



Urgent change needed in industrials?

Trends in the industrial sector in 2022

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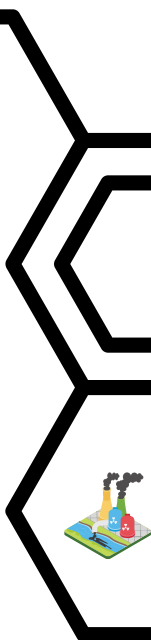
Introduction

No matter how varied and diverse, the industrials sector is a cornerstone player in today’s market. From electrical components to machinery used in manufacturing, the industrials sector produces and provides goods and services that the regular consumer may not see in their everyday lives. Nonetheless, a seasoned professional is sure to keep their eye on changes within industrials, as changes in this foundational sector have far-reaching impacts.

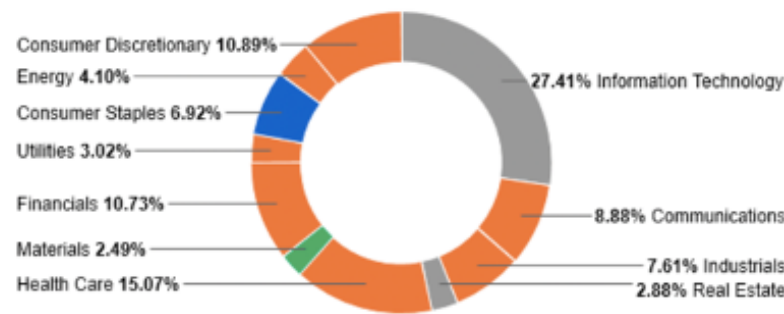
Fidelity divides the industrials sector into three main functions. The first includes “the manufacture and distribution of capital goods, including aerospace & defense, construction, engineering & building products, electrical equipment, and industrial machinery,” the second includes “the provision of commercial services and supplies, including printing, employment, environmental, and office services,” and the third includes “the provision of transportation services, including airlines, couriers, marine, road & rail, and transportation infrastructure.”



Manufacturing facilities in Artesia, Calif.



Fidelity further states that the industrial sector accounts for approximately 7.61 percent of the S&P 500 and has a market cap of \$4.66 trillion, both as of July 1, 2022. Within the sector, aerospace and defense is the largest industry with a market cap of \$743 billion, while transportation infrastructure is the smallest, with a market cap of \$20 billion. The 10 largest companies in this sector by market cap include United Parcel Service, Inc., Union Pacific Corporation, Raytheon Technologies Corporation, Honeywell International Inc., Deere & Company, Lockheed Martin Corporation, Caterpillar Inc., The Boeing Company, General Electric Company, and Automatic Data Processing, Inc., all of which have a market cap between \$90 billion and \$200 billion.



Market weightage by sector. (Credit: Fidelity)

In the last year, the sector has been underperforming compared to the S&P 500, with a net growth of -13.98 percent compared to the S&P500's -10.99 percent. This may be the result of the industrials sector's reliance on economic activity and the cyclical nature of its performance.

While the United States has faced a tumultuous business cycle, largely due to the onset of the COVID-19 pandemic in early 2020, Fidelity estimates that the country is still within the mid-cycle phase of the economic cycle but nonetheless approaching the late-cycle phase. This does not bode well for the industrials sector as it sees growth during the early-cycle phase and declines during late-cycle and recessions.

Supply chain's shortcomings

The changing economic landscape caused by the pandemic and recent surges in COVID-19 variants has had cascading impacts on the industrials sector. Supply chain issues have been on the rise with lockdowns in China further hindering the ability of companies to access both the finished parts and raw materials that they need. This has only been further complicated with the costs of raw materials and freight increasing with inflation while concurrent transportation issues in the U.S. have prevented deliveries from reaching their destinations. Sub-industries within this sector, especially electrical equipment, construction, transportation infrastructure, and engineering & building products, are severely impacted by the increased costs and delays caused by the supply chain issues.



Caterpillar, Inc., for example, noted that 50 percent of its orders from 2021 are backlogged due to their inability to receive the necessary components on time, while Boeing has had to pause the production of its 787 Dreamliners due to these supply chain issues, going as so far as to say that production will not begin to ramp up again until the supply chain stabilizes.

Analysts have been quick to point out that the current supply chain disruptions are rooted in structural shortcomings that have been a long time in the making. Beginning with low inventory levels championed under a regime of Just-in-Time inventory management systems that have persisted since its peak in the 1990s, a steady decrease in supplier pools, and the shift of manufacturing jobs to sources outside of the country, COVID-19 became the final factor causing many companies to reevaluate their inventory management systems.



Caterpillar, Inc., construction machinery

Proposed solutions include diversifying suppliers, increasing Just-in-Case inventory capacity, employing digital solutions to data analytics, and moving operations closer to consumers through greenfield and brownfield investments to combat large-scale network catastrophes. In relation to greenfield and brownfield investments, discussions around insourcing manufacturing back into the U.S. from Asia have become more and more common. A large issue facing the U.S. is the specialization of manufacturing among manufacturing leaders. Different parts of the world are more skilled at producing different products or subcomponents. For example, China, South Korea, and Japan manufacture a vast majority of electrical products, while European countries are far better equipped to produce precision tools.

In order to bring these jobs back into the country, which in turn would aid in decreasing supply chain disruptions, both companies and the government need to focus on creating an educated population able to break into these niches long dominated by foreign nations to create a self-sustaining manufacturing network. Ultimately, the end goal of these corporations is to bolster their operations while driving up competitiveness in a market that has had holes poked into its systemic integrity.



Acute labor shortages

Another major challenge that has plagued the industrials sector is a massive labor shortage. All of the industries within the sector are struggling to retain existing and find new employees to deliver the level of output needed to fulfill demand. The industrial sectors' workforce is undeniably aging. Manufacturing jobs are dominated by baby boomers who are soon reaching retirement age. Conversely, younger generations like millennials do not seem to be filling the vacancies at the same rate as they are created, leading to an impending labor collapse. Moreover, firms are becoming increasingly wary of a so-called "brain drain," in which baby boomers take not only their labor but their amassed knowledge with them as they retire. This loss of talent is compounded when considering that the rapid improvement of technology places pressure on existing workers to adopt newer techniques to increase efficiency; however, many are opting instead to retain their current practices or leave the industry completely to avoid extra training.

Finally, the sector has yet to recover from the pandemic's detrimental effects on tourism and commercial travel, which left thousands without jobs during the height of the disease and hurt revenues for many major players, thus exacerbating the gap between the current industrials workforce and where it must be in order to meet demand. Analysts estimate that the construction industry, for one, has over half a million vacancies that need to be filled, with some asserting that the figure is closer to 650,000.



A laid off construction worker.

In the short term, companies in this sector must reevaluate their hiring practices. This could include diversifying their target applicant pools by decreasing the weight of a college degree when judging an applicant's fitness for the position or employing newer recruitment methods (especially social networks) to reach broader groups. But it should not end here. Companies need to invest in the specialization of their workers while increasing benefits such as flexibility and better working conditions to retain their employees. In the long term, these companies should focus on creating leaders who can carry forward the sector while investing in automation to increase their resilience to labor contractions.

Shifting energy sources

With climate change forcing governments to take action on reducing emissions and decreasing reliance on fossil fuels, many companies within the industrials sector are diverting their cash into green energy sources.

A few companies have capitalized on this market and are making great headway into the future of renewable energies. For example, Hitachi and Petrofac have teamed up to develop wind energy infrastructure offshore. After seeing a steady compounding increase of 15 percent per year between 2015 and 2020, wind energy saw a production spike in 2021, leading both environmental and energy experts to feel optimistic about wind as an energy source to meet a large percentage of the nation's energy demands. Moreover, solar energy has garnered the attention of firms and consumers alike, with solar panels increasing in efficiency through research and testing and popularity with home installations on the rise by over 30 percent annually.

Finally, in light of the price hikes for oil caused by the Russia-Ukraine war, firms are becoming increasingly cognizant of the volatility of nonrenewable energy, making investments in green energies seem more appealing. The coming decade will likely see a more expansive implementation of renewable energies across industries.



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Change is inevitable

At a glance, it may seem as though the troubles for the industrial sector outweigh any positive outlooks.

Supply chain disruptions and rising gas prices are forcing companies to reevaluate the fundamentals of their operations, whether it be inventory management or energy acquisition, while labor shortages spell trouble for the sustainability of many of the sub-industries within the sector.

Change in this sector is necessary and inevitable, as the existing practices have been proven fallible over the last three years. However, in conquering these issues in the short run, companies will be able to set themselves up for greater resilience in the face of future market upheavals.



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