?

Sekera: To some degree, it's really kind of back to more normalized types of expectations. So, again, I kind of want to hear what's going on with net interest margins. Those should increase over time as short-term rates come down, as the Fed starts to ease monetary policy, and really anything to do with their loan-loss reserves, what's going on with the consumer, defaults, and so forth. But really specifically with the regional banks, anything that might have to do with what they're expecting for the commercial real estate sector.

Dziubinski: And we have a couple of tech companies reporting this week that are on your radar, and both have ties to AI. They're ASML and Taiwan Semiconductor.

Sekera: Yeah, and for those of you that don't know ASML, that's the company that makes the equipment, which is then used to make the semiconductors. And of course, they make the very, very high-end equipment, which is used for making the semiconductors used for artificial intelligence. So really, I'm going to be listening for any commentary they have on their order book, any kind of takeaways they may have for growth on sales for that AI equipment. And then with TSM, that's the foundry that makes the semiconductors. They have a lot of different clients, but of course the most high-profile client is Nvidia.

So again, any kind of commentary they may make regarding the GPUs for AI that Nvidia designs. And of course depending on the results from both of those companies that could swing not only Nvidia, but all of the AI-related stocks.

Dziubinski: Now, do ASML and Taiwan Semiconductor look attractive ahead of earnings?

Sekera: I mean, yes, technically both are attractive here. But I'd note not very large margins of safety, especially for companies in the technology sector. So technically, yes, both are rated 4 stars right now. But I'd note they're right on that boundary between a 3-star rating and 4-star rating. ASML is trading at a 15% discount and TSM is at a 10% discount.

Dziubinski: Now, Netflix also reports earnings this week. And Netflix is one of those stocks that to me today almost feels retro in that it was one of the FANG stocks, but then it was sort of left off that list of "Magnificent Seven" stocks. So give viewers a little bit of a refresher on Netflix.

Sekera: Netflix right now is rated 2 stars and trades at a 45% premium to our fair value. And when I look at the history of Netflix stock, not only over just the past few years, but really over the past decade, it has a history of just really wide volatility based on the subscriber numbers that they report. When I look at this stock, it was a 1-star stock coming into 2022. That stock got cut in half by April of that year, but we think it dropped too far, went into 4-star territory.

But when I look at the chart, it's really just marched higher ever since then. Now, we have increased our fair value a couple of times since then. I mean, not huge increases. The company has had a pretty good benefit from the crackdown on password sharing as well as their ad-supported business. But at this point, we think the market has just run up too far over the same time period. So it is now back into 2-star territory.

Dziubinski: Now, Netflix has maintained its position as the leading platform in streaming across the globe. So given that, what will you be watching for in Netflix's numbers this week?

Sekera: Well, first of all, it's really just going to be trying to hear anything as far as additional benefits from that crackdown on the password sharing and the ad-supported business. But our analysts noted they're not really coming up against kind of that one-year, year-over-year comparison period. So we think the benefit from those are starting to probably diminish at this point. The other thing to keep an eye on are going to be its operating margins to see if they start to expand.

We think Netflix has been shifting its strategy to focus more on profitability and getting away from subscriber growth. Now, if they're unable to maintain that kind of margin and earnings growth that the market is looking for, that stock could come under some significant pressure here. We think that growth rate has probably peaked, and we think the market is probably still pricing in too much growth for too long.

Dziubinski: Well, let's talk about some new research from Morningstar, starting with our take on what we heard from J.P. Morgan and Wells Fargo last week during their earnings calls. Anything unexpected, and any changes to our fair value estimates on these two stocks, Dave?

Sekera: No, nothing that I read in our analyst notes that was unexpected. After I read through them this past weekend and I'd note, it kind of sounds like the J.P. Morgan results were very strong and the Wells Fargo results were probably good enough. J.P. Morgan just hitting on all cylinders, running down the list here, good net interest income. Their investment banking groups are recovering, trading outperformed this past quarter, and they're starting to provide some indications that their loan growth may be picking up.

However, all of that good news is already priced into the stock. No changes to our fair value, no changes in our long-term assumptions. It's a 2-star rated stock at a 25% premium to fair value. Turning to Wells Fargo, fee income was pretty good. Expenses remain under control. But net interest income did decline, but declined within our expectations. Probably the disappointment here might be loan growth, maybe a little bit less than what we were hoping for.

Now, having said all that, the stock had traded up after earnings, just because I think expectations were much lower here. But from our point of view, it's a 3-star-rated stock. Trades pretty much right on top of our fair value.

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Dziubinski: Now, we also saw Alphabet in the news again last week after a federal judge ordered the company to open its Google Play Store to competing app stores. And then the very next day, the Department of Justice released its remedy framework in its Google search antitrust case. And one of the proposed solutions would be breaking up Google. So first, Dave, how likely is it that the government's going to break up Google?

Sekera: Yeah, just to get right to the point, we think it's going to be very unlikely that it's going to get broken up anytime in the near future.

Dziubinski: What's Morningstar expect to happen?

Sekera: Our analyst noted that in order to impose a breakup, the Department of Justice has to prove that other remedies and potential remedies wouldn't necessarily work by themselves in order to resolve the issues here. And we think it's very unlikely that a federal judge would view a breakup as a necessary condition without first testing those other potential types of remedies.

And then I'd also note here a final judgment here it won't come until next year and then even after that Alphabet will probably appeal the entire decision and that's going to start a process that we think takes at least a year, if not more, to finalize. In fact, there's some legal experts proposing timelines that could be out to five years. So again, it's going to be a while before we end up even getting to the point where they're going to put in some remedies, much less be in position to potentially try and break up Alphabet.

Dziubinski: So despite last week's news, Morningstar still thinks Alphabet's stock is attractive, right?

Sekera: Exactly. So fundamentally, the company is still hitting on all of its cylinders. Each different parts of their business lines are doing very well. So it's a 4-star-rated stock, trades at a 22% discount to fair value. And I'd note we actually increased our fair value pretty substantially after this past quarter's earnings results.

Dziubinski: Now, in last week's episode of *The Morning Filter*, we talked a bit about your fourth-quarter stock market outlook, and viewers can access your outlook via a link beneath this video. And I'd like to follow up on a couple things we just didn't get to last week from your report. First, you said in the report that undervalued stocks are getting harder to find, and when you do find them, many of them are what you're calling idiosyncratic. So explain what that means, Dave.

Sekera: Well, it's also like when you hear people talk about, oh, this is a stock-picker's market. Really, when the market is significantly undervalued or if there are specific sectors that are out of favor and significantly undervalued, at that point in time, investors could either just buy a market index or a sector-specific ETF to take advantage of those valuation dislocations.

Now, in today's market, with the market being at a slight premium, most sectors are already either at fair value or overvalued. I think for investors to outperform from here, you're going to have to do a lot more fundamental work. Look to buy individual story stocks where story stocks are those that are down usually pretty substantially because of some type of short-term issue. Maybe the top line is contracting for some reason or operating margins are getting squeezed.

And the combination of that may cause the stock to sell off too much to the downside as the market is then overextrapolating those short-term issues too far into the long term. And whereas we may be expecting those short-term issues will normalize over time, again, maybe looking for revenue to bounce back or looking for margins to get back toward historical averages. But again, looking for those individual stocks where there's some kind of story that's caused them to sell off in the short term.

Dziubinski: When investors buy stocks of companies with these idiosyncratic risks associated with them, what should an investor's expectation be in terms of maybe additional monitoring he or she will need to do or in terms of perhaps expecting or accepting that things may need to get worse before they can get better?

Sekera: Well, again, in my own mind, I think it requires a lot more research and a lot more due diligence, looking and really reading everything that you can, looking through the financials. Because really, you're going to have to develop an investment thesis and have confidence in that thesis that results are going to start to rebound and that it's not a value trap, which might continue to keep sinking over the short term into the medium term.

And like you mentioned, I think these are situations which really require much closer monitoring to see if the situation develops as you expect. So if the situation doesn't develop as you expect, you're going to need to reevaluate and decide if your long-term thesis remains intact. And if so that might be an opportunity to buy some more stock, dollar-cost average down if that stock sells off. But if that thesis is not playing out or has changed, you then need to decide whether or not to exit that position, even if it requires you to take a loss at that point in time.

Dziubinski: Now, also in your fourth-quarter outlook, you say that there are two sectors that are pretty significantly overvalued and that you think investors should consider taking profits in, and that's consumer defensive stocks and utility stocks. So talk first about consumer defensive stocks: what's been driving performance there, and just how overvalued these stocks as a group really are.

Sekera: I think what's really interesting here is, while both sectors are overvalued, the dynamics of how each are overvalued is different. And I also think it requires a different way to invest in these two sectors today.

So starting off with consumer defensive, I just have to note Procter & Gamble, Walmart, Costco, each of those account for about 10% of the index. So those three stocks are over 30% of the index. We currently rate Procter & Gamble with 2 stars, and we rate Walmart and Costco both with 1 star. So the combination of their high percentage of the index, as well as that significant overvaluation, skews the consumer defensive index evaluation higher, currently trades at about a 12% premium over a composite of our fair values.

Now, if you take that index and you actually remove those three stocks, the sector valuation actually drops down to fair value. So in this case, there shows that there's actually a fair number of stocks in that sector that remain undervalued. And in this case, I think you're actually better off picking individual undervalued stocks and would probably be better off steering clear of investing through a consumer defensive ETF, which is going to own those three stocks in there.

Dziubinski: Now, the second sector that looks overvalued is the utility sector. And it seems it was just yesterday, right, where you and I were talking about utilities trading at these historically large discounts to their fair values. But not anymore, huh?

Sekera: Now, in fact, it was, I think, October of last year when our analytical team was highlighting to some degree that the sector was as undervalued as they had seen it over the past decade. Since then, the sector, I believe, is up over 40%, up over 30% just year to date. And at this point in time, the utility sector, almost everything in there is either fair value or overvalued. In fact, there are a couple of small or midsize companies that are overvalued, but they're small enough that they don't necessarily skew the overall index valuation.

So in this case, if you listen to us a year ago and you bought maybe a utility sector ETF, I think now is probably a pretty good time to take some of those profits off of the table. And if you bought individual utilities stocks, you could probably look to take profit out of those individual stocks, swap out of those that have become too overvalued and into those that still remain at least fairly valued.

Dziubinski: And that's what your picks are today, Dave. We're going to talk about some swaps, four stocks to sell, and four stocks to buy instead, focusing again on stocks in the consumer defensive and utility sectors. So let's talk about your first two stocks to sell that are in the consumer defensive sector. And you mentioned them both already, Walmart and Costco. And Dave, I've got to say, you've been telling us to sell Costco for months.

Sekera: Yeah, way to call me out on the carpet on that one, Susan. So, yes, I mean, we have been talking about Costco and talking about that it's significantly overvalued for a number of months now. But I also looked at the chart here, and I mean, I do have to note that that Costco stock really has gone pretty sideways since June. Now, fundamentally, both companies are doing very well. I mean, for example, when you look at Walmart, they are picking up a lot of new customers, seeing more foot traffic. More middle-income consumers have been trading down from the traditional supermarkets and going to Walmart with its everyday low price.

But both of these stocks are just at valuations that we think are way too high. And while we're not a PE-focused shop, I just got to point out like Walmart trades at 33 times our projected earnings for 2024, and Costco trades at 50 times this year's projected earnings. So, again, to me, yes, they're both fundamentally doing very well in the short term. But I just can't see how those two stocks justify those kind of multiples when you think about how they'll do over the long term.

Dziubinski: Now you suggest that investors looking for exposure to the consumer defensive sector buy Dollar General and Constellation Brands instead. Let's talk about each of these stocks, starting with Dollar General. Give us the key stats on this one.

Sekera: Dollar General is a 5-star rated stock, trades at a 37% discount to our fair value, and the dividend yield is currently 2.9%. It's a company we rate with a narrow economic moat, and really that moat is going to just be based on their large store network. We think that does give them cost advantages over a lot of their competition in the rural areas, specifically smaller local grocery store chains. And we also rate the company with a Medium Uncertainty Rating.

Dziubinski: Now, Dollar General's results have really been hurt this year by reduced spending among lower-income consumers, and management has lowered guidance for the rest of the year. So why is Dollar General a stock to buy today if things look kind of grim short-term?

Sekera: What I think really is interesting here, at least to me anyways, is to some degree Dollar General is really the polar opposite of Costco. And when I look at Dollar General's customers, typically they're going to be in the lower-income households, whereas Costco is going to be middle upper middle and even lower upper income households dollar general customers typically can only afford to buy small amounts of product at any one point in time Whereas Costco customers are certainly buying in bulk any time that you go there.

And the Dollar General customers have really been the ones that have suffered the most from inflation going all the way back to when inflation really started to take off in 2021. And even with the rate of inflation slowing, they remain under a lot of extreme pressure because wage income over that time period hasn't kept up with the pace of inflation. So what we're seeing here is that spending increasingly is shifting to necessities such as food away from discretionary items. And Dollar General's margins have been getting squeezed as food items have a much lower margin than discretionary items have.

So the thesis here is that as inflation remains low over the course of the next couple of years, wage income will start to catch back up and you will start seeing spending power improve among the lower income groups. So at that point in time, consumption patterns will start to normalize over time. The pattern between the amount spent on food and the amount spent on discretionary. And as that discretionary spending goes back up, we'd look for margins to expand back toward that historically normalized level that we've seen at Dollar General in the past.

Dziubinski: Your second pick in the consumer defensive sector is Constellation Brands. What are some of the key metrics for this stock, Dave?

Sekera: It's now a 4-star rated stock, trades at a 17% discount, and the dividend yield is 1.7%. A company we rate with a wide economic moat as well as a Medium uncertainty.

Dziubinski: Constellation Brands' stock price is around where it started the year, but there have been a lot of ups and downs this year. What's Morningstar's take?

Sekera: After earnings, we bumped up our fair value a little bit by 4% to 291 per share, whereas actually over that same time period, the stock has retreated 6%. So this divergence now between our fair value and the market pricing has been enough to pull that stock into that 4-star territory. I read through our analyst note here, and I would say really no surprises in the past quarter. Their beer performance, which is the preponderance of their business, was pretty solid, 5% volume growth. And that's on top of a tough comp period last year of 9% growth. So again, I think that bodes pretty well for the company.

Now their wine and their spirits divisions did do relatively poorly. They saw declines of 10% and 3%. But again, that's a much smaller portion of their business growth. Overall, no meaningful changes in our longer-term forecast. This year, we're still projecting $13.70 of earnings per share this fiscal year. We're looking for kind of that 10% to 11% earnings growth over our five-year forecast period. Stock currently trades at just under 18 times our 2025 projected earnings, which is this current fiscal year. So it looks pretty attractive to me.

Dziubinski: All right, let's pivot over to the utilities sector, which is also overvalued. Your stocks to sell here are Vistra and Public Service Enterprise Group. Now, that premium on Vistra is exceptionally high.

Sekera: That it is. It trades at 170% premium to our fair value, puts it well into 1-star territory. In fact, it's probably one of the most overvalued stocks under our US coverage. So our fair value is only $46 a share. Looks like it's trading about $125 per share in the market. Now, you have to be careful with this one. Vistra is not a regulated utility, but an independent power producer. We rate it as not having an economic moat. And in our view, and I look at the model here, we think the market is just way overestimated the benefit that it will derive from additional demand from artificial intelligence.

And then taking a look at Public Service, not nearly as overvalued, only a 30% premium. But again, for utility, that's still enough to put it in a 1-star territory. It only has a 2.7% dividend yield, so that's going to be lower than what we see across most of the rest of the sector. We do rate Public Service with a narrow economic moat and a Low uncertainty, but that's not a differentiator as pretty much all of the regulated utilities are rated narrow moat, Low uncertainty.

Dziubinski: Now, there aren't any screaming buys in the utilities sector today. So your stocks to buy aren't terribly undervalued, but they're still more attractively priced than the sector overall. So let's get to the picks. Your first one is Evergy. Give us the basics on this one.

Sekera: Yeah, I think it's probably the last of the 4-star rated stocks in the utilities sector, for the regulated utilities anyways. It's a 9% discount from fair value, 4.3% dividend yield. And again, like all of the other regulated utilities, narrow economic moat and a Low uncertainty.

Dziubinski: What's Morningstar's take on Evergy? What's the market missing here?

Sekera: I'm not necessarily sure the market is really missing all that much. I mean, it's still kind of only a 9% discount to fair value. I think really it's also just more indicative that maybe the market valuation of the rest of the sector is just too high. For those of you that don't know Evergy, it is a regulated electric utility. It serves eastern Kansas and western Missouri. Our utilities team recently noted and I think made it one of our top picks for this quarter as it was really just the last of the undervalued US utilities. But fundamentally, there are some positive growth fundamentals going on here. We do think that could lead management maybe to boost its growth outlook later this year. And if so, that could provide a pretty good positive catalyst for the stock.

Dziubinski: And then your final pick this week is WEC Energy. Run through the key stats on this one, Dave.

Sekera: 3-star rated stock, very close to our fair value, only has a 2% discount, 3.5% dividend yield, and again, narrow moat, Low uncertainty.

Dziubinski: WEC is expected to enjoy some strong demand growth from data centers in the next few years. Is that right?

Sekera: Exactly. And really, when I look at it, one of the big reasons why utilities have done so well this year is that they were caught up in the whole artificial intelligence trade. They have become considered a second-derivative play on the growth in AI. AI computing, of course, requires multiple times more electricity than what you require for traditional computing. And again, we agree all of that is true. However, if you're just buying utilities today to try and play that theme, I think you're already a year too late to that game.

Last October, we had highlighted the utilities sector was trading at valuation levels that were at their lowest valuations as compared to what we'd seen over the past decade. But at that same point in time, our analytical team noted that, fundamentally, the outlook for the sector was as strong as we had ever seen it. Utilities are already up now 40% since last October. Taking a look at our financial models here, and including WEC, we've already incorporated into our forecast the electric demand growth from these data centers. And data centers will increase cumulative electric demand by 46% through 2032.

Specific to WEC, there are a number of data centers currently in construction, a few more that we expect to get permitted. A lot of the demand here in Wisconsin is, of course, as a colder environment in the Northern states, it costs less to be able to cool those data centers. So we're looking for good growth there with WEC. We also know that it's a company that combines best-in-class management with above-average growth opportunity. So again, 3-star rated stock, trades pretty close to our fair value, but still a relatively attractive dividend yield.

Dziubinski: Thanks for your time this morning, Dave. Viewers who'd like more information about any of the stocks Dave talked about today can visit Morningstar.com for more details. We hope you'll join us for *The Morning Filter* 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.

Got a question for Dave? Send it to themorningfilter@morningstar.com.

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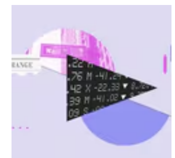

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