minackadvisors

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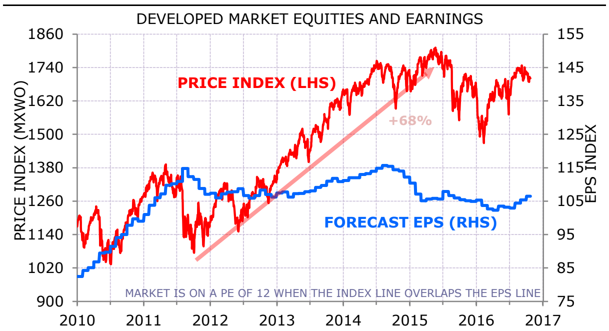
How Expensive Are Defensives?

The 2011-2015 global equity rally included a paradox: *absolute* returns were, in aggregate, driven by valuation, while *relative* returns were largely driven by earnings. So it is true that defensive stocks re-rated – but everything did. The relative out-performance of defensives was due to superior earnings. It's not clear that that will change.

Developed equity markets rallied almost 70% from the late-2011 low to the mid-2015 high. All of that gain was due to valuation expansion (Exhibit 1).

Exhibit 1

It Was All About PE

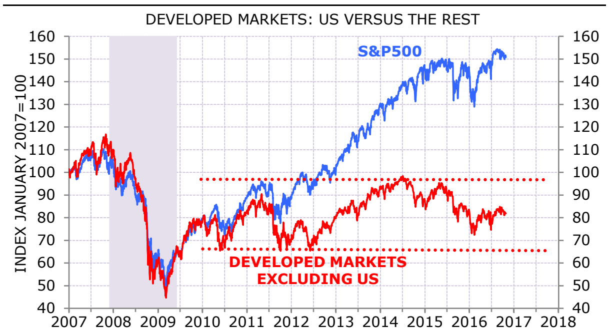


Source: MSCI, IBES/DataStream, NBER; Minack Advisors

Of course the component price gains were uneven. For example, US equities handsomely out-performed other developed markets (Exhibit 2).

Exhibit 2

US Out-performance

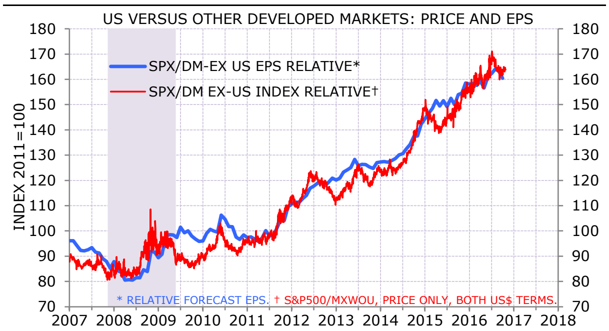


Source: Bloomberg, MSCI, NBER; Minack Advisors

The out-performance of US versus other markets was almost solely due to earnings: Exhibit 3 shows the relative performance of US equities tracking the forecast EPS in the US relative to forecast EPS for other developed markets. The US did not re-rate versus other developed markets.

Exhibit 3

US Out-performance Driven By Better EPS

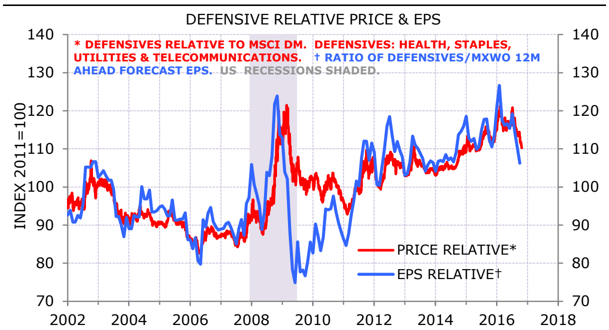


Source: Bloomberg, MSCI, IBES/DataStream, NBER; Minack Advisors

Exhibit 4 likewise shows the same story for defensives: all of the out-performance of defensive sectors from 2011 to 2015 was due to superior EPS. Defensives did not re-rate relative to the market.

Exhibit 4

Defensive Out-performance Was EPS Driven

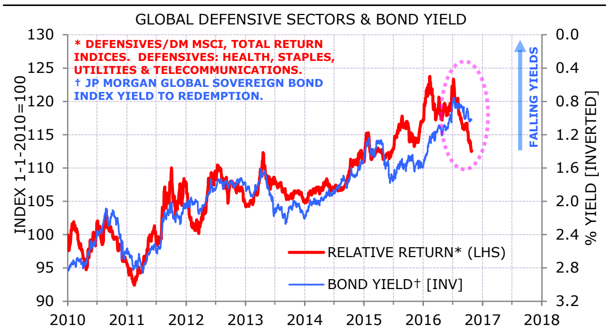


Source: MSCI, IBES/DataStream, NBER; Minack Advisors

Despite this EPS-driven out-performance, the rise of defensives has been associated with the fall of bond yields (Exhibit 5 – which compares the total return of defensives to the overall market).

Exhibit 5

Defensives Rise As Bond Yields Fall



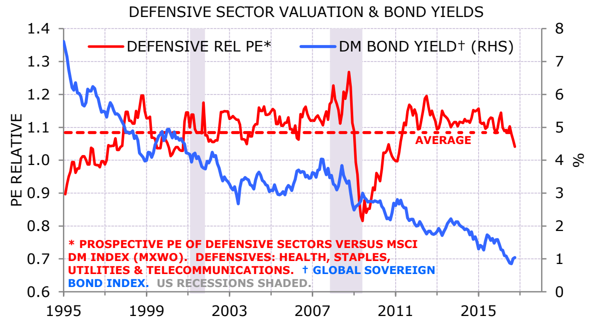
Source: MSCI, JP Morgan; Minack Advisors

Note from Exhibit 5 the sharp fall in relative returns since July went hand-in-hand with a relatively minor increase in long-end yields. There is no doubt that the defensive equity sectors had become crowded trades.

However, the more important point is that there is no correlation over the medium-term between the relative valuation of defensive stocks and long-end yields (Exhibit 6). On a prospective PE basis, defensives are now trading at a smaller-than-usual premium to the overall market.

Exhibit 6

Relative Valuation Unaffected By Yield Decline

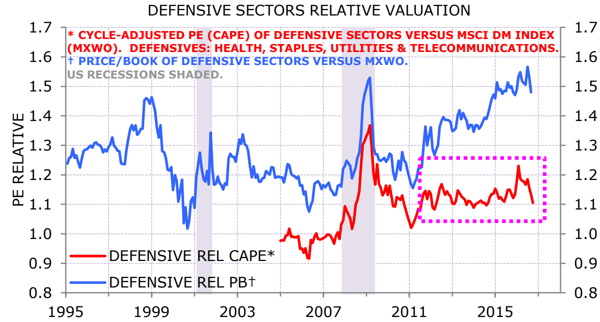


Source: MSCI, IBES/DataStream, JP Morgan, NBER; Minack Advisors

To be fair, defensives do not look cheap on a price/book basis (Exhibit 7). However, that is largely due to the de-rating in other sectors: defensives now trade on a price/book of 3.2, marginally above the long-run average of 2.9 (data from 1995). On a cycle-adjusted PE (CAPE) basis, defensives have not re-rated, and are now at a normal valuation premium.

Exhibit 7

Not So Cheap On Price/Book



Source: MSCI, IBES/DataStream, BLS, NBER; Minack Advisors

In summary:

- Equities everywhere re-rated through the 2011-15 rally. The out-performance of defensive stocks reflected their above-average EPS growth (and, on a total return basis, their above-average dividend yield).

- Lop-sided equity positioning meant that a relatively minor lift in bond yields triggered a more pronounced correction in defensive stocks.

- There is no long-term correlation between the relative valuation of defensives and bond yields.

- If growth remains tepid – my base case – then it seems likely that defensive-sector EPS will continue to rise faster than the market average. Consequently, the current set-back is likely to be a correction rather than a trend-change.

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