

CORNERSTONE MACRO

Economics, Policy, Strategy & Technicals

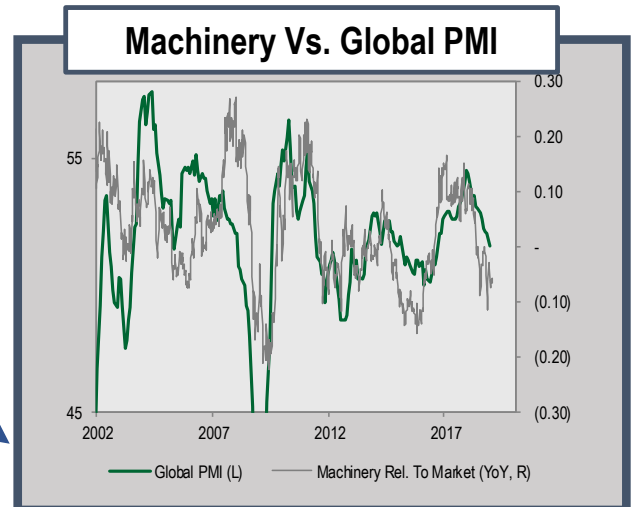
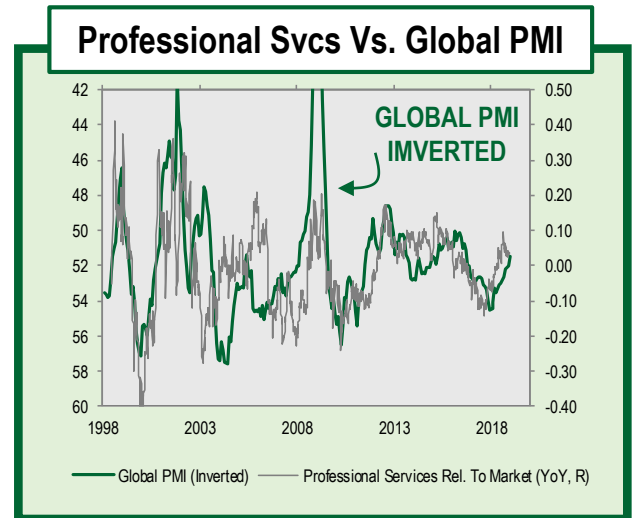
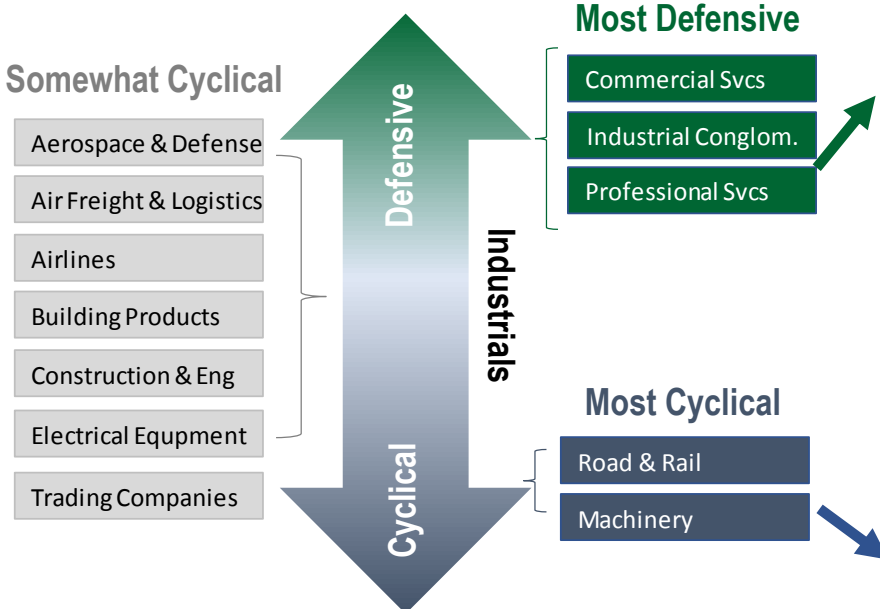
Portfolio Insights

TIPS FOR NAVIGATING THE MOST DIVERSIFIED SECTOR

A new year is upon us and equity markets have already been on quite a ride. Last years beaten down sectors/stocks came into '19 like a lion but have in recent days retreated some. This “relief rally” as some have called it created renewed optimism that cyclicals, and the market in general, were not on a one way path to a recession. The question now stands, what is next for cyclicals?

We believe that we are unlikely to see a renewed surge in global growth and a decline in risk ... all of these being conditions for a sustained cyclical reacceleration. As such, we are underweight cyclical sectors like Industrials. This does not mean we dislike every industry or stock in the sector by a long shot. There are plenty of defensive segments and stocks within the sector where investors can tactically produce alpha.

Spotlight On The Industrials Sector



Stephen Gregory
(212)257-4972
sgregory@cornacteam.com

Michael Kantrowitz, CFA
(212)257-4971
mkantrowitz@cornacteam.com

Emily Needell, CFA
(212)257-4974
eneedell@cornacteam.com

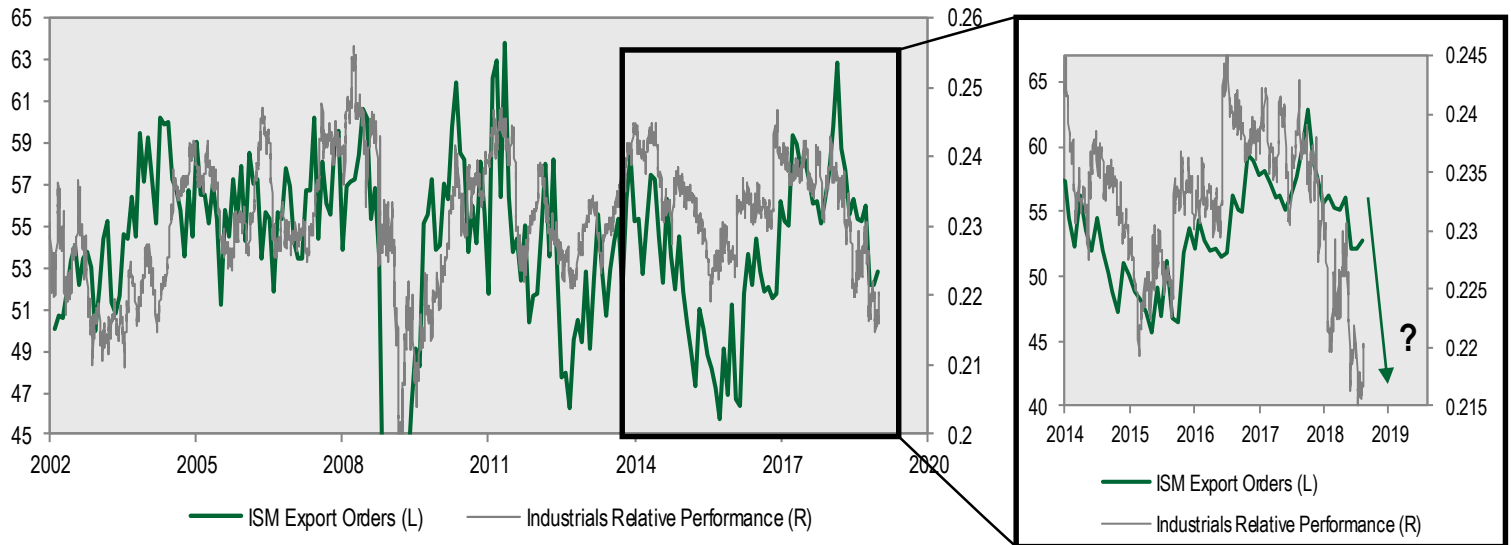
Justin Brant
(212)257-4973
jbrant@cornacteam.com

Copyright 2019 Cornerstone Macro. All rights reserved. This report is prepared exclusively for the use of Cornerstone Macro clients and may not be redistributed, retransmitted or disclosed, in whole or part, or in any form or manner, without the express written consent of Cornerstone Macro.

INDUSTRIALS IS A CYCLICAL SECTOR ... WITH LOTS OF CAVEATS

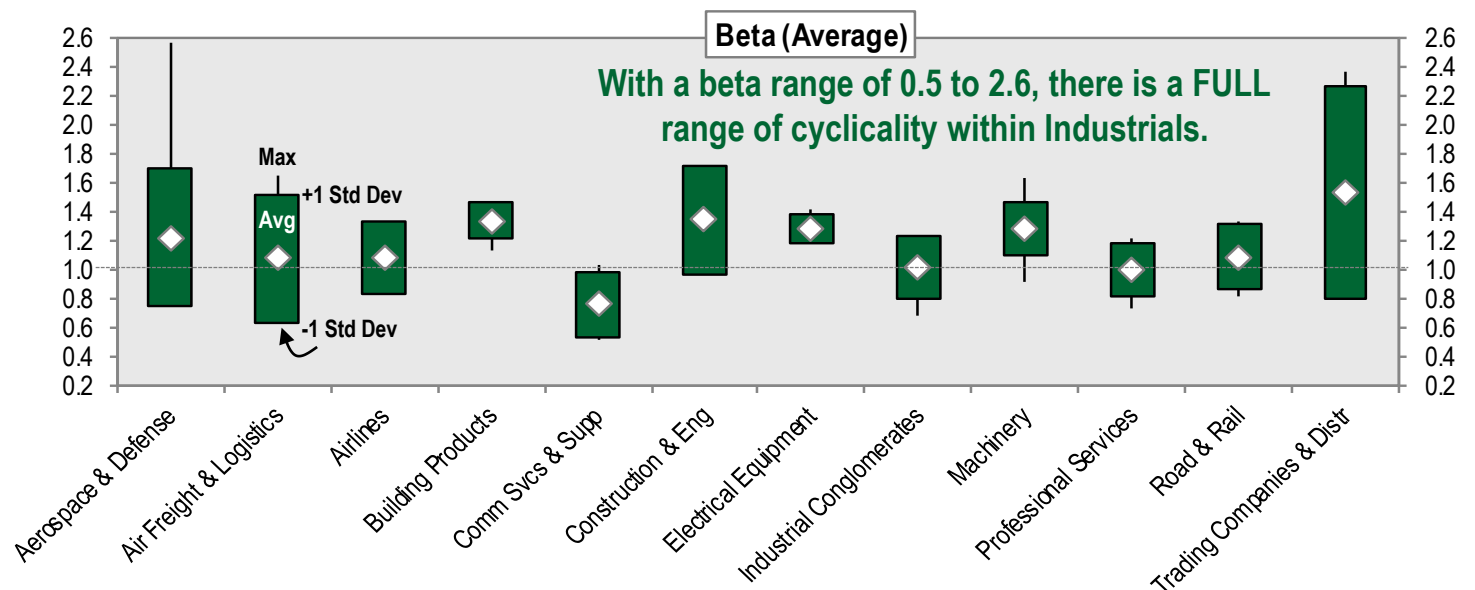
Without a doubt, the Industrials sector in aggregate exhibits cyclical characteristics. Along with Energy, Materials and Financials, we classify Industrials as one of the four most cyclical sectors in the market and we are underweight the sector in aggregate.

The Industrial Sector Is Cyclical In Aggregate ...

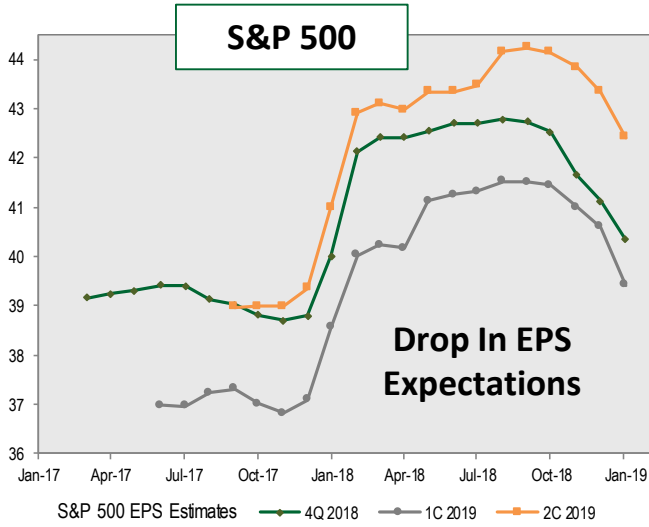


Despite being cyclical in aggregate, the Industrials sector is as diverse as they come. The box and whisker chart below illustrates the beta of the various industries within Industrials. The beta ranges from as low as 0.5 to as high as 2.6. The industrials universe is clearly not one size fits all and there is something for everyone within the sector.

... But The Attributes Of The Industrials Sector Are All Over The Map



EARNINGS OUTLOOK

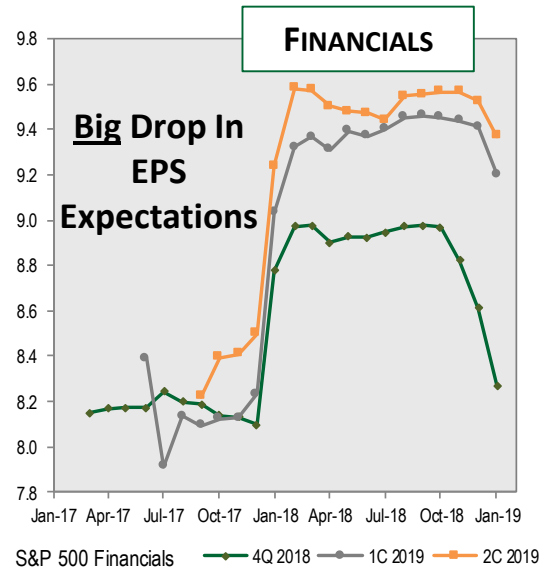
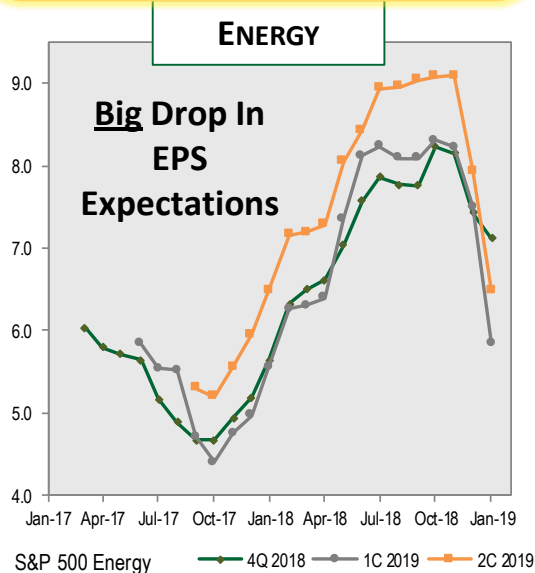
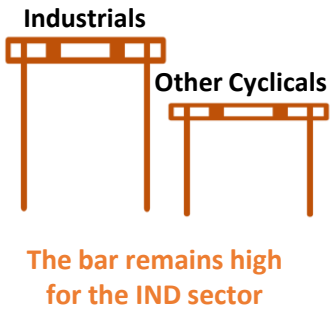
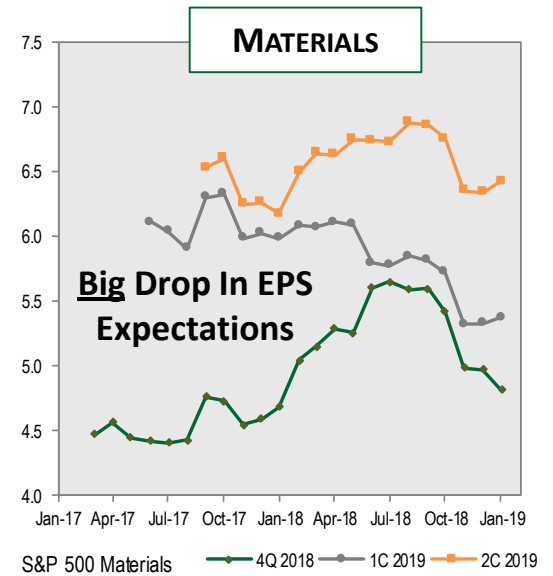
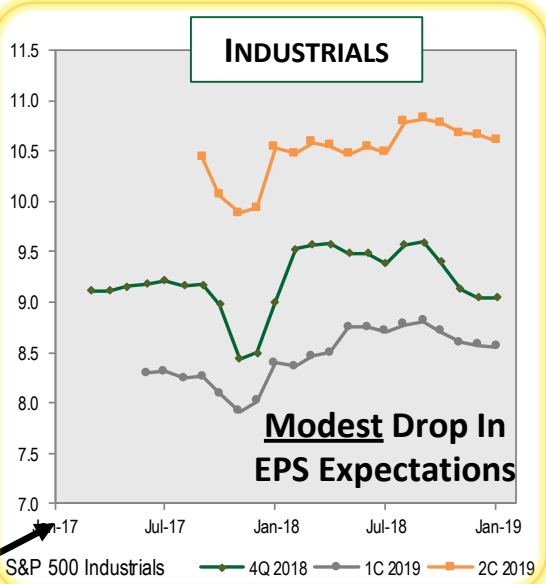


Change In Q4 2018 EPS Estimates

Sector	Estimates
MAT	-14.08%
ENR	-13.49%
FIN	-7.89%
IND	-5.72%

Industrials has seen the smallest decline in Q1 EPS expectations of all the cyclical sectors.

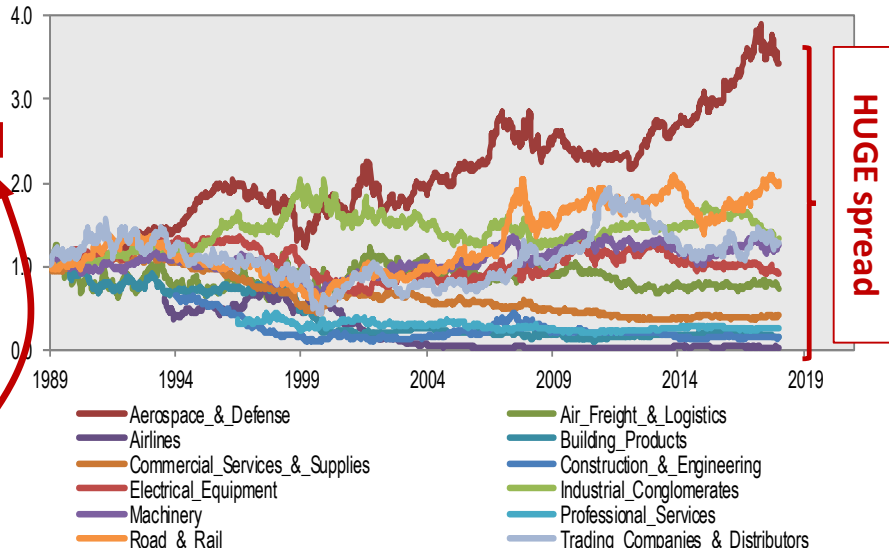
Analyst Expectations Remain Elevated For Industrial EPS.



INDUSTRIALS : AS DIVERSE OF A SECTOR AS YOU CAN GET

The Industrials sector always finds itself somewhere in the middle of the pack at the end of the year. The reason for this is the sector's diverse number and type of industries and stocks. Unlike sectors such as Materials and Energy, which exhibit high correlations within, Industrials' diversified companies provide investors with both winners and losers every single year.

	# Of S&P 500 Stocks	# Of Industries
Industrials	71	12
Financials	67	5
Information Technology	67	6
Consumer Discretionary	65	11
Health Care	63	6
Consumer Staples	32	6
Real Estate	32	2
Energy	29	2
Utilities	29	4
Communication Services	26	4
Materials	24	4



Industrials is the sector with the most stocks and industries.

The Industrials Sector Is So Diverse ... It's Rarely The Best Or Worst Sector

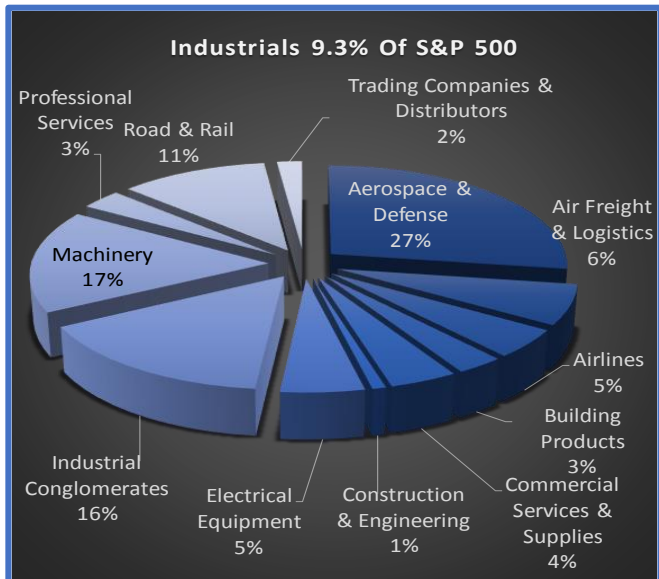
	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
1	Shops	Durbl	Telcm	Hlth	NoDur	Telcm	Shops	Telcm	Hlth	Shops	Durbl	Durbl	HiTec	HiTec	Enrgy	Telcm
2	Durbl	Enrgy	Enrgy	NoDur	Utills	Enrgy	NoDur	Hlth	Enrgy	Hlth	Other	Telcm	Hlth	Hlth	Other	Other
3	HiTec	Shops	Utills	Other	Hlth	Hlth	Durbl	NoDur	Utills	Other	Shops	HiTec	Manuf	Other	Manuf	Hlth
4	NoDur	Manuf	NoDur	Telcm	Telcm	NoDur	Telcm	Other	NoDur	NoDur	Telcm	Enrgy	Enrgy	Telcm	HiTec	Shops
5	Hlth	Utills	Other	Shops	Shops	Durbl	Enrgy	Enrgy	HiTec	Manuf	Manuf	Other	NoDur	NoDur	Hlth	NoDur
6	Telcm	NoDur	Durbl	Utills	Durbl	Manuf	Other	Utills	Shops	HiTec	NoDur	Utills	Other	Manuf	NoDur	HiTec
7	Other	HiTec	Manuf	Manuf	Manuf	HiTec	Manuf	Shops	Manuf	Utills	HiTec	Manuf	Telcm	Utills	Durbl	Manuf
8	Utills	Other	Hlth	Enrgy	Other	Utills	Utills	Manuf	Telcm	Durbl	Utills	Shops	Shops	Enrgy	Shops	Enrgy
9	Manuf	Telcm	Shops	Durbl	Enrgy	Other	Hlth	Durbl	Durbl	Telcm	Enrgy	NoDur	Utills	Durbl	Utills	Durbl
10	Enrgy	Hlth	HiTec	HiTec	HiTec	Shops	HiTec	HiTec	Other	Enrgy	Hlth	Hlth	Durbl	Shops	Telcm	Utills

Since the '80's Industrials Has Not Been The Best Or Worst Sector

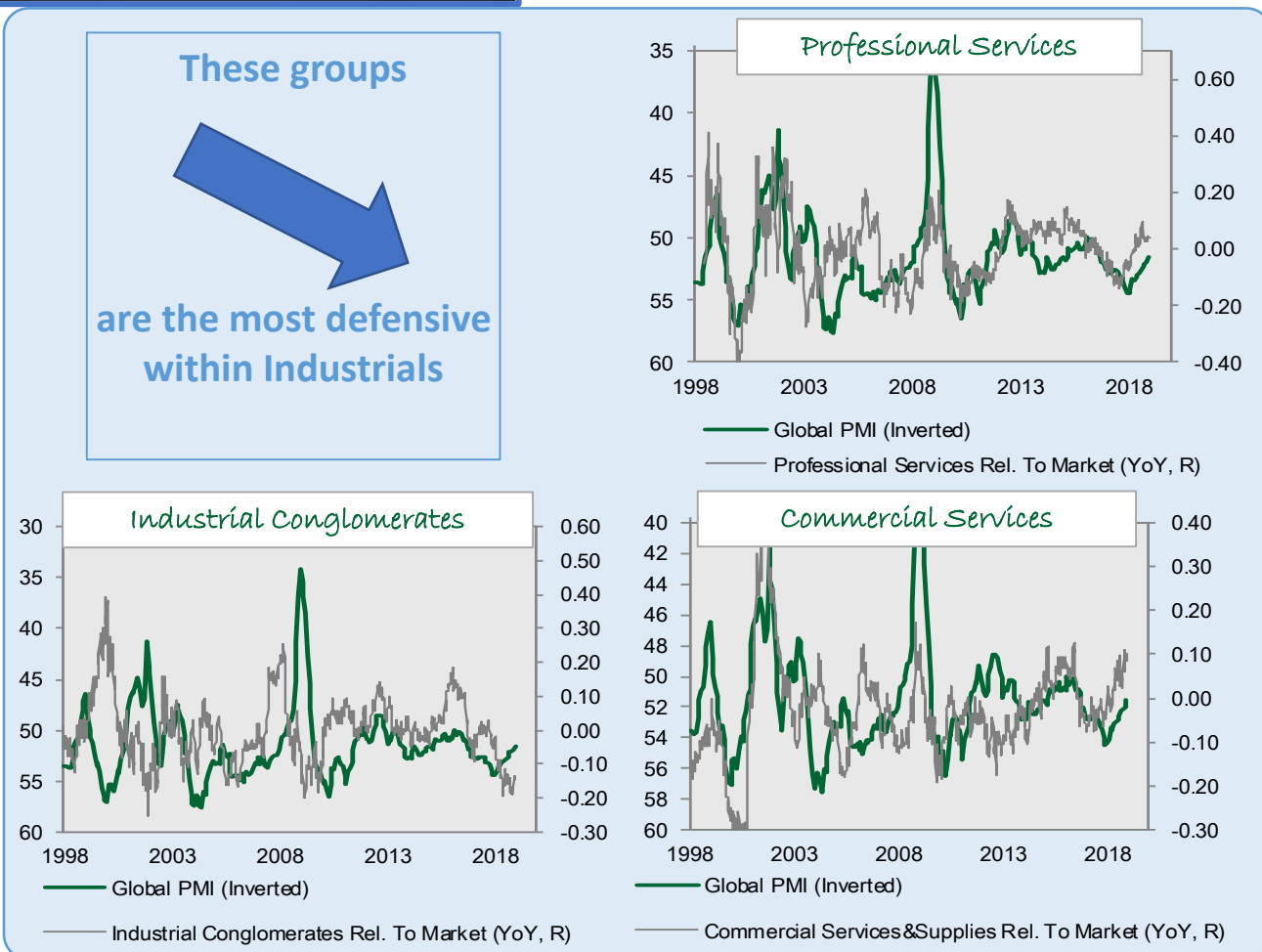
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
1	Hlth	HiTec	Utills	Shops	NoDur	HiTec	Enrgy	Enrgy	Telcm	Enrgy	Hlth	Durbl	Durbl	Utills	Telcm	Durbl	Hlth
2	HiTec	Telcm	Hlth	Durbl	Manuf	Utills	Enrgy	Utills	Enrgy	Manuf	NoDur	HiTec	Telcm	NoDur	Hlth	Other	Utills
3	Telcm	Enrgy	NoDur	NoDur	Enrgy	Shops	Manuf	Other	Durbl	Utills	Utills	Manuf	Manuf	Shops	Shops	Hlth	HiTec
4	Durbl	Shops	Enrgy	Other	Other	Durbl	Other	Shops	Utills	NoDur	Enrgy	Shops	Shops	Enrgy	Other	Manuf	NoDur
5	Shops	Manuf	Other	Manuf	Shops	Other	Durbl	Manuf	Manuf	HiTec	Shops	Hlth	NoDur	Hlth	NoDur	Shops	Other
6	Utills	Hlth	Manuf	Enrgy	Durbl	Manuf	Telcm	Hlth	NoDur	Hlth	Telcm	NoDur	HiTec	Telcm	Durbl	Telcm	Telcm
7	NoDur	Other	Shops	Hlth	Utills	NoDur	NoDur	HiTec	Other	Telcm	Manuf	Telcm	Utills	Manuf	HiTec	HiTec	Shops
8	Other	Durbl	Durbl	Utills	Telcm	Enrgy	Shops	NoDur	Hlth	Shops	HiTec	Other	Enrgy	HiTec	Manuf	Enrgy	Manuf
9	Manuf	Utills	HiTec	Telcm	Hlth	Hlth	HiTec	Telcm	HiTec	Durbl	Other	Enrgy	Other	Other	Utills	NoDur	Durbl
10	Enrgy	NoDur	Telcm	HiTec	HiTec	Telcm	Hlth	Durbl	Shops	Other	Durbl	Utills	Hlth	Durbl	Enrgy	Utills	Enrgy

FINDING OVERWEIGHTS WHEN GLOBAL PMIS ARE FALLING

We expect the global economy to continue losing momentum and thus suggest that investors remain tilted towards counter-cyclical industries like Professional Services, Commercial Services or Industrial Conglomerates.

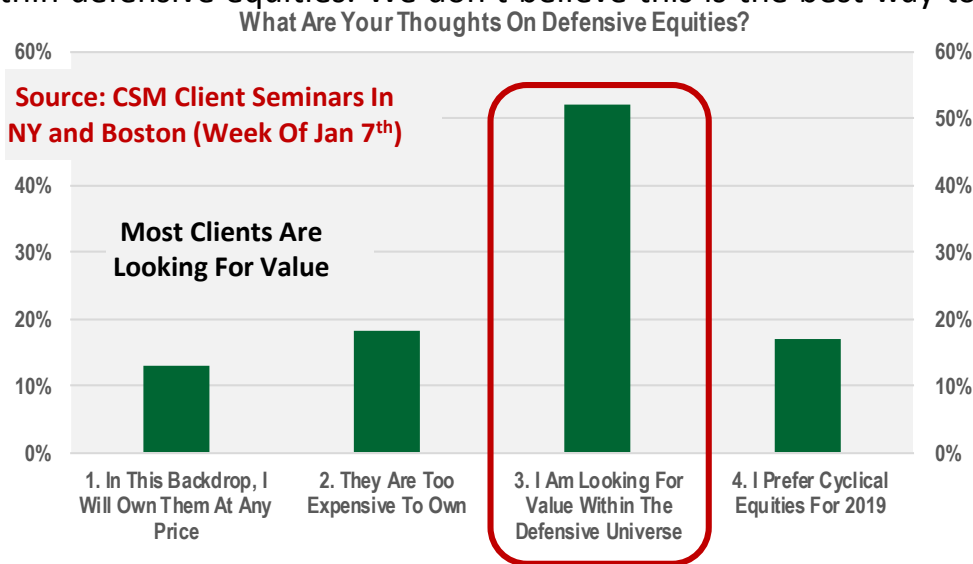


Industry	Weight	OW Relative To Market	OW Relative To Sector
Aerospace & Defense	27.2%		
Air Freight & Logistics	6.5%		
Airlines	4.6%		✓
Building Products	3.0%		✓
Commercial Services & Supplies	4.1%	✓	✓
Construction & Engineering	0.8%		
Electrical Equipment	5.1%		✓
Industrial Conglomerates	15.7%	✓	✓
Machinery	16.6%		
Professional Services	3.1%	✓	✓
Road & Rail	11.2%		
Trading Companies & Distributors	1.9%		



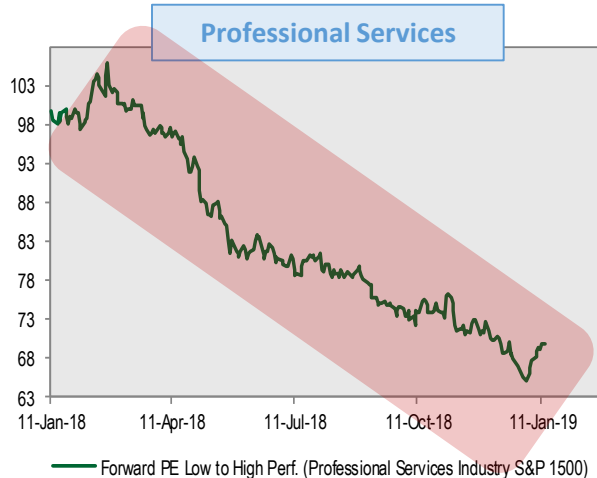
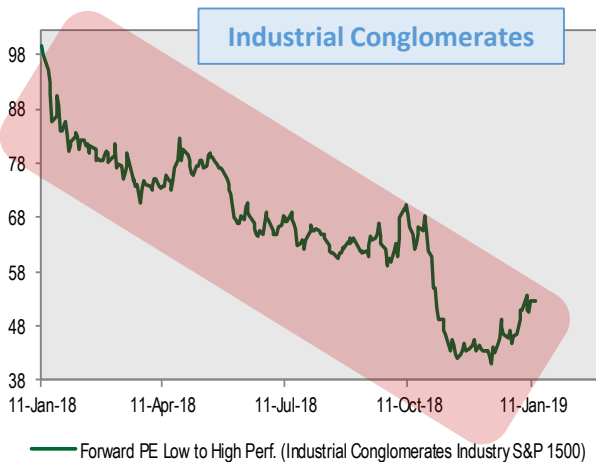
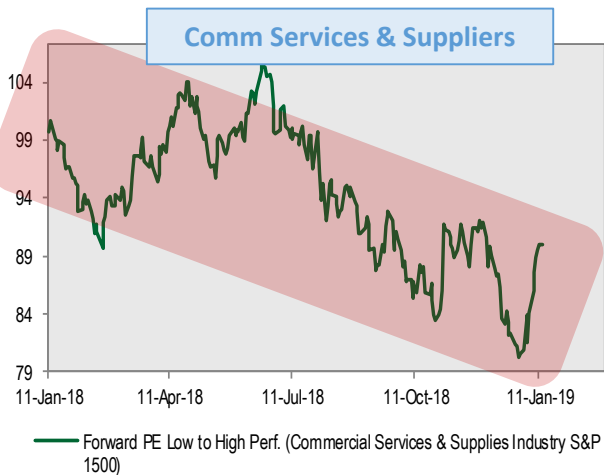
BE WARY OF LOOKING FOR VALUE WITHIN INDUSTRIALS

Over the past two weeks we've been traveling around to a number of cities presenting our key views for 2019. In New York and Boston, over half of investors surveyed answered that they were looking for the cheapest stocks within defensive equities. We don't believe this is the best way to position in 2019. We know that investors have been paying up for growth, stability and defense over the past decade as economic growth has remained weak. Being opportunistic, or buying stocks that others aren't willing to pay "up" for, comes with risk which isn't what you want when growth is slowing and macro risks are rising.



Industry	Median P/E
Airlines	10.0
Road & Rail	10.1
Building Products	16.1
Aerospace & Defense	16.9
Air Freight & Logistics	17.3
Machinery	17.9
Electrical Equipment	19.0
Trading Companies & Distr	21.4
Construction & Eng	21.9
Comm Svcs & Supp	23.1
Industrial Conglomerates	25.0
Professional Services	28.1

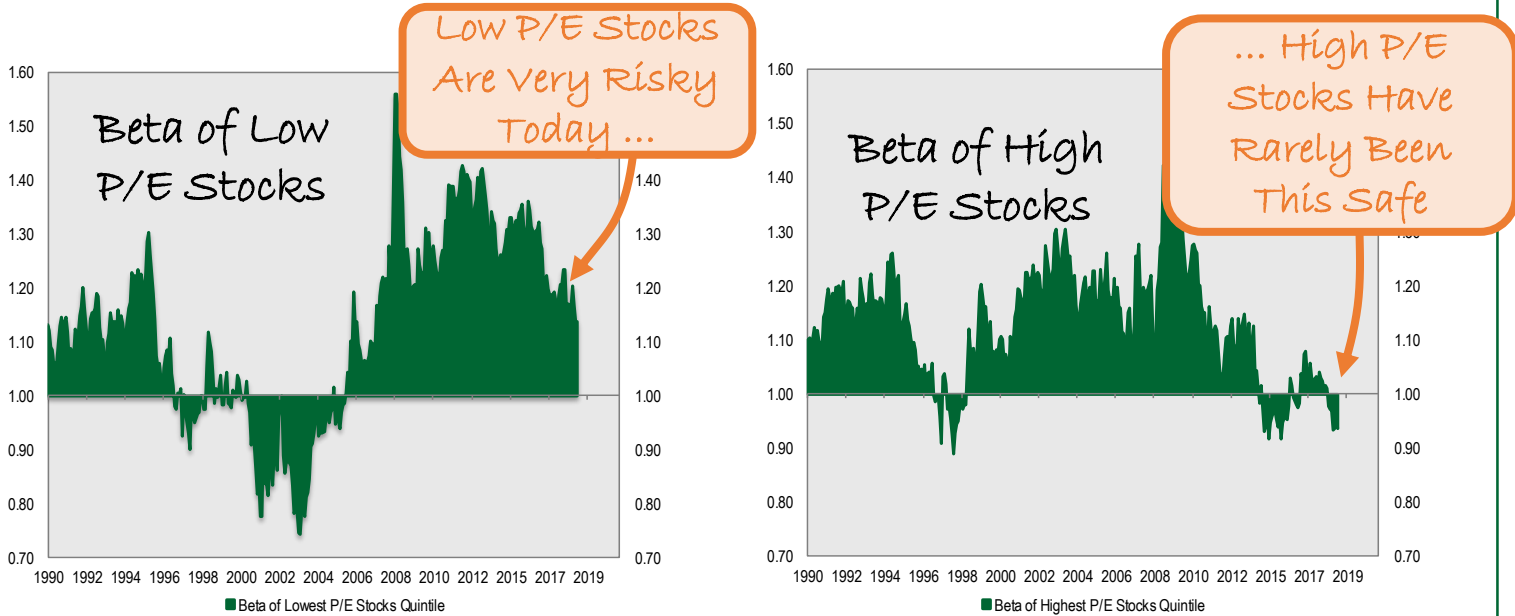
The highest P/E Industries are the most defensive



LOW VALUATIONS MAY LURE INVESTORS INTO RISKY STOCKS

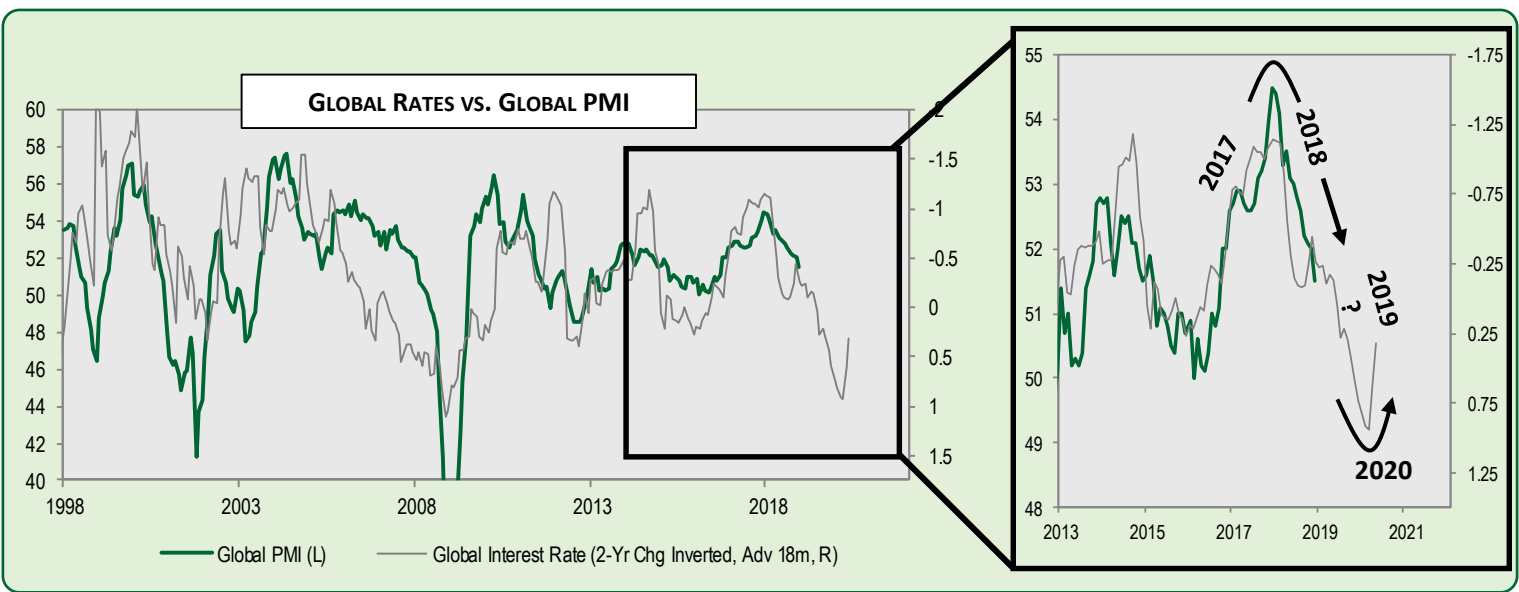
With overall valuations nearly back to 2010 levels, it is not surprising that investors are spending a lot of time talking about P/Es. While it may be tempting to wade into proverbial “cheap” stocks, we believe there is a high potential that today’s “cheap” gets “cheaper.” In the end, valuation is the markets pricing of risk and globally we believe there is still more weakness to come.

Is Valuation The Right Way To Look At Risk And Safety?



A Continued Slowdown Means A Poor Risk /Reward

<p>2018: The Year Of Rising Risks</p>	<p>2019: A Year Of Slower Growth</p>	<p>2020: A Recovery or A Recession?</p>
--	---	--

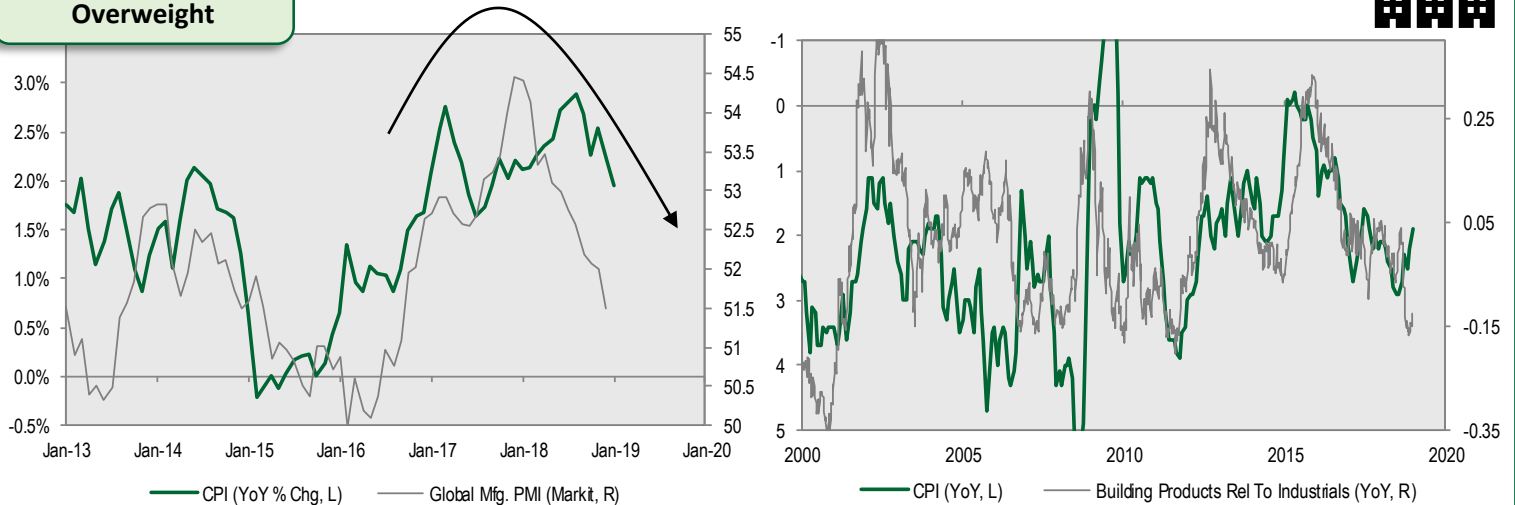


WITHIN INDUSTRIALS, OVERWEIGHT BUILDING PRODUCTS & AIRLINES WHEN CPI FALLS

While there is plenty of debate as to when we are likely to see an end to the current cycle (i.e. recession in '20, '21 or beyond), there doesn't seem to be much chatter of a potential cyclical upswing. Given there is tightening in the system yet to be digested by markets, we tend to agree with investors. As such, investors needing to have exposure to the cyclical Industrials sector should focus on the least cyclical industries in the sector.

Building Products Overweight

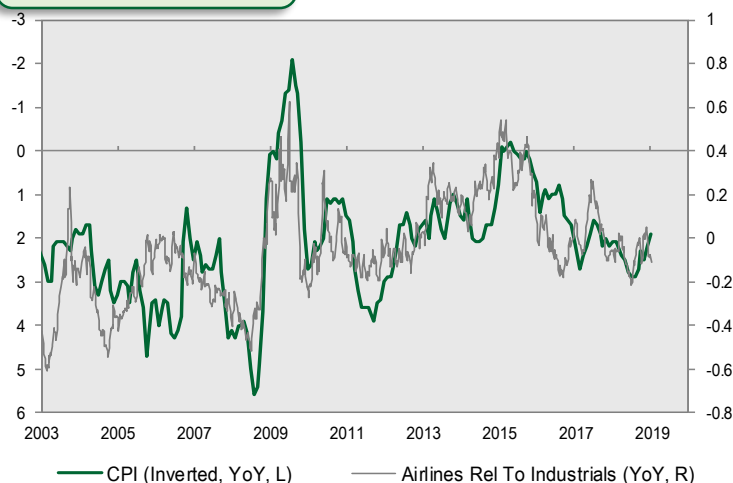
Within Industrials... Overweight Building Products When Inflation Falls



Within the Industrials sector we are overweight building products and airlines. Both of these industries tend to outperform the Industrials sector when inflation wanes. Typically CPI falls when growth slows. Given the tightening still in the system, we remain cautious on PMIs, our favorite proxy of growth, and in turn expect CPI to decline from here.

Airlines Overweight

Within Industrials... Overweight Airlines When Inflation Falls



Tic	Name	Volatility	Price Target Dispersion	Financial Leverage
UAL	United Continental	0.40	0.12	4.74
LUV	Southwest Airlines Co.	0.35	0.13	2.70
DAL	Delta Air Lines, Inc.	0.46	0.12	3.86
ALK	Alaska Air Group, Inc.	0.44	0.14	2.97
AAL	American Airlines	0.64	0.14	31.08

Look For Stability and Low Leverage



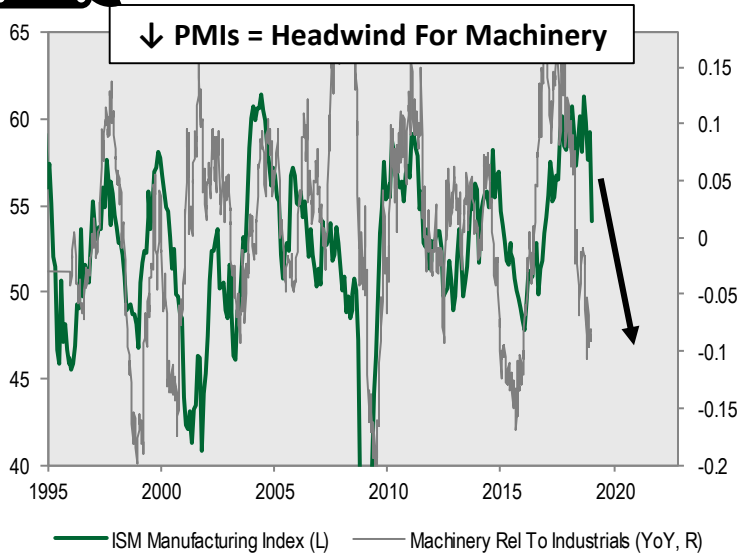
THE UNDERWEIGHTS – AVOID MACHINERY AND ROAD & RAIL WHEN GROWTH SLOWS

While the Industrials sector is an amalgamation of diverse Industries, the overall bias for the sector is cyclical. Two of the driving industries behind this cyclicity are Machinery and Road & Rail. These highly cyclical groups typically outperform when risks are falling and growth is rising. We are quite removed from either of those conditions today. As such, we are underweight these two industries and believe investors need to be very prudent about equity investments within them. On a relative bases, investors looking at equities within these cyclical industries should focus on stocks with stable fundamental attributes.



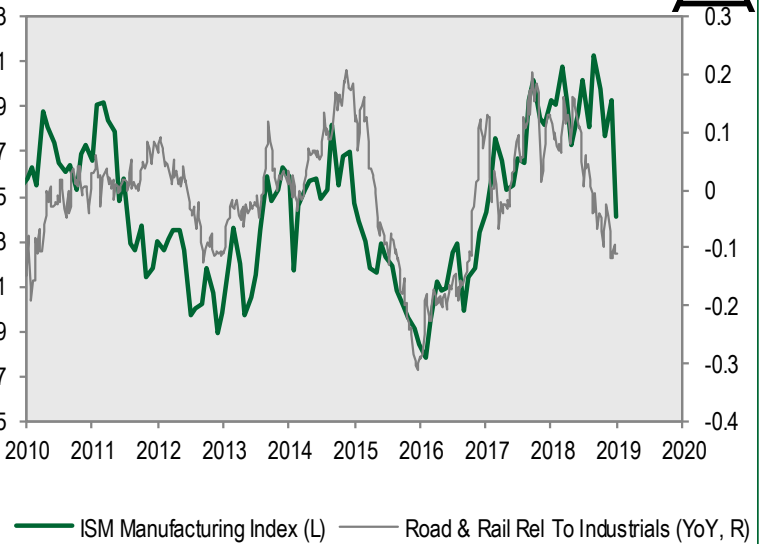
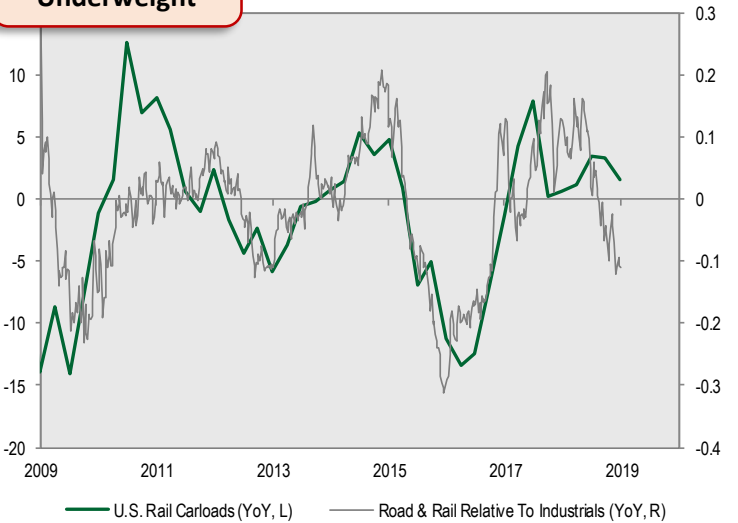
Machinery Is The Most Cyclical Group Within Industrials

Machinery Underweight



Road & Rail Underweight

Slowing Growth Prospects Is Bad News For Road & Rail's Relative Performance



UNDERWEIGHT ELECTRICAL EQP , MARKETWEIGHT AIRFREIGHT & LOGISTICS

When investors think of the cyclical segments of the Industrials sector, Machinery and Road & Rail are the obvious choices, but Electrical Equipment also tends to trend with economic prospects. In all, the Electrical Equipment industry has the highest percent of revenue derived outside of the U.S. of any industry in the Industrials sector.

Within Industrials... Underweight Electrical Equipment When USD Rises

Industry	% Foreign Sales (Ind Average)
Electrical Equipment	49.21
Machinery	47.51
Industrial Conglomerates	46.78
Building Products	41.49
Professional Services	40.76
Construction & Engineering	37.03
Air Freight & Logistics	35.32
Aerospace & Defense	24.97
Airlines	19.94
Trading Companies & Distr	14.91
Road & Rail	11.64
Commercial Services & Sup	6.08

Electrical Equipment Underweight

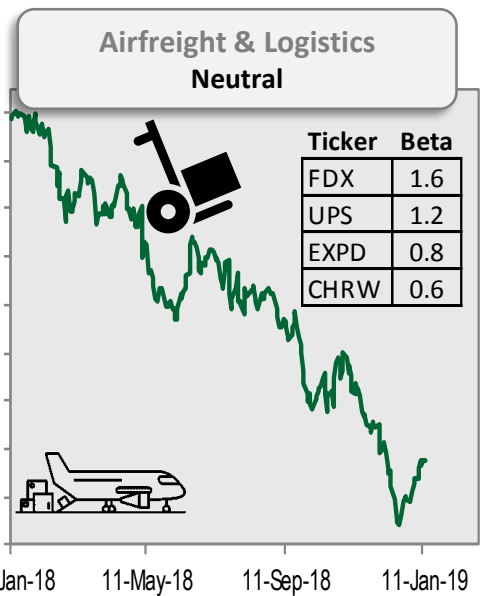


HIGH FOREIGN SALES



As we highlighted, the Industrials sector is diverse. Within the Industrials sector there are cyclical and defensive industries. There are also industries with Industrials that *themselves* are veryAs w and dive

Airfreight & Logistics Stocks Relative To IND Sector



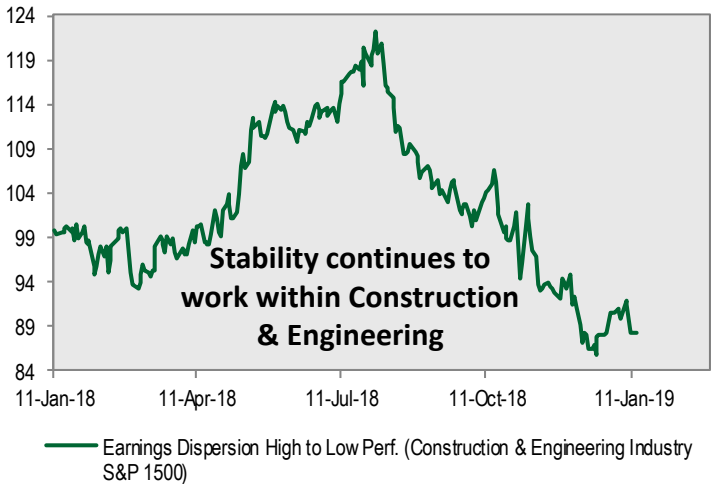
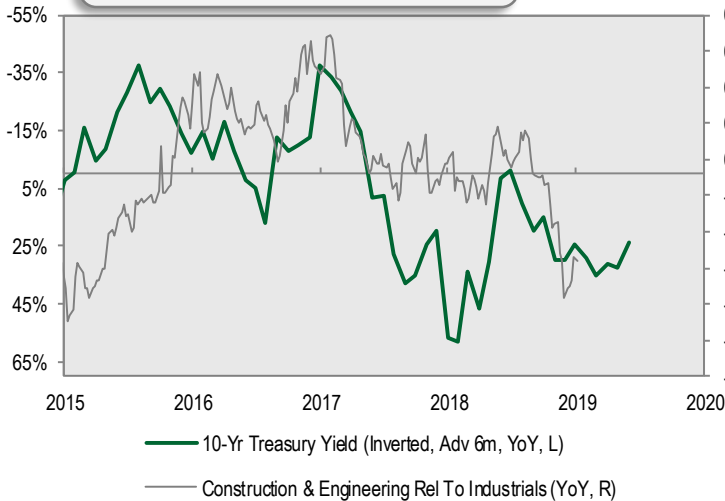
THE NEUTRALS – CONSTRUCTION & ENGINEERING AND AERO & DEFENSE

As we begin 2019, we maintain a neutral view on Construction & Engineering stocks. This industry is influenced by the ebb and flow of rates. Recent talk of the Fed slowing could bode well for the sector. In the interim, we believe investors within the industry should focus on stocks with defensive characteristics.



**Construction & Engineering
Neutral**

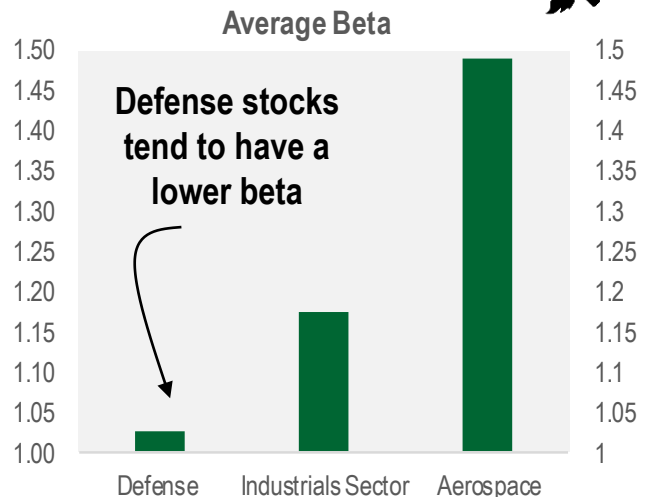
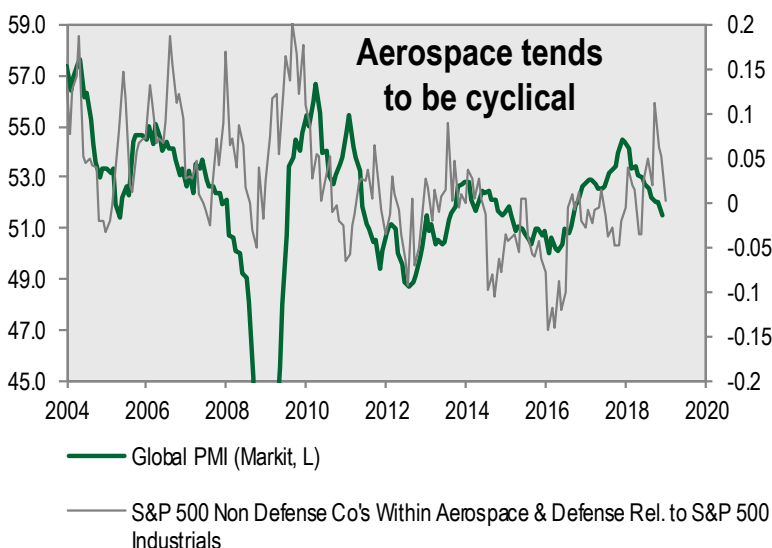
Const & Engineering; Look For Stability Within Sector



We are also neutral on Aerospace & Defense as a whole. This industry tends to be highly cyclical, as several aerospace names within track closely with the Global PMI. Despite this, investors can find refuge in the relatively lower-beta names within the industry which tend to fall more in the defense sub-category.



Aerospace & Defense Outlook Could Face Cyclical Headwinds Despite Budget Approval



**Aerospace & Defense
Neutral**

WHAT'S MOVING IN THE IND SECTOR?

We are firm believers that all leadership trends should work across and within. By this we mean that if a stock theme is outperforming in the overall market, it should also be outperforming within size, style and sectors. If a theme is not working across and within, then it is likely correlation and not causation. As such, we monitor trends within sectors very closely in our chartbooks. If you would like to be included in our monthly distribution, please email quant@cormacteam.com.

