RBC BlueBay Asset Management

Don't run for the hills! Cyclical sectors can offer value

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Published August 2023

"One sector we like at the moment is capital goods, specifically in areas with pricing power."

Capital goods and packaging are just two areas that look attractive despite where we may be in the credit cycle, says Nesche Yazgan.

Fixed income investors are understandably wondering whether we are at or approaching the 'downturn' phase of the credit cycle. Central banks have been raising interest rates aggressively to control inflation, and in these circumstances, we would often expect recession to follow. Tighter credit conditions would come with that.

Reasons to be cheerful

In this context, investors might be forgiven for running for the hills when it comes to issuers in cyclical sectors. However, there are two reasons why this would be misjudged.

First, hopes of a soft landing are rising. Despite almost 500 basis points of interest rate hikes in the US, we have yet to see any serious deterioration in company fundamentals.

And second, even if a downturn does come, cyclical issuers can still be viable, but the important thing is to protect yourself by being selective. This means seeking out those issuers with resilient balance sheets, good market positioning and geographic diversification.

Sectors to consider

One sector we like at the moment is capital goods, specifically in areas with pricing power. Investment grade companies tend to have big balance sheets, and there are issuers with great market positions in automation, robotisation, oil and gas production and aerospace supply chains. We're particularly interested in those that have exposure to the US. We see better fundamentals here than in Europe and certainly in China, where the recovery has been extremely sluggish.

Elsewhere, we like packaging companies that have robust fundamentals. This sector has good pricing power because the market is very concentrated and, therefore, not very competitive. Companies have been able to pass on significant cost increases as a result and now have the potential to benefit from cost decreases in their input material over the past two quarters.

Finally, we like aerospace companies and suppliers as we think they have solid long-term fundamentals, and we like airline companies because traffic numbers have returned following Covid. The latter are classic cyclical issuers because consumers tend to cut back on overseas travel if they are feeling the pinch. Yet they are looking robust at the moment, with holidaymakers spending their savings.

Areas to avoid

On the flip side, we are staying away from areas where consumers depend on financing to purchase big-ticket items. Cars, for example, look vulnerable, even though we've been surprised at the sector's resilience so far. Supply chain issues allowed auto companies to aggressively price following the pandemic. Still, demand could now turn, given the increase in interest and leasing rates as well as potential pressure on employment levels.

We're also cautious about construction. Interest rate increases have made this sector very exposed especially with regard to new activity in commercial property and residential, and we feel our caution has been vindicated by recent performance.

Finding the right attributes

So overall, we have remained relatively neutral on cyclicals, retaining exposure to those issuers with good fundamentals. We can't be sure where the cyclical journey is heading, but we can look for companies that can be nimble about cutting capex to generate cash flow or have low leverage.

As well as balance sheets, we look closely at companies' product portfolios, the types of businesses they are running and, more importantly, how resilient the customers in their end markets are. Some very well-placed cyclical companies can come out of any potential downturn as winners with enhanced market positions while delivering good returns for their stakeholders.

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