Thackray Report

Defensive Sectors Whispering Caution

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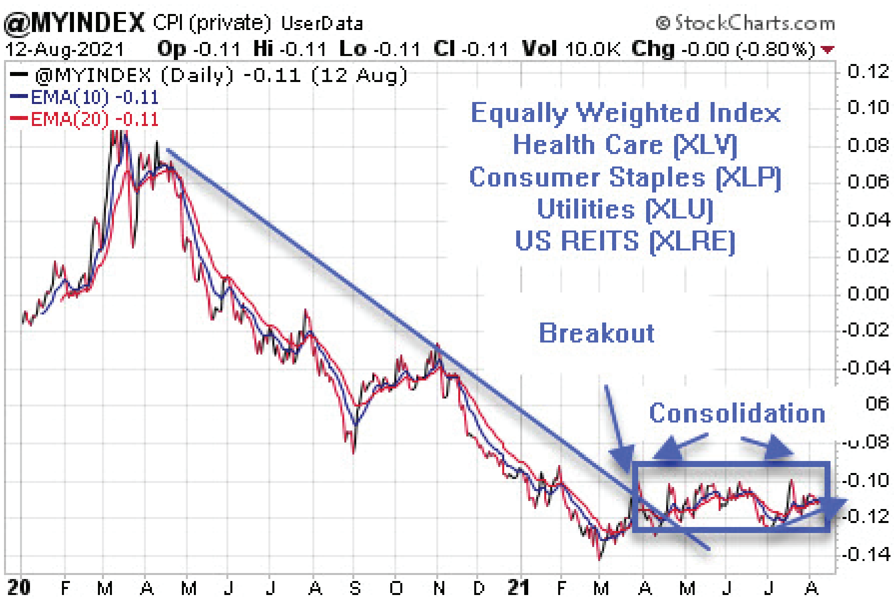
"Today's" investors are interested in investing in growth and meme stocks. Defensive sectors are boring. So, when defensive sectors start to outperform, investors should listen.

Defensive sector outperformance in a rising market can often mean that investors are getting concerned with market valuations, or think that the stock market might be in a topping process. Wanting to still be invested, investors seek refuge in the defensive sectors. Recently, the defensive sectors of the market have been showing some life. As a group, the consumer staples, health care, utilities and real estate (US REITs) sectors have broken their down trend relative to the S&P 500, and have formed a consolidation pattern. They have recently been outperforming the S&P 500.

The graph below is a custom index of a weighted average of the performance of the consumer staples, health care, utilities and real estate (US REITs) sectors - relative to the S&P 500. When the line is rising, the custom defensive sector index is outperforming the S&P 500 and vice versa.

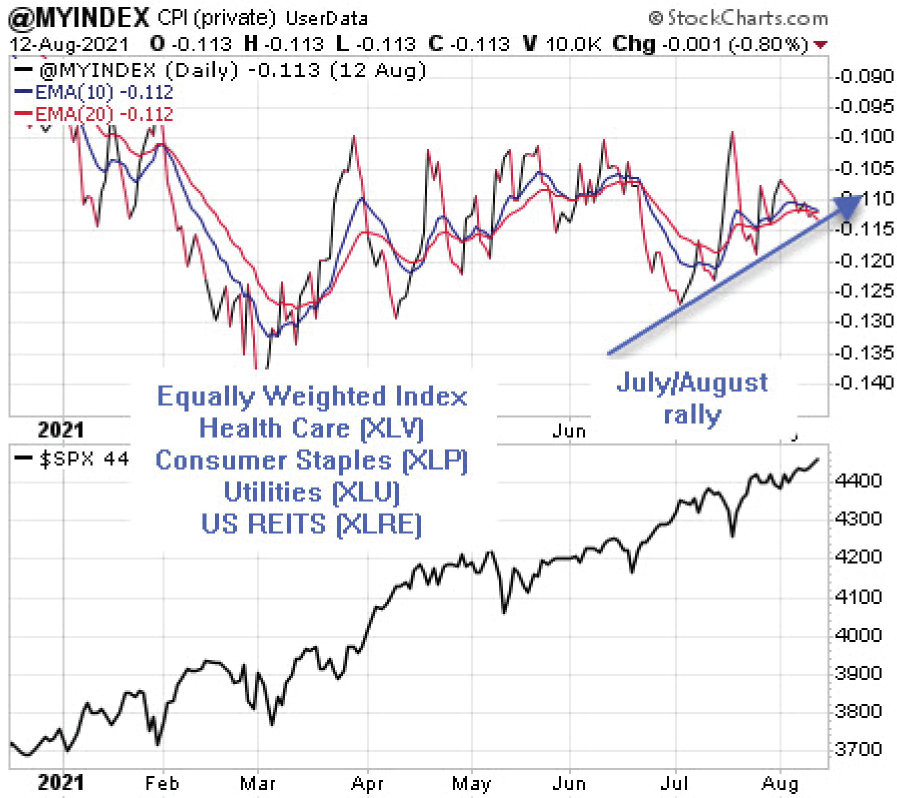


The graph above illustrates that the defensive sectors underperformed the S&P 500 from March 2020 until March 2021. Since March of this year, the defensive sectors have been consolidating relative to the S&P 500. More recently, since the beginning of July, the defensive sectors have been outperforming the S&P 500.

It is not uncommon to see the defensive sectors outperform the S&P 500 when the S&P 500 is performing poorly. This has not been the case recently. The S&P 500 has been moving higher and setting all-time highs. Typically, when this occurs, it is the more speculative stocks and sectors that drive the stock market higher, not the defensive sectors. When the defensive sectors perform well as the stock market moves higher, particularly at all-time highs, the relative performance is indicating that investors are getting concerned with the stock market valuation.

Investors generally do not want to exit a market as it continues to set all-time highs. They fear that if they leave the stock market, they will miss out on large profits. Not wanting to leave the markets, investors tend to hide in safer segments in the stock market, including the defensives sectors of the stock market. This is what is happening today.

The graph below shows the relationship between the defensive sectors custom index relative to the S&P 500 (top panel) and the S&P 500 (bottom panel). The defensive sectors have been outperforming the S&P 500 since the beginning of July, at a time when the S&P 500 has also been increasing. This shows the preference of investors to be defensive despite a rising stock market.



On a seasonal basis, the defensive sectors generally perform well at this time of the year. There are some differences in relative performance and when the sectors finish their seasonal periods. The consumer staples sector finishes its seasonal period of strength on October 27, the utilities sector in late September, the health care sector in October and the real estate sector in late September. It should be noted that although the real estate sector is considered a defensive sector by most analysts, its performance profile can be most unlike the other sectors listed. If the economy is thought to be decelerating at a fast pace this sector can perform poorly and could abruptly cut its period of strength short.

Currently, the utilities sector is performing particularly well. The sector is somewhat dependent upon the direction of interest rates. In fact, the sector can be followed to monitor rising rates and the impact on the overall market. The sector tends to finish its strong seasonal period in late September, ahead of when yields start to turn higher on a seasonal basis, at the beginning of October.

It should be noted that both the health care sector and consumer staples sectors perform particularly well in both September and October, relative to the S&P 500. The health care sector has been outperforming the S&P 500 since April 2021, but is still substantially off its relative performance peak in April 2020.

The consumer staples sector has been underperforming the S&P 500 since March 2020 and has only recently started to stabilize. Compared to the S&P 500, the sector is still below its 2018 level and could represent good relative value, especially since the sector tends to preform well on a seasonal basis in September and October.

The defensive sectors of the stock market have recently started to stabilize and show strength relative to the S&P 500. The sectors may not be very exciting, but they should be respected. Where investors place their money in the stock market tells us something about investor sentiment. Right now, the defensive sectors are whispering that the stock market valuation might be too high and a market top could be in the offing. If their voices start to pick up, it would be wise to listen and heed caution.

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