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Consumer Sectors and Inflation

The Addepar Investor Sentiment Index (ISI) Research Note is uniquely designed to provide transparency into the investment behavior of the wealthiest tier of investors. Leveraging Addepar's network of RIAs and family offices, we analyze the investment data on our platform to gain insight into how ultra-high-net-worth (U/HNW) investors are making portfolio adjustments and therefore express their views on the economy and markets. Additionally, where relevant, we conduct client interviews to supplement the data analysis presented in our research notes. To ensure privacy, we never disclose identities.

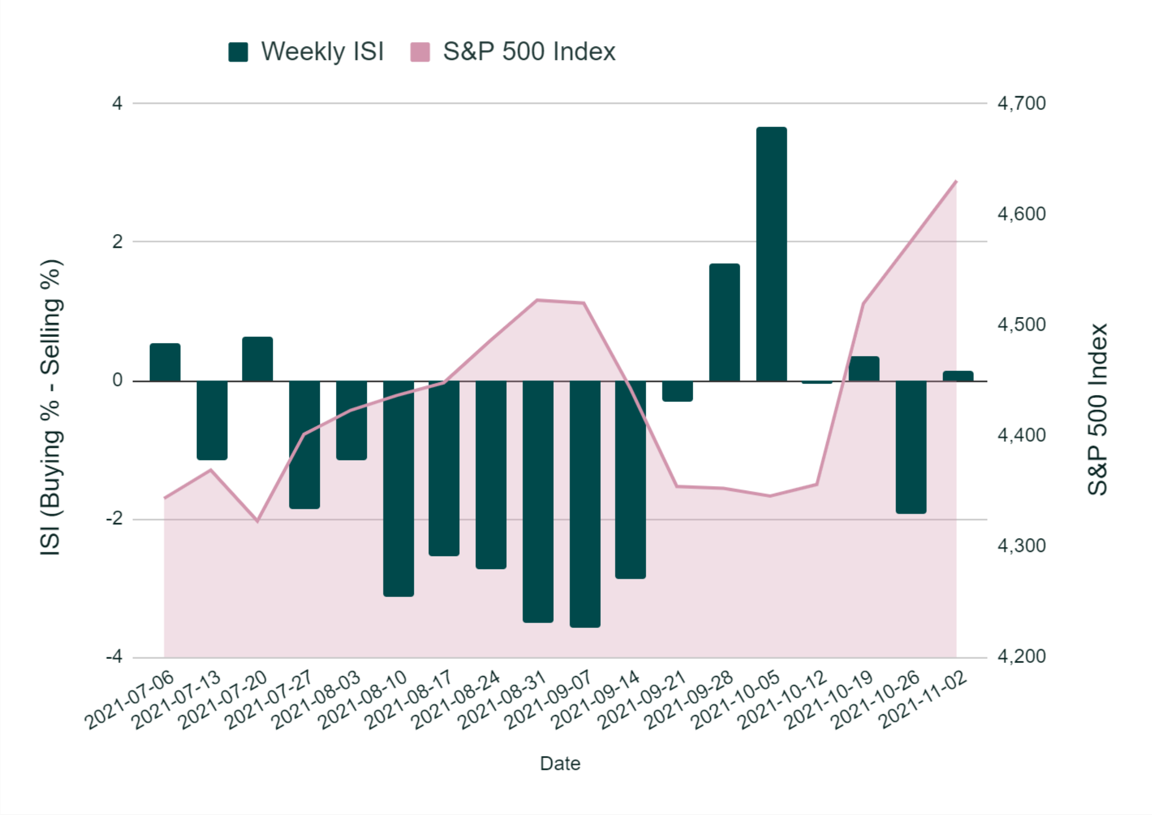
Key October findings:

- The consumer cyclical and consumer defensive sectors historically underperform in rising inflationary environments. Yet sentiment and performance are peaking for these sectors as investors bet that increasing supplier costs will be passed along to consumers or that inflation will subside.
- At the stock level, investors were broadly bullish on consumer cyclical stocks with the exception of home improvement stocks such as Lowe's, Home Depot, and JR Horton.
- Investor sentiment bet on rising long-term interest rates throughout October, though modified their position to falling rates in the last week of the month. The broader market continues to cautiously weigh how the Fed will respond to rising inflation.

Investors buy on the dip and sell on the rally

After September's sell-off, U.S. equity markets shot up 7.0% in October on strong Q3 earnings, reaching another all-time high. Meanwhile, investor sentiment was neutral. Figure 1 shows sentiment at the weekly level. Investors bought U.S. equities in the first week of the month as the market bottomed and sold equities in the fourth week when markets peaked.

Figure 1: Weekly Addepar Investor Sentiment Index
June 30, 2021–November 2, 2021



Source: Addepar, S&P Global

Betting on high consumer demand

Figure 2 shows sector-level sentiment compared with overall market performance. Sector sentiment is ordered from largest to smallest reads relative to sentiment history in that sector. Consumer cyclical and energy outperformed others, although returns were positive across all sectors.

Investors had historically high bullish sentiment in the consumer-oriented sectors. In addition, they had strong sentiment in the "production" sectors including industrials, energy and basic materials. However, investors were bearish on technology, financial services and communication services, which are all sensitive to changes in interest rates.

The sector-level rotations largely reflect the macroeconomic picture. Consumers, flush with cash due to government stimulus and pandemic savings, are creating demand that's far outstripping supply. Meanwhile, supply has rebounded to pre-pandemic levels, but cannot seem to catch up with consumer demand.

Figure 2: Sector Sentiment and Performance

October 2021

Sector	Sentiment	Performance
Consumer cyclical	5.0	10.9%
Consumer defensive	2.1	3.9%
Industrials	2.5	6.9%
Energy	1.3	10.4%
Basic materials	0.7	7.6%
Real estate	1.3	7.5%
Utilities	0.6	4.7%
Healthcare	0.4	5.2%
Technology	-1.7	8.2%
Financial services	-0.8	7.3%
Communication services	-1.3	2.8%
Bullish/Bearish		
Relative to own history:		
Strong -		
Moderate -		
Strong +		
Moderate +		

Source: Addepar

Consumer sectors historically underperform in inflationary times

Recent reports continue to show high rates of inflationary price increases. For investors, an important question is how inflation affects different parts of the economy and their investments? Given that inflation continues to surprise on the upside, it's intriguing that investors are so strongly bullish on the consumer-oriented sectors, which have traditionally been highly sensitive to inflationary pressures.

To put a finer point on this, figure 3 shows a 50-year historical analysis of how sectors respond to rising versus falling inflationary environments. Sectors are based on Kenneth French's 12-industry model due to the quality and length of the historical time series. The "shops" sector, which maps closely to today's consumer sectors, relatively outperforms the most in falling inflationary environments, while "energy" outperforms the least in environments with falling inflation (and is, therefore, the most hedged to rising inflationary environments).

Figure 3: Sector Performance in Rising and Falling Inflationary Environments

January 1960–August 2021

	Avg. Ann. Ret.	Avg. Ann. Ret.		
Sector	Falling Inflation Environments	Rising Inflation Environments	Difference	Return to Vol. Ratio
Shops	25.0%	-3.2%	21.8%	1.3
Consumer durables	29.1%	0.9%	30.0%	1.2
Consumer non-durables	19.7%	-6.4%	13.3%	1.0
Chemicals	18.8%	-5.0%	13.9%	0.9
Money	19.9%	-5.6%	14.3%	0.8
Manufacturing	20.1%	-5.9%	14.2%	0.8
Business equipment	21.5%	-6.2%	15.3%	0.8
Health	19.5%	-7.9%	11.6%	0.7
Other	17.7%	-5.0%	12.6%	0.7
Telecommunications	16.0%	-5.9%	10.1%	0.7
Utilities	12.9%	-7.9%	5.0%	0.5
Energy	13.9%	-10.9%	3.0%	0.1

Source: Kenneth French Data Library, Federal Reserve Bank of St. Louis, Addepar

At a more mechanical level, the consumer cyclical sector is a catch-all for everything consumers buy when they're in the position to do so—including vacations, clothes and cars. In environments such as today's, where input prices (such as gas for transportation) rise, businesses must decide whether to pass along these costs to consumers and potentially lose market share, or temporarily reduce profitability if they believe prices will revert. As a result, businesses in this sector often end up "eating the cost," which is why historically they have underperformed in rising inflationary environments.

Investors bet this time is different in consumer sectors

To provide a little more color on the magnitude of the consumer cyclical sentiment, figure 4 shows the time series against the total return index for the sector. Looking across the chart, you can readily see that the consumer cyclical sector hasn't been this bullish since March 2020 (when investors were broadly bullish on all stocks). In fact, this is the highest reading we've had since we've tracked the index—excluding the March 2020 data point itself.

A number of explanations may account for the bullish sentiment. The simplest one is that investors believe that businesses will be able to raise prices. Q3 earning reports showing continued improvements to profit margins in the sector reinforce this interpretation[1].

The magnitude of consumer cyclical and consumer defensive sectors' sentiment ("demand") relative to the sentiment within industrials, energy and basic materials ("supply") is also interesting to juxtapose against what Fed Chair Powell has been recently telegraphing. "Supply-side constraints have gotten worse," Powell declared. "The risks are clearly now to longer and more-persistent bottlenecks, and thus to higher inflation." This sentiment data can be interpreted as investors believing these supply constraints are actually the result of high demand and not of constrained supply.

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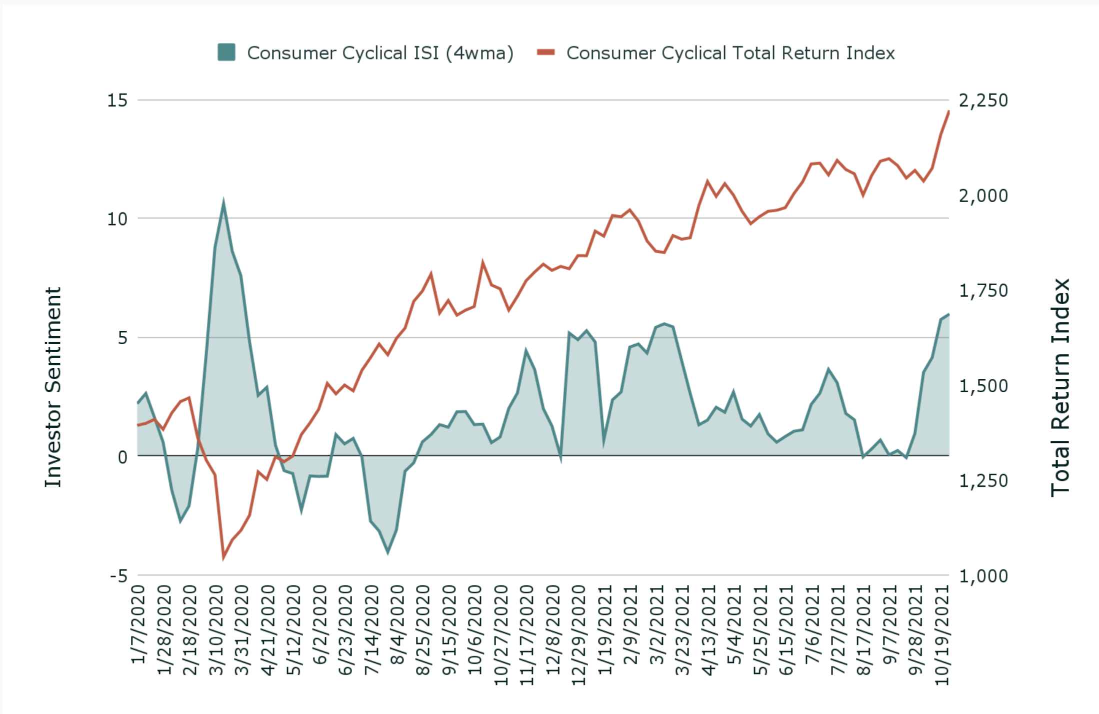
[1] *The Wall Street Journal,* "What Does Inflation Mean for American Businesses? For Some, Big Profits," November 14, 2021

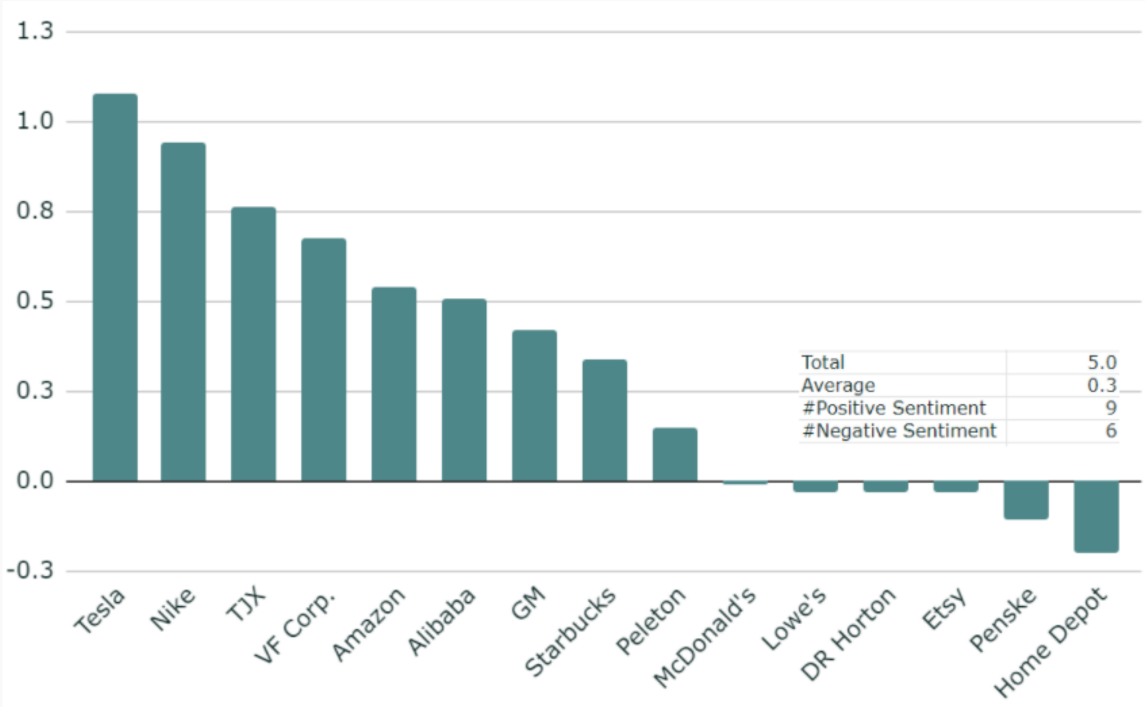
Figure 4: Consumer Cyclical Sentiment vs. Total Return Index
January 1, 2020–October 29, 2021



Source: Addepar, S&P Global

Most stocks within the consumer cyclical sector had bullish sentiment. A few stocks were modestly neutral or bearish including Lowe's, DR Horton and Home Depot—all home improvement names.

Figure 5: Consumer Cyclicals Sentiment Most-Traded Stocks
October 2021



Source: Addepar

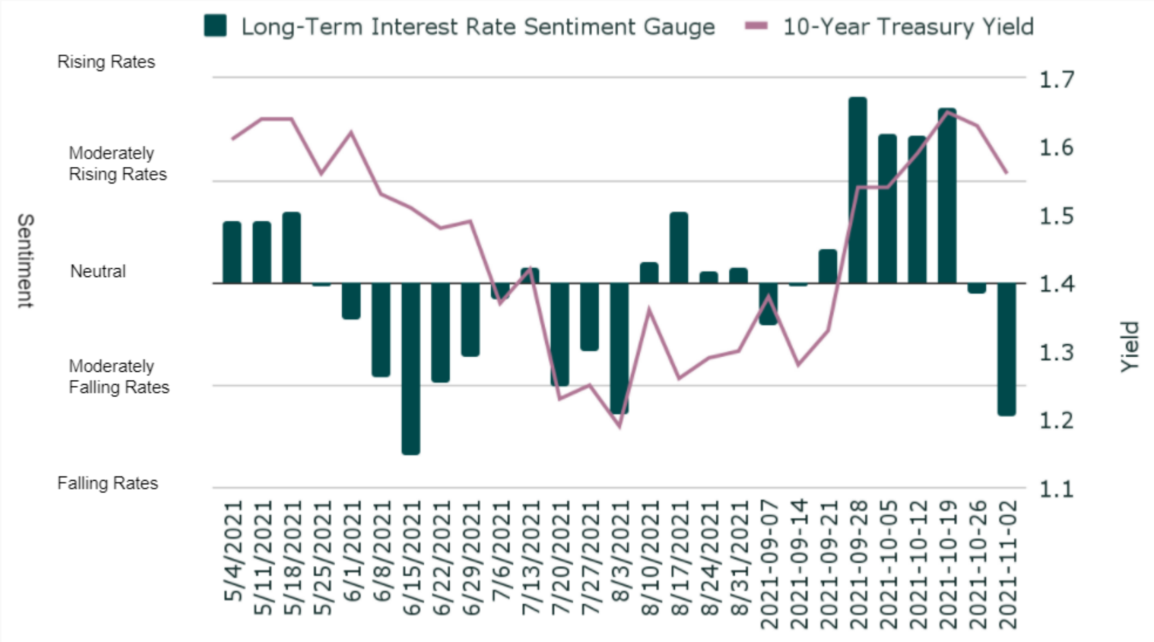
Sentiment to interest rates highly consistent with the market

Also on point is the evolving narrative of the Fed's optimization between achieving full employment while balancing inflation risks and its reflection in bond market pricing. Federal Reserve officials are now set to begin winding down their bond purchase program in November. The yield curve, shorthand for the spread between 10-year Treasuries and 2-year Treasuries, flattened 0.17% due to short-term rates rising to their highest level since March 2020. The flattening of the yield curve is seen as indicating that the Fed's actions will dampen long-term nominal growth as the board raises short-term interest rates sooner than previously expected.

In our August periodical, we introduced a sentiment gauge for long-term interest rates based on sector-level sentiment (methodology and analysis updated in the appendix). Figure 6 shows this sentiment tracked against 10-year Treasury rates for the past six months. Neutral views in August turned sharply higher, propelled by rising rates in the last week of September as the 10-year Treasury rate rose. Sentiment reversed course due to falling rates in the final week of October.

Figure 6: Long-Term Interest Rate Sentiment Gauge vs. 10-Year Treasury Yield

May 1, 2020–November 2, 2021



Source: Addepar

Stay tuned

We'll continue to develop analytics that provide additional value to our clients through the aggregated and anonymized investment data on our platform. We'll also keep posting the monthly ISI index, our key observations and periodic research notes on our website.

Appendix

Characterizing sectors in terms of the connection between their performance and Treasury rates is both intuitive and can be rigorously documented through regressions. Energy, industrials, financial services and materials ("cyclicals") do well when inflation and growth are rising, which often coincides with increasing 10-year Treasury rates. Similarly, "defensive" sectors—including consumer defensive, real estate and utilities—will outperform when inflation and growth are falling. This also may track with falling 10-year Treasury rates. While healthcare is traditionally thought of as a defensive sector, it can have elements of growth in it as well, and will be excluded from this analysis. We will subsequently write a note just on this sector.

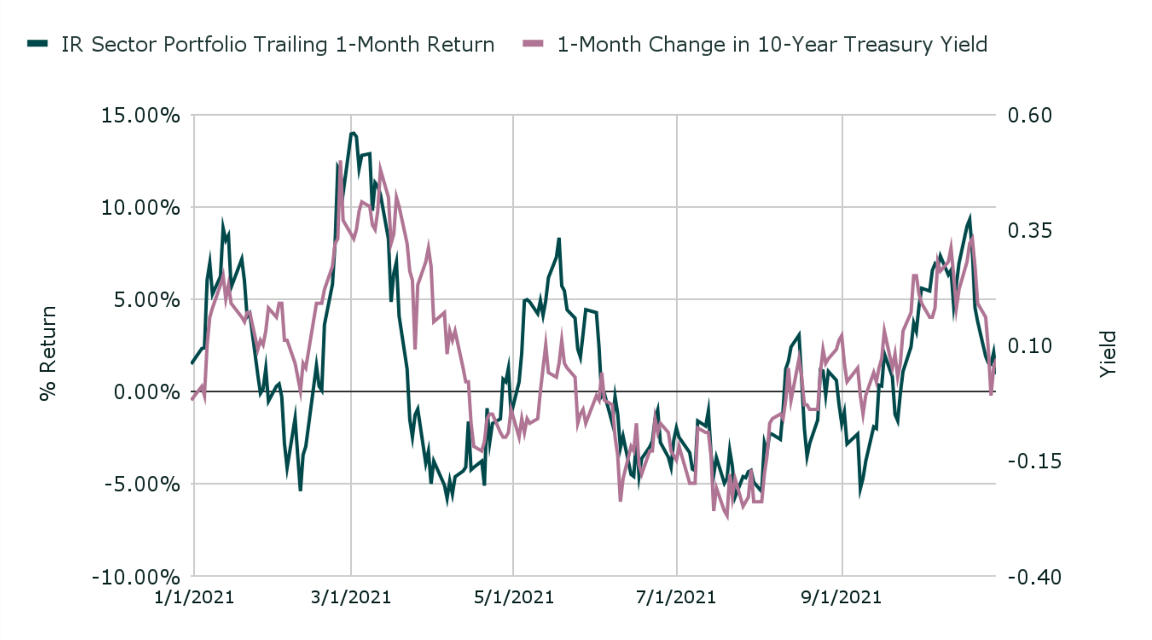
A portfolio that's engineered by taking equally risk-weighted cyclical sectors while shorting defensive sectors generates returns that track the path of interest rates, an approach that we'll call a "reflation portfolio."

To illustrate how this reflation portfolio tracks interest rates, figure 7 shows the trailing 1-month return of a reflation portfolio relative to 1-month changes in Treasury yields. Correlations are very high at .7. Regression analysis (not shown here) dating back to the start of 2020 yields comparable results.

A weekly sentiment gauge constructed similarly to the reflation portfolio can be used as a proxy for the implicit view on long-term rates by investors.

Figure 7: Interest Rate Sector Portfolio vs. 1-Month Change in 10-Year Treasury Yield

December 31, 2020–October 30, 2021



Source: Addepar, S&P Global

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