Mitch on the Markets

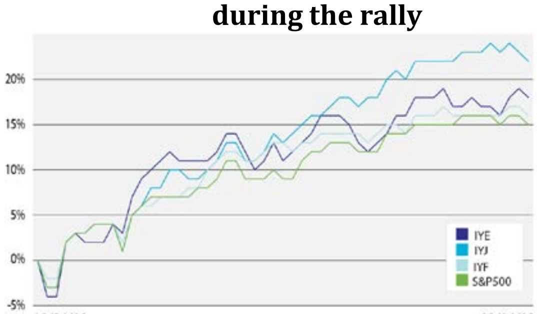
What Does the Surprising Cyclical Stock Surge Mean?

By Mitch Zacks
Portfolio Manager

The S&P 500 spent a single day in bear market territory on Christmas Eve, but since then the index has rewarded investors who didn't panic. As I write this column, the S&P 500 has steadily rallied over +18% [1] off the bottom, and one category, in particular, has exhibited strong, noteworthy gains: cyclical stocks.[2]

Here's what the data tells us. As you can see from the chart below, Industrials (IYJ), Financials (IYF), and Energy (IYE) have all outperformed the broad S&P 500 since the low on Christmas Eve. The Industrials sector is on pace to outperform the S&P 500 on a quarterly basis for the first time in over 5 years:

Cyclicals have outperformed the S&P 500 during the rally



Closing Price (Index) Data from 12/24/18 to 03/04/19, Source: Yahoo Finance

Why does this matter?

From a macro standpoint, cyclical stocks have historically been a useful gauge of investor confidence in the U.S. economy. Cyclicals tend to outperform early in economic cycles when investors are confident about the U.S. rebounding out of a recession and into a fresh growth cycle. Small-cap stocks also tend to outperform in this phase, for the same reasons.

But as economic cycles wear on and get 'old,' cyclicals often underperform as profitability wanes and growth rates slow. That's technically where we're *supposed* to be in this economic cycle - currently in its 10th year, with a recession "just around the corner." But cyclical stocks appear to be telling us a different story.[3]

Investors may have been reassured by the Federal Reserve's decision to pause rate increases, strong data in the labor market, and maybe some tailwinds from strong bank earnings and steady lending activity posted in Q4. Even if growth slows down as expected in 2019, cyclicals' outperformance may be telling us that the chances of a recession this year are low. A good sign.

But in my opinion, there is a more important investment takeaway from this story.

Here it is: While tracking cyclicals may offer investors and market watchers some macro guidance, I would argue that when it comes to portfolio construction, investors would be better served determining their cyclical and non-cyclical exposure by focusing on individual company earnings – not on the macro environment.

In other words, I believe stock selection matters more than top-down decision making.

The idea that we should own cyclical stocks early in an economic cycle and then switch to a non-cyclical bias late in a cycle doesn't hold water, in my view. At Zacks Investment Management, we want to buy and own companies that are consistently printing upward earnings estimates and/or have attractive valuations, as opposed to trying to time where we are in the business cycle. If you own quality and you own companies that grow earnings, that to me will add more value over time than shifting between sector and style based on timing the business cycle.

Bottom Line for Investors

If a cyclical stock is growing earnings and revising earnings higher on a consistent basis, my view is that it will do well no matter what 'inning' of the business cycle we're in. The same applies to non-cyclical stocks or really any other equity category, in my view.

Macroeconomics matter, of course – knowing economic fundamentals can help an investor determine the earnings outlook for a particular sector or region, which may play directly into setting expectations for corporate bottom lines. But at the end of the day, the bottom line for investors is that it matters more, in my opinion, to construct a portfolio on a company-by-company basis based on bottom-up analysis of earnings and other fundamentals. That's the approach that we find has worked for us here at Zacks Investment Management since the beginning.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Yahoo Finance, March 6, 2019. https://yhoo.it/2tRUDsf
[2] The Wall Street Journal, February 24, 2019. https://www.wsj.com/articles/resurgence-in-cyclical-stocks-pushes-dow-industrials-toward-new-high-11551016801
[3] The Wall Street Journal, February 24, 2019. https://www.wsj.com/articles/resurgence-in-cyclical-stocks-pushes-dow-industrials-toward-new-high-11551016801