Earnings Season Takeaways 3Q 2022: Global Growth Team Observations

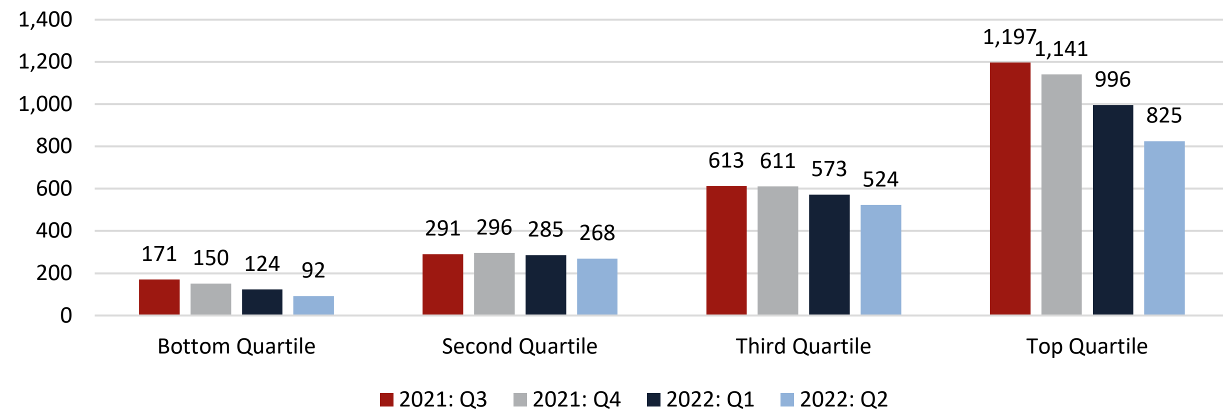
November 16, 2022

Consumer spending

From individual company earnings, it can be challenging to paint a clear picture of the economic situation in the US. Large "bellwether" retailers such as Walmart and Target have called out consumer trade down and cancelled billions of dollars in orders for general goods merchandise. However, Marriott has seen "just the opposite" and cannot find any signs of demand weakness.

We see a few drivers at work here. The first is widely understood – the shift from goods spending back to services. As Mastercard commented on its Q3 earnings call, "The trend towards spending on experiences continues. We saw notable strength in airline, lodging and restaurant spend with a shift away from categories like home furnishings and appliances. The current mix between retail, T&E and other categories of spend is now broadly similar to pre-pandemic levels." The second gets less airtime – American consumers continue to spend down excess savings, a tailwind that is likely to last well into 2023 or even beyond for some consumers. Investors need to be careful here, however. Wealthier consumers still have a large runway of excess savings, while there are fewer dollars left for the bottom 50% and especially the least well-off quartile.

Excess Savings by Income Cohort



Source: US Federal Reserve

In our view, this is being lost against the narrative of strong blue collar wage growth and layoffs at some investment banks and technology companies, which get disproportionate news coverage on Wall Street despite representing a tiny fraction of US jobs. Whether consumers have a large pool of savings to spend from matters far more than whether their wages grow 3% or 6% in a given year. Because of this, we have counterintuitively believed more "premium" consumer companies like Louis Vuitton and Lululemon have much more durable growth profiles than Nike or Adidas, who face significant headwinds despite less expensive product offerings. While this has begun to play out in 2022, we think investors are overly attributing that divergence to temporary factors when in fact it is likely to persist for years as the latter two simply had a period of unsustainable growth due to low income consumer stimulus that they attributed to structural trends. In fact, we would note that Nike and Lululemon currently carry almost an identical forward multiple (based on Bloomberg consensus), despite the latter growing nearly 3x faster.

Resilience within Industrials

Another example of where this leads us to believe macro concern is overdone relates to aerospace companies, such as Airbus and Safran. Investors remain concerned that Airbus will not be able to return to peak production rates, despite airlines publicly stating they are severely undersupplied given demand. The path back to these levels by 2025 offers investors a 9% free cash flow yield in Airbus, a duopoly with decades of mid-single digit air traffic growth ahead driven by the developing world. While we understand travel cannot remain immune to a slowing economy forever, hotel spending has only now recovered to 'normal' levels, cross border travel remains significantly below normal, and the consumers most likely to travel by air have ample excess savings. We will admit it is a bizarre combination to see travel grow at a double-digit rate while Walmart warns about consumer spending, but therein lies the opportunity for outsized returns. While large hotel companies are back to 'peak' earnings, Airbus and Safran are the last in the value chain to see this tailwind, which we believe means the aerospace supply chain is earlier in the cycle than the market believes. This is reinforced by an eight-year backlog in Airbus' core A320 lineup. Airlines unwilling to take delivery of planes are moved to the back of the line, risking a large and durable market share loss. Instead, we believe that airlines will mitigate moderate economic fluctuations by retiring their oldest, least efficient planes – reducing operating costs and carbon emissions.

Semiconductor update

The semiconductor sector has de-rated significantly and faces headwinds from the slowing consumer goods spending described earlier as well as decelerating IT spending growth. On top of this, concerns over conflict in Taiwan have grown significantly in the past year. Historically, we have not tried to call the semiconductor cycle beyond adding to positions as they shrink on bad headlines and trimming as they rise on good ones. Clearly, we are well into the 'bad' in 2022. We view this as a large but typical inventory correction and expect to stick to the playbook described previously.

Competitive positions in the industry remain quite similar to a few years ago, with the exception of AMD leapfrogging Intel in x86 processors (in no small part due to TSM's superior fabrication process technology). Long term demand seems healthy with tailwinds from AI / machine learning, self-driving cars, and rising semiconductor content in most consumer goods. Potentially disruptive new entrants in China have been badly undermined by recent US policy actions. This remains under-appreciated in our view, with many market participants focused on the demand impact to fabrication (WFE) vendors like ASML. While there is some demand destruction due to a pullback in spending from newer, less efficient foundries in China, the long-term setback to local WFE competitors is a powerful offset. These companies – such as Shanghai Micro Electronic Equipment (SMEE) - have gotten little airtime in the Western press compared to companies physically producing chips such as SMIC or Yangtze Memory, but will be a much more critical determinant of China's competitiveness in leading edge semiconductors in the long term. Cutting off both the leading-edge demand from domestic foundry customers in addition to limiting their ability to source Western components will represent a multi year setback in their effort to compete with the ASMLs and Applied Materials of the world.

As a final note on semiconductors, we would identify a few areas of emerging interest outside of the well understood secular growth engines of Nvidia's datacenter GPUs or ASML's EUV. The first is the expansion of general processor offloading to silicon besides GPUs. As the rate of improvement of CPUs has slowed – an inexorable trend driven by physical constraints beyond the scope of this note – servers are becoming more complex with compute tasks allocated to specialized silicon that can offset the CPU performance headwind. Nvidia GPUs for machine learning are the most famous, though others such as smart NICs have been growing for years. We see a few interesting approaches to capitalize on this, such as AMD's $49Bn acquisition of Xilinx to create a more integrated CPU and FPGA, as well as more custom CPU designs built off of ARM reference designs. We believe that both of these are large and investable opportunities (as ARM returns to public markets soon) but will require excellent execution to succeed.

Software and SaaS

The other area of technology we have had exposure to historically is software. The boom and bust in software as a service (SaaS) stocks is a bit more complicated and will take a longer time to repair than the demand driven trends in semiconductors. The precipitous decline in SaaS multiples is driven by both a pullback in end demand and 'peak' overcapitalization of the sector. As public markets rewarded SaaS companies with higher and higher multiples from the last 'trough' in 2016 to 2021, venture capital poured money into the sector. North American VC funding grew 130% y/y in 2021 with over 300 companies valued above $1Bn, versus <100 in prior years. Clearly, many of these deals are deeply underwater given public market multiple compression. However, the reality for public software companies is these companies will compete for talent and customers until they run out of money (or for a few, reach escape velocity). Furthermore, we don't believe private market investors will simply throw in the towel – we will likely see downrounds and attempts to minimize burn before capitulation occurs. Per EY, VC funding YTD through September was down just over 50% - a precipitous decline, but still comparable to 2019 levels. This means pressure on market share and employee compensation will take time to abate, and the market structure of some incumbents may be disrupted. This thinking led us to materially reduce our highest growth and valuation software positions in late 2021 and fully exit the remainder in early 2022.

On a more positive note, we do think management teams focused on driving margin expansion will be rewarded, at least on a relative basis, and have a significant longer-term opportunity to gain market share from "growth at any cost" companies that end up deeply impaired. As large enterprise customers hesitate to buy from vendors on rocky financial footing, organic and inorganic consolidation is inevitable. We believe companies protecting margins and maintaining the trust of their investor base – such as ServiceNow – are likely to end up well positioned to take market share organically or via deeply discounted acquisitions. We still see a wide range in how grounded management teams are in the new reality of higher discount rates and investor concern over unsustainable practices like stock-based compensation expense which exceeds free cash flow generation.

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