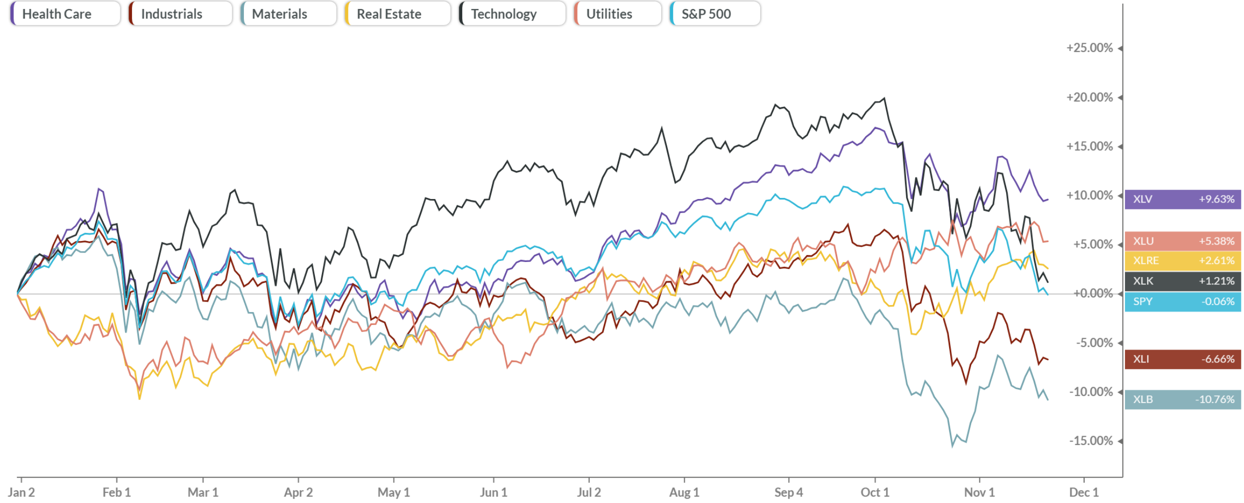
BI-WEEKLY RESEARCH & ANALYSIS

Sector Dashboard



Long vs Short Sector Matrix

1D 5D MTD 1M QTD 3M 6M **YTD** 1Y 3Y 5Y

	+ XLY	+ XLP	+ XLE	+ XLF	+ XLV	+ XLI	+ XLB	+ XLRE	+ XLK	+ XLC	+ XLU
– XLY	-	-5.7%	-13.4%	-9.5%	5.1%	-10.5%	-14.4%	-1.6%	-2.9%	-4.1%	1.1%
– XLP	6.1%	-	-8.1%	-4.0%	11.5%	-5.0%	-9.2%	4.4%	3.0%	1.7%	7.2%
– XLE	15.5%	8.9%	-	4.5%	21.4%	3.4%	-1.2%	13.6%	12.1%	10.8%	16.7%
– XLF	10.5%	4.2%	-4.3%	-	16.2%	-1.0%	-5.4%	8.8%	7.3%	6.0%	11.7%
– XLV	-4.9%	-10.3%	-17.6%	-14.0%	-	-14.9%	-18.6%	-6.4%	-7.7%	-8.8%	-3.9%
– XLI	11.7%	5.3%	-3.3%	1.0%	17.4%	-	-4.4%	9.9%	8.4%	7.1%	12.9%
– XLB	16.8%	10.1%	1.2%	5.7%	22.8%	4.6%	-	15.0%	13.4%	12.1%	18.1%
– XLRE	1.6%	-4.2%	-12.0%	-8.1%	6.8%	-9.0%	-13.0%	-	-1.4%	-2.5%	2.7%
– XLK	3.0%	-2.9%	-10.8%	-6.8%	8.3%	-7.8%	-11.8%	1.4%	-	-1.2%	4.1%
– XLC	4.3%	-1.7%	-9.7%	-5.7%	9.6%	-6.7%	-10.8%	2.6%	1.2%	-	5.4%
– XLU	-1.1%	-6.7%	-14.3%	-10.5%	4.0%	-11.4%	-15.3%	-2.6%	-4.0%	-5.1%	-

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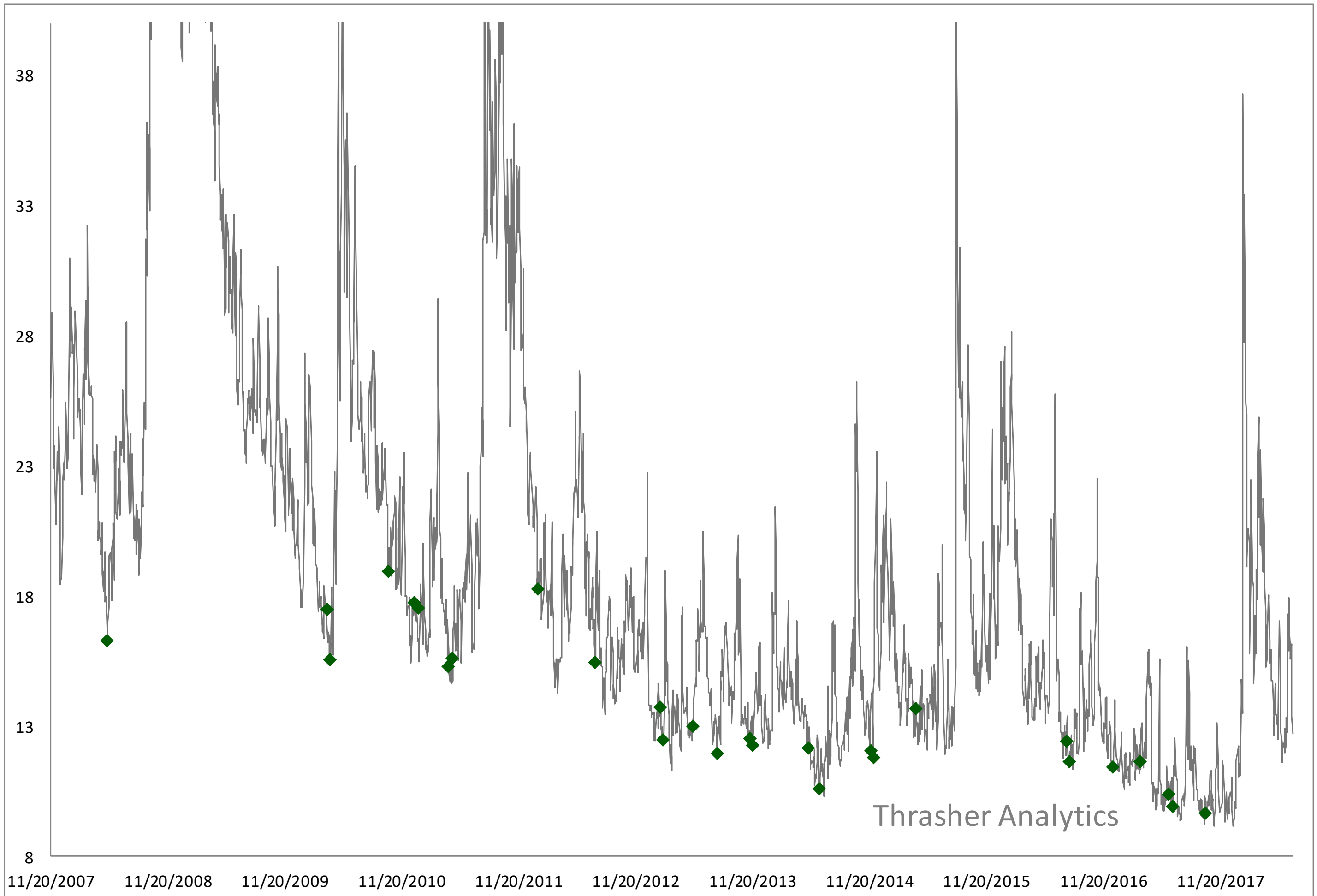
VOLATILITY RISK TRIGGER (VRT)



For many of the major indices that have dropped down to test their October low, their respective volatility gauges have remained below their own October peaks. This is (somewhat) of a positive development, but not one we can put too much weight on. The Volatility Index (VIX) futures curve has begun steepening again as the premium placed on front month contracts has begun to ease.

However, since the VIX itself has remained in a relative range, the metrics of the VRT have begun to decline, as dispersion for volatility has once again begun to narrow. We aren't to a level that would signal a concern of a large spike in the VIX, but the data is beginning to work its way back to such a possibility.

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Broad Market Commentary

Not the way you'd hope a shortened holiday week would turn out. The bulls had their low volume chance to buy equities while they were on an early Black Friday sale but that didn't seem to take place this year. After the S&P 500 met resistance at the October pivot high of 2820 the index dropped back down to its October low on above-average volume. In fact this retracement back to the low has occurred on several days of above-average volume, even with the expectation of many institutions not trading much size before the holiday, Wednesday was the largest volume day in two weeks.

We'll get a better 'feel' for the market this week as everyone returns to their trading desks. The February/ March lows are going to appear as magnetics to many investors with many traders I've spoke with expecting a test of those lows and many assuming they will not hold based on what's going on globally and in the fixed income markets with credit spreads widening.

Many trend followers saw the S&P 500 break their long-term monthly moving averages, whether it was the 10 -month, 12-month or so far this month, the 20-month as well. A close this week under 2640 (20-month MA) would push many trend following models to take a further step in de-risking.

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Equity Volatility vs. Bond Volatility

After the initial move higher over several days in the VIX in October, the 'fear index' declined into the start of November along with the Treasury Volatility Index also moving lower. However, a divergence was created with the bond VIX staying above its October pivot low as the VIX undercut its own. A heightened sense of fear in fixed income often leads equities as we've seen several times this year as shown by the blue lines noting the past divergences, many of which preceding rises in the VIX. Once again, we saw the equity VIX move higher back above 22 as we headed into the shortened Thanksgiving week. Treasury Volatility has begun to dip again while the Volatility Index has stayed firmed, I'll be watching this relationship this week and looking for signs of confirmation if equity vol begins to follow suit and decline with Treasury volatility or if the reverse happens and the rumbles in the bond pits begin to push Treasury Volatility back up.

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Positive Divergences in Breadth

I showed this chart as a warning (among many) of the narrowing level of participation in the equity market. Breadth was narrowing since August and only worsened in September and October before the final straw broke and sellers overwhelmed the market. Well now breadth has begun to improve with the 10-day Adv-Dec Line holding above its October low, as well as the 5-day total of Net new Highs on the major stock exchanges. This is a positive sign, and one I mentioned in my last Special Update email last week. Improvements in breadth are very important for the market to draw out a bottom but they are not the end-all-be-all. Market leadership as well as strengthening in fixed income risk-taking are also key signs we want to see.

As of right now (which I'll cover more on later) we don't have the thumps up from fixed income yet, and that's a concern that overshadows the firming up in market participation that we current are experiencing.

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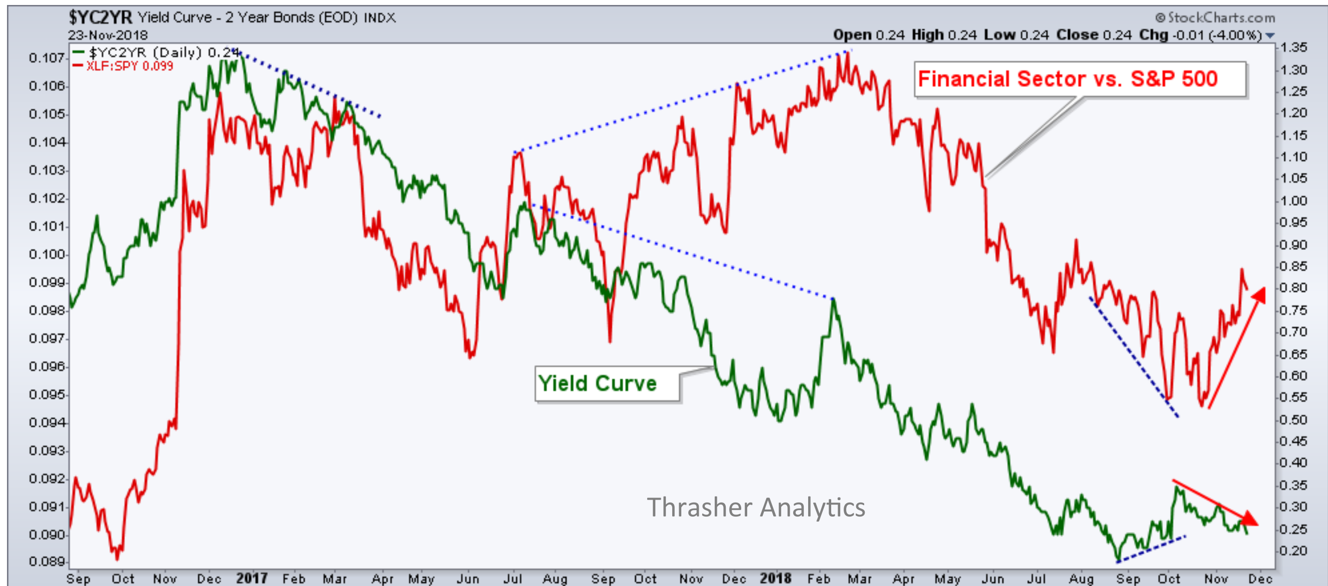
Yield Curve Not Confirming Financial Sector Strength



The Yield Curve has been an excellent tool in timing strength in the financial sector. When the two diverge, the curve is almost always 'right' in the eventual direction. We saw a large divergence build up in mid-20017 through early 2018 before the Financial Sector began to under-perform from March until late-October. The strength since mid-October was led by higher lows in the curve.

However, the Yield Curve has once again begun to flatten, creating a series of lower highs. But the Financial Sector has been ignoring this development for the last few weeks. If history is our guide, then we'll soon likely see a move lower in the financials relative to the S&P 500. In fact, on Nov. 20th, the ratio of XLF vs. SPY (not shown) hit its 200-day Moving Average and moved lower. That very well could have marked the end of the relative performance run for XLF, especially if the broad market continues to fall as well.

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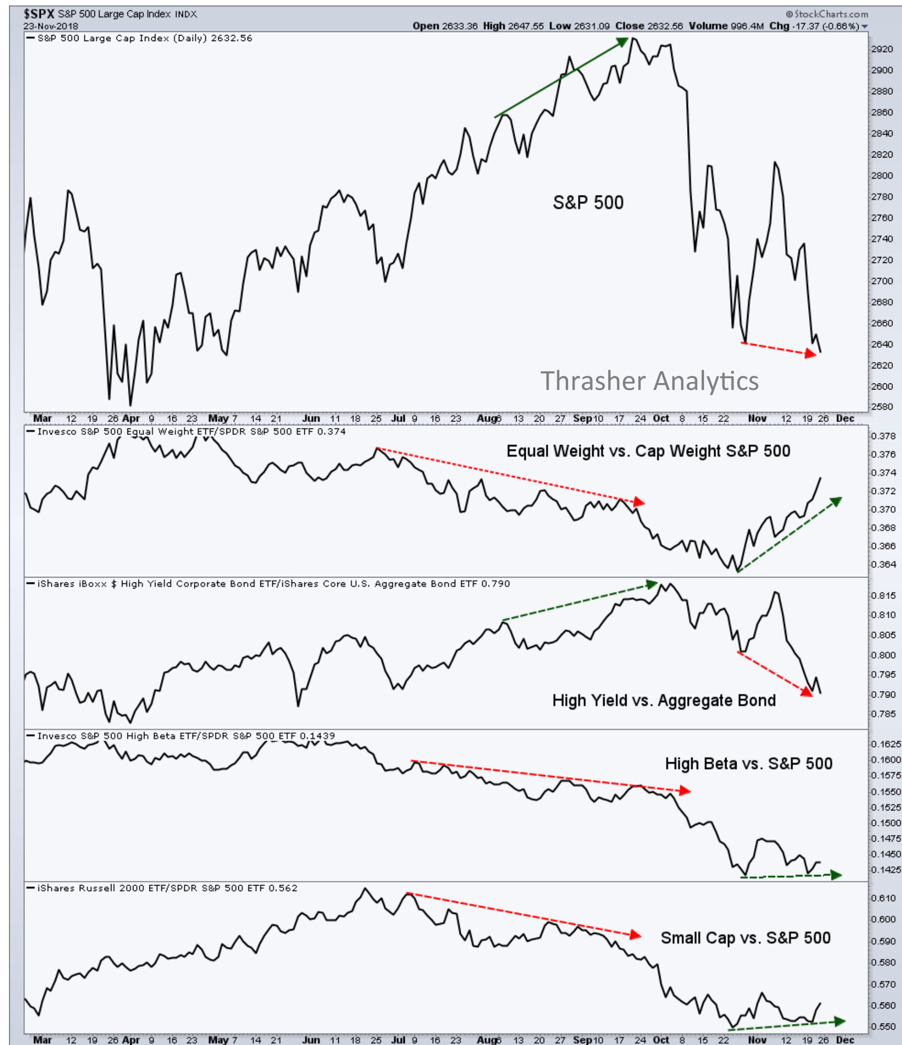
Investor Risk Appetite



Similar to the breadth chart I showed a few pages back, the risk appetite metrics have mostly improved, albeit in fixed income. I pounded the table with this chart that the market was not healthy in the summer as nearly each of the risk appetites ratios were not confirming the move in the broad indices. Ironically, high yield vs. aggregate bond was the one ratio that was confirming the markets trend in the summer and now is the one ratio that's still signaling 'risk off.' Spreads have been widening in many areas of fixed income, General Electric is basically seeing its debt trade like junk, so much for being an eternal blue chip company!

It is encouraging to see small caps and equal-weight S&P 500 strength. Honestly, I'm actually pretty surprised to see equal weight doing as well as it has since the October low. I believe it's largely due to the focus of selling on the market leaders, notably the FAANG stocks (more on this later).

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FAANG Stocks Get Slaughtered

What goes up must come down and the beloved FAANG stocks have been no exception. The S&P 500 made a closing high on September 4th and since then has fallen a little over 9%. Meanwhile, Google is down 16%, Apple has lost 24%, and Facebook and Amazon are down over 25% in that short time period.

Over the last month, the worst performing S&P 500 stocks have been PCG, GE, NVDA, and ATVI but Apple isn't too far down on that list. Of the S&P list, Apple has been the 9th worst performing component. If we were to dicing the data a little more and look at the mega cap stocks (+ $200 billion) then Apple is the worst performer, followed by Facebook at #2, Amazon at #3, AT&T at #4, and Exxon Mobil at #5.

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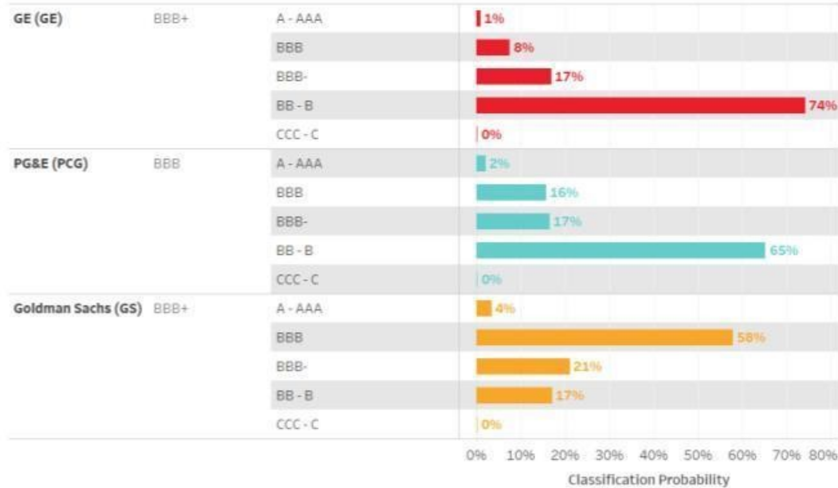
Is General Electric Headed for Junk Status?



Speaking of GE, Arbor Research & Trading shared the above chart publicly (so I'm able to pass it on to you here). It shows the markets expectation that GE debt (along with Goldman Sachs and PG&E) being downgraded. Specifically to BB-B status at S&P. Arbor uses CDS spreads, news sentiment, and other alternative data to generate these probabilities, which current have GE sitting at a 74% chance of dropping to junk bond rating levels.

The issue here is bigger than just General Electric. There's been a massive amount of IG debt issued over the last ten years with rates at historic lows - and rightfully so in most cases, as companies take advantage of those low rates to finance growth. However, if this IG debt begins to get downgraded, like GE, then we'll see a large amount of re-shuffling of indices and with it selling out of mutual funds and ETFs. The specific problem here is on the ETF side, which trades as if its underlying holdings are completely liquid (they aren't). IG ETFs will be forced sellers and if liquidity dries up, as it's begun to do, then we're going to have a real problem.

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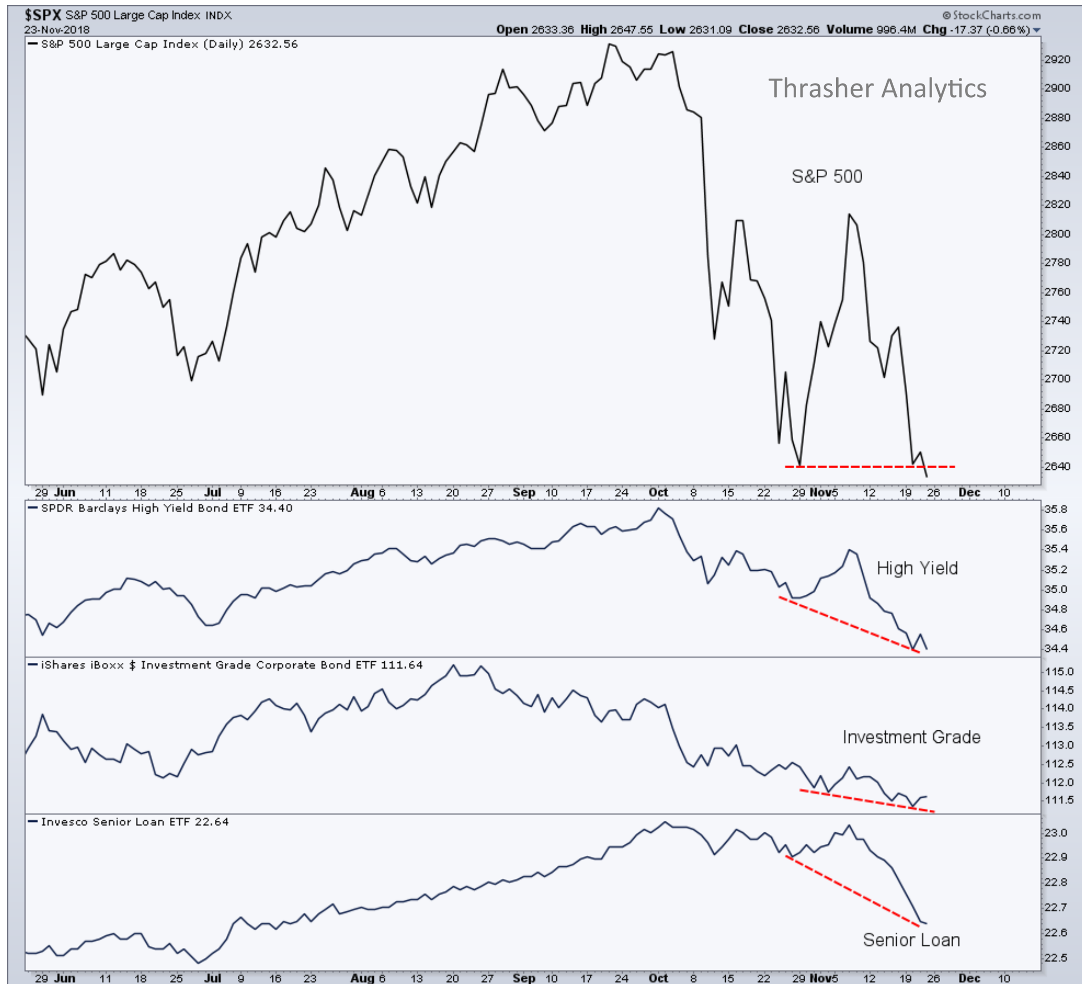
Fixed Income ETFs Make Lower Lows



One easy to read chart to show the breakdown in fixed income is simply looking at the price action of three of the largest/most popular fixed income funds: High Yield (HY), Investment Grade (IG), and Senior Loan. Each have taken out their October lows, with quite a bit of selling hitting senior loans specifically.

I've discussed several times in the past the growing concern in the leveraged loan market, which has grown to over $1 trillion now, if CLOs and cov-lite loans do begin to mimic what we saw with the shitty debt created with mortgages pre-2007, then this garden variety correction in equities is just the beginning. If the selling was just focused on the far ends of the risk curve then that would be one thing, but IG debt is getting whacked too which warns of a larger macro issue of slowing growth and potential trouble brewing internally within the debt market. With the Fed continuing to raise rates, cash is now paying *something* and is slowly becoming a more attractive asset class to investors. No longer does cash have to be parked in some realm of fixed income, especially as fixed income loses its diversification value factor as correlations across nearly all assets have moved positive - which is a problem when things start heading south.

All eyes should be squarely on fixed income going forward.

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European Sector Credit Spreads Hit 52-week Highs

					wk 47		
pos	0%	0%	0%	0%	0%		
neg	100%	100%	100%	100%	100%		52wk roll z
	1w	1M	YTD	1Y	vs avg		
ALL CORP INDEX	7	20	96	54	39	52wk HI	2.5
FINANCIA – BANKS	8	19	58	57	38	52wk HI	2.2
FINANCIA – INSURANCE	5	20	106	99	69	52wk HI	2.1
NON-FINANCIALS SECTORS – AUTO & PART	11	18	82	81	61	52wk HI	2.6
BASIC RES	10	17	56	57	43	52wk HI	2.3
CHEMICALS	7	18	33	33	26	52wk HI	2.7
CONSTR & MATER	8	16	64	67	46	52wk HI	2.4
F& B	7	18	37	37	29	52wk HI	3.1
HC	7	21	33	23	29	52wk HI	3.2
IND G&S	6	24	58	60	44	52wk HI	2.7
MEDIA	8	24	49	46	36	52wk HI	2.6
OIL & GAS	10	27	48	48	36	52wk HI	2.7
RETAIL	8	21	46	48	36	52wk HI	2.7
TECH	8	22	31	32	26	52wk HI	3.2
TELCOM	7	21	43	45	35	52wk HI	2.7
TRAVEL & LEIS	9	20	32	33	28	52wk HI	3.0
UTIL	7	17	47	49	33	52wk HI	2.2

The above chart comes from Kai Pflughaupt and shows the Equity sectors of Europe and their respective credit spreads. Notice that each is currently at a 52-week high. While it's no surprise that Europe has had its fair share of problems. But the breakdown in credit in Europe appears to now be having a bit of contagion to across the ocean and here at home in our own bond market.

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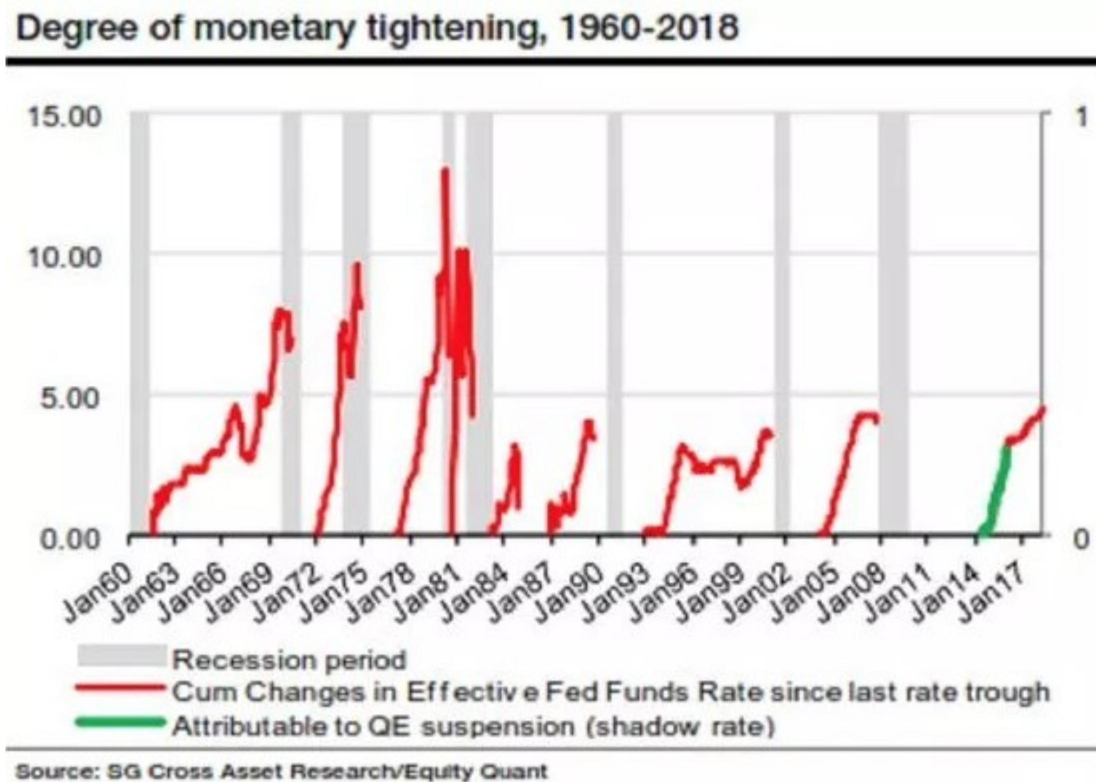
Will The Fed Pause After December?



What's the Fed going to due next? The likelihood of a rate hike, while expectations have been falling, will likely move ahead as scheduled. After that, I think we'll see a pause. I wrote in last letter that I believe the employment has probably peaked and the UR likely has bottomed. Inflation is less of a concern, especially as oil tumbles. The third Fed mandate, the unspoken one: financial market stability/volatility, is going to get more airtime at the December meeting.

Societe General put out the above chart and shows when you take into account the ending of QE and market that as a 'fed hike' then we're approaching five hikes which, since the 1980s, is typically when the Fed has paused. In fact, we didn't even get five hikes before the 2007 recession.

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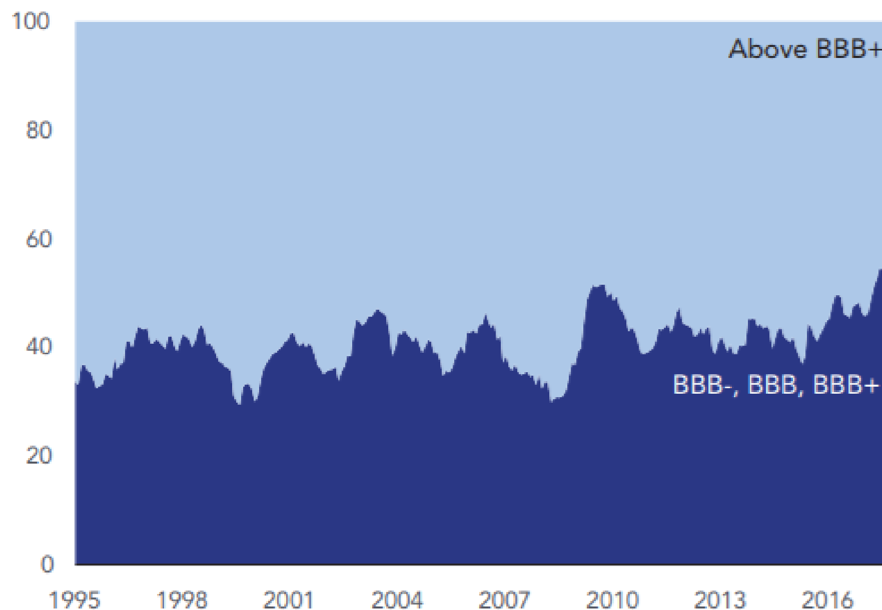
Low-Rated Debt is On the Rise



You know who else is worried about the growing low-rated debt? The Office of Financial Research (OFR), which just released their 2018 Annual Report to Congress which is basically a massive file of their reporting on the economy and any concerns they may have. I wonder how many in Congress actually read it? Well I did, and pulled out a few key topics. One of their opening lines of the report is as follows: "We continue to see macroeconomic risks as moderate. Unemployment is exceptionally low, growth remains healthy, and inflation is close to the Federal Reserve's target. However, we see more risks to the outlook this year than last. Key risks stem from interest rates potentially rising more quickly than expected, an unsustainable fiscal path of growing government debt, and substantial uncertainty surrounding trade tensions."

Here a quote from the report that accompanied the above chart, I think it's important to see the language they use rather than me summarizing: "Rapid growth in leveraged lending is a concern. These commercial loans, often used by borrowers with credit ratings below investment grade for buyouts, acquisitions, or capital distributions, can leave borrowers highly indebted. Strong investor demand for these higher-yielding loans is behind the rapid growth. Less creditworthy corporations took advantage of that demand by seeking more funding in leveraged loan markets. As a result, more than $1 trillion of leveraged loans are outstanding. That is more than 11 percent of all U.S. nonfinancial debt — a record high."

The OFR also cited concerns about cov-lite loans and their highly speculative nature.

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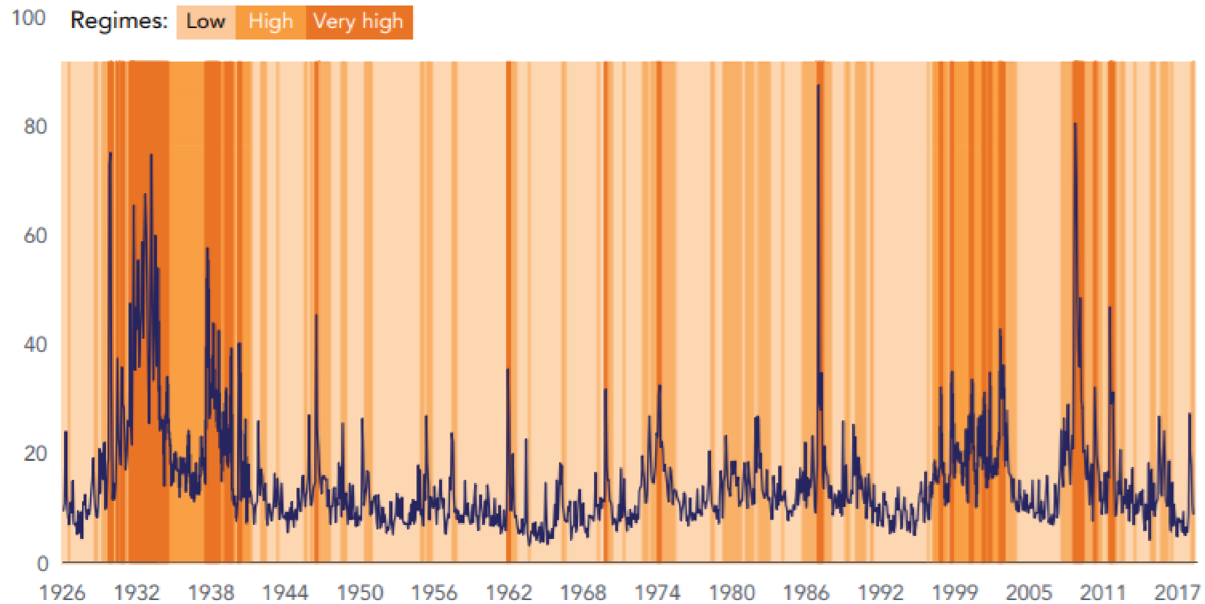
Volatility Can Rise Even in Strong Economies

Figure 25. Stock Market Volatility Model Shows Very High Spikes Are Rare (annualized percent)



Note: Data as of June 2018. The dark blue line is realized volatility and is the monthly standard deviation of daily returns for a stock market index that includes all U.S.-listed firms weighted by their market capitalizations. Median realized volatility is 11.8 percent from January 1926 through June 2018.

Sources: Calculated based on data from the Center for Research in Security Prices ©2018 Center for Research in Security Prices (CRSP®), the University of Chicago Booth School of Business; OFR analysis

The above chart also came from the OFR's report to Congress. You can imagine how happy I was to see them address the Volatility Index in their writing. They looked at when volatility shifts to a very high level and if its only associated with a deteriorating financial or economic landscape, which they concluded it was now. However they also noted that it was rare for vol to move straight from a low level to an extremely high 'regime'. Specifically they cited that "a high volatility regime is much more likely to transition to a low one than to a very high one. […] A low-volatility regime rarely shifts directly to a high one." They went on to conclude, "the evidence shows that very high spikes in volatility are not always associated with obvious economic and financial conditions." This shows that we can have large moves in volatility outside of recessions and financial crisis, February of this year is a perfect example.

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