Global Industrial Outlook: Batten Down the Hatches

Brian Langenberg

Third-quarter earnings confirmed the worst-case scenario—plunging oil prices are whacking almost the entire industrial sector. The theme is hardly new, as the pattern of our headlines has revealed over the past fifteen or so months:

Nov. 2014	Houston, We Have A Problem
Feb. 2015	Oil Slick, Currency Headwinds Challenge Growth
Mar. 2015	Oil Slick, Currency Headwinds Worsen
May. 2015	Slow Growth Ahead, Farm Belt Can't Help
Jul. 2015	Sluggish
Sep. 2015	Game Changer
Oct. 2015	Weathering The Storm
Nov. 2015	Oil Slick Cascading
Jan. 2016	Batten Down The Hatches

So what is in store for us over the next year or so? With oil prices continuing to plunge the pain will only worsen, and some see half of North American shale producers going bankrupt.

The Macro Economy. It sucks; Conoco and Marathon are calling out up to (60%) capital spending cuts for 2016, while other companies are talking (10–15%) cuts in their annual plans. Guess how that is going to go. Biggest electrical equipment company exposures are Emerson, Dover Corporation and General Electric, but the effect continues to be the worst for construction machinery companies.

Regional View. To the extent your company is exporting, here is how things stack up now—and at least through 2016:

North America. U.S. continues to slog forward despite headwinds (Oil, FX, the Obama Administration, Congress). Housing and construction should benefit from lower commodity prices on a net basis, excepting the Gulf Coast and the Dakotas.

Europe. Western Europe faces a major headwind (China weakness), partially offset by a weak Euro that benefits exports to the U.S. Russia is acting tough militarily, but is living on borrowed time given low commodity prices as most of their economy is oil, gas, and minerals.

Asia. China remains weak. Australia is indeed down under. India continues to strengthen, but this is material only for Cummins; and even then, much of their India-centric production is located in or closer to India; i.e.—does not help you.

Middle East. War is good for defense spending—bad for everything else.

Latin America. Brazil is in deep trouble. On the other hand, a lot of arrogant leftists aren't looking so smart, now that their petro and commodity dollars are going away. Mexico is the (bright) exception—not only are they recapitalizing their oil sector (Pemex) with outside capital and technology, but the country continues to encourage, and see, investment in manufacturing including automotive, aerospace and consumer goods. We see this continuing given the close economic and cultural relationship between the U.S. and Mexico, common interests (keeping "El Chapo" in jail, Sean Penn notwithstanding), and not having all our mutual eggs in the China basket.

Risks, Variables, and Black Swans

The question is, What can go right from here, and what can go wrong. The "what can go right part" includes the positive benefit of low commodity prices. The possible downsides:

1. Oil price-driven recession? We don't see it.
2. Fed policy error—raising rates too much, too soon? It's Janet Yellen; let's be serious.
3. Black Swan—Russia and the U.S. are shooting live rounds in the same freakin' geographic area. Mistakes happen.

	S&P 500 Earnings			Implied Price Return		
	<10%	<5%	Street			
P/E	$113	$119	$126	$113	$119	$126
16x	1,812	1,908	2,008	(11%)	(7%)	(2%)
17x	1,926	2,027	2,134	(6%)	(1%)	4%
18x	2,039	2,146	2,259	(0%)	5%	11%
19x	2,152	2,265	2,385	5%	11%	17%
20x	2,265	2,385	2,510	11%	17%	23%

Market Return	% Prob.	
↑ ↑	0.001%	Election year repeal of Obamacare, Dodd-Frank, tax reform.
↑ ↑	0.001%	ANYTHING from above.
→ →	95%	$40 oil, US low growth, Middle East slows, China stinks.
↓ ↓	4.999%	US recession (low oil, policy error)
↓ ↓	0.999%	Black Swan: Shooting war w/Russia.

Market Outlook

Given the rough January market start we are going to write from an investment perspective instead of our usual focus company. Why? Because it affects your 401K!

Despite the fact that about nobody can really time the market, consistently, over time, we have a market view anyway.

This is an election year. That means big decisions are postponed until 1H 2017. We do pencil in a not so scientifically derived 0.002% chance that President Obama and Congress do something productive this year. We call this optimism.

Muddling through is likely. The bad news is that China is weak and energy prices have plummeted. The good news is that much of the impact has already been felt or is at least explicitly or implicitly factored into the production schedules of your customers and, to a significant extent, the market.

U.S. recession is unlikely — but possible. In 2013 three of the top four U.S. corporations in terms of revenue were ExxonMobil, Chevron, and ConocoPhillips with about $950 billion in revenue, which equates to about 5% of U.S. GDP. Oil was at $100 or so. Now it is below $40. While consumers and logistics companies benefit, the Gulf of Mexico (important) and the Dakotas (not so much unless you live in the Dakotas) will see their regional economies hit.

However, markets climb a wall of worry and we see 2150 on the S&P 500 as reasonable at year-end.

What should you do about this? Nothing different — unless you are a committed investor, make sure you have your savings plan in place, appropriate asset allocation in your investment and retirement accounts and, as well, make sure you have thoroughly reviewed the performance, costs, and tax efficiency of any investment vehicles in your retirement plan.

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Brian K. Langenberg, CFA has earned recognition as a member of the Institutional Investor All-America Research Team, a Wall Street Journal All-Star, and Starmine Best on the Street. As Principal of Langenberg & Company, he advises CEOs and senior executives on strategy and capital markets, and makes numerous public speaking appearances. In July 2015 he was named Chair (and Lecturer)of Graduate Business Programs at Aurora University.