Our Outlook for Industrial Stocks

The inventory cycle hasn't yet fully played out for industrial stocks.

By Eric Landry, Associate Director of Stock Analysis

- Industrial manufacturers are now benefiting from inventory rebuild cycle, a dynamic we expect to last for a while.
- Total inventories likely won't surpass the prior peak for several quarters.
- Leading industrial indicators are still very healthy, but there are signals of an economic slowing sent from at least one more economically diverse indicator.

What a difference a year makes! Last year at this exact time the U.S. industrial production index sat 15% below its December 2007 peak after declining for 17 of the 18 previous months. The decline was the largest since the U.S. dismantled the industrial complex after World War II. Our outlook three years ago was cautious, yet optimistic based upon some positive indications emanating from our trusty leading indicators. As it turns out, June 2009 marked the bottom in this broad index, and today it stands 8% above that level. In fact, manufacturing is currently enjoying one of its strongest recoveries in three decades and is widely regarded as one of the pleasant surprises of the recovery. Much work needs to be done, however, as it's still 8% lower than peak levels attained in December 2007, and investors appear increasingly nervous about a slowdown in economic growth.

Inventories Still Need to be Rebuilt

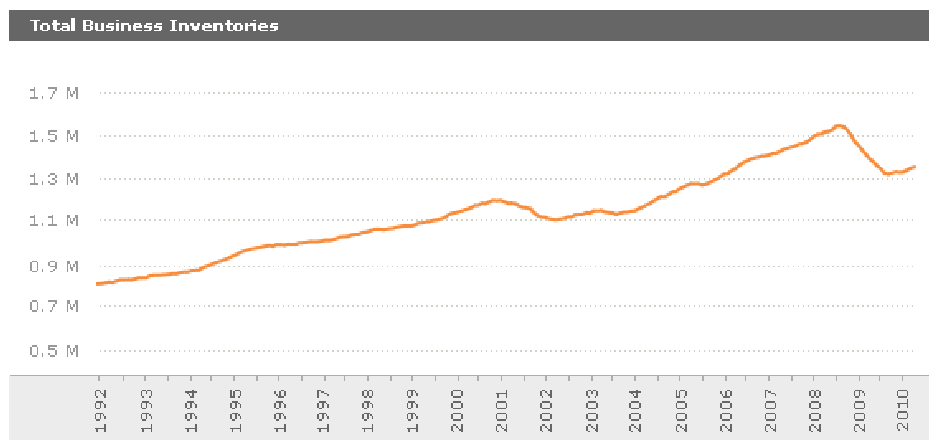
As watchers of the space know full well, industrial manufacturers' top lines exhibit significant volatility because of the business' position in the value chain. In general, when consumers, who drive the front end of the demand cycle, slow their activity, industrial companies are put down for the count more times than not. The reason, of course, is inventories. Once retailers and other consumer-facing businesses sense a slowdown, as they did in a big way more than two years ago, they cut orders and essentially satisfy any lingering demand mostly through depleting their inventory.

Distributors then do the same thing, forcing manufacturers to drastically cut production as the entire system rids itself of unwanted inventories. These manufacturers, in turn, eliminate or drastically reduce plans for capital expenditures, sending the order books of capital-goods producers into a downward spiral even more precipitous than that of their customers. Proof of this hierarchy lies in the data. Real consumer spending declined 2.3% from its November 2007 peak to its December 2008 trough, compared with the above-mentioned 15% peak-to-trough decline in industrial production and a 21% pummeling of real capital spending.

This sequence, of course, is a big benefit on the way up as manufacturers enjoy the fruits of expanding demand. Not only must this final demand be filled through increased production, but inventories of retailers and distributors must be replenished as well, adding an additional kicker

to the top lines of the firms making the product. Take automotive production, for instance. The Department of Commerce reported seasonally adjusted light vehicle sales were up 18% year over year in May, yet Illinois Tool Works ITW, which sits a few layers upstream from the dealers by supplying the automakers with components such as fasteners, gas cap lids, intake manifolds, and hundreds of other products, reported 29% growth in its transportation segment.

Lately there's been talk that the inventory-rebuild cycle has largely played itself out, and, as such, can not be counted upon to add to economic growth in future quarters. We disagree, and in fact feel the industrial sector is still relatively early in this dynamic. Below is a chart of business inventories that shows total inventories in retailers, distributors, and manufacturers have rebounded slightly but not near the extent of actual production. At $1.35 trillion, it sits about 2.5% above its low, yet still 12.5% below its peak set in mid-2008.



Source: U.S. Census Bureau, Federal Reserve

A look at the prior recession indicates it may be a while before inventories reach a new peak, as the level stayed below its 2001 peak for 41 months until a new high was made in mid-2004. Yet there's reason to believe inventories may be built up a bit quicker this time around, benefiting the industrial space. The early 2000s were a time when many companies were seriously embracing lean techniques for the first time (one of its major tenets was less need for inventories), outsourcing to China was accelerating, and advancements in CRM software was allowing tighter control of inventories. All of this made for a time when business could recover lost revenues without having to add as much inventory as they would have prior to these advancements.

Of course business will improve their abilities to operate with less inventories going forward, but they're starting from a leaner inventory position today. The chart below shows the inventory/sales ratio of U.S. business has never been lower than now. In fact, we'd argue the level may be a bit too low as many manufacturers have enjoyed more order activity than expected of late. In summary, we think the inventory cycle is just starting and is likely to lift the results of manufacturers for months to come.

Leading Indicators Showing a Bit of Ambiguity for First Time in a While
Most of our leading indicators pertaining domestic to manufacturing remain in good shape. The Institute for Supply Management's monthly Purchasing Manager's Index finished May at a very strong 59.7, indicating strong growth ahead. The index was off slightly from April's 60.4, but still impressive. Even better, the most forward-looking indicators within that survey (new orders, backlog, and production) point to similarly strong months ahead. Durable goods orders through April, a good leading indicator of industrial activity, point to higher industrial production in the months ahead, as well.

In addition, we maintain that at least two of the three areas we've written about quite a bit in the recent past, housing and truck production, are still operating at unsustainably low levels. Rebounds in these areas are inevitable in the coming quarters and will lead to a likely sustained uptick in activity for several quarters to come. The third area we've recently talked about, auto production, has already bounced back smartly yet still has more good years ahead. The trough in auto production was so deep that it will take another year or two to regain some semblance of equilibrium. Proof of this lies in the current record-high prices of used cars as noted by the Manheim Used Vehicle Value Index. At 121 in May this index has been making new highs for the past three months (seasonally adjusted) as not enough cars are being traded in to satisfy demand for used ones.

However, one of the indicators that we watch closely for early signs of a change in economic trend is the weekly leading indicators assembled by the Economic Cycle Research Institute. This series identified both the most recent downturn and subsequent rebound perfectly, turning down decisively in early 2008 then up in early 2009. It also has an excellent track record of calling prior recessions and recoveries. Lately it has once again rolled over after an historic leap upward during the past 12 months, indicating overall economic growth may be slowing.

The index hasn't yet displayed the persistent downward action we look for before sounding the alarm bells, but it's is worth paying attention to its weakness of late. We wouldn't be surprised if the economy may now be transitioning to a slower rate of growth after significant growth in the past three quarters. Investors understandably get nervous around these turning points,

resulting in volatile prices and in some cases lower valuations. Even so, the long-term outlook for most of our industrial names looks pretty promising.

Industry-Level Insights

A few names have fallen into more attractive valuation ranges during the past several weeks as a result of the global uncertainty surrounding the economic recovery. The space overall offers better but not an overwhelming margin of safety at today's levels, as the group sits at 87% of fair value in aggregate, down from 96% at the end of March. We're sensing some value in areas connected to housing as the market gets nervous about a double-dip as the government removes various legs of support.

The homebuilding and construction products sector sits at about 76% of our estimated intrinsic value. In particular, homebuilders have gotten routed in the past six weeks as these names sit anywhere from 25% to 40% below the highs set in late April/early May. The building materials sector is cheaper, at about 55% of fair value, with names such as Masco MAS and USG USG offering some value at today's levels. Diversified industrials sit about 77% below fair value, driven primarily by General Electric's GE low valuation.

Top Industrial Sector Picks

Company	Star Rating	Fair Value Estimate (USD)	Economic Moat™	Fair Value Uncertainty	Price/Sales TTM
Masco Corporation	★★★★	22.00	None	High	0.6
3M Company	★★★★	100.00	Wide	Low	2.4
Toyota Motor Corporation	★★★★	113.00	High	Narrow	0.6
Tidewater Inc.	★★★★★	62.00	None	Medium	1.9
Winnebago Industries	★★★★	24.00	Narrow	Very High	1.1

Data as of 6-22-10.

Masco MAS

Building product maker Masco may provide investors with an opportunity to play a recovery in the residential construction market and will also benefit from the above-mentioned inventory dynamic. The company's leverage to the housing market has pressured its stock price because around 80% of Masco's revenue is derived from North America while 25%-30% is tied to new construction. Although the firm's installation segment will likely continue to struggle in 2010, Masco should be a prime beneficiary of a recovery in the repair and remodel end-market. The company makes Behr paint, the private-label brand of Home Depot HD—the big-box retailer is the firm's largest customer, making up around 20% of overall sales. The firm has reduced its cost structure significantly during the downtown by closing manufacturing facilities and reducing head count, which should bolster margins as sales volumes return. We don't forecast a robust 2010 for Masco's top line, but the firm has limited commercial construction exposure compared with other firms in our universe.

3M MMM
With returns on invested capital generally north of 20% (and still above 15% even during the recent recession), we believe 3M possesses one of the widest economic moats among our industry coverage universe. This innovation stalwart gathers more than a quarter of its revenue from Europe, which is likely to see continued general weakness, but we think the potential impact to 3M is somewhat insulated; the company's largest exposure lies in its health-care and safety segments, where end-market demand is heavily geared toward small-ticket staples such as wound-care products, medical tapes, and personal-protection gear.

Toyota TM
Toyota's stock sold off nearly 22% once its sudden acceleration problems became worldwide news a couple of months ago. Although this issue damages the firm's ability to differentiate itself from competitors via quality, we still think highly of the firm's long-term earnings potential. CSM Worldwide forecasts global light-vehicle production to rise to 89.5 million units by 2016, up from 66.9 million this year. We expect Toyota's earnings to increase as the industry recovers, and we are not worried about the legal risks from sudden-acceleration lawsuits. The market was starting to price in this recovery until the recall news hit. The company's balance sheet is a fortress with consolidated cash and investments as of March 31 of more than JPY 4 trillion ($44.5 billion). Excluding the financing arm, cash and investments total more than JPY 3.1 trillion ($34.3 billion), so the company has ample liquidity to get through its legal problems and still fund operations in our opinion.

Tidewater TDW
Tidewater is the world's largest operator of supply vessels for the offshore rig industry. Recently, the stock has seen massive weakness as a result of lower oil prices, global economic concerns, and the Gulf of Mexico Deepwater Horizon rig disaster. However, we believe Tidewater's long-term prospects remain unchanged and think the current market valuation offers a suitable margin of safety to investors who are willing to wait. Even if oil remains at current levels (or again dips), we think Tidewater's clean balance sheet and strong competitive position shield the company from significant downside risk.

Winnebago WGO
Winnebago Industries recently surprised the street with a great fiscal third quarter, yet the stock remains cheap. Motor-home sales have been hit hard in the recession but we still see a market for them even if gas prices keep rising. We see Winnebago gaining more share over time because dealers will want to order from a manufacturer with top brands that dealers know will continue to be in business. The company also is finally increasing its share in Class A diesel models, as a result of it being the first to base its Class A model on the fuel-efficient Dodge/Mercedes-Benz Sprinter chassis. Demographics are also in the firm's favor as more Americans are reaching retirement age, a common time to buy an RV. The company can wait for a recovery for a long time because the balance sheet is debt free and cash and short-term investments at May 29 were 35% of total assets, or $2.66 per share, up from about 23% at year-end.

Eric Landry does not own shares in any of the securities mentioned above.