Industrial Reality Check for Chicken Little: the Sky is *Not* Falling

Global capital spending cycle—with dents—is intact. Institutional investors entered the second quarter earnings season mulling three areas of intense interest: Europe, China, and fiscal cliff. We counseled our clients—correctly—that Europe would be important—to Europeans—and an annoyance to the broader industrial economy. Southern Europe is indeed a drag—but is more than offset by growth in Northern Europe and Russia.

It's not about Europe; it's about cash flow. Resource-rich regions (think Brazil and Russia—the "BR" in BRIC—which includes India and China) have it—or they sell to countries that have oil, gas, copper, etc., and need technology and capital to get it—think Germany, the Nordic region. What we expected—and have seen—is that Southern Europe is an annoyance and nothing more.

China: mixed bag—with upside. Current concern is underscored by continued overproduction of steel; it is already hurting steel producers globally and demand for material handling equipment and Caterpillar's well-publicized inventory overhang cast a shadow over many machinery companies. But reality will rule as second-half comparisons become easier and the combination of developing stimulus plans and a leadership transition are set to drive growth acceleration in 2013. This is positive for cranes, low-voltage equipment, rail and power generation.

Fiscal cliff—the wild card. Taxes are set to rise at year's-end on payroll, personal income and dividends—unless action is taken—but neither side is budging in front of elections. We think a deal gets done, but probably not until after the election. The impact would be felt in the March/April 2013 tax refund season, but is already impacting capital plans on the margin, according to several management sources.

Currency and materials offset. The steady drumbeat this quarter is: miss on revenue, make the numbers, modestly cut guidance. Companies are typically missing sales projections by 4–5 percent—mostly due to currency translation (strong dollar)—while benefitting from lower raw material costs. Markets have breathed easier as cuts in earnings guidance have been quite small.

Outlook varies by sector. Regionally, the U.S. economy is slowly improving—evidenced by improving demand for housing and autos—even as broader consumer spending is weak. As one very savvy client stated recently, "I've yet to see a recession when homebuilding is going up." For Europe—the weak parts stay weak—we anticipate synchronized acceleration in industrial automation, drives and power generation investment supporting Chinese reacceleration in 2013. Brazil has taken actions to stimulate its economy as well.

Key power transmission sectors:

Energy. Fossil-based power generation is poised for an upswing, with two straight quarters of positive order pricing—a benefit to GE, Siemens and Alstom. Gas-based generation will improve globally as will coal orders from emerging markets. A combination of wind (tax credits expire at year's end), global investment in energy efficiency and, in some cases, financing constraints, have held the cycle in check. For 2013 planning purposes, forget nuclear and solar. Moving into the exploration-and-production side, we are clearly seeing continued high activity—oil-focused—which on an energy-equivalent basis is priced at 3X gas. But some activity has been marginally hampered by logistics; moving equipment from Northern gas fields to oilfields takes time, money, and temporarily holds down parts activity, particularly in pressure pumping.

HVAC. Clearly improving residential activity seen; way below peak but going to 700K new builds from 500K is a 40 percent improvement, and California homebuilders, for example, are seeing new sub-divisions going up for the first time since 2007. Non-residential, new-build activity is limited to industrial usage—not commercial—but refurbishing and efficiency upgrades are strong and transactional activity for existing properties signals improvement.

Machinery. Varies by product; the agriculture cycle is mature but cash receipts are high, and both Deere and AGCO are pursuing global growth. In construction we see replacement driving demand for cranes and construction equipment—Caterpillar's China excavator overhang notwithstanding. There is a lot of **run way**—power generation cycle, non-res turn and, someday, a real highway bill—all of which is on the come. Truck builds have moderated globally, but age (U.S.) and global growth are unlikely to facilitate an actual downturn.

Consumer cyclical. Auto build rates, new program launches and increased

OEM investment augur well for the sector, while residential housing, as noted, begins to improve.

General industrial. Industrial production remains below peak levels but, as a general rule, parts and aftermarket activity suggest continued demand. Short-cycle businesses have shown weakness the last two quarters—particularly in Europe—but by and large we think supply chains are tight and incremental demand acceleration—at least on a year-over-year basis—happens in the second half.

Aerospace. Build rates at Boeing, Airbus and business/regional jet manufacturers are increasing, limited only by supply chain stress that is being addressed as quickly as possible. Budget sequestration of up to 15 percent of military spend is possible but, we think, is ultimately resolved. Commercial spares orders and repair-and-overhaul dipped this quarter at both GE and UTX, as airlines chose to park older aircraft—757's for example—and part out their engines or put off optional upgrades. We see this as short-term. Oil prices have declined and typically this triggers better activity on a six-month lag.

***The global economic recovery is fragile—or* not.** While risks persist and high debt levels will likely hamper global economic growth for some time, we also think: global political leaders have done a decent job of managing—or at least slogging through—widely divergent economic, political and geopolitical interests; most economies continue to improve; and cash levels, investment plans and actual economic activity point to a continued, constructive outlook.

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