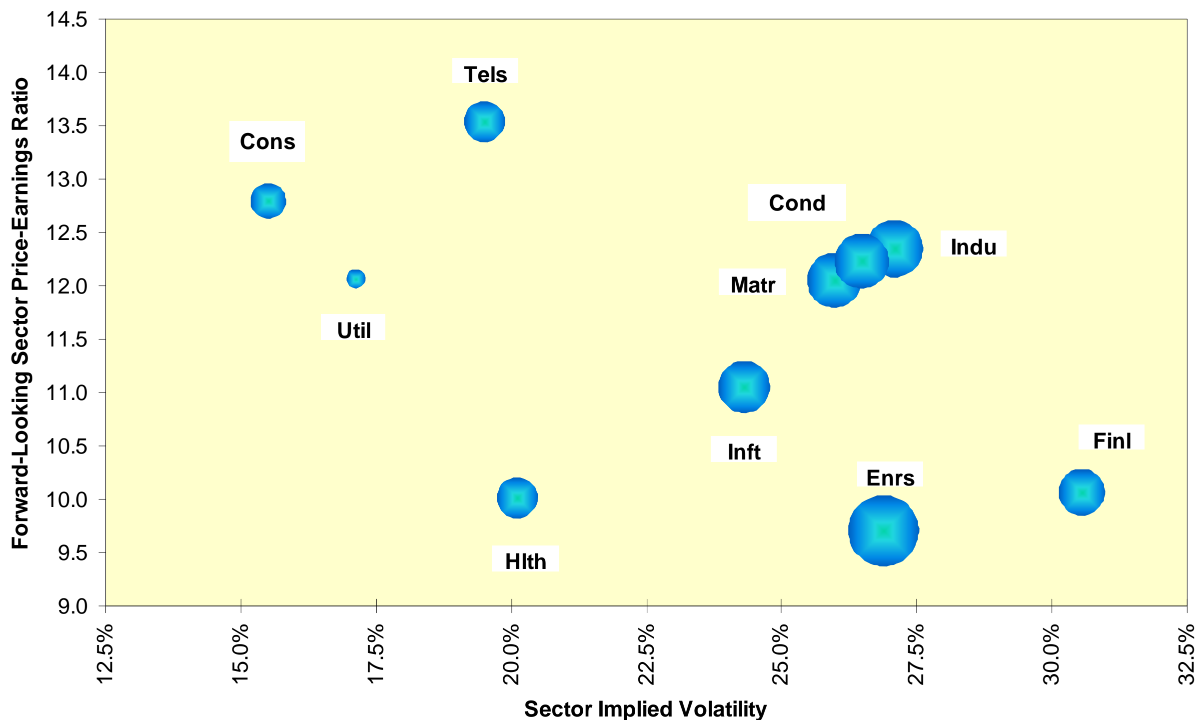
Sector Performance And Regression To The Mean

I live in mortal fear that someday a marauding band of avengers will take over the United States and start seeking out the financial types by shouting terms like "consumer discretionary" into a crowded room and seeing who flinches.

Expectations And Performance

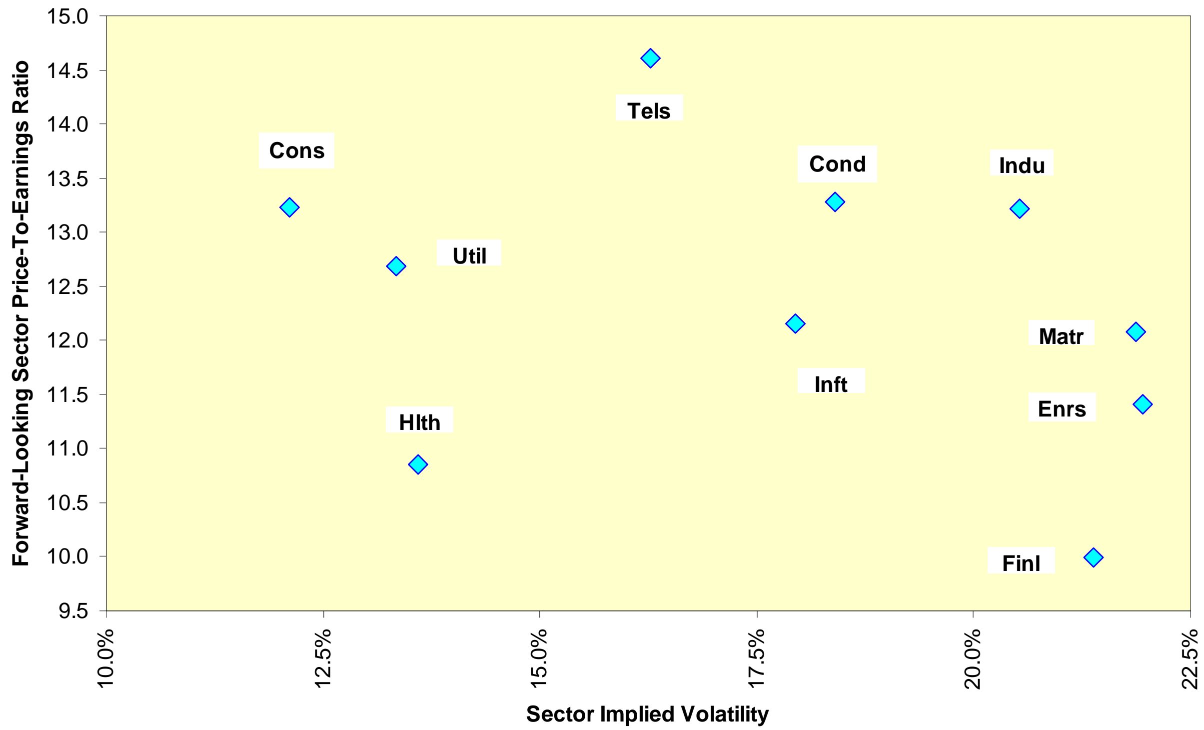
Let's return to Jackson Hole and that day when Ben Bernanke filled his lungs with that fresh mountain air and wondered why everyone could not be a billionaire and mapped where each of the ten economic sectors as defined by Standard & Poor's (consumer discretionary is one) lay along the forward-looking dimensions of implied volatility and forecasted price/earnings ratios. If we depict each sector's total return since then with a bubble whose size corresponds to the magnitude of that return, we see the largest total returns belong to the sectors with the highest implied volatility. The collective expectations for P/E ratios were largely irrelevant; sectors such as consumer staples (get him!) and telecommunications had high forward-looking P/E ratios and yet failed to deliver much.



The current state of affairs is rather mundane; think of it as the New Normal meets the Old Boring. The highest implied volatilities belong to the financials, energies and basic materials, all of whose fortunes are linked to excess liquidity. The lowest implied volatilities belong to the healthcare, utility and consumer staples (twitch) sectors on theory you have to treat 'em, have to heat 'em and have to eat 'em.

If we move over to expected earnings multiples, we find the highest ones are once again in the telecommunications, consumer discretionary and consumer staples sectors (Why are you handing me this shovel? I don't need a hole). The lowest expected multiples belong to the heavily regulated utility, financial and healthcare sectors.

If we place these on the same map as before, sans the bubbles for actual future total returns, whose dissemination is frowned upon by compliance departments everywhere, we see a distinct split between low- and high-implied volatility sectors. If the returns for the high-volatility sector during the QE2 era were linked to excess liquidity, it would stand to reason an end to the money-printing would diminish the returns on financials, energy, basic materials and industrials. The defensive trio of healthcare, utilities and consumer staples (Cigarette? No thanks, I don't smoke) would do well by relative comparison.



The opposite would hold true, however, if money-printing from elsewhere, such as Japan, found its way into our market. The real conclusion is to forget about analysis, forget about expected P/E ratios, and forget about everything but the magic money machines. This is not so much a New Normal but a Brave New World we are speaking of here.