Economic and Industrial Market Commentary — Gear Industry

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At the mid-year point of 2017, it appears that the U.S. economy, and the manufacturing sector in particular, are gradually accelerating, with most markets seeing an upside breakout from the flat or down conditions of 2015 and 2016.

This is good news for the gear industry — many companies are seeing the best top-line sales growth numbers in three years or longer. We see the growth trajectory for gears breaking away from the overall flat-line trend of the last two years, with some markets (and company sales reports) showing the potential to reach double-digit gains in the second half and momentum continuing into 2018.

While the improvement isn't as dramatic as way back in 2010, that was a year assisted by a bounce back from the trauma of the "Great Recession." Right now, we are eight years into the current economic expansion, so there isn't the same source of pent-up demand.

However, many of the constraints that held industrial growth in check during 2016 — such as excess inventory, a too-strong dollar, slack overseas demand for U.S. goods and reticence to invest when the view to Washington was perceived as antagonistic to business — have been reversed this year.

Inventories have been trimmed, the dollar has stabilized and in some cases weakened since late 2016, overseas economies (especially Europe) are rebounding and buying U.S. goods and while there is still ambivalence in regard to the Washington political scene, the perception that it is anti-business has been mitigated by last year's election results.

Logically enough, improving business conditions start with more positive attitudes. Starting in the fourth quarter last year, consumer confidence numbers from the Conference Board and University of Michigan, metrics such as the NFIB small business optimism survey and big business attitude readings (Business Roundtable outlook from Fortune 50 CEOs) took a major turn for the better. Some of these readings have reached levels that were the best in ten or more years.

That impression is confirmed by looking at the most important confidence measure of all — the stock market. Major stock market indices (Dow Jones Industrials, S&P 500, NASDAQ) are at or near record highs, and at mid-year, U.S Machinery stocks are up 13.7 percent from December 31, almost five percentage points ahead of the S&P 500's 8.9 percent gain. While security analysts can be wrong, their valuations seem to confirm that conditions have improved for the economy and for industrials and the machinery sector in the last six months.

Taking a look at more detailed sector performance, here is our current assessment of key industrial markets:

Passenger Car and Light Truck — After steady advances from the depths of the Great Recession into 2016, light vehicle sales and production are reaching a plateau and likely will decline from last year's levels. Auto inventories are too high, but even when they settle down, we are probably in a mode where light vehicle sales and production will be stable at high levels, not pushing into new record volume territory.

Commercial Vehicle — Medium duty trucks (Classes 5 to 7) are benefitting from a strong consumer sector, especially online retail and parcel delivery, in a market that should grow about 5 percent in 2017. Heavy duty trucks (Class 8) have had a surprising upside in 2017 with a positive acceleration in orders dating back to the Fourth Quarter of 2016. Class 8 production in 2017 may rise by as much as 5% from prior year, a big change from views that prevailed last December when a second year of production declines was anticipated.

Industrial Machinery — Shipments look to post a mid-single digit gain in 2017, as capacity utilization tightens, manufacturing activity increases, and export markets see a pickup in momentum.

Off-Highway Mobile Equipment — Mixed outlooks, depending on sector. Material handling has been consistently doing well, based in part on the warehouse boom supporting online retailing. Construction equipment is turning the corner after weak mid-decade years, in part on the prospects for a boost in publicly funded infrastructure. Farm machinery and oilfield/energy/mining equipment remained tied to the ups and down of commodity prices. This was a drag on 2015 and 2016 performance, though signs of stability (especially oil prices picking back up to the $45 to $50 per barrel level in the last 12 months from lows below $30/bbl) in energy and farm commodity prices have at least put a floor on production and offer some hope of a 2018 improvement.

Aerospace — 2017 is turning out strong, with an improving global economy driving increased air travel (critical for aftermarket) and accelerating deliveries of commercial aircraft. Some recovery in defense industry spending, mainly in the U.S. and Europe, will round out an improving across-the-board 2017 for aerospace.

No market review is complete without an assessment of risk. Short-term, downside risks are low and stem mainly from disappointed expectations if Washington fails to deliver on promises for business-friendly health-care law changes, tax reform, and infrastructure boosting programs.

Longer term, the Federal Reserve Board is on a quest to end its easy

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monetary policies and "normalize" interest rates. Its own statements and documents suggest that short-term interest rates, such as the Fed Funds rate and 90-Day Treasury yields, could reach as high as 3 percent by year-end 2019 from the 1 percent of June 2017. The combination of escalating rates and a shock could be fatal for the expansion. It has happened in the past, when rising rates and an exogenous negative (such as the oil price spike in 1980, the Persian Gulf War in 1990–91, the technology bubble bursting in 2001 and oil prices/housing collapse in 2007–2009) proved to be expansion-ending in earlier episodes. It will be important to keep a wary eye should the Federal Reserve raise rates to 2 percent or higher in 2018. If linked to a shock, it could set the stage for ending the current business expansion that dates back to 2009.

Jim Meil has been recognized as a leading industrial sector economist and planner for more than 30 years. As Principal Industry Analyst at ACT Research, he is responsible for forecasts and commentary on the North American economy, analyzing how goods-producing sectors are contributing to freight conditions and vocational activity. He is a contributor to Blue Chip Economic Indicators and The Wall Street Journal monthly U.S. economic forecast panels. Meil has received first-place recognition in the Wall Street Journal's survey of 50 forecasters and has been ranked among USA Today's "Top 50 Economic Forecasters" for accuracy. Prior to joining ACT Research, Meil spent 30 years in the planning department of Eaton Corporation, retiring from the position of Vice President and Chief Economist in April 2014. He previously served on the Board of Directors for the National Association for Business Economics, and he also worked for Chase Econometrics and Burroughs Corporation before joining Eaton. He holds an MBA degree in finance and a Bachelor of Arts in economics from the University of Chicago.