

Better Long than Short

Brian Langenberg, CFA

Third-quarter activity has slowed.

Fears of a “fiscal cliff” and a presidential election are combining to drive (mostly) negative news flow in the media and, indeed, on the margin—a sluggish 3Q economy. We anticipate most industrial companies will miss revenue forecasts while “meeting” Street estimates on cost cutting and lower material prices. We also expect cuts to earnings guidance for 2012 and a cautious tone on 2013, reflecting a combination of current softness, fears of fiscal cliff and—possibly—election year preference for “change.”

But underlying economic activity remains positive—particularly in the U.S. We point to record attendance and brisk machinery sales at IMTS in Chicago this year, rising residential construction activity and continued spending in resource end markets (oil, gas, minerals), with only pockets of weakness, along with commercial aerospace.

We also anticipate inventory re-stock and that necessary capital spending will continue to drive at least modest overall gains in 2013.

Europe—same-o, same-o. Europe has modestly downshifted, but high

commodity prices continue to drive demand in Scandinavia, Russia and most of Northern Europe. The problem children remain: Spain, France (but only a nuisance to itself) and noise.

China is likely to accelerate in the second half of 2013. In the near-term, pockets of overcapacity persist (non-residential construction near the coast, excavators) and the export model is shifting. And, labor unrest continues (another incident at Apple supplier Foxconn), even as a new leadership generation prepares to take power. Many view this with concern; but *we* see it pointing to rising levels of capital spending.

Our one-year base S&P 500 forecast is 1,650—up 15 percent. We assume 2013 S&P earnings climb to \$105 from the current \$93 (trailing 12 months)—below the current-but-declining consensus of \$112 and above



Ksawery Langenberg (age 12) demonstrates proper use of a Nintendo DS3 at IMTS 2012.

the \$93 fiscal cliff scenario espoused by some (Table 1).

Deal with it: elections matter. Simply relying on guidance and current fundamentals would be an ignorant way to make calls on industrials—or any other sector—less than a month before a presidential election.

We do not know who is going to win. And neither do you. This is why everybody is sitting on his or her hands. But we do know how to think and map out various scenarios in which the upside case is stronger than the downside case for these reasons:

- **Demand is rising.** Housing is up—not a lot, but up—as is employment (though anemic and way below potential), energy investment, the global aerospace cycle, and construction activity to name a few.
- **Natural gas is the new COD.** A plentiful, cheap natural resource that has structurally improved the U.S. competitive position in manufacturing.
- **Fiscal cliff scenario really a pothole.** Obama is open to attempting to keep taxes lower for the majority of the population and would love to spend on infrastructure.
- **Near-term investment pull-back = pent-up/delayed demand—but not destroyed.**

S&P 500:		1456					
		S&P 500 Earnings					
P/E	\$93	\$105	\$112	Price Return			
14x	1,302	1,470	1,568	(11%)	1%	8%	
15x	1,395	1,575	1,680	(4%)	8%	15%	
16x	1,488	1,680	1,792	2%	15%	23%	
17x	1,581	1,785	1,904	9%	23%	31%	
18x	1,674	1,890	2,016	15%	30%	38%	

SKY IS FALLING	S&P 500	Impl. Ret.
5/6/09 Armageddon	683.38	(53)%
8/19/11 US Downgrade	1123.5	(23)%

Table 1

In the past month or so we've attended the IMTS trade show, SPX Corp, Oshkosh Corp, GE, Tyco, Kennametal and Tyco International. Our take: we remain in a recovery with significant pent-up demand.

- **High corporate cash and deal activity.** Plenty happening, and multiples remain high for a reason.
- **Americans are stubborn.** Growth is happening despite gridlock, regulatory hostility, a diabolically cynical public education establishment, unwillingness of banks to lend and a tax code that drives investment offshore.

There are downside scenarios, more cliff than we're aware of—i.e., a slower China driving a 10 percent decline—and we illustrate a couple disaster-like price moves. But the latter do not strike us as realistic.

We are not betting on multiple expansion. The S&P traded in the high teens for most of the slow-growth era in the mid-late 1950s; i.e., financial repression before competing demands for capital on two fronts—Vietnam and social spending—eventually drove inflation and lower multiples.

This time is different, owing to obvious budgetary challenges, e.g.—entitlements, cash-strapped state governments, pent-up capital requirements on infrastructure. Though we've opted not to put in another chart, an example: equity investors from 1966–1982 did not make any money, adjusted for inflation—ouch!

But staying out of the market in fear of contraction has proven costly for many. The market's earnings/free cash flow yield is nearly 7 percent, compared to 2 percent U.S. 10Y Treasuries. Obviously the market is already pricing in a significant combination of risk and future inflation. In theory the current market multiple would correlate to a treasury yield of 6–7 percent.

- **Commodities.** High—and staying there. Scramble for resources will continue and is showing up in geopolitical tension in multiple regions.
- **Wages.** Going nowhere in the U.S.—but rising in emerging markets. A positive for capital goods: more capital spending to substitute capital for labor.
- **Interest rates.** Low for the foreseeable future. The U.S. dollar is

the safe haven big enough to absorb fear.

In terms of an investable horizon (not trade)—be it 3–5 years, 1 year or a 6–9 month trade—the rational course of action is to assume interest rates, wage growth (ex public sector unions?) and general price inflation remain quite low.

Is there a long-term problem? Of course. And it hits right when I turn 65.

The glass is at least half-full—and there is no hole in the glass. While fiscal cliff disaster is a possibility, we're thinking more fiscal pothole.

But that is in 2028, and we have few requests to discuss our 14-year forecast.

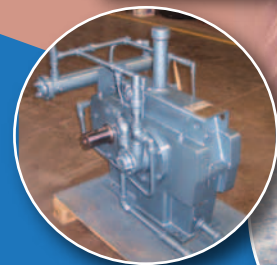
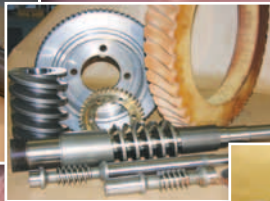
Let's review market and interest rate history along various periods. Starting from a period (1975) with high rates of inflation in commodities, wages and general price levels.



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Table 2 S&P 500 – Jimmy Carter to Present
 Blue/Left scale – S&P500
 Red/Right scale – U.S. 10-Year yield

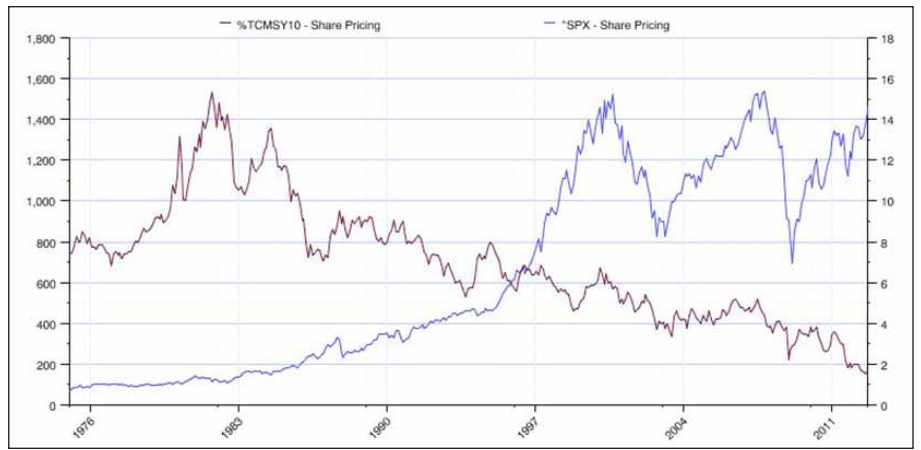


Table 3 S&P 500 – New Millennium to Present
 Blue/Left scale – S&P500
 Red/Right scale – U.S. 10-Year yield

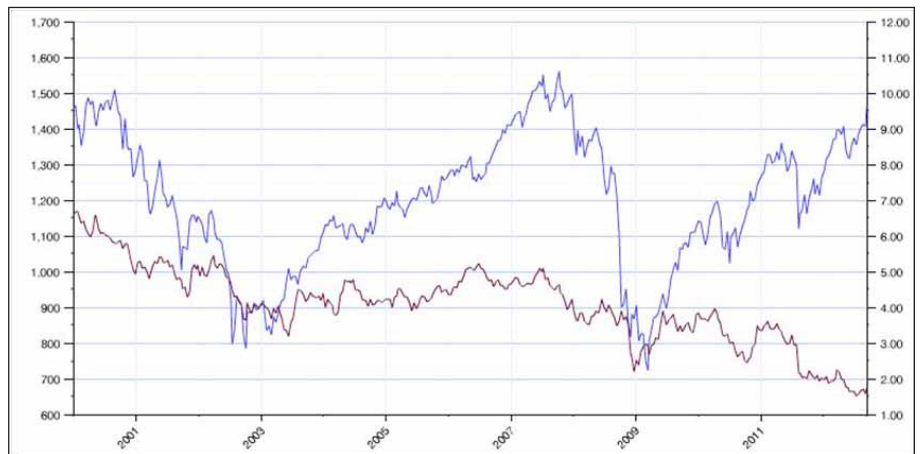


Table 4 S&P 500: In Fed We Trust (Hope) to Present
 Blue/Left scale – S&P500
 Red/Right scale – U.S. 10-Year yield

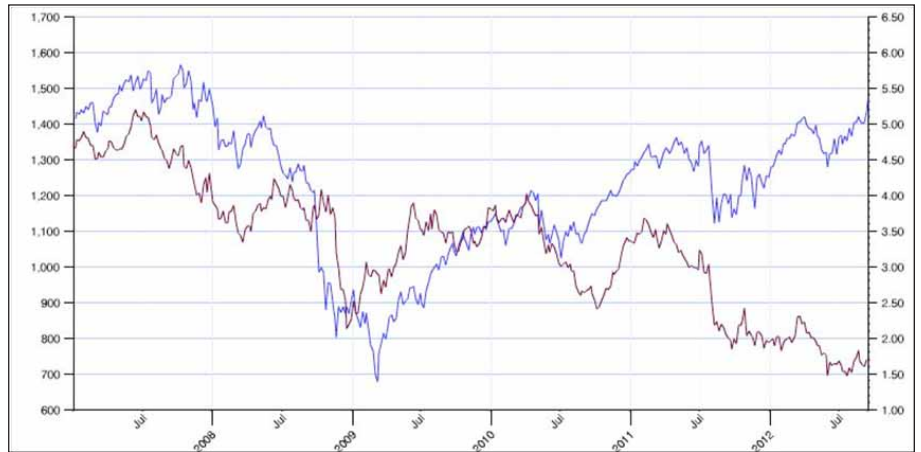
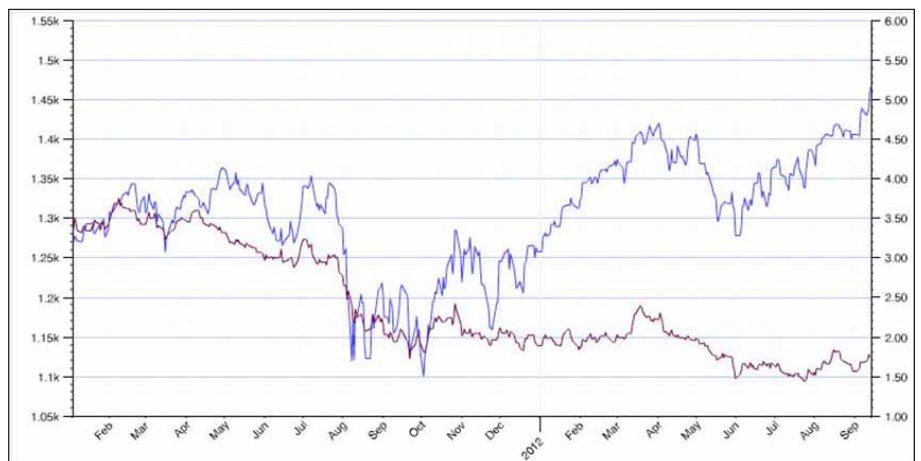


Table 5 S&P 500: 11 Aircraft Carriers to Present
 Blue/Left scale – S&P500
 Red/Right scale – U.S. 10-Year yield



We all know what happened (if at least 45 years of age!). Jimmy Carter (Obama 1.0) loses to Ronald Reagan who crushes the PATCO (air controller) strike, lets Paul Volcker raise rates to get inflation under control and eventually defeats the Soviet Union. Meanwhile, interest rates go from 15 percent (really 8 percent before being raised first) to 2 percent, which tends to support financial markets and multiples (Table 2).

Sure—we are all looking at that 1998–2012 trading range and suspect it is keeping a lot of cash on the sidelines. But we note the lows were driven by full-fledged downturns; e.g., in 2002 the culmination of September 11/tech bubble/Asia meltdown/recession, and the obvious financial meltdown that hit the market with full force in 2009.

Here is another look starting from 1/1/2000; an easy-money era as rates have declined from 6–7 percent to 2 percent would suggest the market has an upper cover on it.

In our view, a major reason so many investors are sitting on their hands is some variant of Table 3. Yet one can argue this is a fundamentally better market: the tech bubble era saw unusually high multiples on the S&P, driven by stratospheric multiples on tech darlings that in combination with large weightings softened the indexes whack.

“Normal company” multiples were in fact similar to current levels. Prior peaks were built on sand; i.e.—whether unrealistic expectations in 2000 or leverage and hubris in 2007. This one is different; we are near prior market peaks with everybody scared out of their wits and it shows; e.g.—equity risk premium of 500 basis points (Table 4).

And finally—the 2011 downgrade by S&P of U.S. debt. Long-term S&P has a legitimate point; markets, after an initial panic, figured out that flight to quality means *buying* the debt and currency of a nation that can afford 11 aircraft carriers (Table 5).

The market discounts significant—if not dramatic—risk. While the structural programs and political/societal debates likely preclude multiple expansion, in turn the earnings picture is constructive and the case for multiple compression quite weak.

Overall, we remain in a slow economic expansion. The glass is at least half-full—and there is no hole in the glass. While fiscal cliff disaster is a possibility, we’re thinking more fiscal *pothole*, because even President Obama is seeking to maintain lower taxes on the majority of the U.S. population—at least in the near-term—and there will be bipartisan desire not to drive the U.S. economy into a full-scale recession. **PTE**

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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.



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