PIMCO is Buying Cyclical Stocks: Wisdom or Inexperience?

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Dear Fellow Investors:

In a recent Bloomberg article, Michael Patterson shared that the relatively new equity division of PIMCO was using the China monetary policy shift to buy basic material, heavy industrial and emerging market stocks. Here is how Bloomberg explained the move by the world's largest bond fund manager:

"China, which reduced the amount banks must keep in reserve by half a percentage point to 21 percent on Nov. 30, may cut the ratio by as much as three percentage points in the next 12 months, Masha Gordon, the head of emerging markets equity portfolio management at PIMCO, which oversees about $1.35 trillion worldwide, said in an interview. Inflation in the nation may slow to between 3 percent and 4 percent from 5.5 percent in October, she said.

'We've seen the first clear shift from tightening to selective easing on the monetary side in China,' Gordon said by phone in London yesterday."

Gordon went further to argue that low PE ratios in those sectors and in emerging market countries make a compelling contrarian case. Here is her argument as quoted by Bloomberg:

"'We started with light positioning in the cyclicals and have been selectively adding to companies in the materials and industrial space where we believe valuations are pricing in extreme distress,' Gordon said. Some stocks tied to economic growth in developing nations "are very cheap relative to their average earnings power if you take the view that growth in emerging markets on a secular basis isn't coming to a halt," she said, without naming any specific companies.

The MSCI Emerging Markets Materials Index trades at about 8.6 times analysts' profit estimates, or 24 percent lower than the average ratio of 11.4 since Bloomberg began compiling the data in 2006. The MSCI Emerging Markets Industrials Index is valued at a 17 percent discount to its five-year average, the data show. MSCI's gauge of Chinese industrial stocks trades at 9.4 times profit estimates, down from a historical mean of 16."

Over the years, we have been very hesitant to buy cyclical companies based on PE ratios. The reason is simple. The best time to buy cyclical stocks is when their industry is hurting and they have little or no earnings. The old adage is "buy cyclical stocks at high PE ratios and sell them at low PE ratios." We are not big fans of using the Schiller 10-year smoothed earnings for the market as a whole, but for cyclical companies where earnings disappear in downturns, it is a great way to look at the PE ratio. We thought that we would use US companies which have been huge BRIC-trade beneficiaries of the "secular case" on emerging markets to get a feel for where we are at with cyclical stocks in general. Therefore, let's look at Caterpillar (CAT), Joy Global (JOY), Deere (DE), US Steel (X) and Schlumberger (SLB) on a 10-year smoothed earnings basis and see if they look cheap on the basis of PE ratio. The results are below:

Schiller 10-Year P/E Calculations on DE / JOYG / X / CAT / DE / SLB

As of December 6, 2011

	Last	*10-Yr Avg EPS*	*P/E on 10-Yr Avg EPS*	*P/E on 2011 EPS*
DE	$0.00	$3.35	23.4	11.8
JOYG	$0.00	$2.55	35.1	15.1
X	$0.00	$3.94	7.2	706.8
CAT	$0.00	$3.89	24.7	14.1
DE	$0.00	$3.35	23.4	11.8
SLB	$0.00	$2.51	30.5	20.9
$SPX	$0.00	$73.88	17.0	13.0

The only stock on this list which looks attractive on a Schiller 10-year smoothed earning basis is US Steel at 7.2 PE. All the others look very expensive relative to the S&P 500 Index.

We believe that buying cyclical stocks and emerging markets under the assumption that secular forces in emerging markets will nullify the cyclical nature of sectors like energy; mining and heavy machinery exposes investors to a great deal of risk and shows a lack of understanding of the history of the markets. Please show me a cab driver or shoeshine boy who doesn't know that there are secular forces at work in emerging markets.

Over-paying for stocks based on "well-known facts" is not a good way to take advantage of the "current distress". We believe it would be better to wait for three to five years of poor performance in these stocks, which we expect to see, and until earnings have declined quite a bit before you buy. After all, it is just the first monetary easing move after a year of constant tightening in China. Besides, China could be starting its first real economic contraction as a quasi-capitalist country.

Best Wishes,

William Smead

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