Fidelity Connects

Building Blocks: industrials and materials in the fourth quarter – Robert Reynolds and Claire Fleming

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

As we settle into the last quarter of the year, we hear from two of Fidelity Canada's Equity Research Analysts Robert Reynolds and Claire Fleming, who explain how industrials and materials are shaping up in Q4.

They speak to host Bryan Borzykowski about the two sectors, how they relate and collaborate. Robert points out that in the top 20 performing Canadian stocks in the past five years, five were industrials.

They talk about the impact a recession would have on the two sectors. In regards to materials, Claire points out that many companies have stronger balance sheets than in past recessions, but still, elevated global energy prices are creating major differences in the outlook for companies compared to past cycles.

Claire and Robert also touch upon how geopolitical tensions in Europe are impacting industrials and materials, and how the sectors could look like once China re-opens after its strict zero-Covid policy.

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Bryan Borzykowski: Bobby Reynolds and Claire Fleming. Thanks for being here.

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Bobby Reynolds: Nice to be here.

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Bryan Borzykowski: My first question to both of you, I know you've been on this webcast before, but what is the connection between industrial and materials? Why do we have you on together today?

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Bobby Reynolds: Great question, Bryan. There's a lot of connections between the industrial sector and the materials sector. A lot of industrial companies are logistics providers or suppliers to mining companies or agricultural commodity companies. By working on these sectors, myself and Claire together, we can get some insights on potential cost inflation in the pipe for mining companies and how customer health might look for the industrial companies selling into these customers.

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Bryan Borzykowski: Great. Claire, how do you see that connection?

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Claire Fleming: I think I'll just follow up on Bobby's point by emphasizing that this creates a great opportunity for us to help add value for PMs that we work with just by being able to collaborate on research with exposure to similar themes. For example, some of our sub-industries might have exposure to different areas of the value chain in mining or agriculture. By presenting PMs with our research on these sub-industries we can help them get exposure to different themes by allowing them to help invest in the best area of the value chain possible to get exposure to some of those themes that we think are interesting on the medium to longer-term outlook.

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Bryan Borzykowski: You both were on in August, what has happened since your last webcast? Where are we at in both the industrial and materials sectors? Claire, maybe you can start.

[00:03:37]

Claire Fleming: We were last on this webcast a few months ago and I think it's interesting to look at the Canadian materials benchmark performance versus the index and see that within the past few months, relative performance has been within a few percentage points. But underlying that headline number, there's been a lot of variation in relative performance across the sub industries that make up the Canadian Materials Index. For example, the copper and diversified miners, forest products, agriculture and commodity chemicals. There's a lot of different drivers impacting the relative performance of those groups. Perhaps I'll start with what's different and then emphasize what themes are still the same and in focus.

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I think we've seen changing demand expectations in the shorter term across some of these sub-industries based on differences in the relative economic outlook between North America and Western Europe, exposed commodities relative to some of the more Asian-exposed commodities within the Canadian materials benchmark. In the shorter term, there's been some change in expectations for sub-industries like forest products that have exposure to the North American housing market that's been under a bit more pressure from some of the higher interest rates in North American and European economies. When looking at some of the other areas of the coverage group that have more exposure to demand from Chinese economies, some of the continued strength in infrastructure investment in the region as well as more recent rumours about a potential pass from COVID-zero in the region are starting to increase some of the potential demand expectations for commodity chemicals or base metals with exposure to that group.

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In terms of what's the same, I think on the last webcast we were talking a lot about cost inflation and how that's impacting the capital expenditure outlook as well as operating costs outlook for the companies across my coverage group and I think that's still a key theme that's impacting companies as we move throughout the Q3 earnings reporting season.

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Bryan Borzykowski: Great. Bobby, before we get to you, I'm just curious, Claire, materials has been up quite a bit today, anything driving that that you can see why that kind of tear that it's on today?

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Claire Fleming: I think where we've seen some of the relative strength across sub-sectors has been in some of the copper and diversified mining sub-industries. I think that follows up a bit more on the point that I made about some of the potential changes in market expectations for demand from China exposed materials. I think it has been related to some of those rumours about potential changes in policy or starting to get more visibility on the path from COVID-zero is viewed as incrementally positive for some of the end markets, whether they're industrial or consumer applications that really require base and bulk materials as inputs to those end markets that have caused some of the more recent strength we've seen within the materials industry.

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Bryan Borzykowski: Great. Bobby, what's happening since the last webcast in industrials?

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Bobby Reynolds: If you look at August, it was a pretty bad first half of the year for most of the market, industrials included especially if you're a more cyclical industrial. The economy was still really hot in August, but the Fed was hiking aggressively and the market could really look forward to what those rate hikes would do in terms of the aggregate demand for the general economy and a lot of industrials are levered to GDP growth. You saw the multiples derating, but earnings outlooks weren't really changing yet, at least what the sort of sell side would have been forecasting.

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Fast forward to early November, we're finally starting to see some cracks in terms of these tighter monetary conditions flowing through on to the ground in the real economy. Anything consumer exposed in the industrial space, you could think about logistics companies that might move consumer goods. There's too much consumer goods in the economy right now. You're starting to see earnings weakness out of those companies. You're seeing anything housing related, we were already worried about it earlier this year, but it's actually starting to show up in the data. It's becoming more of a confirmation of the points that the market was worried about three months ago and now the question is, actually, are some of these more cyclical companies, have they been derated enough such that you can look over the valley of whatever this downturn induced by inflation and the Fed's efforts to curb inflation bring and are they cheap enough to start to get involved or do you still want to stick with the more defensive names or the stocks that provide more visibility on what earnings will look like in '23? Those have been the outperformers year-to-date. Typically, those are the underperformers once you get back to the upswing of a cycle. That's what I'm wrestling with, that's what market participants and portfolio managers are wrestling with when they think about how to position themselves for 2023.

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Bryan Borzykowski: We saw big job numbers today. I think people are sort of waiting for things to kind of turn in the economy and a recession to come. How does kind of a recessionary environment impact maybe both your sectors? If you look out in a few months from now if a recession may come, does that kind of change where you're looking at or how could that impact both of the sectors that you cover?

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Bobby Reynolds: Short copout answer, it depends what the recession looks like. What do we know in terms of where can we be confident that we're going to see further weakness? I think housing, anything housing related, it's pretty obvious when mortgage rates are 7% in the US and 5% plus in Canada that housing has already slowed down and needs to slow down more. Part of the reason it hasn't slowed down more is there's a lot of backlogs and work to be done from homebuilders and from renovation perspective that just take time to work through and that's why monetary policy works with a lag. You haven't seen the bottom yet in terms of real activity likely in housing-related sectors. Consumer as well, there's conflicting forces for the consumer. The consumer, especially in the U.S., has saved a lot of money through COVID. They spent less, they got a lot of handouts from the government, but they're also facing a lot of pressures on their wallet right now just from the inflation in essential goods as well as potentially some hit to their sentiment from the decline in the value of their assets in the stock market and in the value of their homes. Anything consumer related, you're probably going to see continued weakness.

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On the other hand, the outlook has arguably brightened for some areas of the economy that are supported by government industrial policy. Another thing that's happened since August is the U.S. has packed two large pieces of legislation, the Inflation Reduction Act and the CHIPS Act. This is really the U.S. government being proactive to onshore a lot of critical industries in the U.S., try to decouple from China. It's a theme we can talk more about but that impacts the outlook for a lot of Canadian industrial companies by virtue of its impact on non-residential spending in the U.S. The problem is it also keeps the pressure on the labour market in the economy and, arguably, the workers that might not have a job in homebuilding now or in six months can more easily find a job elsewhere. As wage inflation persists for longer and the Fed has to keep hiking for longer, does that mean the downturn in the future is worse? This is where it becomes very complicated and a bit of a circular argument and it's why the market is so choppy. It's all of these debates it's having with itself.

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Claire Fleming: I can follow up just on how increasing expectations for a recession in certain markets is impacting the outlook for some of the Canadian materials names. I think that Fidelity does a great job when you initiate on companies internally on really emphasizing that there should be sort of a downside risk or recession scenario in that work that you're doing as an analyst. That was a great foundation to have from when I initiated on this group of companies about a year ago internally to be able to present to PMs just on how I think about the relative downside risk across the companies within my coverage group and some of the different sensitivities by sub-sector. I think that across the group, of course, materials is incredibly cyclical. Most of the sub-industries are linked to GDP in terms of the longer-term demand outlook. We definitely see a lot of volatility in the group on expectations for different levels of GDP growth.

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I think what's really in focus when we're doing this analysis is presenting to portfolio managers how we think about what these companies' income statements, balance sheets, capital expenditure levels might look like in a recessionary scenario and how we think about where trough valuation levels could get if we were to go through a recession and then let the portfolio managers take their view on what they think the probability of a recession might be into their investing process. I think as well, maybe what's a bit different in the cycle or things that we're keeping in mind that could impact the relative performance of some companies relative to past recessions or downturns that we saw is that a lot of these companies do have stronger balance sheets compared to past recessions just because we've gone through a couple of years where commodity prices were above average and allowed these companies to generate above average cash flows and have stronger balance sheets, which reduces, perhaps, the risk for some companies relative to past downturns or recessions where balance sheets weren't as strong.

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I think we're also seeing implications of some of the elevated global energy prices, especially in European markets, creating some differences in the relative outlook for companies compared to past cycles. I think really there's a focus on recession scenario analysis for this group and also understanding some of the potential differences versus past cycles that might impact relative performance of Canadian materials compared to past downturns.

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Bryan Borzykowski: On Europe and just elsewhere around the world, the big story, really, for commodities, at least the beginning of the year but I think still is geopolitical strife in Ukraine and Russia and how that's impacted the global commodity environment. Claire, how has the war in Ukraine impacted the companies that you cover and where do you think that could go from here?

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Claire Fleming: That definitely has been a key driver of relative performance across some of the sub-industries I cover. I might spend a bit more time discussing the agriculture outlook just because I think that's one of the sub-industries that's been the most directly and indirectly impacted by the conflict year-to-date. I think we're still seeing the implications of the conflict showing up in global grain inventories and prices. Global grain stocks to use levels, essentially, inventories remain very low relative to history and that's playing out in terms of crop prices even though they've come off of peak levels when looking at things like corn futures prices out to 2025 still being over $5 per bushel, that's an above average level that is really trying to incentivize production from farmers globally to address some of the supply challenges that have been impacted by the conflict.

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I think more broadly than just on crop prices, the conflict is having a lot of implications for the fertilizer industry as well within the agricultural industry, just given the share of supply that comes from Russia and Belarus for certain fertilizers like potash, as well as the implications on the cost of producing fertilizers because natural gas is used as a key input for certain fertilizers such as nitrogen that are typically applied annually by farmers. We're seeing a lot of companies with

North American assets responding still by trying to increase their potash production levels over the medium term to help respond to some of that supply disruption. We're also seeing the potential for higher nitrogen or other types of fertilizer pricing over the medium term just from that higher cost curve that I mentioned has been increased by elevated natural gas prices, especially in Europe over the past few quarters.

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Bryan Borzykowski: Great. Bobby, how is that impacting your sector?

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Bobby Reynolds: To Claire's example on the agricultural commodities, those are shipped via rail generally to port to be exported, so that's a nice tailwind for the Canadian railroads. On the negative side, there are a number of Canadian industrials, whether they be engineering firms or capital goods companies, that do have customer bases in Europe and the economic environment there has become more challenging as a result of the energy crisis that they're going through. If you're an engineering firm you can point to the need for Western European countries to invest more in their own energy production and energy security as part of the solution to weaning themselves off Russian gas over the medium to longer term. Potentially, that's a tailwind for them in a few years but the more immediate impact is less demand or less help from their customer to purchase goods. Currency has also been a huge factor this year. If your earning revenue is in euros, that's a big headwind, even if you're Canadian dollar reporter, let alone a U.S. dollar reporter. That's something that's been a factor this year as well.

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Bryan Borzykowski: Great. Claire, what are your thoughts on copper, the climate transition, more EVs and the demand from both materials and industrials kind of around climate change. Maybe, Claire, what is your thoughts on copper and maybe talk a bit more broadly just about ESG and the climate transition?

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Claire Fleming: There's been a lot of factors impacting the outlook for copper over the past few quarters. I think prices definitely came off of peak levels from earlier this year just because of some of the decelerating GDP growth expectations, especially across North America or Western Europe, in response to higher interest rates starting to impact the outlook for some of the more cyclical end markets for copper. I think if you look at some of the more recent data points, which I referenced about rumours of a potential reopening in China from some of the COVID restrictions that have been in place over the past few years, potentially being more positive in the near to medium term, as well as still favourable longer-term outlook for copper just given its role, as you mentioned, in applications related to the electrification of the economy, whether that's in the electrical grid and renewable generation or electric vehicles, perhaps providing more visibility on the longer-term outlook for copper relative to some of the other commodities within my coverage group.

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Perhaps more recently as well, just to follow up on the implications of cost inflation and higher global energy prices in the copper sector, I think visibility on the longer-term supply outlook has perhaps become a bit more challenged just given some of the volatility in input prices that we've seen. I think in the shorter term, just given that building a copper mine is a very long process, it takes several years and it's very capital intensive. In the shorter term, we will likely see some of those projects that have been under construction for many years starting to ramp up. In terms of looking over the medium to longer term, given how much uncertainty there is on the cost of building a mine, given the inflation and steel or labour prices or energy prices or other really key inputs globally, I think that's caused some companies to be a bit more cautious or just wait a bit longer before committing to new, larger scale projects that would fill that supply deficit many years out until there's a bit more on certainty on what the longer-term input prices would be to make sure they're earning an appropriate return on capital.

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I think there's definitely been some more challenging near-term demand headwinds from decelerating expectations for GDP growth globally but more visibility on longer-term demand from China, the electrification economy, and also decreasing visibility on longer-term supply growth in copper, I think might create some really interesting opportunities within the sector over the next few years.

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Bryan Borzykowski: Bobby, just on the electrification angle, for the companies you cover is that an opportunity there that you're looking at?

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Bobby Reynolds: One of the great things about industrials is there's so many ways to play electrification and the energy transition. Specifically, on electrification, you could look at building EV plants in the United States. You have Canadian companies that help the auto manufacturers actually set up these plants and since the Inflation Reduction Act was passed and if you're an automaker, you get up to $10,000 a vehicle of government credits if you set up your battery supply chain in the U.S. There's just been a wave of work that's been announced since that act was passed in August and it's been very helpful to the stocks with exposure to that theme.

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More broadly, I would say Canadian railroads, they're not part of the electrification theme but the climate change theme, if you want to save on emissions in your supply chain, it's 75% more fuel efficient to ship your goods via rail versus truck, so it's a solution that companies can pursue today to reduce their greenhouse gas emissions. Then the engineering companies in Canada are also very well positioned to benefit from the electrification and climate change themes given the type of work that they do.

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Bryan Borzykowski: Another question is whether industrials and materials can be an inflation hedge. Bobby, do you want to take that one on first?

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Bobby Reynolds: Great question. For the most part, industrial companies cannot reprice their products immediately but many of them do have pricing power. This is actually an area of opportunity in some regard looking to 2023 is which companies have pricing power but it comes with a lag. You've seen them get hit with input cost inflation in '22, so margins have been squeezed. They've been taking price but that's just starting to flow through results or will start to flow through results in future quarters. That's probably an area where the market might be missing something or getting it wrong and that's one of the ways where you can find stocks that could outperform. Good examples of companies with pricing power, again, the railroads, the garbage companies, those are two areas that I'd say are commonly thought of as having strong pricing power and the market's been rewarding them this year for that.

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Claire Fleming: When looking at Canadian materials, the impact of inflation does vary based on sub-sector across the group. I think when looking at some of the base and bulk materials such as copper, that's an example of a commodity that historically has tended to perform well during periods of rising or accelerating inflation just given that for a copper producer, usually copper prices would be rising in an inflationary environment, which allows them to still earn an appropriate margin even if some of their input costs are going up. I think inflation can be more challenging sometimes for some of the more defensive areas of the Canadian materials group such as metals and glass containers or companies that might just have more trouble passing through input cost inflation to the prices that their end customers are paying just because those prices would involve more negotiation or discussion than some of the other commodities where prices tend to be linked to benchmarks more closely.

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Bryan Borzykowski: How has the relationship between Canada and China... Has the export market for industrials and materials been strained at all by that relationship, which has kind of fractured over the last little while?

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Claire Fleming: As I mentioned earlier, I think the outlook for China is important for a lot of Canadian-listed materials companies just given that demand for copper still is over 50% coming from China. I think there's definitely implications for this demand outlook for a lot of these companies based on changes in the policy or economic outlook in China. In terms of geopolitical implications, there's been some more recent headlines, I think, about the strategic importance of battery metals and other critical minerals to the Canadian government outlook given that there have been some restrictions of Chinese ownership or perhaps a bit more scrutiny on ownership of certain Canadian-listed companies that have access to really critical minerals within the battery metals value chain. I think that's something that will continue to be in focus over the next few years and might have implications for the ownership or potential transactions or buyers for some Canadian-listed companies that have exposure to battery metals such as lithium, for example.

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Bryan Borzykowski: Bobby?

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Bobby Reynolds: For the Canadian industrial space, we don't really have any manufacturers that sell their goods directly into China, or I should say, none that are significant companies in the TSX. It's more of an indirect exposure. If you're shipping goods, if you're a logistics provider, you're shipping them to port for them ultimately to go to China. If those exports need to be rerouted elsewhere, potentially you could be impacted. It's probably more on the supply chain or input cost side if you're a Canadian industrial. We still rely on China for a lot of inputs. If that source of input gets cut off and you're a Canadian industrial, that could be a source of risk in a future conflict. We haven't seen it arise as an issue yet.

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Bryan Borzykowski: Just continuing on the China theme for a minute, when China opens up, how could that affect international markets broadly and the Canadian companies you cover? Claire, you said that markets are up-to-date in materials in part because there's an expectation maybe they could open earlier or just there's more visibility perhaps into the opening there, but what is the real impact of that once things do open up?

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Claire Fleming: I think, as you said, there's certainly still a lot of uncertainty on exactly the timing or pace of reopening in that economy, which is why even rumours such as the ones that have come out more recently are having such a dramatic impact on the performance of certain sub-sectors. I think some of the copper and diversified miners within my coverage group, as well as some commodity chemicals might have the most exposure or changes in expectations if there were to be more visibility on that reopening just given the share of demand for copper. Met coal, global steel production as well that has exposure to Chinese markets. Although we're not exactly sure when or the magnitude of that reopening, I think those are the areas that might see more changes and expectations for demand relative to some of the other commodities that have a greater share of their demand coming from North American or European markets globally.

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Bryan Borzykowski: Bobby, anything to add?

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Bobby Reynolds: I would say you can think of the airlines. China was a reasonably large-sized market for some of the Canadian airlines and it's basically zero right now, so that could be a nice tailwind for them when it reopens. More broadly, you have to think about the impact across the commodity space and what that means for aggregate global demand to things like oil prices and metals prices. Demand is being depressed right now because of China reopening and we still have a tight market. If that reopens, what does that mean for all of these commodity prices and how does that impact the economy and policymakers and the stocks that we follow?

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Bryan Borzykowski: We only have 30 seconds left, so just quickly, why industrial and materials, why should advisors and investors look to these sectors for opportunities? Bobby, do you want to go first?

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Bobby Reynolds: There's a ton of great businesses in the Canadian industrial space. I was recently sent a list of the top 20 performing Canadian stocks in the last five years and five of them were industrials. Some of them are household names, some of them probably not. This is also an area when you're going through a bit of a tech downturn, we've seen it in past cycles, early 2000s, industrials were big outperformers because you had a lot of demand for commodities and industrials were the picks and shovels that helped those companies enable that demand, so there's a lot of opportunities.

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Bryan Borzykowski: Claire?

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Claire Fleming: On materials, I think that a lot of these companies are playing a role in really critical medium to longer-term themes, whether that's providing food security globally through their production of fertilizers or helping with the electrification of the economy, as we discussed earlier, with materials such as copper, nickel and lithium that all have exposure within the Canadian materials benchmark. I think especially as well, given how challenging it is to build new capacity, given cost inflation [indecipherable] and the time required, that will create some really great medium to longer-term opportunities for some of the Canadian-listed materials companies who are playing a role in those medium to longer-term industry trends.

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Bryan Borzykowski: Well, unfortunately, we've run out of time but I'm sure we will talk again soon and get another update in a few months. Thank you both for being here today.

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Bobby Reynolds: Thank you.

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Claire Fleming: Thank you.

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