Global Industrial Outlook: The C.H.I.E.F. Issues

By Brian Langenberg, CFA

Global economic activity remains good—noise about China slowing, notwithstanding—and despite the ObamaCare debacle, non-Christmas-related consumer spending looks pretty good. Europe is *still* Europe and China continues to grow 7-8 percent—even as the government seeks to clamp down on its own shadow "banking" system. And India remains a mess.

Backing up our views are meetings we attended with these companies during the month of December:

Marathon Oil; General Electric; United Technologies; AGCO; Danaher Corporation; 3M Company; Lennox International.

In February 2012 we began to write to our clients that the U.S. was becoming a structurally more attractive place to manufacture—despite ourselves—because of cheap natural gas and rising international labor rates. But both drivers are *gradually* playing out.

There is going to be a rising debate in the U.S. and abroad about—depending upon your philosophy of life—economic opportunity or income inequality; they are two sides of the same coin.

The U.S. has five "CHIEF" issues impacting the economic recovery and long-term health of the U.S. economy. Three are more or less going to be sorted out—housing, immigration and financial services reform—while two require action—corporate tax reform (Congress, President Obama), and education/employment (several moving parts).

C.H.I.E.F.

Corporate tax reform
Housing
Immigration
Education and Employers
Finance

Corporate tax reform: This *will* get fixed—either in 2015 with a new Congress or the next presidential election. There is understanding on both sides of the aisle that corporate taxes still keep a lot of work offshore. Instead of being esoteric we will make this simple. Boeing has $35 billion of capital invested in its operations—plant, working capital, tooling, etc. In 2012 they earned $5.9 billion of pre-tax income. They paid $2 billion in tax—34 percent and close to the 39 percent statutory rate. As a result their after tax income was $3.9 billion, or about an 11 percent return on capital. Respectable—but hardly excessive given the incredible complexity of their operations, products and services, and position as a premier U.S. exporter! BAE Systems, a U.K.-based aerospace and defense company, enjoyed a U.K.-based 21 percent tax rate. Had Boeing enjoyed a similar regime, their income would have been *$1.1 billion higher* and generated a more appropriate 13-14 percent return on investment. Instead of being criticized for moving operations to South Carolina, perhaps they should be thanked for *not* moving operations to the U.K.

Housing: For all the political yapping, including any rants I might do on *Facebook*, there is *one* area of broad bipartisan agreement: *no massive foreclosures*. This is why we are going to have QE3, QE4 and QE-to-infinity until home values are comfortably above mortgages. The political classes want to keep their jobs, and all constituencies want to remain in their homes—*period*.

Immigration: Insanity is doing the same thing over and over and expecting a different result. Reality check: 11 million people who are already living here *are not leaving*. As a practical matter, I refuse to waste my time arguing this point or whether it is right, wrong, etc. An accommodation will be made that leaves everybody grumbling sooner or later, but allows the U.S. to move forward. Meanwhile, an improving economy is lowering the temperature on the conversation. Corporate entities are increasingly pushing for "reform" because they want to hire minimum wage labor; think hotels, leisure, retail. I suspect we will see piecemeal reform vs. a grand bargain—but I am not sure.

Education and Employers: Stand by for a soapbox here, and I mean 1) the education mafia at the public school and college level, 2) anybody stupid enough—not to mention their parents—to borrow money and attend college for six years without a goal, and 3) the 85 percent of U.S. management teams that do not adequately invest in employee training, abrogate their labor force engagement to resume-screening software, HR, and legal psychobabble, and then complain when they can't find "good" employees. We are at, or near, a tipping point and change is underway.

Failure of the public education system in the U.S. has multiple factors, but suffice to say that with the majority of kids leaving U.S. public schools either unprepared for college, or trade skills to get hired, the economic costs are huge. Worse—we see no quick fix.

College is another story. Years of hype and marketing by the "college industry"—all of which are "for profit"—fooled many to thinking a college degree is an automatic ticket to a good income. Wrong. As Michael Goldstein, the publisher of this fine magazine has commented, "We make 500,000 sociology majors per year. We need 50,000."

Excluding the "elite" schools, a four-year degree will cost about $120,000 net of grants and discounts and leave the graduate with a large debt load.

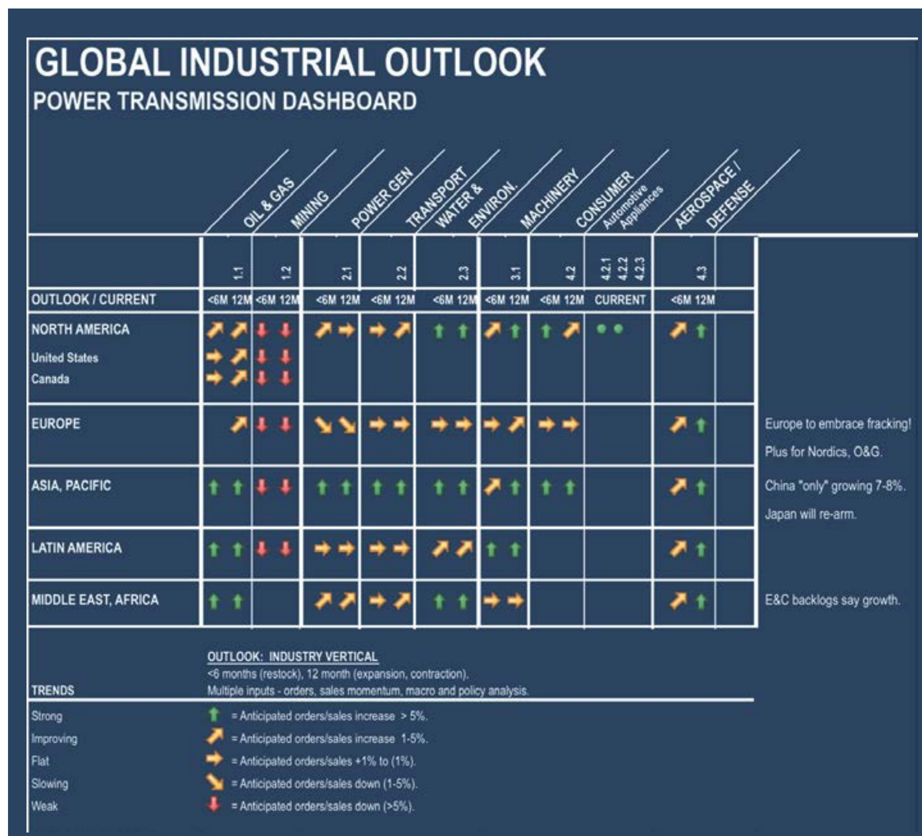
Aside from indisputable facts and figures, the opinions and conclusions are the author's and do not necessarily reflect the position of Randall Publications LLC.

Revolution is afoot. I am an adjunct instructor in finance for Southern New Hampshire University, which is leading the charge to deliver a cost-effective online education that comes to $38,000 for a quality degree. My best research associate graduated from that school. Pricing and enrollment are heading down and schools that do not drive out waste and costs will close. Expect "The Theory of Hair"-type courses and administrators to go first.

Finally, let's talk about the majority of large- and medium-sized U.S. companies. They are going to *have to get their hands dirty instead of outsourcing everything*. For all the complaints about U.S. labor, few companies see leadership, development and retention of a loyal employee base as their responsibility or a competitive advantage. I am not espousing paternalism, but most HR and benefits consultants are there to prevent lawsuits, craft executive compensation schemes for their C suite and boards and to do paperwork.

Here are some fantastic and executable ideas for larger employers that would a) save companies money, b) provide benefits to their employees and c) lead to fewer anti-business voters. To some extent these can be applied even in a small company, or if a few banded together for common purpose.

Healthcare: Average premium for a family of four in an employer healthcare plan is $11,100, according to Hewitt. Primary care physician salary and benefits-per-family of four is $640. Somebody needs to explain to me why a competent manufacturing organization with even 500 people can't do a better job of negotiating discounts and driving out cost than any benefit consultancy, insurance company or hospital. Self-insure the rest except catastrophic and pre-fund long-term health care policies for each employee they can take with them. Save your company money and lower your employees' costs. I think any large manufacturer that took this on could drive 30-40 percent reductions in healthcare costs. Even smaller employers could do this by banding together; a doctor that does not have to pay malpractice and have staff spend 40 percent of their time on paperwork has a much lower cost structure.



Education: Partial tuition reimbursement is the wrong approach to retaining employees. Better yet, negotiate steep price discounts for volume with schools frequented by employees and then reimburse. No excuse not to negotiate with vendors. If an employee attends a more expensive school, reimburse up to a set point.

Training: I am sick of hearing about a qualified labor shortage—particularly from larger companies. The true unemployment rate is about 15 percent—whether young with no skills or older with the wrong skills—maybe 10-15 million people. And yes, there are social issues. Tough; at least half would be good employees with training and leadership. Just do it even if they don't all work out.

Finance: Wall Street, capital markets, Dodd-Frank, and compliance. Expect continued drag for some time, given the higher regulatory costs of Dodd-Frank, anti-business government attitudes and also, lamentably, the fact that banks still get almost "free" money, which they can turn around and hold in government securities as long as the Fed Funds rate is held abnormally low. Not an ideal situation, but at the same time the banking system is rebuilding its capital base.

That is it for the potential enablers; let's talk end markets.

Oil & Gas: Pockets of relative slack potentially occurring as Petrobras and other multinationals slow their capital spending plans and North American onshore drilling activity also slows. Increasingly, the majors are going to focus on earning a return on their huge investments and that means driving production growth. National oil company investment remains strong. Top growth area likely to remain midstream—pipeline, transportation and infrastructure—as investment must catch up with upstream production. Expect stable to higher demand overall, given world energy needs and growth.

Mining: Global equipment orders remain weak though we anticipate rate of decline to slow. We maintain our view that new-equipment demand can decline another 30-35 percent through 2015. U.S. coal, particularly in Appalachia, remains the worst. On the flip side, high utilization rates will continue to support consumables and parts demand; Atlas-Copco is always a great source to track the sector.

Power generation: U.S. wind continues to roar back against easy comparisons, renewed favorable tax treatment and large utilities taking the path of least resistance and installing wind turbines at $2-4 million a crack, instead of fighting to put up a new gas plant (forget coal in the U.S. anytime soon) in an environment devoid of demand growth, rate relief or a reasonable regulatory environment. Wind is by no means the most efficient energy source, but it is a Band-Aid. In the meantime, your company hopefully benefits.

Transportation infrastructure: U.S. infrastructure spending will remain flat until *late* 2016 at the earliest, as it would require bipartisan support and willingness to spend on *infrastructure*. Forget it. Roads with potholes and dangerous bridges don't vote and are thus not a Democratic constituency demanding funding, and the bulk of Republicans (Tea Party) don't want to spend — period. Global passenger rail activity remains strong and we continue to see new order announcements. Beneficiaries include Bombardier, Siemens, Alstom and Wabtec.

Water & environmental: Municipal demand is improving, given pent up maintenance requirements but also higher interest in capital projects. Improving home prices are driving the improved tone, but we still believe significant growth is a couple years out. Industrial activity — particularly dewatering and mobile equipment associated with mining — remains weak.

Machinery: Overall picture continues to improve. Construction equipment production is gradually recovering after three straight quarters of dealer inventory cuts. Mining equipment will remain weak; we still expect a further decline of up to (20-30 percent) in spending over the next two years, and even worse on new equipment. *Truck*: while 2013 production forecasts drifted downward throughout the year, we anticipate solid U.S. demand in '14 driven by high fleet utilization. Internationally we see continued strength in China and Brazil. India remains awful. *Agricultural equipment*: Expect flat markets at best in '14, given farm investment cycle maturity and a pull-back in some grain prices. John Deere growth investment emphasizes Brazil, China, India and Russia. AGCO is emphasizing Russia, Africa and Latin America as providing long-term potential.

Consumer (auto, appliances): Increased consumer confidence supported by recovering home prices and improved stock markets is driving higher demand for durable goods. Auto manufacturers continue to add North American capacity. We expect some continued growth in auto (both OEM and aftermarket service), appliances and housing. Expect the Fed to keep interest rates low, at least through the November 2014 elections, a slight reduction in "QE" notwithstanding. The U.S. economy is better, but not that much better. European comparisons are now easier against a low basis but we do not see any real pickup.

Aerospace/Defense: Commercial aviation spares continue to run strong — General Electric recently reported a 16 percent increase year-over-year on a 5 percent rise in global flight hours; pent up maintenance and restocking by airlines drove the improvement. Build rates at both Boeing and Airbus and increasing order books at Bombardier signal a robust outlook. In Defense, the worst is over given the recent budget deal but do not expect a huge pick up for some time as the U.S. is politically in "withdrawal" mode from exercising global influence. I don't agree with it, but it is happening.

Focus Company: Marathon Oil (MRO)

Energy — exploring, producing, transporting and selling of oil, gas, coal — influences practically every end market we cover. In December we had the opportunity to attend the analyst outlook meeting of Marathon Oil and speak with new CEO Lee Tillman and his management team. Mr. Tillman was recruited to Marathon Oil after a successful 24-year career at Exxon, where he headed engineering for the Exxon Mobil Development Company.

Marathon is a $24 billion market cap exploration and production company. Recruiting an Exxon Mobil executive was no accident; XOM has built a multi-decade reputation as *the* most financially disciplined oil producer. Like others, MRO has spent massive amounts of capital exploring, developing and acquiring properties to drive production growth. Already possessing an above average track record operationally, their priorities are to drive continued operational efficiency (production up time) and *rigorous* portfolio management. In other words the numbers and project risk profiles will drive the decisions.

Their capital spending has increased from about $3.3-3.5 billion per year in 2010-2011 — to about $5 billion annually the past couple of years. What *you* care about is where they will spend capital. As the industry shifts from "find the stuff" to "pump it out" to "pump it out better," i.e. — higher profitability — equipment manufacturers that are aware of customer needs (like MRO) and bring solutions and services that drive oil field uptime and yield will have better growth prospects. Any equipment manufacturer serving Schlumberger, Halliburton and Baker Hughes should still do well.

Our Integrated Company Dashboards (ICD) will give a better sense of these trends. These analyses are available on our website for $199, but readers of *Power Transmission Engineering* magazine can email me directly at *Brian@Langenberg-llc.com* and ask for a copy by putting "*PTE* Offer" in the subject line and the ticker for which company they want. Choose one from: ALFA.IX, AME, ATCOB.IX, CAT, CMI, DOV, EMR, GE, HON, MMM, MTW, ROK, SDVKF, SKFB, UTX, or XYL. We also offer subscriptions at special rates for *PTE* subscribers. **PTE**

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