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TRIVARIATE RESEARCH

MARKING-TO-MARKET THE MARKET

05/01/2022

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SUMMARY AND CONCLUSIONS

After digesting and analyzing the first 10 days of earnings season, we are focused on three major themes:

1) **The US Consumer** – Earnings season so far has showed us that the consumer is in excellent shape. Banks, discretionary, and staples in aggregate confirmed this, and our preview to focus on value stocks in the discretionary space and avoid expensive growth staples has largely been supported.
2) **Growth Stocks** – We have seen substantial dispersion, but our conclusion in aggregate is that it is too early to be bullish on growth investing. For relative opportunities, we have been circling around semiconductors for the first time in six months given they are down 25% YTD. We also recommend mid-cap. biotechnology as a better speculative bet than profitless software among the hyper growth universe.
3) **Earnings recap:** Marking-to-market the data we gathered from corporate earnings reports so far and the price action, we are more bullish now than we were last week at the same time. The consumer remains robust, corporate earnings look likely to grow, yet in the last week, stock prices are lower and sentiment has gotten more negative.

We also continue to recommend energy as our top sector and offer seven reasons we are still bullish. While we are aware there could be short-term pullbacks, we currently see supply-demand imbalances as likely for a 18-24-month time-frame, and this combined with momentum, revisions, and valuation keep us sanguine.

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EARNINGS SO FAR SUPPORT A BULLISH STANCE ON THE US CONSUMER

We wrote in late March that we thought the US consumer was in good enough shape to increase the Fed's chances of a soft landing.   The first quarter earnings results so far have indicated continued overall strength in the US consumer, something we previewed in our March 28th consumer note "Threading the Needle".

Banks: Management teams from GS, C, BAC, and JPM among others consistently reported that consumer spending and demand remains strong. Master Trust data showed 30-day credit card delinquencies were modestly lower month-over-month, and 90-day credit card delinquencies remain hovering near all-time lows. V and MA results also showed a buoyant consumer.

Consumer: Over 90% of staples and 60% of discretionary companies reporting so far have shown upside surprise, with the only demonstrable softness in COVID winners where trends and expectations are slowing (DPZ, ORLY). The magnitude and breadth of strength was noteworthy, including restaurants (CMG, MCD, CAKE, BLMN), apparel (SKX), gaming (BYD), food (MDLZ). Many of the management teams, like the banks, pointed out that there is no material change in consumer spending.

Energy: We have observed limited evidence of demand destruction, miles driven, or signs that the consumer behavior is slowing. The cash generation reported by both XOM and CVX are high-level proxies for the enormous ability of the consumer to absorb higher energy prices to date.

Macro: The personal income and spending data showed upside surprise in consumption. The savings rate, while down from 6.8% to 6.2%, is still healthy, and wages from the Employment Cost Index showed the largest quarterly increase since 1990.

Consumer ideas: We recommend long value consumer discretionary and short expensive growth. We highlighted MDLZ, MGM, DRI, and HAS, among others, in our preview, and are more cautious staples like BGS, SKIN, CLX, and CL, among others.

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IT IS STILL TOO EARLY TO BE BULLISH ON GROWTH STOCKS…

We know the consensus view is that the Fed has done a terrible job and is way behind the curve. Our judgment is what matters for stocks is not a critique of the Fed, but rather, can they can incrementally hawkish now? We have been tracking the Fed Fund Futures as a proxy for the perception about rates, and that has moderated after a sharp move last fall into the spring of this year. Our judgment remains that between underweight and market-weight exposure to growth stocks is prudent, focusing on gross margin expansion, pricing power, and positive free cash flow. We have seen material bifurcation between winners and losers during earnings season so far, particularly where starting valuation was wide (FB vs. NFLX).

NFLX: As we mused about last week, we think this the type of stock that we would be comfortable beings short when we have other longs against it. While we do not do fundamental single-stock recommendations, we recognize they reported both a change in the business model and substantial macro pressure. This, combined with the stock having a high correlation to our work-from-home basket (we remain cautious this group), a high correlation to our beta-adjusted inflation basket (we remain cautious this group also) and now, despite the pull-back, the stock trades at roughly 100x price-to-forward free cash flow (not the kind of stock that typically works following a growth stock sell-off). Our experience is more alpha is generated on the short side after a stock is way down from its highs, rather than shorting at its highs.

Long mid-cap biotech and short profitless software: Biotech now is basically discounting zero innovation. Only 15% of biotech companies ever generate cumulative positive free cash flow, as they typically get bought once safety and efficacy is imminent. Hence, buying the pipeline at these prices and shorting profitless software against it to remain “ARKK factor”-neutral while still getting exposure to some innovation is our recommendation.

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…BUT SEMIS ARE STARTING TO LOOK INTERESTING

What's the catalyst for buying growth? While any directionally dovish commentary could certainly be a catalyst for growth-style stocks to appreciate, we think what is more likely is continued data points through the earnings season that many of these companies have pricing power and earnings growth.

Earnings: We think 2022 earnings for technology will be well above 2021 earnings. The current consensus is for 10% earnings growth this year, on top of 32.2% growth last year. Even if these slightly moderate, this still offers good risk-reward for a sector now at just above 22x forward earnings.

Semiconductors: Many semiconductor companies are in this odd position of over-earning their long–term trend, but with decelerating current fundamentals. The market has anticipated a point later this year where production and consumption align and grappled with the specter of potential future backlog cancellations even as book-to-bills are currently above 1.0x, causing the group to retrace 25% so far this year. However, our view is that the long-term potential of above GDP revenue growth fueled by end-market silicon penetration, pricing power, and the technological moats many of these business enjoy creates an interesting risk-reward. It is hard to know when the stocks will trough, but what feel confident in is that a basket of AMAT, KLAC, LRCX, ASML, SNPS, CDNS, TXN, ADI will materially beat the S&P500 over a 2-5-year horizon.

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SEVEN REASONS WE STILL LIKE ENERGY EQUITIES

Revisiting our top sector call - the reasons to like energy equities include:

1) **Upward earnings revisions** – the correlation between the change in oil prices and the change in the net income of the energy sector is 0.81, and oil prices are generally higher quarter-over-quarter.
2) **Cheap valuation vs. history** – strong earnings have enabled many companies to be still be attractive on price-to-book and price-to-free-cash flow despite price movement
3) **Positive price momentum** – energy has been the best performing sector, up 35.4% YTD, vs. the SP500 down 13.31%.
4) **Demand growth is exceeding supply growth**
5) **Sentiment is negative** both because of ESG and because of a view we think is misguided that the terminal value of oil is zero.
6) **Many funds do not have an energy team**
7) **Flows could massively change** if select allocators move from using Sustainability Score Level to Change in Sustainability Score as energy has beaten darling areas like communication services by 70% in the last 12-months. Investors were fine with ESG ETFs that were closet QQQs when they were making money, but not when they are down

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