TRIVARIATE RESEARCH

PAIR-TRADING CYCLICALS INTO A RECESSION

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RESEARCH SUMMARY

The investment landscape is presenting different and potentially unconventional ways to outperform as the Fed implements quantitative tightening. One potential paradigm shift could be how investors think about buying cyclicals given how anticipatory markets have been of a recession-induced earnings decline. Perhaps the mantra of selling when they are cheap and buying when they are expensive will change going forward, particularly for those cyclicals where excess profits could vastly improve income statements and balance sheets for sustained periods of time. In that light, we evaluated thirteen historically cyclical industries to see where there are potential long / short opportunities.

We looked at the historical relative and absolute price-to-forward earnings and sales, net margins over time, and historical earnings declines from prior peaks to prior troughs. Our goal is to contextualize any potential imminent earnings decline for these thirteen industries: airlines / airfreight & logistics, autos and auto parts, building products, chemicals, electrical equipment, energy equipment & services, hotels, restaurants and leisure, homebuilders, machinery, metals & mining, oil, gas & consumable fuels, semiconductors & semi caps, and specialty retail.

Many cyclicals now trade at all-time low absolute multiples and this left us wondering whether an earnings collapse was already largely discounted. Even if a third or more of earnings are wiped out, our judgment is that we could there could still be relatively attractive risk-reward.

Most cyclical companies today do not have huge capacity or inventory build-ups that could exacerbate an earnings collapse. This likely means a decline will not be as quite as bad as the worst cyclical declines in history. Some cyclicals are embedding and pricing-in a larger earnings collapse than others, and hence, we offer long / short stock ideas based on relative valuation and estimate achievability – see slides 15 and 16.

INVESTMENT CONCLUSIONS

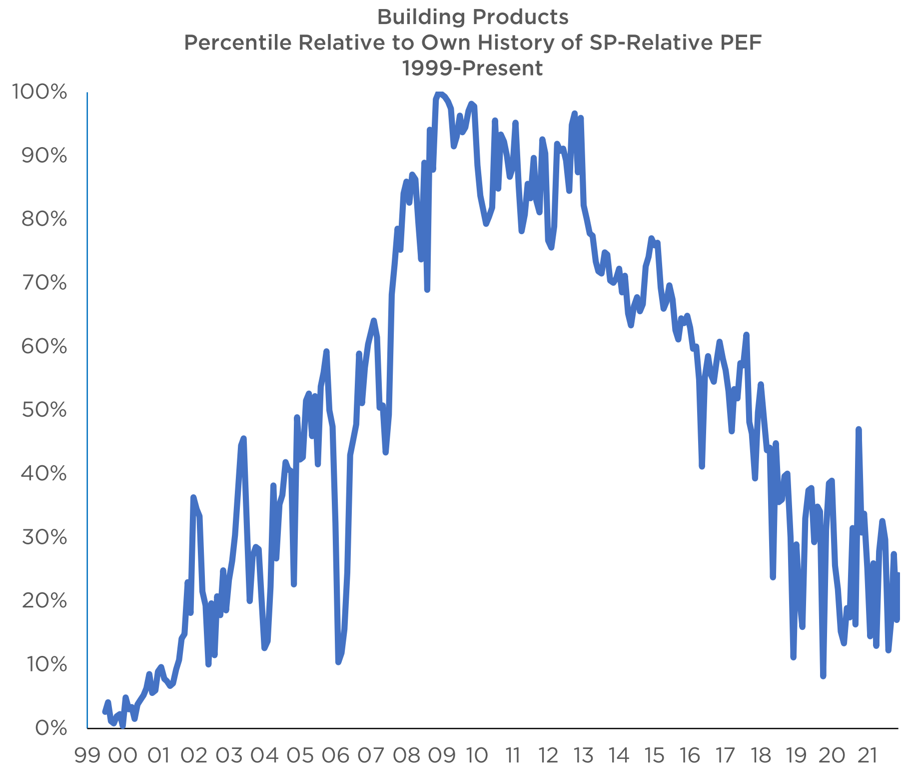
Valuation and margins: On valuation – specifically price-to-forward earnings relative to the broader SP500 - building products, chemicals, homebuilders, metals, oil, gas & consumable fuels, and specialty retail have basically never been cheaper. On profitability, chemicals, machinery, homebuilders, metals & mining, semiconductors and semiconductor capital equipment, building products, and specialty retail have peak or record net margins. Machinery and building products are now expensive on price-to-sales, with machinery at multi-decade highs.

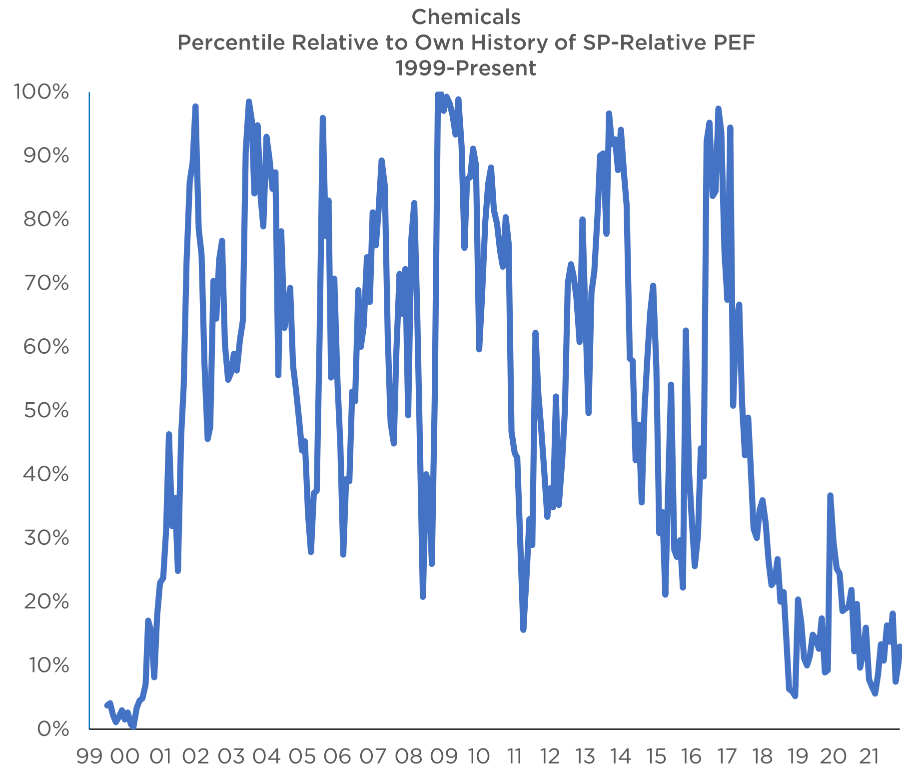
Earnings scenario analysis: In aggregate, it appears the three most severe prior troughs reduced earnings for these cyclical industries between one-third and one half, though in most cases earnings typically strongly grow following these declines. If we assume an earnings decline of 33% for each industry, and a 10% decline in earnings for the overall market, then oil, gas & consumables, homebuilders, specialty retail, metals & mining, chemicals and building products all still look cheap. Hotels, restaurants & leisure, electrical equipment, and machinery do not look attractive, while semiconductors (which we would argue merit a premium to the market for other reasons) would still trade at a slight discount to the market in that scenario. Oil and gas stocks would trade at 8.6x forward earnings if their estimates are cut by a third. **Machinery stocks would trade at 19.7x under the same assumptions. We continue to recommend long energy and short machinery.**

Except for airfreight & logistics, estimates are forecasted to rise for the other 12 cyclical industries. A reset is likely as recessionary fears grow. Our judgment is that the potential for a material earnings decline in the near-term (between now and year end) and the medium-term (2023-2024) varies by industry. We think **autos, electrical equipment, hotels, restaurants & leisure, machinery and specialty retail are more likely to see a 33% earnings hit earlier than the other industries. As such, we prefer chemicals, metals & mining, oil, gas, & consumable fuels, and semiconductors & semi caps believing they have lower risk of an earnings hit this year.**

BUILDING PRODUCTS AND CHEMICALS ARE QUITE CHEAP VS HISTORY

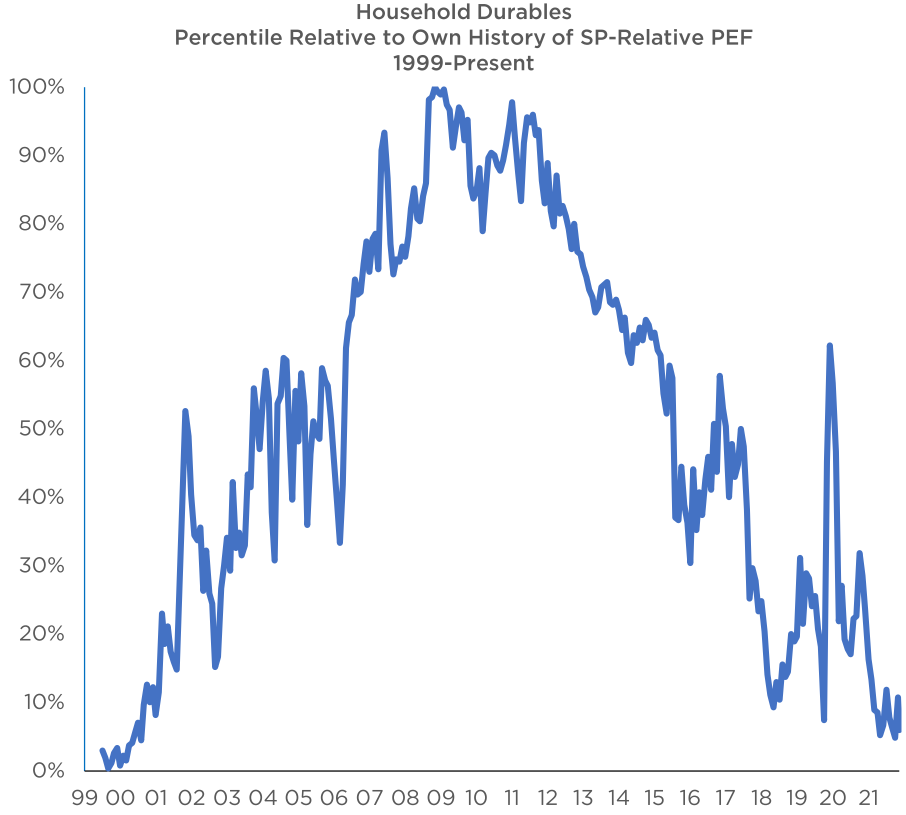
We observed that many of the traditional cyclical industries have experienced multiple contraction as their earnings continued to grow. What clearly is in the price is a substantial collapse in earnings. Building products (left) and chemicals (right) are near 25-year lows on relative-to-SP500 price-to-forward earnings.

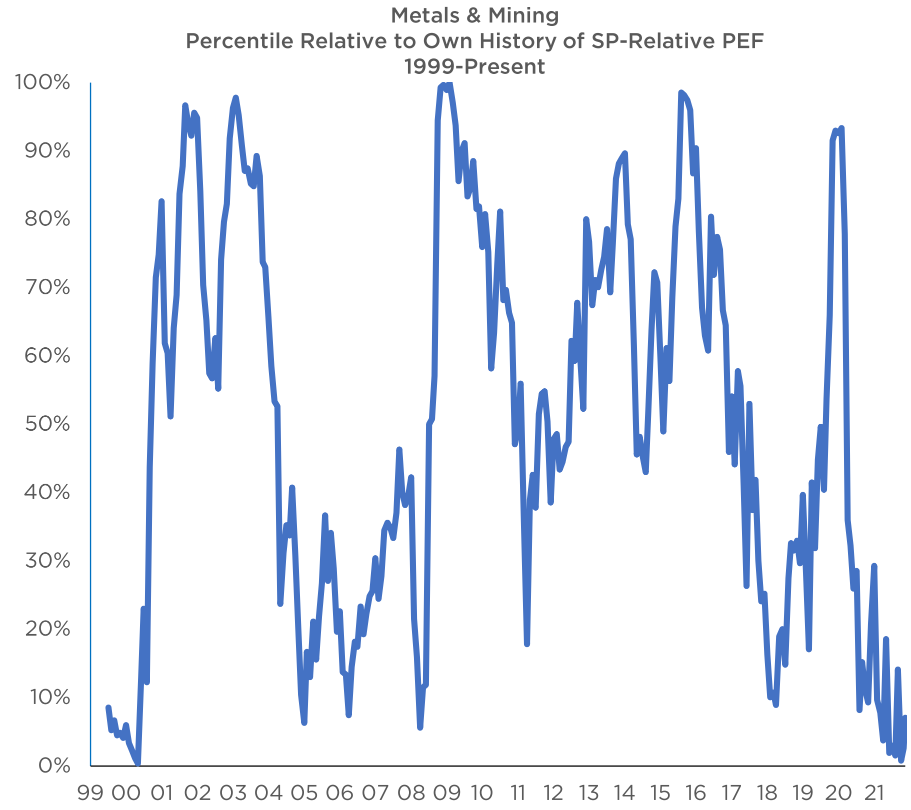




HOMEBUILDERS AND METALS & MINING ARE ALSO CHEAP

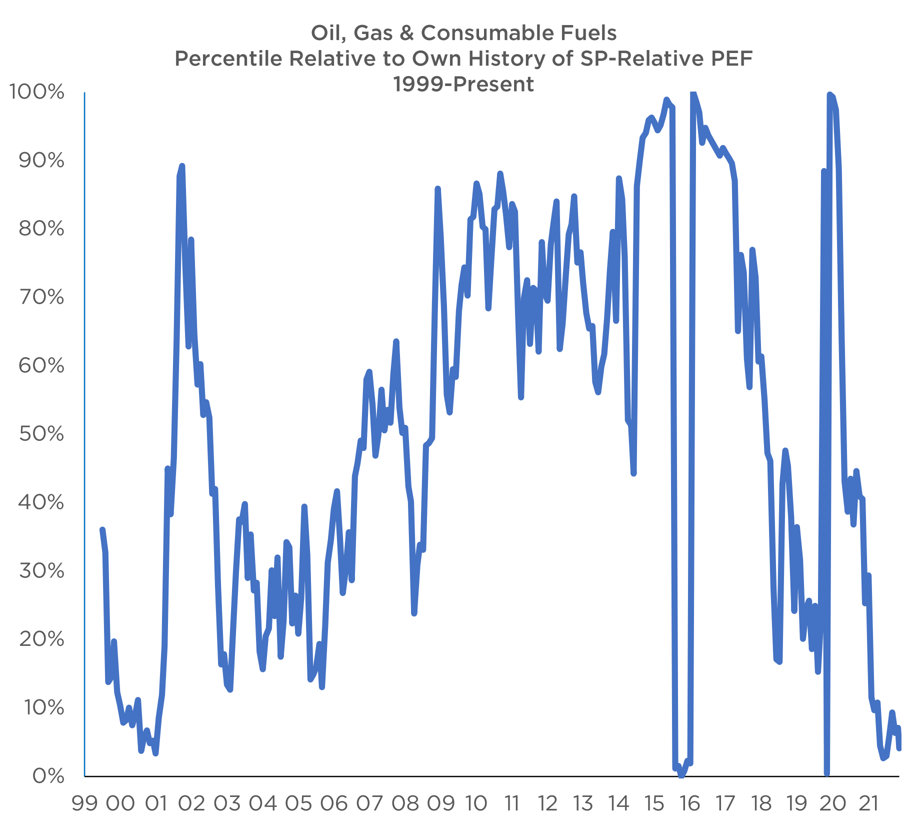
Homebuilders, which comprise most of household durables cohort (left) and metals & mining (right) are also near multi-decade lows on relative-to-SP500 relative their-own-history price-to-forward earnings. Many homebuilders and steel companies trade below 5x forward earnings.

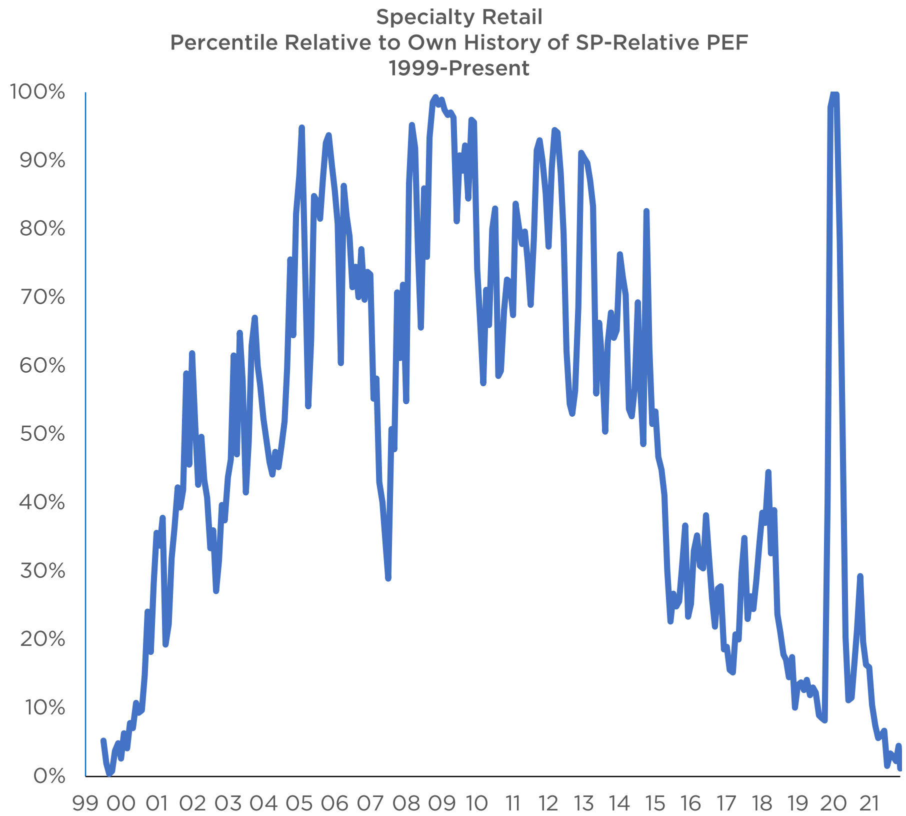




ENERGY AND SPECIALTY RETAIL HISTORICALLY CHEAP ON EARNINGS

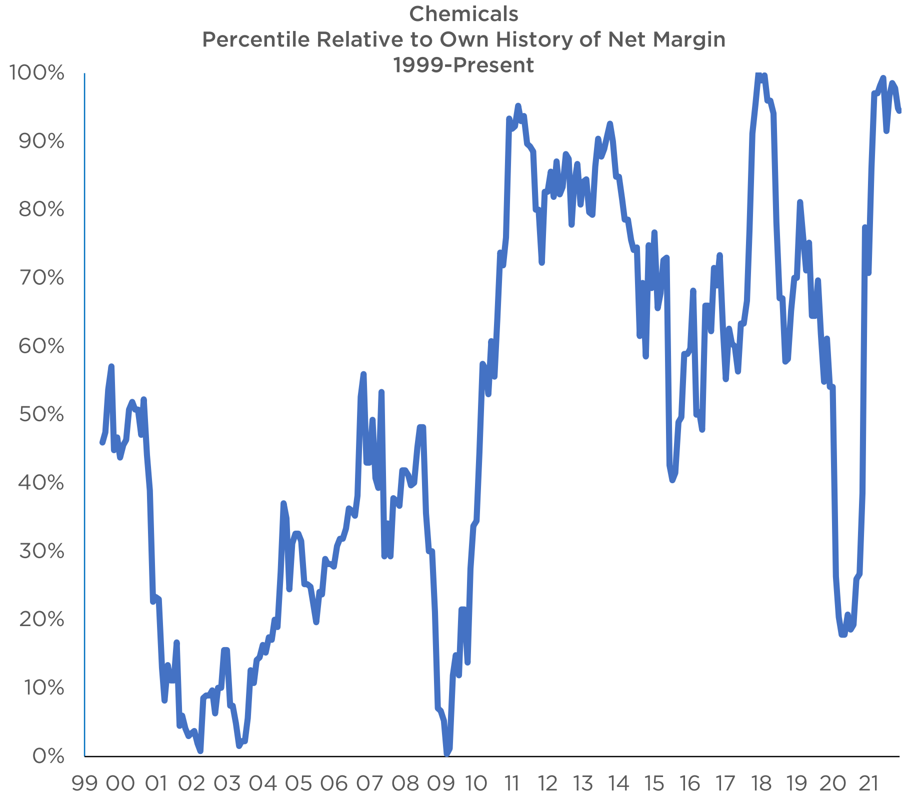
Despite the massive outperformance of energy stocks in the last year, the stocks are still near multi-year lows on relative price-to-forward earnings as earnings strongly grew with higher oil prices (left). Specialty retail stocks have also never been cheaper, and many trade in the low-to-mid-single digits on absolute price-to-forward earnings. They are at all time lows on relative to SP500 price-to-forward earnings. (right). Rising oil means oil stocks will be better than specialty retail stocks in the near-to-medium term.

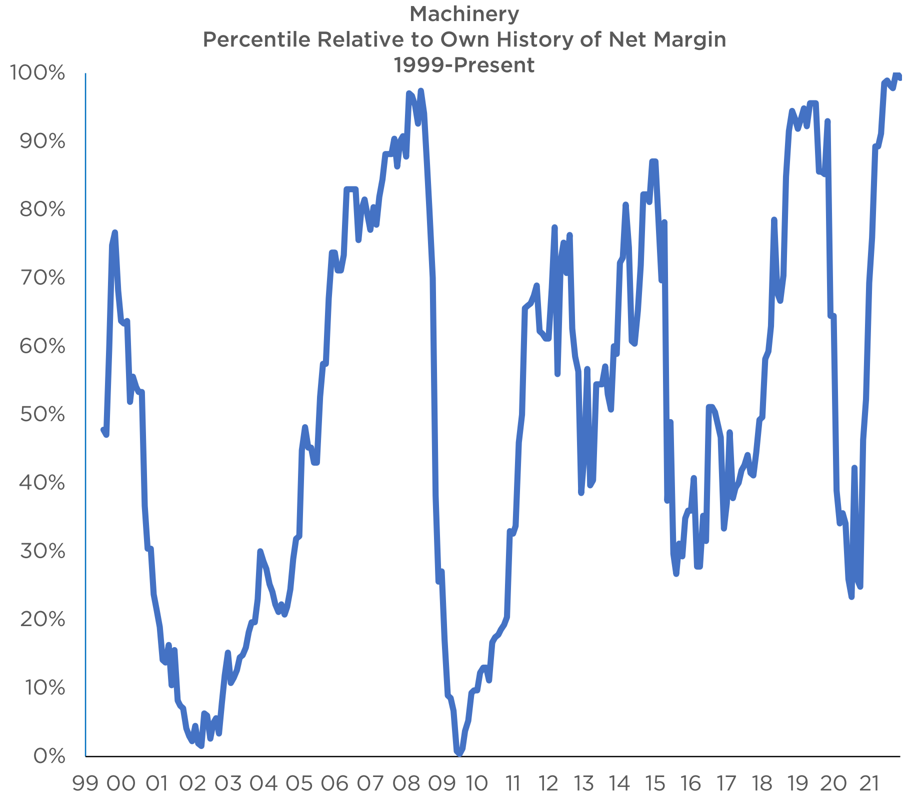




CHEMICALS AND MACHINERY MARGINS ARE AT HIGHS

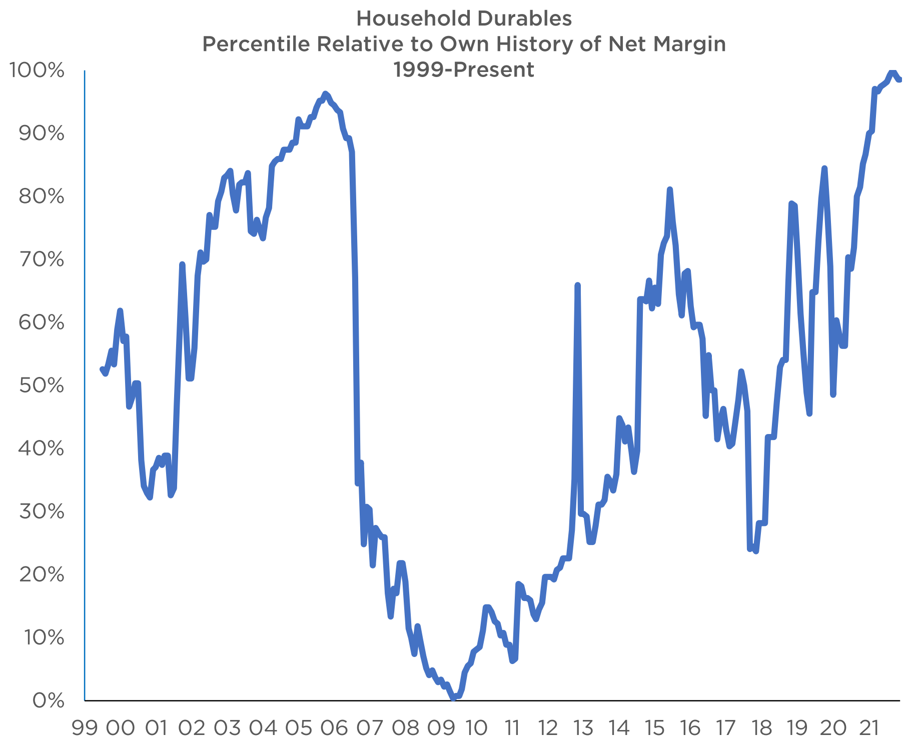
Profitability has been strong for many of these cyclical industries, and the oft-used playbook for deep cyclicals is to sell them when profits have peaked and multiples are low. Chemicals (left) and machinery (right) have record net margins.

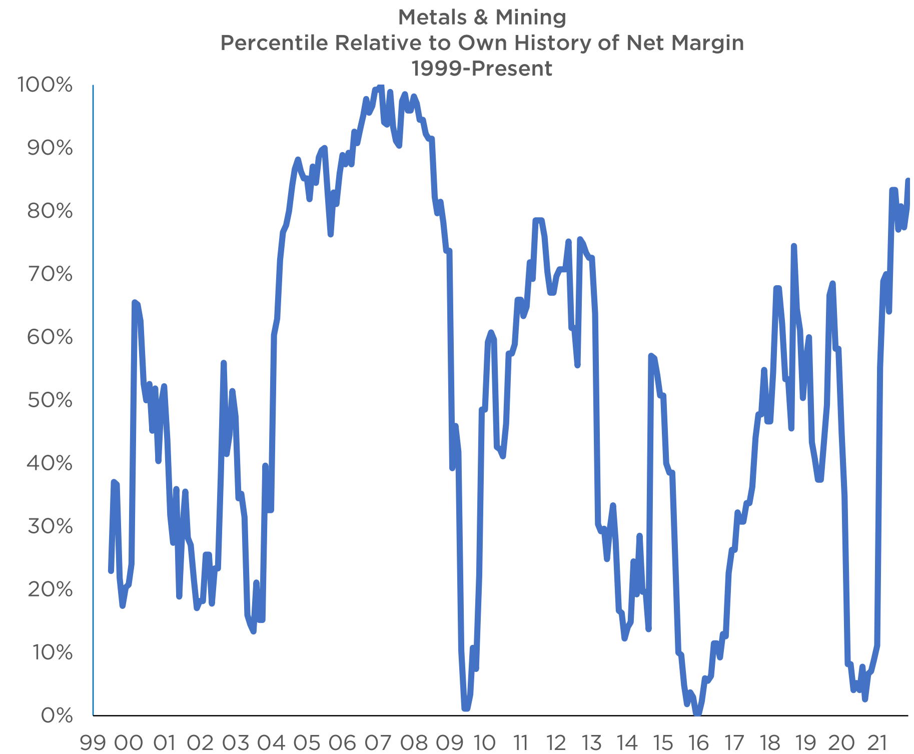




HOMEBUILDERS AND METALS HAVE NEVER BEEN MORE PROFITABLE

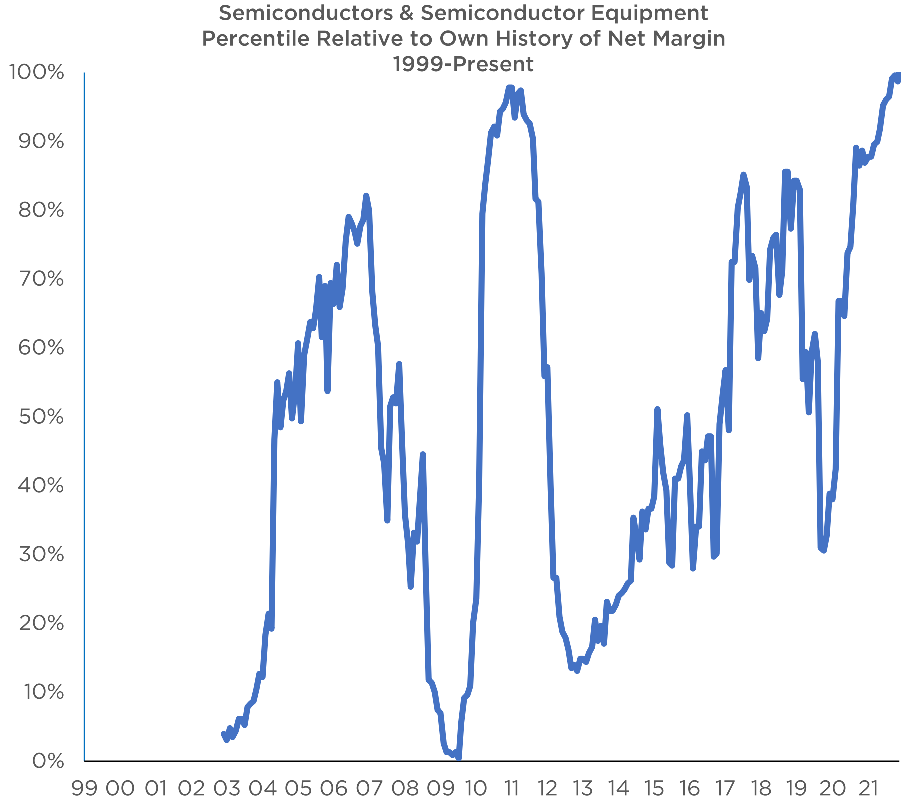
Household durables (left) like homebuilders also have record profitability, and supply /demand dynamics in steel, aluminum, and copper have left the median net margin for metals & mining stocks are record highs as well (right).

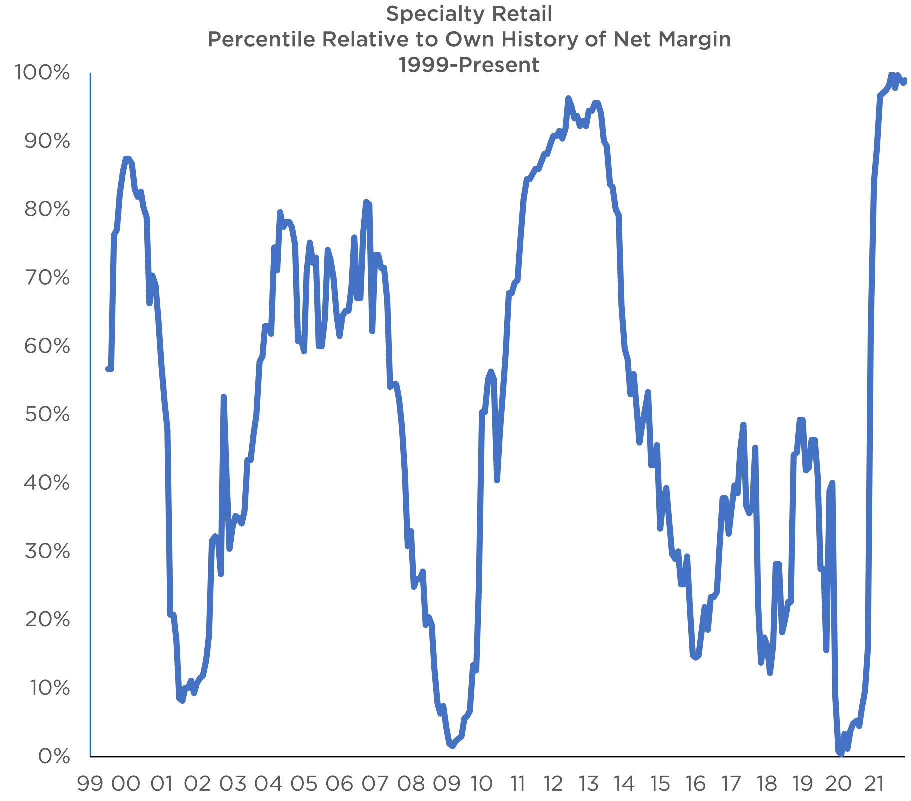




SEMICONDUCTORS AND SPECIALTY RETAIL ALSO HAVE PEAK MARGINS

Semiconductor and semiconductor capital equipment stocks have 20+ year high net margins (left), as do specialty retail stocks (right).





PRICE-TO-SALES VARIES, BUT IS ATTRACTIVE IN SOME INDUSTRIES

Stocks at are cheap on price-to-forward earnings but have record net margins are not necessarily cheap on price-to-sales. Homebuilders (left) and metals & mining (right) are cheap on both traditional valuation metrics.

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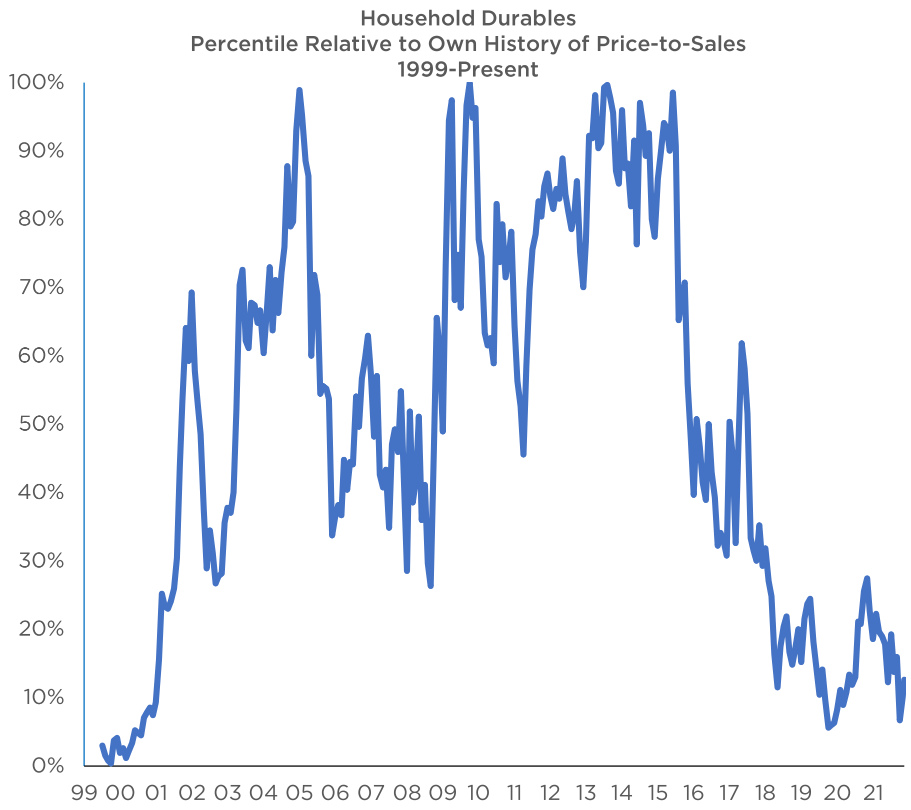
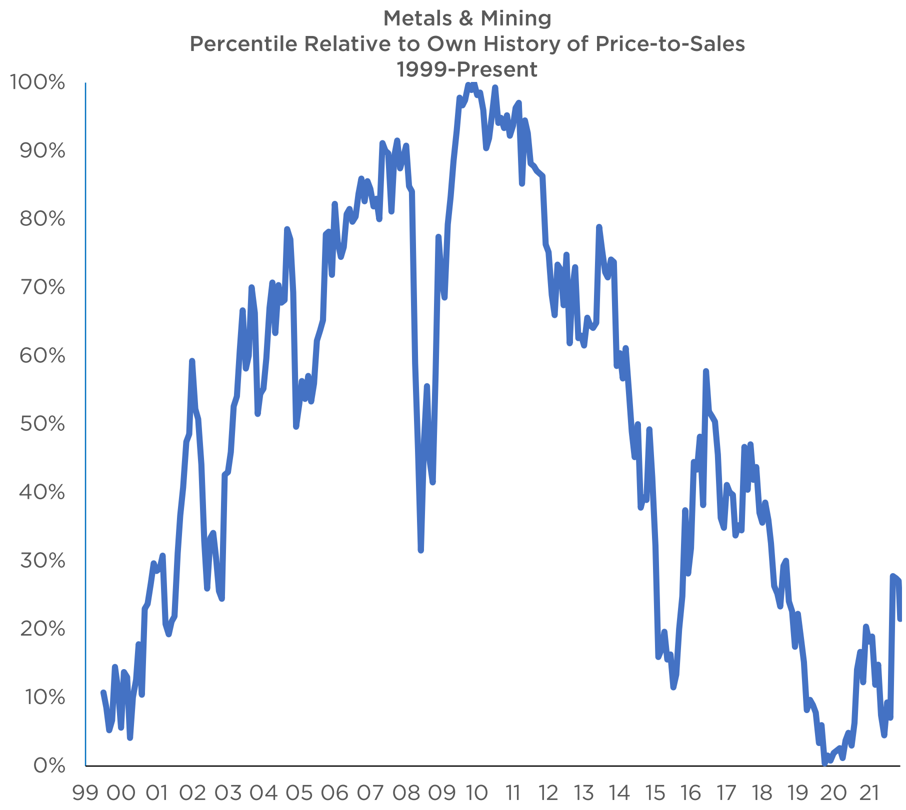
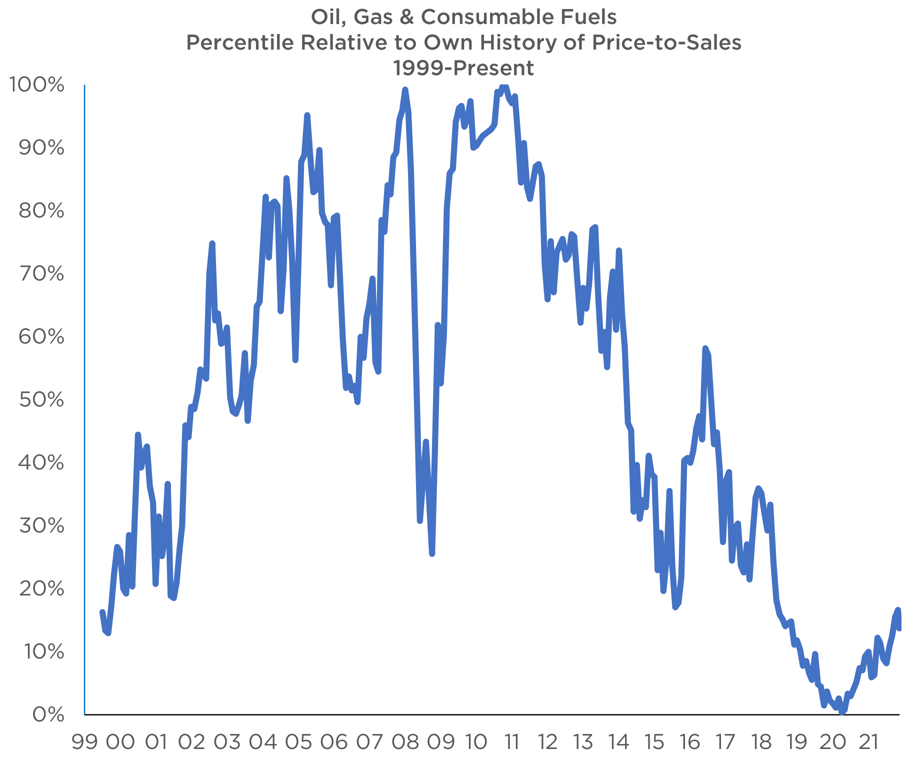
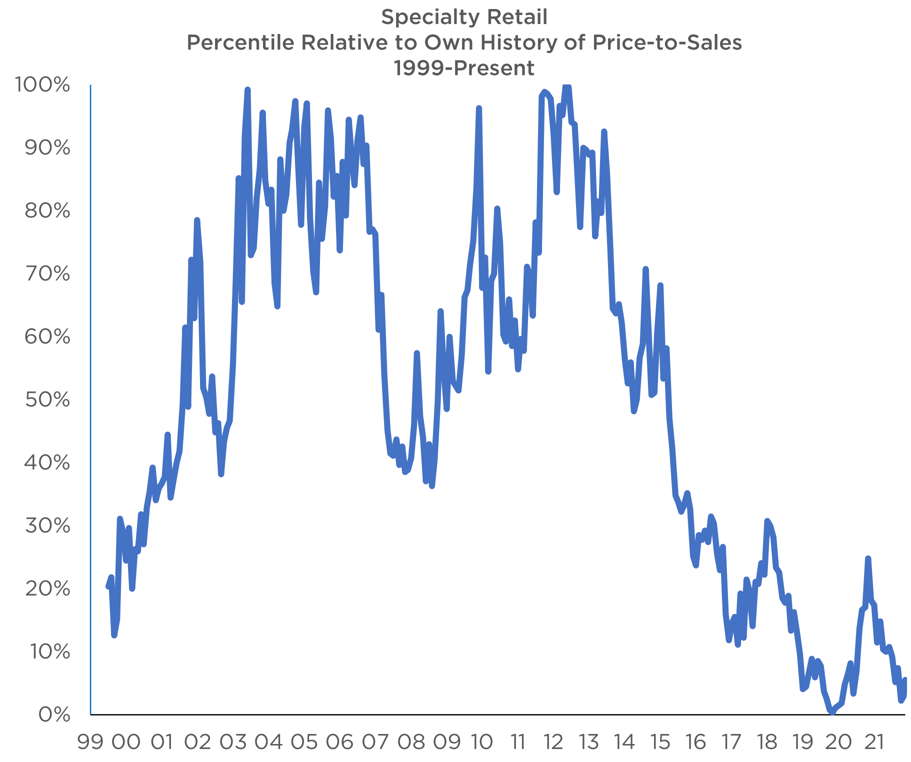




ENERGY AND SPECIALTY RETAIL ARE ALSO CHEAP ON SALES

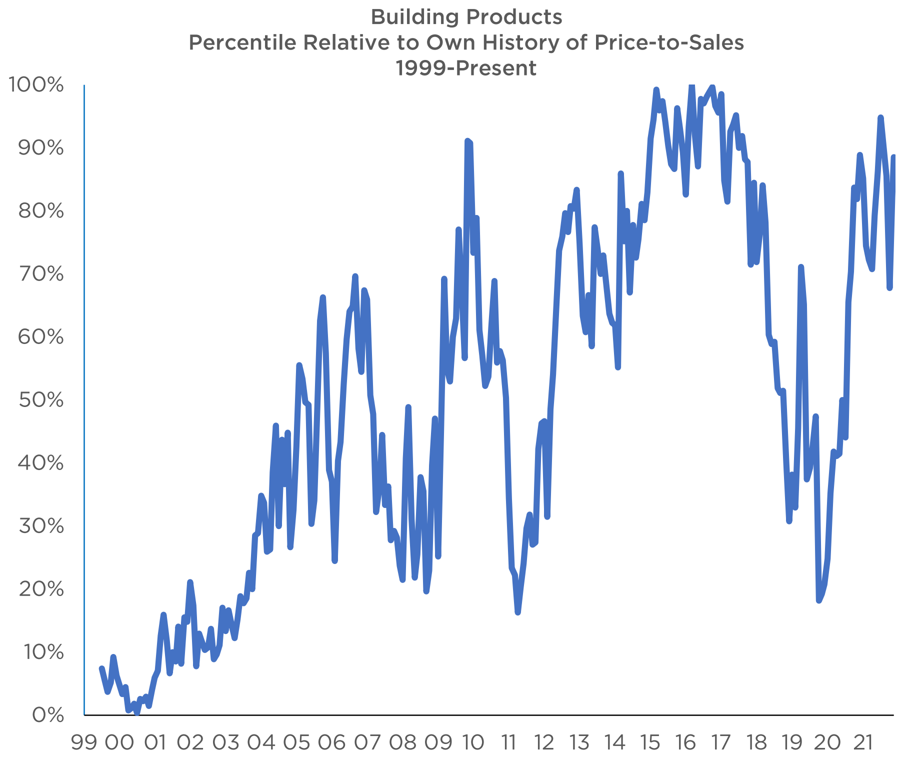
Despite the outperformance of energy stocks (left) they remain compelling cheap on price-to sales, more expensive 80% of the time in their history. For specialty retail (right) valuation is at a trough, though macro conditions and industry challenges likely make this more structural than cyclical in many cases.

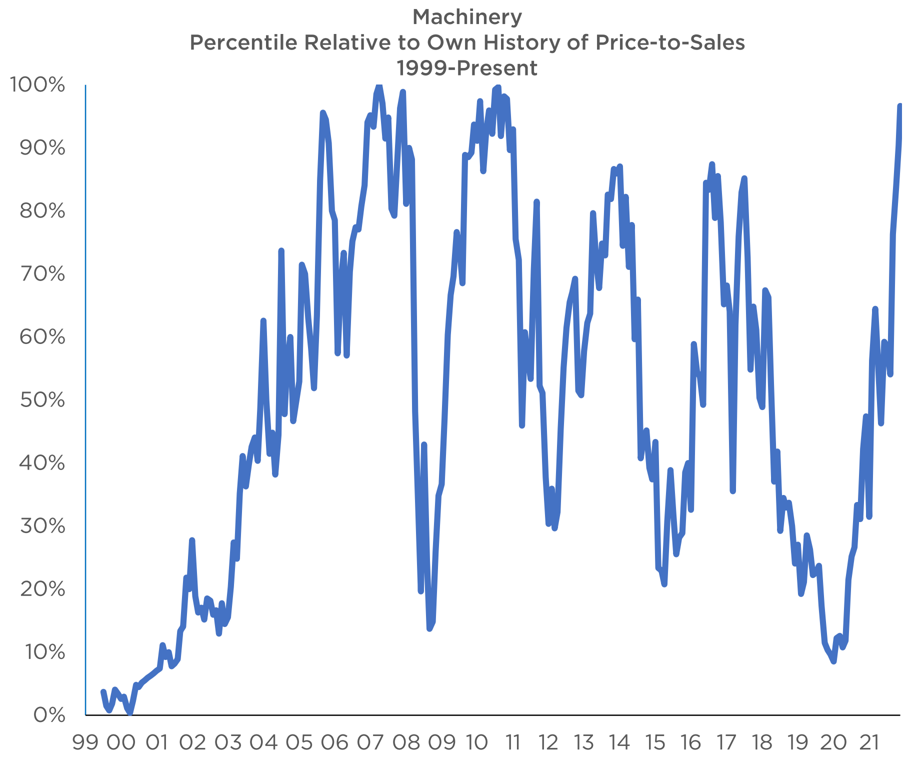




BUILDING PRODUCTS AND MACHINERY ARE LESS CHEAP ON SALES

On price-to-sales, building products look relatively more expensive (left) and machinery stocks are expensive (right).





USING HISTORICAL DOWNTURNS TO GAUGE WHAT'S PRICED IN

The most severe prior cyclical downturns reduced earnings between 1/3 and ½. If we assume an earnings decline of 33% for each cyclical industry, and a 10% decline in earnings for the overall market, then oil, gas & consumables, homebuilders, specialty retail, metals & mining, chemicals and building products all still appears cheap in that scenario. Hotels, restaurants & leisure, electrical equipment, and machinery do not look attractive, while semiconductors (which we would argue merit a premium to the market for other reasons) would still trade at a slight discount to the market in that scenario. This supports our long energy / materials and short industrials calls based on relative estimate achievability and risk to forward estimates. Oil, Gas and Consumable fuels would be at only 8.6x forward earnings if their estimates are cut by a third whereas machinery would be at 19.7x under the same assumptions.

Historical Average Price-to-Forward Earnings
Vs. Current Price-to-Forward Earnings
Vs. Price-to-Forward Earnings Assuming Earnings/Price Declines

Industry	Avg. Price-to-Forward Earnings At Historical Troughs	Current Price-to-Forward Earnings	Price-to-Forward Earnings Fixed Price 33% Earnings Decline	Price-to-Forward Earnings 33% Earnings Decline 10% Price Decline
Oil, Gas & Consumable Fuels	18.0x	7.7x	11.5x	8.6x
Household Durables	16.9x	8.1x	12.0x	9.0x
Specialty Retail	25.1x	8.1x	12.1x	9.0x
Metals & Mining	22.6x	10.6x	15.8x	11.8x
Chemicals	16.3x	13.6x	20.3x	15.1x
Building Products	18.6x	14.3x	21.3x	15.9x
Automobiles & Auto Components	39.2x	16.3x	24.3x	18.1x
Airlines & Airfreight & Logistics	19.2x	17.7x	26.4x	19.7x
Machinery	21.0x	17.8x	26.5x	19.7x
Semis & Semis Equipment	24.6x	18.3x	27.4x	20.4x
Electrical Equipment	21.2x	20.3x	30.2x	22.5x
Hotels, Restaurants & Leisure	29.9x	23.6x	35.2x	26.2x
Energy Equipment & Services	10.3x	32.2x	48.1x	35.8x

THE NEXT 2 YEARS: OUR JUDGMENT VS. THE SELL-SIDE CONSENSUS

Except for airlines / airfreight & logistics, analysts are still projecting earnings growth for all 13 cyclical industries. We show our judgment about a near-term (between now and year end) and medium-term (2023-2024) collapse in earnings below. Our view is autos, electrical equipment, hotels, restaurants and leisure, machinery and specialty retail are more likely to see a 33% earnings hit earlier than the other industries. We prefer chemicals, metals & mining, oil, gas, & consumable fuels, and semiconductors & semi caps as having lower risk of a major earnings hit this year.

Consensus and Trivariate Views
By Cyclical Sector

			Is a 33% or More Earnings Decline Likely?	
Industry	Consensus View	Comment on Consensus	Trivariate Judgment Next 12 Months	Trivariate Judgment 2023-2024
Airlines & Airfreight & Logistics	Negative to Positive	(30B) a year ago to 15B now	Unlikely	Likely
Automobiles & Auto Components	119.7%	From 15b to 33B, but peak of 36B was 2/22	Possible	Likely
Building Products	56.1%	From 10b to 16b in last year	Unlikely	Likely
Chemicals	90.2%	1-year expectations have doubled in last year	Unlikely	Possible
Electrical Equipment	18.8%	Estimates are down 10% in last month	Possible	Likely
Energy Equipment & Services	Less Negative	More than (50b) in 2020 to (3b) and improving now	Unlikely	Likely
Hotels, Restaurants & Leisure	Negative to Positive	(27B) a year ago to 7b now	Possible	Likely
Household Durables	44.6%	Expectations continue to expand	Unlikely	Likely
Machinery	38.4%	27B to 37B YoY but down from 40B 3 months ago	Possible	Likely
Metals & Mining	362.3%	Estimates have doubled YoY and still rising	Unlikely	Possible
Oil, Gas & Consumable Fuels	Negative to Positive	(110B) in March 2021 to 105B now and risng	Unlikely	Possible
Semiconductors & Semiconductor Equipment	53.8%	Estimates continue to rise	Unlikely	Possible
Specialty Retail	43.2%	Flattish last few months	Possible	Likely

CYCLICALS THAT ARE CHEAP EVEN IF EARNINGS DECLINE 33%

Oil & Gas, metals & mining, homebuilders, and building products stocks that appear cheap even if earnings are down 33% in a market where overall earnings are down 10%.

Quantitatively Derived Longs
Semis, Oil & Gas, Metals, Building Products, and Homebuilders,– May 18th Close, 2022

Ticker	Company	Industry	Market Cap ($B)
AMAT	Applied Materials, Inc.	Semis & Semis Equip	98.36
LRCX	Lam Research Corporation	Semis & Semis Equip	66.23
KLAC	KLA Corporation	Semis & Semis Equip	49.82
NXPI	NXP Semiconductors N.V.	Semis & Semis Equip	46.05
MCHP	Microchip Technology Incorporated	Semis & Semis Equip	36.77
ON	ON Semiconductor Corporation	Semis & Semis Equip	24.26
OXY	Occidental Petroleum Corporation	Oil, Gas & Consumable Fuels	60.26
CLR	Continental Resources, Inc.	Oil, Gas & Consumable Fuels	35.67
FANG	Diamondback Energy, Inc.	Oil, Gas & Consumable Fuels	22.78
MRO	Marathon Oil Corporation	Oil, Gas & Consumable Fuels	18.94
APA	APA Corporation	Oil, Gas & Consumable Fuels	13.68
FCX	Freeport-McMoRan Inc.	Metals & Mining	51.22
STLD	Steel Dynamics, Inc.	Metals & Mining	14.32
RS	Reliance Steel & Aluminum Co.	Metals & Mining	11.30
AA	Alcoa Corporation	Metals & Mining	11.16
MAS	Masco Corporation	Building Products	12.82
CSL	Carlisle Companies Incorporated	Building Products	12.74
BLDR	Builders FirstSource, Inc.	Building Products	10.88
DHI	D.R. Horton, Inc.	Household Durables	23.13
LEN	Lennar Corporation	Household Durables	20.98
NVR	NVR, Inc.	Household Durables	13.61
PHM	PulteGroup, Inc.	Household Durables	9.89

CYCLICALS THAT WOULD BE UNATTRACTIVE IF EARNINGS DECLINED

Select machinery, specialty retail, and electrical equipment stocks that would be unattractively valued if earnings declined 33%.

Quantitatively Derived Shorts
Electrical Equipment, Machinery, and Specialty Retail – May 18th Close, 2022

Ticker	Company	Industry	Market Cap ($B)
ETN	Eaton Corporation plc	Electrical Equipment	54.47
EMR	Emerson Electric Co.	Electrical Equipment	49.63
AME	AMETEK, Inc.	Electrical Equipment	26.87
ROK	Rockwell Automation, Inc.	Electrical Equipment	22.72
ITW	Illinois Tool Works Inc.	Machinery	63.34
OTIS	Otis Worldwide Corporation	Machinery	30.53
FTV	Fortive Corporation	Machinery	20.71
DOV	Dover Corporation	Machinery	18.65
IR	Ingersoll Rand Inc.	Machinery	17.71
HD	The Home Depot, Inc.	Specialty Retail	294.7
TJX	The TJX Companies, Inc.	Specialty Retail	70.69
ORLY	O'Reilly Automotive, Inc.	Specialty Retail	39.43
AZO	AutoZone, Inc.	Specialty Retail	36.51
ROST	Ross Stores, Inc.	Specialty Retail	32.61
TSCO	Tractor Supply Company	Specialty Retail	20.32
ULTA	Ulta Beauty, Inc.	Specialty Retail	18.3

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