10 Reasons We Still Like Industrials

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As the Ukraine conflict continues and COVID ramps up in parts of the world, it seems like all eyes are focused on supply-chain dynamics and labor shortages, which could, in theory, bode poorly for industrials—but a recent research trip abroad only solidified our view that these stocks are well positioned for growth (and deserve their overweight in our broader global equity portfolios). Here are 10 observations about industrials.

1: Labor Shortages Are Structural

We hear a lot about labor shortages, and it's not just unskilled labor that has disappeared: engineers, electricians, welders, and plumbers are also in short supply.

There are a number of structural reasons for the shortages. Many people retired during the pandemic, for example. As a society we have also failed to grow the talent pool fast enough to keep up with demand. Those situations cannot be remedied by raising wages, so the labor shortages are not likely to disappear anytime soon.

Labor shortages will undoubtedly hold back some companies' ability to satisfy end-market demand for a number of products. But as with many things, the situation is multifaceted. Labor shortages are good for automation, for example, so that's a key theme we'll be watching.

2: Supply-Chain Woes Continue

We had hoped to see some normalization of supply-chain constraints in 2022 as COVID-19 resolved, but that may not happen anytime soon.

There are two reasons: the conflict in Ukraine has limited the availability of raw materials (such as rare earth elements) and created some logistical challenges, and COVID-19 is ramping up again in China.

Both situations are disruptive. Supply chains are complex. Hundreds of thousands of products are manufactured and shipped around the world daily, and it takes just one blockage to choke up the entire pipeline.

In the short term, then, I expect continued disruption, which could cause market volatility. That said, we see some policy shifts that may mitigate the COVID-driven disruptions. Chinese policymakers are being more liberal this time around, working with companies to keep production going, and I believe other countries are likely to follow suit.

We're also keeping our eye on longer-term implications. People are seeing the fragility of supply chains, leading to a policy shift toward regionalization, and that could create new winners and losers among industrials. We believe active management will be critical.

3: Demand Is OK

It seems like everyone is focused on demand. They're worried that, in the wake of the Ukraine conflict, demand will fall off a cliff like it did during the Lehman Brothers crisis or during the pandemic. But the industrial companies we spoke to on our recent research trip—around 25 of them—are just not seeing that.

Companies with sales in Ukraine and the surrounding region have been impacted, but otherwise it has pretty much been business as usual for the companies we spoke to. In general, they are benefiting from significant backlogs because of strong demand and component shortages that held back deliveries last year.

That said, everyone is watching secondary impacts of the Ukraine conflict. For example, what will higher energy costs do to disposable income and ultimately consumer confidence? Will there be an impact on demand later?

4: A Focus on Efficiency Benefits Industrials

We've seen an increased focus on energy and labor efficiency worldwide. At the same time, supply chains are becoming more local, shifting back to regions and countries.

In our opinion, these changes create a greater need for automation and digitalization, and industrial companies are at the center of these trends, providing solutions to help meet demand. Any solution that helps decarbonize the world, for example, is likely to come from an industrial company.

Efficiency, in many ways, is at the heart of industrial companies' value proposition, and we believe this should keep them relevant as the world evolves.

5: Deeply Ingrained Businesses Diminish Disruption

Industrial companies are not just manufacturing substitutable widgets; they're deeply ingrained within their customer bases, making critical components. That makes the cost of switching suppliers high. Add a layer of turbulence as we have seen lately, and it seems to me that industrial companies are not going to be disrupted anytime soon.

6: Industrials' Runway for Growth Is Long

Few people have a true appreciation for just how long the runway for growth is within industrials. Sustainability and digitalization, for example, are generational shifts. Companies at the forefront of these trends today will likely be at the forefront in 10, 20, or 30 years.

7: Industrial Companies Are Resilient

We're looking at a more pronounced economic slowdown globally than we expected just a few months ago, and there is potential for a recession. And traditional wisdom holds that industrial companies, which are cyclical, will suffer in such a scenario. But I think we are over-sensitized to the cyclicality of industrials.

That's because many industrial companies learned from the global financial crisis. They have better balance sheets. Their portfolios have been cleaned up to diversify away from business lines that could be hit hard by cyclical changes, such as construction, and they've added more software and aftermarket services to the mix.

Management teams of the more savvy industrial companies are watching the situation closely. They understand that higher energy prices will have a big impact on their operations. They acknowledge it will drive some sort of slowdown. But they're not in crisis mode, because they are better positioned to weather a significant downturn than they were 20 years ago.

8: Pricing Power Should Distinguish Winners

Separating the performance of the best companies will likely be the ability to use pricing to offset higher input costs. Everyone is facing the same challenges, but there's a big difference between the companies with pricing power and those without. Again, we believe this makes active management critical.

9: Great Industrial Companies Are Still Great

The verdict: As much as the world has changed over the past two years, many things haven't changed. In my opinion, great industrial companies are still well positioned to solve current (and future) challenges. The current environment has given high-quality industrials with pricing power, great management, and a solid value proposition the opportunity to display their strengths.

10: We Believe an Overweight Is Warranted

Our broader global and international portfolios have significant overweight in industrials, which is a differentiator versus some peers. But we believe it's warranted, as we believe the market tends to overreact to the economic cycles influencing the best-managed industrial companies, creating potential opportunities for active managers.

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