

# Shopping for cyclicals

Investors should start hunting for industries that may rebound quickly when the economy recovers, writes *Eddy Wong*

Various indicators suggest that the global economy is in full recession – a near-rock bottom that will cause long-lasting financial effects. Industrial production worldwide has ground to a halt, unemployment is skyrocketing and economists say the worst has yet to come.

The silver lining is that each stage of the economic cycle comes with its own set of investment opportunities – and being in a full recession means the economy is getting closer to a recovery.

Regional stock markets have already factored in a great deal of pessimism – the price-to-book ratios of Asia excluding Japan is trading near a five-year low. Governments around the world have invested in huge stimulus packages since the fourth quarter of 2008 and the effects will surface in the coming months. For example, China's latest economic data indicates signs of recovery across all industries except exports. Financial stocks are also rebounding, with JPMorgan Chase reporting better-than-expected net profit in the first quarter. Improving earnings figures and the aggressive Troubled Asset Relief Programme by the U.S. government will help banks rebuild their balance sheet.

Given the financial cycle runs ahead of the economic cycle by three to six months, investors should consider buying cyclical stocks to prepare for an eventual recovery because such companies are sensitive to economic changes and their revenues will significantly improve as the economy gets better.

**Table 1: Performance of major sectors in 2008**

Sector	2008 returns	Nature of sector
Healthcare	-22.9%	Defensive
Consumers	-24.9%	Defensive
Utilities	-31.4%	Defensive
Telecommunication	-35.6%	Defensive
Energy	-39.4%	Cyclical
Consumer discretionary	-42.8%	Cyclical
Industrial	-44.2%	Cyclical
Information technology	-44.4%	Cyclical
Materials	-51.0%	Cyclical
Financials	-55.6%	Cyclical

Source: MSCI, Standard and Poor's, iFAST Financial, returns in US\$ terms

Defensive sectors are industries whose earnings do not highly correlate with the economic cycle and can therefore better weather a financial rollercoaster. Telecoms, utilities services and consumer staples, such as food and shampoo manufacturers, all belong to this category (*see table 1*).

Last year, the cyclical financial services industry recorded a 55.6 percent decline in returns compared to its 2007 figures. In contrast, the healthcare industry, a defensive sector, saw only a year-on-year decline of 22.9 percent.

As the global economy braces for a rebound, cyclical sectors such as energy and materials may benefit from increased infrastructure spending and quantitative easing efforts to boost money supply such as re-purchasing government bonds and cutting interest rates to zero, as a larger money supply is followed by higher inflation, which

will prop up the prices of raw materials. In the high-tech sector, recent declines coupled with improved sentiment on technology stocks indicate that a rebound may soon follow.

In comparison, defensive sectors may start to underperform when the worst passes. For example, after hitting the bottom in September 2002 following the technology bubble burst, global markets took three years to gradually recover. During this period, the MSCI World Index rose at an annualized rate of 21 percent, while the MSCI Health Care Index climbed just 13 percent.

Now is the time for investors to overweight cyclical industries.

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