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MARKETS

Health Care And Consumer Staples Offer Investors Opportunities

A conversation with Kevin Caron, Market Strategist, Stifel Nicolaus & Co.

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Kevin Caron: The market has come full circle from where we were six months ago. We've now gone through a summer that has been brutal for investors. We've seen most of the data on the global economy settle into a pace that borders precariously on contraction. The globe is still going through a deleveraging process, after a significant run-up in the amount of debt held by households and government.

As we look out at 2012, we expect to see continued growth – but it's not going to feel like growth, because it's not substantial enough to draw down the pool of unemployed labor. It's not going to be substantial enough to increase the capacity for utilization of our factories. The improvements that we've seen in corporate profitability have had more to do with financial engineering and companies that are reluctant to spend capital in the face of very weak demand. So the market has become somewhat skeptical of those forecasted earnings, which is why we see the S&P 500 trading at only around 13 times earnings.

The good news in all of this, of course, is that markets have anticipated a lot of what I've already discussed. We've gone through a significant correction in the months of August and September.

Although we expect see some choppiness over the next couple months related to the settling out of positions around Greece and Europe's broader financial issues – we see that there has been a historic repricing of risk in recent months as long-term Treasuries have rallied and stocks have fallen. Markets have factored in, in other words, a lot of the economic weakness that may lie ahead. This adjustment leads to buying opportunities when growth resumes.

Sectors with consistent growth that can perform well when pricing power is limited remain attractive areas to look for opportunities. Health care and consumer staples are examples.

Forbes: Are you suggesting that people wait a couple of months? Or is there an opportunity to do some accumulation in these areas now?

Caron: Well, take for example consumer staples. I think that the market is prepared to pay something of a premium for stability and quality of balance sheet. There are many companies within the consumer staples segment that fit that bill. In our view, that's a place in the portfolio that would benefit not only from the stability factors in this kind of uncertain environment, but also from the potential longer-term secular growth rates in emerging markets and other places around the world where we see rising standards of living – and expect to see rising standards of living in the years to come.

Forbes: In consumer staples, are these primarily U.S. companies or are there also opportunities in non-U.S. companies?

Caron: Well, when you look at large, well-established consumer brand franchises, typically, what you're dealing with are multinational companies, by definition. These are companies that are deriving a lion's share of their growth from exploiting new opportunities in local markets around the world – Latin America and the Far East being chief among those opportunities. Even though

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many of the companies have American names, they're clearly global companies.

Forbes: In other words, international companies that may be American-based.

Caron: Yes, exactly.

As we look at the world in the near term, we recognize several things. Number one, Greece continues to be the flashpoint for a broader potential crisis in Europe. I think that as we move through the next couple weeks, there are several things that are going to be important for investors to pay attention to, as it relates to Greece in particular, and more broadly, the European financial crisis.

Does Greece get their next round of funding? It looks like they're moving in that direction, but Europe's political appetite for open-ended funding is fading fast. A vote was held last week that would move Greece closer to that additional money, to forestall any further significant missing of that payment and the fallout that would come from that.

Also, we expect to see several things unfold, including a greater amount of participation by the ECB in terms of their role in the crisis – to provide some stability in capital, in support of the banking system. We expect to see rate cuts by the Bank of England and the ECB. We would expect, also, to see European parliaments ratify a plan that will bolster the European Financial Stability Fund (EFSF) and allow that fund to operate more like our U.S. version of TARP (Troubled Asset Relief Program). That should relieve some pressure on banking system finances.

That would be obviously very, very well-received by markets, which have already largely anticipated a recession along with a Greek default. Then beyond that, it gets down to fundamental improvement in the growth rates in those countries. That's going to require significant reform of their tax structure and the creation of incentives that encourage private sector growth, in order to allow those countries to be able to make good on their pledged promises for debt.

Forbes: So you think that these are outcomes that are more likely than some of the feared outcomes that have been dominating the market of recent vintage

Caron: There is always the potential that politics can impede good sense. Ultimately, however, we think the parties involved still have the mission to support a unified Europe, and each believes that it is their own best interest to find an orderly solution and to avoid a growth-killing banking and currency crisis. Politics make it difficult for to predict the date resolution will be reached, but at least the incentives are lining up to move the parties towards a more conciliatory, cooperative approach to solving the continent's issues.

Forbes: Well, that's very encouraging. And sure would bring sighs of relief throughout the world, if they pull that off.

Caron: Absolutely. We've had a lot of stress in the financial system in recent years. Investors have had a very difficult time coming to terms with the lingering effects of household – and now government – leverage. Credit and capital formation has not returned to what it was before the financial crisis. Any improvement on these fronts wouldgreatly improve confidence, which has been significantly damaged over the last couple years.

Forbes: That's for sure. But that sounds encouraging. I sure hope it's going to work out that way for all of us. It has been hard to see through to the sunshine recently.

Caron: I hope so too. The last thing I'd point out is that ultimately this comes down to valuation and earnings. And when we look at the earnings for the S&P 500, at this time, we're looking at an S&P 500 that is expected to have earnings of about $107 in the next twelve months. The index trades at approximately $1,177, so $107 divided by $1,177 is an earnings yield (the inverse of the P/E) of 9%.

If you compare that to the yield on a risk-free treasury, which is at approximately 2%, you're looking at a 7% premium in terms of the earnings yield for stocks, as a proxy for value for the stock market relative to bonds. Even if earnings fall well short of the expectation, there is a significant margin of value in these figures that suggests that, when fundamentals begin to improve, there will be attractive buying opportunities that are being created right now. It just requires some improvement in the underlying fundamentals. We're hopeful that policy makers will come together in such a way as to support that improvement over the next several months.

Forbes: Well, that's encouraging. Thanks, Kevin.

Caron: Thank you.

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