China!

By Brian Langenberg, CFA

Our last installment called out the likely headwinds from both the C.R.A.P. currencies (Canada, Russia, Australia and Latin America) and also weather impact. As companies start reporting in the coming weeks, expect first quarter results to be mildly impacted.

China bears discussion. After the leadership transition in 2012—when Xi Jinping ascended to the presidency—most corporate executives, investors and (we believe) markets implicitly assumed they would simply "switch on" the engine and stimulate growth. This has not played out. We stated at the time that the removal of Bo Xilai from power (remember him?) was a unique indication of the rivalries beneath the surface, given his family lineage and close associations with the military hierarchy.

Recent and developing anti-corruption actions have a purpose. Actions against current and former senior military leaders *and* the former head of China National Petroleum Corporation are intended to strengthen the power of the central government, reduce military political power and reform/improve the energy sector. Roundhouse punches are being thrown by and at big people. In a hierarchical society, decision-making slows when fights are still occurring at the top because the lower-level people duck.

The financial sector is also a concern. A recent *Wall Street Journal* article highlighted the fact that with lack of liquidity from banks, Chinese companies are trading bills and invoices as IOUs in lieu of cash; that isn't the way it is supposed to work. China knows the export-driven growth model is receding and must put in place the reforms to enable healthy long-term growth tied to increasing consumption—all the while tackling an awful pollution problem and shortages of energy and water.

Long-term growth will remain solid. Assuming political stability can be maintained or improved, we still see massive opportunity—even if rate of growth is slower—in supporting infrastructure build out (rail, roads, commercial aviation) as well as rising car and truck demand.

Oil & Gas. The headlines out of Big Oil, with respect to capital spending notwithstanding, we see a stable capital spending profile in 2014 and beyond. Indeed, the big boys have stepped back a bit—when mega projects in the tens of billions experience overruns, the accountants and controllers take over. But the action isn't over. And closer to home, the U.S. is still punching holes in the ground, drilling and building out the midstream infrastructure to move the oil and gas.

Refinery capital spending out of Phillips 66, Valero and Marathon Petroleum is slated to rise 55%, collectively. With the cold U.S. winter (not yet over!) and utilities running all out, natural gas inventory going into spring is down year over year and below their five-year average.

Mining. Current conditions remain awful but we see signs of a thaw and stabilization beyond 2014. But not this year. Capital spending in the mining sector will fall another 25-35% this year and can fall further in 2015. But we are starting to see private equity capital formation behind experienced management teams (Mick Davis, who sold Xtrata to Glencore, is raising a $3.75 billion fund) while the "Big 4"—particularly Rio Tinto and BHP Billington—are seeking to rationalize and sell off non-core assets. Near-term, this causes further weakness, but once the assets change hands, new projects become likely. Near-term, high utilization will drive continued stability in consumables and service.

Power generation. Global power generation capacity continues to expand—coal, gas and some renewables—while the U.S. is experiencing a strong wind turbine recovery in lieu of additions to, or renewal of, baseline generation capacity. The U.S. remains a mess in that most wind is located away from people, coal- based generation is nearly at capacity, and natural gas is the "popular choice now," yet the gas delivery infrastructure is strained to ensure full supplies. Without a ratio-

ENERGY SECTOR CAPITAL SPENDING TRENDS			
Exxon	$42,500	$37,000	(13%)
Chevron	41,900	39,800	(5%)
Pemex (Mexico)	25,000	28,000	12%
Petrobras (Brazil)	48,100	Flat/off	Flat/off
NORTH AMERICA	**157,500**	**~153,000**	**(3-4%)**
PetroChina	51,400	47,800	(7%)
Sinopec	25,000	24,000	(4%)
CNOOC	15,000	>15,500	Up
CHINA	**91,400**	**>87,300**	**(1-4%)**
UPSTREAM NON-INTEGRATED – Top 6	52,500	56,100	7%
DRILLING – Top 5	7,400	8,650	16%
MIDSTREAM	7,200	8,500	18%
REFINERS	6,250	9,700	55%
TOTALS	$322,250	$323,250	Flattish

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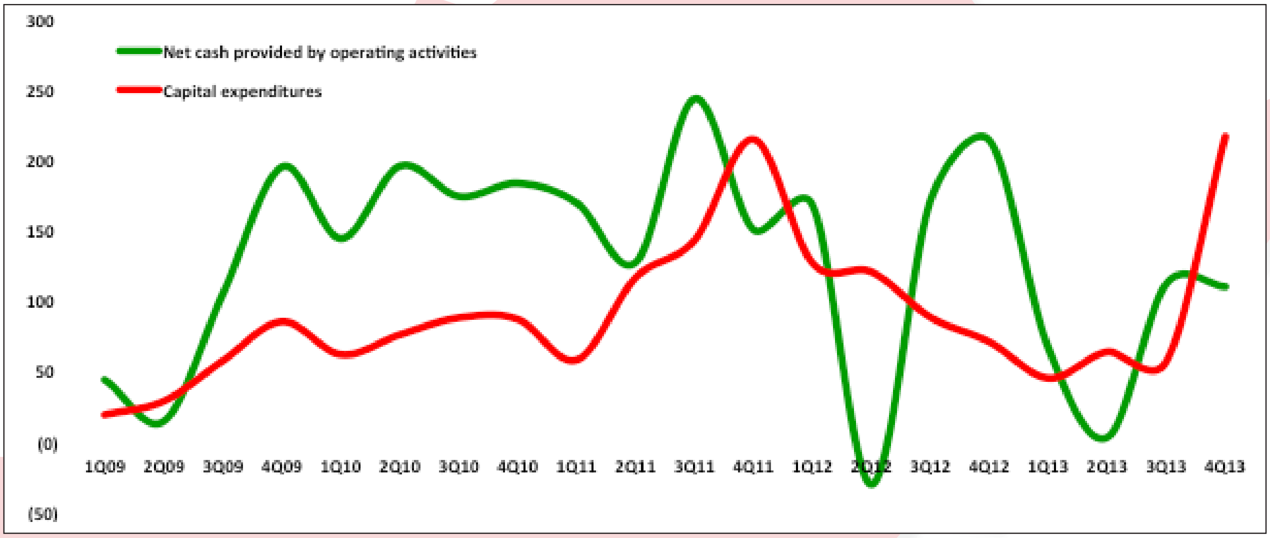

nal tax (pro wind) and regulatory (anti-coal) environment, expect to benefit from deliveries of band aids (wind) and incremental gas units.

Transportation infrastructure. No change here. U.S. infrastructure spending will remain flat until *late* 2016 at the earliest, as it would require bi-partisan support and willingness to spend on *infrastructure*.

Water & environmental. Municipal demand improved with positive sales momentum the past two quarters. Improved home prices should start to reduce the strain on municipal budgets, and industrial markets continue to grow at a moderate pace.

Machinery. Expect more of the same: *strength in construction equipment* driven by replacement demand and anticipation of rising late-cycle activity; refineries, non-residential construction and LNG all look good. *Truck demand also continues to improve*. According to the USDA, U.S. farm cash receipts are slated to fall 6-7% in 2014 and we see a similar decline in North American demand.

Consumer (auto, appliances). U.S. auto demand remains strong, with March running at 16.33 units SAAR (seasonally adjusted annual rate) and consistently running over 15 million units. Pent up demand, low interest rates and gradually declining unemployment support continued stability. Appliance demand continues to benefit from an improved housing market — even if weather likely impacts starts going into spring and an uptick in rates has cooled activity a bit.

Aerospace/defense. Commercial aviation continues to look good. Boeing continues to book large orders ($23 billion recently moved into backlog on one order alone!), which will benefit GE's aircraft engines business in particular. Aftermarket activity, including spares uptake and shop visits, remains strong and airlines are making money. Longer-term we think the downtrend in defense spending is near. Russia's invasion of Crimea will prove to be a wake-up call — we think — for Europe *and* the United States. For example, the Chief of Naval Operations finally stood up last month and told Congress we need a 450-ship navy, *not* the 283 we have (which includes reserve cruisers, littoral combat ships, even hospital ships). My sense is that U.S. defense spending starts to rise again after the 2016 presidential election. Stay tuned.

Focus Company: Alpha Natural Resources (ANR)

"People are entitled to their own opinion, but not to their own facts" (*Senator Daniel Moynihan*). Contrary to popular belief, coal consumption for electricity generation is going to rise globally over the next few years — even if U.S. domestic consumption declines moderately. In addition, metallurgical or coking coal is absolutely necessary to support steel production.

Currently the price of both thermal and metallurgical coal can only be described as awful and, as a result, capital spending in this subsector of mining remains particularly weak.

As mentioned, mining sector capital spending will decline this year and probably into at least the first half of 2015, but we also think you may have opportunities to cultivate and support your customers beforehand in anticipation of the next upswing — particularly given the increasing level of Chinese competition and customer willingness (at least offshore) to buy their equipment.

Our Integrated Company Dashboards (ICD) will give a better sense of these trends. These analyses are available on our website for $199 but readers of *Power Transmission Engineering* magazine can email me directly at Brian@Langenberg-llc.com and ask for a copy by putting "PTE Offer" in the subject line and the ticker for which company they want – choose 1 from: ALFA.IX, AME, ATCOB.IX, CAT, CMI, DOV, EMR, HON, MMM, MTW, ROK, SDVKF, SKFB, UTX, or XYL. We also offer subscriptions at special rates for PTE subscribers. **PTE**

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