

POISED FOR A STRONG FUTURE: INDUSTRIALS SECTOR INSIGHTS FROM OUR EXPERTS

The Industrials sector offers investors unmatched diversity in types of companies to invest in — many of which are tied to basic needs, like infrastructure and energy. But how are these companies handling persistently higher inflation, global conflicts and political polarization, and a historically low unemployment rate? We asked two of our Equity Research Analysts, Taylor Cope and Lulu Zheng, for their expert sector insights and outlooks.

Highlights:

- ▶ The Industrials sector is a broad and diverse sector, with plenty of opportunity for investors.
- ▶ Despite high inflation, multiple spots of global conflict, and a very low unemployment rate, many companies in the Industrials sector — particularly in utilities, construction, and shipping — are poised to do well in the near term.
- ▶ While 2024 is likely to be a transition year for much of the sector, our team is encouraged by secular trends they're witnessing, such as onshoring and an increase in both traditional and innovative infrastructure investment in the US and other countries.

Q: Describe the makeup of the Industrials sector — what are the main subindustries or sectors within it?

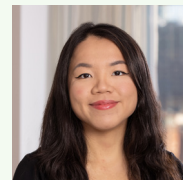
Lulu: Industrials is a catch-all sector that covers diverse functions of the economy. Companies included produce capital goods, transport those goods, and deploy human capital to make or use productive assets. Each end market has its own unique drivers and characteristics. For example, an accounting consulting firm and a manufacturing company that makes plumbing pipe fittings are both considered Industrials, but they have uncorrelated cycles and distinct supply and demand dynamics. That's what makes Industrials interesting to analyze — and an essential part of any diversified investment portfolio.

Taylor: Indeed, the sector is the largest weight of any sector in our smaller cap core benchmarks: 17.5% of the Russell 2000 Index, and 20.6% of the Russell 2500 Index (**Figure 1**).



TAYLOR COPE, CFA

Equity Research Analyst

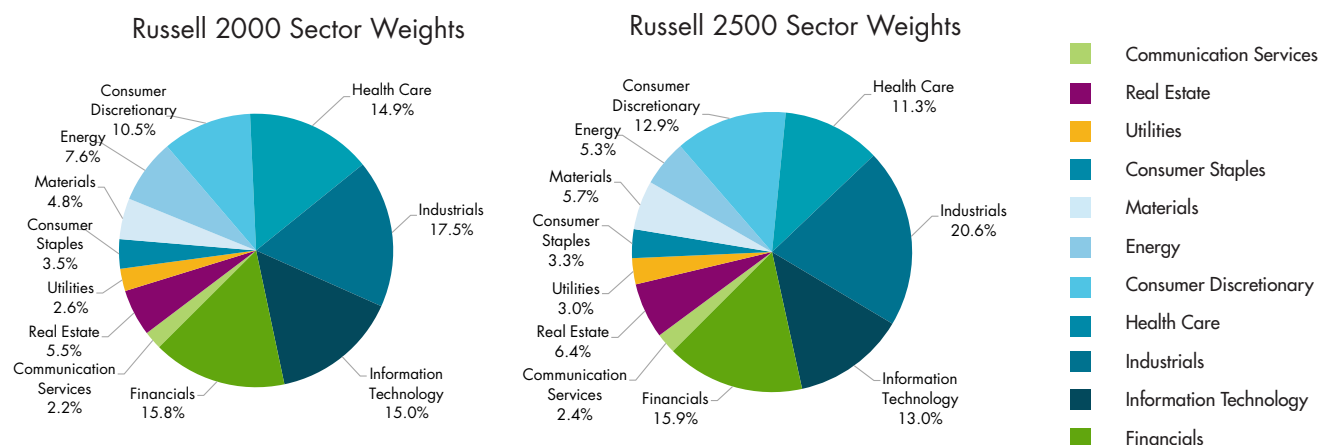


LULU ZHENG, CFA

Equity Research Analyst

FIGURE 1

Russell 2000 & Russell 2500 Sector Weights — Industrials Are a Big Slice of the Pie



Source:FactSet
As of June 25, 2024

Of the three subindustry groups, capital goods is the largest and most heterogeneous (**Figure 2**). This includes machinery, building products, electrical equipment, aerospace & defense, construction & engineering, and trading & distribution. This is probably what most people think of when they think of “industrials:” companies that make or build stuff. This can range from very small components that go into larger systems, like a single valve on an aircraft carrier, all the way up to larger pieces of completed machinery, like an aerial work platform. We spend a lot of time focused on this industry group, particularly the machinery stocks, because they’re typically involved in the production of specialized, highly engineered components or equipment that are mission-critical and have a high cost of failure — meaning the companies that produce them can earn attractive margins and returns.

The second group is commercial & professional services. These can be companies providing payroll and accounting services to other businesses, but it also includes contractors that sell their technology expertise to parts of the US government, such as the Department of Defense or the CIA. These tend to be less cyclical and more defensive than the machinery names, and we typically look at stocks in this industry group as providing ballast to the portfolios, especially in periods of macroeconomic uncertainty.

The third, and smallest, group is Transportation. This includes trucking and rail companies, as well as passenger airlines and logistics providers. This is arguably the most cyclical of the three groups, and we are highly selective in terms of our exposure here.

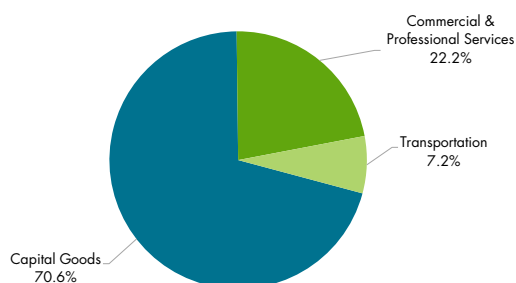
“We spend a lot of time researching capital goods companies as they are often mission-critical and have a high cost of failure — meaning they can earn attractive margins and returns.”

— Taylor Cope

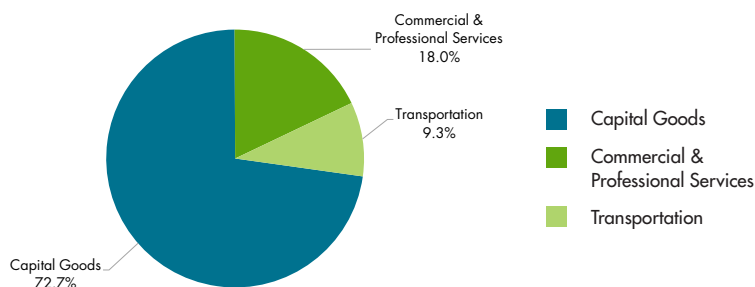
FIGURE 2

Industrial Subsectors

Russell 2000 Industrials Subsectors Weights



Russell 2500 Industrials Subsectors Weights



Source:FactSet
As of June 25, 2024

Q: Has there been any major impact on these businesses due to the rise in interest rates? What about the rising cost of oil and/or other commodities?

Taylor: Any capital spending decision has, as an intrinsic part of its analysis, a calculation of the projected return against the required rate of return, referred to as the “cost of capital.” The latter part is calculated using the cost of debt and equity, with that second part including the “risk-free rate” (typically the rate on US Treasury Bonds) as an input. So, higher rates on debt and/or a higher risk-free rate will increase the required return on a project. The effect of this is that projects that might have gone ahead in a lower-rate environment may be deferred or cancelled as companies are more judicious about their capital allocation.

A separate impact comes in the form of how much inventory is held through the supply chain. For companies that sell their products through distributors or dealers, those intermediaries must finance their working capital. All things equal, higher rates mean that a distributor may keep less stock on hand than they would in a lower-rate environment. Combined with the normalization of supply chains following pandemic-related disruptions, we have seen various parts of the channel work to reduce inventories over the course of 2023 and into 2024.

Higher oil prices make oil and gas exploration and development more attractive, so the companies that sell into those end markets have benefited. On the other hand, those who use oil or its derivatives, such as an airline burning jet fuel, have to deal with a higher input cost burden. Higher prices for metals, such as copper and aluminum, which have both increased over the past three months, are impactful, as these are inputs for a lot of industrial companies. Companies can

either pass the higher costs along as part of contractual escalation clauses, or through periodic price negotiations with customers, or bear these higher costs themselves, which reduces margins.

Lulu: Some companies are still reaping the benefit of legacy low-cost debt, and in the meantime, businesses are adjusting to a higher-rate environment, just as homebuyers are adjusting to higher mortgage rates. While higher interest payments are certainly impacting highly levered companies, we tend to favor companies with a solid balance sheet, so they can be operationally flexible and act quickly when others are strapped for cash. An example would be an opportunistic acquisition of a financially stressed competitor, or capital investment projects to upgrade plants and expand capacity, which will enable them to gain market share when the cycle inflects.

When raw material costs first started to surge, many companies went through a period of supply-chain shortages and squeezed margins. As Taylor mentioned, many of these companies were able to pass through rising costs and inflation to their customers, albeit with a lag. What I have seen is higher prices on the same or lower level of volume, which means some businesses, particularly original equipment manufacturers and rental companies, are posting better bottom-line results than before the pandemic. On the other hand, some labor-intensive businesses, such as professional services or consulting, are facing the pressures of increased wages and a talent shortage. More commoditized businesses, such as truckload freight companies, are enduring both higher fuel costs and increased competition from the nearly 195,000 new carriers that began operating during the pandemic. We are seeing divergent impact of higher interest rates and price inflation. Our fundamental research helps us assess the trends more clearly on a company-by-company basis.

Q: Where are margins relative to the sector's past? How about compared to other sectors' margins over recent history — do they move together or separately?

Taylor: Because of the great diversity of companies in the sector, it's difficult to generalize. Looking over the past 10 years, operating margins fell in the early part of the pandemic, before beginning to recover in 2021 and 2022. 2023 saw a large step up in margins as companies realized the benefit of pricing to address higher inflation. This is not universal, however. For example, trucking companies have been struggling with industry overcapacity and a reduction in demand, with many players falling below breakeven as rates for trucking have declined.

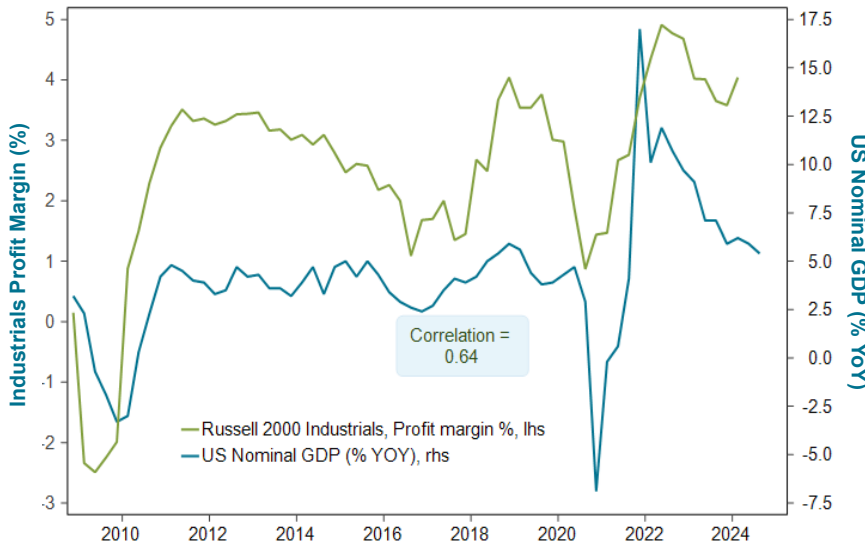
To the extent that industrials are reflective of the overall health of the US and world economies, we'd expect margins in the sector to correlate strongly to economic conditions generally, which would affect other sectors as well. (**Figure 3**).

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— Lulu Zheng

FIGURE 3

Industrial Sector Profit Margins are Positively Correlated with US GDP Growth



Sources: GW&K Investment Management, BEA, Bloomberg, and Macrobond

Lulu: Many Industrials are beneficiaries of post-pandemic inflationary forces. The number of widgets in a home improvement store may be the same, but the total value has gone up, which shows up in widget makers’ income statements as higher margins. In general, this margin benefit manifests more in asset-heavy businesses with higher degrees of operating leverage.

For other sectors, such as consumer staples, rapid increases in wages may create margin pressure, like in the food service industry. For regional banks, a combination of higher-cost deposits and outflows have compressed net income spread on top of potential credit headwinds from commercial real estate exposure. Building-products companies in the Consumer Discretionary sector, on the other hand, have benefited from solid pricing and strong housing demand due to the persistent shortage. I would say that overall, margin trajectories have become less synchronized across industries and sectors.

Q: Many of these companies have seen meaningful growth from a series of new laws in the US, including the IIJA, CHIPS, and Inflation Reduction acts. Where are these in the cycle of rollout? Has their impact been felt already?

Lulu: California, a state with a C grade on its infrastructure report card, is projected to receive about \$42 billion in the Infrastructure Investment and Jobs Act (IIJA) funding from 2022 through 2026. Through April 2024, \$26 billion has been distributed, \$6.72 billion has been invested, and

only \$0.65 billion has been completed. The rolling out of public projects continues at a steady pace and is expected to create employment and upgrade US infrastructure for years. We are already seeing the benefits of public funding in companies' order books and project flows, particularly for roads and bridges, electrical transmission and distribution, and clean energy projects. While we have targeted companies that are set to benefit from these new laws, we tend to favor companies whose intrinsic value has not been fully appreciated by the market, given the current level of valuation.

Taylor: Yes, we're just beginning to see the effects in terms of the flow of funds to relevant projects. The companies we speak to typically reference these bills as providing support in 2025 – 2026, driving a constructive multi-year view on the sector.

Q: With US elections ahead, is there a risk to these growth drivers? Is there a risk these acts could be rolled back?

Taylor: There's a lot of difference between the policy priorities of each party in terms of their support for fossil fuels, the energy transition, and industrial policy, such as tariffs and subsidies, more generally. This has increased uncertainty, and company management teams are saying this has manifested in a hesitancy on the part of their customers to move forward until there's greater certainty which party will be in power, and which of their legislative priorities might take precedence.

Lulu: Reshoring and nearshoring seem to be the consensus since Covid brought unprecedented challenges to a global supply chain. We are increasingly seeing companies investing in dual sourcing and localized production. This may fuel the demand to upgrade and expand the nation's infrastructure in the medium to long term, but as Taylor points out, the election overhang is certainly top of mind for company leadership teams when making capital deployment decisions, so we are seeing some caution and delays in certain pockets or regions.

Q: What are the key factors impacting the Industrials sector positively and negatively?

Lulu: In terms of secular trends, in addition to reshoring and nearshoring, the energy transition, and automation, electrification is another overarching theme driving capital investments. For instance, an electrical components company will supply more components for electrical vehicle charging stations, while an internal combustion engine maker may find itself in need of a new identity and use the cash generated from its core business to fund investments in alternative drivetrains. Some manufacturers are driven more by operational expenditures (opex), like auto-parts suppliers, and thus more impacted by the production volume of their customers, while some are more focused on capital expenditure (capex), like an automation company, and thus more impacted by investment projects. There are short-cycle businesses, such as trucking brokerage or staffing, that are driven more by the Purchasing Managers' Index (PMI) and other leading/concurrent economic indicators, while long cycle businesses, such as aerospace and defense, have varying supply/demand dynamics and are more backlog and order driven.

"Reshoring and nearshoring seem to be the consensus since Covid brought unprecedented challenges to a global supply chain."
— Lulu Zheng

When we look at an industrial company through a fundamental research lens, we tend to tease out the short- and long-term demand trends, which part of the supply chain it sits in, what its competitive dynamics are, how aligned its management team is, and how effective it is at allocating capital — all of which are factors that help us evaluate the business.

Taylor: The biggest driver for Industrials broadly is the health of the economy. GDP growth is the baseline, typically, on top of which each of these industries will grow or contract. As Lulu mentioned, unique positive drivers include those key pieces of legislation we discussed, the trend toward onshoring, an increasing use of automation, and the transition toward more clean energy. On the negative side, we've got macroeconomic uncertainty, political uncertainty, fluctuations in materials costs, labor availability, supply-chain functioning, and the willingness, or lack thereof, of channel participants to increase or reduce inventory.

“The biggest driver for Industrials broadly is the health of the economy.”
— Taylor Cope

Q: How has the Industrials sector been impacted by the low unemployment rate? You've mentioned that labor supply is an issue for some companies in the sector.

Taylor: Labor supply seems to be easing, though this is not uniform. Skilled tradespeople, for example, are still in tight supply. This is partly a long-term demographic issue. As experienced electricians and welders are aging out of the workforce, we've seen a reluctance from younger generations to embrace these vocations, leading to a shortage at the same time demand for these trades is increasing.

Companies are doing their best to creatively address this disparity. We've spoken to companies who are recruiting high school seniors to finish their last semester as manufacturing employees, with the promise of a full-time position on graduation. Other companies have leaned into automation, using robots and material handling technology to complete tasks that previously would have been done by a human being.

Lulu: In construction, more than one in five workers are 55 or older, and nearly 30% of union electricians are near retirement. An aftermarket business with highly skilled technicians can be the hidden gem of a company. As Taylor highlighted, companies are responding with increased recruiting efforts, training programs, and more focus on culture and retention. There has been a resurgence of union activity post Covid due to the skilled trade crunch. Recently, UPS rectified a new union agreement that means its 340,000 drivers can earn an average of \$170,000 at the end of a five-year term. We are seeing higher labor costs show up on financial statements. In some instances, the impact can be margin neutral if companies pass through the increase. Companies unable to recuperate these costs will attempt to absorb inflation by investing in higher labor productivity and or automation.

Q: Have Industrials companies been impacted by the changing commercial real estate environment?

Lulu: While higher rates and lower valuations are starting to erode the credit quality of some banks, industrial companies serving the commercial real estate end market have not seen

meaningful deceleration, especially if the work is related to maintenance and repair, with weakness from office- and hospitality-related work. Elevators still need to be serviced annually, and hospital uniforms need to be routinely cleaned.

Regarding new builds, we are seeing some delays in the decision-making process, and order activity for commercial construction customers is slower. Globally, industrial companies serving commercial real estate end markets in some countries, such as China, are more challenged as new construction activity slows and vacancies soar. We are also seeing pockets of strength in some industrial companies that are benefiting from energy-efficiency upgrades in Europe and North America, and multifamily construction in the US has remained a bright spot as high mortgage rates dry up existing home inventory.

Taylor: Some companies that have been negatively affected by the post-pandemic increase in hybrid and remote work are finding ways to pivot to areas where demand is stronger. For example, I recently spoke with a company that provides large cooling towers for commercial HVAC applications. A cooling tower that previously sat atop an office building might today be used instead to cool a data center or a semiconductor fabrication plant. As always, the best companies will change and adapt to their environment, and we own shares in a few that have had success doing this.

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— Taylor Cope

Q: What about the rising demand for power?

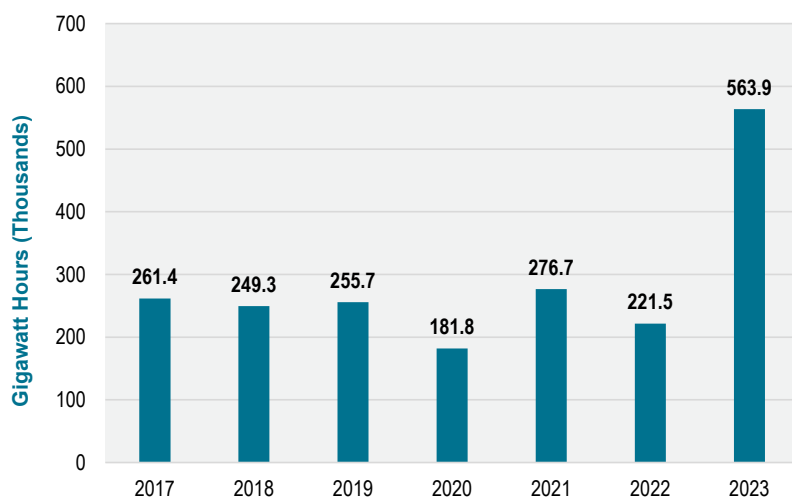
Taylor: As Lulu said, electrification is definitely a structural thematic driver for Industrials (**Figure 4**). Whether we're talking about the rise of electric vehicles or the massive amounts of money being spent to build datacenters for AI, the demand for electricity is growing. This is being addressed in many ways that touch Industrials: investment in power generation, particularly renewable sources like solar power, upgrading transmission and distribution infrastructure after decades of underinvestment, and the development of more energy-efficient technologies to reduce power use. We have numerous portfolio holdings that directly or indirectly benefit from these trends, which we expect to persist through the end of the decade and beyond.

Lulu: Much of the US power grid was built in the 1960s and 1970s, and in addition to the need to upgrade existing infrastructure, electrification and AI have created additional burdens on the grid. Twenty years ago, a datacenter might have required 5 megawatts of power. Today, a single hyperscaler datacenter can consume 30 megawatts — enough power for up to 30,000 homes! Expected demand for power from AI and decarbonization are fueling growth for electrical & clean energy companies. We have domestic and international portfolio holdings that are benefiting from this demand, as they provide either critical electrical components — with a wait time of a year or longer — or related services expertise.

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— Lulu Zheng

FIGURE 4

Electricity Demand in the US Is Poised to Grow



Source: 2023 North American Electric Reliability Corporation Long-Term Reliability Assessment

Net energy growth rates in North America are increasing more rapidly than at any point in the past three decades.

Q: What is your outlook for the sector overall in the coming quarters and years?

Lulu: The sector benefited from surge pricing and operational leverage during the supply-chain bottleneck coming out of the pandemic, and now we are seeing the normalization of margins, factory usage, and channel inventory, which will probably persist in the short term. Globally, we are seeing localization of production and companies increasingly positioning themselves for a more uncertain geopolitical environment. We are also starting to see unsynchronized growth patterns on the country level due to varying policy responses to the pandemic. Longer term, as mentioned, companies in the Industrials sector are the backbone of the economy. We are on the cusp of a paradigm shift, and the sector will continue to innovate and provide essential goods and services. We favor industrial companies that provide recurring services with robust cash flow and earnings power, that can weather business cycles and deploy capital in secularly growing end markets and return cash to shareholders.

Taylor: The rest of 2024 will remain a transition year. The end of destocking, the peaking and eventual decline of interest rates, recovery in markets like residential construction, and the rebalancing of transportation supply and demand are all expected to transpire at some point this year. We're keeping our eyes on high-frequency data to monitor inflections and positioning our portfolios according to our relative confidence levels in the macroeconomic and industry-specific outlooks.

"We are also starting to see unsynchronized growth patterns on the country level due to varying policy responses to the pandemic."
— Lulu Zheng

Looking out a few years, we're encouraged by some of the secular trends we've already discussed previously. Manufacturing capacity is being brought back to the US and its neighbors, which will mean increased demand for construction services and equipment, manufacturing equipment, and eventually for aftermarket parts and consumables. The US also has a long way to go in terms of infrastructure investment, whether in the form of traditional infrastructure like roads, bridges, and power transmission, or "new" types of infrastructure like digital infrastructure, communications networks, and semiconductor production capabilities. We're shareholders of companies that we feel are well positioned to grow with — and ideally outgrow — these markets, meeting the anticipated demand with innovative and highly engineered products and services that will support continued strong financial performance from a multi-year perspective.

DISCLOSURES:

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