Thackray Report

Defensive & Growth Sectors Benefitting As Cyclical/Value Sectors Fade

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The cyclical and value sectors have become synonymous with the re-opening trade and their performance relative to the S&P 500 has recently been fading– what does this mean?

For the longest time the growth sector of the stock market, including technology, "ruled the world." It was all about the stories of how the technology sector was going to change the world forever. There was one dynamic that helped support the growth sector, that was not talked about frequently: falling interest rates helped the growth sector outperform the stock market. Growth stocks are akin to a long duration bond with their stream of payments far out in the future. As interest rates fall, growth stocks become more attractive.

Starting in the summer of 2020, the narrative in the stock market changed and the cyclical and value sectors of the stock market have been the main focus of investors as investors started to realize that the economy was re-opening faster than previously expected.

Value vs. S&P 500 and US Treasury 10 Year Yields

As investors anticipated a faster re-opening of the economy, interest rates have moved higher, until recently. The graph above shows the relationship between the performance of the value sector compared to the S&P 500 and the direction of interest rates. In the autumn of 2018, value outperformed the S&P 500 as interest rates were rising. This occurred just before the *Powell Pivot* which took place in the stock market as it bottomed on December 24, 2018. It is interesting to note that the yield on the US Treasury 10 Year Note turned down before the stock market turned higher. In addition, the relative performance of the value sector compared to the S&P 500, also stopped its ascent before the stock market bottomed in late December.

The next period of value sector outperformance took place in 2019, starting at the end of the Q3. This coincided once again with a rising yield on the US Treasury 10 Year Note. The value sector started to underperform the S&P 500 towards year-end at the same time that the yield on the US Treasury Note started to turn lower.

The value sector started to outperform the S&P 500 during the summer of 2020 and continued its outperformance until the beginning of March in 2021. At this time, the yield on the US Treasury Note started to stabilize from its long climb that started in Q3 of 2020. Recently, in March of 2021, as the yield has dropped, the value sector has continued its underperformance.

A lot of investors are sold on the reflationary trade and that stronger economic growth than previously expected will continue to power higher, resulting in strong cyclical and value sector performance. There is a strong argument for this case as central banks and governments slosh excessive stimulus into the system.

It is easy to get caught up in the narrative story of the cyclicals and value outperforming and believe that this will be the case for many years to come. The reality of the situation could be something different in the short and medium terms. Recently, we have seen the yield on the US Treasury 10 Year Note head lower. One may argue that this move is only temporary. On the other hand, it is possible that the bond market is starting to see economic growth expanding less than anticipated. The bond market is much bigger than the stock market and the direction of yields often leads changes in the stock market. In late 2018, yields on the US Treasury Note moved lower well before stock market investors were convinced that Powell would pivot to a loose monetary policy stance.

This time, it looks like stock investors are lining up with bond investors. Although the overall stock market has been moving higher, the value sector of the stock market has been underperforming. Is it possible that lower bond yields are currently either anticipating slower economic growth or more subdued inflation and as a result investors are moving to other sectors of the stock market?

Where is the money going?

In March of 2021, the defensive sectors of the market: consumer staples and utilities outperformed the S&P 500, despite rising interest rates. Typically, the defensive sectors do not outperform the S&P 500 at this time of the year, especially when interest rates are rising. The defensive sectors of the stock market tend to perform better when interest rates are falling for two reasons. First, falling interest rates often indicate a slowing economy, making defensive stocks more attractive because of their greater earnings stability. Second, the defensive stocks tend to pay higher dividends, making them more attractive as interest rates decline.

The fact that the utilities sector and consumer staples sector outperformed in March while interest rates were increasing is an indication of a shift in markets. The stock market is close to all-time highs and investors want to stay invested, but are starting to become more conservative.

In April, the consumer staples sector and utilities sector have been underperforming the S&P 500 while interest rates have been falling. The utilities sector is only marginally underperforming the S&P 500. Part of the underperformance can be explained as a reaction to the size of outperformance of the defensive sectors in March. In April, investors have been shifting their focus back to the technology sector. Falling interest rates in April have helped to support the technology sector.

The main message is that investors have been moving out of value to other parts of the stock market, independent of whether interest rates are rising or falling. If interest rates start to tick higher, which is generally supportive of value outperforming the market, investors should not count on value outperforming the S&P 500. Rising interest rates did not help in March, so why would it help now?

On a seasonally basis...what can be expected next

On a seasonal basis, the value sector ends its strong seasonal period on average, on April 19 (Thackray's 2021 Investor's Guide). In other words, it appears that the value sector has already finished its seasonal period early.

Of course, if economic numbers come out extremely strong and interest rates start to climb higher, this would help support better value sector performance. This should not be counted on as the market has already priced in strong economic growth.

In addition, other seasonal trends in the market place are supportive of sector rotation in the markets. First, interest rates on a seasonal basis tend to decline starting in early May (Thackray's 2021 Investor's Guide). If interest rates continue to decline, as per their long-term seasonal trend, it would not be expected that the value sector would outperform.

On a seasonal basis, the defensive sectors of the market have either started their strong seasonal period recently or are about to start their strong seasonal period which is supportive of the defensive sectors outperforming in the future. For example, the consumer staples sector tends to start its strong seasonal period on April 23 (Thackray's 2021 Investor's Guide). The utilities sector tends to start its strong seasonal period in early April. In addition, the health care sector starts its strong seasonal period at the beginning of May.

A sign of a healthy stock market occurs when the sector that has been leading the stock market higher, continues to lead. Sure, there can be rotation within the market, but the best kind of rotation for the market to move higher is a rotation into higher risk sectors. This is not what is happening currently.

The growth sector lead the market off the COVID-19 bottom in March of 2020. The market rotated into the cyclical sectors of the economy (generally higher risk) in the summer. The small cap sector (generally higher risk) then picked up the ball and lead the market higher starting in autumn. In March, the small cap sector and the cyclical sectors started to underperform, as investors started to shift to a lower risk preference. Up until March of this year, investor risk preference kept increasing. In March, investor risk preference shifted to become more conservative.

When the stock market is making all-time highs and investors are shifting to a more conservative portfolio stance, it is often a sign that the stock market is "hollowing out," which is a sign of weakness in the stock market and possible "softness" in the near future. It is not a signal that the stock market is about to suffer a major correction, although it does indicate that the stock market is more susceptible to a correction. Given that the stock market is on the threshold of the six-month unfavorable period for stocks, which runs from May 6 to October 27, now is probably a time to be cautious in the stock market.

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