




Global Industrial Outlook: Oil Slick, Currency Headwinds Challenge Growth

By Brian Langenberg, CFA

End market conditions for the power transmission industry have arguably worsened since our last column. In December we stated that with two armed conflicts underway impacting economic performance in Eastern Europe and the Middle East our stance was “Buy on the Sound of Cannons... Selectively” while cautioning PTE readers not to be sanguine.

Three factors are challenging growth:

Oil	Currency	War
		

What has changed?—Oil price.

Simply put, in December WTI oil stood at about \$75 and was down (about 25%) despite two conflicts owing to excess supply. At that range it made sense to assume cuts to upstream exploration (drilling new wells) and production (keeping older, high cost rigs working), while mid-stream activity (pipelines, infrastructure) and downstream (refining) spend would hold up fairly well.

With U.S. oil price hovering at \$50-\$52 per barrel—(down 50%)—all bets are off because industry cash flow is driven, like all businesses, by revenue—expenses. When your unit price plummets (50%), cash flow gets killed, capital preservation becomes paramount, and capital spending budgets are slashed. Recently announced spending cuts (selected):

Chevron	13%
British Petroleum	20%
CNOOC	35%

The general consensus is about a (25%) reduction in 2015 capital spending, which seems right but can worsen in 2016 should oil price not recover.

To be clear—very, very few industrial companies (i.e. your customers) have publicly acknowledged it will have a

significant impact on them. This is called self-delusion; with *Caterpillar* a notable exception.

Currency has become a challenge. Remember in 2011 when the U.S. dollar was supposedly going to plummet when S&P downgraded? Wrong! See chart below. The mighty greenback is at its highest level in over a decade as the U.S. has become a better growth proposition (by default) due to weaker Japanese yen (on purpose), Euro (weak economy) and flight to safety (Fig. 1).



Figure 1



Figure 2



Figure 3

Japanese construction equipment manufacturers are in turn using the weaker yen to fight with price in the Middle East and Latin America; we are already seeing it in revenue and margin (Fig. 2).

In turn the Euro has plummeted on economic weakness, conflict (Ukraine) and fears of a Greek exit. The result: lower international profit for many companies (Fig. 3).

War is a threat to global growth. The war between ISIS, coupled with lack of U.S. leadership, is a threat to the development and sustainment of oil supplies directly in Iraq and Libya in the near-term. One can make the case, and I do, that U.S. foreign policy will be feckless, continue to embolden ISIS, Iran, and Hamas over at least the next two years and, in a worst-case scenario, potentially threaten the stability of the Saudi regime.

Outlook

Here is our outlook for key geographic regions and end markets:

- **U.S. remains best growth spot.** Non-residential construction, consumer durables (auto, housing) and gradually improving employment will offset weaker commodity-based demand.
- **Europe.** Taking a marginal hit (Nordics, resource-related parts of German economy) by conflict in Eastern Europe. The bigger question is geopolitics and the Euro. Russia's Ukraine gambit (combination invasion and "rebel" support) will not lead to broader war because Russia is economically weak and Germany is a geopolitical weakling. With respect to the Euro, it has weakened at least partially on fears of a Greek exit from Europe. I think if Greece exits, the Euro rallies because it is really the old German Deutschemark with baggage. Losing Greece = less baggage.
- **Middle East.** Oil & Gas activity should remain strong — even with production cuts — because mature fields require more capital and the region is seeking to capture more of the value stream. Increased Japanese construction equipment competition is a negative for U.S. manufacturers.
- **Latin America.** Oil & Gas will remain weak (Petrobras, Brazil) and your construction equipment customers are

facing increased competition from the Japanese, given the weak yen. Auto-related investment, particularly in Mexico, remains strong.

Oil & Gas: Oil is now at \$52 not \$75 — look out below. This will hit construction equipment and anything tied to energy-related activity — particularly

in upstream — but the spending cuts will spread. The "consensus" is for a (20%-25%) cut in 2015, accelerating into the second half and possibly further cuts in 2016. Bad for construction equipment, land-based power generation (small p not BIG P), and ancillary products and services.

Mining: Still awful; aftermarket is now stabilized, despite cash burn at coal companies.

Power Generation: U.S. power generation remains weak; owing to efficiency gains throughout the economy and lack of regulatory support for new construction. Globally the industry looks good, including coal and gas.

Transportation Infrastructure: More pot hole filling — no major infrastructure upgrade anytime soon. While I've heard rumblings of a multiyear highway bill, reality suggests other factors including 2016 Presidential election, ObamaCare disruptions, etc., would make for a "status quo" or "status quo with certainty" outcome vs. a big infrastructure rebuild. I would love to be proven wrong. I doubt I will be wrong.

Machinery: Nobody is feeling the love outside replacement demand for U.S. trucks along with modest incremental demand from non-residential and residential construction markets (cement mixers). United Rentals is calling for flat capital spending in 2015, which pretty much tells you the construction equipment outlook. Weakening farmland prices, declining farm cash receipts signal the AG outlook.

Consumer (auto, appliances): Old cars = continued U.S. strength. Auto-related end markets will remain solid. Auto investment in Latin America, particularly Mexico, continues to increase. U.S. residential recovery is on track and will further support construction equipment demand.

Aerospace/Defense: Strong commercial build rates, coupled with two significant wars and depleted U.S. inventories, will continue to support a continued recovery in aftermarket activity. Long-term, we expect a U.S. defense recapitalization — but not before 2017, authorization given the current Administration. Foreign policy matters — and messes — will remain to be cleaned up.

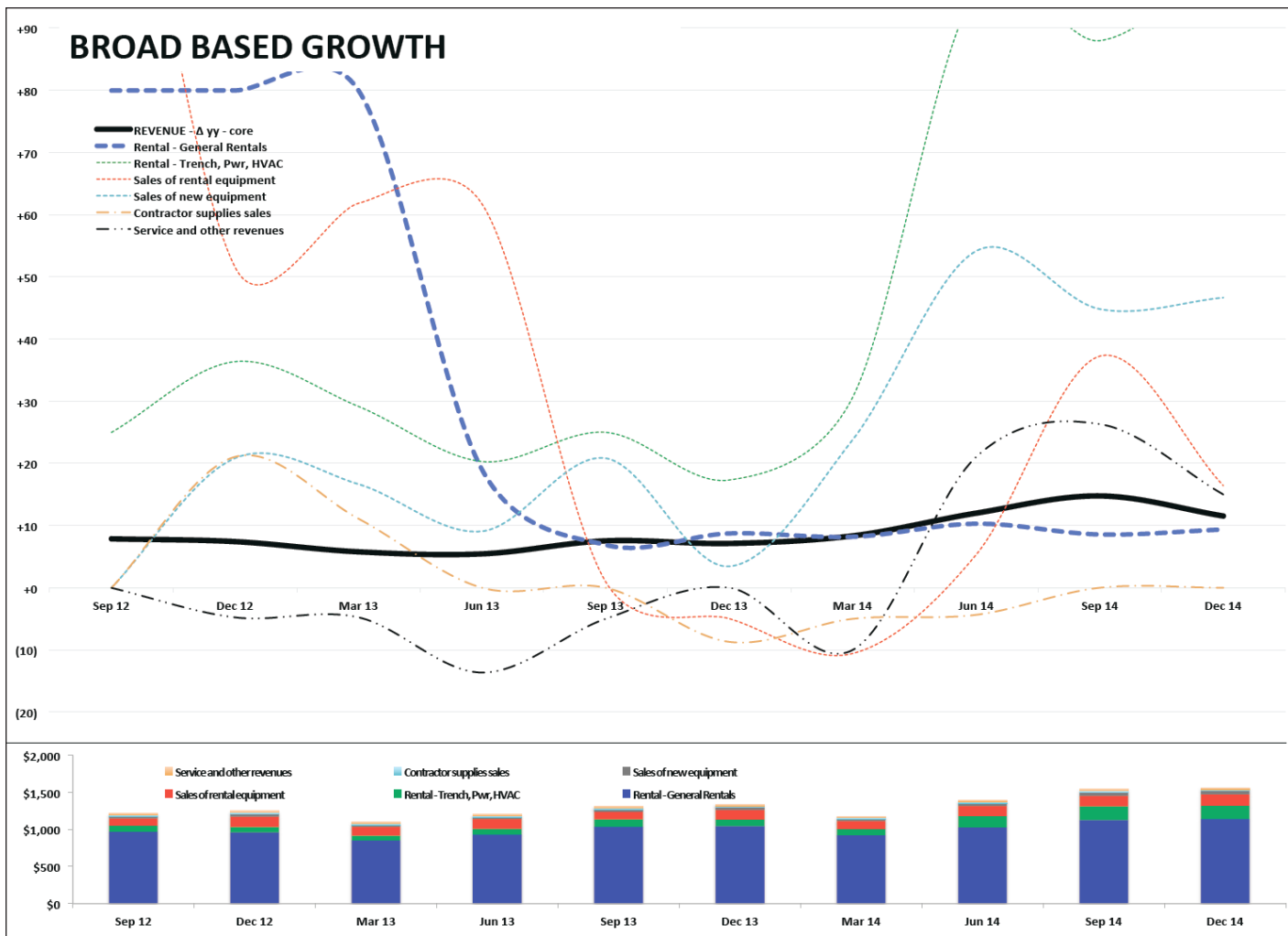


Figure 4

Focus Companies: United Rentals (URI)

There is no better company to track if you wish to monitor the North American construction equipment market than industry leader United Rentals (URI).

URI is the rental equipment industry leader, not only in size but also innovative asset utilization strategies that are driving more activity with less capital investment. For example, while total U.S. construction equipment activity is slated to rise about 8% this year, and URI expects to continue taking market share, their planned capital investment in 2015 is expected to be flat. This is good for them, bad for you. Be aware of that trend (Fig. 4).

In the big scheme of things you can look forward to flattish demand in 2015, despite oil patch weakness as improving non-residential construction activity, along with improved housing demand, continue into 2015.

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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.

