It's quiet out there

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Since our last appearance in this space we've attended the Paris Air Show and met with companies involved in oil production, hydraulic fracturing and wind turbine towers and components. As an investment analyst I am always seeking to help my clients anticipate change in order to manage risk and capture alpha (positive returns relative to market). But as a regular columnist for *Power Transmission Engineering*, I also seek insights that can help your organization do the same. Here is what we've found:

Little has changed in the actual economy since our last article. Second quarter revenue and earnings are indicating a sluggish global industrial economy — but also pockets of growth and, we believe, one that should modestly accelerate both sequentially and against easy prior year comparisons in the second half.

Optimism persists—in certain sectors. Energy and commercial aviation demand continues to grow; both are justified. Energy is a strategic imperative for any growing, or mature, economy. Commercial aviation investment is being enabled by better cash flow and is necessitated by the need to migrate to more efficient aircraft fleets. General Electric and United Technologies continue to spend heavily on engineering to get those new engines ready.

Easier comparisons will help elsewhere. We expect improving year/year results in the second half in construction equipment and truck engines—particularly in North America.

Mining can't be helped. It is rolling over. Expect good consumables activity, but new equipment and projects will taper off; figure down (20–30 percent) over the next 2–3 years.

Overall, we remain in a moderate, global economic growth environment that should continue to support maintenance capital spending and selected expansion, but no significant increases. For detail, eight of the ten industry verticals in our broader GIO are detailed below:

Oil & Gas: Rig count growth globally will continue (upstream), while North America starts to see easier comparisons. We've met with the C suite of two upstream companies this month and activity remains strong. Offshore production remains hot, as upstream is a strategic imperative for developing nations; key beneficiaries include GE, Siemens and Dover Corporation. Closer to home, North American midstream activity (pipelines and infrastructure) remains robust and it is possible, though too early to tell, if the oil train tragedy in Quebec can spur less resistance to pipeline building.

Mining: In our view, capital spending is likely to decline by (20–30 percent) over the next 2–3 years, and this is incrementally negative for Caterpillar, Joy Global and Atlas Copco. Large miners will likely complete current projects but their "unapproved" projects smell like vapor to us. The challenge now is driving productivity, not spending more. And many small mining companies are broke. Not good.

Power generation: U.S. demand will not pick up before 2015–2016, as greater energy efficiency and modest economic growth keep reserve margins (excess generation capacity) sufficiently high to push out investment. While arguments abound that aging plants must close and a "war on coal" might force increased investment, we are highly skeptical the current administration has the muscle to force the issue. Wind comparisons will get better after year end, but we are not holding our breath on a return of the production tax credit (PTC). And even if it happened, we anticipate a more steady pace of activity once those comparisons are worked through. Globally, capacity additions are strong in Asia (Chinese coal in particular) and should continue, while a number of projects are working their way into backlog with E&C companies.

Transportation infrastructure: Offshore-related activity remains strong and we've heard rumors of a pick-up in shipping that we do not believe (well, perhaps a bump off the bottom), except for specialized needs like LNG (liquefied natural gas). Road construction and repair work will be steady—at least through 2014—owing to the two-year highway bill extension, and should be supportive of steel and cement demand at or near current levels. Sequestration matters, however.

Water & Environmental: Municipal budgets remain strained and industrial customers choose not to invest, though we note that easier comparisons are coming in the second half. Internationally we are hearing of strong, continued demand—particularly in desalinization. The North American outlook should improve, on a lagging basis, with rising home prices driving higher priority taxes. Notably, a private E&C executive recently told us he is actively seeking to hire sales engineers to support opportunities in the U.S. and Mexico.

Machinery: Overall picture continues to improve.

Construction equipment production is now rising sequentially, as Caterpillar has worked off excess inventory, and second-half comparisons will be easy. Much controversy is arising from China, given weak exports (though we don't believe the recent "down 3 percent"; that smells like better accounting on invoices). **Mining equipment** is another matter, and layoffs in Milwaukee do not strike us as being likely to reverse. Tough financial conditions with Canadian junior miners could lead to excess equipment coming on market. **Truck** engines are set to recover. **Agricultural equipment** demand in North America is expected to soften year/year through Deere's fiscal year ending October 31st, in what is best described as a "more of same" environment (high farmer cash receipts, steady demand).

Consumer (auto, appliances): In the U.S., improving real estate prices are helping bolster consumer balance sheets and thus pent up demand for durable goods. Nothing dramatic, but

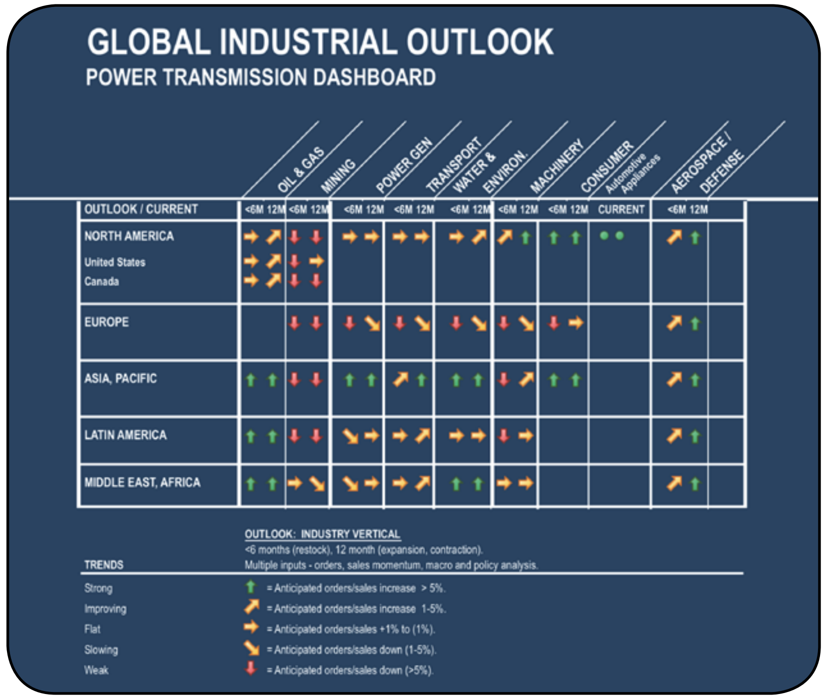

figure > 5–10 percent for appliances and, more importantly for you and the U.S. economy, continued strength in auto production. Internationally, Europe remains weak, though easier comparisons are coming, and certain resource-rich emerging markets (Middle East, Africa) will also show continued growth.

Aerospace/Defense: A couple of moving parts here. Commercial activity remains robust, while sequestration is now sinking its teeth into operating tempo. On the commercial side, at the Paris Air show and in our discussions with multiple executives, continued optimism was backed up by solid order books. Pockets of weakness do persist—lowered air freight demand is a negative—but will be more than offset by airline requirements for more efficient aircraft. Aftermarket MRO remains weak, although components specific to power transmission should do relatively well. General Electric and United Technologies (Pratt & Whitney) continue to invest to grow their new-generation engine offerings to support customer demand. The competitive game is on: UTX is getting back into commercial aircraft engines through its wins with Bombardier (BBD.B) and Embraer (ERJ); General Electric must keep up. Defense is another matter. Sequestration is also taking a bite out of U.S. operating tempo, and international sales are not going to completely pick up the slack. Do not confuse yourself with the idea that long-term thinking will prevail; the F-35 is actually at risk of a delay that will drive higher long-term costs, and even if it doesn't happen, we know of civilian DoD employees that are on 32-hour weeks.

Capital spending: flat at best—no better. Deals create risk for you. The global economy continues to grow, but not fast enough to drive significant growth in global fixed investment. Generally speaking, the C-suites are focused on optimizing footprint, improving supply chain and driving productivity. There is no time like the present to *think very hard about business risk*. The urge to merge is high—and usually leads to delayed or cancelled capital spending at the target. If a single client or factory generates more than 10 percent of your sales, we should talk. We can help you assess your risk and develop a growth strategy to protect your company.

Focus company: Caterpillar (CAT). We chose Caterpillar because it is leveraged to nearly every industry vertical we track: Oil & Gas, Mining, Power Generation, Infrastructure—you name it. After an ambitious capital spending and growth strategy coming out of the downturn, Caterpillar hit a wall in mid-2012 as overproduction of excavators, particularly in China, came home to roost and since then has been exacerbated by weakness in stationary power and now the mining downturn. The company reports three primary segments: Construction, Resources, and Power Systems. But given the audience, we are going to focus on North America as a region.

North American revenue declined (21 percent) in the first quarter and a negative 2Q comparison will be reported by the time this article is published. Power Systems is about 40 percent of current North American revenue and is working through a weak hydraulic fracturing market. After 2Q there will be one more negative comparison, and recent discussions with field contacts suggest the excess equipment in the shale regions has been worked down. Construction (33 percent) is already improving sequentially and comparisons turn positive no later than 4Q. As for resources, mining is, and will remain, very ugly. Aftermarket demand turned negative in the September 2012 quarter, and new equipment revenue followed in 1Q13, and we see continued weakness—possibly worsening—for at least the next year. Continued capacity utilization should at least start to support aftermarket.

Overall, we expect management will maintain a measured approach to capital investment at this point. Global Industrial Outlook: Meh—For Now. **PTE**

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