Economy Continues—GENERALLY—to Improve

But Equity Markets—and the Institutional "Investors" who Move Them—Not So Much

Our April 2012 launch of this column highlighted several key themes; we will re-state each and highlight developments, relying on our monitoring of 75 key global industrial companies and ongoing fieldwork:

- Europe matters—to Europeans
- Improving price/cost
- Energy
- Self-generated growth/urge to merge
- Global power cycle—though price pressure will limit profitability
- Asia/technology complex accelerates by mid-year
- Residential HVAC
- It's not all about China, as emerging markets continue to grow
- U.S. becoming structurally more attractive—if it can get out of its own way

Europe matters—to Europeans. Economically conditions have played out—though a few management teams cited a "step down" on the margin. Stock markets are discounting the worst, but recent elections in France (national) and Germany (regional) signal a lighter approach to austerity. While I would have voted for Nicolas Sarkozy, and do not habitually favor French socialists, the winner—François Hollande—is appointing a centrist (by French socialist standards) cabinet and seeking to spend. And since European politicians—like any other—also enjoy being re-elected, the French result—coupled with a drubbing in a North German election—has prompted German Finance Minister Wolfgang Schaeuble to suggest a little bit of inflation is okay. In terms of the current economy, Southern Europe and Spain are a disaster—but they can't go below zero and the resource-centric Nordic countries and Russia are growing.

Improving price/cost. Pricing is up, materials and oil are down—which augurs well for input costs and freight going forward.

Energy. We have concerns. Low natural gas prices are biting upstream gas activity in North America and are already crimping activity in pressure pumping. And I would anticipate a second, derivative impact on associated services in shale regions. Conversely, oil-related activity remains strong and our underlying view of continued economic growth should support relatively high prices.

Self-generated growth/urge to merge. No change here; large corporates have a lot of cash, are hunting for growth and feel the need to bolster growth opportunities. They want channel, product and technology—and will pay to get it. Expect a lot more deals.

Global power cycle (with continuing price pressure). Broadly speaking, on-track. Price pressure remains intense, particularly in transformers; and while General Electric called out a flat price, we consider that an anomaly. As for the wind sector, enjoy '12 and hope for an extension of the production tax credit and higher gas prices. We have no insight on the former, but expect the latter, as producers begin to shutter activity in the face of low prices, high inventory and lack of storage.

Globally, expect continued acceleration in large power and process orders (Flowserve, Tyco called out in particular).

Asia/technology complex accelerates by mid-year. We are no longer hearing of supply chain issues owing to Thailand

flooding, and supply chains have been adjusted.

Residential/HVAC. Continuing to see reasonable improvement, owing to seasonal inventory build (and lean inventory) and better pricing. Lack of a heat wave so far has not helped.

It's not all about China—or is it? Emerging markets continue to grow. It may not be all about China—but the market thinks otherwise. Many investors see a potential "hard landing," which in China means 6–7 percent growth and no acceleration in 2012—and marking stocks down accordingly. We think this view makes sense—but disagree on magnitude and end-market and think that election year uncertainty in China is at least part of the problem. We anticipate no construction-related turn before 2013—meaning 2–3 quarters of inventory reduction for construction equipment, engines, etc. But energy and capital investment are another story. China is short on power and grid, and wages are rising. We are already hearing about increased capital spending from automation companies and a second-half tech upswing (Asia is 40 percent technology) should drive electricity demand.

U.S. is becoming structurally more attractive. Low gas prices are a game changer. Recent announcements continue to show greater investment from chemical and petrochemical players that should support basic industrial demand. More a trickle than a torrent—the U.S. still could use lower corporate taxes, significant reinvestment in human capital (re-training), infrastructure (a highway bill) and improved regulatory environment. Let's wait and see in November.

So what has changed in two months?

On the margin, very little—but fear is up among institutional investors, and large corporates are redoubling their market surveillance efforts. Still, the trump card is what they do; and with continued investment, high cash positions and gradually improving economic conditions, we see ourselves in a classic mid-cycle recovery within the context of what may be the largest global financial engineering project of all time.

Brian K. Langenberg, CFA, *is a recognized 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.