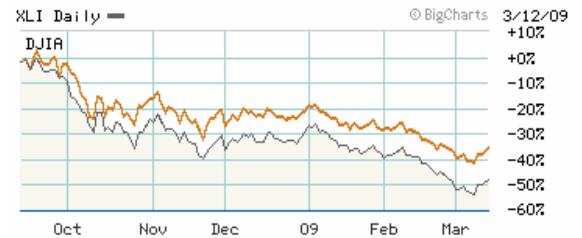


Industrials

Industrial Sector is a broad sector catering to divergent intermediate and end markets. This quarter's report focuses on three industries -- our open recommendations in parenthesis -- Construction and Mining Machinery (MTW, TEX, JOYG, and CAT); Engineering & Construction (JEC and FLR); Aerospace and Defense (GD, HON, BA and UTX). As a cyclical sector the correlation with the overall market trend is largely linear. The performance of XLI (sector ETF for Industrials) has been dragged down by GE in recent months although GE did bounce 40% since March 5th -- as of January 31, 2009 GE still carried a 12% weight in the ETF, 2X that of the second biggest holding (UTX at 6%).



Outlook: Construction and Mining Machinery

The companies in this segment are closely tied to the construction and infrastructure industries and the cyclical nature of commodity and energy prices. With very high fixed cost structures, the cyclical bottoms are very challenging for these companies. Revenue from after-market sales and services, wide geographic distribution, wide product portfolio and product differentiation and having greater flexibility on the fixed cost structure (in terms of having ability to outsource some of the capital intensive production facility) are good hedges in the cycle bottoms. With both the construction and commodity outlook looking very weak in 2009, the year is challenging for all the companies in this segment.

The growth in construction output, understandably, is expected to decline in 2009. IHS Global Insight, a leading economic forecasting firm, pegs 2009 global construction output growth at 1.8% Y/Y. While this level of growth is somewhat similar to that in 2008, it's the slowest growth since 2002 and far below the 4%-6% growth seen during the boom years. The mature markets are expected to see a sharper fall, somewhat offset by relatively sustained growth trends in the emerging markets. US construction output is projected to be one of the hardest hit areas. The projections vary widely. The Associated General Contractors of America (AGC), an apex US trade association representing the US commercial construction industry, projects a decline of 1% to 7% in 2009, while The Portland Cement Association (PCA), a trade association representing the cement companies in US and Canada pegs the fall at 7%. Global Insight, however, has a much stronger view on the fall in US construction output in 2009, estimating the decline 14%. The European 2009 construction outlook looks equally poor. Euroconstruct, a leading European construction business research group, assesses the European construction output to fall by 4.3% in 2009. This follows a decline of 2.5% in 2008. Euroconstruct projects that the growth will return (to) positive in 2010 with marginal growth of 0.4% followed by a gain of 2.2% in 2011. The sharper fall in the Western Europe is expected to be somewhat offset by growth in Poland and the Czech Republic. Among the other mature markets, Japan is expected to see a drop of 1.2% in 2009 with a return to growth in 2010. South Korea is expected to grow by 3.4% in 2009 with acceleration in 2010.

The largest contributors to growth, however, are expected to be the emerging markets, particularly Brazil, Russia, India and China. Global Insight forecasts strong growth in all four markets in 2009 -- Brazil (+3.6%), Russia (+9.0%), India (+8.4%) and China (+7.3%). One of the reasons these emerging countries could sustain investment in the construction sector, albeit at a slower rate versus the boom years, is the financial surpluses they have built up in the recent years because of higher commodity prices and exports. The other notable point here is the significant shares of these emerging markets in the total global play. In earlier recessionary periods these countries might have grown, but their shares in the total global play were relatively insignificant. Now these four countries alone are contributing ~ 18% of the total global construction output with China being the third largest construction market only after the US and Japan. Globally, the falling interest and inflation rates are positive for the industry. One of the growth drivers for the construction industry is the so called stimulus packages of several countries, of which significant parts are dedicated to infra-structure spending. The Obama administration's \$787 billion package has \$126 billion dedicated to 'Infrastructure and Science' and \$65 billion to 'Energy'. The majority of these two investment categories would see money flowing to construction and infrastructure. China had declared a 4 trillion yuan (\$586 billion) stimulus package in November 2008, almost half of which is dedicated to infrastructure. A second Chinese stimulus package is expected to be in the works. In the recent G-20 meeting, the US pressured the countries to take more similar actions to ensure that the US stimulus money does not percolate through to other economies. The Chinese stimulus money, on the other hand, is expected to be largely insulated to the US economy as the US-China trade is mostly one-way traffic. However, through the emerging countries some US goods might see their way to China. With this recovery plan, the Chinese domestic infrastructure construction market players would be the major beneficiaries. The emerging Asian countries and the commodity producing countries like Australia and Brazil, and capital goods producers like Germany and Japan are expected to benefit from the Chinese stimulus with their higher export share to China. Stimulus money, however, is not an immediate 'pass thru' into the industry. The entire money may not materialize into spending. At least three Republican Governors (from South Carolina, Louisiana and Texas) refused to take the stimulus money. The other issue is the timeline before the projects are 'shovel ready'.

Among our portfolio companies, Caterpillar (CAT) is significantly exposed to the construction and infrastructure segment. Caterpillar (CAT) would be facing strong competition from Komatsu in the now important Chinese market with regards to market share. In conjunction with the shrinking construction market, the sharply falling commodity prices would contribute further to CAT's problems. CAT expects a 25% decline in sales and a resultant decline in operating margins in 2009. However, in the long run we expect CAT to gain from its breadth of product line, strong brand equity, widespread distribution network and first-rate production facilities. Our portfolio company, Terex (TEX) is also a major player in the construction equipment industry. TEX is less capital intensive as it could successfully outsource much of its manufacturing activities and therefore, acquire the flexibility to right-size its operations as the end markets shrink. The company also has grown by acquisition to become the third largest construction equipment manufacturer with product lines in certain segments where its peers don't have any comparable offerings.

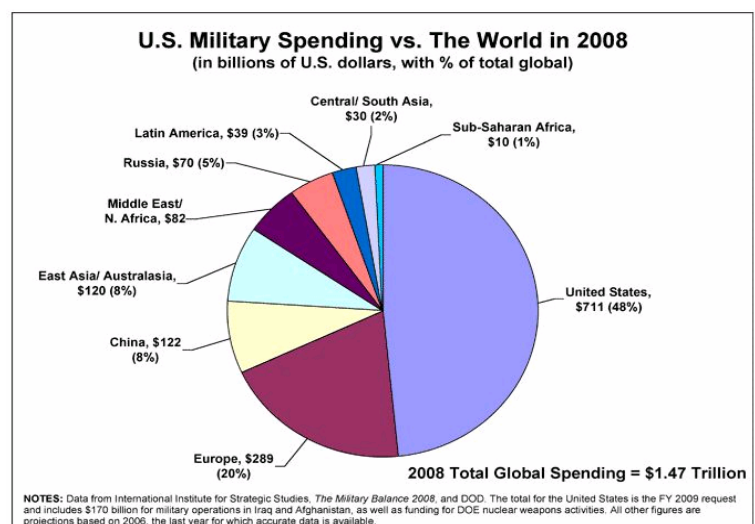
Another portfolio company of ours is Joy Global. JOYG is exposed largely to coal mining, followed by copper and iron ore -- the prices of all are back at 2004 levels. Despite facing challenges at the cycle bottom, JOYG has two primary hedges. The company's aftermarket sales and services business, about 65% of its current revenue, is largely insulated from the (essentially) cyclical nature of its original equipment sales. The after-market segment caters to an already large customer base. Secondly, JOYG's non-US revenue is more than half its total revenue. Despite obvious correlation between commodity price trends in different geographic segments, there is still significant price insulation, particularly in coal guzzling emerging economies of China, India etc. where JOYG now has expanded sales and service capacities.

Outlook: Engineering and Construction

The US engineering services industry is highly fragmented with the 50 largest firms accounting for more than one-third of the revenue. This industry includes large companies such as Jacobs Engineering Group (JEC) and URS Corporation, and the engineering divisions of large construction companies like Fluor Corporation (FLR) and Bechtel and numerous smaller players. The engineering and construction industry is also tied to the construction, infrastructure and commodity cycles. Apart from the cyclicity of business, the biggest risk in this industry is the risk of cost over-run as most of the competitive bidding contracts are fixed-cost contracts. Our portfolio company, Jacobs Engineering (JEC) has successfully hedged this risk. The relationship-based business model is core to JEC's distinct competitive advantage. In a weakening economic situation this is a hedge against both significant revenue and margin erosion. A better understanding of the customers' business, ability to offer products and services across the entire spectrum and life cycle of projects and therefore, to get a higher wallet share, offer better ROI by bundling the services. The ability to get the on-going maintenance business is also the other benefit the company gets with this business model. This mutually supplements the customers' ability to get a better ROI. More than two-thirds of revenue at JEC comes from the preferred relationships. The transactional projects, on the other hand, are lump sum turnkey projects awarded to vendors through bidding or negotiations. Transactional projects are typically big revenue projects but lumpy and pose significant revenue volatility risk. The transactional projects are also fixed price projects. The preferred relationship projects, on the other hand, are cost reimbursable projects where the price is pegged at a *reimbursable cost plus* basis. In addition to the company's ability to hedge against any cost over-run, it gives certainty in terms of margin. Moreover, these engagements are with customers who are dealing with the company on a long-term continuous basis. The revenue is evenly spread and significantly base loaded *i.e.* contributed by larger number of smaller projects. As opposed to JEC's, the industry revenue mix in terms of preferred relationship *versus* transactional projects is almost inversely constructed with the bulk of the revenue being contributed by the transactional projects. The correlation between the revenue contributions by the preferred relationships and cost reimbursable contracts justifies the strength of this business model and how it creates a competitive advantage for JEC. 86% of JEC's FY08 revenue came from cost reimbursable contracts. Our other portfolio company, Fluor Corp. (FLR), however, runs the risks of cost over-run on one-fourth of its contracts. However, the company's double-digit backlog is a good near-term revenue buffer. FLR also has ~ 60% of its revenue exposure to the oil and natural gas segments which are seeing a significant capex cut by the end customers. FLR is expected to have a bigger play in the Iraq war zone logistics support with KBR's near monopoly going as the LOGCAP III expires and a competitive-bidding-only LOGCAP IV starts. FLR's exposure to the nuclear power sector is expected to be a growth area with an increased focus on clean energy. FLR, presently, has a contract to provide engineering and construction services for two new nuclear reactors proposed to be constructed in Bay City, TX.

Outlook: Aerospace and Defense

The aerospace and defense industry is relatively insulated from recessionary trends and less cyclical. However, the US aerospace and defense sector may be facing leaner times ahead with the election of the new President, Iraq troop pull-outs, possible higher oversight on defense budget spending and a significant deficit. These drivers may well impact U.S. defense programs and associated budgets in 2010 and beyond. In 2008, defense expenditures of US accounted for 4% of the GDP. The 2010 \$3.55 trillion US budget proposal includes \$533 billion for the Department of Defense top-line, a 4% increase over the fiscal 2009 level. The budget proposal also includes \$75.5 billion in supplemental funding for fiscal 2009 and \$130 billion for fiscal 2010 for the wars in Iraq and Afghanistan. NASA funding includes \$18.7 billion and an investment of ~ \$2 billion in other aerospace-related areas. Our portfolio companies in this sector include General Dynamics (GD), Honeywell International (HON), Boeing Company (BA), and United Technologies (UTX). General Dynamics (GD) product lines are critical components to the US defense backbone. GD products (*e.g.* the M1Abrams, the army's mainstay battle tank and Virginia class nuclear submarines) are mission critical components. US defense sales account for ~ 67% of GD revenues. GD ranks # 1 (out of 250 stocks) according to our 155-variable computer model in this week's sector report. *See the attached Excel file (sheet 2).*



Though the company's near term visibility is clear with a \$22 billion order backlog, the expected slowing down in defense spending may impact revenue in the mid-term. Moreover, future blockbuster products (e.g. DDG-1000 destroyer) run the risk of getting axed by the new administration. In addition, Gulfstream business jets which account for 18% of the company's business would be impacted adversely. The demand for business jets spiked during the last three years and came to a stand-still during the current recession.

We are currently overweight in this sector with 16 open recommendations. Our industry over-weights are in Aerospace and Defense & Construction and Farm Machinery. NSC, FLR, BA, PH and GD were the higher performing stocks on our computer model from the current open recommendations in the sector.

			REV	EPS	ROE	PRICE	E'PRISE	% OF LT	P/E	
		MKT	5 YR HS	5 YR HS	5 YR	TO	VAL TO	DEBT:	FWD	
COMPANY NAME	TICKER	CAP	GR RAT	GR RAT	AVG	BOOK	EBITDA	CAPITAL	4 QR	INDUSTRY
UNITED TECH	UTX	39089	13.0%	16.0%	22.2%	2.4	5.35	37.0%	9.7	AEROSPACE/DEF
BOEING	BA	24792	6.0%	29.0%	39.5%	NM	4.91	NM	6.7	AEROSPACE/DEF
HONEYWELL	HON	19653	10.0%	20.0%	21.1%	2.8	5.11	45.0%	8.8	AEROSPACE/DEF
GENERAL DYN	GD	15224	12.0%	19.0%	19.7%	1.5	4.39	24.0%	6.4	AEROSPACE/DEF
FEDEX	FDX	12499	10.0%	11.0%	13.9%	0.8	2.53	6.0%	11.7	AIRFRGHT & LOG
SKYWEST	SKYW	655	31.0%	14.0%	12.1%	0.5	3.57	57.0%	6.9	AIRLINES
FLUOR	FLR	6698	20.0%	33.0%	20.4%	2.4	3.95	1.0%	9.8	CONSTR & ENG
JACOBS ENG	JEC	4883	23.0%	31.0%	16.3%	2.0	5.48	2.0%	11.3	CONSTR & ENG
EMERSON ELE	EMR	20596	12.0%	20.0%	22.8%	2.4	5.41	28.0%	10.6	ELEC COMPONENT
CATERPILLAR	CAT	15937	14.0%	21.0%	40.9%	2.6	6.36	79.0%	12.1	MACH CONS/FARM
JOY GLOBAL	JOYG	2123	20.0%	46.0%	37.1%	3.6	3.86	50.0%	6.4	MACH CONS/FARM
TEREX	TEX	910	20.0%	51.0%	21.9%	0.5	0.73	45.0%	14.8	MACH CONS/FARM
MANITOWOC	MTW	506	27.0%	86.0%	16.7%	0.3	5.24	64.0%	3.5	MACH CONS/FARM
PARKER-HAN	PH	4910	13.0%	24.0%	16.9%	1.0	4.54	29.0%	10.6	MACH INDUSTRIAL
NRFLK STHRN	NSC	11493	9.0%	20.0%	15.1%	1.2	4.45	39.0%	7.9	RAILROADS
WESCO INT'L	WCC	673	14.0%	37.0%	30.2%	0.9	4.56	53.0%	4.9	TRADE & DISTRIB

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March 24: Staples-100

April 06: Energy-200

April 13: S&P-500

April 20: Dividends-200

May 04: Healthcare-200

May 11: ADR-200

May 18: Financials-200

June 08: Short Interest-1000

June 15: Russell-1000

June 22: Discretionary-300

July 06: Technology-200

July 13: Materials-100

July 20: Industrials-250

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