

## A Market Of Sectors

Trading and investing are tough schoolmasters. Two of the toughest lessons, both related to Newton's observations on inertia, are a market apparently overbought or oversold can become even more overbought or oversold and just like the trickiest ball for outfielders to catch are line-drives hit right at them, the trickiest market pattern is a straight line on a chart.

This is why I have weaned myself away or at least tried to from serial top- and bottom-calling. However, we have been riding the same train since the global expansion of currency swap lines at the end of November 2011 unleashed a new flood of liquidity into financial markets and relieved a great deal of European interbank stress. Trees do not grow to the sky nor do multiples expand without rational limit unless we are in a bona fide bubble, which we most certainly are not. Real bubbles, as I noted [recently](#), are not characterized by rising levels of risk-aversion amongst large segments of the investing class.

### Prospective Sector Returns

I periodically peruse three-month ahead prospective returns for each of the Select Sector SPDRs as a function of two variables, implied volatility and the sector's top-down forward-looking price/earnings ratios. The simple mechanics of this exercise mean the last datum I can use is from three months ago, which corresponds to the period immediately before the FOMC's surprising postponement of tapering at its September meeting.

Two observations jumped off the page. First, the implied volatility of each sector ETF declined, as had the VIX itself. Money may not solve life's problems but it does suppress price volatility within a bull market. Second, the forward-looking P/E's were out of the range to the high side of the May 22 – September 9, 2013 data sample for Energy (XLE), Technology (XLK), Basic Materials (XLB), Healthcare (XLV), Industrials (XLI), Consumer Discretionary (XLY) and Consumer Staples (XLP). Only Financials (XLF) and Utilities (XLU) had not moved out of the range of observation; if a Select SPDR for the Telecommunications sector existed, it would have been within the sample range.

None of this is bearish per se as markets in motion tend to stay in motion. However, the price and volatility action since September and indeed since November 2011 suggests we have discounted a great deal of good news and have captured a significant and unknowable portion of future returns. The heady gains of 2012-2013 were made in anticipation of future earnings growth combined with low inflation, low real interest rates, a still-steep yield curve and, who knows, perhaps some economic growth as well.

This last point is not to be underestimated: Markets are not GDP futures. The perma-bears of the past five years who keep pointing to slow growth as a source of concern have found a great negative indicator and nothing more. The notion stronger economic growth leads to stronger earnings and in turn to higher stock prices belongs on the same shelf as those "how a bill becomes a law" civics illustrations; it is a nice story for the children and an even better way to underperform.

Finally, the observation neither XLF nor XLU have moved out of their forward-looking P/E range is a signal these sectors should lag if and when interest rates rise. Markets not in outperformance tend to stay out of outperformance