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TRIVARIATE RESEARCH

THE FOUR THINGS THAT MATTER NOW

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SUMMARY AND CONCLUSIONS

During our recent investor meetings, four topics have consistently surfaced. We address those questions in today's note.

1) **Is the market discounting higher rates?**
2) **Should investors buy growth stocks again?**
3) **Is it too late to buy energy?**
4) **Is there a greater meaning to the NFLX report?**

Our quick answers are:

1) **The perception about rates is unlikely to get incrementally hawkish from here following Powell's comments** and the Fed is unlikely to raise rates as much as investors now expect. Ultimately, that likely means the market will be higher 6-to-12 months from now.
2) **We recommend an underweight-to-neutral stance on growth.** Our bias is toward pricing power, margin expansion, and cash flow. Within the hyper-growth space, we have been pushing an "ARKK-neutral" pair trade of long mid-cap biotechnology and short software stocks with decelerating revenue and negative free cash flow.
3) **No, it is not too late. We recommend investors buy energy-sensitive equities now.**
4) **We think NFLX is a good short right now** and is emblematic of low-quality stocks with a high correlation to our work-from-home basket that likely will continue to underperform.

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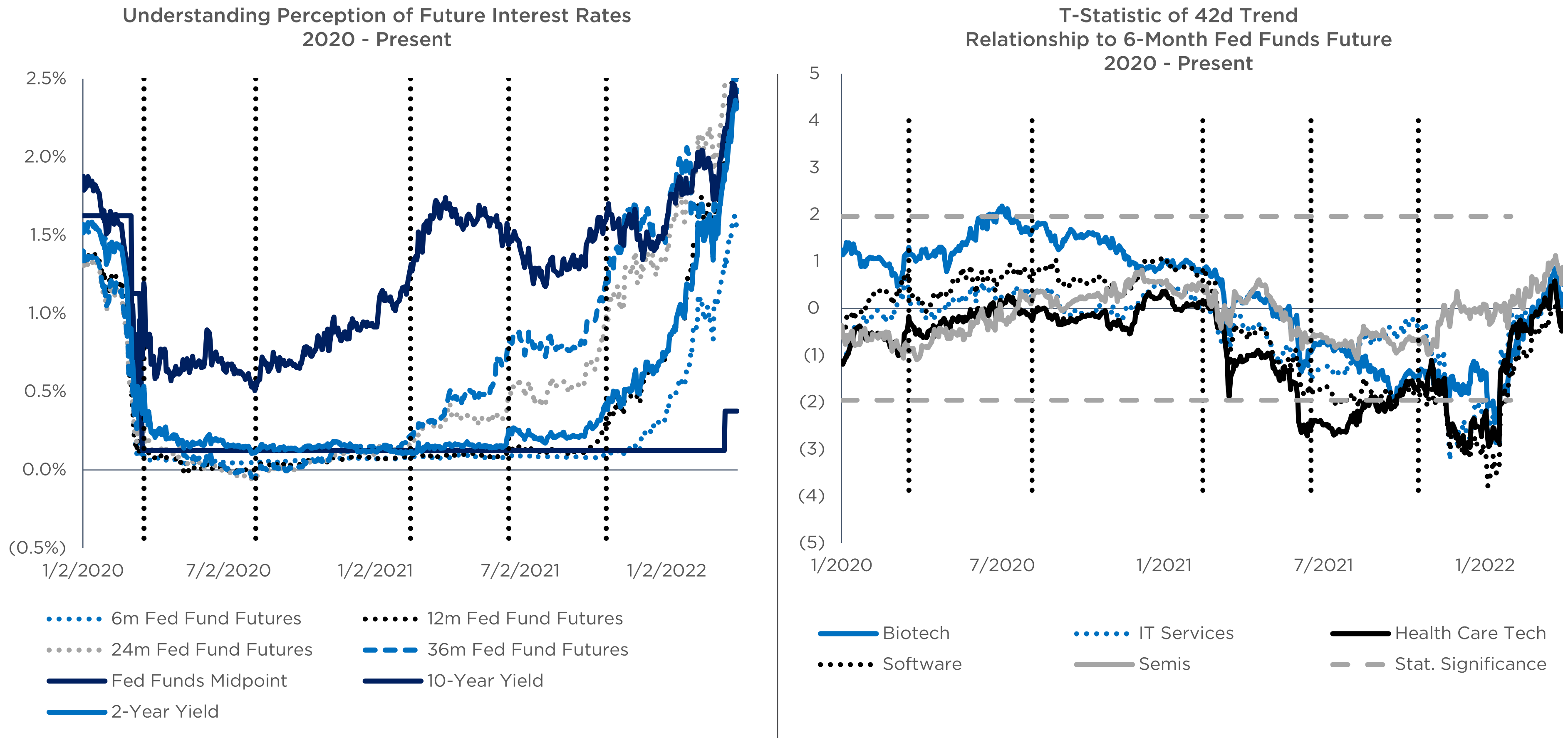
QUESTION 1: IS THE MARKET DISCOUNTING HIGHER RATES?

The rates question comes up in every one of our client meetings in some form. We show below the Fed Fund futures moves for 6-,12-,24-, and 36-months over the last two years (left chart). The five vertical lines are the initial COVID crash, the 10-year yield bottoms, when longer-term Fed Fund Futures started to rise, longer-term Fed funds slowing, and an anticipation of the Fed pivot. Perception about Future Fed Funds Rates is clearly distinct from the actual rates. Additionally, (right chart) we observed that biotech, software, and healthcare tech's returns were statistically significantly related to the Fed Fund Futures, though today there is less of a relationship.



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ANSWER 1: WE DO NOT THINK WE GET INCREMENTALLY HAWKISH

We address this by addressing the relationship between analyzing the relationship between some of the stocks in the growthier technology industries and the Fed Fund Futures. As we show on the previous page, there was a substantial change in the perception of the interest rate path last fall and that was strongly associated with a growth stock sell-off until March of this year. Recently, however, the T-statistic of the relationship between biotechnology and software industry performance and the Fed Fund Futures has been closer to zero, **indicating that the perception about rates is no longer as relevant to the performance of the faster growing / more speculative industries.**

Following Powell's comments this morning, we think it is unlikely that the Fed and investors get incrementally hawkish from here. Several investors conclude almost matter-of-factly that the Fed is late to raise rates. Our view is that Fed is smart and realizes that materially raising rates will slow the economy but will do little to solve some of the issues causing inflationary pressure. The policy is designed to achieve stable pricing and full employment, and you can not achieve this with material rate hikes. You cannot kill demand for wheat to the point there is equilibrium. You cannot incrementally solve silicon shortages that are borne from COVID-related production. You cannot crush demand for oil or natural gas to levels that create supply/demand balances. You cannot solve labor shortages resulting from lower immigration and a dearth of temporary work visas. And so on, and so on. If the Fed wants to have high inflation and create a recession, they will proceed with several more hikes.

Our conclusion is that in the end they will hike more cautiously relative to today's hawkish rhetoric, that corporate earnings will grow 2022 vs. 2021, and likely in 2023 vs. 2022. As such, the market will be higher as earnings becomes the focus.

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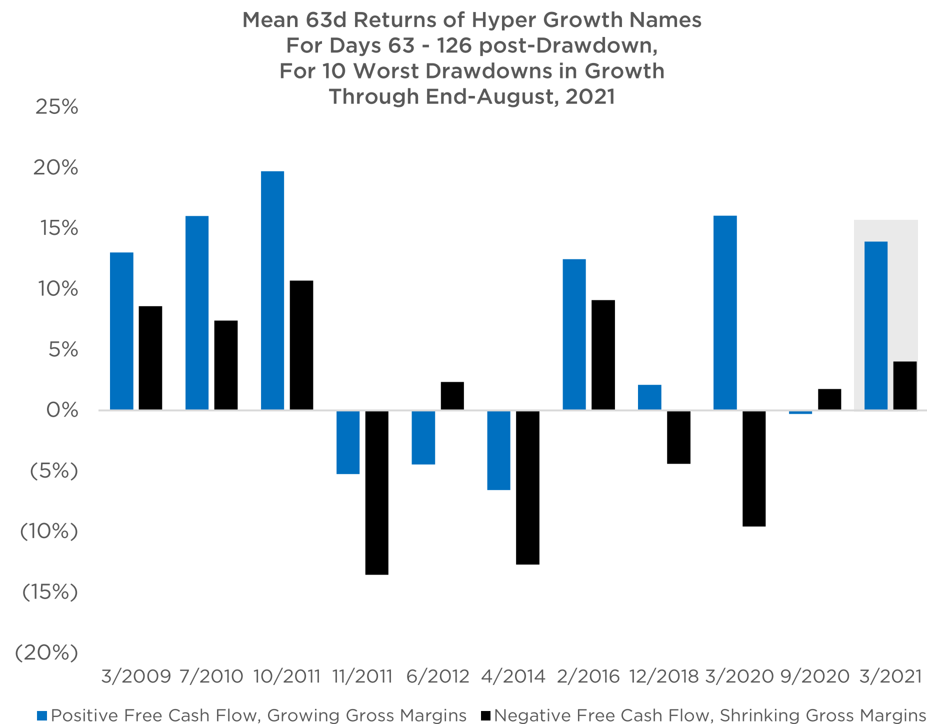
QUESTION 2: SHOULD INVESTORS BUY GROWTH STOCKS AGAIN?

We analyzed the duration and magnitude of 10 growth stock sell-offs (left chart). Positive free cash flow and expanding margins have beaten the opposite, negative free cash flow and contracting margins by nearly 10% per period following the sell-offs.

Date			Drawdown			
Starting	Ending	Days of Drawdown	Absolute	Relative	Prior 12-Month Momentum	Growth : Market Price-to-Sales Multiple
2/20/2020	3/23/2020	23	(30.4%)	3.4%	(8.1%)	1.7x
10/14/2008	3/9/2009	100	(30.2%)	1.5%	(30.2%)	1.7x
10/2/2018	12/24/2018	58	(24.2%)	(5.0%)	(0.5%)	1.8x
7/25/2011	10/3/2011	50	(21.4%)	(3.5%)	2.5%	2.1x
7/21/2015	2/8/2016	140	(17.9%)	(6.0%)	(2.7%)	1.7x
4/26/2010	7/2/2010	49	(17.3%)	(1.7%)	20.7%	1.7x
4/4/2012	6/1/2012	41	(12.4%)	(3.2%)	(3.8%)	1.9x
9/3/2020	9/23/2020	14	(11.5%)	(1.9%)	39.1%	2.3x
3/6/2014	4/11/2014	27	(11.0%)	(8.1%)	21.7%	1.8x
11/9/2011	11/25/2011	12	(10.6%)	(1.5%)	(5.2%)	2.1x
2/16/2021	3/8/2021	15	(10.4%)	(2.8%)	35.5%	2.1x



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ANSWER 2: WE RECOMMEND A NEGATIVE TO NEUTRAL STANCE

Growth stocks in our mind are getting more attractive but are unlikely to work relative to the broader market until the perception of interest rates gets more dovish. That has not happened yet. Powell seems to have become more hawkish this week and the conversation has been around large one-time adjustments to interest rates.

Within growth, however, we see it as clear that positive free cash flow and gross margin expansion will create relative outperformance (as we saw on the previous page has been the case following 9 of the last 10 growth stock sell-offs.)

We believe investors should focus on pricing power when evaluating growth stocks. Many will achieve double-digit earnings growth year nearly independent of the macro environment. Those who were correctly underweight should be increasing exposure (as we did at the end of January when we went from underweight to market-weigh technology). However, we are not bullish. For us, recommending an overweight stance on growth requires an increasing amount of companies and growth market capitalization to have gross margin expansion and positive free cash flow, and that is not a reasonable base case today.

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QUESTION 3: IS IT TOO LATE TO BUY ENERGY? ANSWER 3: NO

We have been pushing a maximum overweight energy equities stance since we initiated our business last May. In the last 12-months, energy is up 65% and the SP500 is up 5%. Year-to-date, energy is up 40.6% and the market is down 7.8%.

During the first quarter, for the first time in at least 25 years where the SP500 was down 3% or more and any sector was up 30% or more during that same quarter. That sector was energy. Naturally, people think it is too late.

We think investors should buy oil-sensitive equities now.

We are recommending energy for a host of reasons, starting with the "quantitative triple crown" of upward revisions, positive price momentum, and cheap valuation vs. history. Demand growth exceeds supply growth, and sentiment is long-term negative.

Many investors will not own energy because it is ESG verboten, or because they don't have an analyst, or because they think the terminal value of oil is zero. Our view is "more for us." Peak oil demand will likely be 8-12 years from now, and maybe longer, and we expect a great deal of free cash flow to be generated in the interim.

On our year ahead outlook we recommended four stocks with the strongest statistical relationship to changes in oil above and beyond equity market beta. XOM (up 42.2% YTD), CVX (up 40.2%), CPE (up 29.2%) and SM (up 28.7%) were our top choices. Please contact us for our top energy sector ideas today.

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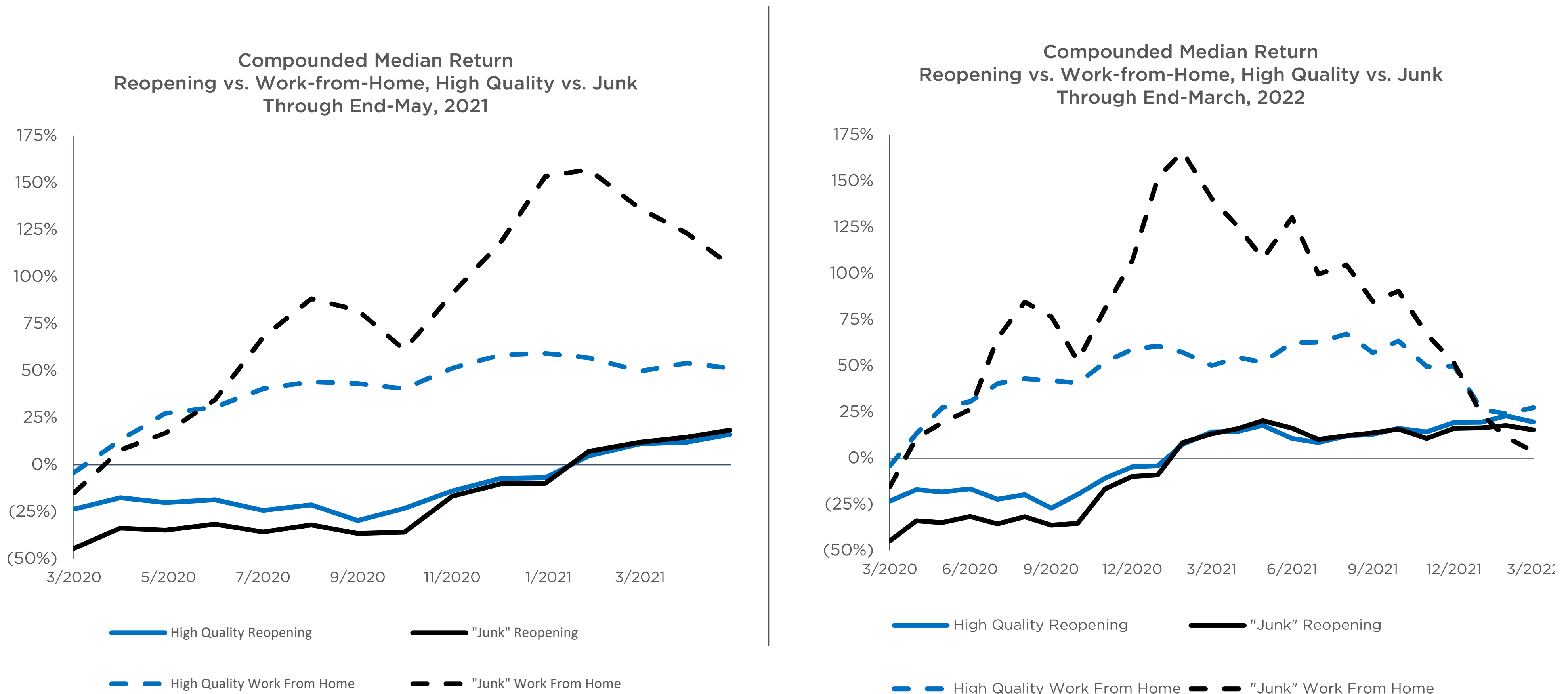
QUESTION 4: IS THERE GREATER MEANING TO THE NFLX REPORT?

We created "work from home" and "reopening" baskets and looked at the correlation of every stock in our universe to both baskets. Look at the two charts below. The left chart is performance through May 2021. At that time, junk work-from-home (like NFLX) still had massively outperformed quality reopening since the inception of COVID. The right is the updated chart through end-March 2021. The quality reopening stocks have just begun to outperform junk work-from-home.



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ANSWER 4: NFLX IS A SHORT, BUT IT IS NOT A HARBINGER OF DOOM

We see NFLX as a stock stuck in areas we have consistently highlighted as vulnerable:

1) It is a junk stock with a high correlation to our work-from-home basket
2) It has a very high negative correlation to our beta-adjusted inflation basket, making it likely to fail when rates and perception of rates are rising
3) It is expensive on price to free cash flow and does not have margin expansion, exactly the kind of growth stocks that typically lag following growth stock sell-offs

Moreover, if you combine those three points with two other points we have learned in the last 20 years:

1) When the thesis changes, do not be afraid to like something less than you used to, even if the stock is down materially. The key question is always what to do now. The business model is changing with both macro and micro headwinds materially deteriorating.
2) We have analyzed a great deal of shorting behavior over the years, and our work consistently shows that price momentum is efficacious on the short side. Most of the time you make **more** money shorting stocks well-off of 52-week highs than you do shorting at highs. This means for large baskets of stocks with charts that look like NFLX's today, shorting has historically been more prudent than buying.

Our conclusion is that NFLX is a short right now, and that the "greater" meaning from the report is only that junk work from home stocks can still lag.

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ANSWER 4: NFLX IS A SHORT RIGHT BUT THERE'S NOT MUCH MORE

Each month we offer a list of junk stocks that have a high correlation to our work-from-home baskets. In the past year, NFLX, PTON, DOCU, ZM, SAM, and BYND are among the stocks that have been on that list.

Please email us if you want the most up to date list of short ideas on this theme.

More broadly, we do not think that NFLX's issues are a harbinger or barometer of impending economic doom. The US consumer remains in strong shape, with jobs, wages, low delinquencies, retail sales, confidence, etc. all showing resilience. Rather, we see NFLX as a player in a maturing and increasingly competitive business, with slowing trends, that despite the pullback is still valued at over 100x price-to-forward free cash flow.

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