

Global Industrial Outlook: the Ugly, the Bad and the Good

By Brian Langenberg, CFA

Global economic demand remains solid—even if you couldn't tell by recent third-quarter results and despite all efforts by U.S. politicians of both political parties. Let's go through what happened and what is coming.

The Ugly—third-quarter results, in general, along with mining, military and India. Let's start with earnings. We track about 50 global companies quarterly and provide deep-dive trend work to institutional investors and corporate executives. Going into 3Q—traditionally known as “confession season”—expectations were low; in fact, half the companies we track reported sales that were below consensus forecasts.

Since most of you are either in these markets or sell to them, you probably felt it. Every single machinery company we track missed revenue forecasts, as construction equipment markets saw continuing dealer inventory cuts, push outs and cancellations in mining, and weak stationary power generation markets. Conversely, Boeing did well thanks to commercial. However, military weakness continued and we believe could worsen beyond the expectations of your aerospace/defense OEM customer, *even if they are not yet sending you this signal*. India is awful; Cummins (CMI), for example, had a (25 percent) revenue decline—partly attributable to currency—but due primarily to weak and deteriorating conditions in truck (off 33 percent y/y) and power generation (34 percent) ex currency. Factor in a) political dysfunction as bad or worse than the U.S; b) elections are *next* year; and c) less wealth. And you shouldn't get your hopes up for a near-term rebound.

The Bad—U.S. short cycle industrial. In the U.S., concerns about sequestration, implementation of ObamaCare and budget clearly had a marginal impact on purchasing activ-

ity; the silver lining is that end market activity remains pretty good.

The Good—what got de-stocked in 3Q will likely get re-stocked in 4Q. The U.S. economy is still 65% consumer, and consumers, while having become perhaps structurally more frugal, are buying more cars and appliances and fixing their houses. Pull-through will happen. Europe has “improved” mathematically, which means easy comparisons—yet for all the talk about “Europe,” the reality is that Northern Europe and the Nordics—which is where the real money is—continue to grow. Middle East project activity is accelerating (good for Germany and the Nordics, power generation, construction equipment) and China orders for elevators (Otis, Kone Oy) indicate demand for construction equipment should continue to improve.

Oil & Gas: Activity remains pretty good—particularly upstream—and that should support capital investment going into 2014. One exception is the Permian Basin (primarily West Texas), as WTI oil price recently fell to \$96. Since the Permian news, the break-even oil price is highest in the U.S. (about \$70); a further oil price decline can hurt. Still, the overall picture remains strong. Worldwide, the dash for carbon in deeper, tougher, more inaccessible locations provides multi-year opportunities for growth and advanced applications.

Mining: New equipment orders continue to plunge, and we are even seeing delayed maintenance and equipment rebuilding activity. Expect continuing declines through next year. The worse-case scenario is that if all “unapproved” growth projects are canceled or delayed, we can see a further 30-35 percent decline through 2015.

U.S. coal in particular continues to see lay-offs in both mines and equipment. There is one bright spot—mine utilization remains high and therefore consumables and parts are holding up fairly well.

Power generation: The global demand growth for coal and gas continues to come from emerging markets—Middle East, China, Latin America. The U.S. is seeing delays and cancellations on new projects because of a) little need—conservation and green initiatives have materially affected demand growth, b) regulatory and political pressure—the president hates coal and gas pipelines; therefore the EPA does as well. Every utility earnings call we listened to echoed the same theme: no rate relief (revenue), no reason to build. The wind people benefit—which is helpful to you—as it is a no-brainer for a utility to throw up another wind turbine for \$2-4 million with no hassles. Going offshore demand for coal and gas powered generation remains strong and is turning into new orders and backlog, with major engineering and construction firms, as well as suppliers like Flowserve (FLS), which saw accelerating core orders and revenue of + 4 percent and + 6 percent, respectively.

Transportation infrastructure: In the U.S., figure no uptick before *late* 2015; that takes government funding, which can't possibly happen before a new Congress takes over that would want to write some checks. There is upside from improving residential housing prices. A boost in new homes and residential development could help on the margin. Europe may be improving—somewhat—off a low base. Atlas Copco (ATCO.B) reported *higher construction equipment orders in Europe*

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for the second straight quarter. Globally, passenger rail backlogs remain firm, if not really growing, at Bombardier (BBD.B) for new rolling stock (locomotives and passenger cars), while improving “low voltage” trends at ABB (ABB) are a positive outlook for 2014 and beyond (you have to lay the track and wire the system before you put the train on the track).

Water & Environmental: Municipal demand is primarily maintenance-driven, but we are seeing signs of higher interest in capital projects. We think the tone is improving with home prices – but real order growth is a couple years out. On the industrial side, de-watering and mobile equipment related to mining remain soft.

Machinery: The big picture continues to improve; *Construction equipment* production is moving toward “less bad” and sell through from distributors to end users was up y/y in 3Q. The worst is almost over for Caterpillar (CAT). *Mining equipment* is another story; we still expect a further decline of up to (20-30 percent) in spending over the next two years, and even worse on new equipment. *Truck:* U.S.—while full year Class 8 forecast has drifted downward, 3Q heavy truck shipments were up 7 percent y/y, driven by higher sales in North America and Brazil. China rose 26 percent, but that included pre-buy in front of higher NS4 environmental standards. *Agricultural equipment:* Our view remains unchanged. North America remains stable while John Deere growth investment emphasizes Brazil, China, India and Russia.

Consumer (auto, appliances): Good news continues—in the U.S., improving real estate prices are helping bolster consumer balance sheets, and thus pent up demand for durable goods. Automotive is proving to be persistently strong as evidenced by SKF’s improving revenue growth trends in its auto segment over the past ten quarters.

GE continued to show gains in appliances—partially from pent up demand and part share gain as GE benefits from actually reinvesting in new products. We expect continued growth in auto (both OEM and aftermarket

	OIL & GAS		MINING		POWER GEN		TRANSPORT		WATER & ENVIRON.		MACHINERY			CONSUMER Automotive Appliances			AEROSPACE/ DEFENSE	
	1.1	1.2	2.1	2.2	2.3	3.1	4.2	4.2.1	4.2.2	4.2.3				4.3				
OUTLOOK / CURRENT	<6M 12M	<6M 12M	<6M 12M	<6M 12M	<6M 12M	<6M 12M	<6M 12M	CURRENT				<6M 12M						
NORTH AMERICA	↗ ↘	↘ ↘	↗ ↗	↗ ↗	↗ ↗	↗ ↗	↗ ↗	●				↗ ↗						
United States	↗ ↘	↘ ↘	↗ ↗	↗ ↗	↗ ↗	↗ ↗	↗ ↗	●				↗ ↗						
Canada	↗ ↗	↘ ↘																
EUROPE		↘ ↘	↘ ↗	↗ ↗	↗ ↗	↗ ↗	↗ ↗					↗ ↗						
ASIA, PACIFIC	↗ ↗	↘ ↘	↗ ↗	↗ ↗	↗ ↗	↗ ↗	↗ ↗	↗ ↗				↗ ↗						
LATIN AMERICA	↗ ↗	↘ ↘	↗ ↗	↗ ↗	↗ ↗	↗ ↗	↗ ↗					↗ ↗						
MIDDLE EAST, AFRICA	↗ ↗		↗ ↗	↗ ↗	↗ ↗	↗ ↗						↗ ↗						

OUTLOOK: INDUSTRY VERTICAL
 <6 months (restock), 12 month (expansion, contraction).
 Multiple inputs - orders, sales momentum, macro and policy analysis.

TRENDS

- Strong ↑ = Anticipated orders/sales increase > 5%.
- Improving ↗ = Anticipated orders/sales increase 1-5%.
- Flat → = Anticipated orders/sales +1% to (1%).
- Slowing ↘ = Anticipated orders/sales down (1-5%).
- Weak ↓ = Anticipated orders/sales down (>5%).

service), appliances and housing. Expect the Fed to keep interest rates low at least through the November 2014 elections. European comparisons are now easier against a low basis, but we do not see any real pickup.

Aerospace/Defense: Boeing just announced a further boost in monthly 737 production; currently running at 38 units per month, but slated to rise to 47 by 2017 in their continuing battle with Airbus. (And speaking of Airbus, this just in: The news out of Paris is that EADS, parent company of Airbus, is “cutting 5,800 jobs over the next two years as part of a major overhaul to reduce costs and refocus on civil aviation.”

At the same time, cracks have emerged in the positive aerospace theme—not enough to change our mind, but it bears watching that freighter production is being cut amid weak demand and falling used aircraft values (AirCastle [AYR], a major air lessor, just took a write off against its 747 freighter fleet), regional orders have not yet happened, and the lower end of the business jet market remains weak. Aftermarket service and spares are improving—finally!—but we anticipate lower shop visit yield as fleet opera-

tors seek to do “just what they need to” on existing aircraft before taking those new deliveries that are driving aircraft engine production at GE and, eventually, UTX.

Military just continues to worsen, with no support from the president or either party in congress—even while China, Japan, and Korea continue to unveil and execute plans to increase their war fighting capabilities. Each of those countries will seek to source, as much as possible, from their domestic industrial base. And, by the way: *it can get worse.* Among other things, I am a member of the Navy League of the United States, which serves as an advocacy and support organization for maintaining our sea power. Having served on active duty during the build to 600 ships (we got to 571), there is now talk of going from slashing the fleet from only 285 ships now to 255 by 2020, and to include cutting total buy of Littoral Combat Ship from the 52 planned to 24 or 32—and even retiring an aircraft carrier early. No reason to think an F-35 can’t be cut or “pushed to the right.” The problem runs deeper than sequestration, which is temporary, and more toward gutting

our declining ability to sustain forward presence.

Capital spending—flat at best. Aerospace production rates are rising overall on the commercial side and under increasing pressure (overall defense) in military. On a net basis, call it positive. Construction equipment *should* improve; United Rentals (URI) is signaling a 5-10% increase in purchases in 2014, but you should think of that as “first-half-loaded” and the second-half as contingent upon what they see. An improving, non-residential construction market (projects are moving again in the Middle East, and the U.S. is improving slightly) are supportive because the first thing you have to do when putting up a new building is move some dirt.

Deal risk remains. Slow growth means “urge to merge” with big companies. Deal pricing is a bit higher, which can hold things in check. There is no time like the present to *think very hard about business risk.*

Supply chain concerns can be an opportunity. Not that it happens willingly, but large companies are concerned about deliverability. Honeywell, for example, suffered a \$100 million- plus revenue impact in its aerospace business this past quarter because of a vendor issue. The concept of “cheap vs. low cost” seems to resonate from time to time, so look for opportunities to supplant an offshore solution without giving away the store. What is slowly changing is “big customer” realization - particularly when safety or headline risks matter. Aerospace, oil and gas, would particularly lend themselves to this theme.

Focus Company: Cummins (CMI).

We selected Cummins because of its high-exposure, multiple end markets that use power transmission and gearing, including construction equipment, mining, truck, and stationary power. Shown below is

our revenue dashboard for Cummins over the past ten quarters.

Cummins continues to build strong global franchises for its engines and aftermarket business, bolstered by significant and extensive production and marketing joint venture relationships in China and India with key local truck and equipment manufacturers and engine producers. In the U.S. a strong R&D program and partnership with Navistar is helping to drive share gains, in addition to a strategy of gradually buying select distributors. The company missed 3Q forecasts and lowered guidance for this year, and particularly called out India as weak — and getting weaker. Mining is awful.

On the positive side: Global truck demand remains solid, driven by both replacement activity and global GDP growth.

Construction equipment outlook is improving. While dealer inventory declined, sell-through in the U.S. was positive and globally there is an improved trend in non-residential construction activity that will translate into more equipment needs.

Our Integrated Company Dashboard (ICD) on CMI 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 sub-

ject line. We expect CMI will continue to execute on its global growth strategies and playing ball with the company will likely require an understanding of how you can best support their desire to grow globally and capture the aftermarket gross profit around that OEM build.

European air and defense company EADS, the parent company of Airbus, said (12/9) it is cutting 5,800 jobs over the next two years as part of a major overhaul to reduce costs and refocus on civil aviation.

The company said in a statement that the jobs would be eliminated from its corporate and space and defense divisions by the end of 2016. The many space and defense divisions will be combined into one arm, to be called Airbus DS. **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.

