

MONTHLY ISSUE #114 | 2nd July 2024

It's not all about AI

EDITORIAL VIEW

- Industrial distributors exhibit consistently solid revenue growth - and stock performances
- The HVAC, water and insulation end markets stand out as particularly attractive going forward...
- ...owing to environmental considerations, the reshoring trend and chronic past underinvestment

GLOBAL STRATEGY

- The global soft landing scenario is back in place, with the Fed next in line to cut rates
- Equity markets have thus rallied to new highs, though with yet narrower breadth
- The second half of 2024 could see higher volatility and more muted returns

ASSET ALLOCATION

- Tactical allocation status quo - A constructive but watchful stance
- Equity - Maintain a diversified all-terrain high-quality allocation approach
- Bonds - Cautiously neutral on sovereign duration and selective in the HY/EM segment

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Relatively simple business models can also be highly rewarding for investors. Industrial distributors have not only proved so in the past but are today being eyed by renowned businessman Brad Jacobs. With AI all the rage on (and off) stock markets, and a subject rather for experts, we thought readers might find an article about simple, boring businesses quite refreshing. Particularly since, beyond their attractive financial metrics, industrial distributors can provide exposure to various environmental trends - in a more defensive manner than, say, investments in renewable energy companies.

A look at long-term compounded performance shows that large industrial distributors, of the likes of Pool Corp, Watsco, Fastenal, Applied Industrial and Grainger in the US, or Beijer Ref, IMCD and Diploma plc in Europe, have well outshone their respective market indices. Such "10-bagger" returns rest on an ability to deliver consistent 5-10% revenue growth. Which, in turn, hinges on quality business models, sitting between a great many suppliers and a similarly large number of - often brand loyal - customers; on very large scale effects, with 24/24 technical support and digital expertise being key; on opportunities for bolt-on acquisitions of (cheap) private companies; and on a supportive regulatory framework in some end markets.

What's more, despite relatively low gross margins inherent to their activity, industrial distributors generate strong free cash flow, thanks to a low capital intensity, a high return on invested capital, and significant (purchasing) synergies achieved through the bolt-on acquisitions.

The HVAC (heating, ventilation and air-conditioning), water and insulation end markets are those currently enjoying the strongest tailwinds, for regulatory reasons but also because of the broader reshoring trend in place since Covid. Indeed, shortages and delivery disruptions during the pandemic made customers

realise the importance of solid supply chains, and hence of scaled distributors.

In the HVAC space, the opportunity lies in improving overall efficiency (such systems today account for 40% of US buildings' energy consumption) and in phasing out prevalent HFC (hydrofluorocarbons) refrigerants - a major source of CO2 emissions - as per the Kigali Amendment, adopted in 2016 but only ratified by the US in 2022.

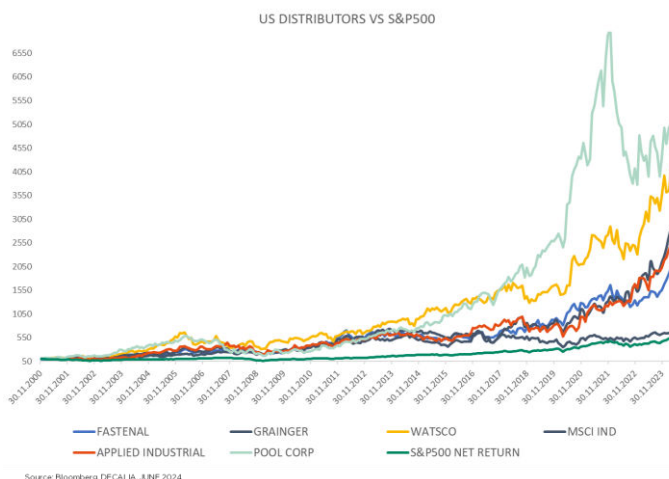
As regards the water infrastructure, not only is it ancient and underinvested, making for increasing water loss and breakage, but natural disasters have also become a regular occurrence, often involving water contamination issues. Recognising the urgent need for upgrade, the 2021 US bipartisan "Infrastructure Investment and Jobs Act" plans to dedicate ca. USD 50 bn to water supply, sewage and waste disposal systems.

For insulation, the investment thesis is simple: it is the best lever to improve a building's energy efficiency. Indeed, insulation products can address ca. 90% of heat loss for a pre-1974 house, be it through the roof (28%), the walls (23%), the ventilation system (23%), the windows (13%), the thermal bridges (8%) or the floor (8%).

Convinced? Let us end by quoting Brad Jacobs¹, whose business track record speaks for itself and who has singled out building-products distribution as his next venture: "Between the construction of housing that's going to be necessary in the coming years, and the need to repair and remodel, I think there will be fairly good demand for building products distribution". And, he adds, "residential housing is not going to be disrupted by AI. It's not going into the metaverse!"

Written by Alexander Roose, Head of Equities

GRAPH OF THE MONTH



¹ Founder of 8 companies (of which 6 trade publicly), Brad Jacobs is currently executive chairman of freight transporter XPO and CEO of QXO - for which he recently raised USD 4.5 bn of equity, with a view to consolidating the building products distribution industry

GLOBAL STRATEGY

The French elections are causing a (welcome) pullback in market sentiment

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It has very much been more of the same on the global macro front recently, with an extra pinch of European political turmoil. Weaker than expected US CPI data, resilient job reports, mixed retail sales and industrial production have all brought the global soft landing scenario back to the forefront. Meanwhile, the central banks' supportive monetary policy easing cycle is now well underway, with the Fed next to cut rates amid resilient growth.

As a result, our base case macro scenario remains unchanged (soft landing with slower but positive growth, and sticky but acceptable inflation, leading to rates normalisation at some point), even though risks of a temporary reacceleration of inflation and/or an economic soft patch cannot be totally dismissed. In our view, stagflation would be the worst-case scenario for balanced portfolios, hurting both equities and bonds – as well as impeding a monetary policy remedy.

In this context, global equity markets continued to rally last month, albeit not all at the same pace. Indeed, wedged by European political uncertainties, global indices posted new all-time highs but with yet narrower market breadth (US tech mega-caps) – despite supportive earnings, more benign US inflation, easing bond yields, and resilient fund flows. Moreover, after gradually re-risking portfolios in recent months, investors took a breather: French uncertainties tempered their enthusiasm, pulling sentiment indicators back to neutral territory while equity allocations stayed close to their long-term average. In fact, the currently elevated index multiples conceal a much more complex reality, with specific market segments such as Europe or small-caps still offering attractive value in our view.

In fixed income, rates remain fairly valued, investors having repriced rate cut expectations to a more realistic path. That said, we do not (yet) see sufficiently compelling valuation opportunities at the long end of the curve, given sticky inflation, higher for longer (neutral) rates, as well as sovereign debt sustainability concerns that require a higher term premium. Moreover, we still struggle to find credit enticing at the

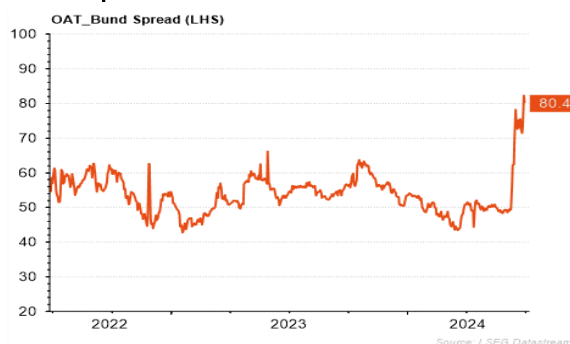
current tight spread levels. As a result, we favour a neutral stance on sovereign duration, especially through convex bonds, while maintaining our preference for corporates over sovereigns (on a “buy & hold” approach) at the short end of the curve, alongside selectivity within the HY/EM segment.

Overall, we have made no changes to our tactical allocation views, after turning slightly more cautious just two months ago. We keep a fundamentally constructive view on equities but do see risks of higher market volatility (bumpy disinflation, geopolitics, timing of monetary easing) causing some price consolidation, and possibly more muted near-term returns. At the portfolio level, in light of the current low equity volatility, we believe that “cheap” tactical hedging makes sense, to protect the solid gains recorded since October. Elsewhere, we keep our cautiously neutral stance on bonds and look to gold for some diversification. In forex, we continue to like both the Swiss franc (even after the SNB's second rate cut) and the US dollar.

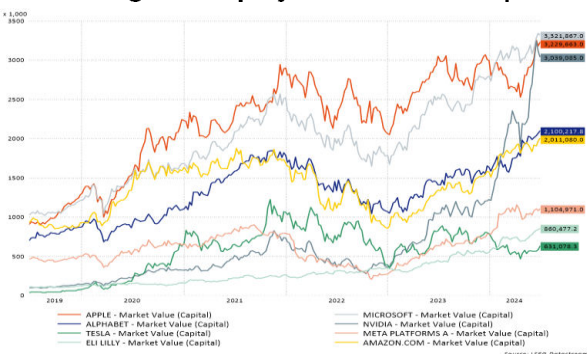
All told, we are not overly concerned by the outcome of French elections for financial markets and actually welcome the resulting pullback in investor sentiment. Still, the latter half of 2024 looks set to remain eventful for risky assets. As such, we stick to a cautiously optimistic stance, favouring an all-terrain approach to portfolio construction, with a well-balanced diversified asset and sector allocation tilted towards high-quality cyclical plays within equities, while aiming for carry, quality and convexity in the bond space.

Written by Sandro Occhilupo, CFA, Head of Discretionary Portfolio Management and by Damien Weyermann, CFA, Senior Investment Manager

French political stress test for bonds



Narrower global equity market leadership



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External sources include: Refinitiv Datastream, Bloomberg, FactSet

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