SECTOR ROTATION

They taught you that 40 percent of a stock's price movement was due to the market, 30 percent to the sector, and only 30 percent to the stock itself, which is something that I believe is true. I don't know if the percentages are exactly correct, but conceptually the idea makes sense.

~ Stevie Cohen

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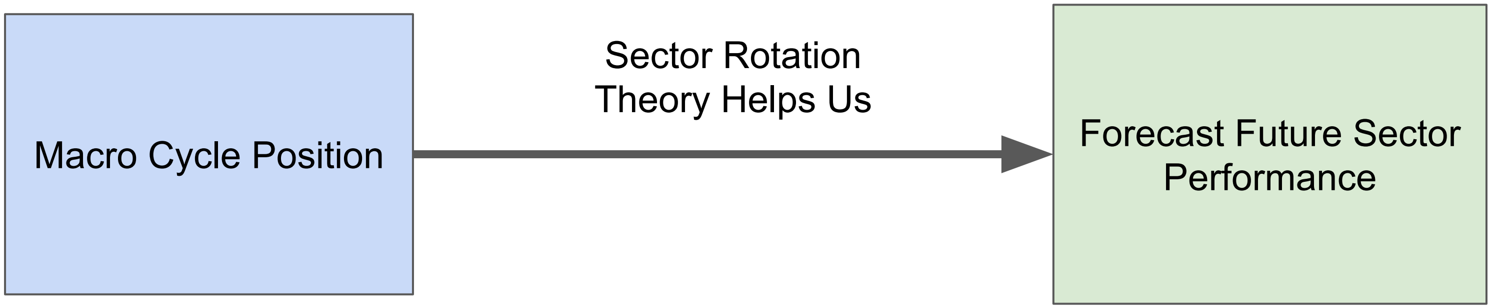
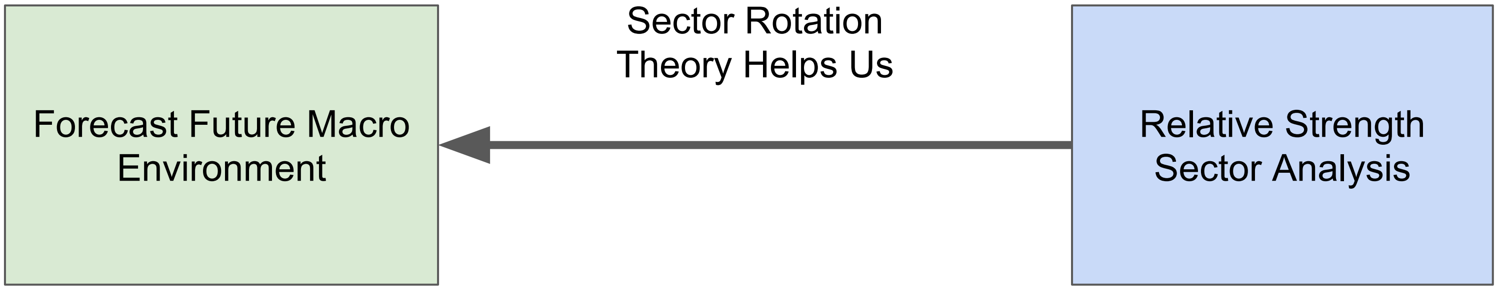
What Is Sector Rotation?

- Sector rotation is the repetitive pattern where money flows from one sector to another as the economy goes from expansion to contraction and back to expansion
- If you know what sectors perform best in each part of the macro cycle, you can focus your stock picking efforts with the maximum amount of tailwind
- ***Sector analysis also works for us in the opposite way - by looking at what types of stocks are performing we can use that as a tool to better identify the macro cycle/business cycle***

Use Case 1



Use Case 2



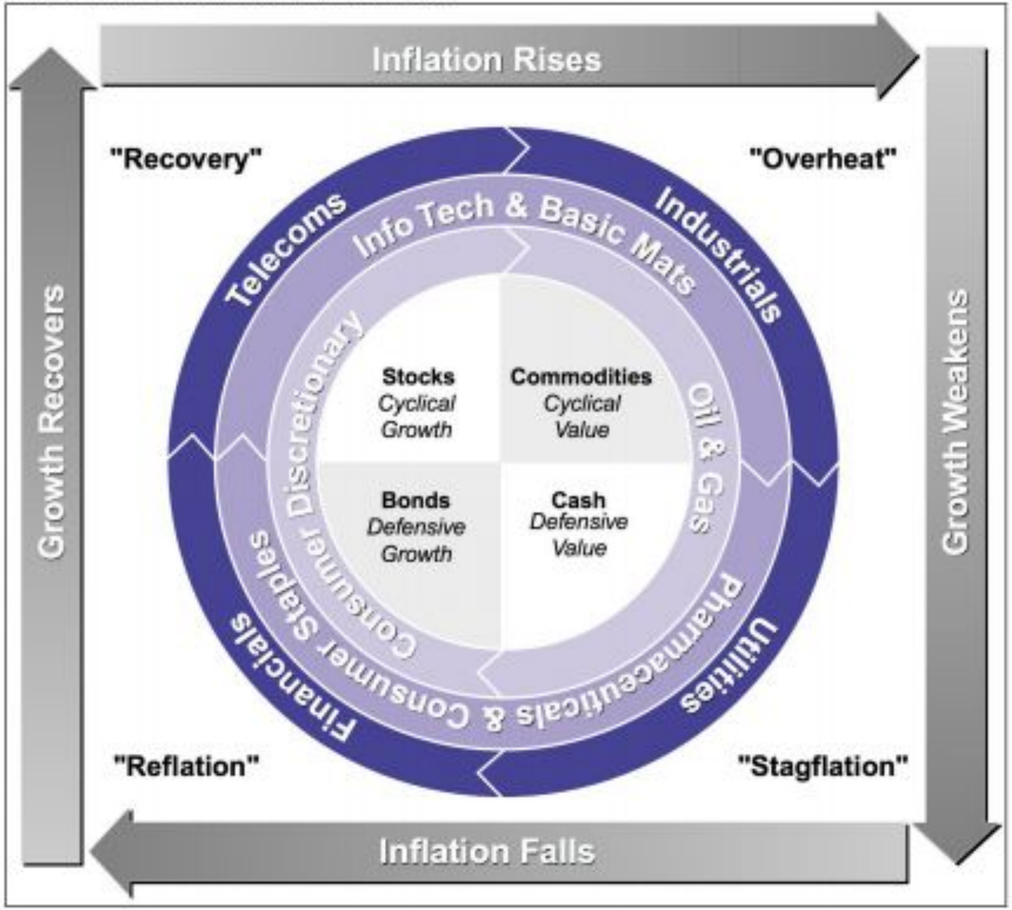
Let’s Talk Use Case 1

Macro Cycle Position $\xrightarrow{\text{Sector Rotation Theory Helps Us}}$ Forecast Future Sector Performance

Macro Cycle Review

- Lots of different models but most subdivide the cycle into 4 parts or stages
- We like the Investment Clock Model
    - **Reflation** - (Early)
    - **Recovery** - (Mid)
    - **Overheat** - (Late)
    - **Stagflation** - (Recession)

Chart 1: Asset and Sector Rotation over the Economic Cycle



Source: ML Global Asset Allocation Team.

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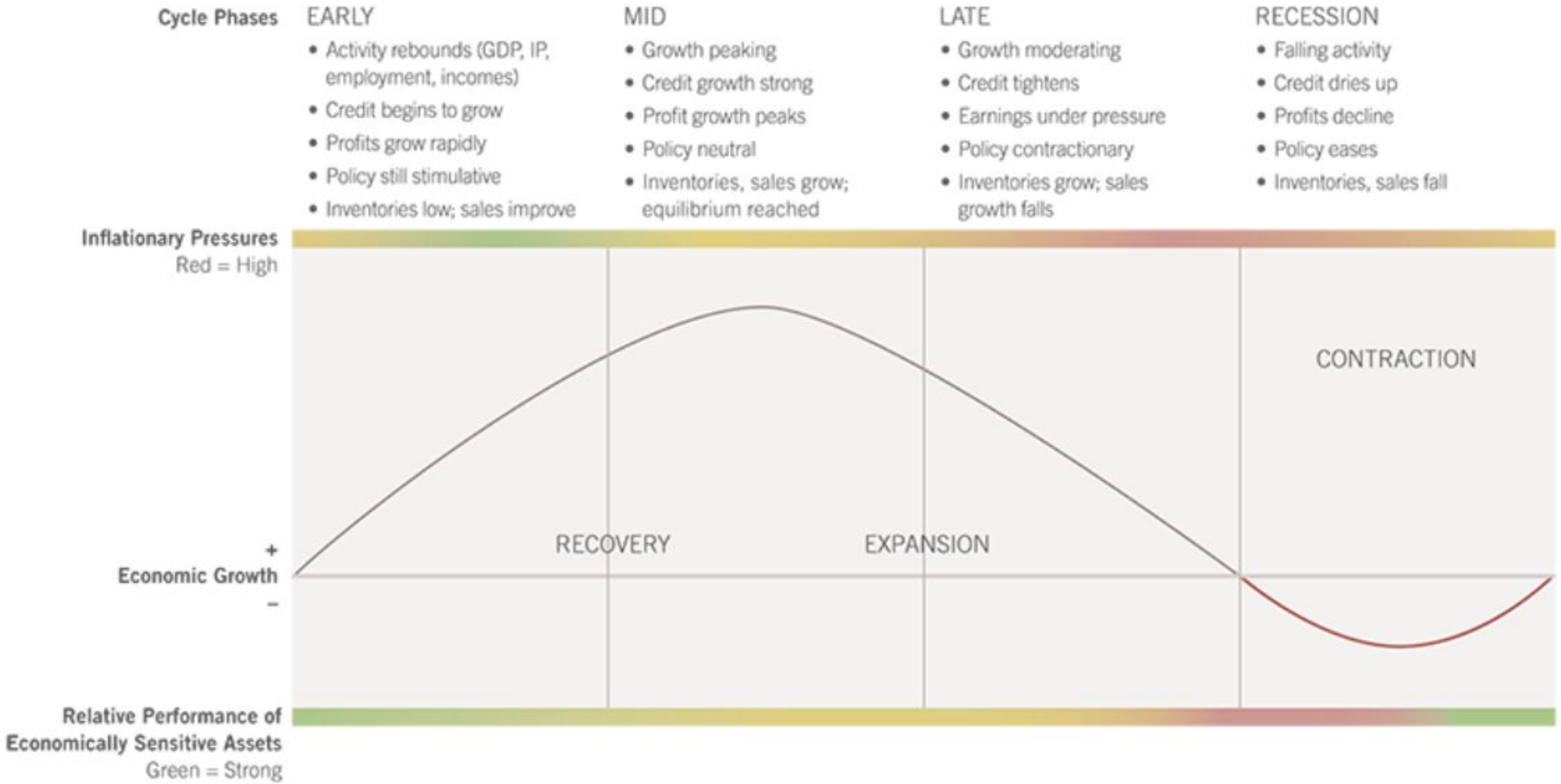
Cycle Phases
EARLY
• Activity rebounds (GDP, IP, employment, incomes)
• Credit begins to grow
• Profits grow rapidly
• Policy still stimulative
• Inventories low; sales improve
MID
• Growth peaking
• Credit growth strong
• Profit growth peaks
• Policy neutral
• Inventories, sales grow; equilibrium reached
LATE
• Growth moderating
• Credit tightens
• Earnings under pressure
• Policy contractionary
• Inventories grow; sales growth falls
RECESSION
• Falling activity
• Credit dries up
• Profits decline
• Policy eases
• Inventories, sales fall
Inflationary Pressures
Red = High
CONTRACTION
RECOVERY
EXPANSION
+
Economic Growth
–
Relative Performance of Economically Sensitive Assets
Green = Strong

The 10 Sectors

- Consumer Discretionary - **XLY**
- Consumer Staples - **XLP**
- Energy - **XLE**
- Financials - **XLF**
- Health Care - **XLV**
- Industrials (Includes Transports) - **XLI**
- Materials - **XLB**
- Real Estate **- XLRE**
- Technology **- XLK**
- Utilities - **XLU**
- **These change over time as the economy changes**

Summary of Sector Rotation Theory

- At the beginning of a equity bull market consumer discretionary, tech, industrials and transportation outperform
- Then energy becomes the leader during the run up into the top (as inflation and rates rise)
- Finally as the market tops and starts to turn money flows into defensive sectors like consumer staples, health care, and utilities

Sector Rotation Theory Explained

- **Early Expansion Outperformance:**
  - Financials and Consumer Discretionary
    - Financials benefit from central banks cutting rates, boosting their net interest margins
    - Consumer discretionary does well because real consumer spending power gets a boost from inflation/rates dropping
    - In early expansion, business spending tends to lag, they just run down their inventory (because they are still wary)

- **Mid-Expansion Outperformance:**
  - Technology and Industrials
    - Sectors that benefit from increased business/manufacturing spending start to outperform
    - Companies are starting to spend to make productivity upgrades and expand production capabilities

Sector Rotation Theory Explained

- **Late Expansion Outperformance:**
  - Energy and Basic Materials
    - Inflation runs higher boosting commodity prices
    - Businesses are building new factories and infrastructure rather than upgrading existing factories

- **Recession/Slowdown Outperformance:**
  - Utilities and Consumer Staples
    - People buy stuff they ***need*** to buy toiletries etc but delay buying stuff they merely ***want*** to buy, electronics etc.
    - Utilities that pay relatively high dividends are very inversely sensitive to interest rates so rates dropping helps etc

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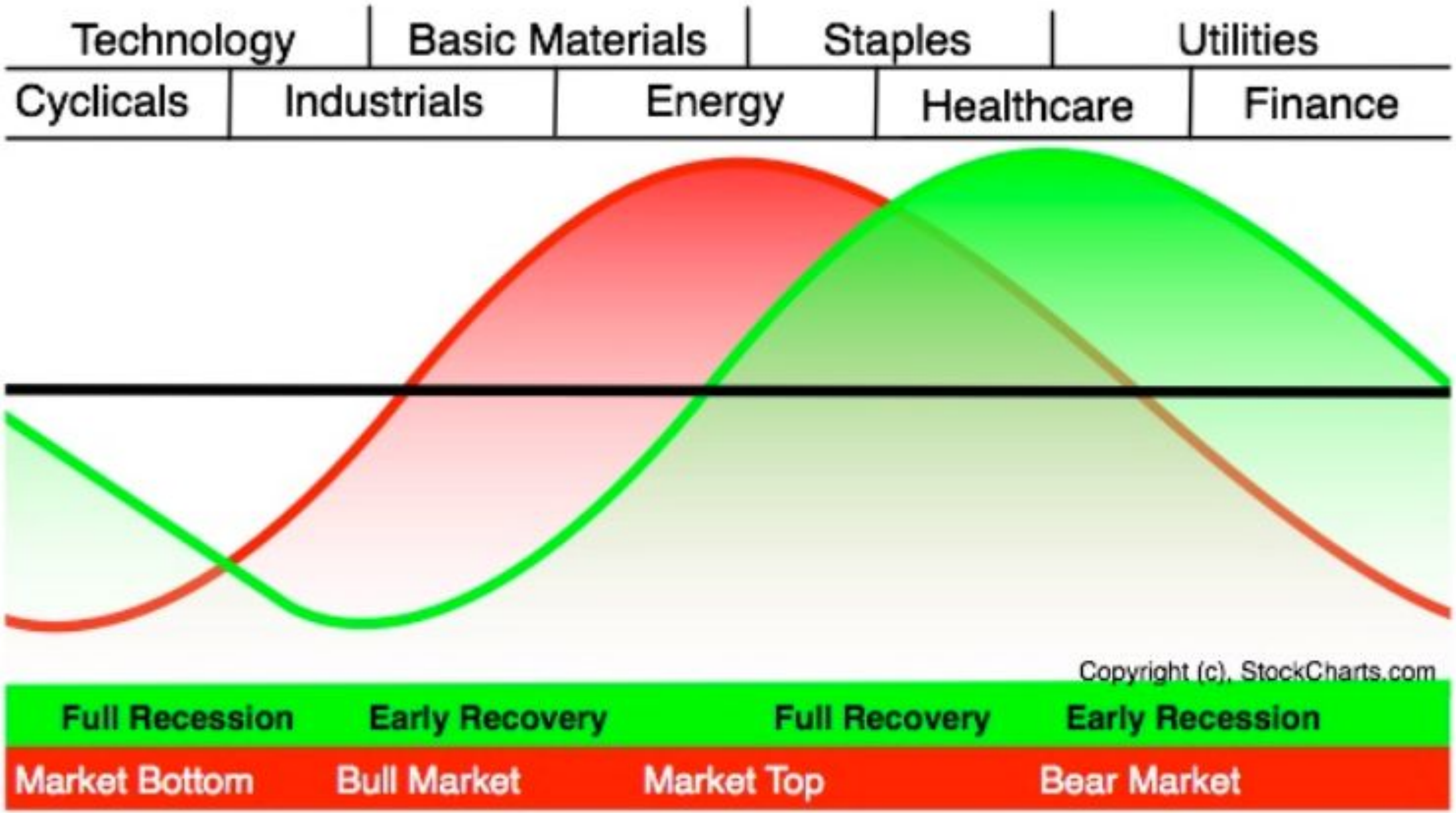

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Best performing sectors in each phase of the business cycle

Sector	Early	Mid	Late	Recession
Financials	+			
Real Estate*	++			– –
Consumer Discretionary	++		– –	
Info Technology	++	+	– –	– –
Industrials	++	+		– –
Materials		– –	++	–
Consumer Staples	–		+	++
Health Care	–		++	++
Energy	– –		++	
Telecom	– –			++
Utilities	– –	–	+	++

*Unshaded (white) portions above suggest no clear pattern of over- or underperformance vs. broader US equity market. Double +/- signs indicate that the sector is showing a consistent signal across all 3 metrics: full-phase average performance, median monthly difference, and cycle hit rate. A single +/- indicates a mixed or less consistent signal. Source: Fidelity Investments (AART).

So...

- If we can determine what part of the investment clock/macro cycle we are in we can focus on stocks that are most likely to outperform
- Our energy picks from September 2017 were developed using this process

What did we see?

- ➢ GDP gap reading was positive indicating economy producing above capacity
- ➢ Capacity utilization and inflation were trending higher
- ➢ We saw signs of rising labor costs
- ➢ Positive growth and positive inflation put us in “Stage 3” or the Overheat/Late Cycle phase of the investment clock
  - ○ Read Sep ‘17 MIR starting on Page 4 for full example of analysis
- ➢ According to sector rotation theory, commodity stocks and specifically energy stocks should outperform
- ➢ We got long an oil basket including W&T offshore (WTI)
- ➢ WTI went on to rally 244% from our entry

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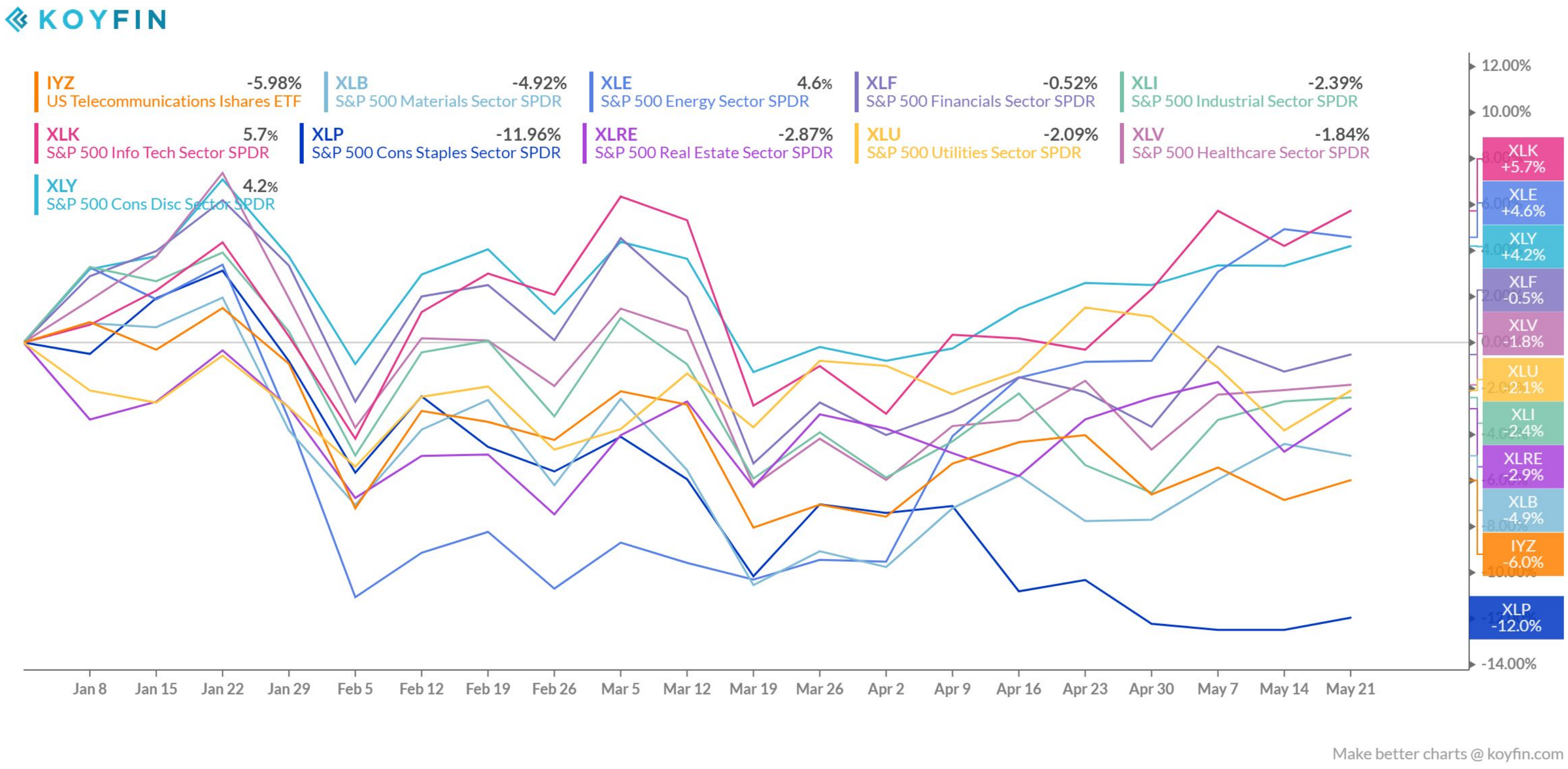
Let’s Talk Use Case 2

Forecast Future Macro Environment ← Relative Sector Strength

Sector Analysis In Reverse

- Instead of starting from the macro cycle and working down we can use relative sector performance to help us reverse engineer what part of the macro cycle we are in
- First determine what sectors are over performing and what sectors are underperforming
  - Use ratio charts and sector ranking charts
- Then use sector rotation theory to determine what part of the macro cycle that we are in or about to enter

Sector Ranking Example



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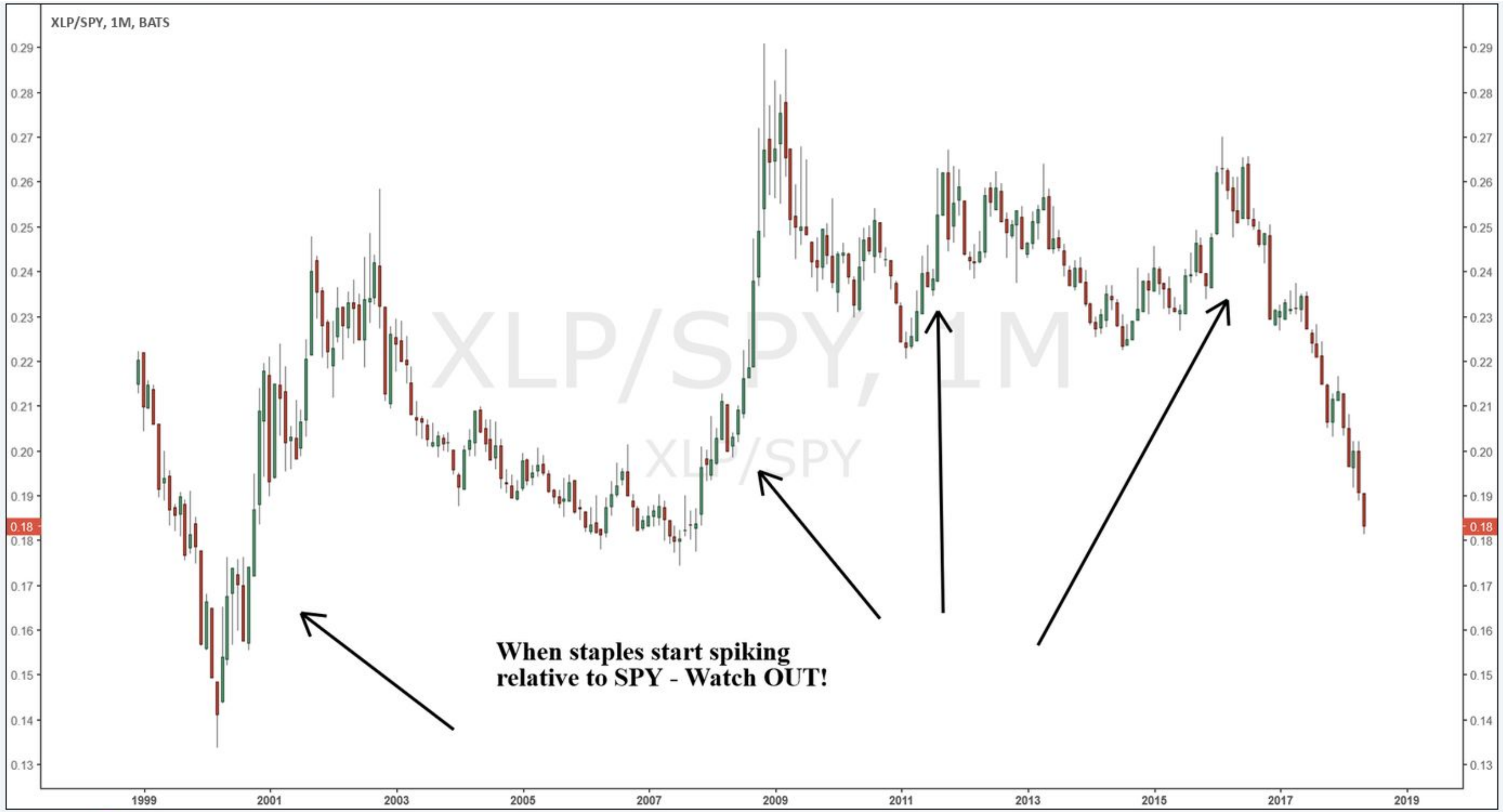
Use Case 2 Example

- The previous chart showed that for 2018 the top three sectors were:
  - XLK - Tech
  - XLE - Energy
  - XLY - Consumer Discretionary
- Bottom three were:
  - XLP - Consumer Staples
  - IYZ - Telecommunications
  - XLB - Materials
- That's a somewhat mixed picture but according to sector rotation theory it would suggest that the current cycle is in Stage 3/Overheat/Late
- Therefore if taking macro trades focus on long commodities and short bonds (long rates)

Consumer Staples Is Key

- Consumer staples/S&P 500 ratio is an excellent contrary stock market indicator
- This shows very consistent cyclical patterns
- If XLP/SPY is trending hard to the upside we are potentially entering into Stage 4/Recession and starting a bear market



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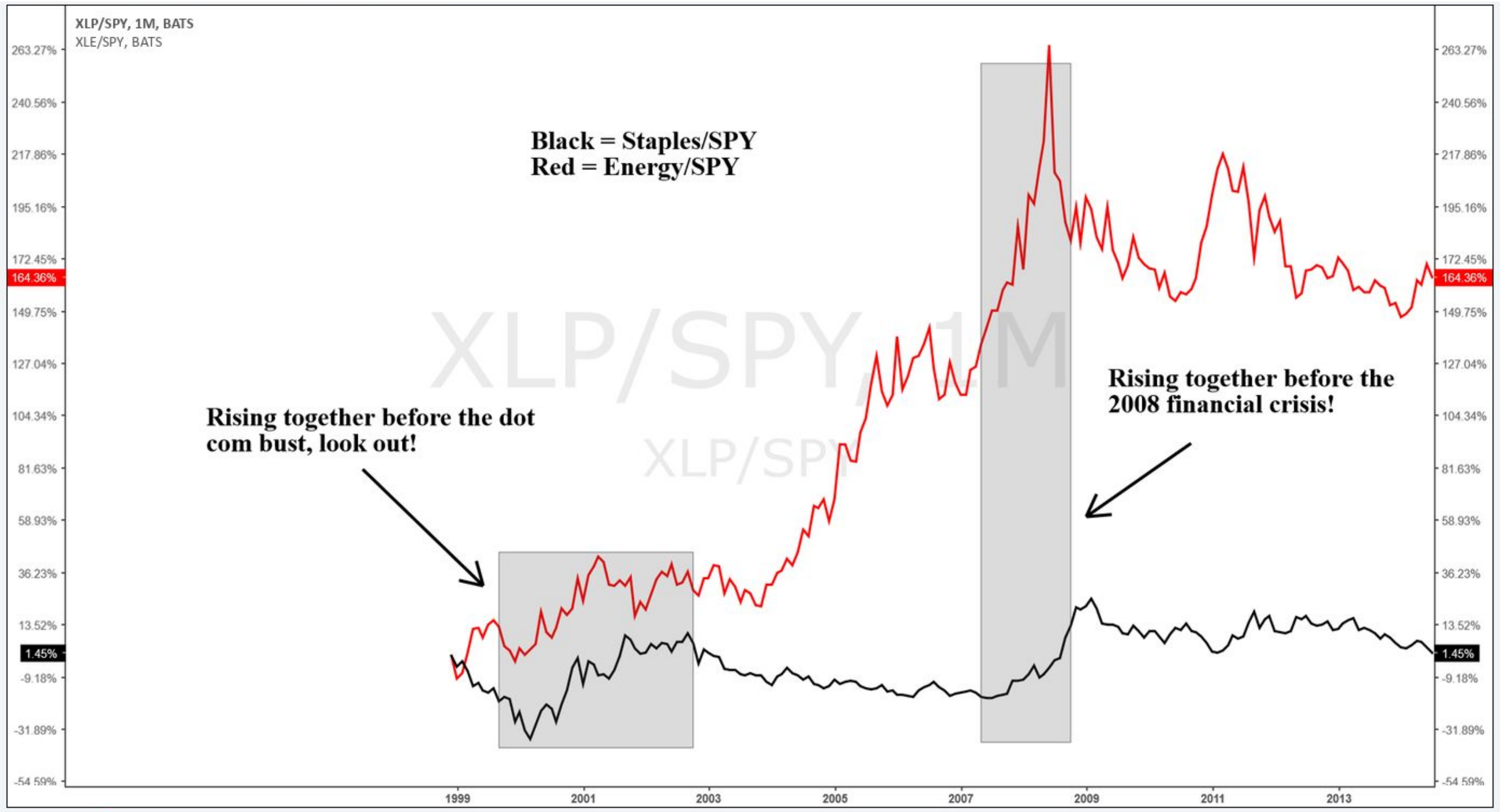
The Big Warning Sign

- ➢ If energy and staples are the two strongest sectors there's a high probability that Stage 4/Recession is imminent
- ➢ That means we're coming off of a high inflationary period that likely has high rates AND investors are starting to get defensive with their holdings



XLP/SPY, 1M, BATS
XLE/SPY, BATS
Black = Staples/SPY
Red = Energy/SPY
Rising together before the dot com bust, look out!
Rising together before the 2008 financial crisis!
263.27%
240.56%
217.86%
195.16%
172.45%
164.36%
149.75%
127.04%
104.34%
81.63%
58.93%
36.23%
13.52%
1.45%
-9.18%
-31.89%
-54.59%
1999
2001
2003
2005
2007
2009
2011
2013

Summary

- Sector rotation theory helps us in two ways:
  1. If we know the position of the macro cycle we can get a good handle on what stocks will perform best
  2. If we know what sectors are showing relative strength we can better determine where we are at in the macro cycle
- Tech, financials, and industrials outperform early/middle of the cycle
- Energy and materials perform late cycle
- Staples, health care, and utilities perform during recessions
- When both staples and energy are strong, a bear market is imminent