Sector Intellect

Trend Analysis – Industrials

March 2, 2017

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Revisiting The Forgotten Case For Industrials

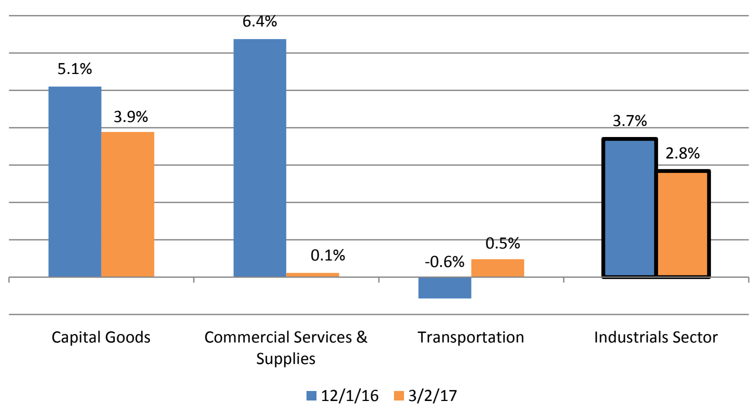
Global Economic Improvement and Spending Plans Should Benefit

The industrials sector has seemingly fallen in to the shadows as 2017 has gotten underway, following a strong showing in 2016. The sector has appreciated 6.5% year-to-date, below the 7.0% rise in the S&P 500 Index, and represents only the seventh-best growth of all eleven sectors in the index. This is a bit surprising given President Trump's focus on stimulating the economy via a large infrastructure spending plan. In his address to Congress on Tuesday, Trump promised to spend $1 trillion on infrastructure projects. Although Trump did not state a timeline, it is expected that the spending would be rolled out over 10 years.

"I am sending Congress a budget that rebuilds the military, eliminates the defense sequester, and calls for one of the largest increases in national defense spending in American history," Trump stated. The industrials sector rose 1.6% in trading on Wednesday, the day after the speech, but that wasn't as strong as the performance of the financials, energy and materials sectors. What may be putting a cap on the industrials sector's performance is the lack of clarity about how such a large spending program will be funded.

Further, consensus earnings expectations for the sector have recently contracted. Earnings growth of 2.8% in 2017 is nearly 100 basis points below growth expectations at the start of December. Most of the decline is related to the Commercial Services and Supplies industry group, which includes companies like Cintas Corporation, Pitney Bowes, Nielsen Holdings and Dun & Bradstreet, which offer professional services that are unlikely to benefit from an infrastructure bill. Airlines and road and rail are the only industries (within Transportation) that had 2017 earnings estimates revised higher.

Chart 1: S&P 500 Industrials 2017 EPS Growth Estimates by Industry Group



Source: S&P Global

Even though the remaining industries had estimates reduced, double-digit growth is still expected from the building products (+23.8% y/y in 2017), industrial conglomerates (10.6%), and road and rail (+10.3%) industries in 2017. We don't think Trump's stimulus plans have been incorporated in these numbers. Corporate management teams are unlikely to include a benefit from increased government spending in their financial guidance prior to receiving details on those spending plans. As such, it's possible that these estimates could even be revised higher over the course of the year as Trump's policies unfold. These three industries would be direct beneficiaries from any announced spending plans.

Fundamentals for the industrials sector continue to show improvement and remain in expansionary territory. The Institute for Supply Management's PMI (purchase managers index) continued its steady rise by increasing to 57.7 in February. Companies interviewed in the most recent survey were upbeat about their current business prospects. The February PMI from Markit Economics stood at 54.2, slightly below January's reading, but was affected by higher inventory levels that were a result of expected improvements in demand. Unseasonable weather has impacted industrial production (related to the utilities component) in a few of the last several months, but we would expect that to smooth out as we progress throughout the year.

Combining this domestic data with some of the PMIs from around the world help build confidence in the sector. In China, manufacturing activity continued its expansion with the Markit Manufacturing PMI improving for the eighth month in a row in January. In Europe, the February Markit Eurozone Manufacturing PMI showed its strongest expansion in factory activity since April of 2011.

In the aftermath of the U.S. election, industrials was among the best-performing sectors for the remainder of 2016 (along with financials, telecommunications, and energy). Since the start of the new year, investors have tactically rotated into the sectors that had not initially benefited from the Trump Bump, underperformed the market from the election to the end of the year, and trade at price-to-earnings (P/E) multiples that are not significant premiums to their historic average. That rotation has contributed to the underperformance of industrials versus the market. Notably, the industrials sector currently trades at 19.0x its next twelve month EPS, a 3x premium to its historical multiple. That expansion in valuation was primarily attributed to the post-election jump.

Chart 2: S&P 500 Industrials Sector Price and Next Twelve Month P/E

Source: S&P Global

CFRA Research remains overweight on the industrials sector as an improving global economy will likely directly benefit this group. Projected increases in defense and infrastructure spending will support upside to the current earnings expectations and help return valuations to more historic levels.

CFRA equity analysts have 5-STARS (strong buy) rankings on 9 U.S.-based industrials stocks (see table). For more diversified exposure to the industrials, investors might consider Industrial Select Sector SPDR Fund (XLI Overweight). For exposure to the road and rail industry, iShares Transportation Average ETF (IYT Overweight) has 43% of its holdings allocated to that industry.

Table 1: CFRA 5-STARS Ranked Industrials Stocks

Company	Price	12-month Target Price	P/E Ratio (TTM)	Dividend Yield
Delta Air Lines	$50.16	$65	8.8x	1.6%
FedEx Corp	$195.55	$240	29.0x	0.8%
JetBlue Airways	$20.10	$30	9.2x	-
Lockheed Martin	$266.61	$302	15.3x	2.7%
Masco Corp	$34.07	$39	23.5x	1.2%
United Continental Holdings	$73.82	$86	11.0x	-
United Parcel Service	$106.35	$140	27.6x	3.1%
United Rentals	$130.75	$155	20.7x	-
USG Corp	$33.95	$37	9.9x	-

Source: CFRA Research

Disclosure