Global Industrial Outlook? Sideways.

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We have just returned from the **Electrical Products Group Conference** in Sarasota, Florida. This is our favorite venue because it allows us to speak with the CEOs of nearly 25 global industrial companies that include **General Electric**, **United Technologies**, **Honeywell**, **ABB** and **Emerson**, with combined revenue of perhaps $500 billion; clearly, they have a lot of spending power. We were also graced with the presence of a partner from **Clayton, Dubilier & Rice**—a major private equity firm with significant investments in the industrial sector. Based upon the presentations, but more importantly, on one-to-one conversations with these executives and their leadership teams, following are the key themes driving their strategies.

As an investment analyst, I go to these events looking for insight regarding how these companies' stocks will perform. But as a regular columnist for *Power Transmission Engineering*, I also look for insights that can help designers of machinery, buyers of components and industrial end users better understand the changes taking place in the global industrial marketplace. Here's what I found:

Economic debate? Minimal. U.S. sideways, Europe dead, and China improving (rate-of-change outlook varies). Only questions are mining (we say it will worsen; some executives are more optimistic) and whether Europe can step down further (most not really concerned). Very few sectors are materially strengthening.

Low-growth playbook. It's about supply chain efficiencies (cost); new products (push gross margin upward); and searching for deals that bring geography, product breadth, technology and (selectively) vertical integration (profit capture).

Capital spending will be flat—at best. Broadly speaking, the "big guys" are playing it close to the vest with respect to gross fixed investment. We see flat growth at best in 2013, and probably through 2014, given developed world constraints (debt, aging populations and lack of political and economic reform—or at least certainty).

Three areas of growth . 1) Aerospace (rising build rates, economic growth); 2) Appliances (residential recovery); and 3) Machinery (easy comparisons, but mining will remain down).

Diving deeper, our ***Global Industrial Outlook (GIO)*** is built around a framework to track, organize, analyze and monitor demand trends in key end- markets and industry verticals. While we have carved out a ***PTE***-centric dashboard for this column, the full *GIO* is available by subscription at *www.langenberg-llc.com.*

Oil & Gas. We expect continued global strength upstream (rig counts will grow), even though North American overcapacity remains. Offshore is hot; offshore rigs and associated infrastructure and equipment to work in sub-sea. Companies like General Electric and **Dover Corporation** are acquiring and are globalizing their businesses. You would be well-served to follow their expansion plans. Near-term and closer to home, North American midstream activity (pipeline and infrastructure) should remain robust.

Mining. Managements remain "constructive," i.e.—optimistic of a near-term stabilization and rebound. They are wrong. The big four—**BHP, Rio Tinto**, **Glencore Xtrata** and **BHP Billington**—are rationalizing operations. BHP alone is cutting capital spending to $18 billion from $22 billion, and many junior miners (small, one-trick-pony, recent capital raises) are said to be slowing activity.

Power generation. Engineering & Construction companies are optimistic globally, but U.S. activity could remain weak through 2015–2016 as greater energy efficiency keeps reserve margin (excess generation capacity) from falling. The off-set is aging plants that must be upgraded or closed; but it always takes longer. International looks better; China is adding coal generation capacity, as will other coal-rich regions. Europe is obviously (still) dead.

Transportation (road, rail, marine). Offshore-related activity remains hot. Strength in LNG (liquefied natural gas) will drive specialized, ship-related capital spending (ties in with Oil & Gas). **Colfax Marine** orders remain positive—up 5 percent in 1Q. Road construction and repair will remain steady through 2014—owing to the two-year highway bill extension—and will support construction equipment demand and associated basic (steel, cement) industries.

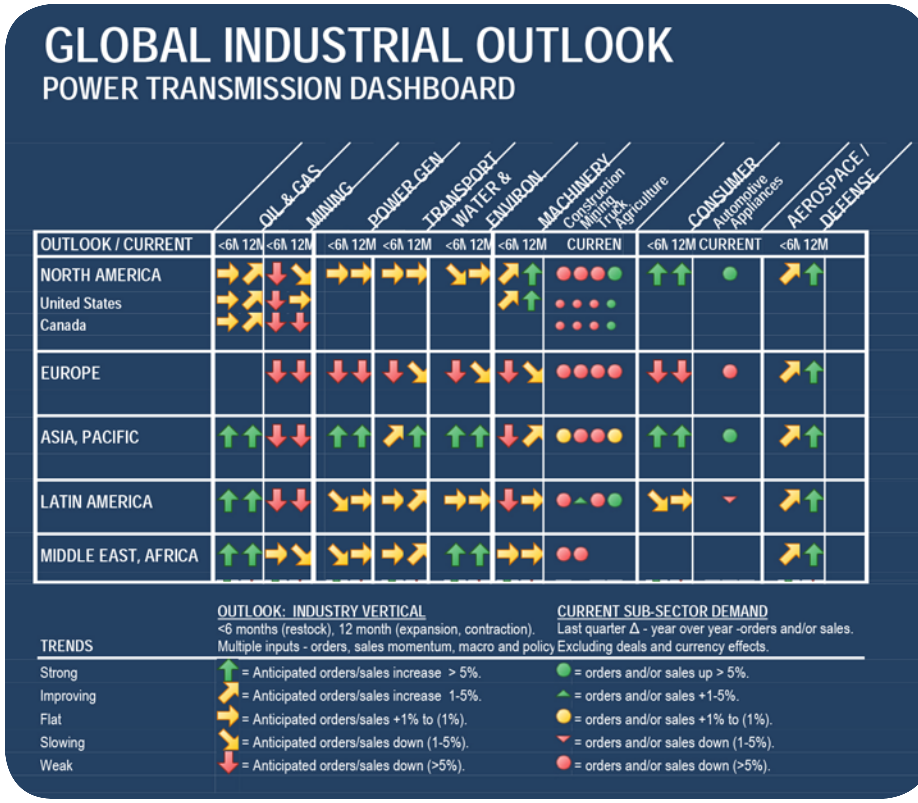
Water and environmental. Weak conditions likely to persist; **Xylem**, the No. 1 global player in water pumps, treatment and test, experienced a 7 percent decline in core revenue and weak orders in 1Q. With municipal budgets strained and industrial customers not investing, we expect continued weakness. One bright spot is desalination plants, where **Flowserve** reported orders up 12 percent in 1Q.

Machinery. The overall picture is improving (easy comparisons coming), but mining will remain a problem.

Construction—Excavator inventory at **Caterpillar** is finally being worked down and production levels are being increased sequentially (vs. 1Q). We expect at least stable-to-rising production through 2013 (up year-over-year against easy comparisons), as China growth (modest-to-solid) offsets European weakness.

Mining—We are less optimistic than manufacturers or equipment suppliers. The biggest mining companies all have new CEOs who replaced overly aggressive predecessors and who are working to rationalize what they have. Utilization remains high, which is good for spares and consumables. But new equipment demand likely remains weak for at least a year or so.

Truck—**Cummins** delivered 27 percent fewer heavy-engine units in 1Q, and full-year demand should be flattish, owing to modest economic growth and aging fleet.



***Agriculture*—John Deere** sees full-year North American unit growth of 5 percent, which implies softening fiscal second-half demand (ending Oct. 31) with strength in larger tractors and combines. Internationally, Brazil remains strong—up 15–20 percent; Asia flat, and Europe (still) down (weak U.K., Western Europe).

Consumer (auto, appliances). Consumer spending is being supported by lower energy costs and slowly, modestly improving consumer balance sheets. Residential housing is up, and though it does not directly impact your business, the spill-on impact for auto and appliance purchases is positive. The appliance revenues of **Electrolux** provide a decent global picture of consumer investment in their homes; 1Q by region: North America plus-8 percent; Asia plus-6 percent; and EMEA (Europe, Middle East and Africa) plus-8 percent; with Europe worse than overall and Latin America 5 percent.

Aerospace/Defense. Commercial aerospace remains the "sure thing" growth market, given high current airline profitability, global growth and the imperative to replace older jets with new, higher-efficiency aircraft. MRO activity and associated parts pull-through have been weak for several quarters, driving pent-up demand.

Expanding on a theme: capital spending will be flat—at best. Senior managements were taken by surprise by further deterioration in Europe, which affected everybody except the resource-rich areas (Russia, Nordics), and they too will have to deal with softening investment in mining and resources. The second derivative impact has proven to be weak Chinese export activity (Europe is a large customer), and the reality of a new political leadership group in China seeking to take the reins. Transitioning to a consumer-led—or at least balanced—economy will take time, involve mistakes, and pose challenges.

Focus company: Emerson (EMR). We chose Emerson to give you a broad view of how economic trends end up affecting your customer and, in turn, orders. Emerson has five segments; these three interest you: *process management* (controls, sensors and instruments that run refineries and chemical plants); *industrial automation* (40 percent of sales are to **CAT Power Systems**; remainder is factories in Europe, the US, China), and *climate technologies* (compressors for HVAC markets).

Emerson recently cut guidance on broad weakness in orders, particularly for industrial automation (CAT, weak Europe), but also their own **Network Power**. Climate is slow, but can turn quickly on warm weather (cooling season). With three straight months of negative overall orders, their June quarter "will" be down. They are also seeing more projects being "pushed to the right." As you can imagine, capital spending is being reined in to a range that suggests 5–10 percent lower investment over the next six months. Granted, much of the impact may be offshore, but indirectly we expect a trickle-down impact in the U.S. What could push it higher?—Nothing obvious, near-term.

Other segments of interest to you:

Process management: Solid to up; North American MRO was weak against tough comparisons, but that will pass. Big refinery projects are coming in 2014–2015.

Industrial automation: Weak next 6 months; need CAT Power Systems upturn (easier comparisons are coming) and/or European recovery (*still* not happening).

Climate technologies: Residential is up; weather could/should help (June is the key month). Bigger upturn is further out and needs non-residential recovery.

But they, as with other companies, will seek ways to refresh their product offerings and innovate upward. Which makes this is a good time to ensure you are very focused on their new product development. **PTE**

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*.