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# How to navigate the next cycle of the recovery

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We are seeing the results of an unprecedented experiment in financial support. Trillions of fiscal and monetary stimuli has fuelled a warp-speed recovery, accelerating consumer demand. The result: the shortest recession on record. From its 20 March 2020 nadir to the end of August 2021, the S&P 500 has rocketed over 95%, according to data from FE fundinfo.

US GDP had already recovered to pre-pandemic levels. In parallel, the stock market recovery has been exceptional when compared to previous recessions. And as the stock market has surged in the early part of the cycle, higher-risk assets and cyclicals have crushed defensives. However, if the past is any indicator, market gravity may be about to weigh on the cyclical rally, as quality and defensives come to the fore.

**Navigating Mid-Cycle Market**

Historically, once growth rates peak, leadership transfers from riskier assets and cyclicals to defensives and quality names. We are already seeing leading indicators flash warning signals. The 10-year treasury yield, the ISM-Manufacturing PMI index and upwards earnings estimates revisions all peaked in the spring.

Indeed, defensives have been leading cyclicals since the spring peak. While in many areas of the market, growth has already been priced-in, for value investors current quality and defensive valuations represent potentially fertile ground.

Quality and defensive stocks are cheap – and very cheap when you compare them to leading blockbuster tech names. Improved sentiment has pushed a lot of consumer tech giants to lofty heights. For us, the overvaluation of the S&P 500, Nasdaq and Dow Jones does not translate into an environment where every stock is overvalued. There remain pockets of value in today’s market.

## Looking beyond big tech

Despite the surge in demand for COVID-19 treatments – and focus on global health, healthcare stocks have underperformed the broader market. Healthcare is also the only sector near the historical P/E average – it traditionally outperforms in the mid-cycle.

CVS, like many US healthcare names, is poised to benefit from long-term secular growth trends – aging population, increased medical innovation, narrowing of the health insurance gap and increased value-based care delivery. We believe the company's transformation from a national pharmacy chain to an integrated healthcare enterprise – health insurance, managed care, pharmacy benefits management, coupled with a leading physical retail pharmacy and medical clinic footprint – can unlock value for all stakeholders. The current valuation is very attractive at a 10x forward P/E and estimated low-teens earnings growth.

We are also particularly interested in underappreciated 'non-big tech' companies. Fiserv is a global fintech and payments company with leading solutions for banking, global commerce, merchant and billing and payments. Fiserv enables money movement for thousands of financial institutions and millions of people and businesses in a world that never powers down.

With solid financials and high revenue growth, Fiserv is well-positioned across markets both in relation to product and geographical mix – and it is currently flying under-the-radar when you compare it with some of the mega-tech names in that space.

## Need for discernment

There are some risks, of course, to the current market – even in the more value areas. Fifty percent of S&P 500 stocks are trading below their 50-day moving average. We are also witnessing peak margins: 14% of net income margins are at risk from taxes and rising input costs. Also, history presents another obstacle: the post-PMI Peak. Historically, one year following a recovery peak, the S&P 500 has been seen to return an average of just 1%. This is a further reason for an element of discernment when looking for current market opportunities.

Yet, over the long-term higher-quality value stocks, which typically have more consistent earnings, and robust balance sheets and higher margins, traditionally outperform low-quality stocks. Now may be a good time to invest; while history may not repeat, it often rhymes.