Global Industrial Outlook: Slow Growth Ahead; Farm Belt No Help

Brian Langenberg

First quarter results confirmed our view. Capital expenditures are being slashed in the oil sector, the stronger U.S. dollar is enabling Japanese machinery competitors to gain share in the Middle East and Latin America, and lower soft commodity prices translate into a continuing North American decline in demand for farm equipment.

Let's review the key headwinds:

Oil. The Saudis continue to step on the gas, driving and keeping prices low; as a result, North American capital spending continues to decline.

Currency. Combination of strong dollar, weak Euro resulted in 2-3% earnings guidance haircuts across the broader industrial sector. Machinery companies are particularly challenged by the weak Japanese Yen— particularly in international markets (Middle East, Latin America).

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. U.S. first quarter GDP was quite weak but largely owing to weather. Export markets will start to take a hit.

Europe. Weak commodity prices weighing on Nordics, Russia, but weak Euro starting to help Germany, France and others.

Middle East. Saudis continue to step on the gas—pun intended—to take out high-cost U.S. oil fracking. Oil & Gas activity remains strong because mature fields require more capital and the region is seeking to capture more of the value stream. Increased Japanese construction equipment competition remains a negative for U.S. manufacturers.

Latin America. Mexico is doing well, while weak commodity prices hinder the rest of the region.

Oil & Gas. Huge capex cuts in upstream exploration and production drove a number of weak first-quarter results for industrial companies, and we see no respite for the next 2-4 quarters before stabilizing at a lower spending level.

Mining. Not just awful—may in fact be *worsening* in the U.S.—given continued deterioration in coal fundamentals.

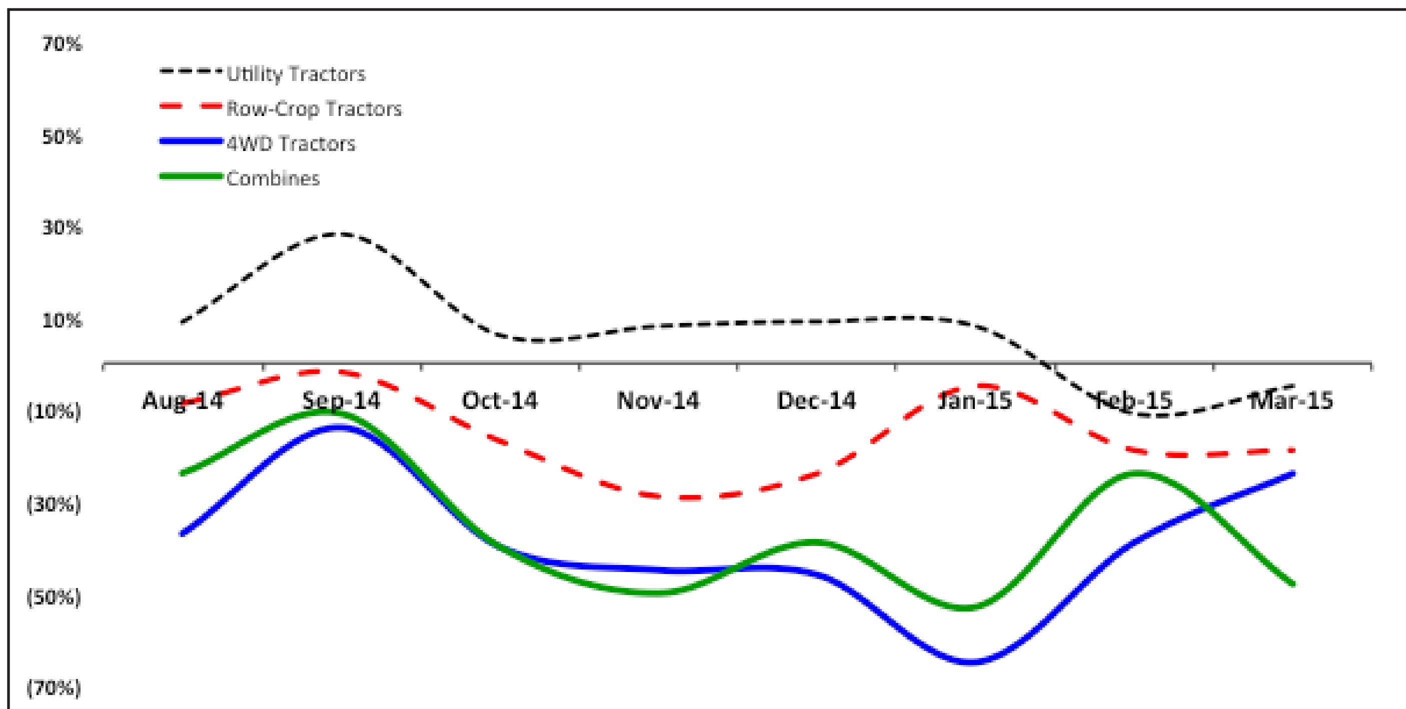
Power generation. No change; U.S. power generation remains weak; Wind (band aids) owing to efficiency gains throughout the economy and lack of regulatory support for new construction.

Transportation infrastructure. We expect stability if not modest growth over the next 12-18 months, but no major infrastructure upgrade anytime soon. If anything, weakening shale oil fundamentals could lessen the growth profile for shale oil shipments by rail.

Machinery. Modest incremental demand from non-residential and residential construction markets is the best news—but more than offset by soft crane and agricultural markets.

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. Weak Euro and Yen are already hurting competitiveness in Middle East and Latin America.

Aerospace/Defense. We just attended an investor meeting with senior executives of Boeing. As always, they are optimistic about everything. On the commercial side, this is completely justified by commercial demand—airlines are flush with cash and recapitalizing their fleets. We expect a U.S. defense recapitalization, but not before 2017 authorization given the current



Administration. Foreign policy matters; e.g.—ISIS has grabbed significant turf in Iraq, Syrian conflict is ongoing and the current U.S. naval fleet is too small. In case you were watching, China continues to militarize the Southwest Pacific.

Focus Company: John Deere & Company

U.S. Agriculture means John Deere, which holds about 65% market share. Nothing runs like a Deere, but Deere sales trends are in the tank across every product area and particularly with larger, high-margin tractors and highly seasonal combines.

After an eight-to-nine-year farm capital spending up-cycle the U.S. farmer is well capitalized with modern equipment and has little urgency to spend given lower commodity prices and thus farm income.

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