Weekend Thoughts 10/15/22

Net: Macro concerns have caused some trepidation in enterprise discretionary spend. In semiconductors, consumer end markets are exhibiting softness. Air transportation is one of few areas where strong demand still faces constrained supply and a rising hurdle rate for incremental capacity. CPG companies are still raising prices and elasticity remains strong. Consumer balance sheets and consumer spending are strong and financials' credit performance remains strong. Reshoring demand is insulating industrial companies from some cyclicality. The rental market is seeing slowing rent growth as rising supply meets softening demand. Federal Reserve speakers have expressed caution at the speed of rate increases, arguing that frontloading was necessary but uncertainty over lag effects necessitates being data dependent as full effects of such an expeditious tightening policy become apparent.

- Information Technology
  - Duck Creek Technologies (DCT)
    - “we have seen more conservative behavior from our customers. . .we're not seeing . . .the length of the term of our contracts be reduced. We are seeing in the larger carriers, our average deal size reduced.”
  - Infosys Limited (INFY)
    - “While the overall demand environment continued to be healthy, as reflected in broad-based growth and robust large deal pipeline, we also see signs of cautious behavior by clients due to macro concerns. Apart from slowness in the mortgage segment of Financial Services and the retail industry segment. . .we see emerging concerns in high-tech and telecom industry segments in the form of reduced spend, especially towards discretionary programs.”
    - “we didn't see any project cancellations in the quarter. We saw some slowness in discretionary spend within the macro segments that I mentioned. . .high-tech. . .telco. . .mortgages within Financial Services . . .parts of retail industry.”
  - Taiwan Semiconductor (TSM)
    - “On the demand side, we continue to observe softness in consumer end market segment. Other end market segments such as data center and automotive-related remains steady for now for TSMC, but we start to see the possibility of adjustment down the road.”
    - “On the inventory side, our customers and the supply chain continue to take action to adjust their inventory. We expect the semiconductor supply chain inventory to peak in third quarter this year and start to reduce in fourth quarter this year. We also expect it will take a few quarters through first half 2023 to rebalance to a healthier level.”
    - “We expect probably 2023, the semiconductor industry will likely to decline.”
- Consumer Discretionary
  - Delta Air Lines (DAL)
    - “After 2 years of delaying travel, it is clear that consumers are getting out and traveling the world. Business travel continues to recover in line with our expectations as bookings have improved after Labor Day and companies reconnect with their teams and their customers. And while consumer spend on experiences is growing, the airline industry revenues are still $20 billion to $30 billion below the

historical trend against GDP, highlighting the significant opportunity still ahead."
        - "while we are mindful of macroeconomic headwinds, the travel industry is experiencing a countercyclical recovery. Global demand is continuing to ramp as consumers shift spend to experiences, businesses return to travel and international markets continue to reopen. Demand has not come close to being quenched by a hectic summer travel season. At the same time, industry supply is constrained by aircraft availability, regional pilot shortages, and hiring and training needs. With record high fuel prices and increasing cost of capital, the hurdle rate is rising for incremental capacity across an industry that's still restoring its financial condition post pandemic."
    - Domino's Pizza (DPZ)
        - "We believe that inflation will impact delivery more than carryout due to the added expenses of fees and tips in that channel. Our research shows that a relatively higher delivery cost might lead some customers to prepare meals at home. This could be exacerbated as consumer spending becomes more constrained around the holiday"
- Consumer Staples
    - PepsiCo (PEP)
        - "we've seen elasticity continue to be strong and stronger than expected through 3 quarters of the year."
        - "we increased prices at the beginning of the fourth quarter. . . And going forward, with the investments that we've made in brands, I still think we're capable of taking whatever pricing we need."
        - "we're seeing is that more and more athletes are drinking caffeine and then also hydration during the game or before the game or at the end of the game, so different parts of their exercise. So we think there is a role for Gatorade to play in that space providing some additional stimulant to the performance, but also providing the hydration in one single consumption"
- Financials
    - Citigroup (C)
        - "Banking was the business most adversely impacted by the macro environment with reduced deal flows and a lower appetite for M&A."
        - "There is accumulating evidence of slowing global growth, and we now expect to experience rolling country level recession starting this quarter."
        - The U.S. economy, however, remains relatively resilient. So while we are seeing signs of economic slowing, consumers and corporates remain healthy as our very low net credit losses demonstrate. Supply chain constraints easing, the labor market remains strong. So it is all a question of what it takes to truly take persistently high core inflation. Now history would suggest that, that will be quite a lot and for some time. Therefore, we could well see a mild recession in the second half of '23. We believe the U.S. economy is well positioned to expand"
    - First Republic Bank (FRC)
        - "Credit quality remains very strong. Nonperforming assets were at a very low 6 basis points of total assets"
    - JP Morgan (JPM)
        - "In the U.S., consumers continue to spend with solid balance sheets, job openings are plentiful and businesses remain healthy. However, there are significant headwinds immediately in front of us – stubbornly high inflation leading to higher global interest rates, the uncertain impacts of quantitative tightening, the war in

Ukraine, which is increasing all geopolitical risks, and the fragile state of oil supply and prices."

- "Nominal spend is still strong across both discretionary and nondiscretionary categories, with combined debit and credit spend up 13% year-on-year. Cash offers remain elevated across all income segments. However, with spending growing faster than income, we are seeing a continued decrease in median deposits year-on-year, particularly in the lower income segment. And not surprisingly, small business owners are increasingly focused on the risks and the economic outlook."
- "We just don't see anything that you could realistically describe as a crack in any of our actual credit performance. . .we've done some fairly detailed analysis about different cohorts and early delinquency bucket entry rates and stuff like that. And we do see, in some cases, some tiny increases. But generally, in almost all cases, we think that's normalization, and it's even slower than we expect"
- "we're in an environment where it's kind of odd, which is very strong consumer spend. Balance sheets are very good for consumers. Credit card borrowing is normalizing, not getting worse. . .So you go in a recession, you've got a very strong consumer. . .And that extra cap -- money they have in the checking accounts will deplete probably by sometime midyear next year. And then, of course, you have inflation, higher rates, higher mortgage rates, oil volatility war. So those things are out there, and that is not a crack in current numbers. It's quite predictable. It will strain future numbers."
- "QT as being one of the uncertainties because it's a very large change in the flow of funds around the world, who are the buyers and sellers of sovereign debt. There's a lot of sovereign debt. But I think if you look at the building alone is a bump, it's not going to change what we do or how we do it. And you're going to see bumps like that because all of the things I already mentioned. It's inevitable that you're going to see them. Whether they create systemic risk, I don't know."
- "we're not over earning in NII, maybe a little bit because the lags and stuff like that, but not a lot, but we are over earning on credit. Think of credit card. And the 1.5%, we've never seen a number of that low risk. We're quite conscious of that."
- "They're roughly the same. (vs 3 months ago) We're just getting closer to what you and I might consider bad events. So -- in my hurricane, I've been very consistent, but looking at probabilities and possibilities. There is still, for example, a possibility of a soft land. We can debate what we think that percentage of yours might be different than mine, but there's a possibility of a mild recession. Consumers are in very good shape, coming in a very good shape. And there's possibility is something worse, mostly because of the war in Ukraine and oil price and all things like that. Those -- I would not change by possibilities and probabilities this quarter versus last quarter, for me."
- "my experience in life has been you have things like what we're going through today, there are going to be other surprises. Someone is going to be off sides. We don't see anything looks systemic, but there is leverage in certain credit portfolio, this leverage for certain companies is leverage. So you're probably going to see some of that. . .You already see very low liquidity. So something like the LDI think could cause more issues down the road, if it happens constantly and stuff like that. But so far, it's a bump in the road. The banking system itself is extraordinarily strong."
- "The banking itself is extremely strong, extremely strong. It's not -- what you're going to see will not be in the banking. . .It might be in credit, it might be in emerging

margins. It might be in FX"

- Morgan Stanley (MS)
  - "We had zero interest rates for a decade. We have massive monetary and fiscal stimulus. We have the first land war in Europe in 70 years. The highest inflation in 40 years, and the Fed had to move. Now my opinion was they moved late, but they moved and they're going to keep moving. And rates are now around 3%, they're probably going to go mid-4s, but that remains to be determined. And with that, there will be consequences. So far, we haven't seen clarity around inflation abating. My guess is that we will see that clarity and it will be more evident certainly by the middle of next year."
- PNC Financial Services Group (PNC)
  - "Our credit quality was largely unchanged in the quarter. While we have not seen any meaningful deterioration in credit quality taking place, our provision of $241 million reflects our slightly weaker economic expectations"
  - "we're seeing balances increase in credit card, which is a good thing. So people are finally drawing down on credit. But we really haven't seen deterioration in the performance of the book across anything."
- US Bancorp (USB)
  - "Credit quality remains strong and in the third quarter our net charge-off ratio improved on both a sequential and year over year basis."
  - "Over the next few quarters, we expect the net charge-off ratio to remain lower than historical levels but to normalize over time."
  - "we recognize the pressure points are building in several areas of the economy that could lead to stress in the future. Borrowing costs are increasing, inflation is high, saving rates are starting to decline, and the stock market is well off its highs. So while the backdrop is favorable today, it would not be surprising to us to see an economic slowdown develop at some point driven by lower confidence levels, which may lead to reduced spending and business investment."
- Wells Fargo (WFC)
  - "Credit performance remains strong. . . Both consumer and business customers remain in a strong financial condition, and we continue to see historically low delinquencies and high payment rates across our portfolios. We are closely monitoring risks related to the continued impact of high inflation and increasing interest rates, as well as the broader geopolitical risks, and while we do expect to see continued increases in delinquencies and ultimately credit losses, the timing remains unclear"
  - "our customers continue to be resilient with overall strong credit performance and solid cash flow. When looking at simple averages across the entire consumer portfolio, deposit balances per account decreased from the second quarter, but were still higher than a year ago and remained above pre-pandemic levels."
  - "our consumer deposit customers' health indicators, including cash flow, payroll and overdraft trends, are still not showing elevated risk concerns. Debit card spending remained significantly above pre-pandemic levels and was up 3% in the third quarter compared to a year ago"
  - "labor demand remains robust, consumer balance sheets remain healthy, and customers have capacity to borrow. . . Both consumer and business customers remain in a strong financial condition, and we continue to see historically low delinquencies and high payment rates across our portfolios. . .And we do expect to

see increases in delinquencies, and ultimately, credit losses, but the timing remains unclear."
        - "Credit performance remained strong, with only 17 basis points of net charge offs in the third quarter. However, as expected, losses are slowly increasing from historical lows, and we expect them to continue to normalize towards pre-pandemic levels over time. . . We are. . . continuing to take some targeted actions to further tighten underwriting standards."
- Industrials
    - Commercial Metals Company (CMC)
        - "looking at our business, we see no meaningful signs of a slowdown. Demand in the fourth quarter was strong across our product lines in major geographies, with the exception of some inventory destocking that resulted from customers carrying higher inventory than historical norms, in order to manage ongoing supply chain constraints."
        - "The key indicators that lead rebar consumption by 9 to 12 months remains strong."
        - "Our downstream bidding activity remained at historically high levels during the fourth quarter driven by a broad basket of project types in both the public and private sectors."
        - "Another meaningful structural trend is the reshoring of critical industries. . .Semiconductor chip and wafer plants are the highest profile examples of reshoring, but other industries are also experiencing increased activity or project planning. These would include LNG facilities for the export of natural gas as well as the automotive supply chain with a particular focus on electric vehicles and battery production. . .Eventually, we expect reshoring to extend well beyond the areas we just discussed."
    - Fastenal Company (FAST)
        - "the most important feedback that we focus on is what are our regional and district leaders hearing from their customers as far as their confidence going into 2023. . . that confidence isn't strong. It's not, hey, the sky is falling, but the confidence is very, very cautious, and we're preparing for that type of environment."
        - "While many commodity indexes have recently fallen from their peaks, global supply chains are filled with product where costing reflects the higher commodities of a number of months ago. It will take several quarters for lower costed product to find its way to the point of use and we continue to see supplier letters seeking to recover these costs. These variables have supported stable product price levels in the marketplace."
        - "As product availability in our hubs has reached our goal, we have been able to slow our inventory build even as improvement in the supply chain has allowed us to slightly shorten domestic and import ordering cycles."
    - PPG earnings warning
        - "In comparison to its forecast at the beginning of the third quarter, company sales were impacted by further softening demand. . .The sales volume declines were most pronounced in September and resulted in a reduction in the earnings benefit from higher selling prices and reduced manufacturing efficiencies versus the prior forecast."
        - "Softer demand conditions are expected to continue into the fourth quarter. . . Raw material cost inflation remains at historically elevated levels but has begun to moderate in some regions. The company is expecting selling prices to be up by

between 10% and 12% compared to the prior-year fourth quarter, and up between 18% and 20% on a two-year stacked basis. The company anticipates fourth quarter year-over-year segment earnings growth of near 20%, as year-over-year segment margin recovery momentum accelerates."

- Housing
  - Redfin (RDFN)
    - "The rental market is coming back down to earth because high rents and economic uncertainty have put an end to the pandemic moving frenzy of 2020 and 2021, when remote work fueled an enormous surge in housing demand that would've otherwise been spread out over the coming years. . .Rising supply is also causing rent growth to slow. Scores of apartments that have been under construction are now coming on the market, and more homeowners are choosing to become landlords instead of selling in order to hold on to their record-low mortgage rates. . .We expect rent growth to slow further into 2023 as Americans continue to hunker down and more new rentals hit the market."
- Federal Reserve
  - Bullard
    - "September inflation warrants "frontloading," but may not need higher overall rates"
    - "Inflation is currently pernicious but I see core PCE below 3% by the end 2023."
    - "The appropriate rate range should be in the 4.5%-4.75% by the end of the year, with any further increases in 2023 being data dependent"
  - Evans
    - "Our rapid pace of rate increases has fast-tracked our arrival to such a restrictive stance. . .Overshooting is costly, too, and there is great uncertainty about how restrictive policy must actually become. . .This puts a premium on the strategy of getting to a place where policy can plan to rest and evaluate data and developments. . .we've already done so much with front-loading, then that sort of puts us at somewhat greater risk of responding overly aggressive."
  - Brainard
    - "by Board staff estimates, the revisions imply that the stock of excess savings held by households is about 25 percent lower, which may imply a more subdued pace of consumer spending going forward than had been projected.
    - "In other sectors, lags in transmission mean that policy actions to date will have their full effect on activity in coming quarters, and the effect on price setting may take longer."
    - "The sharp fall in vacancies at a time when initial claims held steady at low levels provides support for the possibility that businesses that faced significant challenges finding and retaining qualified workers following the pandemic may be more inclined than in past cycles to retain rather than lay off their workers as demand weakens."
    - "Strong wage growth along with high rental and housing costs mean that inflation from core services is expected to ease only slowly from currently elevated levels. In contrast, core goods have been expected to return to something closer to the pre-pandemic trend of modest disinflation as a result of demand rotation away from goods to services, coupled with the healing of supply chains and declining core import prices. Disinflation in core goods would help to offset the inflationary pressures in services."

- "The combined effect of concurrent global tightening is larger than the sum of its parts. The Federal Reserve takes into account the spillovers of higher interest rates, a stronger dollar, and weaker demand from foreign economies into the United States, as well as in the reverse direction. We are attentive to the risk of further adverse shocks—for instance, from Russia's war against Ukraine, the pandemic, or China's zero-COVID policies. And we are also very aware that the cross-border effects of unexpected movements in interest rates and exchange rates, as well as worsening external imbalances, in some cases could interact with financial vulnerabilities. In this environment, a sharp decrease in risk sentiment or other risk event that may be difficult to anticipate could be amplified, especially given fragile liquidity in core financial markets. In some countries, the realization of these risks could pose challenging tradeoffs for policy."
- "In light of elevated global economic and financial uncertainty, moving forward deliberately and in a data-dependent manner will enable us to learn how economic activity, employment, and inflation are adjusting to cumulative tightening in order to inform our assessments of the path of the policy rate."

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