

Reducing beta in Asia but still money to be made

'Reduce beta in May and go away' may not have quite the lyrical simplicity of the original old market adage, but may well prove to be appropriate this year.

A quick perusal of the financial press this weekend could have been from a different planet compared to the doom and gloom of February. Now everyone is spotting green shoots and it is becoming consensual that there is some sort of recovery towards year-end. As you will know from our previous entries, we agree.

However, we think that the markets are starting to get a little carried away with these early signs of economic rebound. It was never going to be an 'L' shaped recovery, but neither will it be a 'V'. The rebound in industrial production is a statistical necessity after the complete stasis of the turn of the year, and it would be as wrong to extrapolate the recovery continuing to move in an uninterrupted fashion upwards as it was to assume the death spiral that was consensus a few months ago. Commodity prices have probably bottomed, but in some cases the rebound is a result of price sensitive Chinese strategic buying – particularly Copper. One cannot assume the same level of interest at \$2.50/lb as there was at \$1.50. Chinese bank lending has reached levels unthinkable even for the bulls of recovery – again, it can't continue to grow at this pace.

The markets have been on fire recently as shorts have been covered and it has dawned on participants that not every company with debt will go bust. This change in perception is where the quick, easy money is made, and much of this low hanging fruit has been plucked. In many cases, particularly for some of the highly geared cyclicals which have been forced to raise a lot of money at recent prices, the capital raising is highly dilutive and per share asset values have fallen as a result. Together with stock prices rising between 50% and 5-6x from recent lows, a lot of value has been priced out of these sectors.

So are we bearish? Luckily not, as at the same time as risk appetite has returned and the VIX has sunk, the 'defensive' stocks have collapsed. 'Expensive' defensives are now 'Dirt Cheap' defensives. A lot of stocks in sectors such as healthcare, utilities, consumer staples and even a few unloved later cyclicals such as media are now offering the sort of value proposition that a lot of the now sexy, then toxic stuff did in February. Record low absolute valuation multiples, often 30% less than they sported three months ago, and relative valuations that have fallen by around 50% over the same time period is a seductive risk/return proposition. They will not need to raise capital, earnings estimates have been pretty stable, and if the rally continues – which we think is likely given the huge amount of cash still sitting on the sidelines – investors will feel comfortable allocating fresh money to these types of businesses. Look at what happened to Unilever after what was a fairly ordinary earnings release (stock rose 10%). If the market corrects, these will not be the first things the fast money sells as it no longer owns them. We have not abandoned cyclicals altogether as there are still a few names which have done relatively little, but the portfolio is now concentrated in these laggard sectors, and while it would be reckless to assume the sort of returns over the remainder of the year that we have enjoyed so far, we can see a realistic prospect of solid, double digit returns but with a likely near term pullback in a few of the more overbought indices.