(BN) Machinery Stocks Gain as Global Slowdown Worries Abate: Eco Pulse

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By Anna-Louise Jackson and Anthony Feld

Nov. 16 (Bloomberg) -- Machinery stocks are attracting investors who are optimistic about economic-growth prospects worldwide, even as the fiscal cliff looms in the U.S.

The Standard and Poor's Supercomposite Machinery Index -- made up of 55 companies including Caterpillar Inc. and Illinois Tool Works Inc. -- has risen 9.4 percent since July 17, compared with a loss of 0.8 percent in the S&P 500 Index. This follows about five months of underperformance when the machinery index lagged behind the broader market by almost 20 percent as economic weakness dragged down the shares, said Robert McCarthy, a senior analyst with Robert W. Baird & Co. in Chicago.

These stocks have "meaningful upside potential" as the companies' customers are showing signs of improvement since the summer, McCarthy said. The shares appeal to a "growing portion of the market that sees the glass half-full, not half-empty."

Martin Leclerc is among investors who are putting machinery stocks on a "shopping list" because of their long-term growth prospects. The bullish view is that this industry will benefit during the next decade from improving demand, said Leclerc, the principal, chief investment officer and portfolio manager at Barrack Yard Advisors in Bryn Mawr, Pennsylvania, which oversees
$350 million in assets.

These machinery suppliers are exposed to end-markets -- including energy, manufacturing and agriculture -- that will bolster revenue as the global economy also becomes more supportive of expansion, Leclerc said. While this is a "very, very cyclical" group, many of these businesses could be considered growth companies on a three-year average earnings- growth basis, he said.

Bull Case

The shares have been "stair-stepping up" since the summer as more investors re-allocate money to them, according to Jim Stellakis, founder and director of research at New York-based research company Technical Alpha Inc. The reversal in the index's early 2012 underperformance strengthens the bull case for these stocks, he said.

The bigger the rally, the more attention these shares will warrant, said Stellakis, also a chartered market technician.
This in turn reinforces the likelihood that the increase could continue and isn't just emotionally driven.

The rebound in the machinery index also coincides with U.S.
and global growth that's been better than forecasts. The Bloomberg Economic Surprise Index, which compares 38 U.S.
indicators with analysts' predictions, was at 0.087 yesterday, up from an almost 11-month low of minus 0.422 on July 30.
Similarly, the Citigroup Economic Surprise indexes for both the euro zone and Asia Pacific have improved from June lows.

Revenue Generators

While the U.S. still accounts for as much as 50 percent of the industry's revenue, the 17-nation euro area makes up about
20 percent to 25 percent, followed by Asia with about 15 percent and Latin America and emerging markets at about 10 percent, McCarthy estimated.

As a result of this diversified exposure, global business confidence "matters a lot" for machinery suppliers, said Andy Kaplowitz, an analyst in New York at Barclays Plc. While "calamity concerns" have lessened considerably since European Central Bank President Mario Draghi pledged July 26 to do "whatever it takes to preserve the euro," there still are concerns about the U.S. fiscal cliff and regime change in China, he said.

Chinese Leadership

The U.S. faces a combined $607 billion in higher taxes and spending cuts that will take effect in January 2013 unless Congress and President Barack Obama agree on how to reduce the deficit. China's new leadership, announced in a once-a-decade transition of power this week, must decide on policy shifts the World Bank says the country should embrace to become a high- income economy, including breaking up state-owned monopolies and deregulating lending rates.

Investors should buy machinery companies "when uncertainty is very high and valuations are inexpensive," said Kaplowitz, who maintains "overweight" recommendations on Caterpillar and engine maker Cummins Inc. While these businesses are "very global," their U.S. operations remain strong and their stocks are trading at about 10 to 12 times earnings. In a more typical mid-cycle recovery, valuations would be about 13 to 15 times, he estimated.

Amid "more muted earnings expectations, these stocks still are at a 30 percent discount to where they should be,"
Kaplowitz said. Investors who are comfortable with the associated risk could be well compensated because it won't take much improvement in the operating environment for the rally in this group to re-energize, he said.

Cautious Companies

Even so, some of these companies are cautious about the prospects for growth into next year. Caterpillar, the world's largest maker of construction and mining equipment, anticipates its U.S. revenue will be up "a little bit" in 2013, thanks largely to an improving housing market, while Europe probably will be "flat to down," Michael DeWalt, director of investor relations, said at a Nov. 13 conference hosted by Goldman Sachs Group Inc.

While the Peoria, Illinois-based company isn't planning on a worldwide recession next year, it projects sales will be "relatively flat" in 2013, DeWalt said.

Similarly, "a lot of cancellations and rescheduling"
resulted in a weaker-than-anticipated September, hurting fiscal first-quarter results for Parker Hannifin Corp., Chairman and Chief Executive Officer Donald Washkewicz said on an Oct. 19 conference call. The Cleveland-based company manufactures motion-control products, including pumps and valves.

Lagging Shares

Shares of Kennametal Inc., a supplier of cutting tools, lagged behind the S&P 500 by 6.4 percent Oct. 24 on news that first-quarter sales and earnings missed analyst forecasts and the company was cutting its fiscal 2013 full-year earnings guidance to between $3.40 and $3.70 a share from $4.10 to $4.40.

The stock has rebounded since then, outperforming the broader market by 5.5 percent, even as monthly orders -- in local currency, excluding acquisitions, divestitures and workdays -- have been negative for the past four months, according to data released Nov. 14 by the Latrobe, Pennsylvania-based company.

The relative performance during the past three weeks shows that investors have largely "shrugged off" Kennametal's weak results, as the stock has retraced most of that one-day loss, Stellakis said.

Avoiding Recession

So long as the world's major economies can avoid recession, shares of these companies probably will benefit from the sluggish expansion, Kaplowitz said. U.S. gross domestic product will expand 2 percent next year, the euro area economy will grow 0.25 percent after contracting 0.5 percent this year and China's GDP will accelerate 8.1 percent, based on the median forecasts of economists surveyed by Bloomberg.

Though most machinery stocks "would get hammered" during another slowdown, they are well-positioned to take advantage of a manufacturing renaissance and energy-independence efforts in the U.S., as well as infrastructure building in emerging markets, Leclerc said.

"This is a good industry for investors to be in because it's at the vortex of a few big investment themes."

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