Risk-On / Risk-Off Trade Will Continue Into 2012

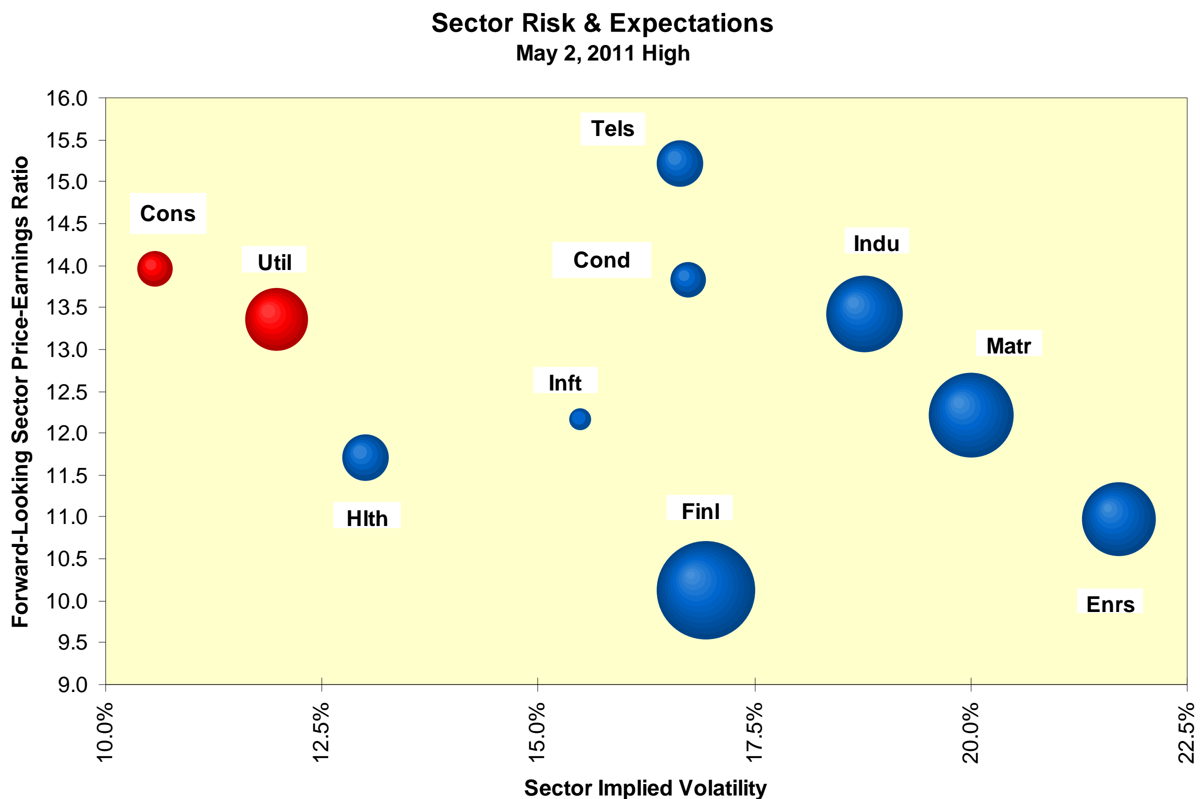
The Sector Expectations Map Has Changed Little Since QE2's End

A long time ago in a galaxy far, far away I was involved in something called "futures research" for an oil company. It had nothing to do with financial futures but rather the study of possible scenarios for how society would evolve. While it sounds as if some hip-boots might have been required, I look back on the issues we identified in the late 1970s and find some of them are with us today, including water as a constraint in energy production and the problems arising from changing patterns of corporate governance.

What we now call the "Internet" was referred to as "packet-data networking." I can tell you we thought it was going to be important; we did not understand just how creatively destructive or destructively creative it would really be. But one thing we left out of the picture despite all of the discussions on national economic planning and the like was just how dominant the role of the Federal Reserve and monetary policy would be.

Expected Risk And Return

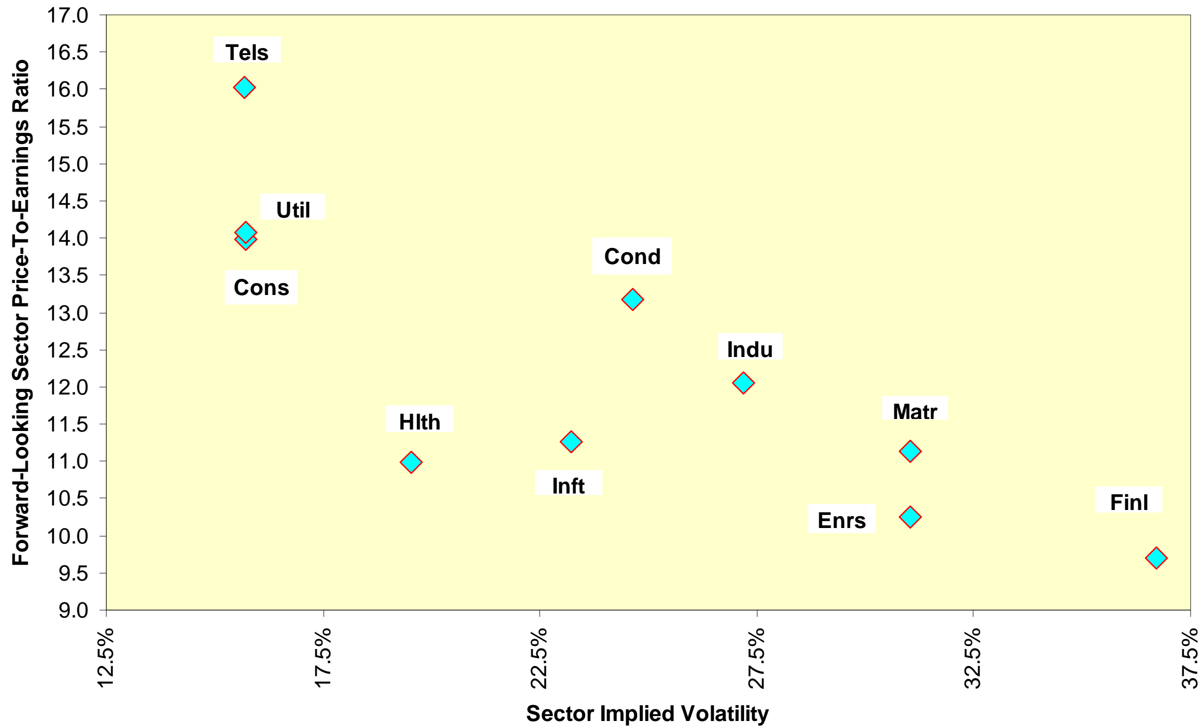
Let's return to the analysis in April's Sector Performance and Regression to the Mean and see what has changed since the impending end of QE2. Each of the ten economic sectors as defined by Standard & Poor's is mapped long the forward-looking dimensions of implied volatility and forecasted price/earnings ratios. The bubbles depict the period total return since the May 2, 2011 high; only the defensive sectors of Consumer Staples and Utilities depicted in red have had positive returns; all others, depicted in blue, had have negative returns. The bubbles' diameters correspond to the absolute magnitude of these returns.



The sectors with the largest negative returns were the high volatility / low forward-looking P/E sectors of Energy, Basic Materials, Financials and Industrials. As I noted at the time:

> *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.*

Where are we today on the same expected risk and return map? The answer nine months later is, "Almost at the same spot." Telecommunications has joined Utilities and Consumer Staples in the low risk / high-P/E northwest corner of the map; the high-risk / low P/E southeast corner is populated by Financials, Energy Services, Basic Materials and Industrials.



It will take a return to the fabled "risk-on" state to reverse this configuration. As policy options globally are in a contractionary mode with the possible exception of China, it is difficult to see what will trigger such a switch in risk preferences. We had to go through a much more severe downturn in 2008-2009 to get to a risk-on state, and then we had the public will to tolerate bailouts, money-printing and extend-and-pretend accounting. Now we do not. Until such a trigger is found, a defensive stance remains warranted.