

Monday Morning Musings

Sector Simplicity in an Era of Complexity

■ Investors have been surprised by the gains in the S&P 500 thus far this year.

As the investment community looks out into December and towards 2014, there is a tendency to review the past 11 months and be almost astounded by the market's appreciation in 2013. It is highly doubtful that fund managers anticipated this kind of performance with even the "uber-bulls" ratcheting up their positions and targets as the index climbed. Notably, few perceive a similar move in the next 11 months, though sentiment readings show that near-term frothiness is in place.

■ For the most part, sector leadership has been quite inconsistent with expectations early on in the year.

A so-called risk-on backdrop would have had investors chasing all cyclical areas even as Energy and Materials have lagged due in part to other regions' disappointing economic trends. Maybe less surprisingly, a more domestically-oriented Consumer Discretionary sector enjoyed the benefits of improved asset price-driven wealth and more jobs. But, Health Care (up an impressive 38% and taking the number one spot for sector performer) probably surprised the broadest group of market participants, though Financials (a client favorite) has outperformed as well in 2013.

■ Laggards have been concentrated within the dividend-oriented sectors.

The change in bond yields has had a profound effect with early leaders like Utilities lagging considerably though Telecommunications Services has fared even worse only to be outdone by the REITs, which have held back Financials slightly. While Utilities and REITs look intriguing at current levels, portfolio managers see them as "show me" stocks at this juncture especially given that momentum has pulled money to other areas.

■ A cyclical bent can be discerned but can it last?

The improved data out of the ISM runs headlong into the weakness seen in Citi's Economic Surprise Index (CESI) generating a confusing outlook. But, the ISM has much higher correlations with the Industrials, Materials, Energy and Information Technology sectors than the CESI and better ISM numbers imply potentially three-to-six months of further gains. Valuation, proprietary lead indicators and other factors do not support overweight positions other than that for IT but it is understandable why investors want to keep on the same trades.

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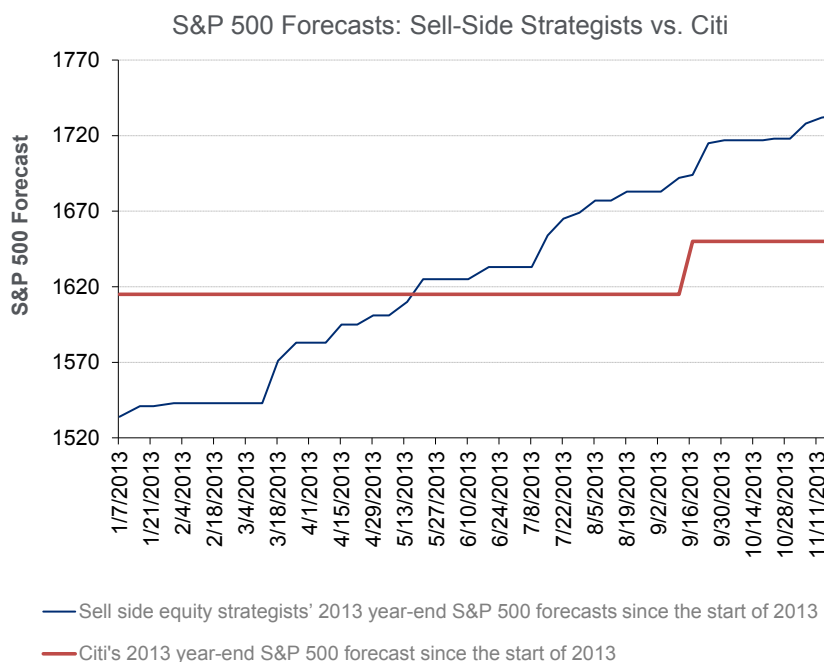
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Keeping It Simple

The powerful performance of the S&P 500 and even more fanciful gains in the small and mid-cap areas clearly caught the majority of the Street flatfooted, with even early bulls such as ourselves being overwhelmed by the almost unceasing ascendancy of index levels. Indeed, Figure 1 shows our year-end 2013 target as the year progressed relative to sell-side consensus and our 2014 number is only a tad above the average sell-side target of 1,880. But, it is the sector leadership that is a bit wild. Figure 2 presents the performance of the various sectors and industry groups by quarter and year-to-date and one has to be impressed with the powering ahead of the Health Care sector, a group admittedly that we have been totally wrong on. In addition, the Consumer Discretionary sector has not even stopped to take a breath with Financials also doing quite well, restrained somewhat by REITs, which are in the dividend doghouse now after enjoying incredible gains the prior couple of years. But, it is the industry group detail that is most revealing with IT being held back by a few names such as Apple and IBM (within the Tech Hardware industry group) while Insurance has been a star within Financials and grabbing top spot amongst industry groups for appreciation thus far this year. Fascinatingly, some more economically sensitive areas have underperformed including Materials and Energy, reflecting disappointment in commodity prices and growth in some areas of the developing world.

Figure 1.



Source: Bloomberg and Citi Research – US Equity Strategy

Figure 2.

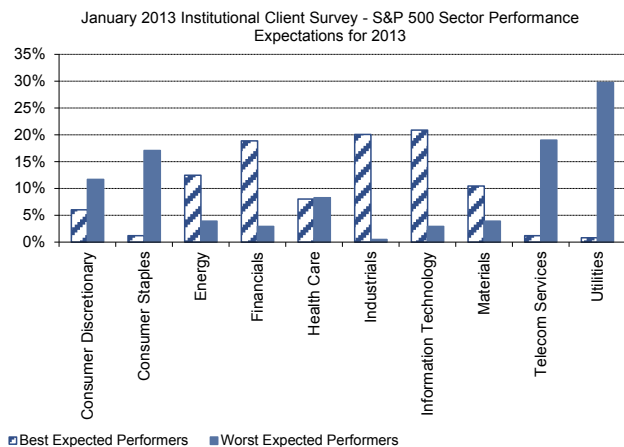
S&P 500 Large Cap Sector & Industry Group Performance

(11/28/13)	Yr to Date				
	% Chg	1Q13	2Q13	3Q13	4Q13
S&P 500 Large Cap	26.72	10.03	2.36	4.69	7.47
Consumer Discretionary	37.85	11.76	6.43	7.38	7.93
Autos & Components	41.74	6.67	11.18	12.72	6.03
Consumer Durables & Apparel	31.66	9.61	5.14	4.73	9.09
Consumer Services	24.79	10.69	1.47	4.42	6.39
Media	40.42	14.89	6.01	8.13	6.63
Retailing	42.41	11.25	8.51	7.47	9.77
Consumer Staples	22.61	13.77	-0.17	0.11	7.83
Food & Staples Retailing	30.63	12.82	0.98	4.41	9.82
Food Beverage & Tobacco	18.32	13.95	-0.44	-1.30	5.67
Household & Personal Products	25.02	14.26	-0.65	-0.77	10.99
Energy	18.90	9.57	-0.93	4.55	4.76
Financials	31.11	10.92	6.78	2.41	8.08
Banks	29.07	8.72	10.12	0.21	7.58
Diversified Financials	36.84	11.61	7.84	3.36	9.99
Insurance	42.93	14.52	7.90	6.08	9.04
Real Estate	-1.26	5.31	-2.55	-3.27	-0.53
Health Care	37.99	15.22	3.33	6.32	9.01
Health Care Equipment & Services	32.85	10.52	6.10	3.25	9.73
Pharmaceuticals & Biotechnology	40.74	17.71	1.99	7.87	8.67
Industrials	32.81	10.08	2.23	8.31	8.96
Capital Goods	32.36	8.97	2.86	8.99	8.35
Commercial Services & Supplies	25.80	12.59	-1.97	4.98	8.58
Transportation	37.71	14.38	1.08	6.60	11.74
Information Technology	20.71	4.21	1.22	6.14	7.82
Semis & Semi Equipment	26.17	9.33	7.15	3.19	4.37
Software & Services	26.16	9.15	2.78	4.21	7.91
Technology Hardware & Equipment	12.35	-3.44	-2.80	10.05	8.76
Materials	17.53	4.16	-2.39	9.68	5.38
Materials	17.53	4.16	-2.39	9.68	5.38
Telecom Services	7.44	8.20	-0.07	-5.45	5.10
Telecom Services	7.44	8.20	-0.07	-5.45	5.10
Utilities	8.23	11.84	-3.67	-0.81	1.28
Utilities	8.23	11.84	-3.67	-0.81	1.28

Source: FactSet and Citi Research – US Equity Strategy

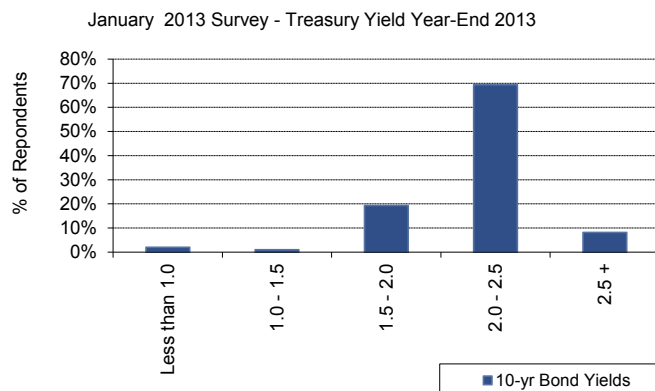
In some instances, the underperformance of Materials can be considered deeply problematic for investors who just wanted to use simple beta positioning which may not have provided all the right results. Five-year beta on REITS have collapsed in the past year and Tech Equipment & Hardware beta has dropped to less than 1.0 even as many still perceived tech as being high beta across the board. But things change over time and one cannot easily extrapolate even in an attempt to simplify decision making. It is somewhat insightful to go back to work that we published in January and see what the investment community was thinking. The quarterly client survey results showed a clear preference for Tech, Financials and Industrials back then (see Figure 3), with Utilities and Telecom in deep disfavor, but Consumer Discretionary and Health Care were not really in the forefront. Furthermore, the IT sector has been disappointing. Thus, it is not all that shocking when we hear many stories of portfolio underperformance. But, Figure 4 may explain why many got clipped within dividend yielding areas, as most of the equity investment community was not anticipating a jump beyond 2.50% on the 10-year yield in 2013 even as the sell-side economists' consensus was in the 2.70%-2.75% range at the time.

Figure 3.



Source: Citi Research – US Equity Strategy

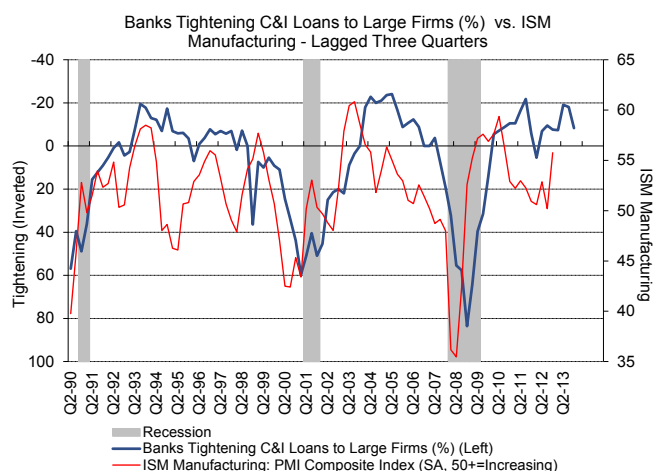
Figure 4.



Source: Citi Research – US Equity Strategy

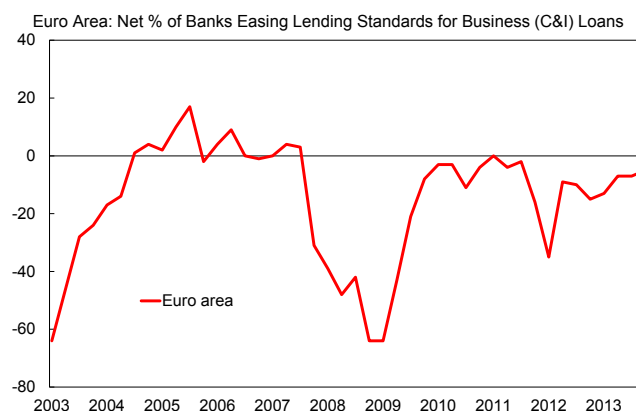
Intriguingly, the Industrials sector suffered through a challenging second quarter but has gathered steam of late as investors have cued off of the improved ISM data which was predicted nine months earlier by better credit conditions (see Figure 5) and there could be more good data in the next month or two. But, Europe may prove to be less exciting with credit conditions there showing very modest improvement of late, while stabilization or stall speed in the economy (see Figure 6) might not provide that much corporate top line growth or commensurate operating leverage. However, technology names should benefit from a probable double-digit gain in 2014 tech capex based on numbers gleaned from 700 publicly traded nonfinancial companies that Citi's US equity research analysts follow. To a great extent, commodity prices and stocks are much more linked to expectations about developing economies which seem a bit more mixed nowadays especially given priority shifts towards more consumerism and less industrial or infrastructure investment.

Figure 5.



Source: Haver Analytics and Citi Research – US Equity Strategy

Figure 6.



Source: ECB, Haver Analytics and Citi Research – US Equity Strategy

There are some conflicting trends between the ISM and the Citi Economic Surprise Index where both the G10 and the US surprise patterns have rolled over (see Figures 7 and 8). But, the CESI does not have that much predictive capacity for

sector performance (see Figure 9). Conversely, the ISM has more impressive predictive correlation (see Figure 10) especially for Energy, Industrials, Tech and Materials with a six-month lag, though we should stress that one should not confuse Materials with Metals & Mining in the US as Chemicals account for near 70% of the S&P 500's Materials sector's market cap. As a reminder, we are underweight Materials and Industrials (specifically, the Transportation industry group), but consider the IT sector to be more interesting at this juncture.

Figure 7.

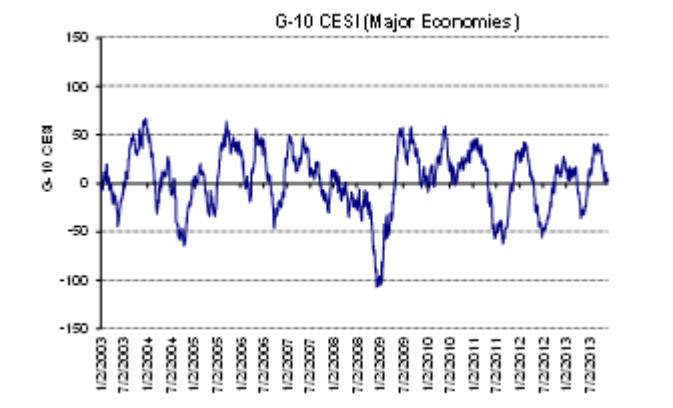
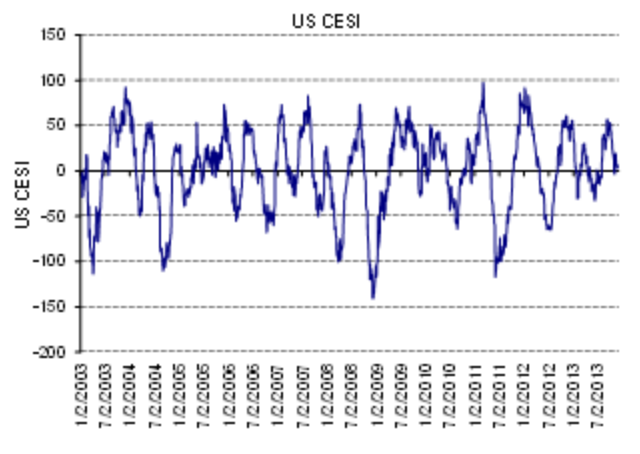


Figure 8.



Source: Bloomberg and Citi Research – US Equity Strategy

Source: Bloomberg and Citi Research – US Equity Strategy

Figure 9. G-10 CESI and S&P 500 Sector Correlations

G-10 CESI and S&P 500 Sector Returns											
	Energy	Materials	Industrials	Discretionary	Staples	Health Care	Financials	IT	Telecom	Utilities	S&P 500
G-10 CESI											
No lead	-0.07	0.05	0.09	0.11	-0.05	0.04	0.19	0.11	-0.04	-0.06	0.11
3 Months	-0.25	-0.25	-0.22	-0.04	-0.16	-0.07	0.03	-0.11	-0.11	-0.14	-0.14
6 Months	-0.38	-0.48	-0.39	-0.19	-0.23	-0.20	-0.07	-0.34	-0.30	-0.33	-0.35
12 Months	-0.10	-0.17	-0.21	-0.14	-0.12	-0.20	-0.12	-0.16	-0.24	-0.18	-0.21

Source: Bloomberg and Citi Research – US Equity Strategy

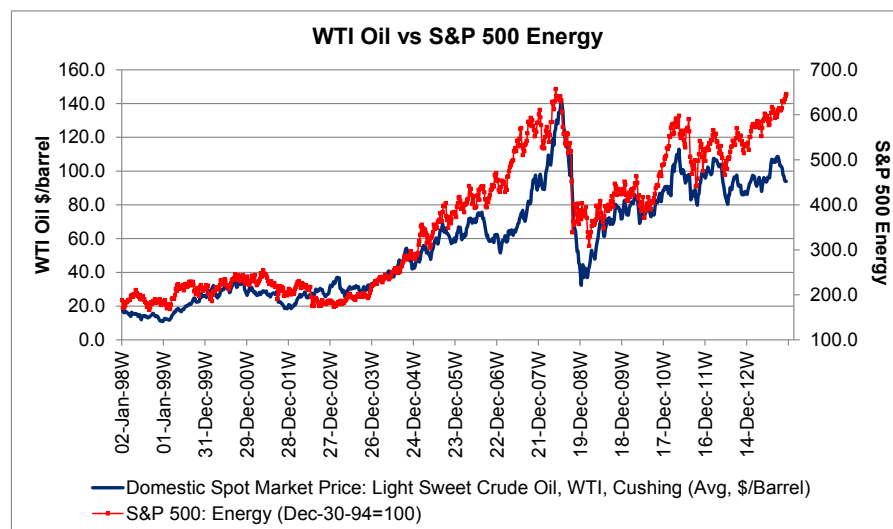
Figure 10. ISM and S&P 500 Sector Correlations

	ISM Mfg: PMI	New Orders	ISM: Production	ISM: Employment	ISM: Supplier Deliveries	ISM: Inventories	ISM: Customer Inventories	ISM: Prices	ISM: Backlog of Orders	ISM: New Export Orders	ISM: Imports
3-mth Lag											
S&P 500	0.110	0.261	0.251	0.100	-0.224	-0.130	-0.281	-0.225	0.373	0.235	0.393
Consumer Discretionary	0.364	0.383	0.396	0.329	0.092	0.132	-0.377	-0.156	0.311	0.141	0.322
Consumer Staples	0.069	0.081	0.084	0.102	-0.041	-0.056	-0.079	-0.063	0.110	0.223	0.078
Energy	0.526	0.434	0.462	0.588	0.372	0.431	-0.228	0.377	0.418	0.498	0.561
Financials	0.310	0.338	0.340	0.235	0.067	0.043	-0.240	-0.121	0.267	0.204	0.304
Health Care	0.058	0.015	0.037	0.127	-0.036	-0.029	0.016	-0.129	0.062	0.062	0.095
Industrials	0.477	0.443	0.469	0.459	0.238	0.250	-0.323	0.107	0.392	0.406	0.435
Information Technology	0.394	0.355	0.390	0.325	0.208	0.135	-0.200	0.038	0.322	0.233	0.259
Materials	0.427	0.495	0.472	0.346	0.264	0.145	-0.436	0.199	0.451	0.485	0.432
Telecommunication Services	0.340	0.270	0.300	0.363	0.084	0.259	-0.099	-0.101	0.234	0.094	0.300
Utilities	0.282	0.176	0.215	0.405	0.104	0.348	-0.046	0.121	0.180	0.234	0.379
6-mth Lag											
S&P 500	-0.089	0.189	0.008	0.475	0.178	0.047	0.349	0.274	0.199	0.299	0.334
Consumer Discretionary	0.081	0.256	0.026	0.428	0.256	0.004	0.383	0.288	0.323	0.253	0.231
Consumer Staples	0.069	0.233	0.023	0.452	0.233	0.016	0.383	0.293	0.288	0.264	0.272
Energy	-0.110	0.146	0.034	0.507	0.084	0.103	0.292	0.166	0.118	0.297	0.416
Financials	-0.345	0.007	-0.047	0.354	0.001	-0.005	0.174	0.131	0.103	0.096	0.210
Health Care	-0.269	-0.047	-0.088	0.317	-0.115	-0.031	0.059	-0.018	-0.085	0.210	0.341
Industrials	-0.256	-0.315	-0.036	-0.271	-0.198	0.054	-0.313	-0.171	-0.334	-0.137	-0.117
Information Technology	-0.317	-0.229	-0.059	0.289	-0.165	-0.077	0.017	-0.073	0.027	-0.107	0.199
Materials	0.289	0.214	0.078	0.380	0.205	0.076	0.325	0.239	0.275	0.199	0.228
Telecommunication Services	0.185	0.027	0.223	0.444	0.128	0.098	0.301	0.116	0.294	0.086	0.272
Utilities	0.271	0.163	0.033	0.528	0.168	0.050	0.318	0.172	0.280	0.265	0.401

Source: Haver Analytics and Citi Research – US Equity Strategy

Furthermore, one can assess very little relationship between noncyclical areas such as Health Care with ISM trends and we continue to worry that the outperformance cannot be sustained. Similarly, Consumer Discretionary stocks look to have run a bit too hard (especially retailing) and need to consolidate gains. In addition, there seems to be some delinking between oil prices and Energy stocks for the first time this year which is disconcerting (see Figure 11), though it may reflect the large integrated energy companies' most recent stock price moves. Nevertheless, we suspect some profit taking is appropriate and some may decide to do so before the year ends and not wait for January as is often suggested to me during client meetings. We do expect the "taper talk" to resume in January as so many Fed watchers (including Citi's) see a possible March start to pulling in some of the QE purchasing program and that could generate some new volatility in markets. Hence, locking in big winners may become the order of the day.

Figure 11.



Source: Haver Analytics and Citi Research – US Equity Strategy

Appendix A-1

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