As Risk Recedes, Market Rises

Doggedly improving economy — and Fed printing press — trump sequestration.

Brian Langenberg, CFA

The S&P 500 (Fig. 1) has rallied six percent since our last review; driven by near-term relief about debt ceiling concern and straightforward signals out of the Federal Reserve that money will be printed in sufficient quantities to support financial assets (i.e. stocks and a nascent housing recovery).

All sectors are up this quarter, led by healthcare (the growth area in government), financials (Fed printing press), consumer-related (discretionary and staples) and closely followed by industrials. Laggards – Info Tech (AAPL) and Materials (mining is weakening).

Two months ago the market risk was, in our view, surprise resilience by tax cutters (Tea Party) in the face of President Obama's reelection. Because about two-thirds of institutional investment funds are managed in Blue States (NY, MA, CA) by people who do NOT know many truck drivers or mechanical engineers, or Tea Party people with disposable incomes below six figures, there is sometimes a disconnect between what markets price in and how things play out.

That risk was quickly chopped away when the Koch brothers (George Soros and others fund the Left; the Koch brothers fund the Right) publicly signaled to the Tea Party that using debt ceiling to get spending down was a bad, bad, idea in pursuit of a good goal. Message received.

The "kicked can" is in play. What each side wants is obvious; their strategies and tactics are evolving, and the question will be for both those in an actual capital goods business and for investors is what government spending gets cut and which end markets does it affect.

Here is our matrix of likely outcomes (Fig. 2), scientifically derived by powerful secret algorithms in a secure underground location (okay, my own judgment):

At this juncture the factions in both parties have absorbed and are beginning to execute their political strategies according to their worldviews. Under the noise (administration, media, both sides) it appears as though the Republicans will play a ground game – Cantor, Ryan, et al. and work through a normal (or semi-normal) budget process and committees. President Obama has decided, apparently, that in year five of his Presidency that meeting with members of Congress who don't agree with him is worth doing (something about having divided government – it's called the legislative branch!). It will be a "process"—but at least now there appears to be one.

We have no reason to anticipate a grand bargain on corporate tax reform — which would drive U.S. job growth into the ozone layer — so figure on continued muddling and a dogged economic recovery.

Debt-ceiling-as-weapon. Unlikely — but there *will* be **economic impact**. The $85 billion in sequestration works out to less than 0.5 percent of the total U.S. economy and perhaps 1.5 percent of total (Fed, State, Local) government spending. But the multiplier effect (number of times a dollar of economic activity generates another dollar of activity) means these cuts, if they continue, can significantly dampen overall GDP growth. The question is where and who.

Defense has less risk than you think. The obvious chatter is around Defense, which involves more than economics. As with any nation, domestic policy inevitably impacts relationships with the outside world. Delaying deployment

S&P 500 SECTOR PERFORMANCE	MTD	QTD	YTD
Energy	1.0%	8.7%	8.7%
Materials	2.9%	4.9%	4.9%
Industrials	2.0%	9.9%	9.9%
Consumer Cyclical	3.8%	10.7%	10.7%
Consumer Staples	1.4%	10.4%	10.4%
Healthcare	2.6%	11.2%	11.2%
Financials	3.7%	10.9%	10.9%
Into Tech	2.2%	3.9%	3.9%
Telecom	2.3%	7.2%	7.2%
Utilities	1.4%	7.9%	7.9%
Source: Standard & Poors			

Figure 1

Market Return	% Prob.	
↑	0.001%	Obama Caves On Spending
↑	0.01%	Grand Bargain (Intelligent policy, corporate tax reform)
↓	25%	Cage Match (Republicans win on spending)
⇨	**74%**	**Muddle Some More**
⇨	0.999%	Republicans Steamrolled

Figure 2

of an aircraft carrier to highlight budget issues while Iran's nuclear program continues unhindered, for example, will not reduce defense spending longer term. Currently I am reading *Diplomacy,* authored by some guy named Dr. Henry Kissinger. It seems appeasement doesn't work.

That kind of irresponsibility leads to a) potentially a lot more people dying in war, later — and not "one per centers" — because of inadequate deterrence, before, and b) spending more on defense, anyway. For example: when the F-22 Raptor was canceled in 2009, and we refused to sell it to Japan and Australia, it reportedly was because there was "no need." Now Japan is seeking to raise defense spending, and the Philippines has publicly stated it likes the idea. Defense will remain a solid area of demand — whether by the U.S. or somebody else.

Questions about Boeing and the 787. The problem is a *battery*, people — *not* the plane. This will pass.

So who gets the knuckle sandwich? Municipal spending-driven end markets — water and wastewater, building construction. While not a federal budget issue directly, austerity rolls downhill and no small part of stimulus spend was federal money funding state and local capital projects. When sugar daddy has no sugar, things get sour. And the improving real estate markets will take at least two years to translate into higher tax receipts at the local level. With respect to highway and infrastructure spending, we anticipate continued stability, but while construction equipment markets are well above-trough on replacement, demand is nowhere near peak.

Market View: Cautious. Our base case for the S&P 500 remains 1,575 at year-end (Fig. 3). Much of the 7 percent upside was realized in the past two months, not on fundamental economics (which are doggedly improving) but the aforementioned Fed and risk issues in the market.

Generally speaking, market multiples are driven by interest rates (lower rate equals higher multiples and unanticipated changes) and risk premium (more volatility / fear drives lower multiples).

We think we have the economics right (U.S. improving, Europe stagnant, China accelerating); interest rates cannot

S&P 500:	1548.2			After market close 3/7/13		
	S&P 500 Earnings			Implied Price Return		
P/E	$95	$105	$112	$95	$105	$112
13x	1,235	1,365	1,456	(20%)	(12%)	(6%)
14x	1,330	1,470	1,568	(14%)	(5%)	1%
15x	1,425	1,575	1,680	(8%)	2%	9%
16x	1,520	1,680	1,792	(2%)	9%	16%
17x	1,615	1,785	1,904	4%	15%	23%

Figure 3

really go lower (but unlikely to move higher), so upside revaluation of the market would likely come from "chopping away" some risk. Consensus operating S&P 500 estimates are $112 for 2013 and $125 for 2014. We use $105 for 2013 because consensus is slowly drifting lower and, traditionally, forecasts start out too high. Also, something usually goes wrong.

Risk. We did not anticipate a rapid backing away from using the debt ceiling as a negotiating tool, but with that risk chopped away the market has been able to rally and the CBOE Volatility Index continues to signal a sanguine view of damaging action by either party. Stocks climb a wall of worry — and it has indeed climbed (Fig. 4).

***China*:** Firm evidence of accelerating demand, particularly in HVAC-related end markets including company commentary from 4Q and (more recently) monthly order data from Emerson. Construction equipment is another matter; figure at least six months of excess inventory to work off (Fig. 5).

***Europe*:** Heavy industry (Germany, Nordics) should benefit from China and emerging market acceleration; rest of Europe likely remains stagnant but stable.

End Markets: No change here — just a few opportunities for double-digit growth in 2013, including:

Global themes: Commercial aviation.

U.S.: Automotive, residential construction, appliances, power transmission, power distribution.

China: Industrial automation, rail, social housing, auto. Overhang in construction equipment likely to persist for at least another 2-3 quarters.

Japan: Military spend.

Europe: Could see strong comparisons in late '13 (China).

What about power generation? Order push-outs at Flowserve signal to us that while inquiries and activity remain high, the combination of efficiency gains (HVAC, grid-versus-generation) and regulation make an upturn in gas turbines in the U.S. unlikely before 2014 at the earliest.

(For those whose responsibilities include business planning and having a broader, deeper grasp of major trends, we encourage you to consider subscribing to Global Industrial Outlook [see our ad, page 50]). **PTE**

Brian's Quick Picks:

GE: You get the yield, and the long-term value is there. My $2.50 earnings power view is intact, but will need a U.S. power cycle that is starting to smell more muted and gradual than I would like. That is, energy-efficiency gains on both the demand side (energy retrofit) and the supply side (utilities investing in transmission to forego further generation capacity additions); but directionally, we have earnings power, limited expectations, late cycle and yield.

UTX: A simple, easy path to value. Guide of $5.85–6.15 (as of this writing) is conservative; I remain at $6.20. Most of what we need to happen, the company can control, i.e., executing the Goodrich integration, cleaning up CCS (Carrier HVAC + Fire & Security), and leverage to a China upturn (Otis).

CBOE Volatility Index
Courtesy of MarketWatch

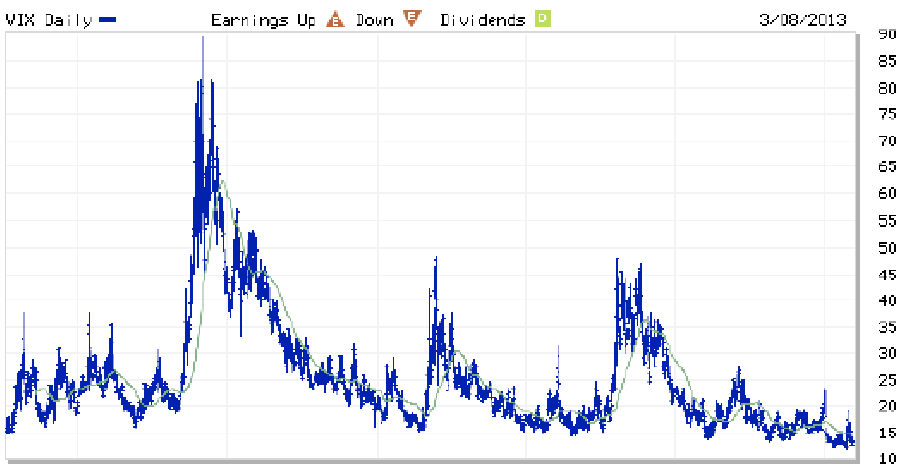

Figure 4

Revenue: Caterpillar, Asia Pacific
Change: year/year

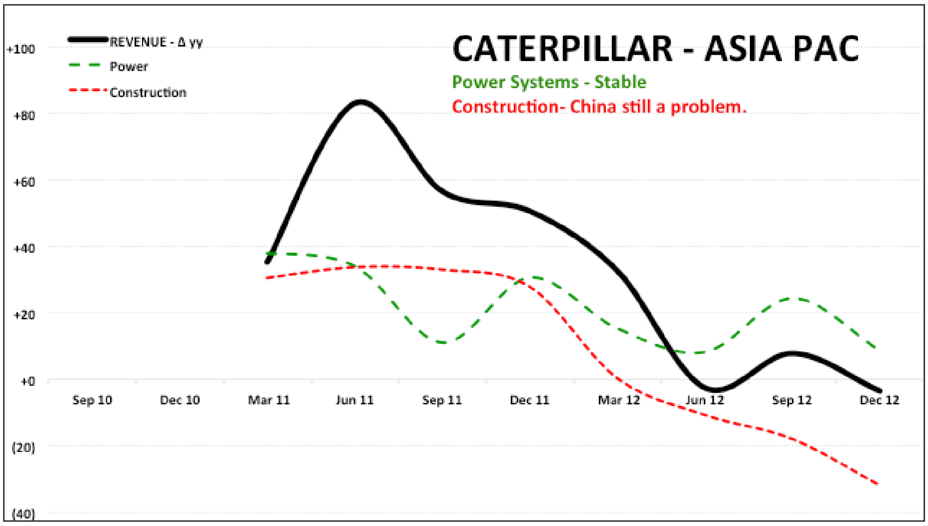

Figure 5

Brian K. Langenberg, CFA, has been recognized as a member of the Institutional Investor All-America Research Team, a *Wall Street Journal* All-Star, and *Forbes/Starmine* (#1 earnings estimator for industrials). Langenberg speaks and meets regularly with CEOs and senior executives of companies with over $1 trillion in global revenue. His team publishes the *Quarterly Earnings Monitor/ Survey*—gathering intelligence and global insight to support decision-making. You can reach him at *Brian@Langenberg-llc.com* or his website at *www.Langenberg-LLC.com*.