US equities

Pricing Power Standouts | 19 May 2020

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- Due to COVID-19, we expect earnings to fall 26% in 2020, but they should rebound quite strongly in 2021.
- In our view, companies with pricing power offer an attractive way to position for the downturn in corporate profit growth without sacrificing exposure to the upside over a longer period.
- To identify companies with pricing power, we assessed industry dynamics such as market share concentration, as well as company-specific characteristics such as relatively high and stable gross margins.
- We continue to believe that companies with pricing power can outperform the broader US equity market over the next 12 months.

When we launched this theme in May 2019, our thesis called for a deceleration in corporate profit growth relative to 2018. The coronavirus outbreak has amplified the downward trend, and alongside the fall in oil prices, the economic and profit growth outlook has been severely altered. Companies with pricing power should continue to fare well in this environment due to their relatively more resilient earnings versus competitors.

In this update, we have made several changes to our stock list to reflect changes in the economic environment. We continue to avoid energy companies, which do not fit the criteria of this theme and are struggling due to the collapse in oil prices. Within industrials, the companies we have identified are defensive compared to their peers. On the consumer side, we lessened the list's exposure to certain consumer spending categories where pricing power may be reduced in light of COVID-19. We continue to see a bright spot, however, in consumer companies with strong brands and omnichannel capabilities.

We expect volatility to remain elevated in the coming months, as the economy recovers from the recent downturn in activity and as the election season comes into full swing later this year.

A version of this report is available with specific security recommendations for the US onshore investors. For a copy, please consult your UBS Financial Advisor.

Source: iStock

In our view, companies with pricing power will be better able to withstand volatile market conditions and should continue to outperform over the next six months.

In this report, we have identified companies with pricing power based on several characteristics: high and stable gross profit margins and a large market share in their respective industries. We outline three catalysts below that should be supportive of the theme going forward.

Uncertain and unprecedented times

Economic growth has collapsed as business restrictions due to the coronavirus have essentially brought the economy to a halt. The US economy will likely experience a sharp slowdown, as job losses continue to mount and businesses remain closed. The government and the Federal Reserve are taking steps to mitigate the economic impact by providing fiscal stimulus and easing financial conditions, which should help stem the fallout. That said, the outlook remains highly uncertain. Should the measures to contain the virus continue longer than expected, or should we see a resurgence in infections force a second lockdown, further headwinds for corporate profits as well as continued volatility could be realized. Against this backdrop, we continue to believe that companies with pricing power could be a way for investors to weather any potential turbulence without sacrificing exposure to the upside.

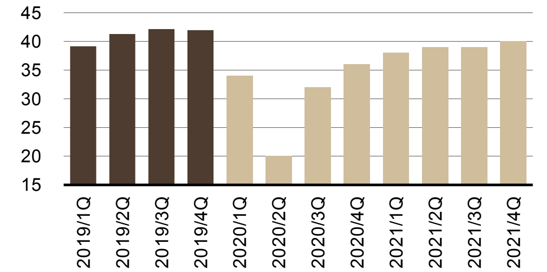
First, we expect both GDP and earnings growth to take a significant hit in 2020. Even with government efforts to mitigate the slowdown, corporate profits will suffer in the near term. We expect earnings per share to be down about 26% in 2020 before recovering in 2021 (Fig. 1). While companies with pricing power are not immune to a broad-based economic slowdown, their typically stable earnings and high gross profit margins compared to peers should help mitigate downside risk. As growth becomes scarce during the economic downturn, companies with pricing power look well positioned to outgrow the market and generate share-price outperformance.

Second, with a lack of clarity regarding the economic growth outlook and the US election, volatility is likely to remain elevated in the months ahead. There is a wide range of potential economic outcomes, as both the lengths the shutdown and the speed of the eventual recovery remain unclear. Outside of the uncertainty posed by the coronavirus, the oil markets provide another driver of volatility and decreases visibility further. In the midst of greater volatility, companies with pricing power may experience less severe drawdowns.

Finally, valuations appear attractive relative to longer-term averages. Historically, the list tends to trade at a premium versus the S&P 500. Currently, the basket of stocks is trading well below its longer-term average premium on a price-to-earnings basis (Fig. 2).

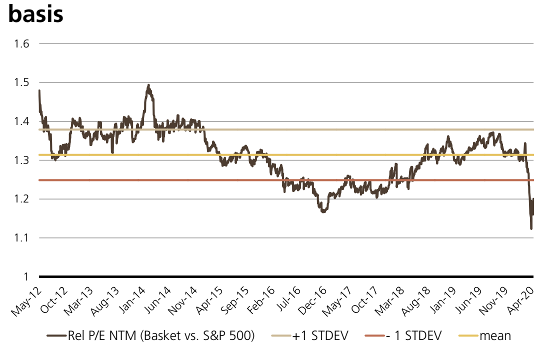
Given these dynamics, we believe there can be further upside over the next six months.

Fig 1. S&P 500 EPS expected to fall in 2020



Source: UBS, as of 29 April 2020

Fig 2. Valuations appear attractive relative to the historical average premium on a price to earnings basis



Source: Factset, UBS as of 28 April 2020

Key risks

There are several key risks that warrant monitoring in the months ahead. The companies included in our thematic list are exposed to a variety of factors that, if realized, could cause them to underperform.

First, companies with monopolistic characteristics are at risk of antitrust regulation, posing a threat for large corporations with high market shares. This risk is especially relevant for the large communication services and technology companies on the list. However, given the complexity involved in antitrust regulation, we don't believe meaningful regulation will come to fruition in the near term. This has also been less of a focus in recent months as governments have shifted attention towards stemming the virus and restarting the economy. We will continue to monitor the regulatory environment as it evolves.

Second, the outlook for inflation on the back of Fed stimulus coupled with the potential for a deflationary demand shock is hard to predict with confidence. Low oil prices are an additional variable to consider. A gradual rise in oil prices from ultra-low levels, a zero lower bound in interest rates from the Fed, and an increasing budget deficit could eventually lead to inflationary pressures. That said, we don't expect inflation to reach the Fed's 2% target for at least a year. Pricing power characteristics could be relatively less impactful in a low inflation environment.

Lastly, the theme's higher exposure to information technology and lower exposure to healthcare do not align with CIO's current sector preferences. The information technology sector could face headwinds due to a slowdown in IT spending in the wake of COVID-19 and slower global growth overall. Meanwhile, the theme's tilt away from healthcare is largely due to complicated pricing dynamics in the pharmaceuticals sector, which can be exacerbated in an election year.

Methodology

To identify companies with pricing power, we undertook both quantitative and qualitative analysis. We began with a universe of global companies with a market cap of at least USD 1bn. We evaluated that universe using economic analysis to determine industry concentration and market share distributions across 90 sub-industries. Industry concentration was evaluated using multiple metrics such as the Herfindahl-Hirschman Index and the 4-firm concentration ratio.

Companies included on our stock list tended to have at least 10% share in one sub-industry, higher-than-average absolute gross margins, and lower-than-average volatility of gross margin. On the qualitative side, we assessed the pricing power characteristics of the companies selected with our CIO sector strategy team and UBS Investment Research analysts. We also considered their suggestions of companies that our screening process may have missed (for example, services companies that don’t report gross margins).

As part of our process, we also reviewed economic moat data from Morningstar, and eliminated companies that had no economic moat, or a narrow moat that was trending smaller. Finally, we considered any potential regulatory action that would impact pricing power in order to minimize the risk to our theme, particularly within the healthcare segment.

Appendix

Terms and Abbreviations

Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
A	actual i.e. 2010A	EPS	Earnings per share
GDP	Gross domestic product	Market cap	Number of all shares of a company (at the end of the quarter) times closing price
Shares o/s	Shares outstanding	CIO	UBS Chief Investment Office

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