

Structural Change and Growth— Coming to a Global Economy Near You

Brian K. Langenberg

(Welcome to the first installment of Market Update—a by-the-numbers, in-the-now snapshot of industrial markets worldwide, along with some prognostication to assist in planning your next moves—when to hold 'em, when to fold 'em, etc. Look for Market Update in future issues of Power Transmission Engineering.)

Rising emerging market income growth and industrialization, increased resource demand and a gradually improving U.S. economy are driving global growth. Recent data points are mixed. Emerson's February order data showed improvement in process automation and "less bad" comparisons in HVAC. Employment continues to slowly improve. Conversely, the shift in energy patch activity to oil from gas is reducing profits for some companies (Baker Hughes—3/21/12).

Europe matters—to Europeans. Surprises concern us, not rehash. The noise from Europe is a loud negotiation about who pays and how much. If policy error did not lead to Armageddon in 2008, 2009, 2010 and 2011, we are hard-pressed to see why 2012 is different. When history books are written, the combined political leadership of most of Europe (with money), China, the U.K. the U.S. and parts of the Middle East are going to look pretty good. I am serious. Currently, European auto production and consumer-related activity is down—likely through the first half—and has impacted demand for drives and industrial capital spending—particularly at Siemens, ABB and Schneider.

Improving price/cost. Raw materials are down (15–25 percent) from six months ago—aluminum, copper, nickel, tin, platinum and palladium—just as price actions are working their way through. Several companies called out materials as a 4Q headwind, but that reverses in the next couple of quarters.

Energy and materials demand. Strong upstream activity for oil, gas and commodities is driving 70–80 percent of incremental industrial demand—from oil and gas (moving to oil) through pipe, welding, machinery and general industrial activity. Growth will be positive;

mix and margin questionable. Close to home, shale plays have provided better price and margin than oil. The energy-equivalent price ratio between oil and gas should be 12:1. With Brent Crude at \$125 and natural gas at \$2.40 the ratio is 54:1, so investment is rushing toward oil.

Self-generated growth/urge to merge. Private equity and geography have structurally changed the growth game—sustainably higher prices for corporate assets and the inability to buy assets that do not exist. Corporates are designing products for emerging market price points, building out sales, manufacturing and local management and, where possible, buying a manufacturing asset. Deals generally bring a customer base or distribution at "healthy" prices that often nearly preclude earning an adequate return. Call it the "new disciplined."

Global power cycle. Rising demand for electricity is a given—the profitability of supplying the market is under stress and pricing in current backlogs is poor. The broad theme from every participant—U.S., European, Japanese—is one of strong demand and intense price as everybody fights for the same emerging market pie.

Home markets will offer little respite—Siemens, Alstom and Mitsubishi Heavy have all expanded North American gas turbine capacity and General Electric in turn has voiced a desire to spend more time focusing on the Ger-

man market. Six months ago GE was looking for 15–20 percent margin in its total energy segment, but the high end is not currently on the radar screen.

Renewables are down. In China 35 percent of installs are not even connected to the grid. Could bounce back in the second half of 2012, but there is no guarantee and it no longer matters to multinationals who were shoved out of the market three years ago. Offshore wind and larger units are the trend, but gas below \$3 makes it a difficult sell. Forget tax credits in '12—it is an election year and President Obama was recently photographed at a pipeline project.

Transmission & Distribution. Again, more competition—but fundamentals are improving. Distribution remains solid, owing to replacement demand; new construction will help—but not this year. New transmission project activity ramped up months ago; the transformers will follow by year-end. Increased competition—Hyundai in particular—may depress peak margins in this cycle.

Asia/technology complex accelerates by mid-year. Indirectly, this end market affected your life in the 4Q as flooding in Thailand impacted key players in process and HVAC—particularly Emerson and Unite

Residential HVAC. Low inventory, better price and no expectations can only help. Trane cut price at least five percent in the 4Q to clear inventory and was not

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.



alone. Empty distributor channels and warm weather should drive a restock and residential refurbishing activity has improved.

It's not all about China. While headlines are headlines, facts are facts. Resource-rich economies are spending cash on resource extraction, industrialization and rising consumption. We've said all along "BRIC" should be split into BR—countries with resources—and IC—countries which must purchase resources.

With respect to China, the bad news is the slowdown is real. The good news: a) it already happened; b) it has mashed mostly construction equipment (ex CAT which took share)—i.e., rail, wind and small Chinese manufacturers whom big process companies do not really sell to yet; and c) it is likely to turn with a stimulus program in the works.


China's current slowdown started last year, and though recent data (growth, targets and lower iron ore price) are negative, we see a trough. One year ago we estimated 45 percent of China's export economy had margins of 10 percent or less; today, rising wages and higher capital costs have worsened the situation. This is a political transition year and China will need to accelerate substitution of capital for labor. They have no choice. This will be good for capital investment and anybody playing in automation. And a precision economy will need precision manufacturing. The issue will be intellectual property protection.

Russia is now a European growth driver; think energy, non-residential construction and agriculture. Brazil struggles with a strong currency but is spending on infrastructure and foreign direct investment remains high. Expect it to continue as Caterpillar, PACCAR, Hitachi and many others are putting in manufacturing capacity. Japanese and Korean engineering and construction companies are citing high quotation and negotiation activity in process, chemicals and power generation from emerging markets ex-China.

U.S. is becoming structurally more attractive—despite itself! The outlook for U.S. manufacturing is its brightest in 30 years, driven by energy costs (lower here)

and labor (rising there).

Offshore markets are no panacea. Intense price competition (energy), industrial policy (when China decides to take over a sector, it does so), and rising labor rates have cut into share, profit and increased business risk. These shifts were always in the sooner- or-later category. Natural gas has changed the dynamic,

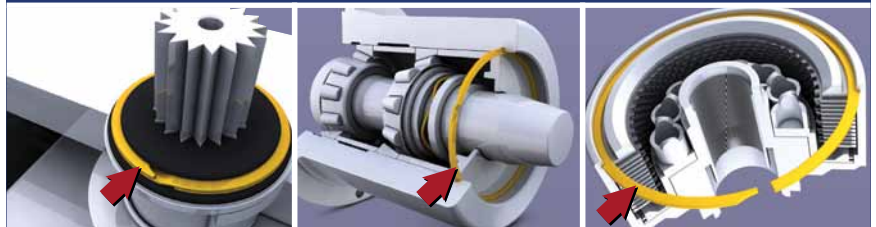
and plans to build multi-billion refineries in places like Pennsylvania (Royal Dutch Shell) generate 5–8 jobs for every person directly employed. Resource-driven economies will continue capturing growth spend, but more growth will be closer to home. We think the outlook for heavy industry is bright. 



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