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Staying Selective in a Challenging Macro Environment

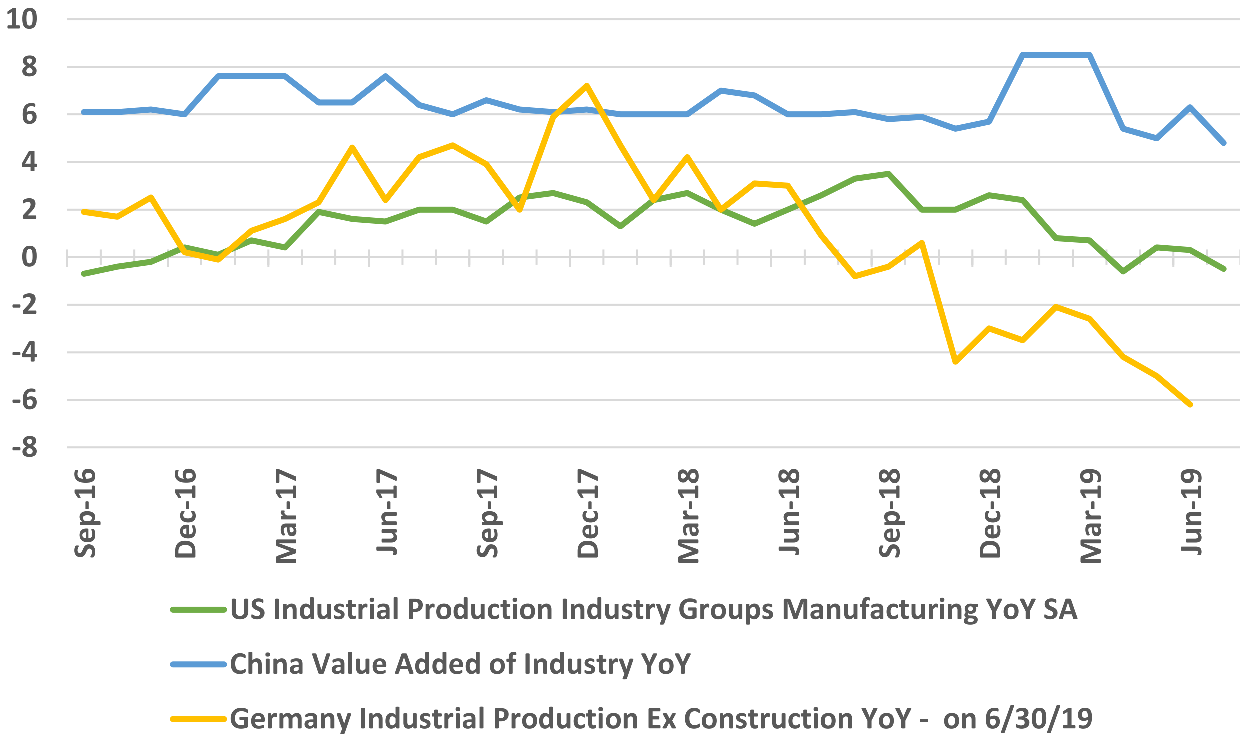
By Janice Wong

Over the past quarter, macroeconomic strategists here at Signature Global Asset Management ("Signature") have become increasingly vocal with their concerns about the economic effects of geopolitical risks and deglobalization. The past few weeks have been rife with signals of a deteriorating economic landscape, with yield-curve inversions in the U.S. and U.K., China's industrial output falling to the lowest level since 2002 and the euro zone's industrial production tipping further negative (down 2.6% year over year (yoy) as at June 30, 2019).

With this backdrop, in this post we provide a bottom-up perspective of the industrials equity sector, as this is where most capital spending outside of the information technology sector occurs.

Capital investment is a telling barometer of corporate confidence in an economy. On that score, Germany, Europe's largest economy, is arguably already in an industrial recession. German industrial production peaked in late 2017 and has been trending flat to down since mid-2018. Meanwhile, U.S. industrial production growth has meaningfully decelerated since the third quarter of 2018, as can be seen in chart 1 below.

Chart 1: Y-o-Y % Change in U.S., Chinese and German Industrial Production
(October 2016 to June 2019)



Sources: U.S. Federal Reserve, National Bureau of Statistics of China, Deutsche Bundesbank and Bloomberg Finance L.P. Market data is as at August 16, 2019.

Directionally, erosion of industrial demand is not new news, but two aspects of the second-quarter 2019 results bear attention: a June 2019 step-down and a broadening weakness in the industrials sector.

June 2019 Step-down

In June 2019, demand appears to have deteriorated suddenly and meaningfully. Reflecting on the second quarter of 2019, the CEO of global mining and machine tooling equipment company Sandvik AB, Bjorn Rosengren, recently told investors:

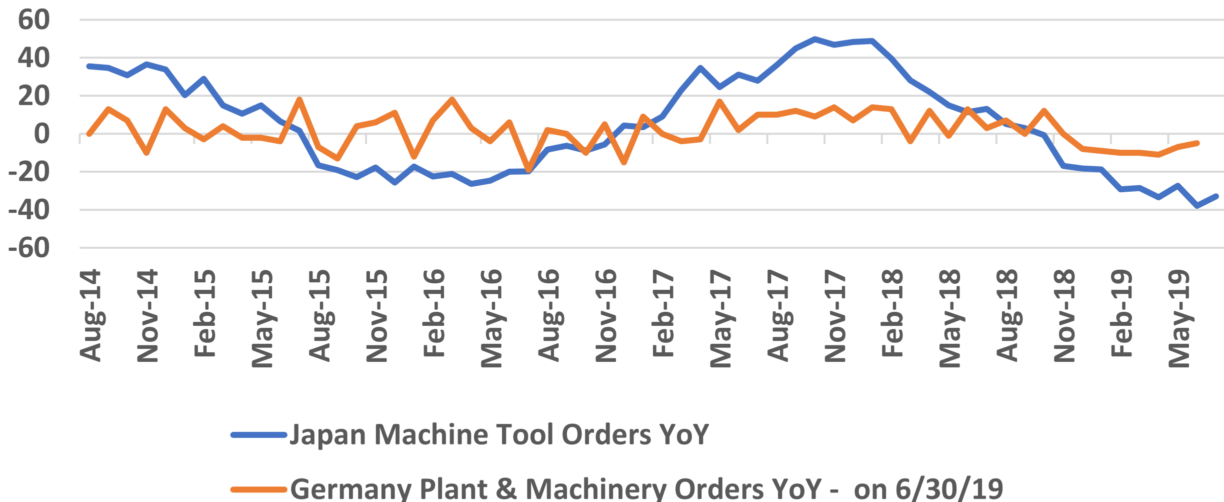
> *"I felt pretty comfortable after two months and was expecting a walkthrough in June and was taken a little bit by surprise there."*

On reducing the growth outlook, Emerson Electric Co.'s CEO, David Farr, commented:

> *"I look at a very gradual growth environment at this point in time … It is a different perspective than I did discuss in May … but I've come to the realization, watching our customer base and talking to our customer base, they're going to be cautious."*

These companies were by no means alone, with multiple businesses highlighting distributor destocking, project delays and customer capital discipline as reasons for revised expectations. The pullback in demand coincides with escalation of Brexit and U.S.-China trade tensions in May 2019, and it was also captured in the step-down of Japanese machine tool orders by 37.9% (year over year) and the year-over-year decline in German plant and machinery orders of 5% in June, as can be seen in chart 2 below.

Chart 2: Y-o-Y % Change in Japanese and German Machinery Orders
(August 2014 to June 2019)



Sources: Japan Machine Tool Builders' Association, Mechanical Engineering Industry Association and Bloomberg Finance L.P. Market data is as at August 16, 2019.

Weakness Has Broadened

While short-cycle demand has been softening for several quarters, the slowdown narrative had been contained. For starters, inventory stocking ahead of Brexit and tariff hikes skewed buying trends and supported orders into the first quarter of 2019. In addition, most of the

disappointment had been in the automotive and consumer electronics markets, with weakness in the latter understandable given its exposure to the global tech war. Through the first quarter, weakness was arguably contained to these two sub-sectors. However, the narrative shifted in the second quarter with weakness spreading to industrials in general. From the perspective of Mats Rahmström, Atlas Copco AB's CEO:

"In terms of what I'd call an operational spend, it takes quite some time for customers to go from quotation to orders. We can see that some customers have pushed orders a little bit into the future … we have seen pushout in all the business areas."

Opportunities Within

In an environment of heightened uncertainty and deteriorating business confidence, how do we invest? At Signature, we prefer to invest in fundamentally higher-quality companies that employ differentiated growth strategies and have recurring revenues, secular support, technology leadership and a proven management track record. In the context of trade wars, we also have a higher weighting toward more domestically focused stocks, defined as operating within geographic boundaries or local-for-local business models, and companies with good pricing power, lower substitution risk and self-help potential. Quality defensive stocks continue to outperform cyclicals, and our strategy of investing in these stocks has served us well, though we are cognizant of extreme valuation spreads.

It is also important to clarify that despite what we see as a clear deterioration in corporate messaging during the second quarter, most caution is still targeted at shorter-cycle businesses. Services and late-cycle industrials have remained relatively resilient. These include aerospace, mining, process automation and non-residential construction. At Rockwell Automation, Inc., CEO Blake Moret summarized the company's June quarter as follows:

"Organic sales growth was led by heavy industries, including oil and gas, pulp and paper and mining, as well as life sciences, each of which grew double-digits … Offsetting the longer-cycle growth in the quarter was weakness in shorter-cycle end markets, including automotive, semiconductor and food and beverage."

Secular dynamics such as digitalization, electrification and decarbonization continue to march forward. Business operating needs such as repair and maintenance, waste management and data management all thrive within industrials sector firms. There are opportunities in this space, and we are nimble in pursuing them.

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Sources: Bloomberg Finance L.P. and Signature Global Asset Management, as at August 16, 2019.

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