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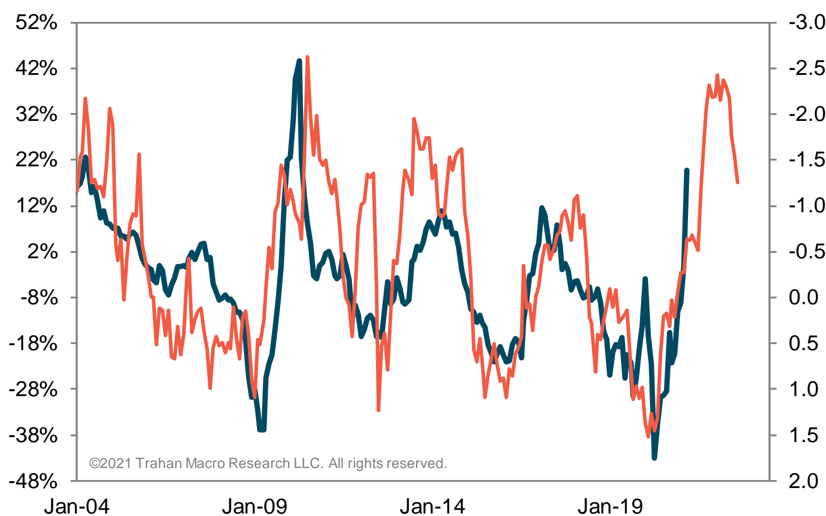
The Fourth Inning Of Cyclical Leadership

Surprisingly, pitching the Cyclicality/Value story has been harder than I had anticipated. I thought the strong performance of Cyclicals in the last six months would have made this an easier sell. Clearly, I underappreciated just how entrenched the Growth trade is in the investment world nowadays. In truth, Growth has dominated as an investment theme for over a decade now. That said, in the post Global Financial Crisis era, *I can't think of a time when Cyclicality/Value presented a more compelling investment than it does in 2021*. It's a simple thesis. The Fed and the Federal Government have pumped an insane amount of monetary and fiscal stimulus into the pipeline and the economy is still in the early stages of benefiting from this force.

Stimulus Should Support Cyclical Leadership Throughout The Rest Of 2021



We use various tools to forecast trends in Leading Economic Indicators (LEIs) and their market equivalents (like Beta in the chart above). These are all proxies of Fed policy and every single one is additive to our process. The best Anticipatory Economic Indicator (AEI) for timing an upcoming peak in LEIs, however, is the yield curve. It has a better track record than other proxies of policy like money supply or the fed funds rate.

At this stage, the yield curve argues that LEIs are unlikely to peak until 2022. This is encouraging as it argues that Cyclicality is likely to continue to generate alpha throughout the year. Worded differently, there are at least another nine months left in this Cyclicality/Value trade. *In this week's report, we focus on historical episodes that share similarities with today's backdrop in the hopes of finding lessons that can be used to help navigate 2021.* As always, your feedback is greatly appreciated. All the best, Francois

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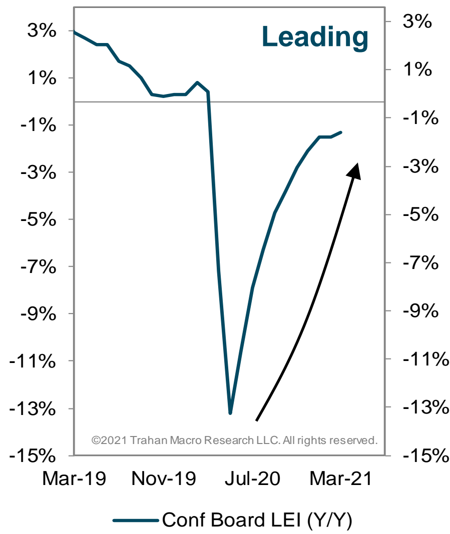
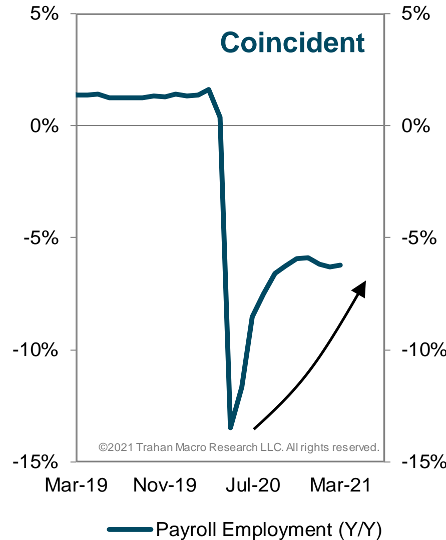
What We Know About The Economy: A Recovery Is Underway

The recovery is well under way across almost all types of economic data. LEIs started their rebound in the spring of 2020 and Coincident Economic Indicators (CEIs) followed suit fairly quickly. Meanwhile, Lagging Economic Indicators, as is typical in an economic recovery, took a little longer to find a footing but are now pointing north as well. The point is that no matter which data you are examining, you are seeing series that are now well off their lows, and in many cases they are sitting at cycle highs.

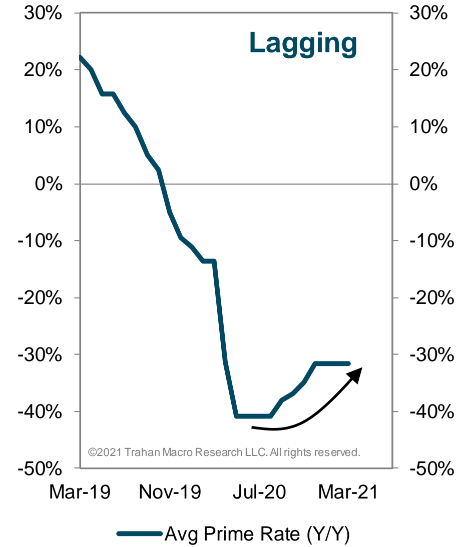
LEI Uptrend Well Underway



CEIs Not Far Behind



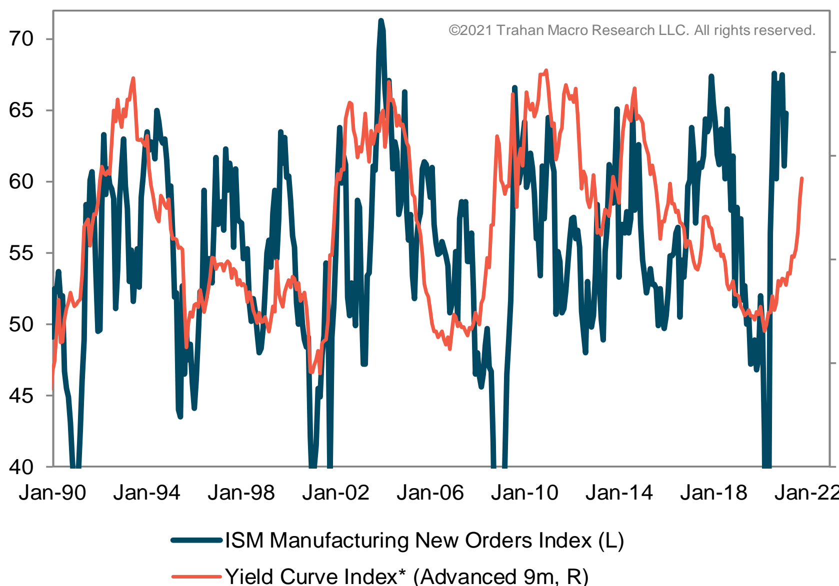
LAIs Following Suit

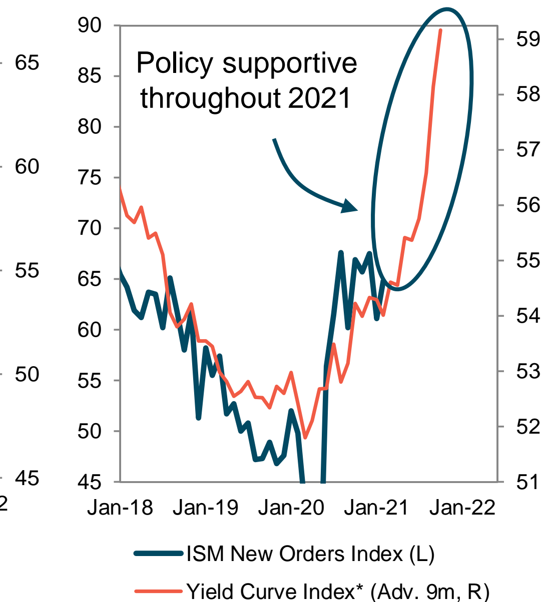


What Policy Says About The Economy Ahead: The Data Keeps Improving!

There is a "feel-good" effect coming from the recovery in the data we are seeing. That said, this feel-good data has been priced into financial markets a long time ago and the only thing that matters now is what's going to happen going forward. *The good news is that proxies of Fed policy, like the yield curve below, suggest that LEIs are likely to trend higher all year and ultimately peak in 2022.* This IS the basis of the Cyclicality/Value thesis and the one development that MUST occur.

Yield Curve Argues For Stronger Leading Indicators Throughout 2021





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When "Exactly" Will PMIs Peak? Yield Curve Argues ~9 Months

We've been using interest rates and proxies of Fed policy to forecast LEIs, and PMIs more specifically, for 20 years now. We find that every one of these series has something to add to our process for forecasting financial markets. That said, when it comes to "timing" the likeliest month of a future peak in the data, the yield curve has proven to be more accurate than others across time.

How Accurate Are Monetary Policy Tools In Forecasting A Peak?

Cycle Peak	10yr Yield	2yr Yield	Money Supply	Yield Curve
2017	✓	✓		✓
2014	✓	✓		✓
2009		✓	✓	✓
2004			✓	✓
2000			✓	✓
1998		✓	✓	✓

✓ Forecasted PMI peak within a 4-month window

The yield curve has the best historical record for "timing" a future peak in PMIs.

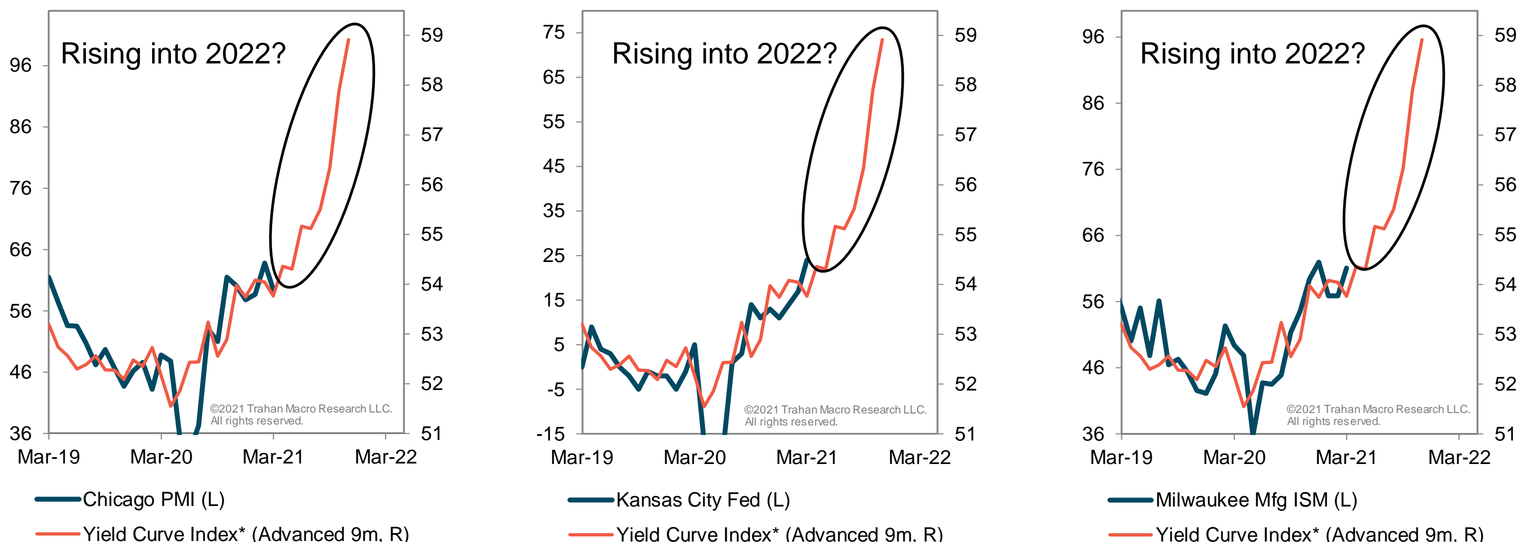
The table shows the efficacy of timing past peaks in the ISM New Orders Index for four proxies of Fed policy. This is not an apples-to-apples exercise as the 10-year and 2-year yield have longer lead times than money supply or the yield curve, but the latter is clearly the superior tool when it comes to timing.

When Will PMIs Peak This Cycle According To Monetary Policy?

Cycle Peak	10yr Yield	2yr Yield	Money Supply	Yield Curve
2021-22?	Q1'22	Q3'21	At least Q4'21	At least Q1'22

The yield curve helps forecast various LEIs with a lead time of about nine months. This is shorter than the other proxies of Fed policy we use, but it has been more accurate in timing inflection points across history. Since the yield curve is currently sitting near its steepest levels of the cycle, it argues that a peak in LEIs, or PMIs in the clip charts below, is likely to be 9-months away, or in other words, in 2022.

The Yield Curve Argues The Peak In PMIs Is At Least 9-Months Away



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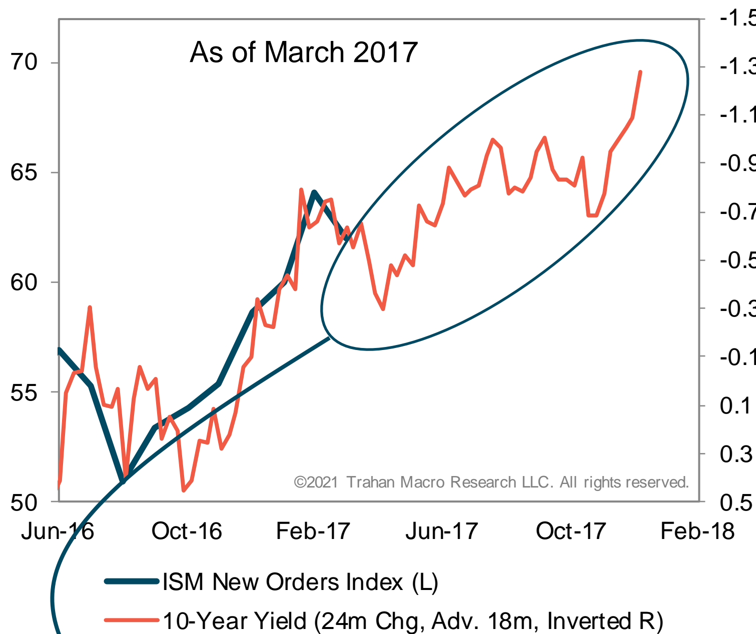
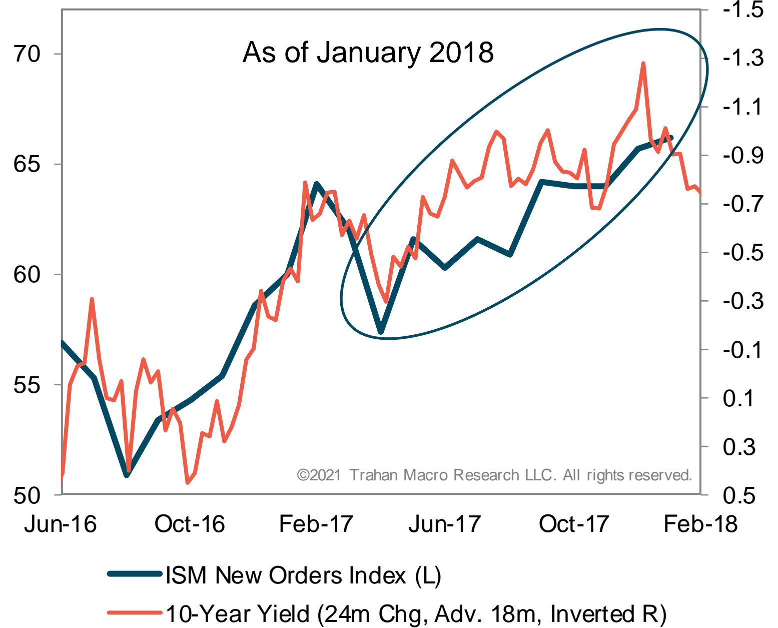
9-Months BEFORE A Peak in PMIs: The March 2017 Experience

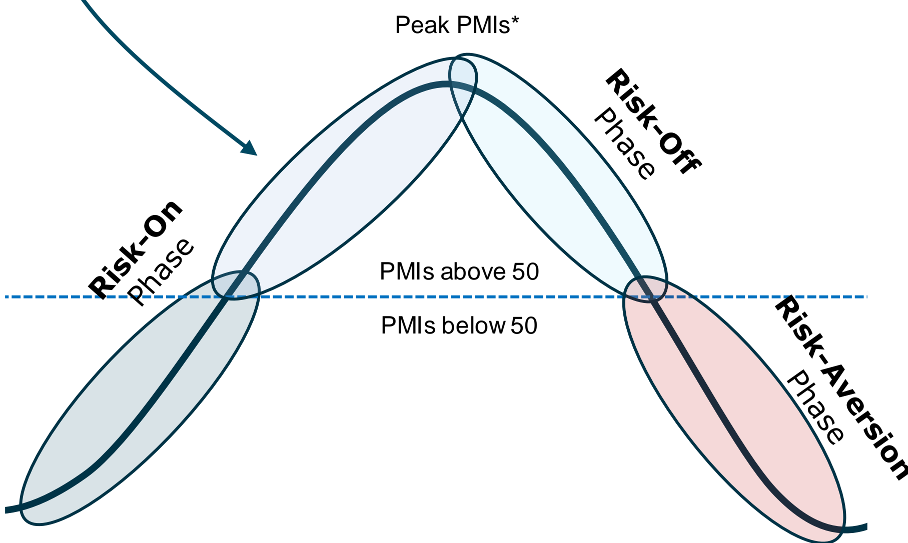
The last time investors were facing a similar set of interest rates/PMI conditions was in March of 2017. The equity market had been in Risk-On mode (i.e., Cyclical leadership) for six months at that time. The dilemma whether to stick with cyclicals or move to a more defensive portfolio was very real. Indeed, the ISM had moved lower in the prior month and concerns were brewing over inflation and the Fed's potential response to it (which sounds familiar today). Interest rates, however, were giving a very clear message. *They argued that the uptrend in LEIs, like the ISM in the left chart below, was intact and likely to continue for another nine months at least.* Worded differently, cyclical leadership was set to continue.

Rates Argued For More Upside In PMIs …



… And PMIs Trended Up For Another 9 Months





Rule Of Thumb For Risk-On Leadership

	Risk-On
Equity Dynamic	P/E Up; EPS Up/Down
Asset Allocation	Equities > Bonds
Style	Value > Growth
Size	Small > Large
Sectors	Cyclicality
Factors	• High Beta • High Volatility • Book Yield • Sales Yield

It takes a leap of faith, of course, to believe that Fed policy will work the way it has in the past, and to believe that a trend already in place will continue for several more quarters. The point is that proxies of Fed policy, like the yield curve, have a lot to offer as to the most likely path of the business cycle back in March of 2017. Moreover, *understanding the coming course of economic prospects revealed a lot about the optimal positioning for the rest of 2017, just as it does today.*

*Peak PMIs: Two months prior to the peak in PMIs until one month after

March 2017 Redux: Consensus Was VERY Concerned About Inflation

Most economic recoveries end up creating inflationary pressures at some point. That's just a reality. This helps explain why it's not unusual to find that investors have concerns about inflation when equity markets are in Risk-On mode (Cyclical leadership). This was the situation in March of 2017, as is the case today, when PMIs were six months off their lows and set to trend higher for another nine months. The key point here is that inflationary pressures only intensified over the course of the year as PMIs continued to trend higher.

Inflationary Pressures Built Throughout 2017

<u>Headlines from March 2017</u>:

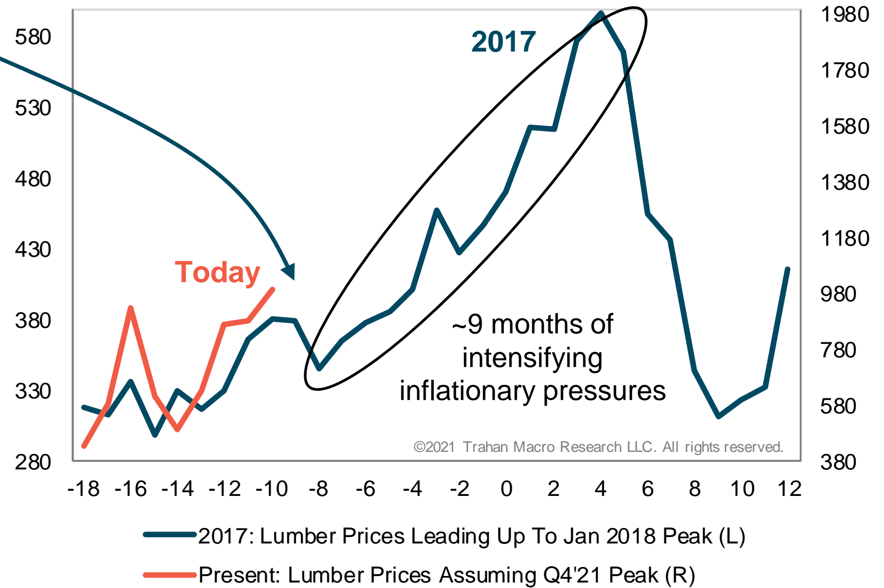
Inflation hits the Fed's target for the first time in nearly 5 years

Dudley says growth, **inflation risks** may be shifting to upside

Rosengren says there is evidence actual **wages going up**

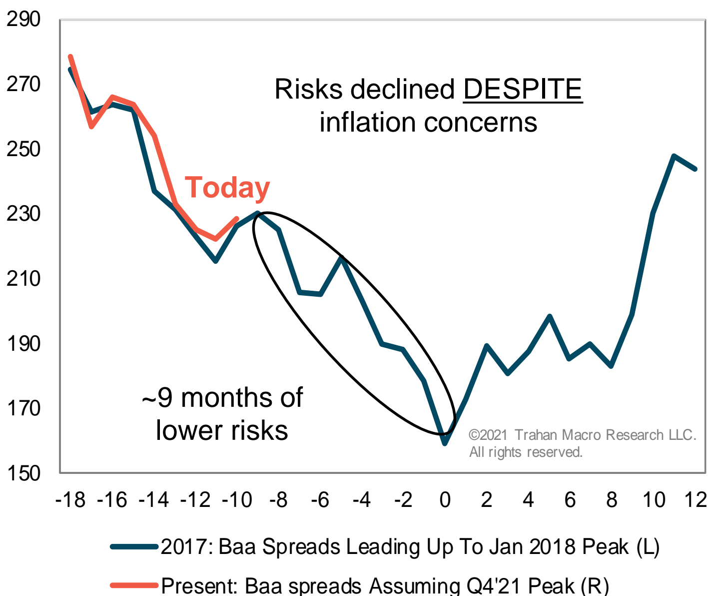
Rosengren says **inflation** worries seen in wages, asset prices

Williams: running policy too hot too long will spur **inflation**

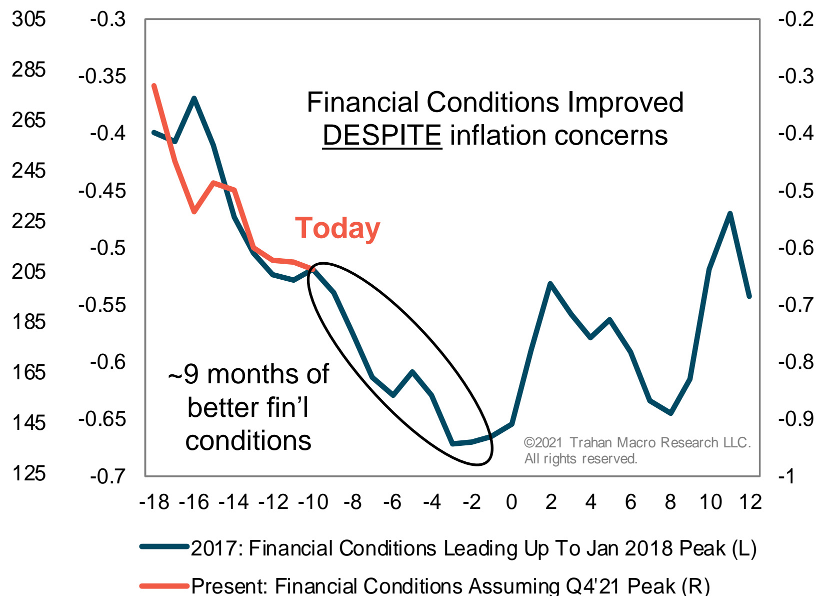


Inflation was a concern in March 2017. Pundits and the media discussed it regularly as did Fed officials. Nonetheless, LEIs continued trending higher over the course of the year. More importantly perhaps, risks (see Baa spreads in the lower left chart) receded consistently through 2017. Similarly, financial conditions also continued to improve UNTIL the eventual peak in PMIs. The point here is that is it OK to be concerned about inflation in 2021. *It is fairly textbook for inflation to accelerate at this stage in the cycle. What history shows, however, is that these concerns do not necessarily derail a recovery.*

Financial Risks Continued To Decline



Financial Conditions Continued To Improve



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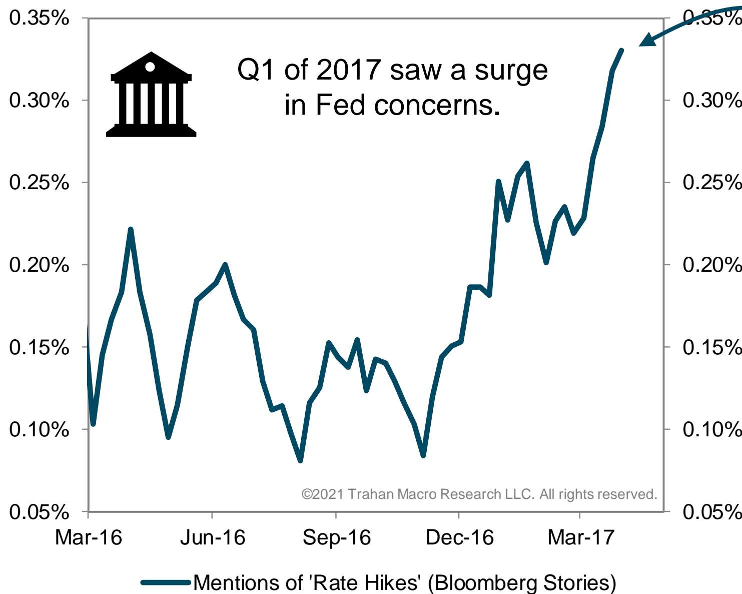
March 2017 Redux: Consensus VERY Focused On Fed Rate Hikes

The Fed's intentions are almost always a focus for the markets. Across history, however, it is more likely to be a concern when markets exhibit Cyclical leadership because those periods are typically synonymous with better data. Therefore, it's no surprise that the potential for further rates hikes was THE topic on investors' minds in March of 2017. The Fed ended up raising rates three times that year and the topic dominated the news flow. All that said, none of these concerns were enough to derail the uptrend in LEIs, and the ISM continued to trend up throughout the year.



Headlines from March 2017:

Fed's Kaplan: **three rate hikes** good `base case' for this year

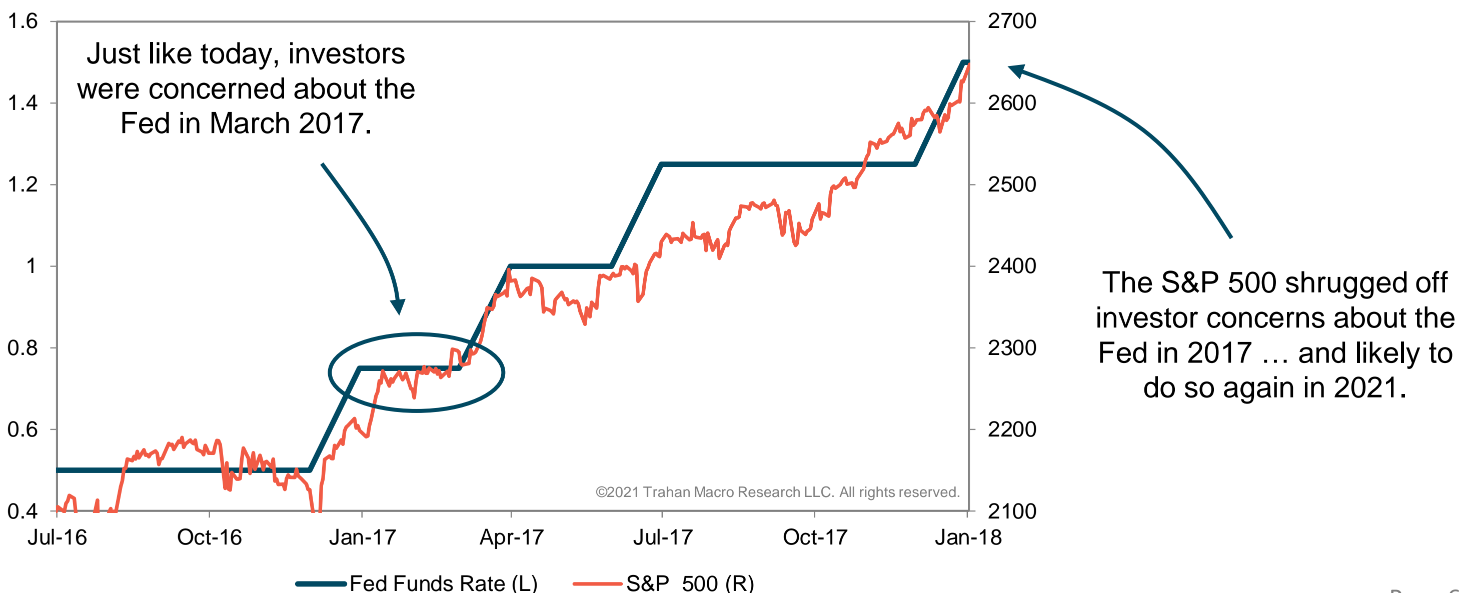
Cleveland Fed's Mester backs **multiple rate increases** this year

Fed officials say they may need to pick up pace of **rate increases**

Fed's Rosengren says **4 hikes** may be needed in 2017

Fed's Williams Says There Could Be **Disruptive Market Correction**

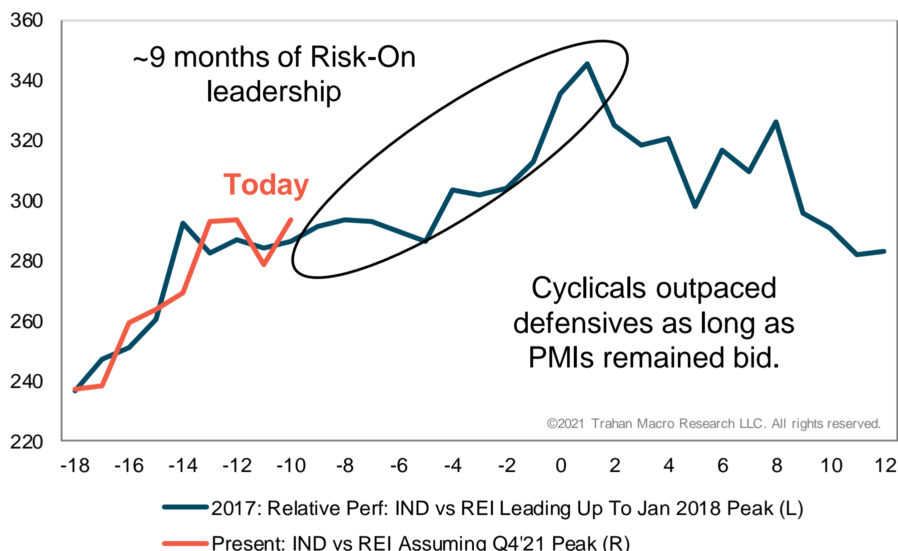
One common inconsistency across history has to do with the stock market and its relationship to the Fed. Undeniably, there exists a positive relationship between the fed funds rate and the S&P 500. This is because the stock market itself rises or falls with the ebb and flow in economic prospects; the same prospects that influence Fed policy. We believe that today investors should fear an easing cycle, not a tightening cycle, at least not in the near-term. *In 2017, rate hikes and concerns about the Fed did not prevent the stock market from moving higher throughout the year.*



March 2017 Redux: Cyclicals Had Been Leading And Continued To Lead

The S&P 500 had a great run in the six months leading up to March of 2017. Indeed, the Index was up 8.9% in that short time frame. Cyclicals (Risk-On segments) were up over twice that amount, on average, during the same period. The temptation at the time, in the face of mounting inflation and Fed concerns, was to take profits. The correct call, however, was to stick with the Risk-On trade which ended up gaining another 20.1% for rest of the year. Defensives (Risk-Aversion trade) lagged in the lead up to March 2017 and thereafter while Risk-Off (Growth) was basically in line with the S&P 500.

Cyclicals Outpaced Defensive Sectors



Cyclicals Led As Long As PMIs Were Up

	Perf From Q4'16 – Q1'17	Perf From Q2'17 – Q4'17
Risk-On	**19.7%**	**20.1%**
Risk-Off	**11.2%**	**15.4%**
Risk-Aversion	**0.8%**	**2.9%**
S&P 500	**8.9%**	**13.2%**

Average Abs. Performance By Classification*

	Q4'16 – Q1'17	Q2'17 – Q4'17
Risk-On	**19.7%**	**20.12%**

Very strong gains for Risk-On sectors leading up to March 2017 followed by even stronger gains in the next nine months until the peak in PMIs.

Most of the stronger performers in the lead up to March of 2017 were Cyclical industries like Banks, Semiconductors or Transportation. These segments continued to outperform through the end of the year, as data, like the ISM, continued trending up just as interest rates had suggested. Most of the biggest laggards leading up to March 2017 and thereafter were defensive segments like REITs and Telecom. *The conclusion is to let your winners ride as long as the backdrop is supportive. In March 2017, just like today, the yield curve argued that you had another nine months to go.*

Risk-On Segments (Cyclicals)

S&P 500 Risk-On Segments	Perf. From: Q4'16 - Q1'17	Perf From: Q2'17 - Q4'17
Banks	32.12%	18.06%
Diversified Financials	18.51%	20.56%
Semis	11.76%	26.86%
Tech Hardware & Equip	21.05%	16.07%
Transportation	14.84%	19.04%
Avg of Risk-On	19.66%	20.12%
S&P 500 Index	8.97%	13.16%

Absolute Performance

Risk-Aversion Segments (Defensives)

S&P 500 Risk-Aversion Segments	Perf. From: Q4'16 - Q1'17	Perf From: Q2'17 - Q4'17
Telecom	-1.70%	-0.96%
Real Estate	-2.69%	4.32%
HH & PR Pdts	-0.09%	3.89%
Food, Bvg, Tobacco	5.06%	2.44%
Comm & Prof Services	3.24%	4.96%
Avg of Risk-Aversion	0.76%	2.93%
S&P 500 Index	8.97%	13.16%

Absolute Performance

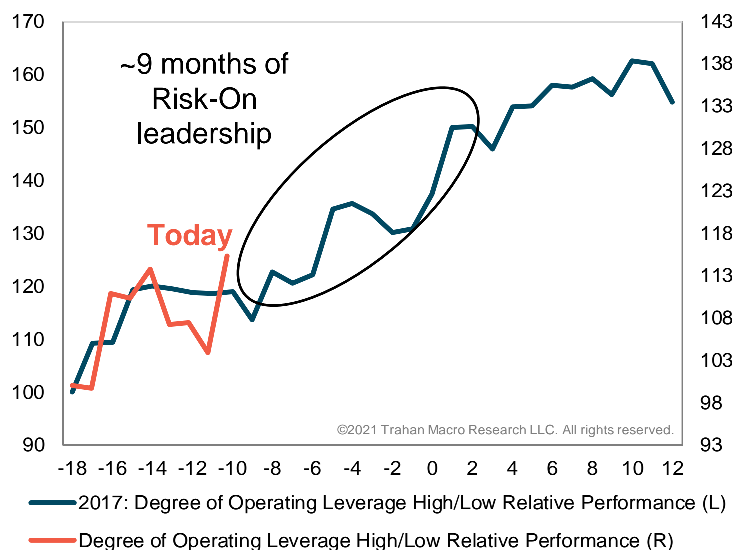
*Risk-On: Banks, Diversified Finl's, Semis, Tech Hardware & Equip, Transportation
Risk-Off: Media, Consumer Svcs, Tech Software, Retailing,. Health Care Equip
Risk-Aversion: Telecomm, Real Estate, HH&PR Pdts, Food,Bvg&Tobacco, Comm & Prof Svcs

March 2017 Lesson: Stick With Your Winners (Stocks Adding Alpha)

The point of revisiting the March of 2017 episode – a time when PMIs had been rising and rates argued that they were set to continue rising – is to show that inflation or concerns about the Fed are normal by-products of cyclical leadership. Cyclicals work when the economic outlook is improving which is often when inflationary pressures build, and Fed-speak is increasingly hawkish. Neither of these concerns derailed the cyclical trade in 2017 as it was driven by improving data and not much else. At the end of the day, what outperformed going into March of 2017 continued to do so throughout the year. Better data was the ultimate driver of the cyclicality-leadership trade in 2017.

	Q4'16 – Q1'17	Q2'17 – Q4'17
Working Capital	**14.3%**	**18.1%**
S&P 500	**9.0%**	**13.2%**

Absolute Performance



	Q4'16 – Q1'17	Q2'17 – Q4'17
Op. Leverage	**11.8%**	**20.6%**
S&P 500	**9.0%**	**13.2%**

Absolute Performance

I realize that the story is beginning to feel repetitive, but what unfolded at the sector level played out exactly the same way amongst factors. Indeed, factors that generated the most alpha leading up to March 2017 were mostly cyclical factors, like "Degree of Operating Leverage" in the chart above right. Importantly, these factors continued to generate significant alpha throughout the rest of 2017 as economic data kept improving. The opposite was true of the more Defensive, or Risk-Off, factors.

Risk-On Factors Generated The Most Alpha …

S&P 500 Risk On Factors	Perf. From Q4'16-Q1'17	Perf. From Q2'17-Q4'17
High Operating Leverage	11.8%	20.6%
High Dividend Yield	15.8%	15.9%
High Earnings Yield	17.9%	13.2%
High Operating Margins	12.3%	15.6%
High Working Capital	14.3%	18.1%
Avg of Risk-On	14.4%	16.7%
S&P 500 Index	9.0%	13.2%

Absolute Performance

… Risk-Aversion Factors The Least Alpha

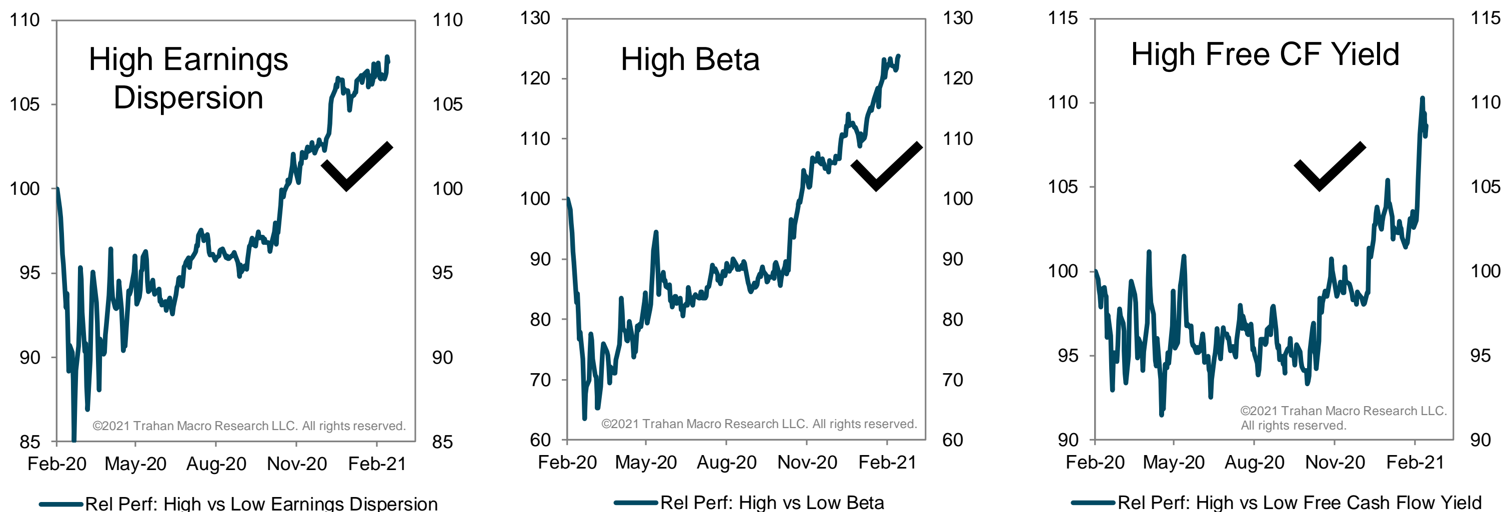
S&P 500 Risk Aversion Factors	Perf. From: Q4'16-Q1'17	Perf. From: Q2'17-Q4'17
Low Beta	5.7%	11.1%
Low Momentum	7.0%	6.9%
Low Interest Coverage	2.6%	4.1%
Low FCF Yield	4.7%	6.1%
Low Earnings Dispersion	4.2%	12.3%
Avg of Risk-Aversion	4.8%	8.1%
S&P 500 Index	9.0%	13.2%

Absolute Performance

Keep A Close Eye On LEI Trends And Stick With The Winners

The last time we had Risk-On leadership and proxies of Fed policy that were calling for another nine months of higher PMIs was in March of 2017. *Like today, there were concerns back then about inflation and the Fed raising rates. The correct call, however, was to stick with what was working, which was cyclicality.* For the most part, what had been working continued to work. There are many factors currently adding alpha in 2021, and most of them we would classify as cyclical factors.

The Factors Adding Alpha Are Mostly Cyclicals … Supported By Stronger Economic Data



There are factors generating alpha in each of the categories we follow, with the exception of Profitability, where every factor we track is underperforming. The one commonality found across the factors highlighted above is that they tend to correlate with the business cycle (i.e., they are cyclical). The same could be said of Debt-To-Equity, which we classify in the Governance category, or Capital Intensity from Operating Efficiency. All five of these cyclical factors are included in the screen below. This is not meant to be all-encompassing, but rather a way to focus investors on the stock characteristics that are likely to be rewarded throughout the rest of 2021.

Some Of The Top Cyclical Factors Adding Alpha In 2021

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Universe: S&P 500

Calculations As Of: 3/18/2021

Lower Deciles Rank Better In All Categories

(1 = High, 10 = Low)

Ticker	Name	EPS Estimate Dispersion	Beta	Leverage	FCF Yield	Capital Intensity	Price	Market Cap	Sector
LVS	Las Vegas Sands Corp.	1	3	1	10	2	$ 65.93	50,360.2	Discretionary
NRG	NRG Energy, Inc.	1	7	1	1	7	$ 36.18	8,852.8	Utilities
BKNG	Booking Holdings Inc.	1	4	2	9	4	$ 2,461.78	100,838.9	Discretionary
GE	General Electric Company	1	5	2	9	4	$ 13.61	119,559.1	Industrials
LYB	LyondellBasell Industries NV	1	2	2	5	8	$ 108.72	36,326.9	Materials
TMUS	T-Mobile US, Inc.	1	9	3	9	5	$ 127.30	158,209.0	Communication
ETSY	Etsy, Inc.	1	1	3	8	9	$ 218.44	27,534.2	Discretionary
VNO	Vornado Realty Trust	1	3	4	5	1	$ 48.42	9,923.1	Real Estate
UDR	UDR, Inc.	1	8	4	6	2	$ 45.20	21,765.9	Real Estate
HES	Hess Corporation	1	1	4	10	3	$ 70.85	21,750.0	Energy
DVN	Devon Energy Corporation	1	1	4	8	4	$ 23.68	15,938.7	Energy
RL	Ralph Lauren Corporation Class A	1	2	4	8	6	$ 121.07	8,854.7	Discretionary
UAA	Under Armour, Inc. Class A	1	3	4	9	9	$ 22.99	9,594.1	Discretionary
PEAK	Healthpeak Properties, Inc.	1	9	5	6	2	$ 32.49	17,501.9	Real Estate
TSLA	Tesla Inc	1	1	5	9	8	$ 701.81	673,634.8	Discretionary
MPC	Marathon Petroleum Corporation	1	1	5	10	9	$ 56.21	36,647.2	Energy

Full list is available for clients of Trahan Macro Research. E-mail us at quant@trahanmacroresearch.com if you would like to receive the full stock screen.

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