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Market Comment

Expensive defensives: what are the alternatives?

Summary

Until the summer of this year, there was clear equity market leadership by a group of companies that have one thing in common: non-cyclical growth. I have asked myself for some time whether this is likely to continue or whether there is reason to assume a change in leadership.

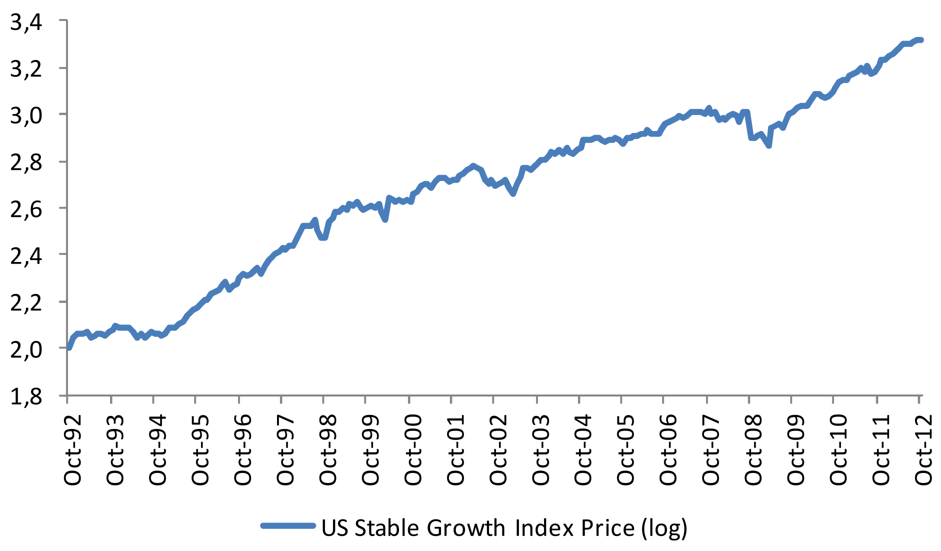
The following analysis shows that this "stable growth" group of companies has become very expensive, particularly relative to cyclical stocks. Also, price trends for many of the former leaders have started to struggle. As a consequence, the risk/reward profile for the stable growth segment has deteriorated.

On the other hand, while "quality" and "yield" as themes have attracted attention in public communication for some time now, these factors are not yet anywhere near overvalued extremes. Therefore, "quality yield" stocks may be a reasonable compromise for investors who do not want to invest in expensive former leaders but do not have sufficient trust in the global economy to invest in cyclical areas. The S&P US dividend aristocrats index is a good proxy for the "quality yield" theme.

Expensive defensives

During the summer, I selected a group of companies based two factors: intact primary uptrends and relatively stable earnings growth patterns. As secondary factors, data quality and diversification across sectors were taken into account. For the US, I selected 40 companies. These are shown in the table 1.

Chart 1: US stable growth leaders: price index (log)



Source: Bloomberg, MarketCybernetics.de

Table 1: US "stable growth" leaders (as of July 2012)

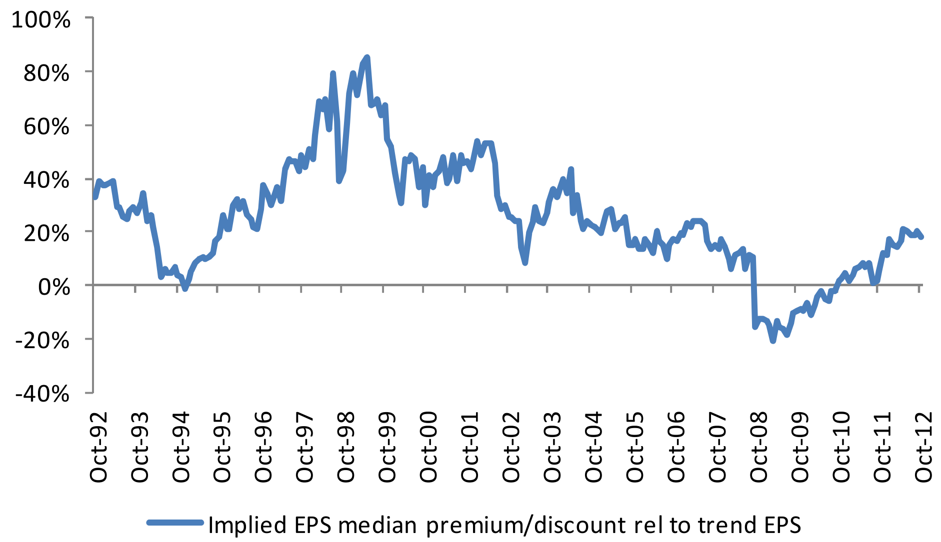
Name	Sector	Name	Sector
Ecolab	Chemicals	TJX	Retail
FMC	Chemicals	Costco	Retail
PPG	Chemicals	Walmart	Retail
Sherwin-Williams	Chemicals	Brown-Forman	Beverages
Cintas	Industrials	Coca-Cola	Beverages
Coach	Textiles/Luxury	Hershey	Food
Darden	Restaurants	Pepsi	Beverages
Nike	Textiles/Luxury	McCormick	Food
VF Corp	Textiles/Luxury	Genuine Parts	Distributors
Chipotle	Restaurants	Kimberly-Clark	Household Products
McDonald's	Restaurants	Estee Lauder	Personal Products
Starbucks	Restaurants	Biogen	Pharma/Biotech
Comcast	Media	Abbott Labs	Pharma/Biotech
Walt Disney	Media	Perrigo	Pharma/Biotech
Dollar Tree	Retail	Total System Services	Technology
Family Dollar Stores	Retail	Apple	Technology
Bed Bath &Beyond	Retail	AT&T	Telecom
Home Depot	Retail	Verizon	Telecom
O'Reilly Automotive	Retail	Consolidated Edison	Utilities
Ross Stores	Retail	Southern Co	Utilities

Source: MarketCybernetics.de

Chart 1 shows the average price performance of this group of companies. Prices have been in a strong uptrend. While this trend remains intact so far, a stock-by-stock analysis shows that many of these stocks are losing momentum and trend consistency; some even have clearly broken their trends.

Chart 2 shows the valuation of this sample of stable growth stocks. Like most other segments of the market, they started the bull market in 2009 from very cheap levels, where the market-implied future trend EPS were significantly below historic trend EPS (i.e. the market was discounting a severe structural downshift in trend earnings).

Chart 2: Median market-implied EPS relative to trend EPS for US stable growth leaders



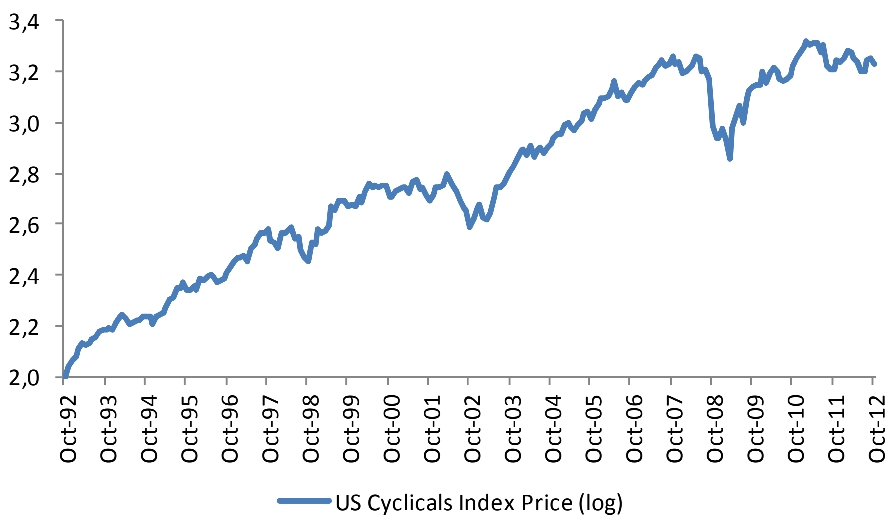
Source: Bloomberg, MarketCybernetics.de

Today, this discount has been transformed into a premium of about 20%. Relative to its own history and excluding the bubble 1996-1998, this is at the upper limit of the range.

Cyclicals with "normalization bias"

While stable growth stocks reached new highs, more cyclical companies overall have been struggling. Chart 3 shows the price index for a sample of cyclical stocks. The criteria for selection in July 2012 were a cyclical earnings profile and the lack of a clear primary uptrend. Overall, cyclical stocks have been and continue to be in a trendless "transition".

Chart 3: US cyclical stocks: price index (log)



Source: Bloomberg, MarketCybernetics.de

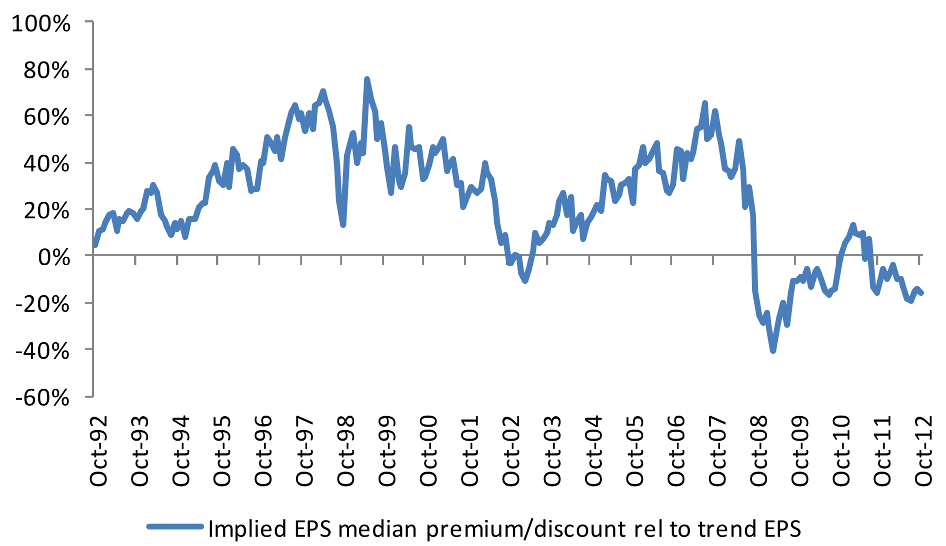
The following 39 stocks were selected.

Table 2: US cyclical stocks

Name	Sector	Name	Sector
Halliburton	Energy	Dover	Capital Goods
Schlumberger	Energy	Eaton	Capital Goods
Valero	Energy	Ingersoll Rand	Capital Goods
Hess	Energy	Illinois Tool Works	Capital Goods
Apache	Energy	Joy Global	Capital Goods
DuPont	Chemicals	Paccar	Capital Goods
Dow Chemical	Chemicals	Fedex	Air Freight
Eastman Chemical	Chemicals	UPS	Air Freight
Alcoa	Metals	Goodyear	Automobiles & Supplies
Cliffs Natural Res.	Metals	Johnson Controls	Automobiles & Supplies
Freeport-McMoran	Metals	Southwest Airlines	Airlines
Nucor	Metals	Cisco	Technology
Titanium Metals	Metals	KLA-Tencor	Technology
US Steel	Metals	Intel	Technology
Fluor	Capital Goods	Broadcom	Technology
Emerson Elelctric	Capital Goods	LSI	Technology
Rockwell Automation	Capital Goods	Texas Instruments	Technology
Caterpillar	Capital Goods	Nvidia	Technology
Cummins	Capital Goods	Xilinx	Technology
Deere	Capital Goods		

Source: MarketCybernetics.de

Chart 4: Median market-implied EPS relative to trend EPS for US cyclical stocks

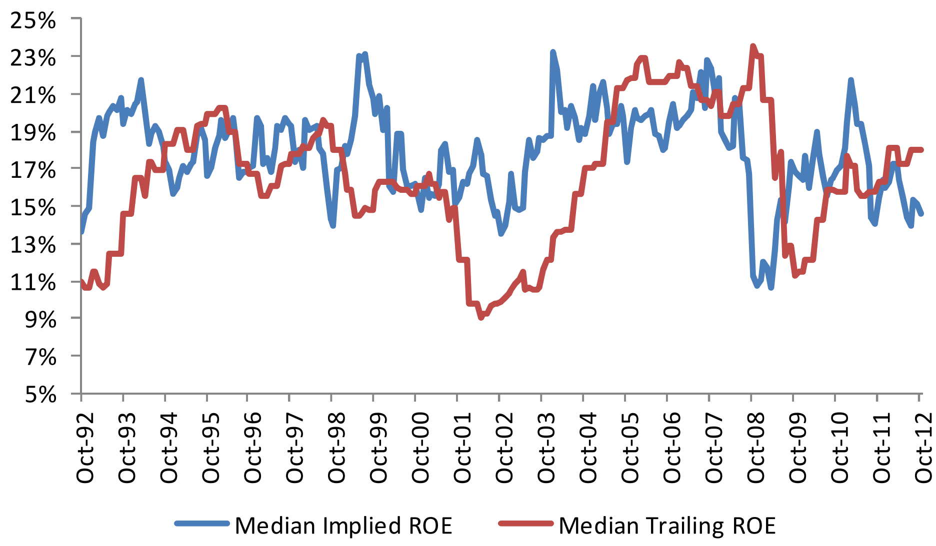


Source: Bloomberg, MarketCybernetics.de

Since peaking in February 2011, valuations of cyclical stocks have diverged significantly from those in the stable growth segment (chart 4). While the former have continued to increase, cyclical stocks have become cheaper, pricing in a downward shift in future trend EPS by 16% currently.

Another way of looking at this is shown in chart 5 which shows the market-implied future ROE compared to trailing ROE.

Chart 5: Market-implied future ROE compared to trailing ROE for US cyclical stocks



Source: Bloomberg, MarketCybernetics.de

There is a positive gap between trailing ROE and discounted ROE, meaning the market already prices in a fall in profits. MarketCybernetics calls this a "normalization bias", leading to an asymmetric risk/return profile. If earnings do fall, there is a buffer because part of this is already priced in. On the other hand, if earnings do not fall, there is catch-up potential. Also noteworthy is the fact that excluding the panic low at the bottom of the financial crisis, market-implied ROE is at the lower end of the historical range.

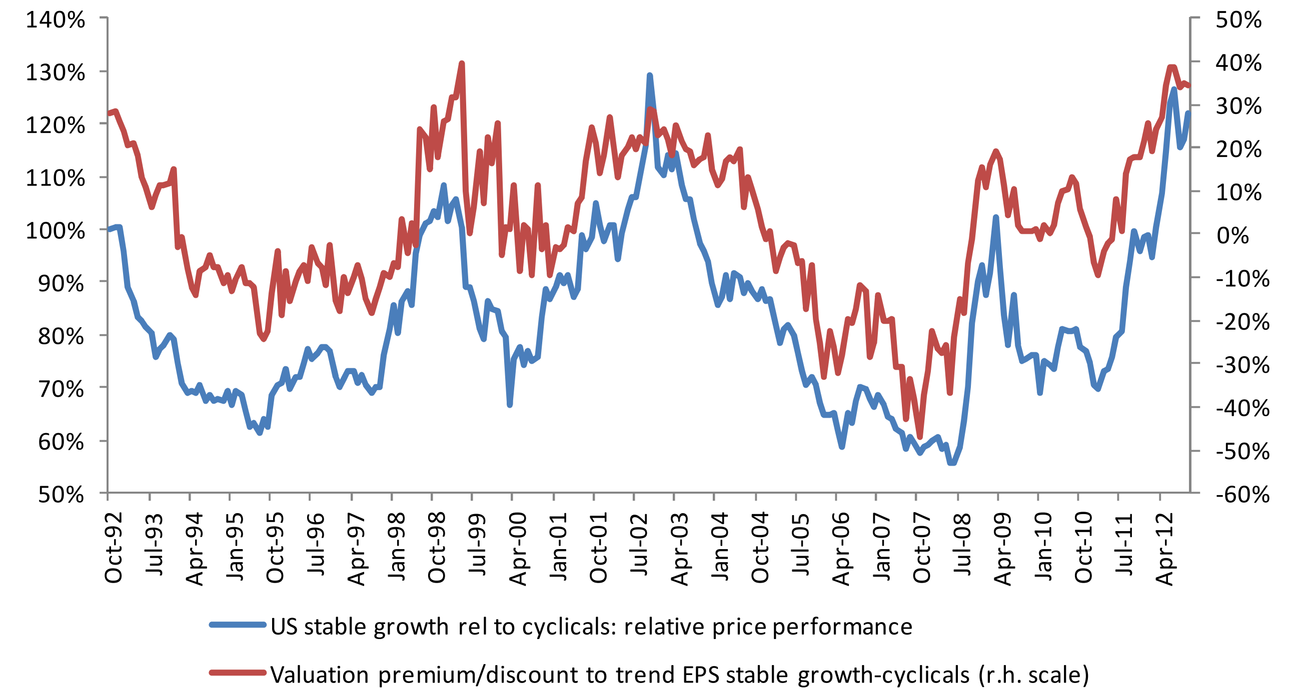
Stable growth relative to cyclicals

Given the divergence in valuations, it is instructive to compare these two groups of companies directly. Chart 6 shows the relative price performance and the relative valuations as measured by the difference in the valuation premium/discount relative to trend EPS (i.e. chart 2 minus chart 4).

Chart 6 shows that stable growth stocks appear to be very expensive relative to cyclical stocks. The drivers of this are clear: Widespread concern about the global economy on the one hand (negative for cyclicals) and extremely low interest rates and a perceived lack of growth opportunities leading to a premium for perceived stable growth stocks on the other hand.

Nobody knows how the economy will develop in the future; however, given current relative valuations, much of this theme appears to be priced in already. Personally, I think that high-quality cyclical stocks are attractive relative to the segment of stable growth stocks.

Chart 6: US stable growth stocks relative to US cyclical stocks: price performance and valuations

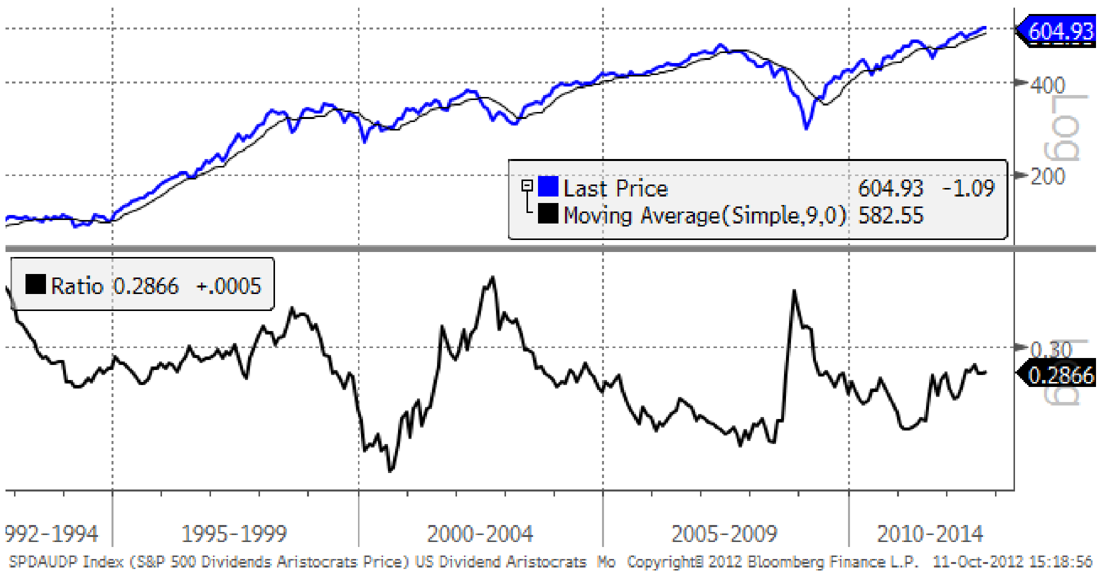


Source: Bloomberg, MarketCybernetics.de

High-quality stocks: a reasonable compromise

Given the uncertainties that worry many investors and the extremely low interest rates, “quality yield” has for some time now been a growing theme in the market’s public communication. A good proxy for this theme is the S&P US dividend aristocrats index. Absolute and relative price performance is shown in chart 7.

Chart 7: S&P US dividend aristocrats index absolute and relative to equal-weighted S&P 500

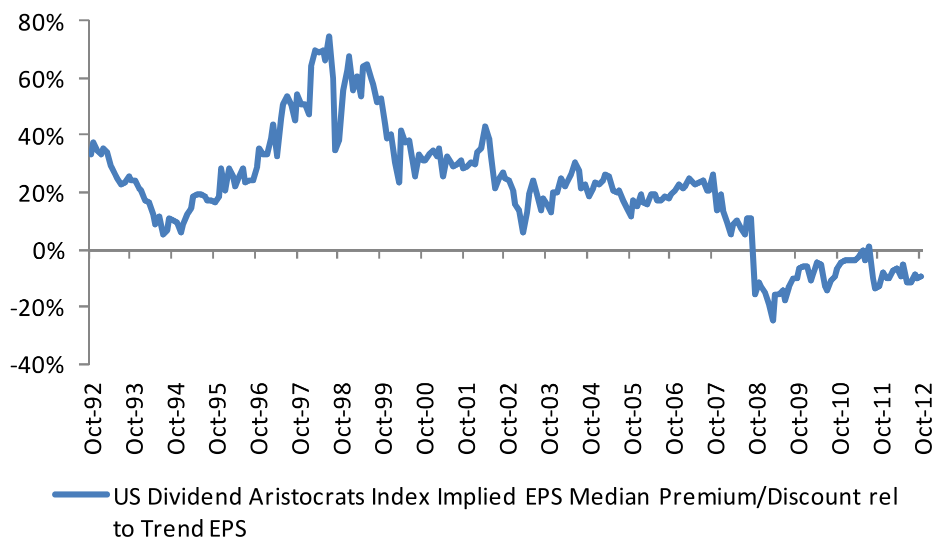


Source: Bloomberg

The dividend aristocrats index is in an intact uptrend. Historically, the pattern of relative performance was straightforward: Outperformance during bear markets due to the high-quality aspect, underperformance during bull markets. In the most recent cycle, relative performance troughed in February 2011 (the same time that the valuations of cyclical stocks peaked). It is now in the middle of the historic range.

Chart 8 shows the average market-implied valuation of the dividend aristocrats index components (excluding financial stocks).

Chart 8: Median market-implied EPS relative to trend EPS for S&P US dividend aristocrats ex financials



Source: Bloomberg, MarketCybernetics.de

While there is a wide spread in valuations between the individual index constituents, overall valuations look more similar to the cyclical stocks than to the stable growth segment, discounting a fall in future trend EPS.

The dividend aristocrats index is well diversified across sectors. It contains stocks both from the stable growth and from the cyclical areas. The common denominator is the quality of the companies, as defined by the historic track record of increasing dividends every year over a long-term period (generally at least 25 years).

So, while the dividend aristocrats do not have a significantly superior dividend yield relative to the market, they have a track record of increasing the dividend. In a yield-starved world, this combination of quality and dividend growth is likely to be attractive to many investors. Valuations show that this potential attraction has not yet led to excessive optimism and overvaluations. Based on this analysis, the quality theme remains a reasonable core investment.

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