Pick the right stocks in the cyclical upswing

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In the year to date, the consumer discretionary index, which includes a number of retailers, is up about 32 per cent, compared with a 12.9 per cent rise in the S&P/ASX 200 Index. **Photo: Rob Homer**

Bina Brown

Investors keen to rotate from expensive high-yield stocks to cheaper cyclicals will need to choose carefully, following a strong run in many traditionally cyclical sectors.

Buoyed by the prospect of a pick-up in global economies including the United States and China, sectors including industrials and energy have had a good run for much of 2013.

At home, signs of a recovery in the housing market have seen stocks in the consumer discretionary sector significantly outperform the broader market since the start of the year.

“The cyclical rotation is happening but the market is forward looking and a lot of the cyclical stocks have run quite hard over the last few months,” says UBS equity strategist David Cassidy.

“Unlike the tailwind that got behind the high-yield stocks in recent times, the outlook for cyclical stocks is not sufficiently strong to lift all boats,” he says.

That makes individual stock selection and timing as important as ever.

Cassidy says that with the domestic economy still quite patchy, the investor’s focus needs to be on picking good quality companies at a good price across all sectors that can grow independently of the business cycle.

The worm turns

Performance of cyclical v defensive sectors*

	Past month	Past 12 months
Industrials	7.2%	11.5%
Energy	6.2%	13.5%
Consumer disc	5.5%	32.9%
IT	3.9%	22.8%
Financial ex REITs	3.7%	24.4%
Health care	2.8%	19.1%
S&P/ASX 200	2.7%	12.9%
Consumer staples	2.1%	12.2%
Materials	1.8%	-5.9%
Utilities	-1.4%	2.0%
A-REITs	-2.2%	3.1%
Telecomms	-4.8%	12.3%

* As at Sep 2012 SOURCE: BELL DIRECT

It is a view shared by fund managers such as John Abernethy, chief investment officer at Clime Investment Management.

"It is much better to focus on quality and value. Cyclical buying anticipates recovery. It also suggests central banks will lift cash rates very quickly. That is not likely and neither is strong economic growth," he says.

Recovery uncertain

Abernethy attributes the recent rise in the market to a response to the quantitative easing programs around the world, but says the positive moves in share prices are anticipating a recovery that is as yet uncertain.

"This recovery must move from its early chaotic stages to a more sustainable level supported by sound economic policy and renewed confidence among both consumers and business," he says.

While sentiment may warrant a move away from high-yielding defensive stocks to those that grow in line with the economy, more proof is needed that profits are on the increase before there is any wholesale shift, Prime Value Asset Management portfolio manager S.T. Wong.

"Money has been repositioning away from defensives to cyclicals on the belief that the election would be positive for the economy and that things were improving, but it is hard to make a case that things have turned," he says.

According to CommSec chief economist Craig James, consumer and business confidence tends to lift approaching elections and shortly after, particularly when a clear election result is likely.

The main reason for the lift in sentiment is removal of uncertainty and a perception that the economy will get back to normal with consumers and businesses spending, investing and employing again, he says.

Bell Direct equities analyst Julia Lee says that provided the pick-up in consumer and business sentiment continues and translates to higher earnings, then buying opportunities among the cyclicals should continue to emerge.

But the cyclical recovery has been a long time coming and a lot of prices have been pushed up in anticipation, she says.

In the year to date, the consumer discretionary index, which includes a number of retailers, is up about 32 per cent, compared to a 12.9 per cent rise in the ASX 200 Index. Industrials are up 11.5 per cent and energy 13.5 per cent.

Fletcher Building and Adelaide Brighton, which fall within the construction materials subsector, are up 25.6 per cent and 14.6 per cent respectively this year.

Not all cyclicals created equal

"But not all cyclicals are created equal and we can expect to see sectors perform differently as the cycle changes," she says.

Lee attributes part of the shift from defensives to cyclicals to the end of the interest-rate-cutting cycle, which means less demand for the higher-yielding, defensive stocks.

Record-low interest rates are helping to fuel the recovery in housing, which implies that businesses with exposure to household goods, white goods, and building material companies should benefit first, she says.

Indeed, several stocks have done exceptionally well on the back of a pick-up in housing starts and finance including JB Hi Fi, up 95 per cent in the year to date, and Harvey Norman, up 67 per cent.

"The clothing retailers, also a cyclical industry, are still doing it pretty tough," says Lee.

She says many clothing retailers continue to struggle with structural issues, including people shopping overseas online for less.

For others the impact of lower interest rates is yet to translate to higher consumer spending.

"With consumer sentiment and business sentiment and house prices rising, the next few months should be crucial for retailers. When people's house prices rise they generally feel wealthier and more secure and generally that leads to more spending," Lee says.

Middletons Securities director Nick Loxton says that while investors are right to be looking at cyclical stocks it shouldn't be a switch at "any old price".

"It is the right thing to be looking for cyclical stocks that will benefit from a pick-up in economic growth, but the key is to have an idea of what you want to be exposed to. Hopefully there will be some bad news that allows an entry point for some of them," he says.

"If global economies continue to recover and the dollar continues to fall then there are companies that will do well, but it may not be a straight switch from defensives to cyclicals."

Loxton says it is difficult to ignore a number of structural changes within the economy that could impact on a cyclical recovery.

High savings rate

One of those is the high savings rate, which some believe could be a structural change flowing from the Global Financial Crisis.

"We have a generation effected by the GFC; they are saving and that could last for many years," he says.

Loxton says contractors and engineers would ordinarily start to pick up at the start of a growth cycle, but are actually coming off a cycle that was not normal, based on the large capital expenditure of the resource industry, which has arguably peaked and is expected to fall considerably over the next few years.

"Traditional media and the automotive industry are usually considered cyclical, but they have structural changes under way, so investors need to be very careful."

Within the property sector, Loxton says he will be watching those developers acting on the changes occurring within the population.

"There is a shortage of dwellings and as the population ages many people will be looking for dwellings close to facilities. A change of government gives more certainty to developers and this could be an interesting space. If they pick up there will be the suppliers, such as bathroom fixtures, paint, plaster board etc," says Loxton.

In short, Loxton thinks cyclicals are "well worth looking at".

"But be sure you understand your view on 'the cycle', the earnings reliability and of course the price."

Prime Asset Value's S.T.Wong says that though improvement in global economies underpins the prospect of finding value among cyclical stocks, several factors are working against a turning point for the overall market, which has the potential to be volatile for another 12 months.

The backdrop to any movement in the market is the significant distortion caused by the monetary environment globally, which is creating more unusual activity, he says.

"One could make the argument that there is value in the cyclicals. Primarily when you look at the economy and the more cyclical sectors it is pretty soft, which means potentially valuations in the sectors are quite attractive.

"But many of the drivers that are going to cause a turning point and therefore a move towards cyclicals are still significantly different."

Signs that lower interest rates are starting to breathe life into the building and construction and housing markets are still too tentative to say the cycle has turned, he says.

Similarly the retail, consumer and transport sectors, which could also benefit from lower rates, are facing the headwind of soft employment data.

Take-home pay not rising

"We think the take-home pay packets of consumers in Australia are not really rising in a significant way. We are seeing some short-term positive sentiment from the election and the housing market improving but there are a number of headwinds consumers still need to deal with."

Wong says companies affected by the currency have the potential to benefit from a weakening in the Australian dollar against the US dollar, but again the signs of this happening are still quite tentative.

Companies that stand to benefit include those engaged in tourism and education as well as exporters.

Then there is the resource sector, which has the potential to do well as China and other world economies improve, he says.

"If you look at some of the resources in the diversified space such as BHP and Rio out to one and two years, there is potentially value to be found."

It is the potential for sustainable earnings in the resource sector that has the research group and fund manager Lincoln pushing the case for select stocks.

"There is more of a case for cyclicals now than there has been for the past 12 months; but you can't just go out and buy a penny dreadful and expect it to double in price," says Lincoln chief executive Elio D'Amato.

"We got a lot of confidence from the recent reporting season, especially from the big resource companies including BHP, Rio and Fortescue, that they are very much engaging in good practice and it is not just growth for growth sake. They have pulled back a lot of capital expenditure which might impact on earnings return but the earnings they achieve will be better quality," he says.

D'Amato says the renewed focus on improving the production profile of the existing good resources rather than paying above the odds to extract resources from a lower grade was something the sector needed to do.

"Unfortunately when things get a bit excited and there has been too much drink, voices get raised and we all dance a little harder and that was what occurred in the mining sector.

"It became very hard to extract anything out of the ground at any margins of profitability, either because there were problems with workers costing too much or engineering firms charging a bomb to drill a home and commodity prices going through tough time.

"We saw capitulation in the sector as expected. Now there has been a good shakedown with models looking better than in the past. We are starting to feel a lot more comfortable with it as a sector than what we did 12 months ago."

Difficult to find value

Morningstar's head of equities, Andrew Doherty, says that despite the market anticipating an improvement in earnings, the outlook for many sectors remains challenging. The recent strength in the market, including among the cyclicals, has made it particularly difficult to find value across the broader market, he says.

An exception may be mining services companies sold down heavily as commodity prices retreated; they offer some prospects in a cyclical recovery, although they also carry more risk.

Companies including Transfield Services and Orica are more tied to increased production than the impact of commodity prices stemming from the broader mining sector, Doherty says.

Given the dearth of buying opportunities, Doherty says investors should stay focused on the defensive sectors, including consumer staples, health care and utilities, rather than make a shift at this point.

"The benefit there is the greater downside protection. If there is a downturn in the market then companies in these sectors will hold up better than others and along the way investors will get a better yield."

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