

Energy Stocks, Industrials, and Materials Remain Overvalued

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Whenever I write or speak in front of a group of people and feel the need to apologize for my message, I am usually right. This usually happens for two reasons.

First, I am likely saying what people don't want to hear; and second, because the message goes contrary to common opinion. So I am probably right about what I am about to say, as I am getting this tingly "don't shoot the messenger, please" feeling while I am typing this: The global slowdown (and the key word here is "global") is just starting and will last longer than most expect.

Until just a few months ago, the slowdown was taking place in the developed world: the U.S. and Europe. The developing world (China, India, Russia and Latin America) appeared to be marching to a different economic drummer. Those countries appeared to be insulated from their biggest customers' economic problems in the developed world. Suddenly in September, developing economies were not tone deaf anymore and started to march to the beat of the developed world's drum and their economies joined up with the rest of the developed world and embarked on the decline.

Developing economies had an incredible decade of growth, but this growth is behind them, not in front of them, at least for awhile. An unstoppable growth train, mighty China, is derailing. The Chinese purchasing managers' index fell from 47.7 points to 45.2 points in October, the steepest monthly fall and the lowest point since the index was started in 2004. Meanwhile, a government-backed survey of manufacturers dropped 6.6 points to 44.6 in October, also a record fall.

How much trust would I put in these numbers? Not very much as they are reported by a communist government, in a country where the expression "don't



shoot the messenger" has a different and more literal meaning. Anecdotal evidence from Chinese companies or companies doing business in China bears a lot more weight than government statistics that will likely lag reality by months (if not longer).

Here is some anecdotal evidence pointing to the actual severity of a slowdown. Unsold car inventories hit a four-year high, producers are defaulting on commodity orders as the demand for their products is not materializing; commercial and residential markets began to resemble their counterparts on the coasts in the U.S.; airlines started losing money as global travel declined; and the list goes on and on.

The longer a boom lasts, the deeper and wider it morphs into the economic system, and the more dire the consequences of its fallout. Take the U.S. housing and credit bust. It is not just limited to houses and subprime mortgages. It spilled into private student lending, completely shutting down that market. Prime and super-prime borrowers, once showered with money as if it were their birthday every day of the year, are unexpectedly getting their credit card limits lowered, according to a Federal Reserve survey of prime borrowers.

Since developing economies experienced a very significant boom that lasted a lot longer than most expected, the fallout will likely be deeper and wider than most expect. We are only in the beginning stages of the global slowdown. Being in the U.S., it feels as if it has lasted forever, but the global slowdown is just in the early stages in the developing world.

The global economy will not stabilize until developing economies do, and their destabilization journey has just started. Investors need to normalize, actually sub-normalize as one of my readers puts it, earnings of companies that have benefited tremendously from the global boom. I call them "stuff" stocks: materials, industrials and energy stocks. Though many of them look cheap based on trailing earnings, in many cases those earnings are an aberration. They were inflated by tremendous growth in the developing world and won't be revisited for a long time.

Stuff stocks look cheap today just as the housing stocks looked cheap in 2005, Toll Brothers for instance was "only" trading at eight times earnings in 2005, but the cheapness was deceiving as the \$4.76 of earnings it made in 2005 turned into a \$1.55 loss in 2008. Many respected value investors jumped into housing stocks after they got halved in 2006, just to see them get halved again and again. Don't make a similar mistake with "stuff" stocks.

Let's take Caterpillar (CAT) for instance. More than 60% of its sales come from outside of the U.S., and its revenues almost doubled, and earnings tripled, over



last four years. It sports a price-earnings ratio of only eight times 2009 already lowered earnings and the stock is down 50% since May. This has got to be a value investor's paradise kind of stock, right? Maybe not.

CAT's earthmovers are similar to houses, not just because they are about the same size and cost as much, but because, like houses, earthmovers are very durable and have very long lives. Also similar to the housing sector, CAT's past sales compete with its future sales. The sum of CAT's revenues from the four years between 2004 and 2008 exceeds the sum of the revenues CAT generated in the previous eight years from 1997 to 2004.

As I discussed above and [in a previous article](#), developing economies in recession don't just build less stuff, they build a lot less stuff. They are likely to be drowning in overcapacity since until just two months ago their economies were geared for growth, not decline.

Thus, CAT's normalized 2009-2010 earnings are not likely to be around \$5, as Wall Street expects today, but closer to around \$2 or \$3, or CAT's earnings circa 2004 before its sales went on a tear. At \$40, CAT is not as cheap as it appears.

Not all stuff stocks are created equal. Some make products that are a lot less durable in nature so that their past sales do not cannibalize present and future sales. For instance, Mine Safety Appliance is a stuff stock but it manufactures hard hats, working clothes and respirators--products that are not as durable as backhoes or homes. It also sells as much to firefighters as mine workers. Earnings need not be normalized so severely since the products that Mine Safety sells are replaced much more frequently than those of Caterpillar or Toll Brothers. This does not mean that I'm running out to buy Mine Safety since demand for these products decline during a global recession, even though past sales will not compete with future sales to the same degree [though I'd love to buy it a lower price].

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