Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

WEEKLY CLIENT COMMENTARY November 21, 2019

Is the Market Back in "Risk-On" Mode?

A few weeks ago, I wrote in a Mitch on the Markets column that I'd been observing a notable rotation in the equity markets. I saw a significant shift away from cyclical sectors and towards defensive sectors. I noted in the column that in Q3 2019, the traditionally defensive Utilities and Consumer Staples sectors had been outperforming Information Technology by a ratio of at least 2-to-1, and that there were nearly 2.5 times the amount of put options on the S&P 500 Index as there were call options.

It was clearly a signal, in my view, that investors were worried about economic and equity market performance going forward, and that they were hedging against downside risk as a result.

My conclusion in that column was that investors were overpaying for this defensive posture. I believed better-than-expected economic news could drive mean reversion in the equity markets, with cyclicals outperforming. That's what we've seen so far in Q4.

Over the last month, cyclical sectors like Financials, Industrials, Information Technology, and Materials have outperformed while non-cyclical, defensive sectors like Utilities and Consumer Staples have sagged. Here is a snapshot look at performance over the last month[1] for these sectors:[2]

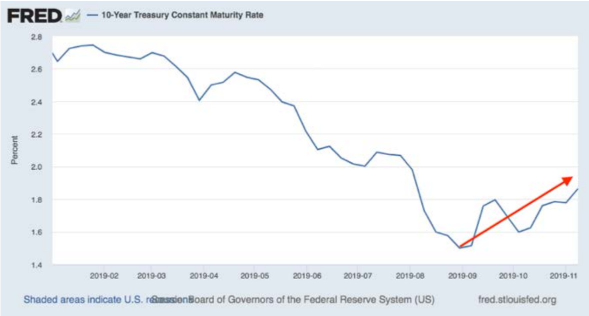
- Financials: +8.79%
- Industrials: +8.41%
- Information Technology: +7.36%
- Materials: +7.33%
- **S&P 500: +5.23%**
- Consumer Staples: -0.15%
- Utilities: -4.25%

It's clear to see that the sectors generally labeled as defensive have gotten beaten up during the current market rally. In my view, this divergence of performance marks a clear pendulum swing back into riskier categories, which we might classify as the market environment being "risk-on" again.

There is other evidence to support this shift in investor sentiment. Two exchange-traded funds (ETFs) that brand themselves as "low volatility" – the Invesco S&P 500 Low Volatility ETF and iShares Edge MSCI Min Vol USA ETF – have experienced large outflows in November and have underperformed the S&P 500 this month. Investors seem to be fleeing the defensive, worried-about-recession trades in favor of higher risk/reward categories like cyclicals.[3]

The bond markets are also reflecting this potential "risk-on" shift. Over the past couple of months, the 10-year Treasury yield has rebounded to its highest level since July, which is a signal that investors have been selling bonds. As you can see in the chart below, the uptick in bond yields has corresponded fairly tightly with the Q4 market rally, which I'd take as further evidence of a rotation.

10-Year Treasury Bond Yields Have Risen Over the Past Couple of Months



Source: Federal Reserve Bank of St. Louis[4]

To be fair, these are all short-term moves. As a long-term oriented investor, I do not put a whole lot of stock in month-to-month or even quarter-to-quarter changes in prices across sectors and asset classes. But it is interesting to note that the prevailing recession sentiment (and the corresponding 'wall of worry') has seemingly been replaced with renewed optimism for stocks and growth in the U.S. economy.

So, what's changed? In my view, pretty much nothing at all! The media narrative on trade has changed slightly, as hopes of "Phase 1" of a trade deal between the U.S. and China may include the reduction or elimination of some tariffs between the world's two largest economies. Time will tell.

The other, less frequently cited reason for renewed optimism and support for stock prices comes in the form of better-than-expected earnings results from Q3, in my view. To me, this offers a better explanation for why stocks have performed well recently. Total earnings (or aggregate net income) for the 469 S&P 500 companies that have reported results as of November 20 are down -1.2% (year-over-year) on +4.3% higher revenues, but a stout 72.7% of them beat EPS estimates and 57.6% beat revenue estimates.[5] The takeaway: American corporations have not fared as badly as many expected.

Bottom Line for Investors

Much of this week's column has focused on short-term price movements in the equity markets. As a client of Zacks Investment Management, you know we place far greater importance on longer-term trends and the value of investing in stocks for 10, 20, and 30 years – not 10, 20, and 30 days or months.

Short-term shifts in investor sentiment are interesting to observe, but I hope you can see the folly in attempting to toggle back and forth from "risk-on" to "risk-off." Doing so increases the risk of mistiming the markets, and in my view, will almost certainly compromise an investor's ability to generate attractive long-term returns.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Fidelity, November 14, 2019. https://eresearch.fidelity.com/eresearch/markets_sectors/sectors/sectors_in_market.jhtml

[2] Performance by sector from October 13, 2019 – November 13, 2019

[3] The Wall Street Journal, November 11, 2019. https://www.wsj.com/articles/november-rally-weighs-on-low-volatility-funds-11573493124

[4] Board of Governors of the Federal Reserve System (US), 10-Year Treasury Constant Maturity Rate [DGS10], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DGS10, November 14, 2019.

[5] Zacks.com, November 20, 2019. https://www.zacks.com/commentary/629846/weak-retail-sector-earnings

IN FOCUS THIS WEEK

- No more rate cuts in 2019. What does this mean for the economy?
- Could U.S. GDP growth fall below 1%?
- Total global trade is declining. What's next for U.S. – China trade dispute?
- Saudi Aramco could make history as the biggest IPO of all time.

No More Rate Cuts in 2019

Federal Reserve Chairman Jerome Powell met with Congressional lawmakers and President Trump last week, and in doing so he made one thing quite clear: there will almost certainly be no more rate cuts in 2019. Perhaps the only possibility of a rate cut would come from some unforeseen credit crisis or sudden decline in economic activity, neither of which seems likely at present, in our view. In Mr. Powell's own words, "we see the current stance of monetary policy as likely to remain appropriate as long as incoming information about the economy remains broadly consistent with our outlook of moderate economic growth, a strong labor market, and stable inflation." In other words, likely no rate cut in the balance of the year.[1] We have argued before that even recent rate cuts by the Fed were arguably not needed, as we believe the economy has been on relatively firm footing all year. The market is not ready to commit just yet, however, as the odds of a rate cut in 2019 remain at 50/50.

Will Saudi Aramco Make History as the Biggest IPO Ever?

The state-owned oil behemoth, Saudi Aramco, is inching closer to taking the company to the public markets. Before this week, the Saudis were seeking a valuation for the company of north of $2 trillion, which would essentially make it the biggest company in the world by a factor of two. But after further scrutiny and a lukewarm reception from some of the world's biggest investment firms, that valuation is now being targeted in the $1.6 trillion to $1.7 trillion range. In a potential IPO, Saudi Aramco is aiming to raise $25 billion, which would put it on par with the world's previously largest IPO: Alibaba. Saudi Arabia has indicated that funds raised from the IPO would help the kingdom diversify its economy by investing in the development of new sectors, like entertainment.[2]

Will U.S. GDP Growth Fall Below 1%?

U.S. retail sales rose a seasonally-adjusted 0.3% in October from the previous month, pointing to a resilient American consumer willing to continue spending. Given that the U.S. consumer accounts for approximately two-thirds of economic output, the story of economic growth could stop there. But weakness across industrial production, trade (see story below), and inventory data are becoming a force that the U.S. economy must reckon with. According to Moody's Analytics, U.S. GDP is expected to notch a paltry 0.6% growth rate in Q4, and the Atlanta Fed's GDPNow model forecasts a similar yawn: +0.3% GDP growth.[3]

Total Global Trade Declining

much attention has been drawn to trade deficits in recent years, and how they are somehow bad for the U.S. or any economy. But in reality, we think the focus should be on total trade, not trade deficits or surpluses. When total trade is rising – whether between two nations or within the global economy at large – then it means that more goods and services are being imported and exported, signaling overall growth and robust activity. That's why it is concerning to see reports from the World Trade Organization showing that the global flow of goods and services across borders are set to grow at the slowest pace since the end of the 2008 financial crisis. The obvious culprit, of course, has been the ongoing U.S. – China trade dispute, but global softening of auto sales are also to blame.[4] To the extent that the trade war carries on for the next several weeks, months, or even years, we're likely to see weaker growth numbers in total trade – and perhaps even contraction.

ZACKS INVESTMENT MANAGEMENT, INC.
www.zackspcg.com

[1] The Wall Street Journal, November 13, 2019. https://www.wsj.com/articles/feds-powell-signals-comfort-with-current-interest-rate-stance-11573655401?mod=djem10point

[2] The Wall Street Journal, November 17, 2019. https://www.wsj.com/articles/saudi-aramco-ipo-price-range-values-company-at-up-to-1-7-trillion-11573977968?mod=djem10point

[3] The Wall Street Journal, November 15, 2019. https://www.wsj.com/articles/u-s-retail-sales-rebounded-in-october-11573824926

[4] The Wall Street Journal, November 18. 2019. https://www.wsj.com/articles/trade-flows-set-to-stay-weak-says-wto-11574077395

DISCLOSURE

Past performance is no guarantee of future results. Inherent in any investment is the potential for loss.

Zacks Investment Management, Inc. is a wholly-owned subsidiary of Zacks Investment Research. Zacks Investment Management is an independent Registered Investment Advisory firm and acts as an investment manager for individuals and institutions. Zacks Investment Research is a provider of earnings data and other financial data to institutions and to individuals.

This material is being provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. Do not act or rely upon the information and advice given in this publication without seeking the services of competent and professional legal, tax, or accounting counsel. Publication and distribution of this article is not intended to create, and the information contained herein does not constitute, an attorney-client relationship. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were or will be profitable. All information is current as of the date of herein and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole.

Any projections, targets, or estimates in this report are forward looking statements and are based on the firm's research, analysis, and assumptions. Due to rapidly changing market conditions and the complexity of investment decisions, supplemental information and other sources may be required to make informed investment decisions based on your individual investment objectives and suitability specifications. All expressions of opinions are subject to change without notice. Clients should seek financial advice regarding the appropriateness of investing in any security or investment strategy discussed in this presentation.

Certain economic and market information contained herein has been obtained from published sources prepared by other parties. Zacks Investment Management does not assume any responsibility for the accuracy or completeness of such information. Further, no third party has assumed responsibility for independently verifying the information contained herein and accordingly no such persons make any representations with respect to the accuracy, completeness or reasonableness of the information provided herein. Unless otherwise indicated, market analysis and conclusions are based upon opinions or assumptions that Zacks Investment Management considers to be reasonable. Any investment inherently involves a high degree of risk, beyond any specific risks discussed herein.

It is not possible to invest directly in an index. Investors pursuing a strategy similar to an index may experience higher or lower returns, which will be reduced by fees and expenses.