

The Rise of Domestic Industrial Capacity: A Promising Opportunity for Investors

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Lately, we have noticed a shift that might bring the industrial sector back into the limelight. Contrary to the trends of the past few decades, the future might resemble the 1970s more closely. This shift is prompting us to consider the potential of domestic industrial capacity and the value it could hold for investors.

During the 1970s, energy stocks dominated the market due to energy's significant role in the economy and its scarcity as the US heavily imported oil. Today, the scenario is vastly different. Energy has become a smaller part of the economy, and the US has experienced a surge in domestic oil and natural gas production over the past couple of decades.

Today's scarce resource may well be domestic industrial capacity. For years, US businesses have outsourced their industrial production to foreign countries, especially China, in pursuit of cost savings. However, with the current geopolitical landscape, this practice has become riskier than it was in the past. Heightened tensions between the US and China could potentially lead to China withholding access to industrial capacity, akin to OPEC's oil embargo in the 1970s.

While predicting such an outcome is difficult, the potential risk may make increasing domestic industrial capacity akin to a form of national defense spending for the coming years. Notably, several government programs are already encouraging investment in domestic semiconductor fabs, battery plants and other crucial areas.

Industrial businesses, especially in the small and mid-cap ranges where many firms generate a significant portion of revenue from North American markets, are well-positioned to benefit in this environment. Despite their promising prospects, many of these stocks still trade at considerable valuation gaps compared to the more enticing stocks in the tech sector and other areas of the market.

Although many tech stocks deserve premium valuations based on their excellent results, the valuation gap can shrink if industrial stocks experience improved revenue growth, profit margins, earnings and cash flow relative to tech and the broader market. We have already observed this trend starting, but there is potential for further convergence.

Our portfolios include stocks like industrial distributor WESCO, motor and power train manufacturer Regal Rexnord, motion and control technologies leader Parker-Hannifin, plumbing supplies distributor Ferguson, and welding and cutting equipment manufacturer ESAB, which are poised to benefit from these effects. The stocks of these cyclical businesses certainly trade with plenty of volatility. For example, following WESCO's recent earnings release, the stock had delivered a positive return of nearly 20% over the prior 12-month period. However, this return encompassed three different occasions on which the stock price fell approximately 15% in a single day.



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Despite concerns about adding cyclical exposure given that type of volatility and with a possible recession on the horizon, we focus on long-term business fundamentals and valuations rather than perfect timing or price volatility. Even if stocks experienced temporary declines, we believe solid businesses with attractive valuations eventually yield positive results.

Regarding the possibility of a recession, we refer to the historical yield curve indicator: the inversion of the 3-month US Treasury bill with the 10-year Treasury bond. Although many have been talking about a looming recession for the past 18 months, the inversion only occurred in October 2022. Based on historical patterns, it would be no surprise to see a recession begin somewhere between October of this year and April of 2024. We are not predicting a recession, only pointing out that this would be consistent with historical experience.

In conclusion, the industrials sector presents attractive opportunities amid the current economic landscape. The potential scarcity of domestic industrial capacity and the ongoing shift in valuation gaps could make industrial businesses a wise addition to investment portfolios. By focusing on long-term fundamentals and valuations while staying mindful of potential risks, investors can position themselves for potential gains in the industrials sector.

As of 31 July 2023, Diamond Hill owned shares of WESCO International Inc, ESAB Corp, Regal Rexnord Corp, Parker-Hannifin Corp and Ferguson plc.

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