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Investing in the Industrial Sector

INDUSTRIAL SECTOR REPORT

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Rec. Equity Weight for Industrials: 10%

Buy-rated companies mentioned in this report:

Capital Goods:
- **Ametek (AME - $100.71)**
- **Boeing (BA - $161.14)**
- **CAE (CAE.TO - $19.93)**
- **Deere & Co. (DE - $221.97)**
- **Lockheed Martin (LMT - $395.14)**
- **Snap-On (SNA - $147.53)**
- **Toromont Industries (TIH.TO - $75.73)**

Transportation:
- **Southwest Airlines (LUV - $39.83)**
- **Union Pacific (UNP - $199.80)**
- **United Parcel Service (UPS - $159.66)**

Prices as of market close 9/18/20 and are subject to change. Source: Reuters.

SECTOR INVESTMENT SUMMARY

The industrial sector spans a broad array of companies across aerospace and defense, heavy machinery, transportation, and commercial services. While it is diverse, the companies within the sector share common traits and have leverage to several broad themes that we think make industrials an important part of the equity portion of a broadly diversified portfolio.

The overarching theme across the industrial sector is its sensitivity to economic growth. Demand for industrial products and services tends to be driven by large-ticket capital investments, and typically improves along with general economic conditions. As a result of this economic sensitivity, we view the sector as "offense," meaning it tends to outperform in rising markets and underperform in falling markets.

We think the coronavirus outbreak will have a significant near-term impact on the sector, including the disruption of operations due to supply and labor shortages, as well as a negative effect on demand as companies defer investments in their businesses. Consistent with our view that the sector is "offense," industrials have underperformed year-to-date amid the market volatility. While it is difficult to predict the timing of a recovery, we would expect industrials to outperform in an environment of improving economic sentiment.

While the impact is likely to be broad-based across industrials, we see airlines and aerospace companies with exposure to commercial aircraft as the most heavily impacted due to the weakening in travel demand. Meanwhile, we think defense contractors such as Lockheed Martin are unlikely to be materially impacted given ongoing global conflicts and the government funding of defense spending.

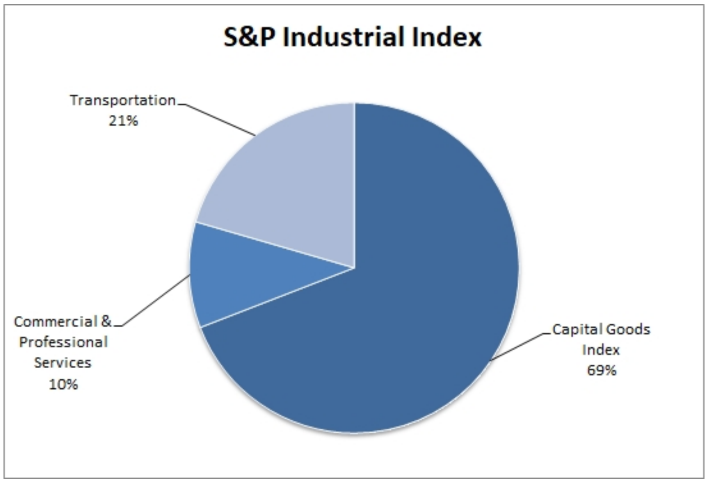
In addition to general economic activity, other key trends and drivers of growth for industrials include
- Construction and infrastructure investment;
- Manufacturing and factory automation;
- Increasing regulation for energy and fuel efficiency;
- Growth in developing countries such as India, Russia, China, and Brazil; and
- Global population growth with a rising middle class.

We recommend a 10% equity sector allocation towards industrials, and we believe portfolio diversification can be further improved by making sure that the 10% weighting is further broken down into each of the three subsectors within industrials: capital goods, transportation and commercial services. Capital goods is the largest subsector **(Figure 1)**, and we recommend starting with this subsector before allocating funds toward the smaller transportation and commercial services subsectors.

Please see important disclosures and analyst certification on page 4 of the report.

Industrials are categorized in three broad segments, including capital goods, transportation, and commercial services.

Figure 1



The S&P 500 Index is based on the average performance of 500 widely held common stocks. The S&P Industrials Index consists of 73 industrial companies within the S&P 500 Index. These are unmanaged indexes and cannot be invested in directly.

Capital Goods (69% of the Industrial Sector)

Capital goods companies are responsible for manufacturing and/or distributing products. These products are typically sold to other businesses (not directly to consumers) and can often be large and expensive (airplanes, tractors, excavators).

- Aerospace & Defense: Companies in this area focus on the production of commercial planes and a wide range of defense products, including jets and missile-defense systems. In the near term, we are cautious on commercial aerospace given weak demand for air travel, which is likely to result in deferred deliveries of new aircraft to airlines. We do believe that air travel will improve over the next several years. Given that there is limited competition in the market, we feel there will be growth opportunities for **Boeing (BA)** as market conditions improve. In addition, we expect long-term demand for pilot training to grow given the significant number of scheduled pilot retirements over the next decade, providing opportunity for **CAE Inc (CAE.TO)**, which is on the Canada Stock Focus List. Finally, we have a positive view on defense companies given the rising defense budgets and geopolitical issues. **Lockheed Martin (LMT)** is on the Edward Jones Stock Focus List.
- Machinery: These companies manufacture large pieces of equipment or provide parts and services. Examples of products include bulldozers, excavators, tractors, tools and large mining trucks. Currently, we favour machinery companies focused on agriculture given our positive growth outlook and positive view of the replacement cycle for large tractors and combines. Our views are more balanced on end-markets such as construction, mining, and heavy trucks given our view that they are in the later stages of their cycles. **Deere & Company (DE)** and **Snap-on (SNA)** are on the Edward Jones Stock Focus List, and **Toromont Industries (TIH.TO)** is on the Canada Stock Focus List.
- Diversified Industrials: Companies in this group are composed of multiple businesses covering a wide variety of end-markets. This diversification can help to smooth out results, as positive trends in one segment can help offset pressures in another part of the business. Our outlook varies for each diversified industrial company based on the specific end-market exposure and the outlook for the company. **Ametek (AME)** is on the Edward Jones Stock Focus List.

Transportation (21% of the Industrial Sector)

Transportation companies tend to be involved with the movement of people or cargo. They could also be involved with planning the logistics of shipping goods. The products can be moved by rail, truck, ship or plane, or may use a combination of those methods.

- Rails: The railroads haul freight over their vast rail networks. While volumes of goods to haul have recently been declining, we believe that the companies will navigate through the challenges given pricing power and the ability to improve network efficiency, reducing the costs of the business. This focus on efficiency is known as Precision Scheduled Railroading (PSR). Our outlook on the companies considers the mix of products being hauled, the level of implementation of PSR, and the expectations for improvements. **Union Pacific (UNP)** is on the Edward Jones Stock Focus List.
- Airlines: Companies in this group operate planes to haul passengers. We have limited coverage in this space, given the cyclical nature of the business, the high costs of doing business, and the fact that most companies in the space are noninvestment grade. The recent concerns with the coronavirus have resulted in a dramatic number of flight cancellations and parked aircraft. Given the volatility, we are cautions on the space and focus on companies with solid financials and a history of efficient operations. We have a Buy rating on **Southwest Airlines (LUV).**

- Freight and Parcel Carriers: These companies are focused on moving packages for businesses and consumers around the world. The growth of e-commerce and the resulting package-shipping requirements has been a positive factor in this segment. Our outlook for the companies considers the efficiency of the shipping network, ongoing investments being made, and the potential for rising competition. We have a Buy rating on **United Parcel Service (UPS)**.

Commercial Services (10% of the Industrial Sector)

Commercial Services companies provide support activities, such as cleaning, security and equipment rental. This is a broad group of companies with a range of services provided. Given the relatively small weighting of commercial services within the broader industrial sector, our coverage in this segment is limited. However, we would tend to favour companies that have competitive advantages and provide services that are more technical in nature. We do not currently have any Buy-rated names within commercial services.

Coronavirus Outbreak to Weigh on Economic Activity

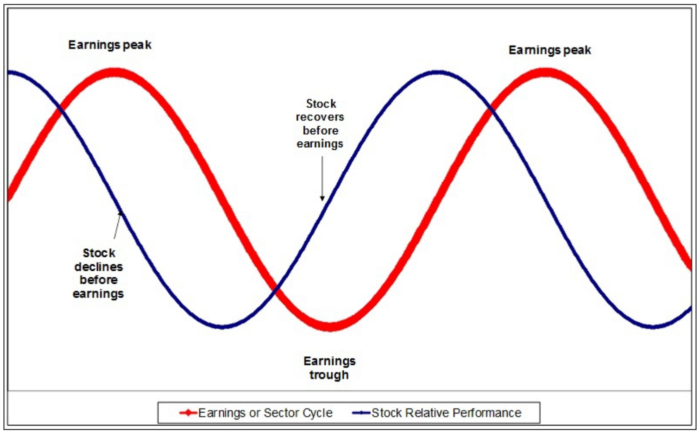
Given the sensitivity of the industrial sector to economic growth, we think the coronavirus outbreak will have a significant near-term impact on the sector, including disruption of operations due to supply and labor shortages, as well as a negative effect on demand as companies defer investments in their businesses. While the impact is likely to be broad-based across industrials, we see airlines and aerospace companies with exposure to commercial aircraft as the most heavily impacted due to the weakening in travel demand. Meanwhile, we think defense contractors such as Lockheed Martin are unlikely to be materially impacted given ongoing global conflicts and the government funding of defense spending. Consistent with our view the sector is "offense" (i.e., outperforming in rising markets and underperforming in falling markets), industrials have underperformed year-to-date amid the market volatility. While it is difficult to predict the timing of a recovery, we would expect industrials to outperform in an environment of improving economic sentiment.

Industrial Cycles and Building Portfolios

Many industrial companies are cyclical, meaning they go through ups and downs as the fundamentals of the industries they serve change. Within industrials, each company may be facing a different stage of its business cycle. As a result, we believe investors can improve diversification by owning stocks from more than one subsector of industrials and selecting companies that serve different industries.

Figure 2 is a simplistic chart that illustrates the typical progression of a business cycle and how stock prices typically lead earnings recoveries off the trough.

Figure 2



Source: Edward Jones

Based on this typical progression, we think that the best time to buy a cyclical stock is when the news is still pessimistic. On the other hand, buying when the news "feels good" is likely an inopportune time.

Valuation

Methods we use to evaluate the attractiveness of industrial stocks include traditional ratios such as price to earnings (P/E) and price to sales (P/S), both on an absolute and relative basis, PEGY ratios (P/E vs. estimated growth and dividend yield), and discounted cash flow (DCF) analysis.

Risks

There are several risks associated with investing in industrial companies. In our view, one of the biggest risks facing them is a prolonged economic downturn. A recession or a sustained period of little to no economic growth will negatively impact performance. Increasing regulations or the further escalation of trade uncertainty could negatively impact global growth. Another risk will be an increasing number of competitors, especially from emerging markets such as China.

Recent Sector Performance

The S&P Industrial Index has underperformed the market over the past three years as a result of rising trade uncertainty, and more recently the impacted economic impact of the coronavirus outbreak.

Please see your financial advisor and read the individual company research reports, which contain additional information on valuation and risks, to see which stocks are appropriate for you and are good values at their current price.

Figure 3

Source: Bloomberg. The S&P 500 Index is based on the average performance of 500 widely held common stocks. The S&P Industrials Index consists of 73 industrial companies within the S&P 500 Index. These are unmanaged indexes and cannot be invested in directly. Past performance is no guarantee of future results.

Required Research Disclosures

Analyst Certification

I certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers; and no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report. Matt Arnold, CFA and Jeff Windau, CFA

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