It is a complicated world out there, part 2

By Sandy McIntyre
Capital Markets Strategist, CI Investments

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Now that I am confused, what do I do?

Part 1 of It's a complicated world out there touched on these themes:

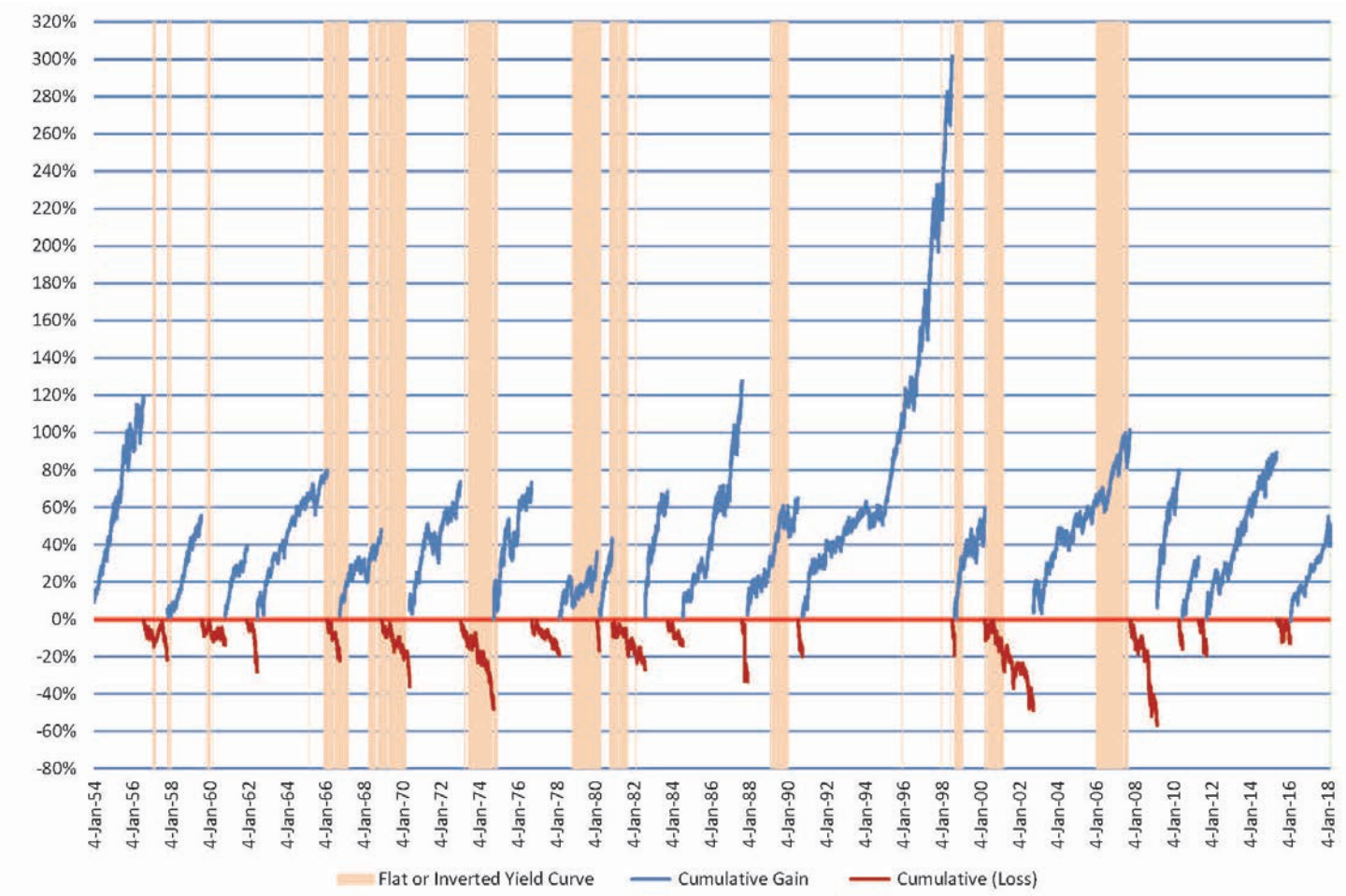
- Earnings growth or decline is directly correlated to stock market appreciation or depreciation.
- Price-Earnings (PE) ratios are cyclical, typically rising through the business cycle then falling as the cycle matures. They are a lousy market timing tool, save for at extremes.
- The U.S. Federal Reserve responds to declines in corporate earnings (using the S&P 500 Index as a proxy) by easing monetary conditions, typically by cutting the Fed Funds Rate.
- In the two previous tightening cycles you were rewarded by staying exposed to equities until the Fed started to ease.
- Rising credit spreads can be a leading indicator of a cyclical market peak and of recession.
- Simple bond math shows the bond market is buying into the trajectory for the Fed Funds Rate over the next two years.
- Long-term interest rates in the U.S. are very sticky. The 30-year minus 10-year curve has been aggressively flattening for the past two years, with the 30-year yield falling and the 10-year yield rising.
- The move above 3% for the 10-year Treasury in May of this year may well be the peak for long rates in this tightening cycle.
- The trajectory for the Fed Funds Rate may flatten the yield curve by late this year or early next year.
- Stock market leadership has narrowed; two sectors, InfoTech and Consumer Discretionary, are providing the bulk of the gains.
- When you look into the two leading sectors it is a narrow group of stocks that are driving performance; the FAANG phenomenon is real.
- Narrow leadership has led to extended valuations for some of the most popular stocks, however other leaders are well supported by earnings and earnings growth.
- And finally, I took a look back at the NASDAQ Composite Index and its major constituents in the aftermath of the peak of the Tech Bubble in March of 2000.

A lot of themes, all intertwined and extremely difficult to explain to an investor. They just want to know what to do. The most important of the themes are two: the slope of the yield curve and the direction of corporate earnings. Unfortunately, these themes often put investors to sleep; they just want to be where the action is.

The slope of the yield curve

A typical portfolio has an investment policy statement that will set target asset mix ranges and, in most cases, will try to address an investor's volatility tolerance. The typical investor only understands one type of volatility: losses. They do not understand that participating in unusual upside volatility exposes them to unusual risk of losses. I spent a lot of time on the yield curve and the impending flattening for a reason. In the post WW II period, a flat or inverted yield curve has occurred 11 times and has led to nine recessions. It is worth exploring what happens to portfolio components during the transition from a positively sloped curve to a negatively sloped curve. Currently, the spread between the 10-year U.S. Treasury and the one-month T-bill is 88 basis points. The 10 and two-year spread that the media is fixating on is 26 basis points. The two-year data on Bloomberg only goes back to 1976. It is a small sample size to analyze. The following chart shows the S&P 500 cyclical bulls and bears over time, with flat and curve inversions (10-year minus three-month) as buff bands. My cutoff for flat is a slope of 25 basis points.

S&P 500 Cyclical Bulls and Bears: Cumulative Gain (Loss)



Source: Bloomberg L.P.; CI Investments

As at August 13, 2018

The first observation I can make is that market peaks during active tightening phases that lead to yield curve inversions occur either very close to the inversion or while the curve is inverted. It is a mistake to become too defensive while the Fed is tightening. For this chart I am using a 13.5% loss as my cutoff for bear markets. This ensures that I capture all recessionary bears as well as meaningful mid-cycle slowdowns like we had in 2015-16. When I went through my data to find the day count between market peak and curve inversion, I found no accurate signaling from the 10-year minus three-month yield curve. When I switched to the 10-year minus two-year yield curve I found there were too many false signals.

A flattening yield curve should force you to consider your options. The bull market in stocks in at the end of the 1970s was anemic. You were much better served by short-term deposits, as short rates were rising rapidly. Indeed, from the late 60s to the early 80s, rising inflation and rising interest rates led to extended periods of yield curve inversion. I am going to go out on a limb: I do not expect extended periods of yield curve inversion in the future.

The bond math in my prior article suggested that we will see the U.S. yield curve invert in 2019. An inversion does not necessarily mean that the bull market in stocks is over. As we move towards that point what should you be doing? First, go to your neutral asset mix. There is nothing wrong with booking some profits. Second, understand that as market cycle matures, the goal shifts from "beating the stock market gains" to "avoiding the stock market losses." Minimizing your drawdowns makes subsequent outperformance much easier.

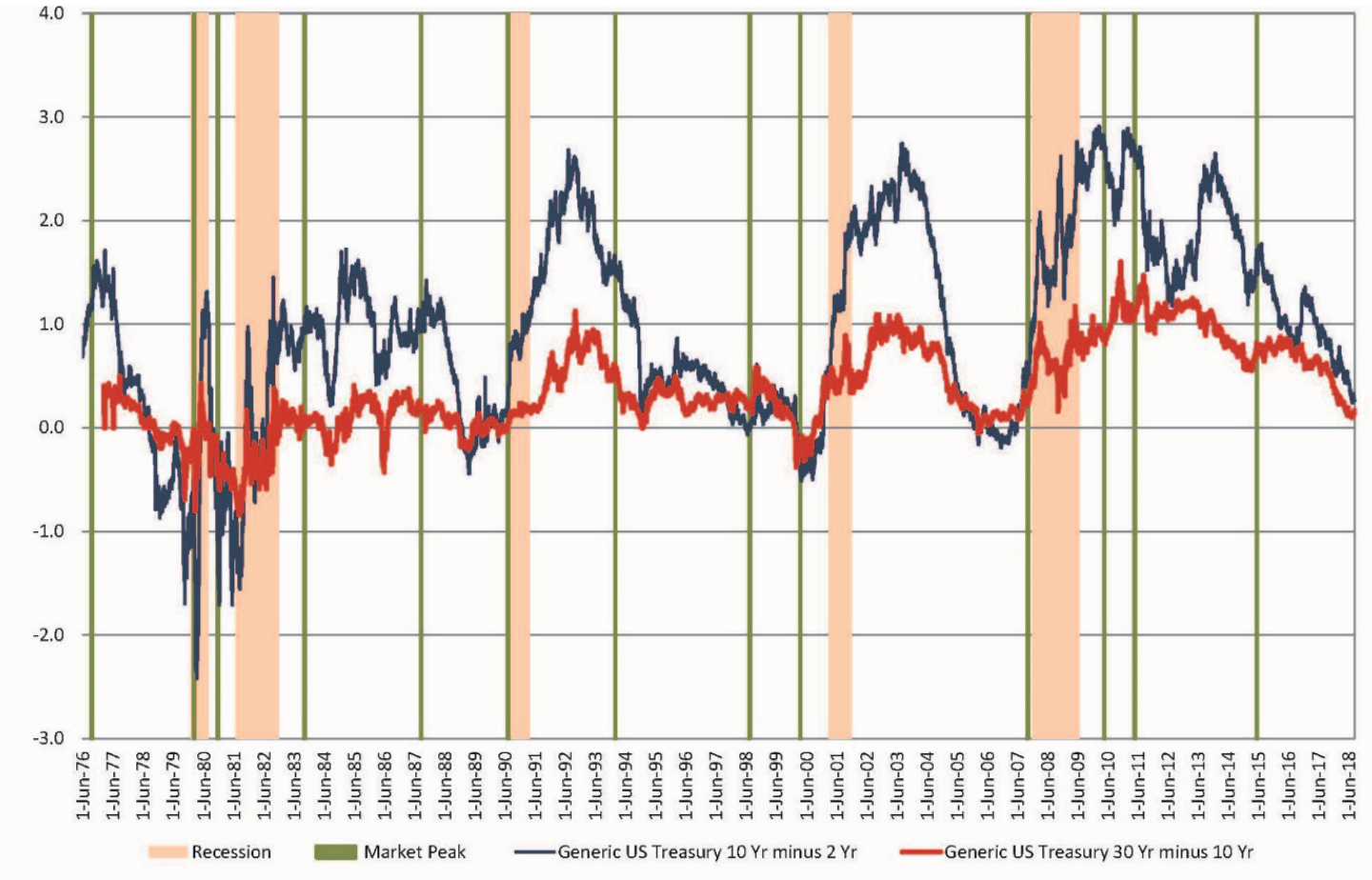
While you are going to your neutral asset mix look at the characteristics of your holdings. The yield curve is a tool that can help you manage your portfolio risk. Most bond investors understand that as short rates rise, you want to avoid rising longer-term rates. To do this you shorten the duration of your portfolio. You can use floating-rate instruments: as short rates rise your interest rate is reset; reduce the average term to maturity or increase yield.

The trouble with some of these approaches is the risk of increasing the correlation of the bond portfolio with the equity portfolio. You want the bond portfolio to be negatively correlated to the equity portfolio at this phase of the cycle. High-yield bonds, floating-rate notes and investment-grade corporate bonds are all ultimately issued by companies that may suffer in a recessionary environment. They will suffer price erosion as confidence wanes.

At some point in the tightening cycle you can consider moving from short duration and higher yield to long duration government bonds. This is why I watch the 30-year minus the 10-year yield curve. It tells me when the long end of the bond market is comfortable with central bank activity. This spread broke the 25-basis point level earlier this year and is currently around 15 basis points. The 10-year minus two-month also broke the 25-basis point level in July.

When you look at the chart, you will likely say, "what's the rush?" The point is, you want to sell equity-correlated bonds when there is decent liquidity. Once the corrective phase starts spreads will blow out and liquidity will dry up.

Slope of the Yield Curve:
10 Year Treasury minus 2 Year Treasury & 30 Year Treasury minus 10 Year



Source: Bloomberg L.P.; CI Investments

As at August 13, 2018

I would be a seller of high-yield and floating-rate debt and a buyer of longer-dated government bonds. In a world with rising macro confusion and tightening monetary policy, I find it unlikely that we are going to have a material spike in safe-haven yields.

Where is the best yield?

As the Tech Bubble was peaking in 1999-2000, the 10-year minus two-month and 30-year minus 10-year were both inverted. At the time of inversion, the 10-year and 30-year Treasuries were yielding around 6.75%. As markets get dislocated I like to look at cross-asset class valuation. For this I look at the spread between the earnings yield of the broad market (S&P 500) and various bond yields. The following chart shows the spread between the earnings yield and the 10-year Treasury yield. In early 2000 there was a larger than 2 ½% yield advantage to owning long Treasuries. Sell equities and buy bonds.

S&P 500 Trailing Recurring Earnings Yield less:
10 Yr US Treasury Yield

Source: Bloomberg L.P.; CI Investments

As at August 13, 2018

The move from an equity growth premium (bonds cheap relative to stocks) through much of the 80s and 90s to an earnings yield premium of over 7% in March of 2009 shows how brutal the revaluation of the 2000s secular bear market was. The 10-year Treasury must get to the 5% level before I begin to worry about equity growth being over-priced. A move of that magnitude is not in my forecast.

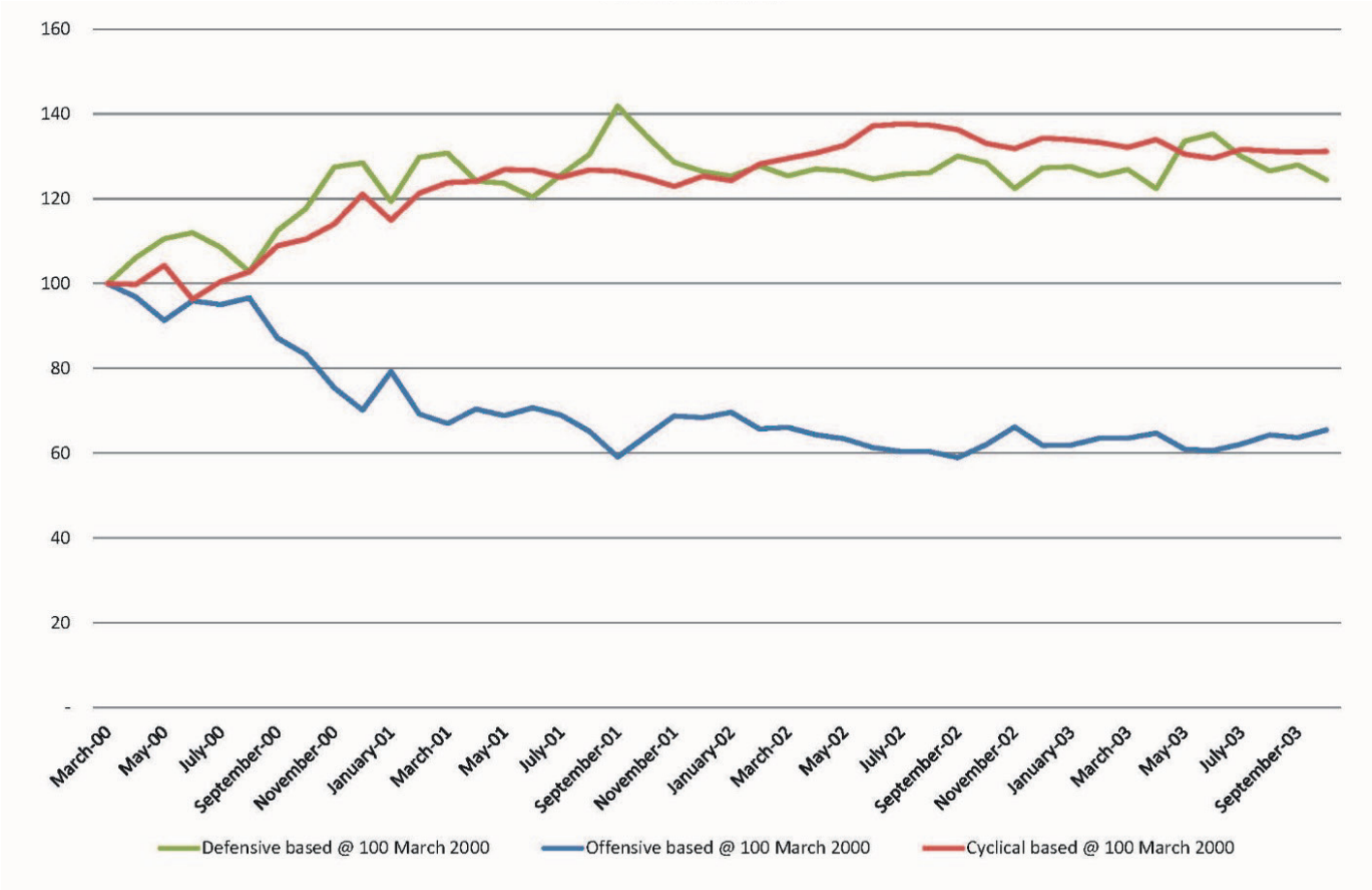
In January 2000 I was a private client investment counsel. In March of that year we were aggressively selling our technology holdings due to valuation (Nortel at 125xs earnings) and buying higher-yielding equities (utilities, pipelines, consumer staples). What we were doing was shortening the duration of our equity portfolio. A Price Earnings Ratio of 125 means you are paying 125 times that year's earnings, an earnings yield of 0.8%. How did this play out?

The following two charts look at the relative performance of the main industry groups post the initial inversions of the 10-year minus three-month curve in March of 2000 and January of 2006. The sectors are grouped as follows:

- **Offensive:** InfoTech and Consumer Discretionary
- **Cyclical:** Energy, Financials, Industrials, Materials and Real Estate
- **Defensive:** Consumer Staples, Pharma, Utilities, and Telecom

The charts are examining which sectors are gaining or losing influence in the overall market. A rising line indicates the group is gaining influence (outperforming) and a falling line indicates it is losing influence (underperforming). In both cases the period examines the market's behaviour into the low for that bear market (October 2002 and March 2009) and through the first year of recovery.

S&P 500 Index: Defensive, Offensive & Cyclical Sectors' Relative Performance

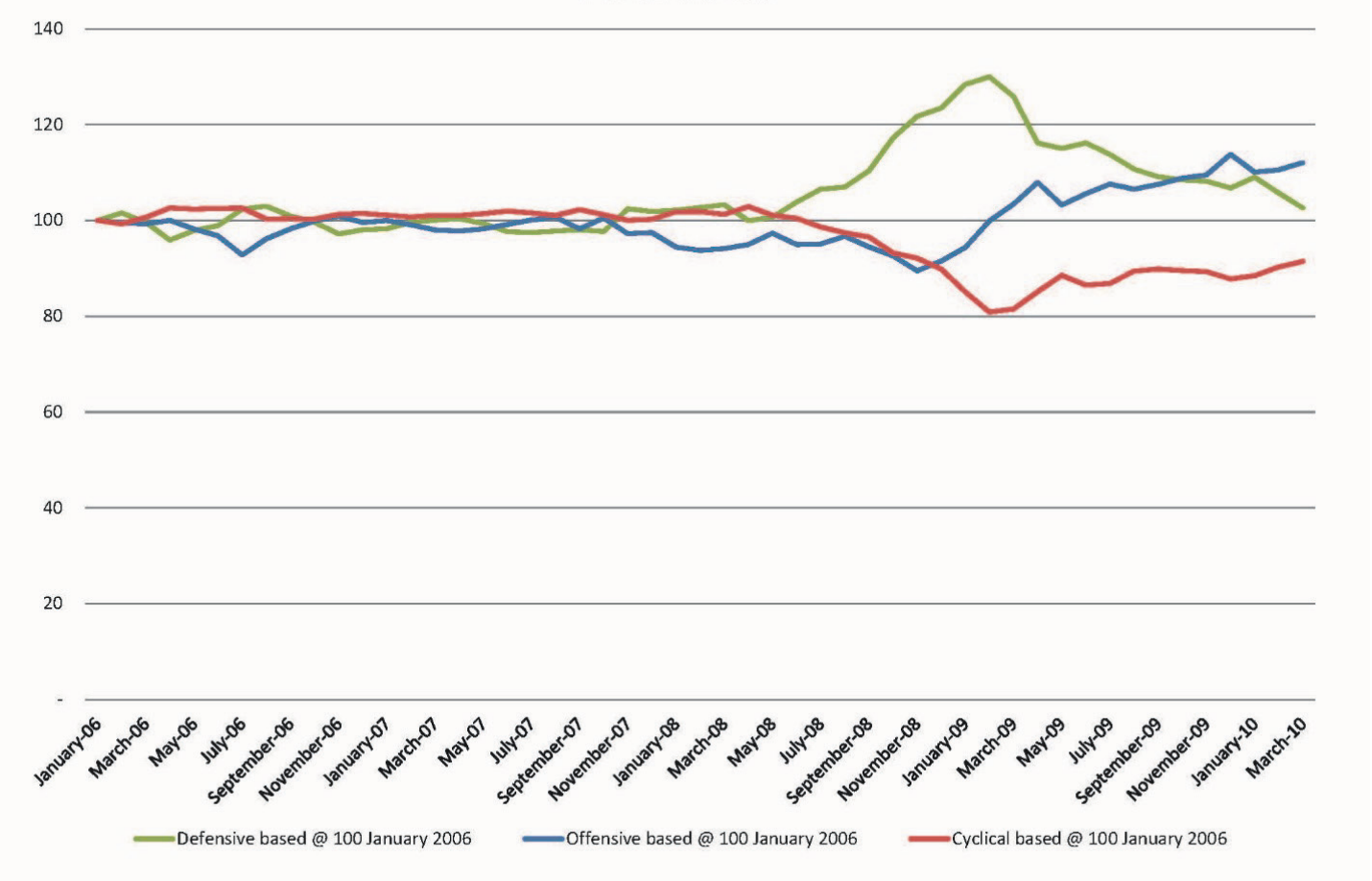


Source: Bloomberg L.P.; CI Investments

As at October 31, 2003

In the 2000 to 2003 period it is pretty clear that avoiding the InfoTech and Consumer Discretionary sectors led to meaningful outperformance. During the Tech Bubble cyclical stocks had fallen deeply out of fashion, but in late 2003 they were the new leaders. While the enthusiasm for concept stocks is not as extreme today, avoiding them as the cycle matures might be wise.

S&P 500 Index: Defensive, Offensive & Cyclical Sectors' Relative Performance



Source: Bloomberg L.P.; CI Investments

As at March 31, 2018

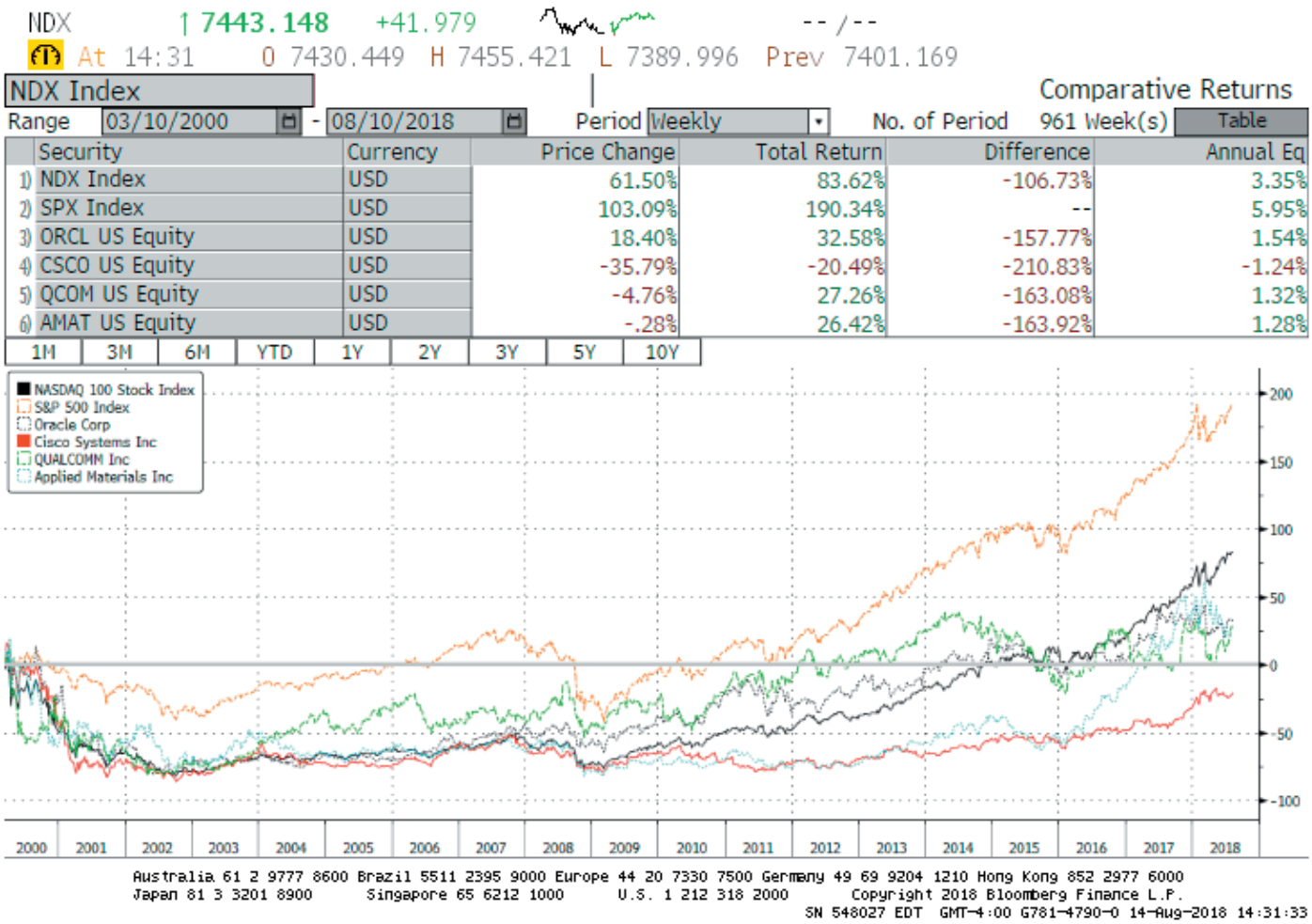
Going into the 2008 bear market, the cyclical sectors had the most influence. Within the cyclical sectors there was an internal rotation happening through 2007 and into 2008 as Financials began to lose weight and Energy and Materials gained influence. InfoTech and Consumer Discretionary had not yet recovered from their severe declines in the aftermath of the Tech Bubble. After the peak in the oil price in June 2008 the old leaders became the biggest losers. Bear markets trap concentrated portfolio bets; when most managers own the same positions in size, who is the next buyer? As the bear began to bite in 2008 there was a clear advantage in holding defensive positions: you avoided the worst losses.

Keeping all of that in mind, let's play with some numbers. A high-growth company like Netflix trades at a PE of 150x. How fast do the current trailing 12-month earnings of $2.27 have to grow to offset a decline in multiple that will occur as the company matures? The NASDAQ 100 (NDX) is a decent proxy for future valuation, it includes mature growth companies like Apple (PE 19.2x) and Microsoft (PE 31x). The NDX trades at 26x earnings.

Let's assume that in 10 years' time Netflix trades at a 50% premium to the NDX (a pretty big assumption) with a PE of 40x. I expect the stock to compound at a double-digit rate of return over the holding period, say 12%, as it's a growth stock. My future value is $1,052.88. Trading at 40x earnings I will need $26.32 of trailing 12-month earnings in 2028. Plugging these values into my calculator I find that the compound annual growth rate is 27.8%. What does this mean? Net income for the company is $370 million, compounded at 27.7% it will become $4.3 billion.

Can it happen? Yes, multiple transformational companies have seen this type of growth. Will Netflix be a good stock? Time will tell. Oracle, Cisco, QUALCOMM and Applied Materials are the surviving darlings of the Tech Bubble that once traded at Netflix and Amazon valuations. They remain good companies. Were they good stocks? No. Earnings growth could not offset multiple compressions. Take a look at your portfolios. Do you have positions that can become subject to bad math? If so, you should begin to take profits.

NDX and SPX Indexes vs Key Tech Stocks



Security	Currency	Price Change	Total Return	Difference	Annual Eq
1) NDX Index	USD	61.50%	83.62%	-106.73%	3.35%
2) SPX Index	USD	103.09%	190.34%	--	5.95%
3) ORCL US Equity	USD	18.40%	32.58%	-157.77%	1.54%
4) CSCO US Equity	USD	-35.79%	-20.49%	-210.83%	-1.24%
5) QCOM US Equity	USD	-4.76%	27.26%	-163.08%	1.32%
6) AMAT US Equity	USD	-.28%	26.42%	-163.92%	1.28%

Source: Bloomberg L.P.; CI Investments

As at August 14, 2018

Putting it together

We are getting signals from the yield curve that the cycle is in it final innings. We have a market that has been led by high growth/high multiple stocks. There comes a time when you should be shortening your equity portfolio duration: reduce the portfolio PE multiple and increase the portfolio yield. You should also consider the volatility and duration of the income streams. I like to call this buying the structures of everyday life: food and drink, fuel/energy, transportation etc. Focus on the areas of consumption that people will not cut back on if times get tight.

Last month I noted that the defensive sectors of the U.S. market had declined in influence to levels that they were at when the Tech Bubble had peaked. While it is early days, the old leaders appear to be fading, and new leadership is beginning to take hold. The FANG+ Index peaked on June 20, since then it is down 8.7% (as of August 15, 2018). Look at how it is performing against the old laggards, now the new leaders: the defensive sectors.

NY FANG Index Comparisons

NYFANG ↑ 2781.84 -56.73 -- / --

At 12:25 d O 2838.58 H 2838.58 L 2759.72 Prev 2838.58

NYFANG Index — Comparative Returns

Range 06/20/2018 - 08/15/2018 Period Daily No. of Period 56 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	NYFANG Index	USD	-8.70%	-8.66%	-13.90%	-44.60%
2)	S5CONS Index	USD	4.82%	5.23%	--	39.45%
3)	S5HLTH Index	USD	5.49%	5.72%	.48%	43.67%
4)	S5UTIL Index	USD	6.58%	6.95%	1.72%	54.97%
5)	S5TELS Index	USD	6.45%	7.84%	2.61%	63.60%
6)	S5RLST Index	USD	4.22%	4.64%	-.60%	34.36%

1M 3M 6M YTD 1Y 2Y 3Y 5Y 10Y

Australia 61 2 9777 8600 Brazil 5511 2395 9000 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2018 Bloomberg Finance L.P.
SN 548027 EDT GMT-4:00 G608-2542-0 15-Aug-2018 12:40:40

Source: Bloomberg L.P.; CI Investments

As at August 15, 2018

Maybe the perpetual motion stocks are beginning to be questioned. Alphabet (Google), Apple and Amazon are still strong but Alibaba, Baidu, Facebook, Netflix, Tesla (until the Musk tweet about going private) and Twitter are all showing strains in a rising market. The distribution phase for popular stocks with little valuation support can be difficult.

Perpetual Motion Stock Comparisons

FB US $ ↑ 177.39 -3.72 A177.35 /177.37K 1x2

At 12:29 d Vol 16,844,540 O 179.34K H 180.87D L 174.78P Val 2.993B

FB US Equity — Comparative Returns

Range 06/20/2018 - 08/15/2018 Period Daily No. of Period 56 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	FB US Equity	USD	-12.18%	-12.18%	-20.20%	-57.12%
2)	AMZN US Equity	USD	8.01%	8.01%	--	65.27%
3)	AAPL US Equity	USD	12.03%	12.43%	4.41%	114.56%
4)	NFLX US Equity	USD	-22.09%	-22.09%	-30.10%	-80.34%
5)	TSLA US Equity	USD	-7.08%	-7.08%	-15.09%	-38.02%
6)	TWTR US Equity	USD	-30.10%	-30.10%	-38.11%	-90.31%

1M 3M 6M YTD 1Y 2Y 3Y 5Y 10Y

Australia 61 2 9777 8600 Brazil 5511 2395 9000 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2018 Bloomberg Finance L.P.
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Source: Bloomberg L.P.; CI Investments

As at August 14, 2018

The rest of the NYSE FANG+ Index members are in the next graph, with the S&P 500 and NASDAQ Composite as comparisons.

Index and Key Stock Comparisons

SPX ↓ 2817.16 -22.80 2816.74 / 2817.61

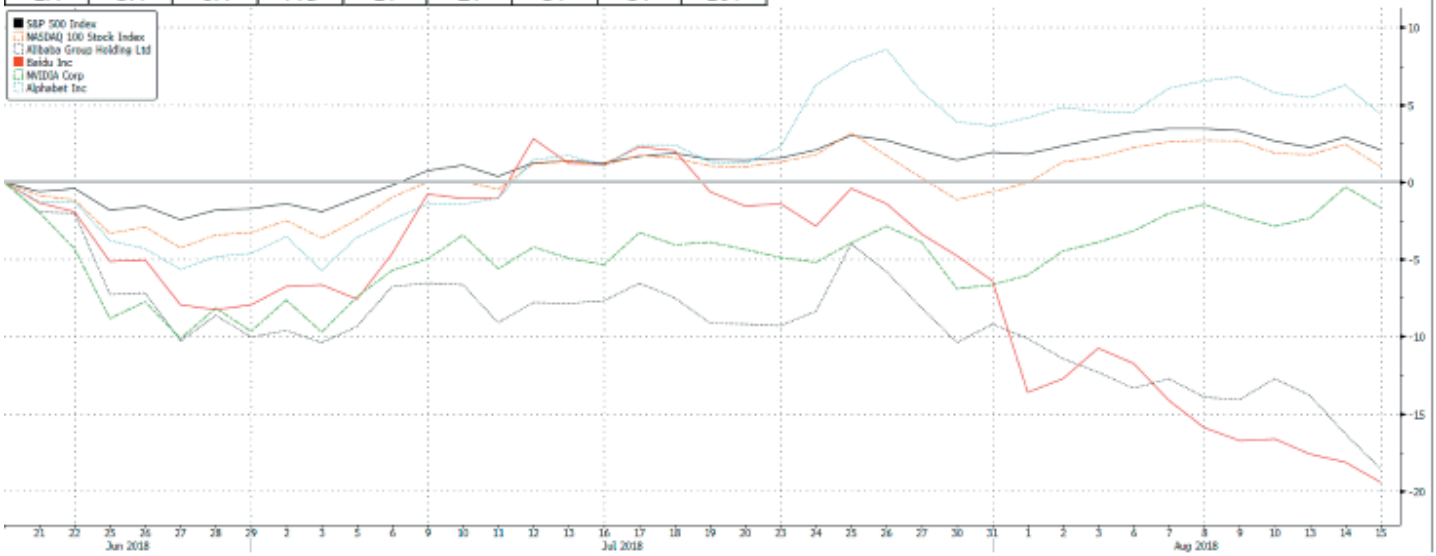
At 12:37 d O 2827.95 H 2827.95 L 2802.49 Prev 2839.96

SPX Index — Comparative Returns

Range 06/20/2018 - 08/15/2018 Period Daily No. of Period 56 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	SPX Index	USD	1.81%	2.08%	1.09%	14.38%
2)	NDX Index	USD	.83%	.99%	--	6.66%
3)	BABA US Equity	USD	-18.56%	-18.56%	-19.56%	-73.77%
4)	BIDU US Equity	USD	-19.44%	-19.44%	-20.44%	-75.57%
5)	NVDA US Equity	USD	-1.65%	-1.65%	-2.65%	-10.30%
6)	GOOGL US Equity	USD	4.38%	4.38%	3.38%	32.20%

1M 3M 6M YTD 1Y 2Y 3Y 5Y 10Y



Australia 61 2 9777 8600 Brazil 5511 2395 9000 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2018 Bloomberg Finance L.P.
SN 548027 EDT GMT-4:00 G608-2542-0 15-Aug-2018 12:51:58

Source: Bloomberg L.P.; CI Investments

As at August 15, 2018

Remember, the sectors that have been the leaders are large sectors that absorbed billions of dollars in inflows. The defensive sectors are much smaller sectors, both individually and in aggregate. They are more easily moved by much smaller flows. Portfolios that had excess exposure to the narrow group of winners will be showing greater-than-market volatility and greater-than-market losses. This process can go on for a long time. There is an old stock market saying: "Selling begets selling." In my view, we are early in this corrective process. Defence wins championships.

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CI Investments

2 Queen Street East, Twentieth Floor, Toronto, Ontario M5C 3G7 | **www.ci.com**

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