ALTMAN INVESTMENT MANAGEMENT

INDUSTRY RESEARCH INSIGHTS: INDUSTRIALS

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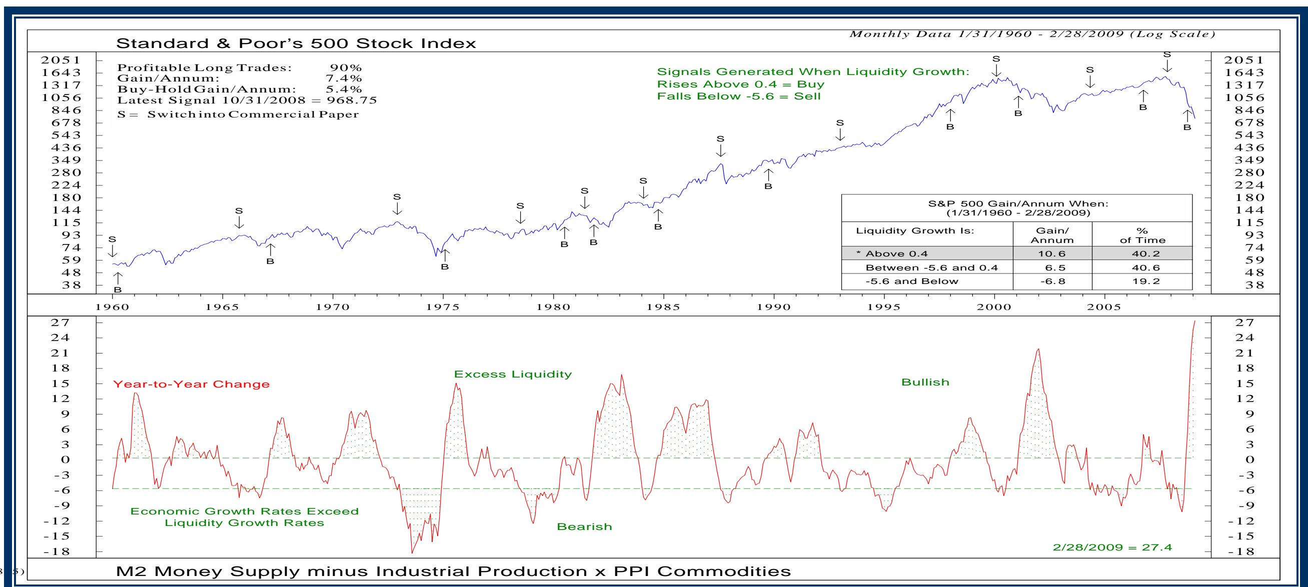
“CLOSE UP”- THE INDUSRIAL SECTOR
Have Investors completely discounted any Global Recovery in the second half of 2009?

The Industrial Sector Revisited:

- **Coincident with the loss of investor confidence in resolving the credit market turmoil and subsequent global economic recovery, the shares of industrial companies were one of the hardest hit sectors in the markets since the November 20th low last fall. This sector accounted for close to 30% of the S&P 500 losses through early this month.** Given the large amounts of government stimulus, we would expect that the U.S. is likely to stage a recovery in the second half of the year. Accordingly we would expect the higher beta cyclical sectors to resume their leadership position as they characteristically anticipate the economic recovery.

- **As the evidence of economic weakness continues to mount, the likelihood of a prolonged “choppy economic environment” warrants increased attention.** In recent history, two periods of this unpredictable economic growth for which we have industry data are 1980-1982 and 2001-2003. While we acknowledge the limits of only 2 recent periods, both periods are similar in that they lasted for two years and contained two phases of recession or economic weakness connected by an interim recovery. In terms of coming closer to the severity of today’s economic downturn, the 1980-1982 period (the more severe and longer case) may be the best case to observe, while the 2001 case fits the expectation for a cyclical bull market within the possible context of a secular bear market that includes a lower interest rate environment.

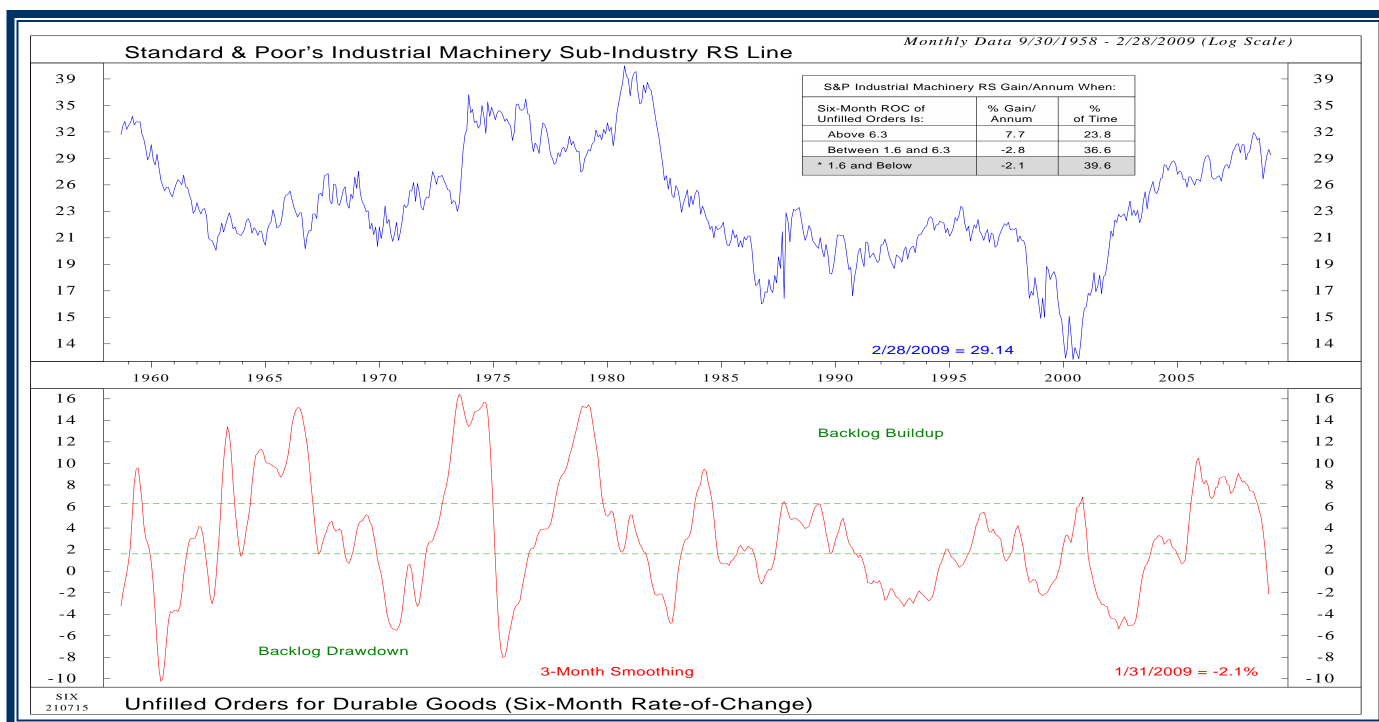
EXHIBIT I



SOURCE: Ned Davis Research, Inc

- **Despite markets' bias towards cyclicals after bear market bottoms, in the current decline the industrials have uncharacteristically lagged behind.** We believe part of the explanation is that the sector has been dragged down by GE's financing arm exposure but more importantly by the heavy dependency on the adverse effects of frozen credit markets. This performance aberration should reverse once the financials, which are extremely out of line with their historical averages, settle down. This will be bolstered by the corrective measures imposed by the Fed, encouraging the credit markets to once again return to a more normal level of activity. We would expect the financials are being set up for a significant short-term rally defining the probable bottom of the bear market and ultimately dragging the industrials along for the ride. Although longer term the banking industry has some serious growth impediments, the positive effect of improving the credit markets should help repair the damage incurred by the industrials and give board rooms some breathing room in the calendar year. We expect that the industrials will regain their market leadership position.

EXHIBIT II

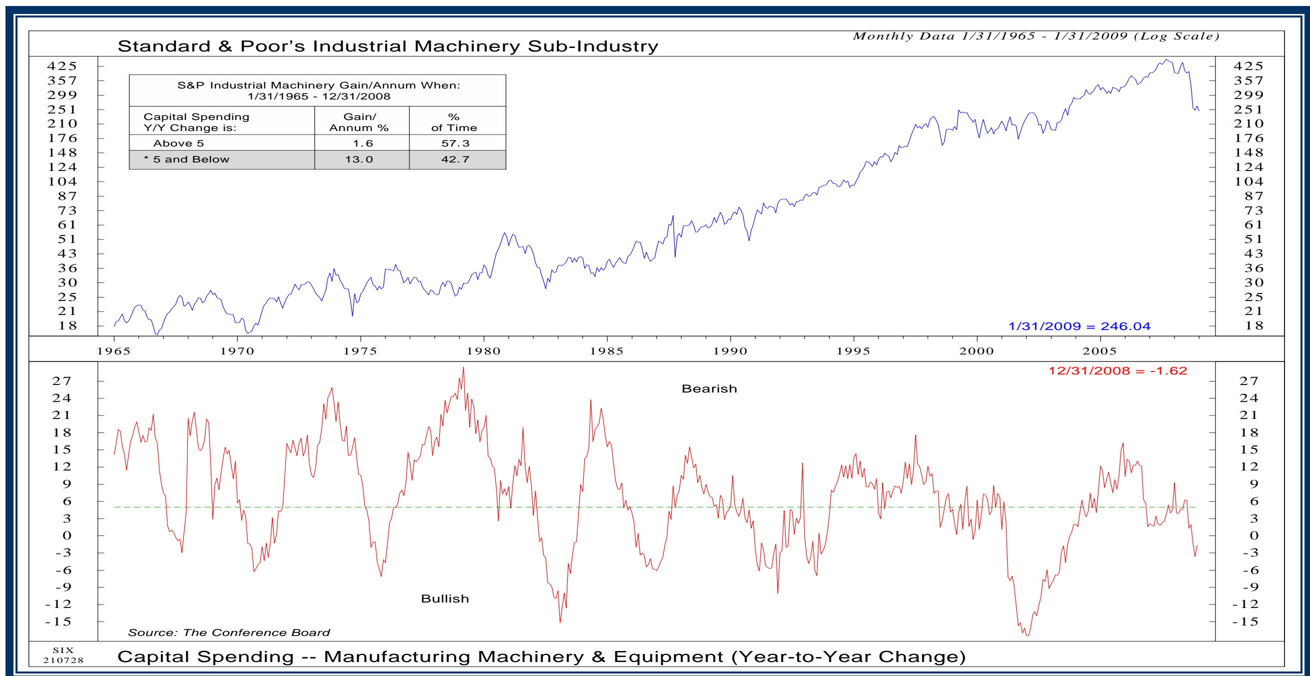


SOURCE: Ned Davis Research, Inc

- **In 4Q 2008, the S&P 500 Industrial Sector was down -24.6%, underperforming the market by 200 bps, and in line with its bear market and recession tendencies.** The relative strength in Exhibit II of the Machinery sub-industry, against the S&P 500, is reversing modestly from its recent lows following GE's better-than-expected credit rating reduction to AA+. The weak performance of General Electric appears to have exacerbated the decline of the sector as noted by the breadth of the equal-weighted NDR sector's performance. While we are favorably inclined towards the sector, based on our historical studies from the bear market bottom to the recession end phase and both domestic and global fiscal infrastructure stimulus, the sector returns may remain under pressure in the near term due to financing exposure, as well as a stronger U.S. dollar. We are watching breadth and durable goods order trends closely for the potential risk of any further deterioration.

- **On March 2, the U.S. Census released January construction spending results. The rate of year over year decline of Total Construction decelerated 9.1 %(Y/Y) versus 6.7% last month.** On a month over month basis, total spending was down 3.3% which missed consensus expectations of a more modest decline of 1.5%. The chief economist at Merrill Lynch, David Rosenberg, attributed the miss to the non residential market which grew at 1/3 the rate that was expected. There is a ray of hope in residential construction spending stats this past month indicating that the rate of decline is decelerating (see Exhibit V). Exhibit III shows that the machinery sub-group year over year spending has fallen into bullish territory.

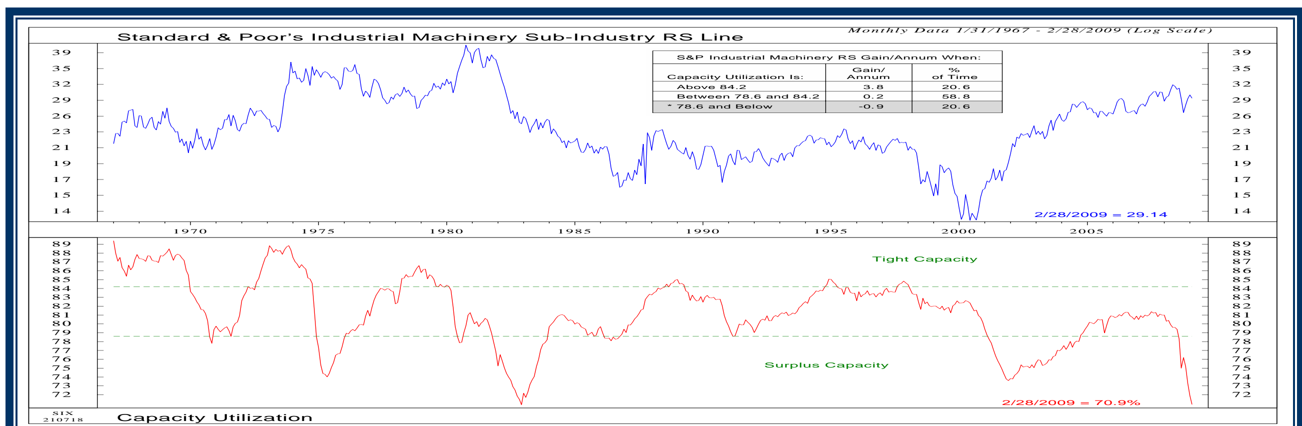
EXHIBIT III



SOURCE: Ned Davis Research, Inc

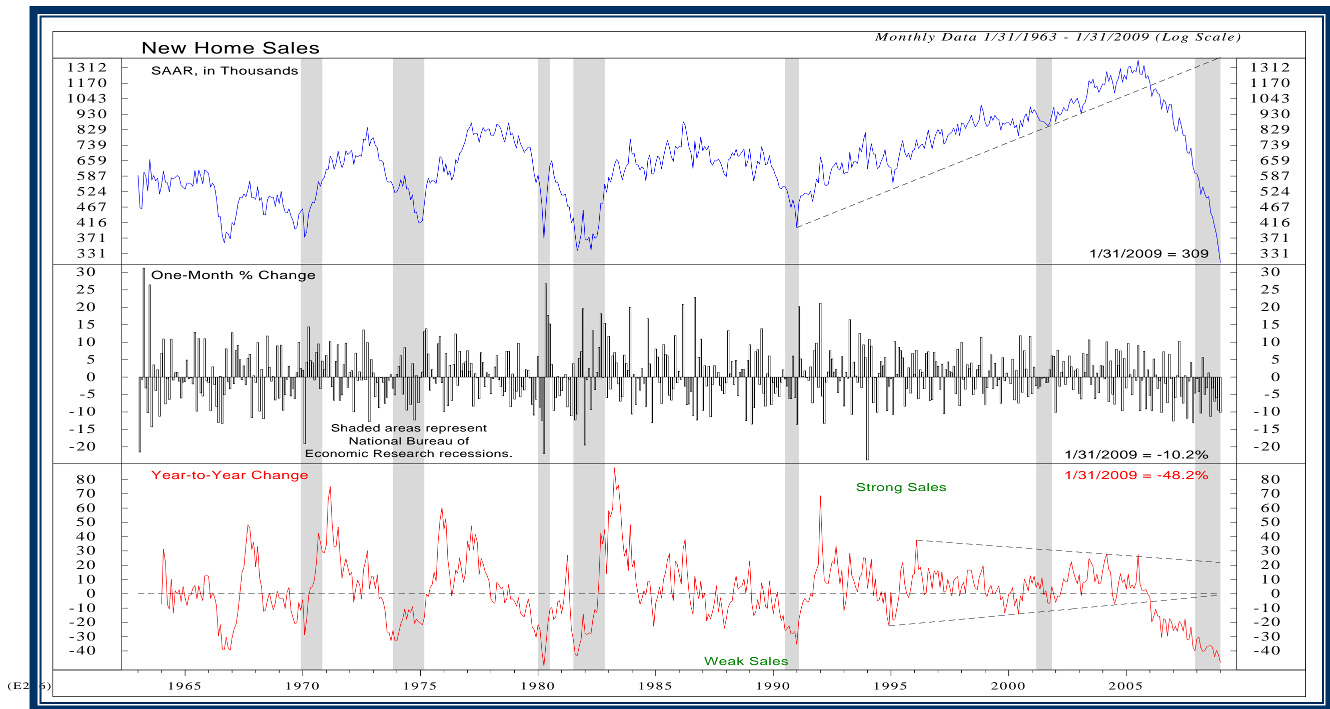
- **Exhibit IV_shows the capacity utilization rate has fallen to the levels we experienced in the early 70's and 80's.** A rate of below 72% in past cyclical downturns usually portends an improving trend in the ensuing months as the U.S. economy begins the rebuilding process.

EXHIBIT IV



SOURCE: Ned Davis Research, Inc

EXHIBIT V

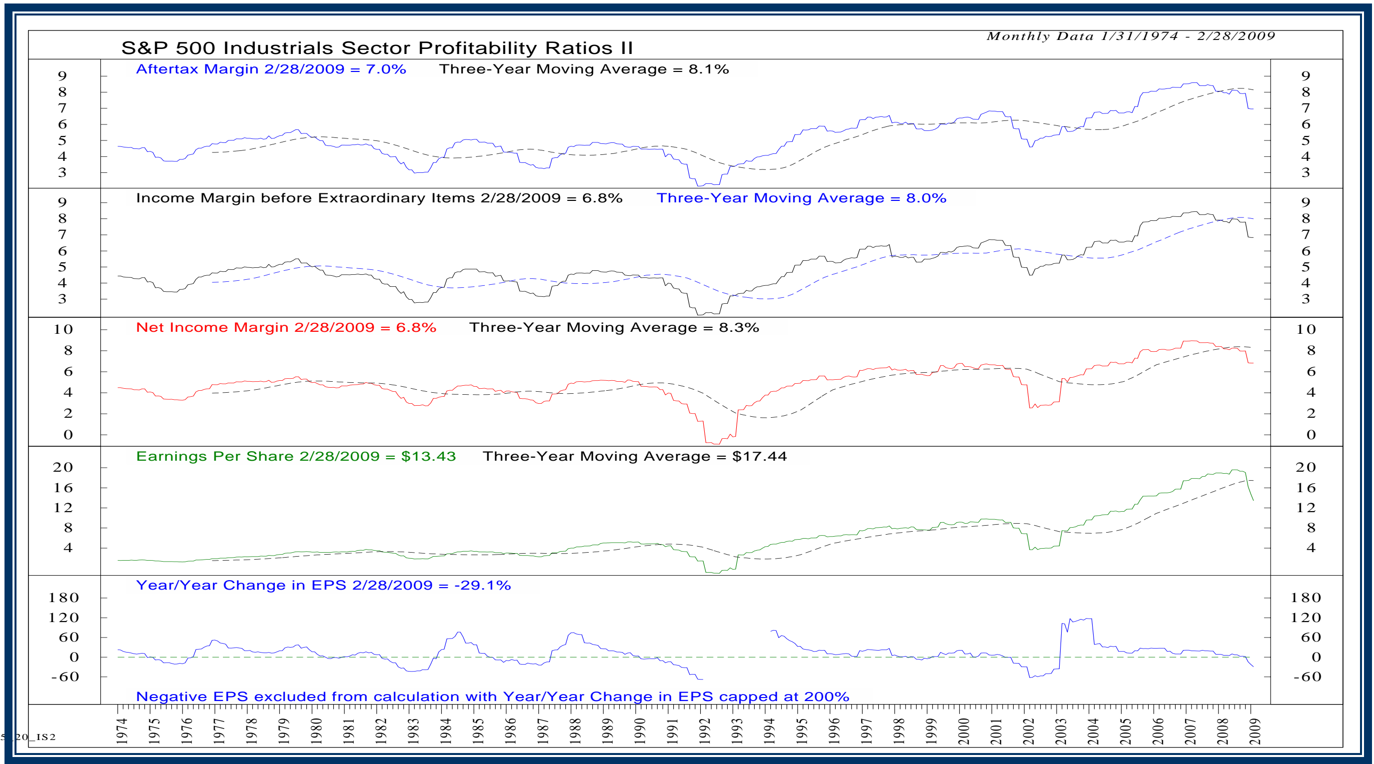


SOURCE: Ned Davis Research, Inc

Machinery Fundamentals

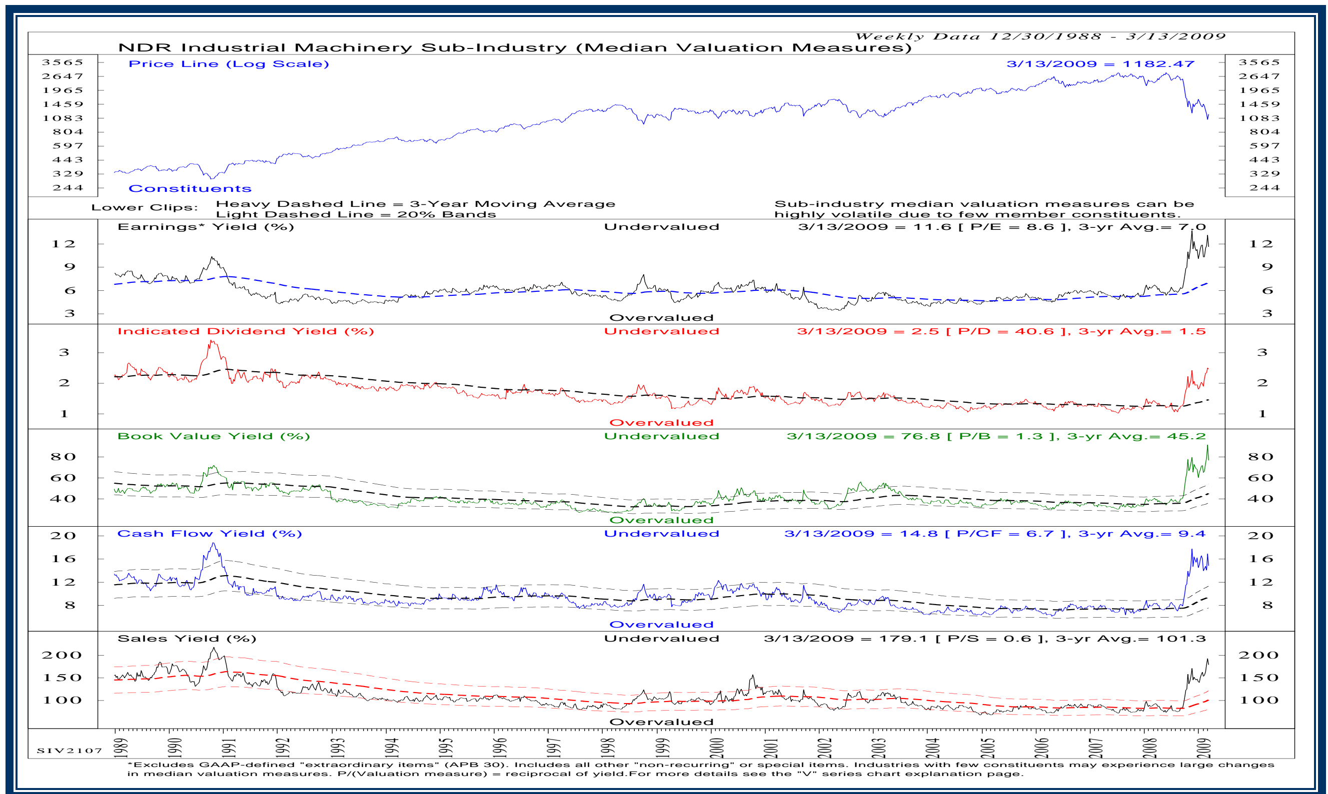
- There is no denying that the U.S. economy is in the midst of a deep recession. However, we believe that despite the current economic malaise, the sharp market sell off has driven equity valuations to levels that offer investors strong, intermediate and long-term return profits. Nonetheless we recognize that corporate profits in the industrial sector are likely to be weaker than our previous forecast. Although we are anticipating corporate profits to decline closer to the mid $50 estimates for the S&P in 2009, we expect an improving trend in 2010. This estimate is still below the 10-15% trend line earnings we experienced in the earlier part of the decade. We believe it would be a mistake for investors to extrapolate today's cyclically depressed earnings into the future. We have included in Exhibit VI the aggregate performance of a number of key valuation parameters both to judge the industry experience through other similar downturns as well as put the individual investment into relative perspective. Exhibit VII shows the machinery sub industry undervaluation with respect to earnings, dividends, book value, cash flow, and sales comparable to the levels experienced in the recession of the early 1990's.

EXHIBIT VI



SOURCE: Ned Davis Research, Inc

EXHIBIT VII

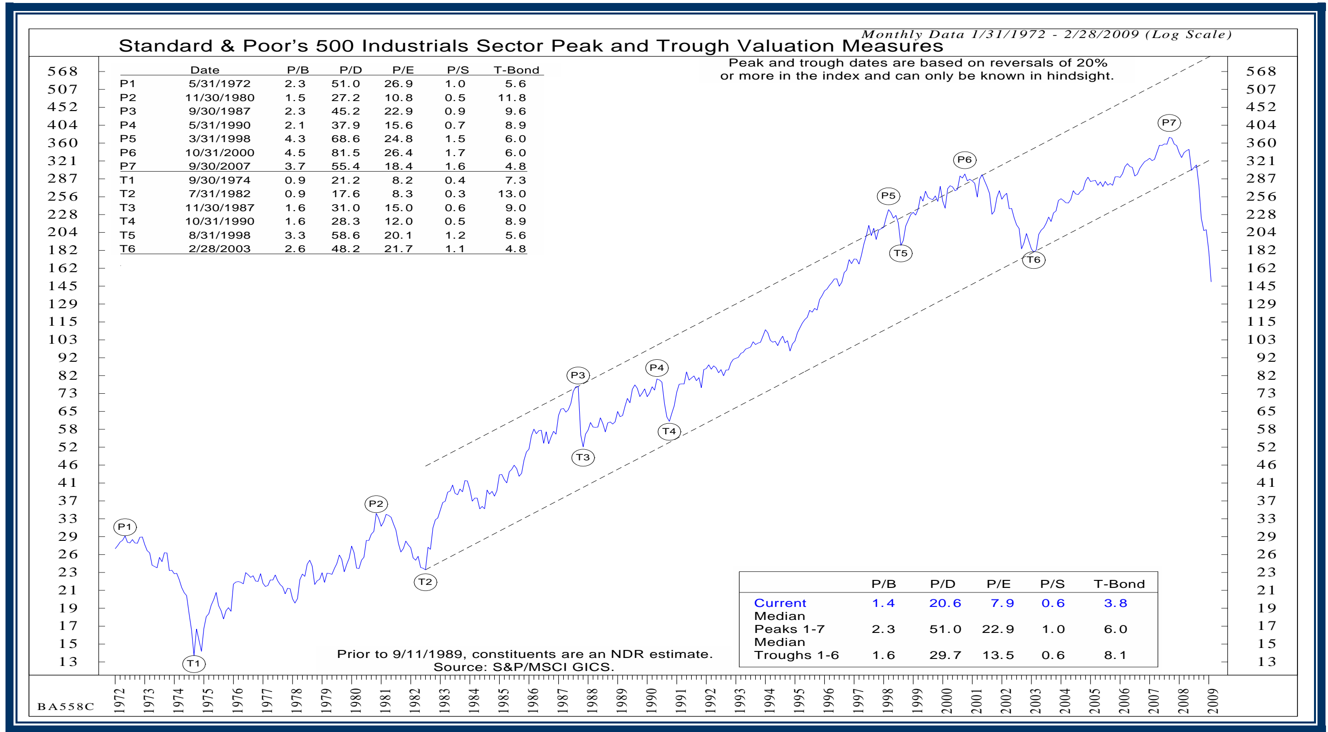


SOURCE: Ned Davis Research, Inc

Industrial Valuations

- **Valuations are extremely attractive relative to historical troughs.** The exhibit below shows that the Industrial Sector index valuation measures are now heading to the median levels experienced at previous economic troughs. See bottom table in Exhibit VIII.

EXHIBIT VIII



SOURCE: Ned Davis Research, Inc

"LOOKING AHEAD"

- In light of our analysis, we are maintaining an overweight position in the Industrial Sector, relative to the Standard and Poor's 500 Index, within the equity portion of our client portfolios.

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