

The sector selection conspiracy

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Everyone likes a good conspiracy theory now and then. That is, until they find themselves at the center of one. In some respects, that's exactly how we imagine a number of portfolio managers are starting to feel in 2014 with financials no longer outperforming and it being necessary to look for alternative sector strategies. Try as you might to pick sectors poised to outperform, it's as if every sector comes with its own Catch-22s and tradeoffs that go far beyond the typical analysis of whether the spread offered is commensurate to the fundamental risk.

To see how complex the process of sector picking has become, consider what happens when one starts incorporating crowdedness into the analysis. One way that we monitor crowdedness is by cumulating TRACE buy/sell data over time and looking for imbalances. The results suggest that within financials (already an extremely crowded sector), insurance and REITs are particularly overbought while utilities, industrials, healthcare and consumer goods top the list among nonfinancials.

But what precisely is the problem with overweighting a sector that's crowded, apart from the obvious issue that an unwind can be nasty (presuming it ever comes) and new buyers aren't plentiful? The way we see it, the primary risk is that investors potentially end up sacrificing spread/carry by not deviating from the crowd enough.

It's difficult to see that this is the case when maturity and rating distributions are very different across sectors. But if one were to look at valuations *after* correcting for these compositional differences, or simply look at a measure like spread-per-turn of leverage, it's striking that the richest sectors also independently screen as the most crowded (see figure).

Spread to ratings/maturity adjusted benchmark vs crowdedness

4 April 2014

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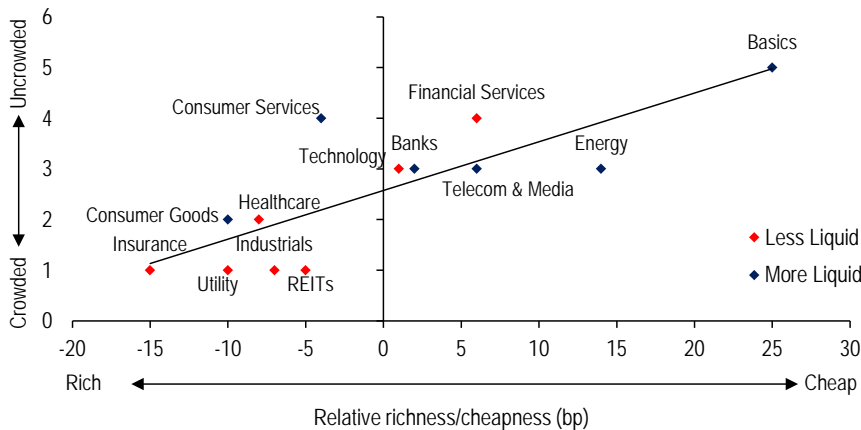
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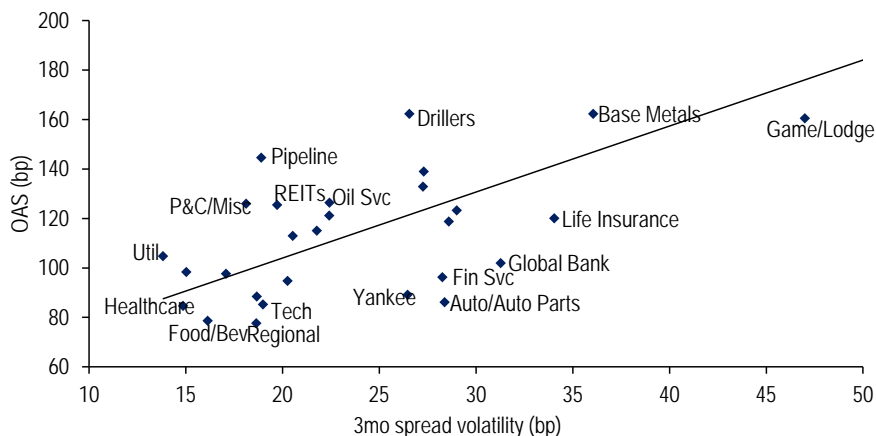


Source: Citi Research, TRACE

Just as disconcerting is that these rich and crowded sectors tend to trade the least. In some cases that may simply be a reflection that few holders are ever willing sellers of bonds in those sectors. Yet equally we worry that the popularity of these sectors has something to do with the fact that they *are* illiquid and investors' willingness to sacrifice liquidity where they perceive little fundamental risk has grown.

To our minds, that's particularly dangerous because when markets don't trade, there's a tendency to draw incorrect conclusions. For instance, imagine a situation where credit spreads are solely compensation for the volatility (mark-to-market) that's likely to be incurred by the holder of a bond and default/downgrade risk is not a concern. In such an environment we expect to see a strong relationship between the spread of a bond (or sector) and volatility. And indeed, that's exactly what's observe at the sector level (see figure).

Spread vs 3mo spread volatility, in bp



Source: Citi Research

When upside opportunities are limited, it's tempting to use such a relationship for relative value purposes. Sectors that are well above the regression line are ones that offer a lot of carry and comparatively little volatility. Conversely, sectors that fall below tend to be relatively volatile and provide little compensation in the form of spread for mark-to-market risk.

Yet what if it's all an optical illusion? Within the financial space for instance, the

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Wednesday:	<u>Consensus</u>
MBA Mortgage Applications	-
Wholesale Inventories MoM	0.50%
Thursday:	
Initial Jobless Claims	-
Monthly Budget Statement	-
Friday:	
PPI Final Demand MoM	0.10%
PPI Final Demand YoY	1.20%
U. Mich. Confidence	81

Key Earnings Announcements

Tuesday:
Alcoa
Wednesday:
Progressive Corp
Friday:
JP Morgan
Wells Fargo

spread-to-volatility ratio of the P&C and REIT sectors is notably high, making them look like attractive longs. But liquidity in both sectors is so poor that one can't help but wonder if the lack of volatility is simply the product of little to no trading going on—what we've in the past referred to as the fake markets problem. Overweighting those sectors becomes difficult because not only is the paper troublesome to source, but once bought, it may not be possible to sell.

On the other hand, for certain sectors the spread-to-volatility analysis really does reveal important tradeoffs that should be considered. For example, banks are among the most liquid sectors, are relatively volatile, and don't offer much spread for all that volatility. That alone is reason for a bit of caution even if one is still comfortable with the fundamentals, as we are. Technology and financial services also screen as problematic on this metric. Both have low spread-to-volatility ratios and the former comes with considerable issuance/releveraging risk while the latter doesn't enjoy nearly the same regulatory "protection" that banks do.

So is sector selection simply an exercise in avoiding the crowd and staying away from illiquid pockets where "fakeness" lives? To our minds, crowdedness and liquidity are definitely important considerations, but fundamentals still matter too. Indeed, removing all the sectors that are rich, illiquid, and don't offer much spread per unit of volatility, leaves a bunch of sectors that are highly sensitive to the global economy (energy and basics) or prone to excessive amounts of event/M&A risk (telecom and media with respect to M&A activity).

So what would we do?

In the table below, we present a truncated sector scorecard that summarizes the dimensions we think most important for formulating a view. But since no sector scores well in every column, it's necessary to prioritize concerns and compromise. For us, we're generally inclined to underweight crowded sectors that look rich, offer below average compensation for volatility, or are highly exposed to releveraging/M&A regardless of how stable the fundamentals may be (with an exception for banks). On the other hand, we're happy to overweight a sector that has above average exposure to the economy—within reason (ie energy but not basics)—and make exceptions where we think the past will not be reflective of the future (telecom & media).

Yet to be fair, our whole point is that any sector decision one makes feels perilous in some capacity, especially compared to last year. We don't expect that Michael Lewis will show much sympathy to the problem and write a book sensationalizing the hidden challenges of modern portfolio theory, but nevertheless we've a lot of sympathy for managers just trying to create alpha.

Sector view scorecard* (red = negative, green = positive)

Sector	Valuation	Technicals	Issuance	Activism/ Event Risk	Fundamentals	View
Energy	92%	75%	83%	8%	Positive	Overweight
Utility	67%	25%	8%	83%	Positive	Neutral; Overwgt pipes
Basics	100%	100%	75%	25%	Stable	Neutral
Consumer Services	58%	83%	0%	42%	Stable	Slight Overweight
Telecom & Media	75%	92%	33%	92%	Positive	Slight Overweight
Banks	8%	67%	100%	0%	Positive	Slight Overweight
Consumer Goods	0%	42%	42%	58%	Positive	Underweight
Industrials	50%	8%	17%	67%	Stable	Slight Underweight
Technology	33%	50%	67%	50%	Stable	Slight Underweight
Financial Services	17%	58%	92%	17%	Stable	Slight Underweight
Insurance	25%	17%	50%	33%	Stable	Slight Underweight
REITs	83%	0%	25%	100%	Stable	Underweight
Healthcare	42%	33%	58%	75%	Stable	Underweight

Source: Citi Research

*We find the percent-rank of each sector in each of the categories listed above. Scores range from 0% for the worst sector, to 100% for the best sector. For each category, we evaluate a number of factors:

Valuation: (1) sector spreads adjusted for rating/maturity profile, (2) spread-over-spread-volatility.

Technicals: (1) position crowdedness, (2) liquidity/turnover.

Issuance: (1) Funding need (capex + refi) in next 12mo, (2) YoY change in net leverage.

Activism/Event Risk: (1 & 2) % of companies/debt outstanding that screen well for releveraging, (3) % of total M&A in the sector (4) YoY change in M&A %.

Fundamentals: Moody's rating augmented with credit strategy house views.

Week Ahead

Next week marks the beginning of 1Q earnings season, with Alcoa reporting on Tuesday. As always, we will get a first look into banks with JP Morgan and Wells Fargo out Friday. Results will be eagerly watched for evidence of weakness in bank trading operations.

Inflation is regaining mind-share as investors debate Fed policy actions going forward, and as such, next Friday's PPI print will be closely watched. PPI YoY is expected to rebound to 1.2% from its sharp turn downward the previous month to 0.9%. We will also follow the Monthly Budget Statement on Thursday and the U. Mich. Confidence due Friday (81.0 expected vs 80.0 previous). With regard to weekly data, MBA Mortgage Applications are out on Wednesday and Initial Jobless Claims on Friday.

Minutes from the March FOMC meeting will be released on Wednesday and should offer valuable insight into the inner workings of the Yellen regime. Investors are likely to look for evidence as to why the Fed's reaction function has seemingly changed. Or asked another way, why did the "dots" move higher during the last meeting?

The US Senate and House passed a bill to provide \$1bn in aid to Ukraine and impose further sanctions on Russia this week. While Russia withdrew troops from Ukraine's borders, it also hiked gas prices for Ukraine by 80%. We will continue to watch developments on this front for any signs of destabilization.

Appendix A-1

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