US INDUSTRIALS TOUR: PUTTING THE PIECES TOGETHER.

JUNE 2023

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I recently spent eight days in the US attempting to measure the pulse of the economy. Travelling across six cities I met with around 30 businesses and economists representing a range of industries including steel, housing, building products, packaging, and waste management. The discussions were wide ranging, but a number of themes emerged.

The US is likely in a consumer recession...

There seems to be a clear delineation between the weakness of the consumer side of the economy and the strength of the industrial side. Under the pressure of higher rates and generally higher living costs, the consumer appears to have reined in discretionary spending, but less so their spending on services. Significant discounts at Home Depot and airports being busier than I can recall in my 20 years of traveling to the US were probably the best real-world examples. Fortunately, continued tightness in employment markets appears likely to prevent a hard landing for the consumer. An obvious cloud on the horizon for the US consumer over the next few months is the recommencement in August of repayments on student loans which were stopped through the pandemic.

...but not in an Industrial recession

The industrial side of the economy is another story, seemingly buoyed by the catch up on spending delayed through the pandemic, government support, and momentum building in the reshoring/onshoring thematic. I was also interested to learn of the increasing manufacturing migration to the south supported by government incentives, cheap land, generally non-unionised labour, and better weather. While I was aware of this trend in population and housing for some time, the shift in manufacturing was news to me. Despite the zeal in the industrial economy, I can't help but wonder how long it persists given the likelihood that consumer weakness will eventually drag it lower.

US housing is improving

Sentiment in US housing markets has clearly improved in the past six months, as borne out in housing starts data. I can't help but wonder, however, if this is overstating the strength of the whole housing market where sales of existing homes and associated inventory levels remain very low. This is a function of around 82% of mortgages in the US being at interest rates below 5% which is well below the current 30-year fixed rate of 6.7%. Further clouding the picture around housing starts is the willingness of the major home builders to commence more spec homes to meet the demand not being satisfied by the existing market, and the market share gains by big builders relative to their smaller counterparts. The big builders are clearly using their superior scale when it comes to finance, offering rate buydowns/incentives to the detriment of the smaller private builders. While this has likely delivered them a 10-15% market share gain through the pandemic, margins are under pressure and they appear likely to increasingly seek to recover this from land developers and building products suppliers. The trouble in delivering starts efficiently and profitably likely means an upper ceiling for activity around 1.0-1.1m.

US R&R appears less healthy

Despite the apparent health in the US housing market, the Repair & Remodel (R&R) market appears less attractive, in line with commentary around the broader weakness in US consumer economy. This is a mix of the "pandemic R&R party" hangover running headlong into an inflationary environment. While repair markets largely remain unaffected the remodel side of the market is weak. Unsurprisingly, larger tickets items are demonstrating greater weakness consistent with faltering discretionary consumer spending.

US steel price risks remain firmly skewed to the downside

Scenarios were painted which suggested HRC pricing could return to levels similar to what we saw in the back end of 2022 around the US$600/T range. Inventories are high, CRC and galvanised pricing is weak, and there is some risk of some short-term market dislocation though 2H CY23 for one of the major integrated players. While there is still a fair amount of capacity to come to market, in the longer term it seems industry discipline is high and further capacity rationalisation is likely to prevent major oversupply and associated price weakness.

Non-discretionary consumer destocking is real

There was a consensus that consumer non-discretionary generally benefitted from higher than usual activity through the pandemic to mitigate the supply chain issues which were prevalent through this period. Inventory levels were inflated by as much as one-third through this period. There was also consensus that this was going to unwind and can take as long as six to nine months. There was less consensus around where we are in that cycle, however, with some suggesting it was finished while others believe it still has one to two quarters to run.

A Financial Crisis appears unlikely

It appears that risks remain for further bank defaults, likely linked to lower commercial property valuations (commercial office rather than commercial industrial) and, potentially, rising personal credit card debt. However, it seems unlikely that globally systemically important banks in the US will come under pressure. The feeling was they have muddled through low interest rate environments so should be able to do better when interest rates are higher.

Inflation appears to have largely run its course

When discussing the outlook with pretty much every company there was little discussion around new pricing initiatives. The only pricing benefit which seems likely to come through in CY23 will reflect the full year impact of any initiatives announced in CY22. The cost push seems to have eroded, as has the willingness of customers to accept further price hikes. This may pose a problem into CY24 when inflation is running at more modest levels and demand has softened. Cost cutting, including through headcount reductions, may move more squarely onto the agenda for a broader range of corporates.

COVID firmly in the rear-view mirror

Seasonality seems to be returning to more normal patterns and supply chains have improved. Labour remains probably the primary hangover from the pandemic. While labour availability seems to have improved it is still tight as noted above and the working from home thematic remains strong. The appetite to change WFH is there but the willingness is not given the power continues to sit with the employee rather than the employer in this regard.

Implications for stocks in our portfolios

- **James Hardie:** I feel incrementally more positive as the company is probably better placed given the modestly larger exposure to the stronger new construction markets. That said, it is only a small part of the business which could easily be overwhelmed by softness in R&R.
- **Reliance Worldwide:** I feel incrementally more negative reflecting the greater likelihood of pressure in R&R and its relative underperformance relative to new construction. While cost reductions should help, pricing will not be there to offset softer demand inflationary cost pressures through FY24.
- **Orora:** At the margin a weak consumer if probably not positive, but I continue to believe this will be mitigated by ORA's self-help initiatives.

And for stocks we don't own

- **Bluescope and Sims Metal:** There will be better opportunities through the back end of CY22 which we should look to take advantage of.
- **Amcor:** Earnings risks for FY24 remain firmly to the downside with destocking likely to continue and discussion around conversion away from plastic packaging gaining momentum.

Overall given the cyclical nature of our coverage universe I don't believe we will be hurt by not adding to our exposure over the next 12 months.

What changed from last year?

It's worth noting that my trip 12 months ago occurred at a time when financial markets were volatile, which I expect heavily influenced the discussions. Last year's chatter around "talking ourselves into a recession" appears now to have largely played out. New topics which were prevalent this year were reshoring and the Inflation Reduction Act both of which are providing support to industrial investment – one of the few bright spots in the economy.

Given the more stable financial markets this time around, I'm hopeful this trip may have provided a more accurate picture of the underlying health of the US economy.

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