Thackray Report

Defensives Outperforming While Interest Rates Rising – What is Next?

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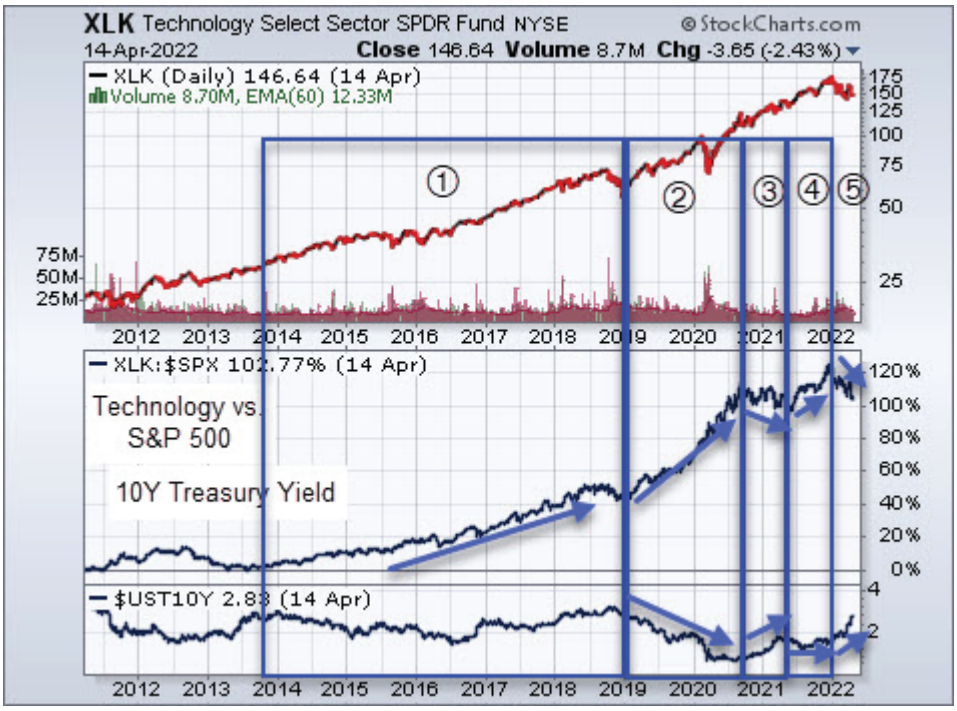
Investors want to invest their money somewhere. Rising interest rates have made the growth sectors, including technology less attractive. A slowing economy and rising inflation have made investors concerned about the prospects of some of the cyclical sectors of the economy. Bond values have been plummeting. Investors have been moving to the defensive sectors of the stock market. What is going on and what does it mean for the stock market?

Investors are losing their love affair with growth stocks. In this analysis, I am using the technology sector as a proxy for the growth sector. From mid-2013, up until the end of 2021, the technology sector outperformed the S&P 500. More recently, during the pandemic it benefitted from the work from home trend during the pandemic. It seemed that the technology sector would outperform forever. The technology sector did have a brief period of underperformance compared to the S&P 500 in Q1 of 2021, as interest rates were increasing. More recently, in 2022, the technology sector has been lagging the S&P 500. Times have changed. Yes, technology is the future, but sectors can become overvalued relative to their future growth, especially when interest rates are rising. Technology investing is not the only game in town and investors are looking to other parts of the stock market.



Technology's relative performance time line.

Period ① - Technology outperforming the S&P 500 despite rising interest rates from mid-2016 until late 2018. This was a period of technology dominance as tech companies grew at faster rates than other companies in the stock market.

Period ② - Technology increases its level of outperformance as interest rates fall from late 2018 to late 2020. Technology companies were still increasing in size with rapid growth in the sector, and falling interest rates helped to fuel a faster ascent of outperformance compared to the S&P 500.

Period ③ - Technology performs at market as interest rates rise and then slightly underperforms.

Period ④ - Technology outperforms as interest rates fall slightly and remain fairly flat. The prospect of falling interest rates helped to boost the relative performance of the technology sector.

Period ⑤ - Technology underperforms as interest rise. This is a normal relationship.

The technology sector is losing its lustre. In the past, investors have rotated back into the technology sector when the market has moved to a risk-on mode. Recently the sector has had trouble starting an extended rally. Investors are not coming back to the technology sector like they have in the past. If interest rates start to fall and the technology sector continues to underperform the S&P 500, this will probably indicate that the stock market is in "trouble."

Industrial sector is underperforming

Although, the cyclical sectors can include industrials, materials, financials and energy, for the purpose of this analysis I am going to focus on the industrials sector. The cyclical sectors of the market are diverse and affected by different variables at different times. The energy sector is performing well due to geopolitical circumstances. Likewise, the materials sector is performing well. The financials sector is performing at market. The industrials sector has been underperforming. The reason that I am focusing on the industrials sector is that it represents the manufacturing sector of the economy and is most likely to give a reading on the economy.

There has been some ups and downs, but the performance of the industrials sector has generally lagged the overall market. From the pandemic low, the industrial sector managed to rally into a peak of relative performance compared to the S&P 500 in May of 2021. At the beginning of 2022, the industrial sector, managed to outperform the S&P 500 into the beginning of March, but has since pulled back.

Industrials relative performance time line

Period ① - Industrials underperforming as China trade war heats up. Rate of underperformance increases as pandemic unfolds. As world economic growth was slowing, cyclical sectors such as the industrial sectors underperformed because of the possibility of diminished earnings.

Period ② - Industrials outperforming as recovery from pandemic gathers steam. This period was characterized by improving economic growth prospects for economies around the world as they re-opened from the pandemic.

Period ③ - Industrials underperforming as growth expectations for the economy start to slow.

The industrials sector managed to bounce of the Covid lows relative to the S&P 500. This has been in part because companies have been able to pass on the cost of inflation. More recently, that has not been the case as real wage growth has been declining. Companies have had to start absorbing the higher costs, which is starting to lead to sky high profit margins turning lower. This is particularly true for the industrial sector as a lot of purchases in this sector are ultimately discretionary. The profit margin data series is a regressive time series and there is a fairly large probability that profit margins will continue to recede from here (see graph below).

Before the Federal Reserve started its tightening cycle, the economy was already showing signs of slowing down. As the Federal Reserve moves further into its tightening cycle, it is expected that economic growth would be impacted in a negative manner. As a result, investors have been moving out of the industrial sector.

Defensives are the cleanest shirt in the laundry

Investors are used to seeing the defensive sectors underperform when interest rates are rising. In the past, interest rates have risen because of economic growth. Defensive sectors are less sensitive to economic growth and tend not to benefit as much as other sectors of the market when the economy is growing at a fast rate. In addition, the defensive sectors generally underperform when interest rates are rising, as their above average yields are worth less on a relative basis. Recently, the defensive sector have been outperforming in a rising interest rate environment (see graph below). Why?

So, why are the defensive sectors outperforming the S&P 500

This time around, interest rates are rising because of inflation and the Federal Reserve is starting to tighten its monetary policy. Investors want to stay invested. They are running from the growth sectors as interest rates move higher. They are running from some of the cyclicals as prospects for a slowing economy are increasing. Investors are moving to the defensive sectors as they are one of the few places to hide.

Consumer staples relative performance time line

Period ① - Consumer staples underperforming as interest rates rising. This is a normal response and it shows a healthy market. Interest rates were rising because of improving economic growth. Investors tend to move away from the defensive sectors of the stock market.

Period ② - Consumer staples outperforming as interest rates falling. This is a normal response as higher yields than the market makes the sector more appealing than the S&P 500. In addition, the sector generally has more stable earnings.

Period ③ - Consumer staples underperforming as interest rates rise. Like period ①, this is a normal relationship.

Period ④ - Consumer staples outperforming as interest rates falling. Like period ②, this is a normal relationship.

Period ⑤ - Consumer staples underperforming as interest rates rising. As interest rates were rising because of improving economic growth, the consumer staples sector lagged the market.

Period ⑥ - Consumer staples outperforming as interest rates rising rapidly. Interest rates have not been rising because of strong economic growth, but rather because of rising inflation. As investors have become concerned with a slowing economy and rising inflation, they have been moving out of the growth sectors and some of the cyclical sectors, and into the defensive sectors.

There are some exceptions to the shift to the defensive sectors. Investors have been moving to certain sectors of the stock market that have benefitted from inflation, such as the metals and mining sector. The risk to sectors such as the metals and mining sector is if demand destruction takes place as global economies slow down from rising rates.

How long will defensives continue to outperform?

One of the major reasons that the defensives sectors are outperforming is that government bonds have been performing poorly. Typically, on a seasonal basis, government bonds tend to perform well from May 6 to October 3, with August being the strongest month of the period. Government bonds have been falling rapidly in price (outside of their seasonal period). Normally, government bonds are a "risk-sink" as on the margin investors rotate out of equities into bonds. Investors want to stay invested, not make a cash call, so some investors typically rotate into bonds when they are concerned about stock market valuations and prospects. The problem is the government bonds have been plummeting in value and investors fleeing the asset class.

If interest rates were to head lower, and government bonds increase in value, the asset class could go back to being a "risk-sink," and investors could once again be attracted to government bonds. In this case, the defensive sectors would become, on a relative basis, less attractive as a place to hide. Falling interest rates are typically good for the defensive sectors, as their higher dividends and distributions become more valuable. The relative performance of the defensive sectors compared to government bonds, will depend on how attractive government bonds become. Falling interest rates do not necessarily mean that the defensive sectors will have negative performance; however, their performance may become more muted.

On of the biggest risks to the defensive sectors is if interest rates move lower and a risk-on rally ensues in the stock market. In this scenario, there is a high probability that the defensive sectors will underperform.

From December 2021, the defensive sectors have been oscillating between outperformance and market performance, with the overall trend of outperformance. The defensive sectors have either started their strong seasonal periods or set to start them soon. At the current time, it looks probable that the defensive sectors will continue their cycle of outperformance and market performance. If interest rates start to stabilize, despite the Federal Reserve's hiking

cycle, consideration should be given to shifting some defensive assets to government bonds. This is especially so, if the stock market enters into a risk-on phase.

The outperformance of the defensive sectors in a rising interest rate environment does not ensure the continued outperformance of the defensives. It is possible that the defensives could continue to outperform, with ebbs and flows of outperformance, but the bigger story is that the strong performance of the defensives in a rising rate environment is acting as a barometer in the market and sending a message that investors are not committed to this market. Typically, when the defensives outperform in this environment, it indicates a low probability of large gains for the overall market in the near future. The defensives' performance does not necessarily indicate that the stock market is about to suffer a large correction, but rather the increased probability of a large correction.

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