Industry Group Boats On Monetary Tide

Remember SARS, the severe acute respiratory syndrome that caused quite a stir about a decade ago and like many other viral diseases ranging from influenza to AIDS has the scary potential to mutate into a really scary pandemic? I will not mention names, but during the last outbreak one of the Wall Street brokerage houses released a global SARS strategy report for you to follow, step by step, as a way of profiting from a potential outbreak.

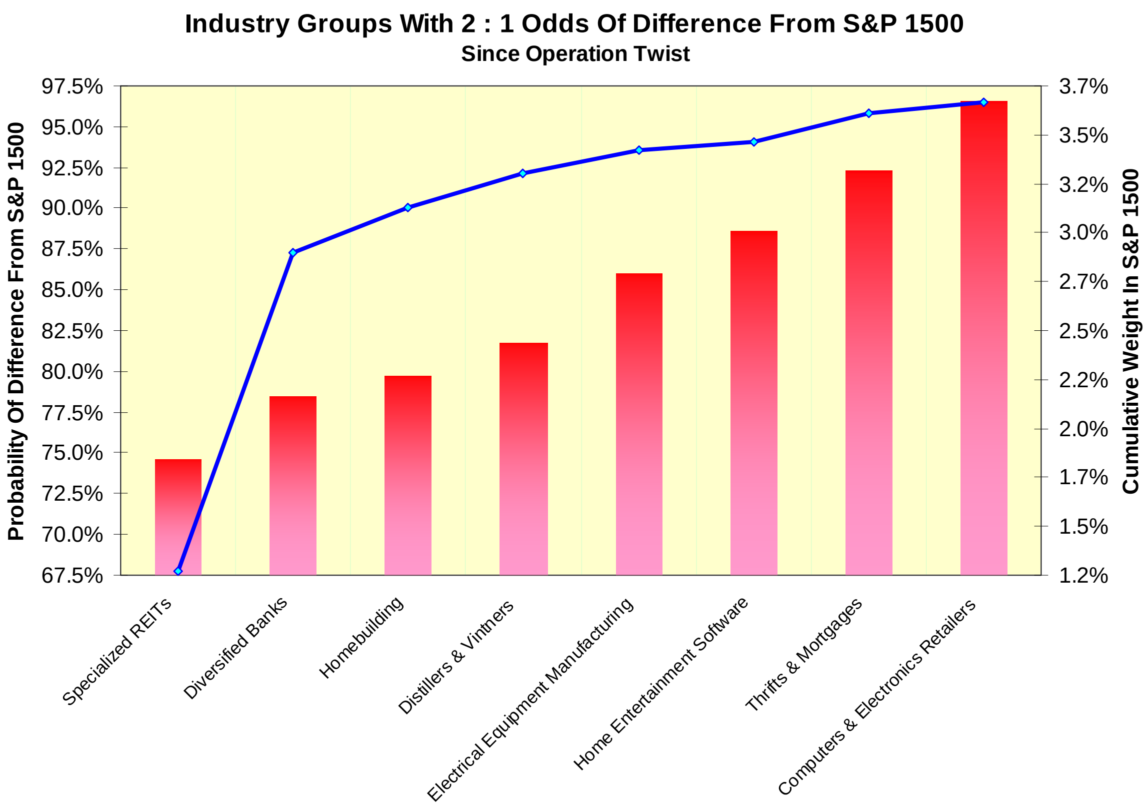
Let's ignore the amorality of that document and keep in mind it went on for about seventeen pages. That is short by the standards of other works of fiction and way too long for useful investment advice. It also succumbed to the fallacy central to today's discussion: For every external action there are distinct investment reactions for you, some of which might – and this will surprise you – generate fees and commissions.

Two Major Monetary Events

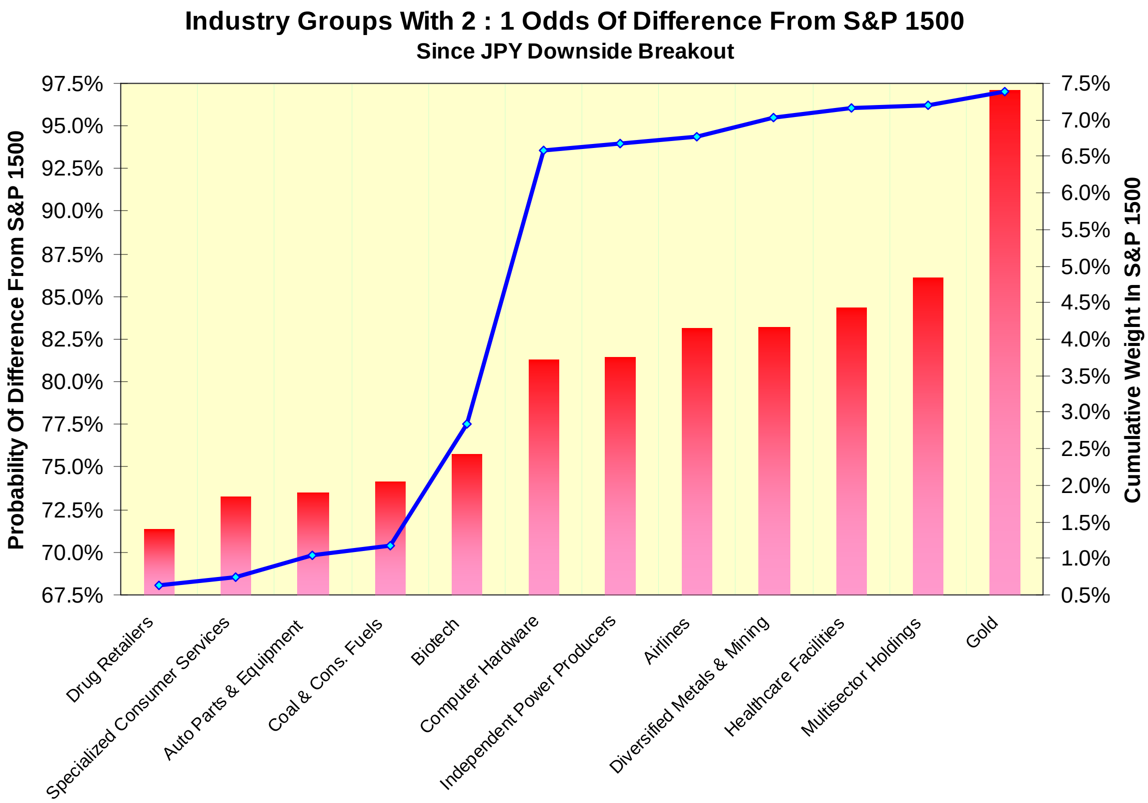
One of the upsides of being a macro analyst these days is the world's policymakers keep giving you things to do. If it is not QE-this, it is Twist-that. It gives us a lot of things to compare before-and-after. Let's take two major monetary events of recent years, the inception of Operation Twist in August 2011 and the downside breakout of the Japanese yen beginning in November 2012, and pose the statistical question of which industry groups' returns were different from those of the S&P 1500 Supercomposite's at even a 66.67% probability (2:1 odds).

The answers are surprising on two levels. First, only a small number of groups are affected significantly by major events. Second, the groups involved have little if any sectoral theme.

Let's take the Twist period first. Of the 144 industry groups examined, on eight groups accounting for 3.6% of market capitalization had returns statistically different returns from the S&P 1500. While several of them, including homebuilders, diversified banks and thrifts & mortgages at least have a housing-related theme, the others are unrelated. I would like to create a link between distillers & vintners and computers & electronics retailers, but I cannot.



The shorter time period from November 2012 should allow for more differentiation, and it does. Here 12 groups accounting for 7.4% of market capitalization pass the 2:1 odds test. One of them is something called "multi-sector holdings," which is a one-company group consisting of Leucadia National. Another is gold, which is Newmont Mining and Royal Gold. The rest of the set is simply another motley collection of unrelated entities.



You will never, and I do mean never, find someone who will tell you in advance a major policy change involving massive manipulation of the U.S. yield curve or the willful debasement of a key currency will have only a trivial effect on the distribution of industry group relative returns. The temptation to show how clever you are by recommending portfolio shuffling is extreme; conversely, saying something to the effect, "They are going to print money in Biblical-sized quantities? Cool; just buy everything you can get your hands on and then some," sounds unsophisticated and even flippant.

However, it is and has been true for these events and others similar to them. The simple fact of the matter is a rising monetary tide lifts all of the industry group boats more or less equally. Unfortunately, that lesson will apply as well for when they remove to stopper from the monetary bathtub, too.