Industry Top Trends Update

Capital Goods

Supply risk overshadows order backlog

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What's changed?

Material cost inflation and supply chain challenges are increasing. Inflationary stress has intensified, putting margin pressure on weak positioned companies, while well positioned companies can still pass on most price increases. Component availability remains a constraint and has broadened testing the flexibility of production networks, sourcing power, leading to higher inventory levels (an increase in safety stock or unfinished goods).

Orders will moderate while backlogs continue to build. Reflecting increasing economic risks and as pent-up demand fades, we expect order intake to moderate in the second half as also indicated by steadily drop in the purchase manager index. Meanwhile, backlogs keep climbing with solid demand, price effects, and tight output. Increased interest rates could strain construction exposed capital goods companies over the medium term.

End market recovery and completed restructuring has led to positive rating actions in the first half. Rating actions materialized, mainly in the 'BB' category (five) and has been fueled by faster-than-expected end-market recovery, bringing operating performance to pre-COVID-19 levels or above, supporting deleveraging efforts and improving financial flexibility (in all cases). Rating actions have been supported by completed restructuring efforts (in three cases).

What to look out for?

Gas supply risk and rising energy costs might weigh on competitiveness on European issuers. Reduced gas supplies to Europe due to the Russia-Ukraine conflict would likely lead to energy cost disadvantages and tremendous pressure on local supply chains, disadvantaging companies with large supply chain, production, or customer exposure to Europe.

Lower-rated companies face refinancing risks. With rising interest rates, weak performing highly leveraged companies might be not able to refinance because the interest burden could become unsustainable even with a like-for-like refinancing.

Acquisitions aim to boost modest growth. Most companies will continue supplementing growth and corporate development with acquisitions and divesting in their industrial repositioning efforts.

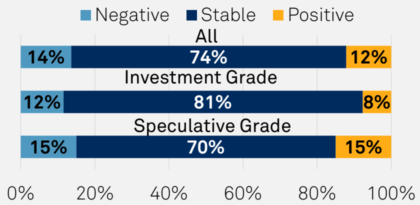
What if there's a recession?

A technical recession with a short duration should be digestible for most. The capital goods industry is typically a late-cycle mover and should benefit from its order backlog, which is elevated by higher pricing and soft order executions on component shortages.

A robust commodity and infrastructure sector might offset a chill in cyclical and discretionary sectors. Investment to diversify European energy resources and energy efficiency, as well as U.S. infrastructure bill and EU recovery funds, should provide a tailwind to capital goods activity over the next several years.

A recession from a gas shortage could be rough. Supply chains would face unprecedented challenges because gas is widely used in processing and production of components. It would also likely lead to intense cost pressure on high energy costs, high interest rates, and depressed demand.

Outlook Distribution



Ratings Statistics (YTD)*

	IG	SG	All
Ratings	26	40	66
Downgrades	0	0	0
Upgrades	1	6	7

Ratings data as of end-June 2022. * Year-to-date

Ratings Outlook Net Bias