

Research Analyst Deep Dive – Core Industrial Themes



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Industrials

“We are encouraged by the significant structural tailwinds supporting the Industrial sector, yet remain vigilant of the tail risks posed by the rising potential for a protracted energy crisis.”

The image of Industrials as a slow-moving, legacy asset class is a relic of the past. Driven by a surge in AI capital spending and a renewed appreciation for low obsolescence risk, the sector has moved from the sidelines to the spotlight. This edition of Research Analyst Deep Dive explores the fundamental strength of modern Industrials and the forces that are coming together to drive a bright future for the sector in an AI-powered physical world.

Sector Outlook

We believe the Industrials sector is entering a healthier period, underscored by broadening growth and short-cycle volume recovery. Several trends support this view:

- **Manufacturing PMI emerging from contraction.** The ISM Manufacturing PMI is emerging from a prolonged period of contraction, corroborating the well-established relationship with Fed easing. When paired with low channel inventories, this is a recipe for a classic cyclical rebound.
- **AI capital investment providing a multi-year runway.** Capital investment related to AI is driving growth across an array of industrial products and services within this ecosystem.
- **Defense budget tailwinds.** Escalating geopolitical tensions, the potential for an outsized defense budget, and a generational shift in the Pentagon’s spending priorities are driving robust growth across well-positioned small- and mid-cap defense technology companies.
- **Commercial aerospace OEMs ramping production.** Production is broadening following years of supply chain disruption and quality control shortfalls.

While stock prices may remain volatile in the short term, underlying demand for many industrial businesses appears steady and/or improving. While we’ve seen a strong appetite for cyclical stocks early in the year, the earnings torque embedded in many of these businesses can support continued upside, in our view.

Cyclical Reacceleration

The ISM Manufacturing PMI spent the last three years essentially in contractionary territory—one of the longest stretches of manufacturing weakness in decades. This has been a significant headwind for the general industrial complex. For months, investors have been awaiting an inflection given the historical linkages between monetary easing and PMI expansions. Headline data was generally uninspiring until recently.

The January 2026 PMI reading marked a key development, coming in at 52.6 (>50 indicates growth) and surging nearly five points from December’s 47.9. That was the first expansionary reading in 12 months and marked the highest level since 2022. Moreover, the leading indicator within this index—new orders—jumped to 57.1, the strongest level since early 2022. Additionally, the February report exhibited decent follow-through with the overall index remaining at 52.4 and new orders remaining at a strong 55.8. We shouldn’t declare victory yet; the recent SCOTUS tariff ruling and the energy shock following the joint attack on Iran have introduced fresh uncertainty. However, the underlying headline data is undeniably positive, and it’s validated by improving order activity at key short-cycle bellwethers.

Outlook: Short-cycle management teams have been reluctant to extrapolate a solid start to the year within their outlooks, which sets the table for outperformance should industrial reacceleration continue. We largely focus our short-cycle exposures on companies poised to benefit from a blend of secular and cyclical drivers, reducing risk in the event of cyclical retrenchment. A looming risk for short-cycle industrials is how companies react to the recent SCOTUS IEEPA tariff decision and the subsequent 15% global tariff implemented under Section 122 of the Trade Act of 1974. Another important watch item is the upcoming joint review of the USMCA trade pact in July. However, with midterm elections approaching, we see pressure on the administration to work quickly toward tariff clarity to avoid stalling the cyclical recovery that is already underway.

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Commercial Aerospace: Growth Handoff from Aftermarket to OEM

The commercial aircraft production cycle remains in its early innings, decoupled from its historically late-cycle roots due to numerous factors that have constrained the aircraft production recovery for multiple years. Production ramps at key OEMs are supported by multi-year backlogs, easing regulatory pressure on Boeing, and ongoing supply chain normalization.

An aging and highly utilized aircraft fleet has supported several years of outstanding growth in aftermarket parts demand. With valuations elevated coming into the year and aftermarket growth decelerating—albeit from very attractive rates—we see a more attractive risk/reward profile at OEM-focused aerospace suppliers.

Outlook: We see commercial aircraft builds eclipsing the prior peak (2019) by over 35% by the end of the decade. We seek exposure to OEM suppliers leveraged to the programs with the greatest relative upside to full production, as well as companies in advantageous market positions that should capture outsized pricing as demand for long-lead-time components and materials threatens to outstrip supply in future years.

AI Capex: Multi-Year Structural Tailwind

The unprecedented magnitude of the AI capex boom has created a far-reaching stimulus that is stretching well beyond the compute value chain and has buoyed numerous areas within the industrials sector. The 65%+ year-over-year capex growth forecast across the “Big Five” hyperscalers for 2026—paired with a shift to higher-performance compute and enabling technologies—is driving robust demand for thermal management, electrical and power generation equipment, as well as the specialty contracting services that integrate and install these critical systems at data centers.

Lengthy interconnection queues and a speed-to-market focus underpinning AI capex plans have shifted the power generation conversation toward behind-the-meter applications, whereas a year ago, the focus was largely on large power purchase agreements between hyperscalers and independent power producers. With heavy-frame gas turbine lead times stretching past four years, hyperscalers are increasingly embracing configurations that will rely on fuel cells, mobile gas turbines, reciprocating engines, and aeroderivative turbines to solve the time-to-power problem inherent in rapid data center deployment.

We have a preference in the portfolio for specialty contractors given: (1) the relative valuation discount versus AI capex component suppliers despite similar growth rates; (2) underappreciated pricing leverage enabled by the scarcity of skilled trade labor; and (3) in the unexpected event of a slowdown in AI capex, contractors that can shed labor with relative ease would fare disproportionately better than manufacturers facing overcapacity.

Outlook: The AI capex complex has a multi-year runway of growth ahead of it. Breakneck demand for critical systems within data centers is driving outsized growth at suppliers with the ability to offer customizable critical systems solutions with relatively attractive lead times. As data center technologies evolve and lead times normalize, we expect to see differentiated performance among equipment suppliers with global scale and best-of-breed solutions capable of keeping pace with the technical roadmap, enabling next-generation compute. Should an AI bellwether alter its technical roadmap in a meaningful way, we see the lowest risk of creative destruction within the specialty contractors.

Defense: Policy Tailwind Building

The Trump administration has voiced a strong intent to make generational investments in the U.S. military’s arsenal and warfighting capabilities. Simultaneously, EU NATO Allies are taking their security far more seriously, with defense spending ramping from roughly 1.5% of GDP over the prior decade to a 5% target by 2035. Both forces are combining to support an exceptional era of demand for allied defense contractors and suppliers. Additionally, a sizeable reconciliation bill could dramatically expand the U.S. defense budget, creating a very favorable backdrop for companies serving the highest-priority areas within the military. Areas such as hypersonic weapons, Golden Dome, military space and satellite infrastructure, unmanned and counter-unmanned systems, submarines, and restocking of strategic and tactical missiles are all poised to benefit. Additionally, the principles laid out in Secretary Hegseth’s “Arsenal of Freedom” speech support recapitalizing the small- and mid-cap military industrial complex—a deliberate shift away from relying on a handful of large defense primes for the majority of the military’s needs. Importantly, this view has been substantiated by a strong pace of new contract wins at smaller prime contractors in recent quarters.

Outlook: We see an attractive opportunity for small- and mid-cap defense technology companies to capture an increasing share of a growing defense budget as the Pentagon shifts budget priorities away from expensive legacy programs toward asymmetric warfare, next-generation deterrents, and achieving superiority in new domains. We focus on defense technology suppliers with affordable, de-risked solutions that shorten time-to-combat and stand out as more attractive options than expensive, built-to-suit offerings at traditional prime contractors with lengthier deployment timelines

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Bottom Line

We believe the industrial sector is ripe with trends that remain in the early innings of growth, particularly around a broader short-cycle industrial reacceleration, ramping commercial aircraft production, rising defense technology demand, and rapid AI data center deployment. Despite the recent outperformance of the sector, we see favorable risk/reward in Industrials relative to other sectors that face greater vulnerability to structural debates around AI disintermediation, potential government policy headwinds, and consumer affordability issues.

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