CAIM

CATHERINE AVERY INVESTMENT MANAGEMENT

3Q21 Earnings Recap

Executive Summary

OVERALL TRENDS IN THE QUARTERLY REPORTS

Once again, we are coming off a strong quarter, as most of our names are benefiting from the Covid rebound. Some key overall trends we have seen include:

MACRO THEMES:

Positive Earnings Surprises Continue – Over 85% of our holdings beat consensus numbers for the 3Q, and some by a lot, despite the efforts of analysts to keep up with the strong pace of recovery. The sectors with the biggest percentage surprises with Industrials, Energy and Financial, despite the cyclical slowdown from the Delta variant.

Inflation Clearly a Trend – As we have written about, inflation is proving persistent and not transitory. It is hard to argue with the data. And it is not just raw materials and goods that are inflating, we are now clearly seeing wage inflation among many of our companies, a combination of a worker shortage and minimum wage increases.

Pricing Power Pass-Through – It is perhaps not surprising the high quality companies with high market shares are able to get pass-through of higher input costs.

Demand Well Ahead of Supply – Huge pent-up demand remains throughout the cash-rich consumer chain, giving this recovery some legs.

Supply Chain Disruptions Taking Much Longer – Most investors thought such disruptions related to Covid would turn when the virus fades. But we are seeing the opposite effect, that the surge in recovery demand is worsening shortages, and it will take longer to catch up. No place is it more evident than in semiconductor chips, which increasingly fuel more industries.

Financial 'Wow" Factor – Profit margins are rapidly increasing, as cost cutting during the pandemic have steepened the profit curve for companies back on the way up. This is resulting in increasing free cash flow estimates, and even cleaner balance sheets. We also see signs of creeping productivity improvement, which will be more apparent as the raw material squeeze eases, since wage increases tend to be more sticky.

Lower Regulatory Pressure – The Biden Administration appears to be hampered on its attempts to increase regulatory pressure on those industries that feared the 'Blue shift', like financial, health care, energy and technology

Spinoff Madness - The era of the conglomerate is clearly fading away, as companies are unlocking value with a rash of spinoffs, at the highest rate in our memory. Some of our names involved here currently are DD, JNJ, MRK, OGN, T.

Value Enhancing M&A – At the same time, record levels of cash appear to be driving a frenzy of acquisitions, the vast majority of which are accretive or value enhancing for our names. We tend to no longer own that do deals we don't like, or don't have cost or sales synergies. Some of our names involved here currently are ABBV, DD, LYB, T.

SECTOR THEMES

Infrastructure & Construction Early Cycle – The pandemic has rewound these sectors from what was late cycle to now a new early cycle. Orders and backlogs are surging.

Time for Transportation - Cars, trucks, rails and now even aircraft are seeing strong rebounds in orders for both OEM and aftermarket channels.

Energy Entering a Structural Shortage – Economic recovery means a higher demand call on energy, and supply is struggling to keep up, clearly exacerbated by discipline of the cartel. Bring on supply among non-OPEC producers is expensive and time-consuming. But with an energy transition looming, producers are wary of increasing capex. And DC politics is making it harder for US shale producers as well.

Energy Transition – This appears to going faster than expected, with Industrial and Energy companies moving faster toward renewables, both on the production and consumption side. And shareholders are approving such transitions on improving ESG scores.

Tech Trends Driving Other Sectors – Someday soon those that define industrial sectors by group will realize that the line is blurring. This is no more apparent than in the Finance, Industrials and Autos, which are rapidly becoming more tech dependent. Should an EV car be defined as a 'computer on wheels'?...

Surprising Power of the 5G Transformation – The next gen network move is more powerful than most thought, with faster growth benefits for our players.

Power of Software & Cloud Transition – We can't talk about Tech the same way anymore. Cloud & Software are clearly where the growth is, and our companies appear to be benefitting faster than we thought in the transition from the old hardware model.

Health Care Recovery & Transformation– With the exception of the Delta variant and consequent double dip in patient visits, there is clear recovery in the sector with respect to procedures and non-Covid related health care. And visionaries like CVS are defining the transition to the future for consumer healthcare.

Easing Competition in the Rising Tide – Price competition appears to be falling by the wayside, helped by rising inflationary trends and a rising tide of demand lifting all boats.

Turn in Financials Metrics Underway – The Financial sector likes a steepening yield curve, improving credit quality and higher interest margin. Check on all three. The laggard desire is increasing loan growth, but we may have to wait until more people need loans. But at least the turn is underway on all these factors.

Branded Market Share Gains – In the hangover of the pandemic, the big appear to be getting bigger and gaining market share, as consumers can now afford to pay up for quality brands.

Wishing you a Safe, Healthy, and Prosperous Fourth Quarter!

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