ENDURO, LLC

Stock Market Basics: A Look at Markets, Industries and Investor Behavior Part 3

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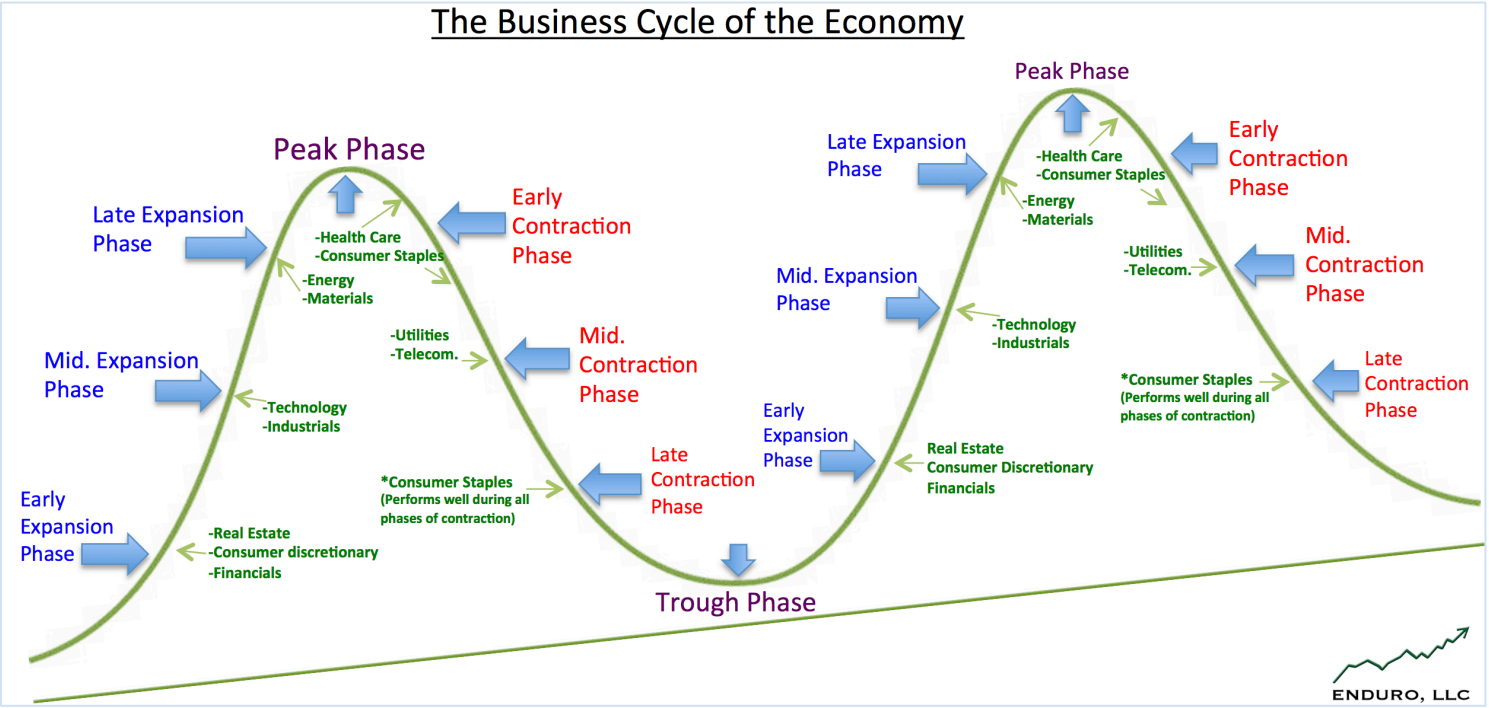
Introduction

In Part 3 of this series, we direct your attention to sector capital flows and the performance of various S&P 500 sectors, relative to both business and stock market cycles. This information reveals how focused analysis of sector money flows may be able to enhance equity returns regardless of fundamentals.

Over the period 1962-2017, the 11 sectors of the S&P 500 have portrayed low performance correlations relative to each other throughout the various phases of the business cycle. Further examination of this data indicates that the S&P's top-performing sectors change over the course of the business cycle.

Figure 1 below, displays the S&P 500's top performing sectors (in green), at each phase of the business cycle (in blue, purple and red).

Figure 1: Leading Equity Sectors of the Business Cycle



During expansionary phases, money flows into cyclical sectors (real estate, consumer discretionary, financials, technology, industrials) and out of defensive sectors (consumer staples, utilities, telecom). Money flows of the expansion phase often boost cyclical sector performance and cause short squeezes amongst contrarians.

During phases of contraction, cyclicals tend to underperform the market as money flows into more defensive sectors. Therefore, companies that produce necessity items, such as food and electricity, often outperform the market when the business cycle contracts.

ETF's are subject to market cycles and risk.

Passive ETFs or mutual funds that mimic the S&P 500 are not invincible to cycles either**.** These funds are heavily exposed to cyclicals, which comprise of more than 60% of the S&P 500's current total weight. Therefore, cyclical outflows will hinder passive index funds if the business cycle contracts.

Leading sector performance analysis throughout phases of the business cycle.

Early Expansion Phase

The early expansion phase of the business cycle provides investors with a 20% return on average and lasts 12 months.

During this phase, consumer discretionary (CD) attains greater inflows than any other sector of the S&P. CD also outperforms the broader market 99% of the time, by 15%. CD's strong performance can be credited to upticks in consumer confidence, new orders, sales of consumer goods, and low interest rates.

Real estate, financials, and industrials also perform soundly during the early expansion phase, as interest rates remain low. However, real estate and financials only beat the market 50 to 70% of the time, by 3 to 7%. Industrials outperform the market 80 to 90% of the time, by 2 to 5%.

Safe haven sectors typically experience heavy outflows during the early expansion phase. These sectors include consumer staples, utilities, telecom, and health care. Lastly, low interest and inflation rates cause the energy sector to underperform the market.

Middle Expansion Phase

The middle expansion phase of the business cycle typically lasts 3 to 4 years and produces a 15% return on average. Here, the economy is strong enough for sensitive sectors, such as technology and industrials to outperform the market.

Furthermore, decreases in business inventories and unemployment, boosts S&P performance during the middle expansion phase. However, market corrections often occur, causing sector leadership to vary. For instance, technology often leads the 11 sectors of the S&P at this stage, but only outperforms the market 40 to 50% of the time.

Lagging sectors of the middle expansion phase typically include materials and utilities.

Late Expansion Phase

The late expansion phase of the business cycle lasts 1 to 2 years and provides a 5% return on average. During this phase, GDP growth slows, CPI numbers skyrocket, and credit tightens.

As the economy approaches its peak, consumer discretionary and technology experience sector outflows. Contrariwise, the materials and energy sectors attain positive capital inflows and outperform the market 85 to 95% of the time.

Contraction Phase

The contractionary phase has provided investors with a noxious average return of -27%. During this phase, consumer staples (CS) attains more inflows than any other sector of the S&P. CS also outperforms the broader market 99% of the time, by 11 to 15%. Defensive sectors, such as utilities, health care and telecom often beat the market 65 to 85% of the time, by 5 to 11%.

Sectors sensitive to interest rates are likely to experience capital outflows as the business cycle contracts. Therefore, consumer discretionary, technology, financials, and industrials usually underperform the market during the contraction phase.

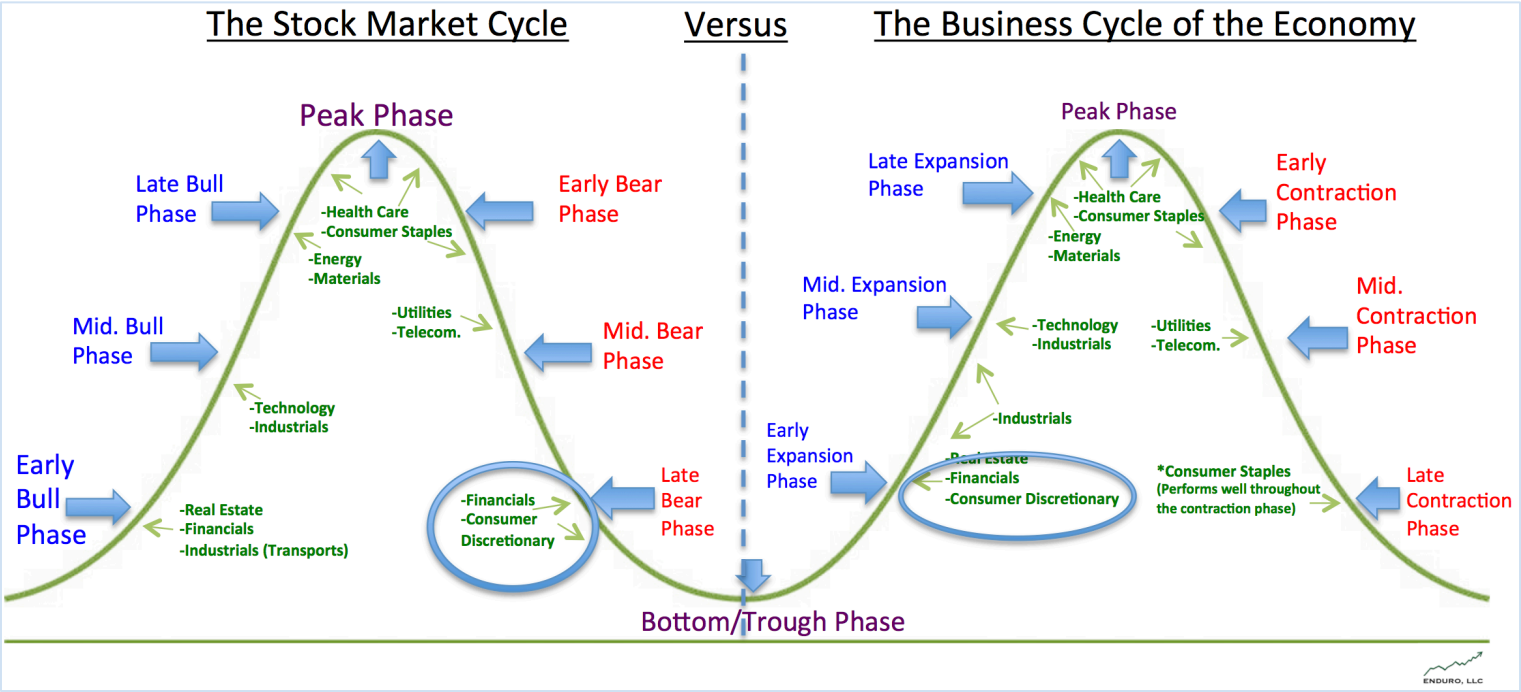
Stock Market Cycles and Business Cycles differ.

Equity performance is a leading economic indicator of the economy. Hence, leading sectors of the stock market tend to change prior to each phase of the business cycle.

For example, financials and consumer discretionary lead the *stock market cycl*e during its *late bear phase*, as circled in figure 2, on page 4. Conversely, financials and CD are not leaders of the *business cycle* until its *early expansion phase*.

Cyclical sectors often experience outflows during late bull and peak phases of the stock market cycle. At this time, active portfolio managers prepare for a bear market by investing in defensive sectors.

Figure 2: Stock Market Phases Tend to Lead the Business Cycle by 6 to 9 months.



Sector flow analysis combined with an astute investment strategy may deliver alpha.

This segment provided an in-depth look at how sectors perform throughout stock market and business cycles. Combining this data with an astute investment strategy helps identify equities to long, short, and/or avoid. For example, cyclical sectors drive bull markets and favor long investors during phases of economic expansion. In contrast, cyclical outflows give short-sellers an edge, as the business cycle contracts.

Summary

- *Top-performing Sectors tend to rotate during the course of the business cycle.*
- *The stock market tends to lead the various phases of the business cycle.*
- *Combining sector flow data and an astute investment strategy can deliver Alpha.*

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