TRIVARIATE RESEARCH

LESS OPINION, MORE ANALYSIS

12/08/2021

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RESEARCH SUMMARY AND CONCLUSIONS

The recent market volatility started as a result of opinions over a perceived Fed pivot and the new COVID variant. Corporate commentary generally indicates a slow path toward the resolution of the logistics, transportation, and supply-chain bottlenecks induced by COVID, with many suggesting normalization is expected in the second half of 2022, albeit with some variability depending on product.   Reopening stocks like consumer services, energy, and transportation have led this week, reversing some of the concerns that followed Thanksgiving.   Given the risk-off / risk-on trading volatility, we took a step back to analyze macro trends and make a data-driven conclusion about the environment. Our process is to ingest over 150 macro variables to assess economic activity, industrial activity, consumer activity, financial conditions, and commodity trends, among others.

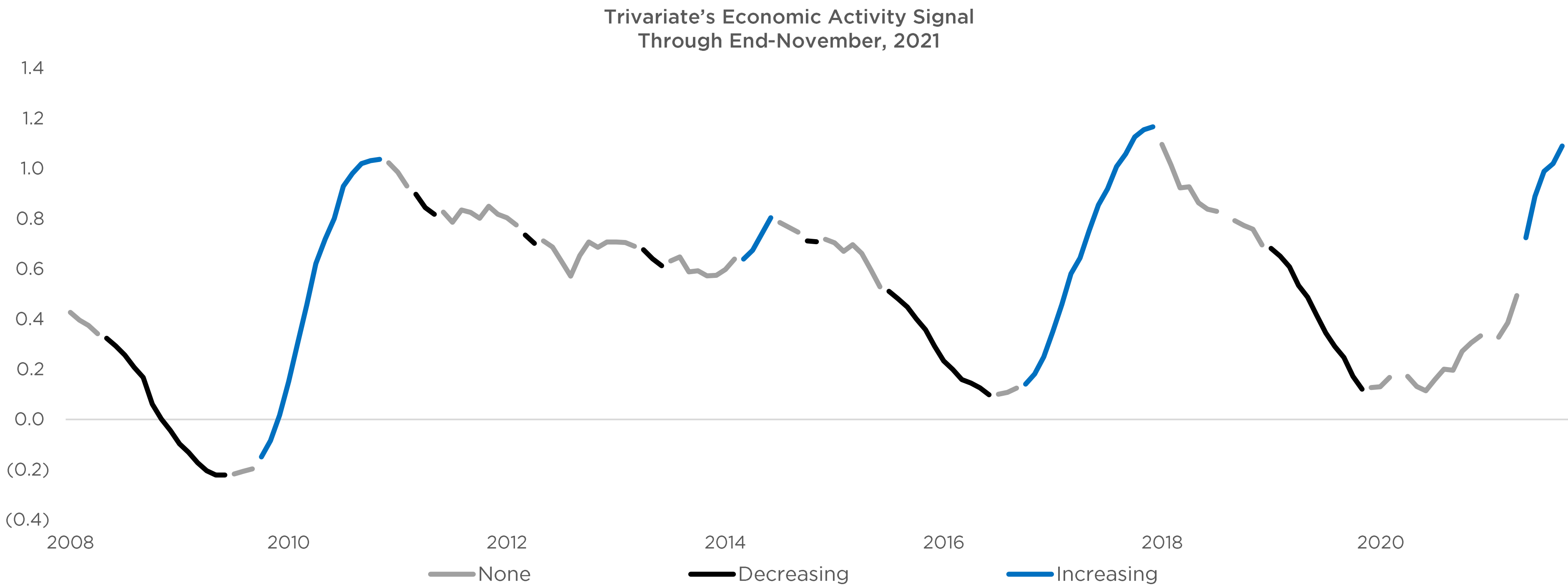
- **Mixed but softening economic activity:** Our economic activity gauge rolled-over last month. While Philly Fed data was most recently positive, the NFIB Small Business Optimism has rolled over and is now near 5-year lows.
- **Mixed but softening industrial activity:** Our industrial activity gauge peaked six weeks ago. While Dry Van Total Rate per Mile is at an all-time high, the Baker Hughes Rig Count is near all-time lows at the 8th percentile vs. history. Auto SAAR and capacity utilization are relatively weak, where as US ISM, despite rolling over, is still in the 98th percentile vs. its long-term history.
- **Relatively robust consumer activity:** This includes payrolls, wages, consumer confidence, retail sales, credit card delinquencies, and other consumer-related metrics.   The challenge is that as we anniversary the stimulus for metrics like personal income, and as byproduct, retail sales, some of the metrics have declined heavily on a 6-month year-over-year basis but have ticked up recently. Overall, real-time data and corporate commentary on the consumer remain relatively strong. We expect our consumer activity gauge to remain strong into 2022.

RESEARCH SUMMARY AND CONCLUSIONS

- **Commodities:** Our proprietary commodity gauge includes 15 underlying metrics, including the Bloomberg Commodity Index, the Bloomberg Diesel Fuel Index, gasoline, aluminum, copper, corn, cotton, gold, lumber, natural gas, silver, soybeans, sugar, and wheat. In aggregate our gauge still shows strength and record levels, though we have seen some sub-components soften and expect most to weaken over the coming six-to-twelve months. This week the group has acted risk-on.
- **Financial conditions have been mixed:** We created a financial conditions gauge which is a combination of the Bloomberg and Goldman Sachs financial conditions indicators, corporate credit spreads, the US Treasury Implied Volatility, and 30-year fixed mortgage rates. We have seen tightening, loosening, and neutral aggregate trends in the last three months, with the Goldman indicator the loosest of the lot.
- **Corporate earnings have remained strong:** The S&P500 is up nearly 25% this year. The bottom-up median analyst earnings expectations have sharply risen all year as well, in fact almost as much as the stock market. Since the end of 2020, 2021 estimated EPS is up 23.2% (from $167.68 to $206.58) and 2022 estimated EPS is up 11.1% (from $199.80 to $222.03). **We remain optimistic about US equities – earnings are likely to be higher next year than this year. Investors should focus on relative earnings estimate achievability within the market.**
- Conclusion: **Following this comprehensive assessment of macro data, our conviction is increased on the consumer discretionary stocks relative to industrials based on relative estimate achievability in the next six months. We also like materials and energy where we see earnings estimate achievability as way above average.**

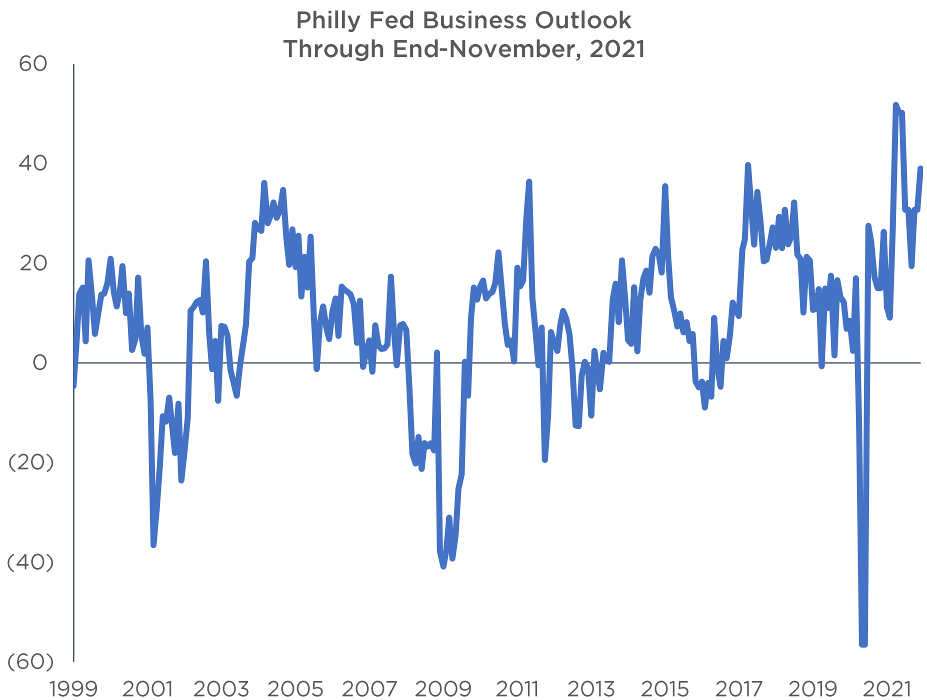
TRIVARIATE'S ECONOMIC ACTIVITY GAUGE HAS PLATEAUED

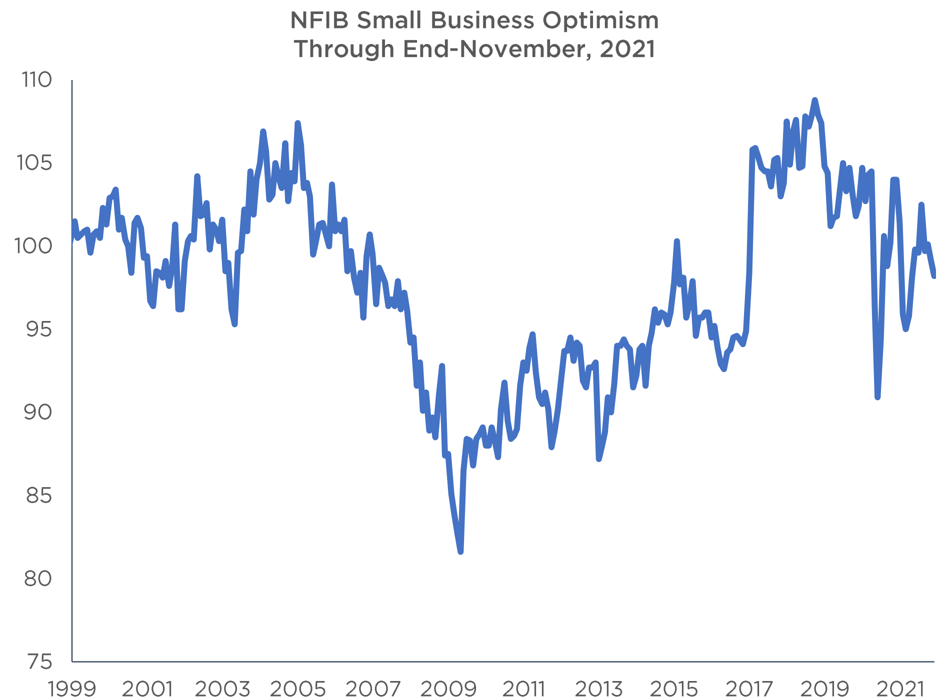
Our economic activity gauge, which consists of several variables including CEO confidence, NFIB Small Business Optimism, Philly Fed Business Outlook, US 5y5y Forward Breakeven, US LEI, etc., has recently leveled off after a strong acceleration in the second half of 2020 and the first half of 2021. The absolute level is high, but clearly the second derivative is no longer positive.



PHILLY FED POSITIVE, SMALL BUSINESS OPTIMISM NEGATIVE

The moderation in the economic activity gauge is the result of what we holistically see as mixed underlying signals. For instance, the recent Philly Fed Business Outlook ticked up and remains very high versus the long-term average (left chart). The NFIB Small Business Optimism however as rolled over and is now near 5-year lows (right chart).

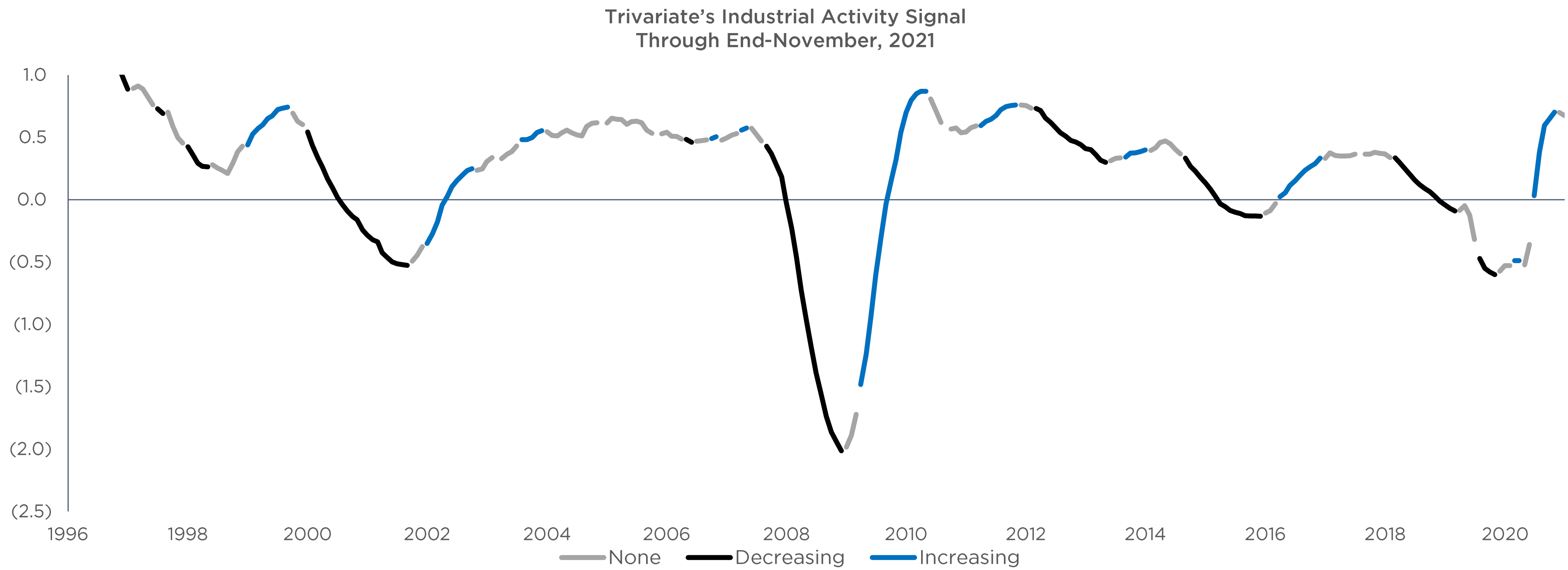




TRIVARIATE RESEARCH

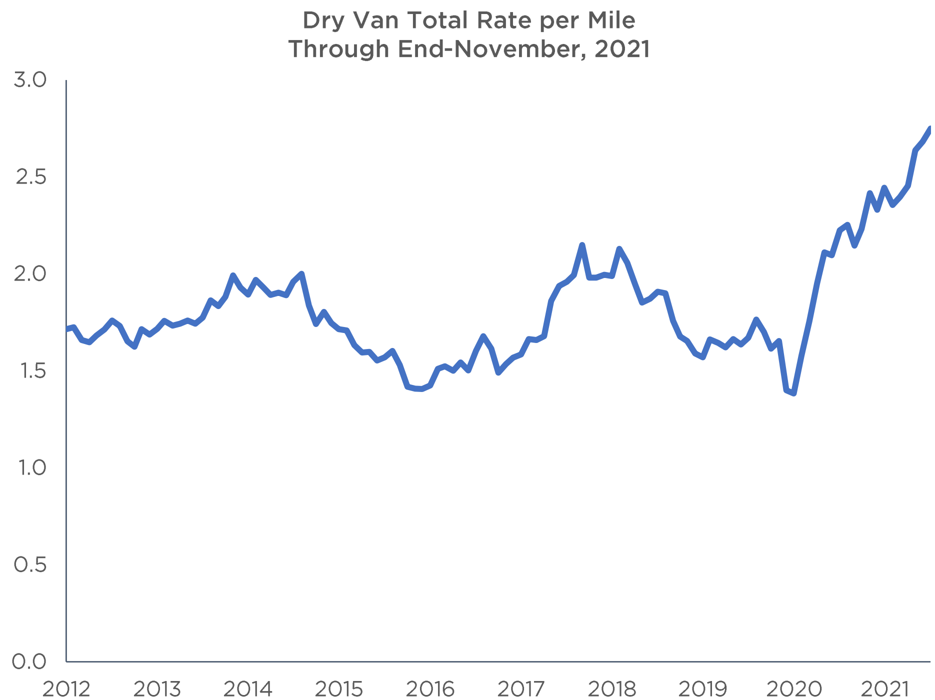
OUR INDUSTRIAL ACTIVITY GAUGE HAS ALSO RECENTLY MODERATED

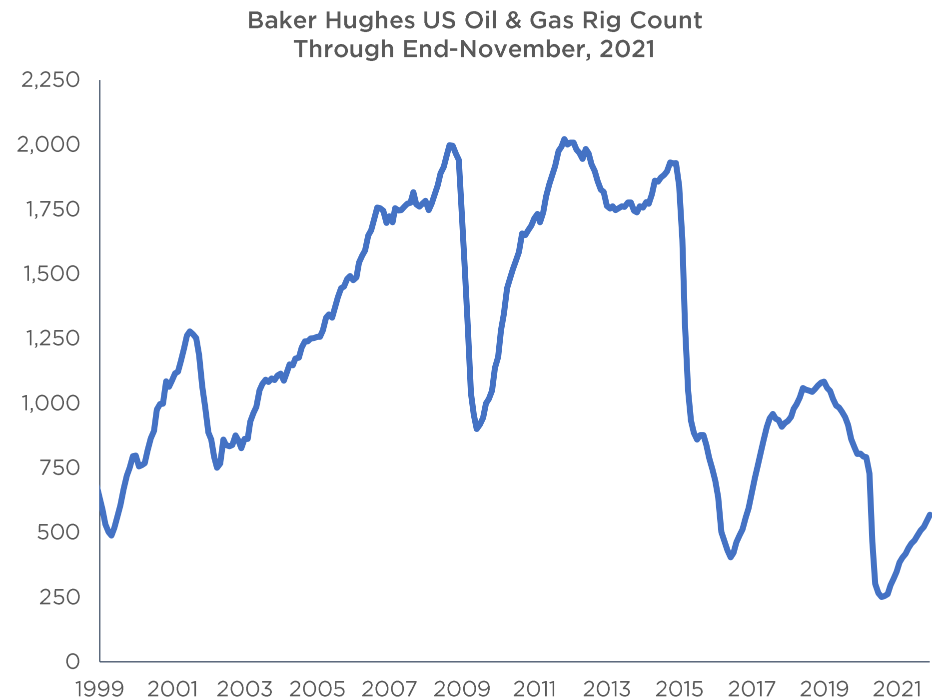
After a strong recovery from the bottom in 2020, our industrial activity gauge plateaued two months ago. This signal includes variables like logistics metrics such as the AAR North American total carloads and Dry Van Rate per Mile, production-oriented metrics like the Baker Hughes Rig count, the US Auto Sales SAAR, Industrial Production, Durable Goods New Orders, and US Housing Starts, as well as some financing metrics like US C&I loans.   Given industrial sector earnings estimates embed above 30% YoY growth every quarter through 2022, we see this inflection as a potential harbinger for downward earnings revisions.



DRY VAN RATE PER MILE AND BAKER HUGHES RIG COUNT

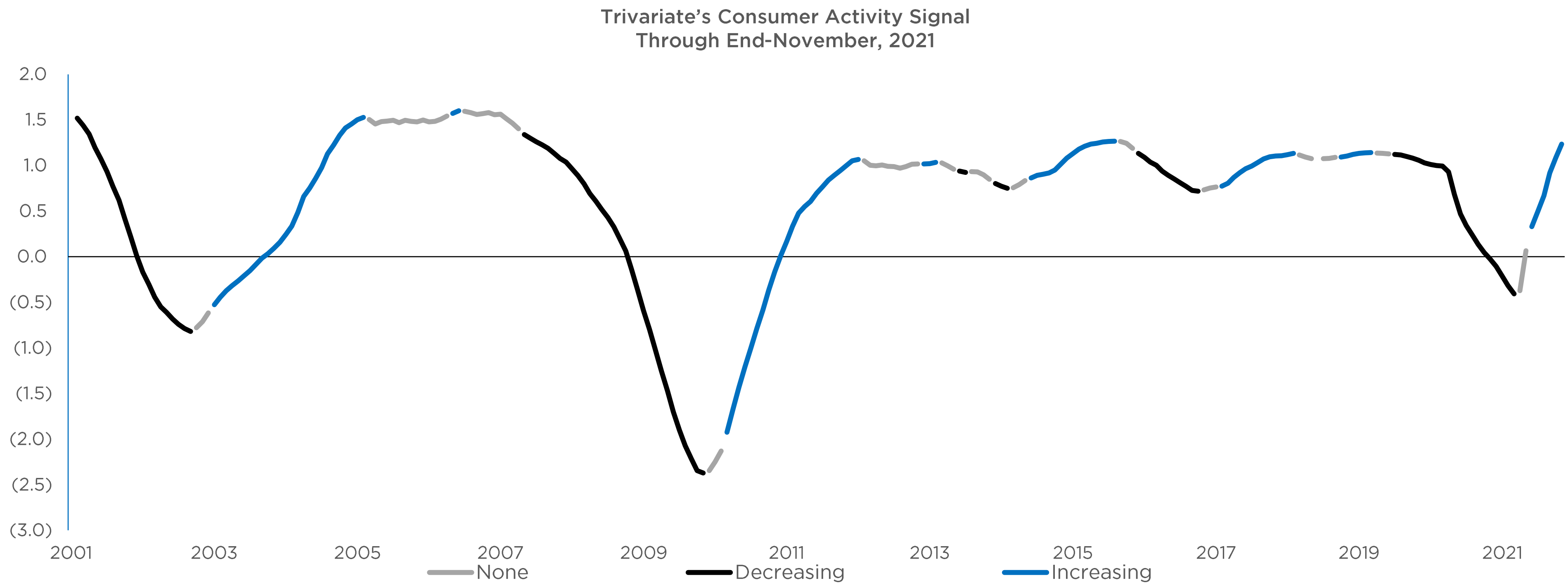
As was the case for the economic activity gauge, there are conflicting signals for the industrial activity gauge as well. Dry Van Total Rate per Mile (left chart) is at an all-time high, where as the Baker Hughes Rig Count (right chart) is just bouncing off of all-time lows at the 8th percentile vs. history. Auto SAAR and capacity utilization are relatively weak, where as US ISM, despite rolling over, is still in the 98th percentile vs. its long-term history.





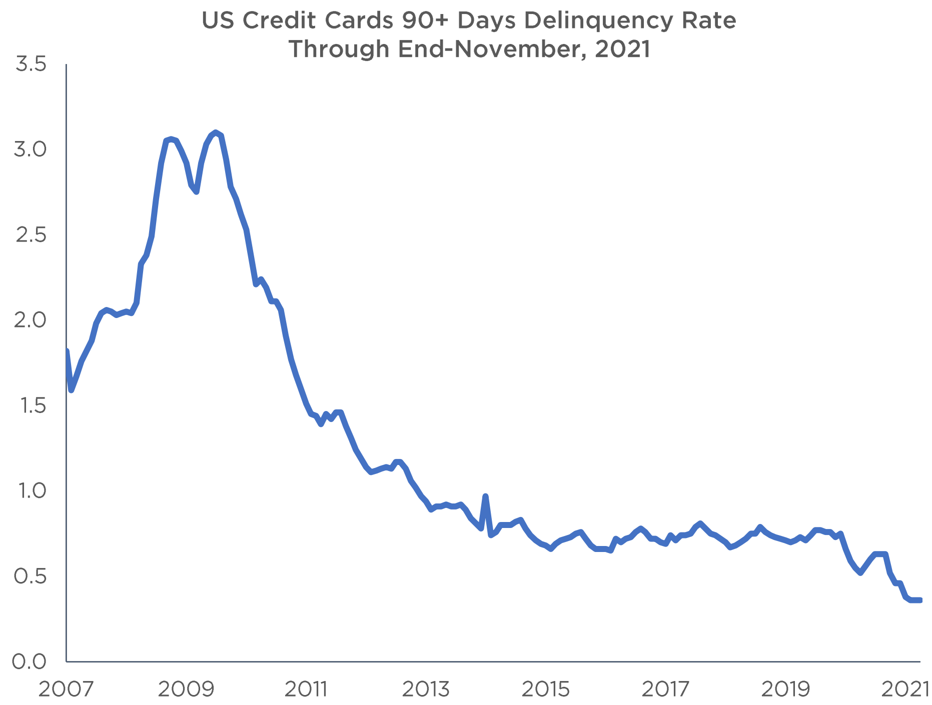
CONSUMER ACTIVITY IN AGGREGATE STILL INCREASING

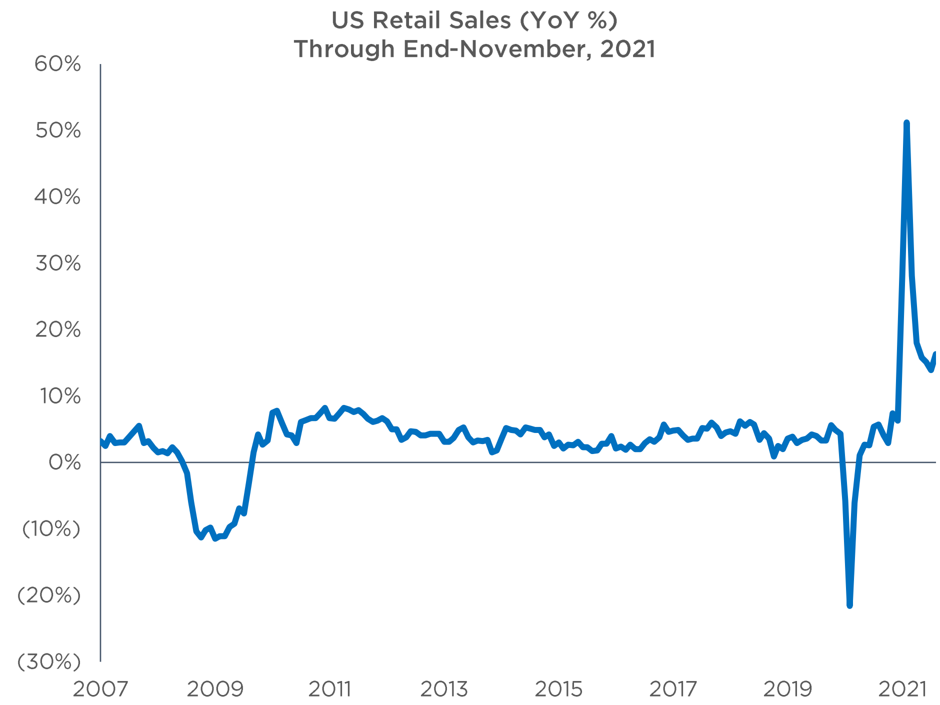
While our economic and industrial activity gauges have stopped increasing, our consumer gauge remains relatively robust. This includes payrolls, wages, consumer confidence, retail sales, credit card delinquencies, and other consumer-related metrics. The challenge is that as we anniversary the stimulus for metrics like personal income, and as byproduct, retail sales, some of the metrics have declined heavily on a 6-month year-over-year basis but have ticked up recently. Overall, real-time data and corporate commentary lead us to believe consumer behavior will remain robust for the foreseeable future.



DELINQUENCIES ARE AT ALL TIME LOWS & RETAIL SALES ARE ROBUST

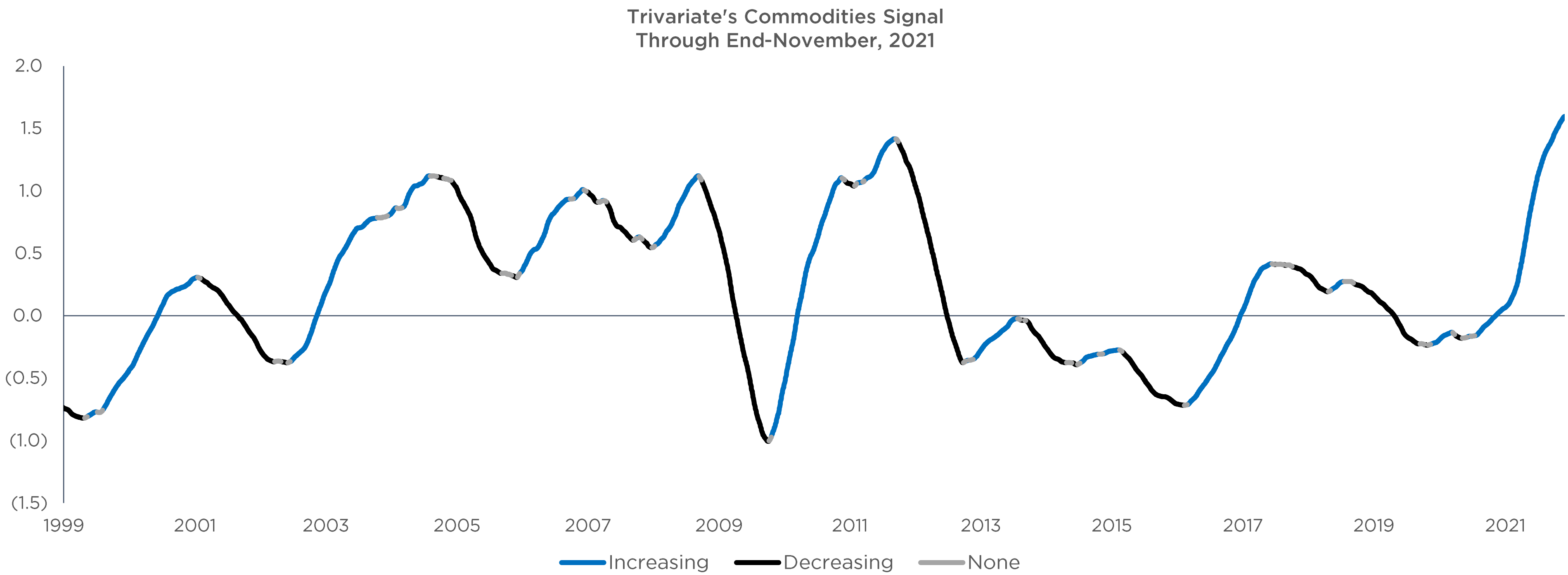
There are limited signs of stress on the consumer, with 90-day credit card delinquencies at all-time lows (left chart). At the same time, retail sales, having annualized the COVID closings, are recently ticking higher (right chart) after the massive YoY correction that naturally follows helicopter money.





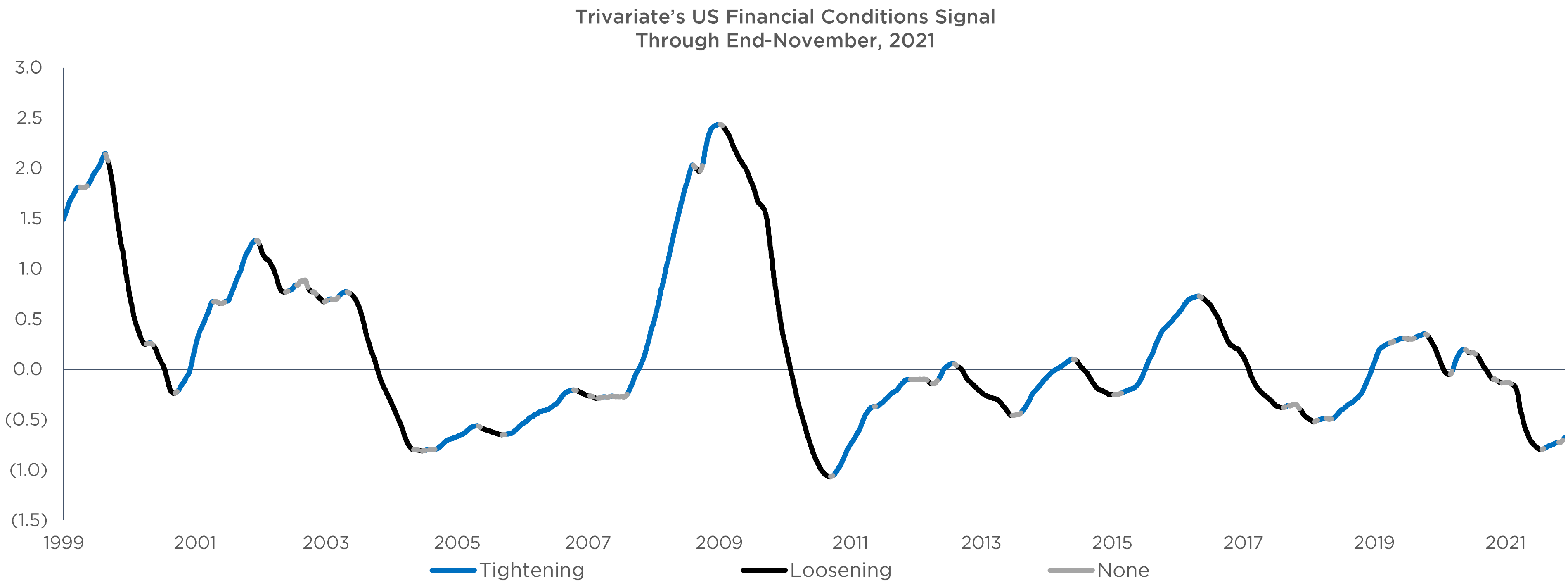
COMMODITIES ARE GENERALLY STILL STRONG, BUT NEAR PEAKING

Our proprietary commodity gauge includes 15 underlying metrics, including the Bloomberg Commodity Index, the Bloomberg Diesel Fuel Index, gasoline, aluminum, copper, corn, cotton, gold, lumber, natural gas, silver, soybeans, sugar, and wheat. In aggregate our gauge still shows strength and record levels, though we have seen some sub-components soften and expect most to decline over the coming six-to-twelve months. That being said, we expect near-term earnings expectations for many energy and materials companies to be achievable, and most stocks embed a substantial earnings correction.



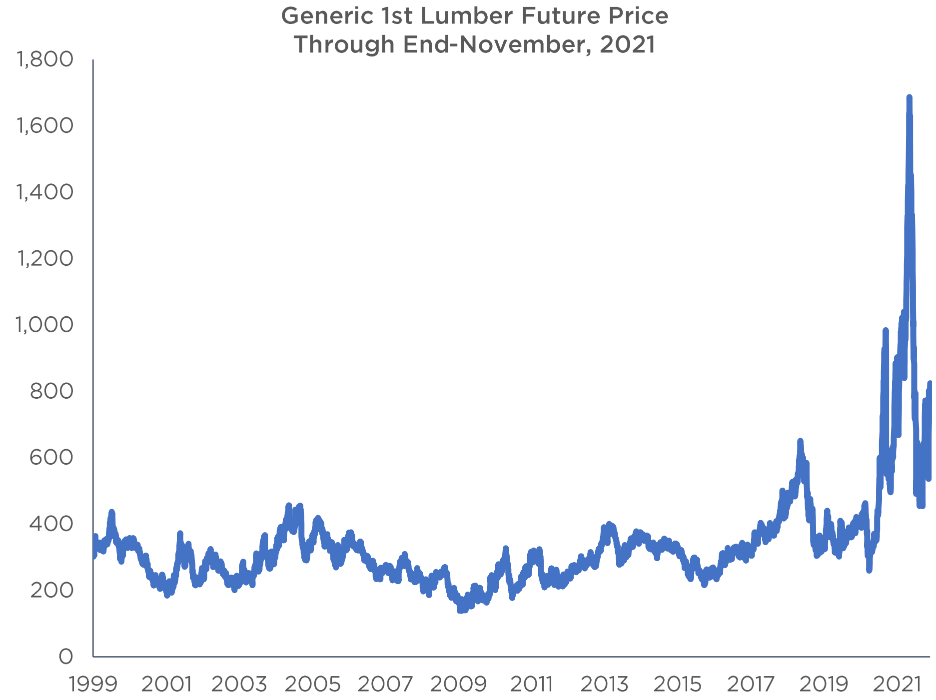
FINANCIAL CONDITIONS ARE RELATIVELY NEUTRAL

We focus on financial conditions as a proxy for risk-on / risk-off market behavior, and for the efficacy of our quantitative models to discern winners from losers in banks. We created a financial conditions gauge which is a combination of the Bloomberg and Goldman Sachs financial conditions indicators, corporate credit spreads, the US Treasury Implied Volatility, and 30-year fixed mortgage rates. We have seen tightening, loosening, and neutral aggregate trends in the last three months, with the Goldman indicator the loosest of the lot.



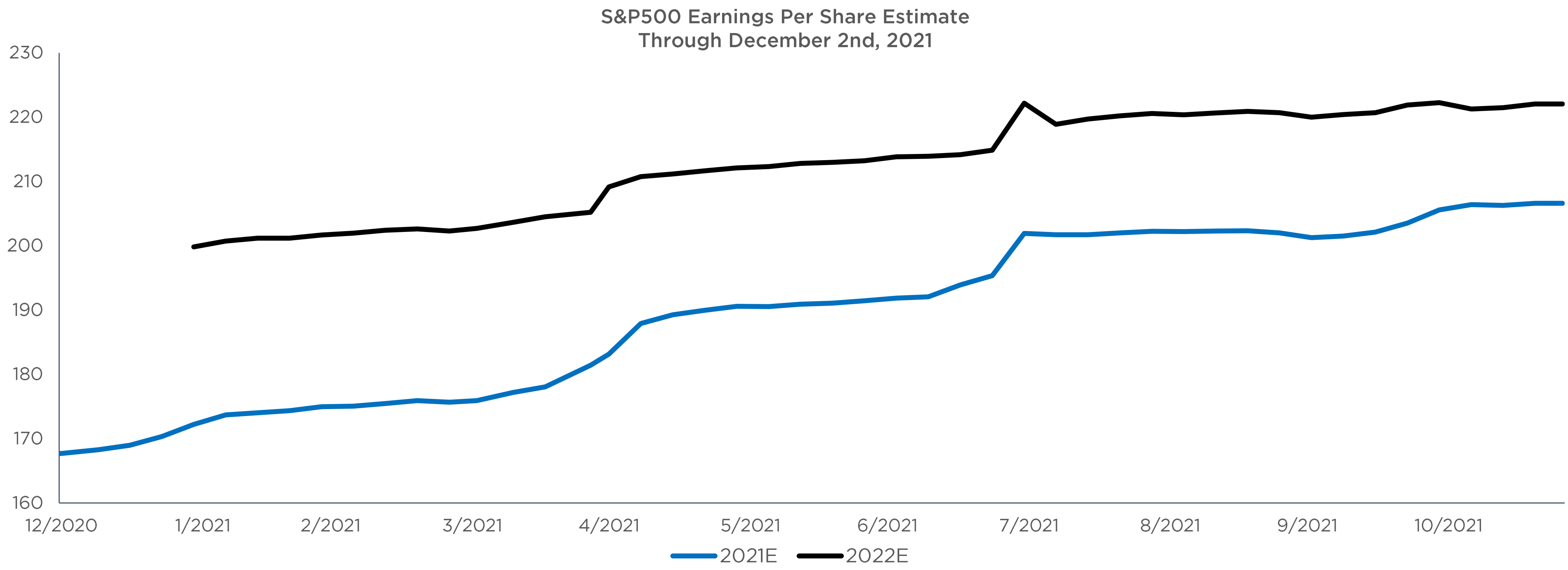
COMMODITIES SOFTENED IN NOV., BUT APPEAR RISK ON AGAIN NOW

The Bloomberg Commodities Index, after appreciating materially through much of 2021, corrected sharply in a risk-off trade in late November (left chart). There has been however a modest recovery in early December with risk-taking back on in the last two days in particular. But the supply / demand of all commodities differ, with lumber an interesting case study (right chart). Obviously, a proxy for economic strength and housing starts, lumber went up eight-fold from April 2020 through May 2021, before declining nearly 75% through mid-September, and doubling again since then.



EARNINGS EXPECTATIONS HAVE RISEN 23% THIS YEAR

The S&P500 is up nearly 25% this year. The bottom-up median analyst earnings expectations have sharply risen all year as well, in fact almost as much as the stock market. Since the end of 2020, 2021 estimated EPS is up 23.2% (from $167.68 to $206.58) and 2022 estimated EPS is up 11.1% (from $199.80 to $222.03). It is unusual for actual earnings estimates at the end of year to exceed the initial forecasted estimates for the following year. Analysts on average forecast 14% earnings growth at the beginning of each year, and the actual growth has been closer to 6%. The only years where initial analyst estimates have ultimately proven to be too low were recession recoveries, or the year after, when the analysts collectively get too pessimistic at the bottom. That behavior was borne out again this cycle, though the sheer magnitude of the upward revisions throughout the year is notable.



EARNINGS EXPECTATIONS ARE FOR MID-SINGLE DIGIT EPS GROWTH

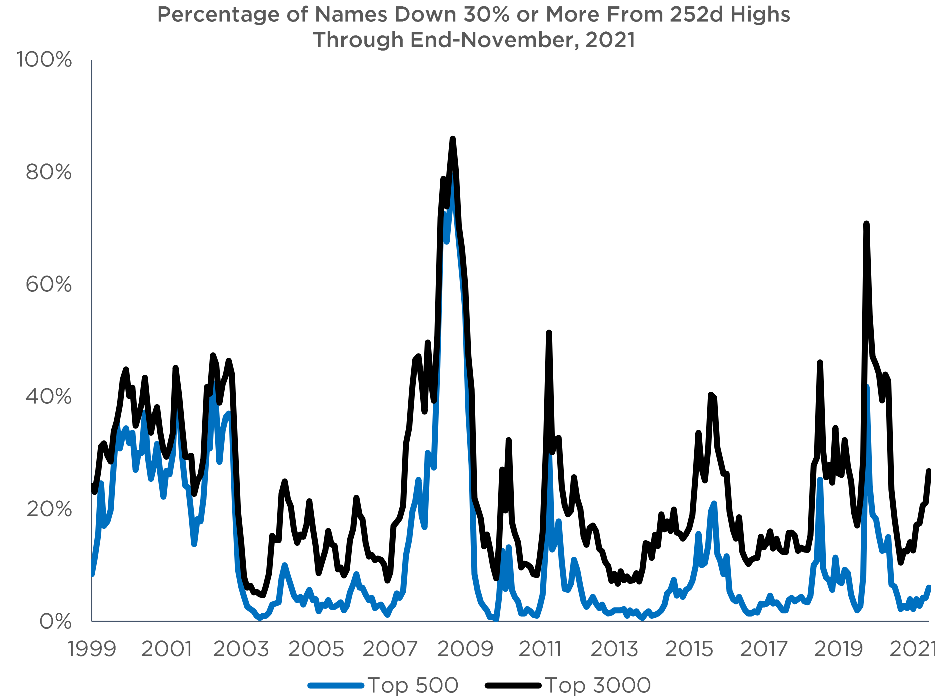
The bottom-up analyst earnings growth expectations are for 39.6% YoY earnings growth for Q3, down from the 91.8% growth in Q2 (a function of the COVID trough) but up from where expectations were at the end of Q2. Earnings are expected to decelerate but remain in the mid-twenties through Q4, trough in Q2 2022, and then accelerate again from there. The energy sector lost money in 2020, so the rebound is to be expected. Industrials companies have very high YoY earnings growth expectations every quarter through 2022, which we thinks create poor relative estimate achievability.

Bottom-Up Analyst Earnings Growth Expectations
December 2, 2021

Sector	1Q21	2Q21	3Q21E	4Q21E	1Q22E	2Q22E	3Q22E	4Q22E
S&P 500	49.7%	91.8%	39.6%	21.7%	6.7%	4.5%	6.6%	12.9%
S&P ex-Financials	36.0%	76.8%	40.8%	26.8%	14.1%	10.3%	9.4%	14.2%
Consumer Discretionary	231.0%	266.1%	13.7%	0.0%	1.2%	23.8%	38.4%	53.8%
Consumer Staples	10.6%	19.0%	(0.1%)	0.3%	5.0%	5.2%	13.8%	10.8%
Energy	18.4%	N/A	N/A	N/A	179.1%	61.9%	6.9%	(12.2%)
Financials	135.7%	191.7%	34.0%	1.0%	(20.1%)	(18.7%)	(6.6%)	6.6%
Health Care	24.3%	22.8%	28.4%	15.4%	6.0%	3.8%	(3.7%)	6.2%
Industrials	(2.6%)	394.9%	71.2%	108.3%	51.5%	30.4%	35.7%	36.7%
Info Tech	40.5%	45.1%	37.0%	14.5%	7.2%	5.7%	6.4%	12.7%
Materials	56.9%	133.4%	86.5%	60.6%	38.8%	3.9%	(2.8%)	(12.1%)
Communication Services	52.8%	72.0%	39.8%	9.1%	(0.1%)	0.3%	5.8%	18.3%
Utilities	1.0%	16.2%	8.4%	2.3%	12.0%	(9.7%)	1.8%	15.2%
REITS	5.6%	30.3%	25.7%	17.3%	9.4%	4.2%	7.0%	10.3%

VALUATION HAS COME-IN WITH MANY SMALL CAPS BEING CORRECTED

The overall valuation of the SP500 remains elevated versus history (left chart). However, multiples have come-in recently, fueled by strong forward earnings growth expectations and a modest market pullback from highs. We maintain multiples will remain elevated versus longer-term history, as the constitution of the market differs from history, and real interest rates remain extreme. The number of stocks that have corrected 30% or more from 252-day highs is substantial (right chart), particularly among small caps, offering more attractive investment opportunities.



TRIVARIATE SECTOR OVERVIEW: SUMMARY RECOMMENDATIONS

Our view is investors should own energy and materials over industrials, healthcare services and pharmaceuticals over staples, and reopening consumer plays. We like large banks over small. An SP500 benchmarked portfolio is 30% technology – we like technology where margin expansion is possible but would avoid those with negative FCF.

Trivariate Sector Recommendations

Sector	Total S&P 500 Market Cap. (US$ Bil.)	Current S&P 500 Weight	Trivariate-Recommended Weight	Trivariate-Relative Weight	Trivariate Recommendation	Comments
Materials	950.96	2.2%	6.0%	3.8%	Maximum Overweight	Buy the cheap stocks with upward revisions
Energy	1,068.48	2.4%	6.0%	3.6%	Maximum Overweight	Oil is rising, and M&A is likely
Health Care	5,195.55	11.9%	15.0%	3.1%	Overweight	Healthcare services are rate-sensitive, and demand trends are above GDP
Consumer Discretionary	5,976.24	13.7%	15.0%	2.3%	Overweight	Retailing, reopening, and services better than durables
Utilities	882.61	2.0%	3.0%	1.0%	Equal-Weight	Some idiosyncratic bets probably sensible
Communication Services	4,781.24	11.0%	12.0%	1.0%	Equal-Weight	Makes sense to keep market-weight FAANGM
Financials	4,666.87	10.7%	10.0%	(0.7%)	Equal-Weight	Large cap banks better than regionals
Real Estate	1,050.61	2.4%	1.0%	(1.4%)	Under-Weight	Commercial real-estate is challenged
Information Technology	13,370.11	30.6%	27.0%	(3.6%)	Under-Weight	Semis are over-earning, focus on margin expansion / cash flow generation
Consumer Staples	2,525.31	5.8%	2.0%	(3.8%)	Under-Weight	Plenty of short ideas in idiosyncratic staples
Industrials	3,182.99	7.3%	3.0%	(4.3%)	Maximum Underweight	Industrial activity is rolling over, but earnings expectation are very high

BUY CONSUMER QUALITY REOPENING STOCKS

With relatively more robust consumer macro trends, reopening consumer stocks in the top quartile of both earnings revisions and valuation seem sensible.

Energy and Materials Sector
Top Quartile in Estimate Revisions and Valuation
End-November, 2021

Ticker	Company	Industry Group	Market Cap. (US$ Bil.)
HLT	Hilton Worldwide Holdings Inc.	Consumer Services	37.65
EXPE	Expedia Group, Inc.	Consumer Services	24.41
ULTA	Ulta Beauty, Inc.	Retailing	20.87
GPC	Genuine Parts Company	Retailing	18.19
LKQ	LKQ Corporation	Retailing	16.29
MHK	Mohawk Industries, Inc.	Consumer Durables & App.	11.37
TPR	Tapestry, Inc.	Consumer Durables & App.	11.04
LEVI	Levi Strauss & Co.	Consumer Durables & App.	10.28
CPRI	Capri Holdings Limited	Consumer Durables & App.	8.91
H	Hyatt Hotels Corporation	Consumer Services	8.66
RL	Ralph Lauren Corporation	Consumer Durables & App.	8.54
CHH	Choice Hotels International, Inc.	Consumer Services	7.95
PVH	PVH Corp.	Consumer Durables & App.	7.59

BUY ENERGY AND MATERIALS

In the six-month periods following rising oil prices, materials and energy stocks that are cheap and have upward revisions tend to strongly outperform.

Energy and Materials Sector
Top Quartile in Estimate Revisions and Valuation
End-November, 2021

Ticker	Company	Industry Group	Market Cap. (US$ Bil.)
DOW	Dow Inc.	Chemicals	40.63
NUE	Nucor Corporation	Metals & Mining	30.37
LYB	LyondellBasell Industries N.V.	Chemicals	29.00
MOS	The Mosaic Company	Chemicals	12.97
MRO	Marathon Oil Corporation	Oil, Gas & Consumable Fuels	12.06
WLK	Westlake Chemical Corporation	Chemicals	11.88
STLD	Steel Dynamics, Inc.	Metals & Mining	11.87
CLF	Cleveland-Cliffs Inc.	Metals & Mining	10.18
RS	Reliance Steel & Aluminum Co.	Metals & Mining	9.31
AA	Alcoa Corporation	Metals & Mining	8.71
OLN	Olin Corporation	Chemicals	8.66
EQT	EQT Corporation	Oil, Gas & Consumable Fuels	7.34
X	United States Steel Corporation	Metals & Mining	6.11
LPX	Louisiana-Pacific Corporation	Paper & Forest Products	5.75
NOV	NOV Inc.	Energy Equipment & Services	4.66
MUR	Murphy Oil Corporation	Oil, Gas & Consumable Fuels	4.11
CMC	Commercial Metals Company	Metals & Mining	3.76
TROX	Tronox Holdings plc	Chemicals	3.38
CBT	Cabot Corporation	Chemicals	2.98
CNX	CNX Resources Corporation	Oil, Gas & Consumable Fuels	2.88
UFS	Domtar Corporation	Paper & Forest Products	2.80
TSE	Trinseo PLC	Chemicals	1.83

SHORT MACHINERY WITH HIGH EXPECTATIONS

Given the mixed but softening industrial data, avoiding industrials with high margin expectations off of already recovered margins seems prudent.

High 2022 Incremental Margin Forecasts and Already At / Near Record Profitability End-November, 2021

Ticker	Company	Industry Group	Market Cap. (US$ Bil.)
HON	Honeywell International Inc.	Industrial Conglomerates	139.23
CAT	Caterpillar Inc.	Machinery	104.59
CTAS	Cintas Corporation	Commercial Services & Supplies	43.66
PH	Parker-Hannifin Corporation	Machinery	38.82
ROL	Rollins, Inc.	Commercial Services & Supplies	16.38
PNR	Pentair plc	Machinery	12.19
AGCO	AGCO Corporation	Machinery	8.25
CFX	Colfax Corporation	Machinery	7.19
WTS	Watts Water Technologies, Inc.	Machinery	6.34
CR	Crane Co.	Machinery	5.67
AIMC	Altra Industrial Motion Corp.	Machinery	3.42

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