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Sector Views: Free Cash is King

Quality has grown in importance as reduced demand expectations and lower consumer sentiment weigh on the macro outlook. The term 'quality' can either mean a healthy balance sheet, consistency in earnings growth, high cash levels, or a combination of all. We believe that cash flow and debt sustainability are likely to become increasingly important as real economic growth slows and credit access tightens.

Strong Cash Flows Provide Stability and Flexibility

Cash flow provides a link between a company's income statement and their balance sheet. Profitability is important, but without positive operating cash flows, higher levels of financing will be required to support a company's operations. Cash offers stability during periods of economic turmoil while providing flexibility to pay dividends or expand operations as opportunities appear.

Focusing on the Russell 1000 Index (the Index), currently around 96% of the Index has positive operating cash flows (OCF). The Information Technology, Health Care, and Financials sectors currently have the highest conversion of revenue into cash.

Taking this one step further, growth in OCF provides useful insights, particularly in an inflationary environment. On a weighted basis, OCF growth, which measures the most recent OCF relative to OCF one year ago, has been positive for about 66% of the Index. The Information Technology, and Health Care sectors show some of the highest levels of OCF growth. On the flip side, the sectors that show the largest hit to their OCF are the Utilities, Consumer Discretionary, and Consumer Staples. Certain sectors are limited to how much of their rising costs they can pass through to the end consumer. Although the Utilities sector provides an inelastic good (you can't easily substitute where you obtain your water or electricity from), it is highly regulated. This stops companies in this sector from passing down all their higher costs to the end consumer, eating into their cash flow. On the other hand, the Consumer sectors, Discretionary and Staples, provide overly elastic goods. This creates competition, along with margin pressure. They are also labor-intensive sectors, so as labor costs go up, these sectors acutely feel the impact on their bottom lines.

On a short-term basis, companies can curtail capital expenditure (CAPEX) to conserve cash. However, CAPEX has the potential to increase productivity and is essential to longer-term growth. Companies that decide to conserve on CAPEX can increase their free cash flow (FCF). This provides them with a cushion that can help offset higher costs and the potential to increase their dividend. As reflected in the table below, only around 45% of the Russell 1000 Index provides positive FCF growth.

The level of CAPEX investment is dependent on sector and industry as some sectors are fundamentally more CAPEX heavy than others, such as Energy and Industrials. Like OCF growth, the sectors with the largest levels of FCF growth are Energy and Information Technology, whereas the Communication Services, Consumer Discretionary and Consumer Staples sectors have the lowest levels of FCF growth. Looking deeper into the Communication Services sector, the industry with the largest difference between its OCF and FCF is Interactive Media and Services, which encompasses social media and internet giants.

CASH FLOW GROWTH

Source: Bloomberg data as of August 19, 2022.

SECTOR	INDEX WEIGHT	WEIGHTED AVERAGE OPERATING CASH FLOW/REVENUE	GROWTH IN OPERATING CASH FLOW (WEIGHTED GROWTH)	GROWTH IN OPERATING CASH FLOW (% POSITIVE)	GROWTH IN FREE CASH FLOW (% POSITIVE)
Communication Services	8%	2.40	4.82	72%	7%
Cons. Discretionary	12%	-0.17	6.79	38%	10%
Consumer Staples	6%	1.10	0.07	54%	23%
Energy	4%	1.10	18.90	98%	89%
Financials	11%	2.67	2.96	40%	43%
Health Care	14%	3.06	2.99	70%	47%
Industrials	9%	1.34	2.63	59%	29%
Info. Technology	27%	9.06	4.71	88%	76%
Materials	3%	0.54	2.83	70%	37%
Real Estate	3%	1.60	0.77	76%	29%
Utilities	3%	0.72	-0.51	26%	38%
Total	**100%**	**23.42**	**3.93**	**66%**	**45%**

Debt Sustainability through Interest Coverage

CFO and FCF only paint half the picture of what can explain a quality company. The other side would be a level of sustainable debt and the ability to pay it in a timely manner. One way to measure this would be to look at company Interest Coverage Ratios (IC Ratio). The IC Ratio is a company's EBIT over Interest Expense. A higher ratio is preferred and a growing EBIT or a lower interest expense would improve this ratio.

This data point fundamentally favors mega caps that have the earnings to support their interest expenses. It also excludes any company that doesn't have serviceable debt. Looking at the entire index, the Information Technology, Communication Services, and Health Care sectors have the strongest ability to service their debt.

INTEREST COVERAGE BY SECTOR

Source: Bloomberg data as of August 19, 2022.

SECTOR	WEIGHT	WEIGHTED IC RATIO
Communication Services	8%	7.9
Consumer Discretionary	12%	1.8
Consumer Staples	6%	1.1
Energy	4%	0.5
Financials	11%	0.9
Health Care	14%	4.4
Industrials	9%	0.1
Information Technology	27%	9.4
Materials	3%	0.5
Real Estate	3%	0.1
Utilities	3%	0.1
Total	**100%**	**26.8**

Putting it All Together

After looking at OCF, FCF, and Interest Coverage, the same sectors tend to come up that continuously meet the criteria that is commonly referred to as 'quality.' Looking past the Energy sector's exceptional year, the Information Technology and Health Care sectors show the highest levels of OCF Growth and FCF Growth. They are also the same sectors, along with Communication Services, that show the best potential to pay their debt.

One drawback when looking just at OCF and FCF growth is that they are based on past performance, while equity valuations are forward looking. Our overall views on the equity sectors extend beyond FCF and OCF growth and consider other macro related variables.

Our sector views table below provides more detail on sector positioning and the current tailwinds and headwinds for each sector.

CURRENT VIEWS ON U.S. SECTORS

	Positive Factors	Negative Factors	Overall View
Communication Services	Beneficiary of reasonably positive trends in subscription services including streaming. Potential future benefactor from development of augmented reality and metaverse.	Privacy overhang from major hardware providers could impact revenues for interactive media companies moving forward. Higher interest rates may adversely impact the discount rate applied to future earnings and cash flows. This has encouraged a rotation from growth to value this year.	**Underweight**

Consumer Discretionary	Consumers have increased their use of online ordering and deliveries over the past two years, while greater savings and a tight job market could encourage spending.	Wage pressure combined with higher input costs in materials and shipping are a risk to margins, especially if companies are unable to raise sales prices. And a deeper economic contraction could weigh on consumer spending. Adversely impacted by rising inventories and ongoing supply chain disruptions. Some companies have indicated plans to cut sales prices to get rid of excess inventories.	**Underweight**
Consumer Staples	Demand for consumer staples could remain steady for the remainder of the year, especially in the event of a deeper economic contraction.	Inflation is likely to negatively impact margins for companies that cannot pass through rising materials material costs to the end consumer. In our pricing power analysis, Consumer Staples generally scored poorly. Higher transport costs by air and sea may negatively impact company margins.[1]	**Market Weight**
Energy	Escalated tensions with Russia and greater natural gas demand from Europe could keep energy prices elevated globally, positively impacting the sector. A delayed supply response in terms of drilling and production could keep energy markets tight and prices high. Large, diversified oil and gas companies have ramped up buybacks along with record profits and healthy balance sheets.	A global economic contraction could weigh on demand, especially from China, thereby lowering energy prices. Rising COVID-19 cases during winter months could negatively impact mobility. Lower demand may reduce energy prices.	**Overweight**

Financials	The financial sector benefits from improving economic growth, higher interest rates and a steeper yield curve.	A deeper economic contraction could offset the favorable rise in interest rates. A flattening or inversion of the yield curve will likely hurt margins.	**Market Weight**
Health Care	Aging demographics around the world combined with the growing middle class in emerging markets benefit health care demand. Health Care is a defensive sector that typically outperforms during severe economic downturns. Sector has strong fundamentals relative to the S&P 500 on a Forward P/E basis.[2]	Drug pricing pressure remains a risk factor. Senate proposals to grant Medicare powers to negotiate prices on some drugs could limit price increases on medicines.[3]	**Overweight**
Industrials	Beneficiary of rising interest rates, inflation, and possible infrastructure spending. Re-shoring and a shift toward automation infrastructure spending will likely be a long-term benefit for Robotics & AI.	Elevated leverage, increasingly expensive valuations, and rising earnings volatility may detract from this sector's performance. Supply chain issues could be a major headwind. Companies are issuing more negative than positive earnings guidance.	**Market Weight**
Information Technology	Sector displays quality factors and positive FCF growth. The increased adoption of certain key disruptive technologies such as cloud computing, cybersecurity, and CleanTech are likely to remain in a post-COVID-19 world as societies adapt to these new technologies.	Increased regulatory scrutiny is a risk for this sector. There is a bipartisan support for increased regulation in this space. Rising interest rates and slowing economic growth would negatively impact long duration growth sectors such as Information Technology.	**Market Weight**
Materials	Increased focus on Electric Vehicle adoption, alternative energy sources	A deeper economic contraction would be a big headwind for Materials.	**Market Weight**

	and energy storage should be beneficial to Lithium miners and Battery producers. Beneficiary of rising inflation, leading to higher prices for raw materials.	Increased regulations, especially those focused on preventing climate change, is a potential negative.	
Real Estate	The Office, Retail, and Hotels segments in Real Estate could benefit from the reopening with increased focus on a return to normal. Residential REITs are seeing strong demand and rising rents, which is translating into higher multi-family rents.	A fast rise in interest rates could increase the cost of financing, and a deeper economic contraction could raise the risk of costs not being passed along to tenants.	**Market Weight**
Utilities	Preferred defensive sector in recessionary environment due to the inelasticity of goods and services. Adoption of renewables could help transform sector in the long run.	The potential for increased climate-related regulations over time may detract from the appeal of this sector. Companies may not be able to pass through higher inflation related costs due to government regulations.	**Market Weight**

Footnotes

1. FactSet, Earnings Insight, 10/22/2021
2. BofA, When Alternatives Go Mainstream RIC Report, August 9, 2022
3. CNBC, 'Once-in-a-generation' Prescription Drug Pricing Reform Could be Coming, 7/29/2022

Definitions

Basis point (bps): A basis point is a hundredth of one percent. It is predominantly used to express differences in interest rates.

Capital Expenditures (Capex): Funds used by a company to acquire, update, and maintain physical assets such as buildings, technology, and equipment; often used to undertake new investments/projects.

FOMC: Federal Open Market Committee

Russell 1000 Index: The large-cap market index consists of the largest 1,000 markets in the Russell 3000 Index.

S&P 500 Total Return Index: The index includes 500 leading U.S. companies and captures approximately 80% coverage of available market capitalization.