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Microeconomic mosaic

Evan Lorenz writes:

Growth or recession, one or the other, is written in the stars, but which will it be? Jerome Powell lines up on one side of the argument—the Fed chairman is hopeful—and investing great Stanley Druckenmiller takes the other. The answer will likely determine the near-term prices of stocks, bonds and commodities as well as the path of inflation.

"The data" only get you so far in macroeconomic soothsaying. Yes, the April jobs report, which showed a surge of 253,000 new hires, topped the consensus estimate by a cool 68,000, but initial jobless claims are also surprising to the upside. American employers have reduced temporary workers by 138,700 over the past six months—not customarily a harbinger of prosperity.

And what about the incredible shrinking money supply or the persistently inverted yield curve? Or the simple, arresting fact that the Fed is tightening into a credit contraction? So, yes, we judge, recession is more likely than not, a conclusion we draw not only from a selective glance at the big picture but also from the operating results of a quintet of hand-picked public companies. Each of these corporate specimens—four cyclicals and a cereal maker—is a former *Grant's* pick not to click, and we remain bearish on the lot. We review them here for what they might say about the direction of business activity.

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United Rentals, Inc. (URI on the New York Stock Exchange), the largest rental company for industrial and construction equipment in the United States, is our Exhibit A. Equipment rental thrived in the Covid era. Manufacturing snarls constrained the supply of new machines, while fiscal and monetary stimulus hyped the demand for what little machinery was available. This supply-demand imbalance allowed the ratcheting up of rental prices and boosted net income to $1.8 billion last year from the prior record of $1.3 billion, set in 2019.

United's first-quarter results seem to support Powell's call for continued growth. Compared with the year-earlier period, sales soared by 30.2% and adjusted Ebitda by 32%. However, much of that gain came from the December acquisition of Ahern Rentals, Inc. for $2 billion; on a pro forma basis, revenues increased 16.6%. An unexpected jump in used-equipment sales lifted revenue over consensus estimates, but adjusted earnings per share disappointed just the same.

"Fleet productivity declined significantly on reported [numbers] but was more stable pro forma (-60bps in y/y growth rates vs. Q4'22)," a team of Barclays analysts, led by Adam Seiden, observed late last month. "If we assume a similar rate growth as [peer Herc Holdings] and a constant mix (as we do each quarter) then time utilization was near the lowest in our data set for a Q1 since 2012."

The decline in utilization is the industry's problem, not just URI's, and United's management does not deny that the Ahern acquisition is distorting its results. Herc Holdings, Inc., America's third-largest equipment-rental house, blamed its first-quarter woes on a slowdown in TV and movie production spending, not to mention the screenwriters' strike (which actually started 32 days after the quarter closed). Peer H&E Equipment Services, Inc. blamed the weather.

"You go from an environment in which for two years these companies have not experienced any seasonality," Mircea Dobre, who rates URI as underperform for Robert W. Baird & Co., tells me. "They have not experienced any weather that impacted utilization. Why? Because demand was high and the supply of equipment was so tight. And then you get to the first quarter of 2023, the first quarter in which demand was no longer uniformly great."

According to the U.S. Census Bureau, construction value put in place grew by 3.8% year over year in March versus a 10.5% gain in the same month last year. To date, residential construction, which accounts for 46% of the total and fell at a 9.8% rate in March, is responsible for the drag. But the run on regional banks puts nonresidential construction at risk, too. Almost three-quarters of respondents in the Fed's April Senior Loan Officer Opinion Survey on Bank Lending Practices said they're tightening standards on construction and land-development loans.

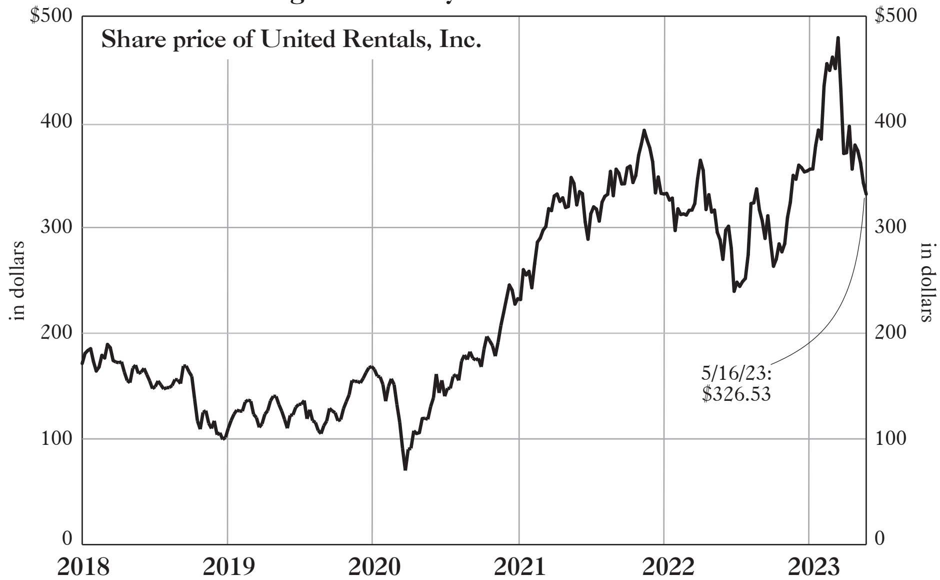
Meanwhile, the National Federation of Independent Business's optimism index slipped by 1.1 points to 89 in April, the lowest reading since January 2013. Certainly, the oil patch is none too cheerful. The number of active drilling rigs in the 50 states has declined to 731 from 784 since November.

Simultaneously, and unhelpfully, new-equipment deliveries are surging as manufacturers work through Covid-era backlogs. In their latest respective quarters, Caterpillar, Inc.'s sales rose by 17% and Deere & Co.'s by 34% (each measured year over year). "Our first-quarter results lead us to expect that 2023 will be even better than we previously anticipated," Caterpillar CEO Jim Umpleby crowed on the April 27 earnings call.

United doesn't look expensive at 13.5 times trailing earnings, but its p/e multiple averaged 12.8 in the three years ended 2019. Because the share price has slumped by 26.9% (versus a 1% uptick in the S&P 500) since we inveighed against the company in the issue of *Grant's* dated Feb. 10, we are less bearish now than we were previously. Even so, a reversal of the earnings surge of 2021 and 2022 might be in the cards.

The Street is bulled up on URI (16 of 25 analysts rate the stock a buy and only three a sell), and analysts are projecting 44.8% growth in 2023 net income. Since the start of the year, insiders have liquidated 31,397 shares for a haul of $14.1 million and purchased not one.

Covid was the good old days



source: The Bloomberg

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There are no mixed signals in the trucking industry, where business is unambiguously lousy. From the peak at year-end 2021, spot trucking rates have plunged by 38.4%, according to FreightWaves, Inc. When business booms, truckers reject lowball freight tenders—and the opposite happens when times are tough. Thus, the percentage of rejected loads, which averaged 22.9% in 2021 and 9.7% in 2022, has plummeted to 2.53% today, taking out the all-time low of 2.57% set on April 30, 2020, when the country was locked down. Bankruptcies of smaller trucking firms are mounting.

First-quarter operating income, measured year over year, slumped by 36% in the case of Werner Enterprises, Inc. (WERN on the Nasdaq) and by 51.4% at Knight-Swift Transportation Holdings, Inc. (KNX on the NYSE). Speaking on the Oct. 19, 2022 earnings call, Knight-Swift CEO David Jackson drew a line in the cyclical sand at $4: Come what may, that would be the trough in earnings per share. It was a pretty optimistic line, at that, given that EPS scarcely topped $2 in 2019. On the April 20 call, Jackson reconsidered to the tune of 55 cents; the new 2023 guidance has a midpoint of $3.45.

A fact to bear in mind is that the two companies derive more revenue from longer-term contracts than from spot bookings. For example, Werner tapped 37% of its first-quarter revenues from long-term dedicated contracts with large retailers and other favored customers. On the May 3 earnings call, Werner CEO Derek Leathers told analysts that revenue per truck in the so-called dedicated division increased by 4.6% over the past year versus a 27.3% year-over-year collapse in average spot rates in the first quarter.

"Normally there's only about a 25 to 30 cent delta between contract and spot rates," John Paul Hampstead, a strategic analyst for FreightWaves, tells me. "Right now, it's something like 80 cents. That implies a huge, gravitational force pulling down contract rates further." In other words, if trucking fundamentals do not improve rapidly, the contract rates that have held up Werner's and Knight-Swift's results will crumble.

Like the rental industry, truckers made hay while the virus rampaged. Locked-down consumers shifted their purchases to TVs, laptops and other merchandise in lieu of dining out or traveling. Congestion at ports and on the rails gummed up freight velocity (thus boosting per-truck utilization) and shifted more goods to trucks. Paccar, Inc. and Daimler Truck Holdings A.G. couldn't make enough big trucks to meet the demand.

Now comes the Covid hangover. Retailers, having overextrapolated the demand for goods, are still trimming inventories. According to Census Bureau data, the ratio of wholesale inventories to sales rose to 1.4 in March—a level, since the turn of the 21st century, that was surpassed only for a few months in the global financial crisis and in spring 2020—from 1.25 times a year ago. The Logistics Managers' Index fell 0.2 points to 50.9 in April, lowest in the seven-year history of the gauge. "The freight recession continues," the accompanying press release warns.

Meantime, truck OEMs are delivering on the backlogs they built up over the past three years, with Paccar, for instance, showing a 30.9% bump in first-quarter sales. The dire state of the market is only slowly impacting manufacturers, Eric Crawford, a senior analyst at trucking analytics firm ACT Research Co., tells me, with the three-month rolling average of new heavy-truck orders dropping 31% from the year-ago period versus a rise of 21% as recently as last fall.

While Crawford anticipates a year-over-year decline in Class-8 truck shipments of 2% in the third quarter and 17% in the fourth, some 318,000 new heavy trucks will nonetheless roll off the production lines this year. Anything over 240,000 units per year means that the fleet gets larger—not what the industry needs to happen just now.

The production surge is buoying the results of Cummins, Inc. (CMI on the NYSE), the largest pure-play engine maker in the world. The March quarter delivered a 70% leap in operating income on the back of a 32.4% jump in sales. While acquisitions flattered the revenue line (organic sales were up 12%), these are record-breaking results for CMI.

In the short term, Cummins is exposed to a late-year decline in truck production. Longer term, it's likewise at risk if the truck fleet goes electric. Following Caterpillar's exit from the business of making medium-duty truck engines in 2010, Cummins's dominant share of that market was even more commanding. Beware, though, what Washington, D.C. giveth. "The Inflation Reduction Act is really the difference between the price of a medium-duty truck that's electric and one that's diesel," Jay Van Sciver, who rates Cummins a sell for Hedgeye Risk Management, LLC, tells me. "The subsidy is up to $40,000."

Cummins does offer an electric drivetrain, which it acquired through its 2022 purchase of Meritor, Inc. However, competition is more intense in the electric truck-parts market than in Cummins's core diesel business, and electric trucks offer commensurately lower margins. Crawford says that big truckers are testing electric trucks to understand the operating and maintenance costs, and if all goes well, the industry will shift more volume to electrics over the next 12–24 months. That would be just around the time when truck production will ramp up again.

Since we said our bearish piece in the issue of *Grant's* dated Nov. 11, 2022, WERN has rallied by 8.1% and KNX by 3.1%, compared with a 3.8% rise in the S&P 500. Today, Werner trades at 17.5 times trailing earnings and Knight-Swift at 12.3 times. The Street is broadly friendly to the duo, with 26 of 40 analysts saying buy against only two saying sell. Since the start of the year, Knight-Swift insiders have sold 67,139 shares for proceeds of $3.8 million while Werner executives have stood pat.

Since Nov. 11, 2022, Cummins has declined by 13.2%, leaving the shares with an 11.8 times trailing p/e ratio. Among analysts who hold a clear opinion, the division is 10:1—bullish. Since the start of the year, insiders have sold 18,686 shares for proceeds of $5.4 million without one single buy.

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To the casual analyst, the latest results at General Mills, Inc. (GIS on the Big Board) show nothing but continued consumer strength. In the three months ended Feb. 26, sales (adjusting for currencies and acquisitions) erupted by 16% and adjusted EPS by 17%, beating estimates. Since a bearish analysis in the issue of *Grant's* dated Jan. 13, the food maker has raised guidance twice and the stock has generated a 10.1% return, outpacing the 3.3% rise in the S&P 500.

However, given that underlying volumes were flat, price hikes are exclusively to thank for that double-digit sales surge. If you wonder what will happen when Covid-induced bottlenecks clear and half-empty store shelves are filled, the answer is at hand. The food makers, having already sorted out their logistics, are back to offering promotional inducements. Between the fiscal years ended May 2022 and May 2021, Mills's advertising expense slumped to $690.1 million from $736.3 million. On the March 23 earnings call, CEO Jeffrey Harmening told analysts to prepare for double-digit jumps this year.

"Branded food volume promotional levels increased ~350 bps y/y in April, the highest y/y increase since December 2021," a team of Jefferies Financial Group, Inc. analysts led by Rob Dickerson advise. "While promo levels remain below pre-pandemic, they've increased at an accelerating rate in seven of the past eight [four-week] periods, all while private label share gain continued."

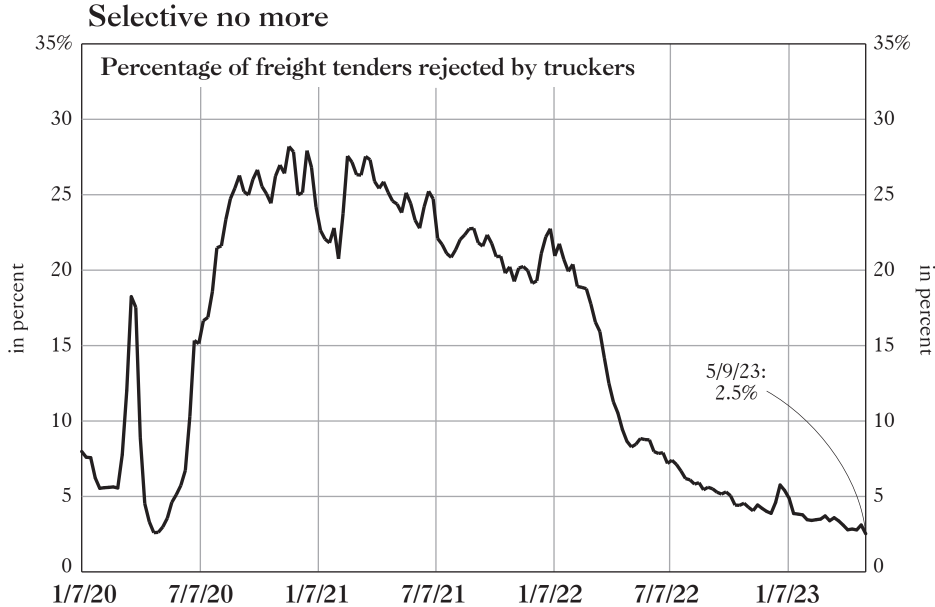
According to Jefferies, Mills increased its marketing outlays by 504 basis points in April versus the year-earlier month, putting the cereal giant among the most aggressive discounters. "[Mills] said it expects to not get aggressive from a pricing standpoint given [that in-stock levels at grocers are] not back to normal yet, but this is the first month since March 2021 in which promotional levels were above that of the same period in 2019," Dickerson and team point out.

In March, the Supplemental Nutrition Assistance Program (a.k.a. food stamps) ended its so-called emergency allotments, or additional funds approved during Covid. For more than 30 million people, this has meant the loss of about $82 per month. The effects are already evident in consumer shopping patterns.

Take Tyson Foods, Inc., the giant chicken, beef and pork producer. Tyson missed Street estimates in the quarter ended April 1 and took an axe to full-year guidance. "Consumers have been buying fewer steaks and burgers to reduce food costs while drought-hit cattle ranchers have been slashing herds, bringing cattle prices to a record," Bloomberg reports. "That's squeezing meat companies like Tyson. Its beef sales in the second quarter fell 2.9% from a year ago."

Nor does it appear that Tyson's volumes have improved since the end of the quarter. "I talked to someone at Hirschbach Trucking the other day," says Hampstead, our source at FreightWaves. "They're a really big private carrier that runs an all-refrigerated fleet. Their whole

Selective no more



source: FreightWaves, Inc.

model is being resilient. They carry food and beverages, stuff that shouldn't be economically sensitive. Their protein shipments are down about 10%."

General Mills trades at 20.8 times trailing earnings, a premium to the S&P 500's multiple of 18.5 times and to the average of 18.4 times that the cereal maker commanded in the five years ended 2019. Though the Street is noncommittal, the Mills front office has expressed its view with sales of 91,296 shares for proceeds of $7.9 million offset by nary a purchase.

Another, and greater, stimulus-era program is set to expire soon, namely, the moratorium on federal student loan payments. Some 43.8 million borrowers owe $1.6 trillion in federally funded student loans. "Payments will resume no later than Aug. 29," Bloomberg reported last week, "depending on when the Supreme Court hands down its decision" on the program. The resumption of loan payments will be a bigger drag on consumer incomes than the cut in food-stamp benefits.

Maybe Mr. Druckenmiller is on to something.

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