Fidelity Connects

Building Blocks: Industrials and materials in the second half of 2022

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Announcer: Hello and welcome to Fidelity Connects, a Fidelity Investments Canada podcast, connecting you to the world of investing and helping you stay ahead.

On today's podcast, host Pamela Ritchie is joined by two members of Fidelity Canada's equity research team: Analysts Robert Reynolds and Claire Fleming.

The equity research analysts focus on specific sectors, providing research and analysis to portfolio managers. Today, we're shining a spotlight on the industrials and materials sectors, breaking down what's shaping those sectors currently, and what is on Robert and Claire's radars in the second half of 2022.

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Pamela Ritchie: Claire, I might ask you to catch us up a little bit in opening, a sort of where things have come since the Ukraine was invaded by Russia, what it's meant for a scramble within markets, particularly, obviously, in the materials sector. Just kind of bring us up to date whether we have better clarity at this point. Where do we stand?

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Claire Fleming: Thanks, Pamela. Of course, there's still a lot of uncertainty and given that materials is such a broad sector, I'll add for context that my coverage includes the copper and diversified miners, chemicals, forest products and some packaging-related companies, so that's what a lot of my comments will speak to today.

I remember we last spoke shortly after the onset of the conflict in a group conversation with Thomas and Joe and a lot of our conversation then focused just on the supply risks for different commodities within my coverage group. Of course, given various levels of disruption from the conflict, we are seeing a lot of commodities approaching peak levels shortly after the onset of the conflict.

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I think what's changed since then is we have seen, of course, some supply disruptions across key commodities especially like fertilizers that tend to have higher concentration in some of those impacted countries. But we have seen still some of these commodities able to exit Russia or Belarus, just because a lot of these commodities haven't been directly sanctioned. They're more so impacted by some of the challenges related to logistics or accessing financing for getting those commodities out of the region. I think two key areas have changed and become an increasing focus since we last spoke though, and that's the implications of the conflict on the cost structures across my coverage group as well as demand-related risks.

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I think on cost structures, of course, given the inflation in global energy prices, we've seen that impacting especially some of the chemicals companies which produce their end products with natural gas-related inputs, as well as some of the... especially mining-related companies that tend to be very energy intensive with their production and seeing cost inflation on diesel and power costs starting to impact their cost structures.

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On the demand side, I think we'll get into this more throughout our discussion but given all the concerns about rising rates and an increasing probability of a recession scenario, just given the breadth of subsectors I cover, that's had varying impacts on just how to think about the relative cyclicality of demand and what that would look like in a recessionary scenario across my coverage group.

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Pamela Ritchie: Right. Bobby, when we look at the industrials, I mean, I feel like Europe's a little bit of a case in point right now. I mean, we're seeing rivers dry up in France. Ultimately, where is the energy coming for some of the industrials to do their job? Paint that picture for us. Again, how as it's evolved since the invasion of Ukraine?

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Bobby Reynolds: I guess if you're referring to industrials with European exposure, those have obviously been some of the hardest hit within Canada if they do have operations in Europe due to the energy cost risk and economic risk, talking about potentially rationing industrial production in European countries to get through next winter. In Canada, the first-order impact is sort of thinking about how could higher energy costs impact costs for industrials and then end demand for the industrial complex? There's lots of different places you can go in industrials in Canada, though, and when you think about it, North America is actually really well positioned to replace some of the commodities that were produced in Russia or states allied with Russia and potash being a prime example, which Claire can speak to. They're now talking about increasing potash production in North America. There's a benefit for the railroads there if you're moving more potash to port. So that's one end.

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But the other end is obviously what happens to the more consumer-oriented parts of the economy given what rising energy prices do to the consumer's ability to spend. That's put a damper on airline stocks, for example. Even though we're seeing really strong demand right now, the question is how long can it last? So there's really lots of different factors at play in the market and we're trying to parse through those to find the opportunities.

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Pamela Ritchie: I might just ask you to add there, Bobby, you mentioned rails. You also mentioned the airlines. What else does your coverage universe include?

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Bobby Reynolds: I cover the waste stocks. There's some capital goods in Canada. There's equipment dealers, equipment auctioneers. There's information services. So there's really a hodgepodge of places you could go, both defensive and more cyclical in Canadian industrials and really lots of great businesses that have been some of their top performers on the TSX over the last decade or two.

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Pamela Ritchie: Claire, are you finding ... we're in the midst of earnings, we're getting snapshots. Many will say that the earnings have kind of held up. I don't know if that's your experience. Is there anything that you're learning through the earnings season but ultimately also when you're speaking to company leadership? You're hearing things generally at Fidelity that not everyone has access to. What is the pulse, if you will, if you're sort of taking the pulse of some of the communications out of companies in this earnings period?

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Claire Fleming: I think during the earnings season so far there have really been two key themes coming up a lot in discussions related to the sector. I think those two key themes are cost structure as well as differences in capital allocation strategy. Of course, cost structure follows up on some of my opening comments which just mentioned some of the differences in relative exposure to cost inflation especially after the conflict. We've seen a lot of especially copper and diversified miners discussing some of their exposure whether that's on labour or diesel or power costs. Just understandings of the differences in relative exposure based on how they procure their power or which regions they're in or which hedging exposure they have to certain inputs, I think has been a key theme across a lot of companies and just trying to get a better sense of which of those cost pressures might be more cyclical or stickier as we move beyond the current fiscal year.

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The other key theme is capital allocation. I'll just add quickly that especially since commodity prices have been relatively strong over the past year or so, we've seen a lot of these companies in a much stronger balance sheet position than they were at the onset of COVID. We're seeing very different strategies across companies in terms of how they're deploying that, whether that's organic growth projects or whether they can be opportunistic and deploy that into share buybacks or acquisitions if that's a part of their strategy in the current environment. We think that's impacting some of the relative risk-reward across companies as well as the current environment as we move throughout earnings season.

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Pamela Ritchie: Bobby, follow up for me, if you would, on the labour. I mean, you say air travel and labour and we all have a vision of what that means, I think, from some of the scenes we've seen in airports. It's a very serious issue across many, many, many industries. Speak to it within industrials, that stickiness.

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Bobby Reynolds: Yeah, I'd say labour has been the number one issue facing most companies in the first half of 2022, that I cover. Different industries are better able to handle what's happening in the labour market. Just to give you a flavour: in the waste industry, for example, they're suffering significant wage or labour turnover and wage inflation. It's actually the turnover and the productivity loss that you get when you have to train up new people that has hurt them more and they expect that inflation to be sticky and mid-single digit level into 2023 which goes to show at the micro-level, there's companies already thinking about inflation being a lot higher than the 2 to 3% that the market sort of hopes inflation falls down to by next year.

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Airlines are an interesting example, given just the complexity of air travel and the nature of the business. Flying planes and your seats that you want to sell are perishable inventory and a lot of your customers have connections that they might have an hour or 2 hours to get to. When one link breaks in the chain, there's a significant ripple effect and we've seen that at Toronto Pearson. I think the latest stats are still over 40% of daily flights have been delayed coming into or out of the airport. When you think about the impact on the airlines, it impacts their ability to increase capacity and it also increase their costs because you need to throw more people at a given level of capacity because it's taking longer to do everything. One of the big issues is people. The customs agents' issues, the passport issues have gotten a lot of press but at the airports, for example, there's a shortage of baggage handlers. That takes a while for the airport to hire up and it's not even necessarily in the airline's control.

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Pamela Ritchie: It's messy. I mean, it is messy. Is the most important thing still, though, to the company leadership of most airlines, it's just still fuel?

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Bobby Reynolds: Fuel is the biggest cost for airlines. It's one that they're ... in this environment where demand is exceeding supply they've pretty successfully been able to price for higher fuel costs. What the market tends to focus more on is their costs excluding fuel because that shows how well the airlines are executing on what they can control. In that area, the industry has been disappointing so far this year. The question is, how realistic are the improvement targets that management teams have for the second half of the year and into 2023?

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Pamela Ritchie: Fascinating. Claire, let's go to the discussion of where actual either miners are located or any sort of resource has their land, has what they mine, has where the trees ultimately they cut down for a lumber company. It is a global labour story for sure, but it's also more sort of layering on top these trade tensions which were obviously ratcheted up pretty seriously this week between China and the U.S. Again, we can't sort of solve or look into those too hard but what does it mean for a company that's taking a look at where its actual production is? This is quite serious.

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Claire Fleming: In terms of geographic exposure, I think some of the two key implications that we focus on are, of course, labour, as you mentioned, as well as just potential policy-related risks and opportunities, just based on different geographical exposure of each company's asset base. To follow up on some of Bobby's comments about labour and the industrial sector, I think, of course, we did see tightness in labour markets over the past year, especially for a lot of North

American-exposed commodities companies, whether those are in mining or forest products, that made it challenging in terms of labour availability or wage inflation to manage some of those pressures.

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But I think what we've really started to see shift in the past few months as well through the conflict is some increasing concerns about labour inflation in some of the emerging markets as well, which makes sense if you think of especially in some of these markets where food or fuel might be a greater share of household expenses. The standard of living started to become under a lot more pressure over the past few months, especially relative to more developed markets which is starting to impact, I think, the cost inflation outlook for some of the companies with greater exposure to those regions.

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I think especially for the miners, of course, policy is always an area of discussion and has implications for the relative attractiveness of certain regions. Of course, there's still always a lot of uncertainty on this but regions such as Panama and Chile where there's copper-exposed assets have been in some negotiations in terms of either proposing new mining royalty bills or finalizing discussions for royalty rates. I think that's something we're always mindful of when evaluating companies across regions, just understanding how labour exposure or any policy risk might impact the relative attractiveness of certain assets.

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Pamela Ritchie: Will metals or industrials – we'll go to you first Bobby on this – be hit harder by China/Taiwan/U.S. tensions? Do you see that? Take a look at it from your universe, what you look at.

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Bobby Reynolds: Canadian industrials don't have significant direct exposure to China. I'd say they're less exposed to China directly than a lot of the metals complexes. One of the fallouts of the geopolitical tensions has been a big effort to onshore strategic industries. I mean, we saw the U.S. is trying to pass the Chips Act or we may have passed it now which –

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Pamela Ritchie: Yeah, we finally did.

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Bobby Reynolds: – provides subsidies for semiconductor plants to be manufactured in the U.S. These are massive multi-billion-dollar projects that require a lot of construction equipment, a lot of labour, a lot of steel. This benefits certain industrial companies like railroads that need to move those materials, equipment dealers that sell the construction machinery. It's interesting that a lot of machinery, for example, isn't fungible in terms of what's sold in China versus what's sold in North America due to different environmental regulations.

In some markets, like commodities, weak demand in China means weak commodity price. But right now construction demand in China is horrible, if you've read about what's happening in their housing market, yet equipment is extremely tight in North America because the stuff that you'd sell in China you can't sell it in North America. I think there are some opportunities in industrials where you get boosts in domestic or North American demand as a result of the issues going on in Asia.

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Pamela Ritchie: What would you say on the materials front, Claire, sort of particular exposure to tensions?

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Claire Fleming: A lot of my companies don't have an asset base within China but I think what the most relevant implications are of any geopolitical tensions are just on the demand side. I think if you look especially at certain commodities like Bobby mentioned that do have demand exposure to China, if you think of copper or certain commodity chemicals, those stand out as areas of my coverage group which tend to be more exposed to any changes in economic growth within China just given that that represents a relatively larger share of demand compared to some other areas of my coverage group.

If you think of other sectors which is forest products tend to have more North American or Western European exposure within their demand base. I think that having that breadth of subsectors sort of allows portfolio managers to take a view, if they wish, on how they think about the relative economic growth outlook between those regions and if that's impacted by global trade tension.

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Pamela Ritchie: Bobby, do portfolio managers take a look at some of those things? That's, I know, on Claire's side of things but from your perspective.

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Bobby Reynolds: Portfolio managers, they all have different styles but in general they're all very macro savvy but they also want to know...

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Pamela Ritchie: Often they say they don't want to talk about macro though, I'll have you know.

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Bobby Reynolds: Yes, but they read a lot. On the micro side, that's why they have us. We're hosting hundreds of company meetings every year and usually we have a few to many portfolio managers within each of our company meetings. As analysts, it's our job to know the nitty gritty of the company and the industry and have those great relationships with managements and industry experts and sell-side analysts to understand what expectations are in the market. We can really help the Fidelity team understand what might be mispriced or misunderstood because of the resources we have to really focus on the specifics impacting a company and sort of get ahead of trends in future earnings or where we think a future multiple might go as a result of that focus and those resources.

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Pamela Ritchie: Let's crack open the discussion of whether there is or isn't on the horizon ... I know commodities have sold off pretty significantly in the last several months ... but this idea of whether we are or are not in a supercycle for commodities and whether we can have such a thing without China being the main demand, with it being demand from North America, from other parts of the world. Claire, what's your take on that overall discussion, the sort of self-sufficiency supercycle discussion?

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Claire Fleming: I think within the past few months, especially since we last spoke, as I mentioned, there has been a lot more concerns on shorter term demand for a lot of commodities just given some of the decelerating expectations for GDP growth globally. I do think that a lot of those secular trends that we've talked about in the past, especially as we look towards the later half of this decade, are still intact for the commodity sector despite some of the more recent concerns related to demand. I think what's particularly interesting to note is just how this period of that lower commodity prices might start to disincentivize certain supply or construction decisions relative to perhaps a year ago when commodity prices were stronger.

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If you think of commodities like copper especially that tend to have a very long lead time in order to construct just given the complexity of line construction as well as some of the permitting requirements associated with that, as well as cost inflation on both the capital expenditure side as well as the operating costs in several regions that are likely starting to push up that incentive price that a company would need in order to earn sufficient return on any capital decisions. I think that is also a contributor to thinking about there likely being supply constraints or issues as you move towards the later half of the decade in certain commodities, especially if a weaker commodity price environment in the short term sort of defers any construction decision time in across the sector.

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Pamela Ritchie: Interesting. Bobby, what would you add to that sort of rather large debate? It does look longer term.

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Bobby Reynolds: I think commodity supercycle is positive for Canadian industrials. Claire just mentioned cost inflation and the need to solve the supply side of the equation. Cost inflation for a miner is revenue growth for an industrial that sells products to those miners. So that's a function of industrials trying to recoup the inflation they've seen in their cost bases and passing along to their customers of which resource extractive industries are a large piece. We're looking for industrials that can benefit from a potential commodity supercycle, industrials that, importantly, have pricing power so that they can get through this period of elevated inflation which might last longer than people expect and maintain or grow earnings faster than they would in a lower inflation environment.

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The railroads are a great example of pricing power benefit from increased oil and gas extraction in Canada. You've got this TMX pipeline that's been delayed until late 2023 at the earliest. We're not in a situation where a lot of crude is moving on the rails today but that could change in a year if Canadian oil production continues to grow. These are sorts of things that aren't necessarily in expectations right now.

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Pamela Ritchie: Really interesting. Let's take that sort of overall debate, and it includes both of you, to sort of the ag sector because it's a crushing international story when you look at it but Claire, perhaps from your perspective, the mining, the potash side of things and then ultimately the production of fertilizer. Again, where does that leave Canada? It sounds like a good spot to be ultimately from an investors perspective but where do you see that going? Claire, perhaps to you first.

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Claire Fleming: To start with the ag sector at a very high level as it relates to the fertilizers, I think some of the key themes that still come up in industry discussions are that global grain stocks-to-use ratios remain relatively low compared to historical averages. That continues to support crop prices that are above historical averages. Those higher crop prices are allowing farmers to continue to have demand for fertilizers even though the price for a lot of those commodities has increased, especially after the onset of the conflict, which disrupted a lot of supply. If you think prior to the onset of the conflict, Russia and Belarus collectively were almost 40% of global potash supply, so it was definitely one of the commodities that was most exposed to challenges at the onset of the conflict.

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As I mentioned earlier, even though a lot of the fertilizers haven't been directly sanctioned, some of the disruptions with logistics and access to financing have still been reducing the available supply globally. We have started to see some of the fertilizer companies with exposure to Canada announcing some plans to increase production just to help to address some of that supply gap that emerged between demand from farmers to help maximize productivity and given strong crop prices, as well as just the availability for brownfield expansions at relatively low costs in the Canadian region. That's an area that since we last spoke we have seen some companies announcing increases to Canadian potash production just given the supply gap and the fact that it's very difficult to bring on capacity in this region if you're starting a greenfield project because of the capital intensity and time required to do that.

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Pamela Ritchie: The multinational story within Canada, yeah, it's fascinating. Bobby, where do you take that a little bit on sort of the ag story broadly? It may again go to the rails but how do you look at that?

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Bobby Reynolds: Yeah, exactly, Pamela. If you're talking about Canadian wheat production, you need to grow to fill the gap that was left by Ukraine, and don't forget, Canada had a multi-decade record drought last year which has really exacerbated the current grain crisis globally. We had our worst grain crop since 2002 last year. It's all about volumes for the railroads. They don't directly benefit from higher prices. Obviously, they're happy if their customers are making more. It's looking like this will be a good grain crop for Canada this year. There's been lots of rain in western Canada and you start to see that grain move on to the global markets sort of in the fall. It's a really meaningful piece of business for the Canadian railroads. It's upwards of 20 to 30% of revenues, so it's very important for them.

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On the potash front, if we're increasing potash production, most of that gets exported overseas via ports and that moves to the port via the railroads. Again, that's a growth opportunity for them that's really detached from what's going on in the economic cycle. That's one of the things that the market likes about those stocks and why they've held up pretty well this year.

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Pamela Ritchie: I'll leave this final supply chain question for both of you. Claire, how closely do you watch logistics broadly but actually particularly the ports? We did mention kind of in the intro here about what we've heard from Maersk. How closely do you watch the ports, the ongoing issues, the backups and so on? That must come very much into your research.

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Claire Fleming: I think any disruption at the ports tends to have the most direct impact on just sales volumes overall for companies in my coverage group. I think oftentimes it does just result in a lag in certain sales volumes but especially during earnings season or other periods I think that is always helpful to be mindful of given that especially if you think of the copper and diversified miners, a lot of those companies require access to ports in order to have access to global markets. I think some of the disruption in the ports continues to be relevant either for sales as well as for some key inputs as well. That's something to monitor, if there's any disruptions there especially for companies that are completing or in the process of constructing larger scale projects given that that has resulted in some delays either project timing or sales across my coverage group.

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Pamela Ritchie: Bobby, just a final thought on sort of supply chains perhaps directly to the ports because that's where the rails go.

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Bobby Reynolds: Supply chain congestion is getting better on the margin. Part of that is the lower demand that you hear about from the Maersks of the world. It's not great. We had a large U.S. equipment producer report their earnings yesterday and say don't expect any improvement in supply chains through the end of this year and this is going to be an issue that lasts well into 2023. I think the market focuses on changes at the margin and at the margins things are getting a little bit more fluid than where they maybe were at their worst six months ago.

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Pamela Ritchie: At the margin. We'll leave it at that. Claire Fleming and Bobby Reynolds, a pleasure to speak with you both. Thanks for joining us.

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