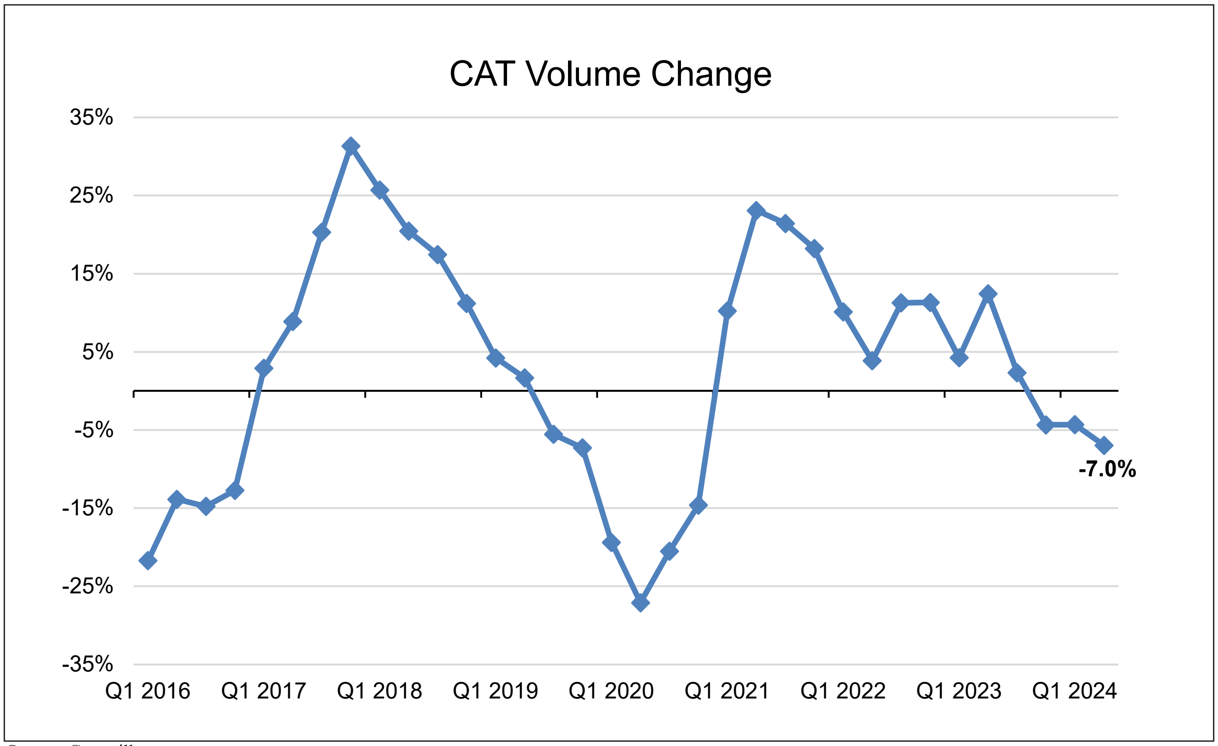
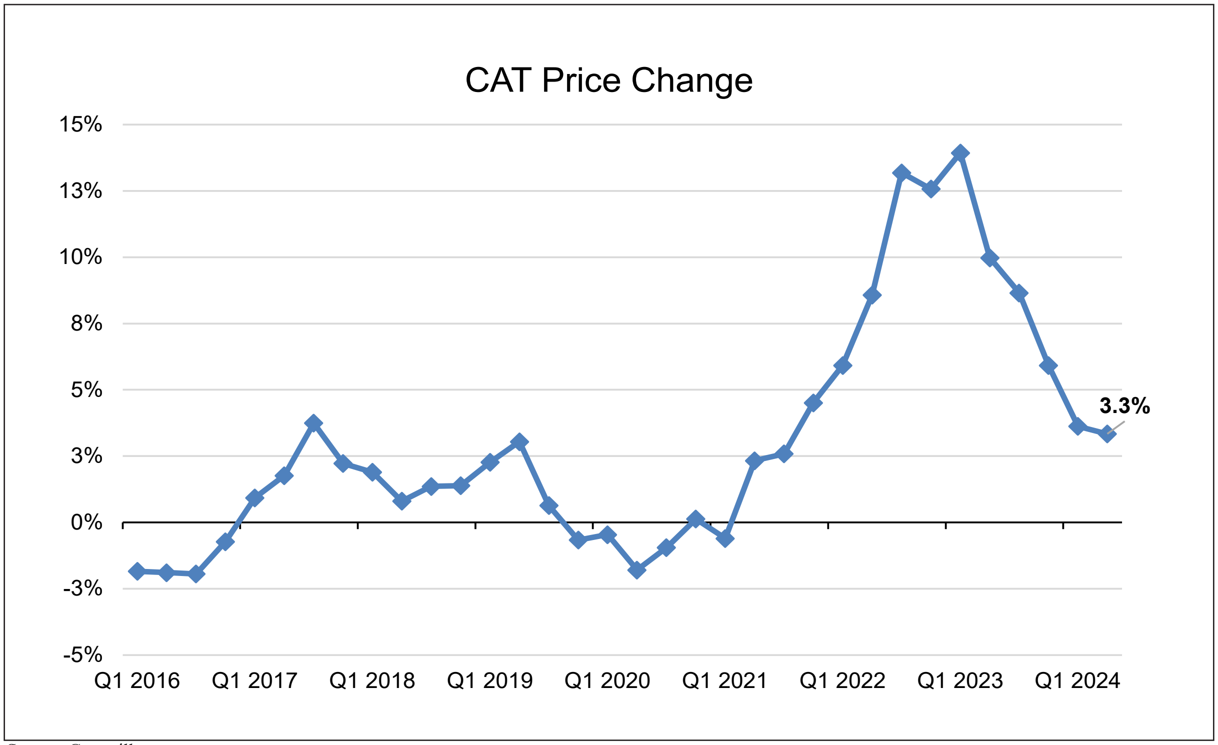
Price Gouging?

For all of the talk of the last 4 years as it relates to price gouging, we can't help but raise an eyebrow when we hear about grocery stores being the prime suspects. In our experience and from our perspective, where we tend to see the biggest price gouging can be with a very different set of companies which just happens to also be a place to look for shorts.

Take for example Caterpillar, a global competitor in the heavy machinery market and one of the world leaders. This is a cyclical market where in good times Caterpillar is able to raise prices and margins as purchase volumes rise. In bad times, Caterpillar reduces prices and margins as volumes decline. Some may call this price gouging, we consider it being involved in a cyclical industry.



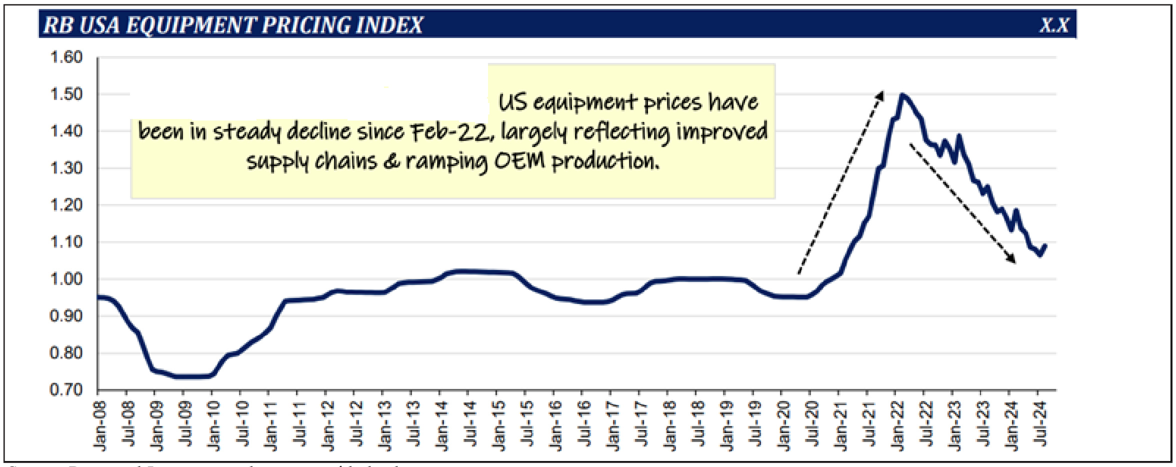
Source: Caterpillar company reports



Source: Caterpillar company reports

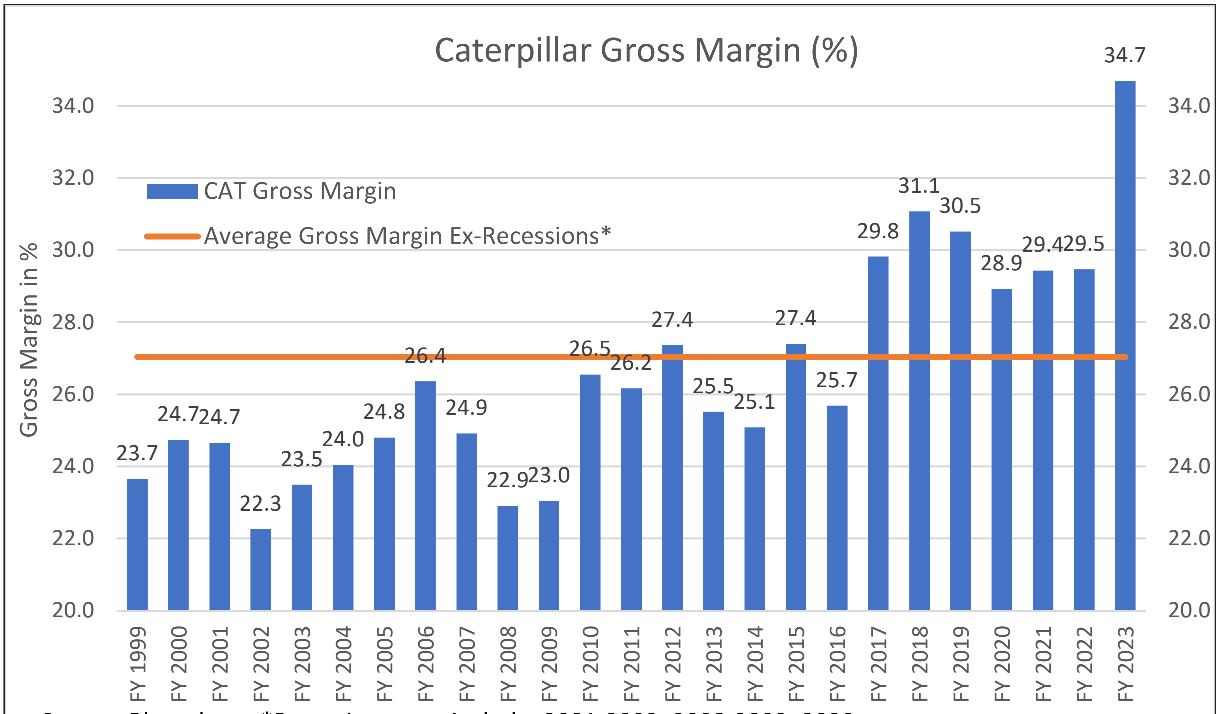
When these cyclical periods of strong demand happen, it not only results in increased pricing power for Caterpillar and its peers but also increased margins. But these margins tend to move up with the bullish cycle and when the economic cycle turns, margins go back down. As you can see below, today, we are at peak margins. With used equipment prices moving down, we believe it could be a precursor to new equipment prices declining.

RB USA Equipment Pricing Index



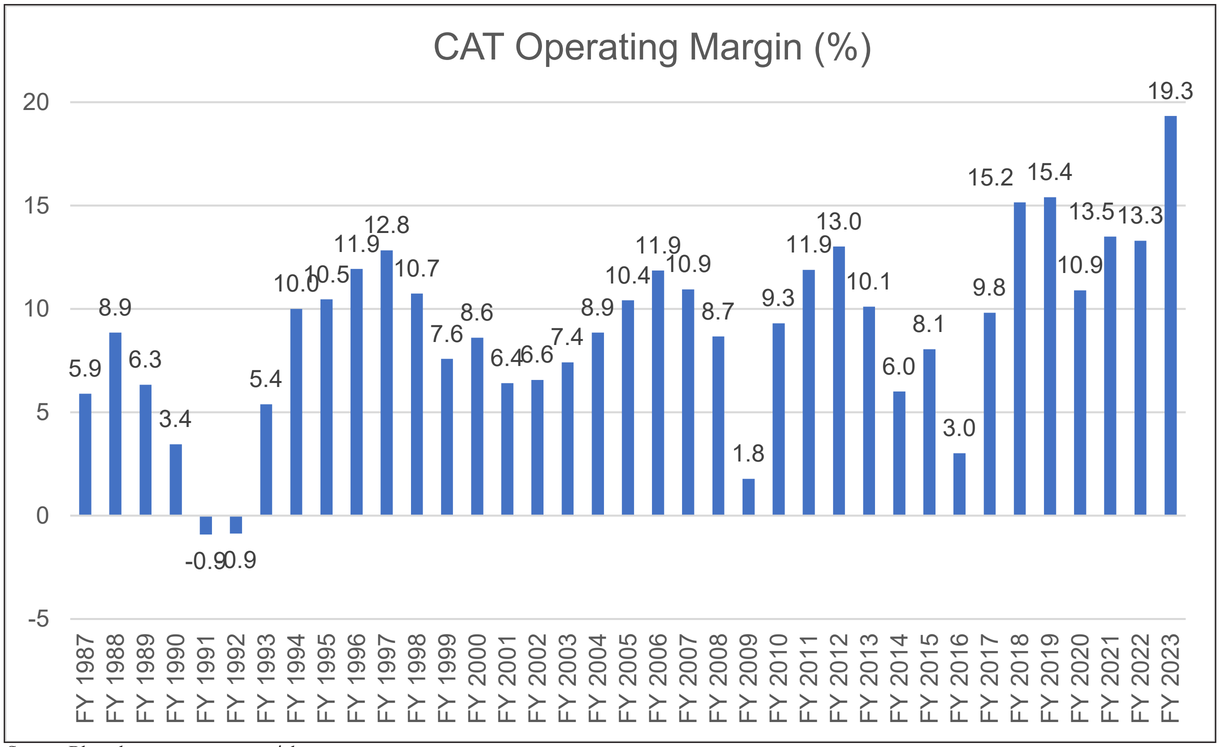
Source: Raymond James research reports, with thanks.

If we were to see CAT's gross margin normalize to 27%, which was the average from 1999 to 2023 excluding recessions, we would estimate a 10.5% decline in revenue. **With a 10.5% decline in revenue driven by price, we estimate earnings to decline by over 50%. Just reverting back to a 30% gross margin, we estimate earnings declining by over 30%, all else equal.**

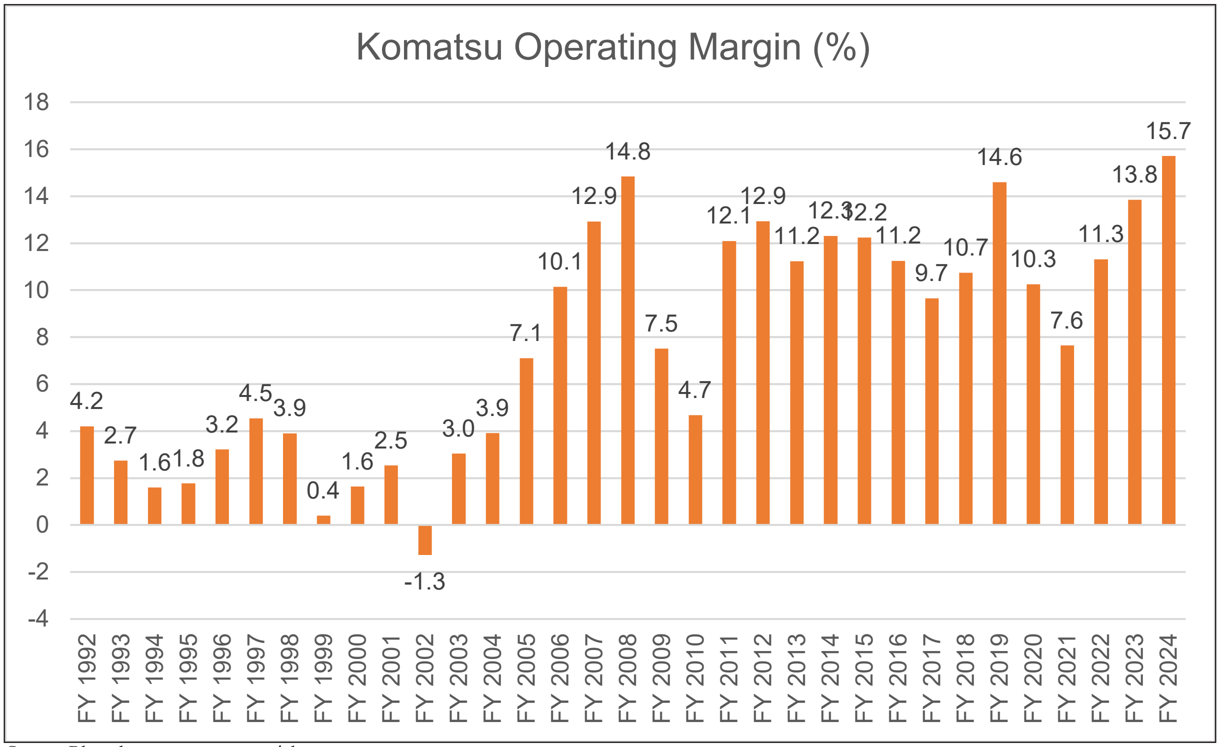


Source: Bloomberg. *Recession years include: 2001-2002, 2008-2009, 2020

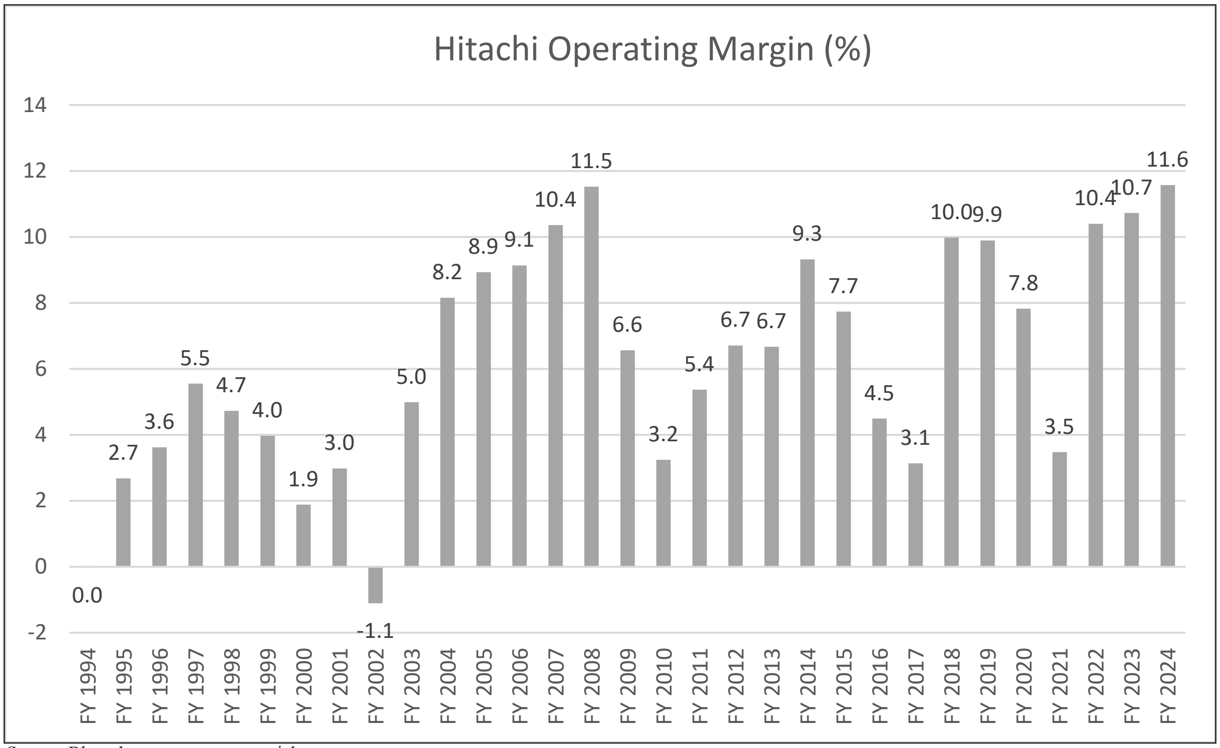
It is not just Caterpillar that is at peak margin, you can see in the charts below that most of the industry appears to be at peak margin.



Source: Bloomberg, company material

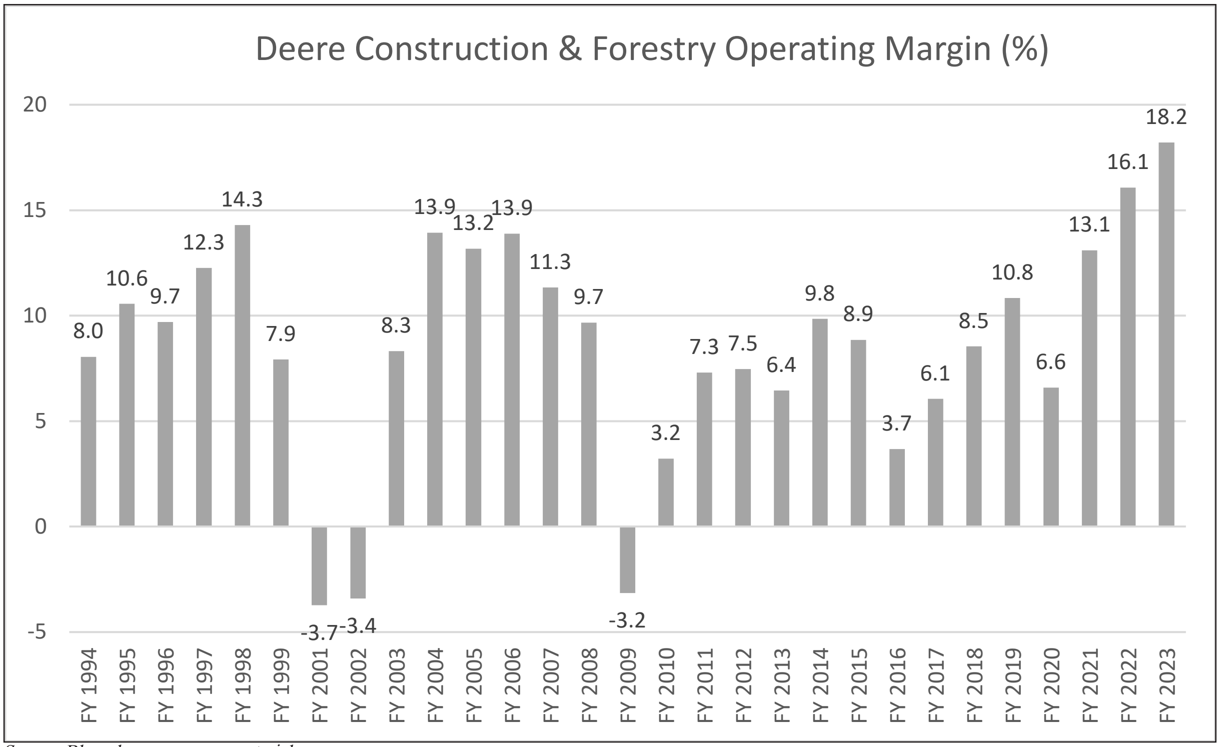


Source: Bloomberg, company material

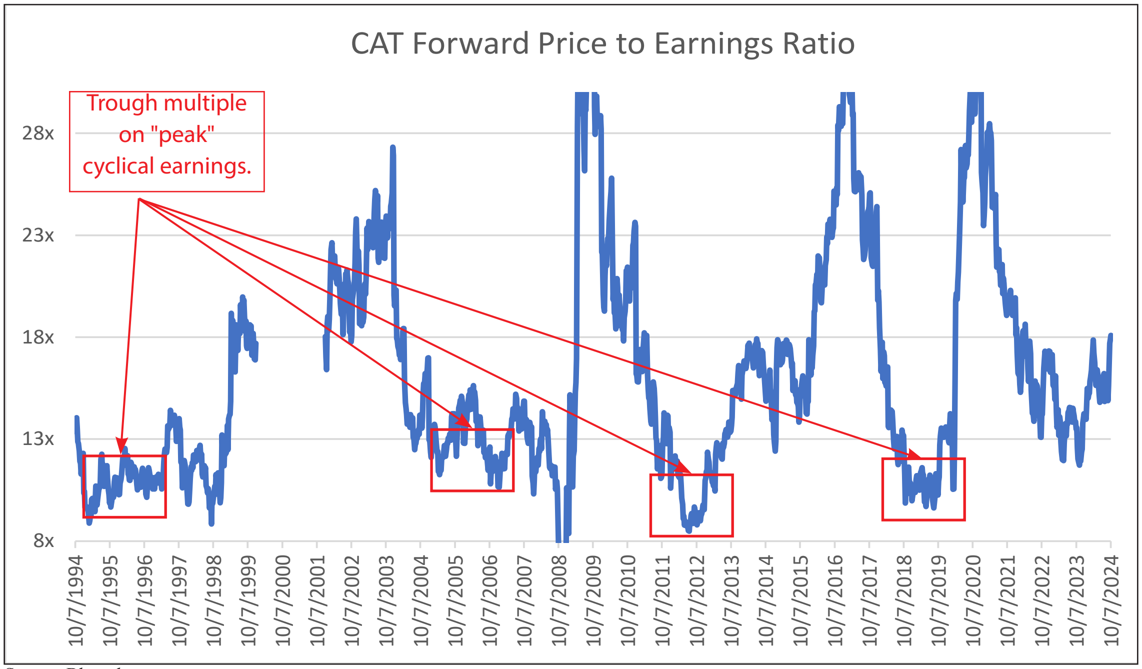


Source: Bloomberg, company material

What makes today different for Caterpillar vs. many historic cycles is we believe the stock is in a unique position of being near peak margin, and near peak multiple. You can see the below, that in 2007, 2012, and 2018-2019, Caterpillar traded at a low price to earnings multiple, likely related to investors not believing margins were sustainable. **Today, on the other hand, we see that Caterpillar is trading near the high end of its valuation range with near peak margins.**



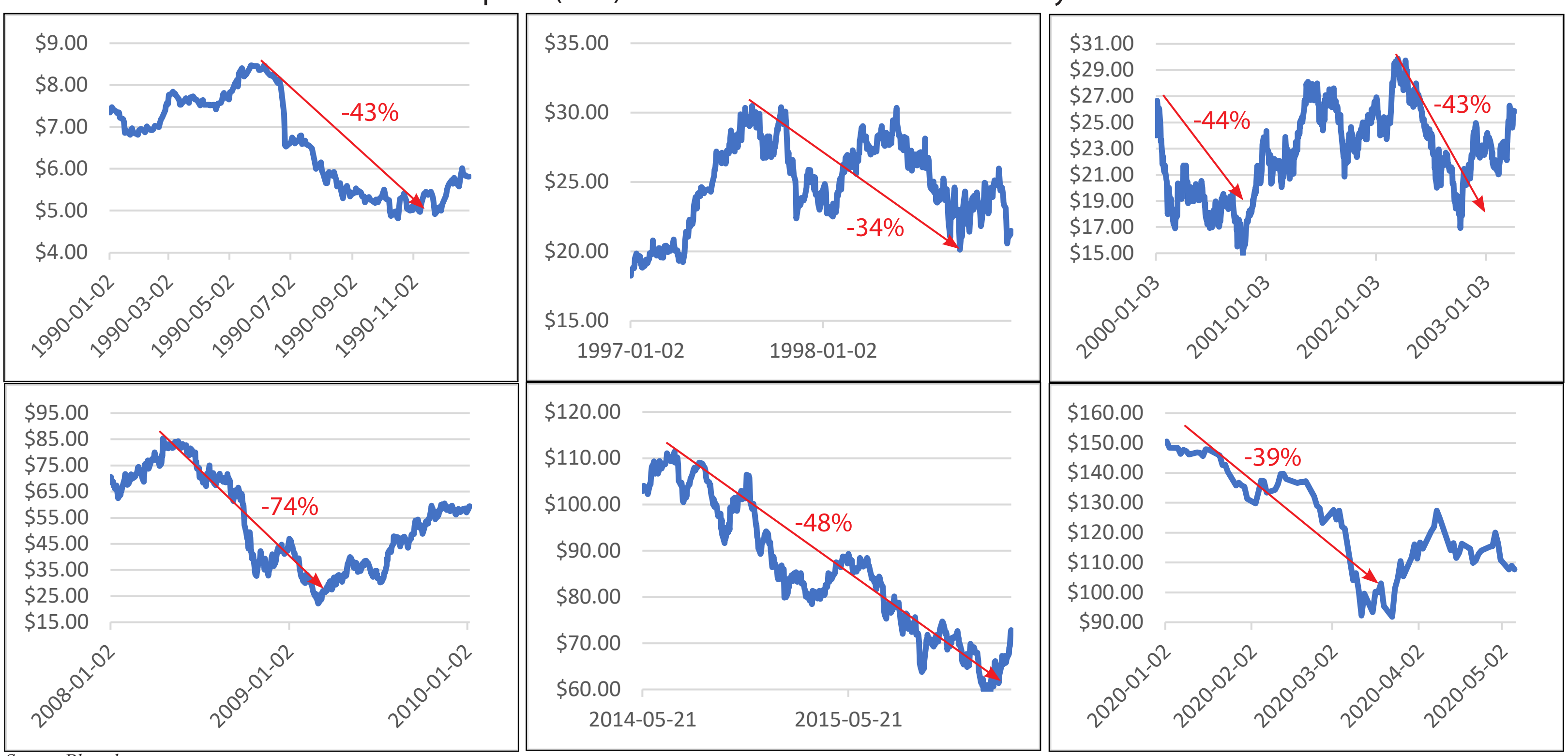
Source: Bloomberg, company material



Source: Bloomberg

The stocks of CAT and its competitors also seem to move in a big way with the economic cycle, as you can see in the below charts of Caterpillar, drawdowns of 20%+ are very common, with large economic cycles generally causing 40-70% drawdowns in the stock.

Caterpillar (CAT) Share Price Drawdown Historically



Source: Bloomberg

We believe that there could be a move in Caterpillar gross margins from ~35% back to the historically high levels of 30%, this could be a 30% drop in earnings power. This, coupled with an associated drop in multiple from 18x to 15x could drive an all in 40% downside move in the stock. We don't know when the economy will turn, but we know that based on history, a stock like Caterpillar could have 30-70% downside potential **in a bad economic scenario.**

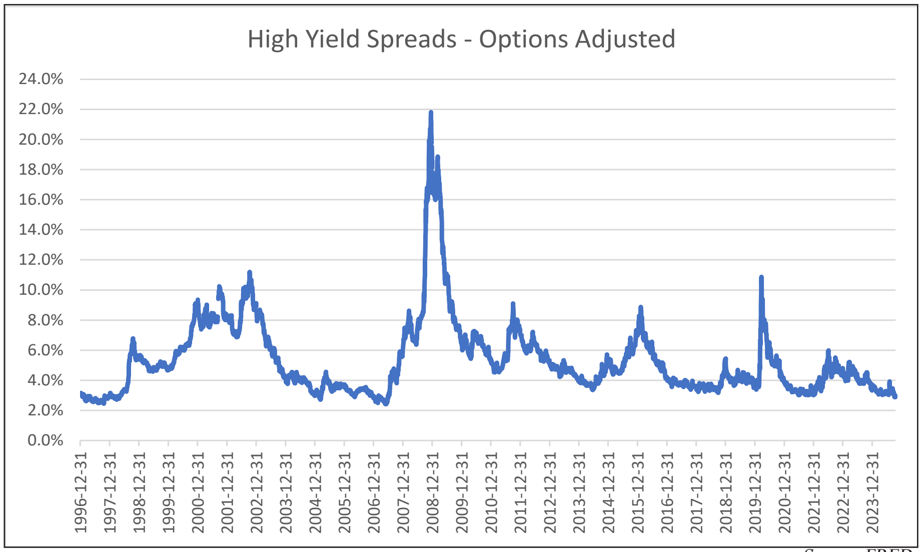
Portfolio Positioning

OUR prediction is that the world is likely slowly moving to a recession. Considering the U.S. deficit is high while the economy is good, the possibility of a long and deep recession is possible.

1. France and USA have deficits of 6% and 6.4% with low unemployment which has never been done before (outside of wars).
2. Markets are likely pricing an acceleration of growth because of lower short-term rates (long term rates have actually moved up on recent FED 50 bps cut).
3. We probably have a bubble of Private Equity capital, along with the "buy the dip" mentality, and passive strategies – ETF flows.

Too many investors are complacent because it's been too easy for too long. Hard times produces strong people and easy times makes weak people. But doing the right thing is painful - for instance both Trump and Harris are pushing for more spending and even higher deficits – clearly not sustainable.

When we see high yield credit spreads at the near tightest on record outside of a few periods, we believe that its not just equities that are expensive, we see it as expensiveness across the markets which makes us retain a defensive posture in our portfolio.



Source: FRED

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