ADDEPAR

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When Growth Decelerates

The Addepar Investor Sentiment Index (ISI) research note is 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 anonymized investment data on our platform to gain insight into how ultra-high-net-worth (U/HNW) investors are making portfolio adjustments, effectively capturing their views on the economy and markets. Additionally, where relevant, we conduct client interviews to supplement the data analysis presented. To ensure privacy, we never disclose identities.

Summary:

A number of indicators are beginning to signal mid-business cycle dynamics, including tightening liquidity, slowing growth and falling asset prices. Unlike previous cycles, long-term interest rates haven't been following the path of nominal growth, but instead are rising on the heels of Fed tightening. These unique dynamics are being reflected in equity sector sentiment as follows:

- Investor sentiment and the broader market are both shifting from cyclical to defensive sectors.
- Defensive sector sentiment is at historically high levels due to bullish sentiment in utilities.
- Investor sentiment regarding financial services (typically linked to interest rates) is becoming increasingly bearish even as rates rise.

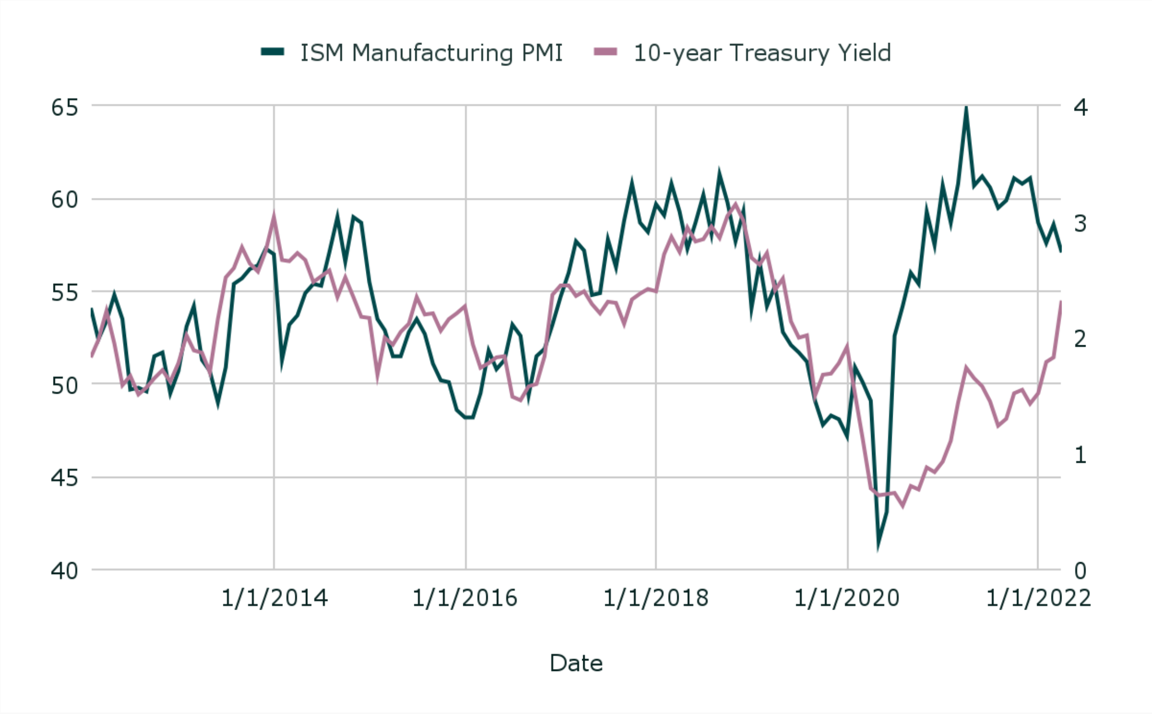
Transition from rising to falling growth

Monetary and fiscal stimulus introduced during the Covid-19 pandemic has been successful in lifting the economy, while generating broad-based income and wealth. High levels of demand have also overwhelmed the supply of goods and services, leading to inflation that's now impacting overall costs of living and forcing employers to increase wages to retain employees. To break this self-reinforcing inflationary dynamic, the Fed and other central banks around the world have begun to unwind stimulus and raise short-term interest rates. Tightening is now being reflected in slowing growth and rising interest rates.

Because of the pandemic, central banks had delayed tightening for some time after inflation began to rise. This led to the decoupling of growth and long-term interest rates, although following the recent Fed tightening, these now appear to be on a converging path. Figure 1 shows a classic gauge of growth, the ISM Manufacturing PMI[1], versus the 10-year Treasury rate over the last 10 years. As the chart suggests, PMI and 10-year Treasury rates have historically moved together until the pandemic time frame of the past two years. While PMI has risen sharply after bottoming in April 2020, the 10-year Treasury rate has remained subdued but is now rapidly moving to track with PMI due to the Fed tightening that's underway.

Figure 1: ISM Manufacturing PMI vs 10-year Treasury Yield

January 2012–March 2022



Source: Federal Reserve Bank of Saint Louis

[1] The ISM manufacturing index, conducted by the Institute for Supply Management, also known as the purchasing managers' index (PMI), is a monthly indicator of U.S. economic activity based on a survey of purchasing managers at more than 300 manufacturing firms. It is considered to be a key indicator of growth for the U.S. economy.

Market rotates into defensive sectors

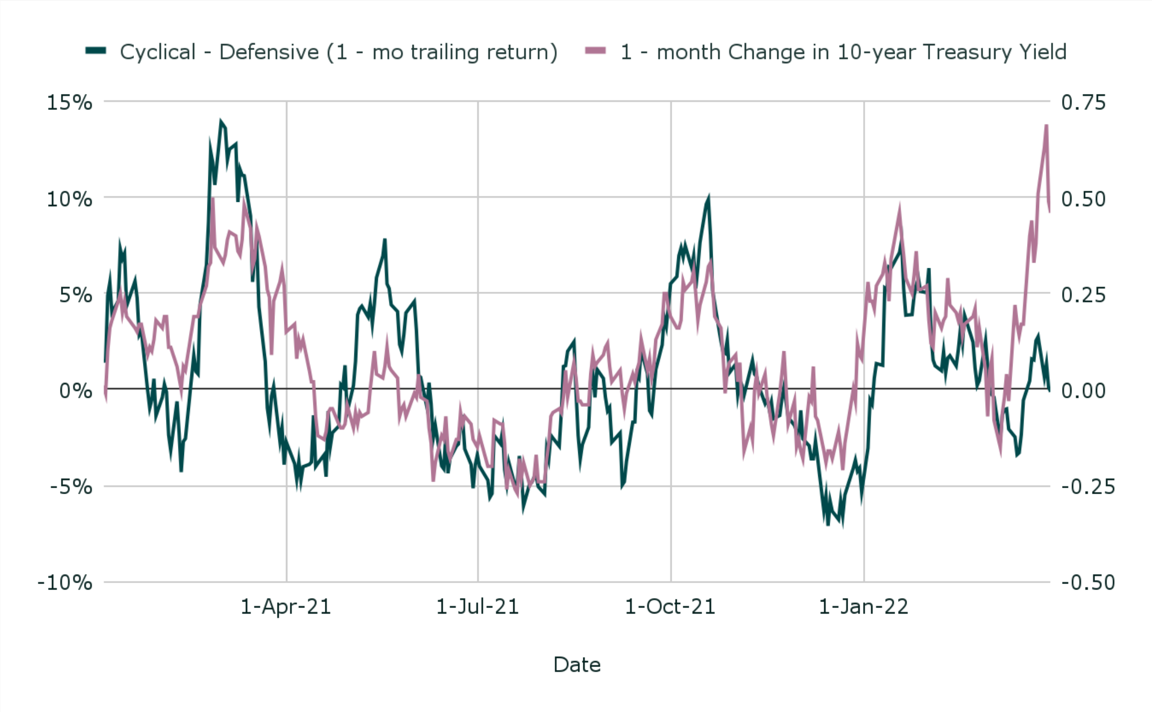
It’s common knowledge that when nominal growth peaks, cyclical sectors begin to underperform defensive ones. In previous studies, we’ve also established the connection between sector performance and interest rates. In this note we ask, what do we see broadly in sector pricing today, and how does U/HNW investor sentiment compare?

Below in figure 2, we show the one-month trailing return of a portfolio that’s engineered by taking equally risk-weighted cyclical sectors while shorting defensive sectors. When returns for this portfolio are positive, cyclical sectors are outperforming, while when returns are negative, the opposite is true (defensive sectors outperform). Relative to this portfolio, we show 1-month changes in Treasury yields. Although the chart only covers a short time frame, long-term correlations are very high—ranging between .6 and .7.

At the broader market level, we’re seeing an outperformance of defensive sectors (cyclical–defensive returns turn negative). While consistent with the direction of ISM Manufacturing PMI, interest rates are rising and we’re now seeing a divergence emerge between long-term interest rates and sector rotations.

Figure 2: Cyclical–Defensive Sector Returns

January 2021–February 2022



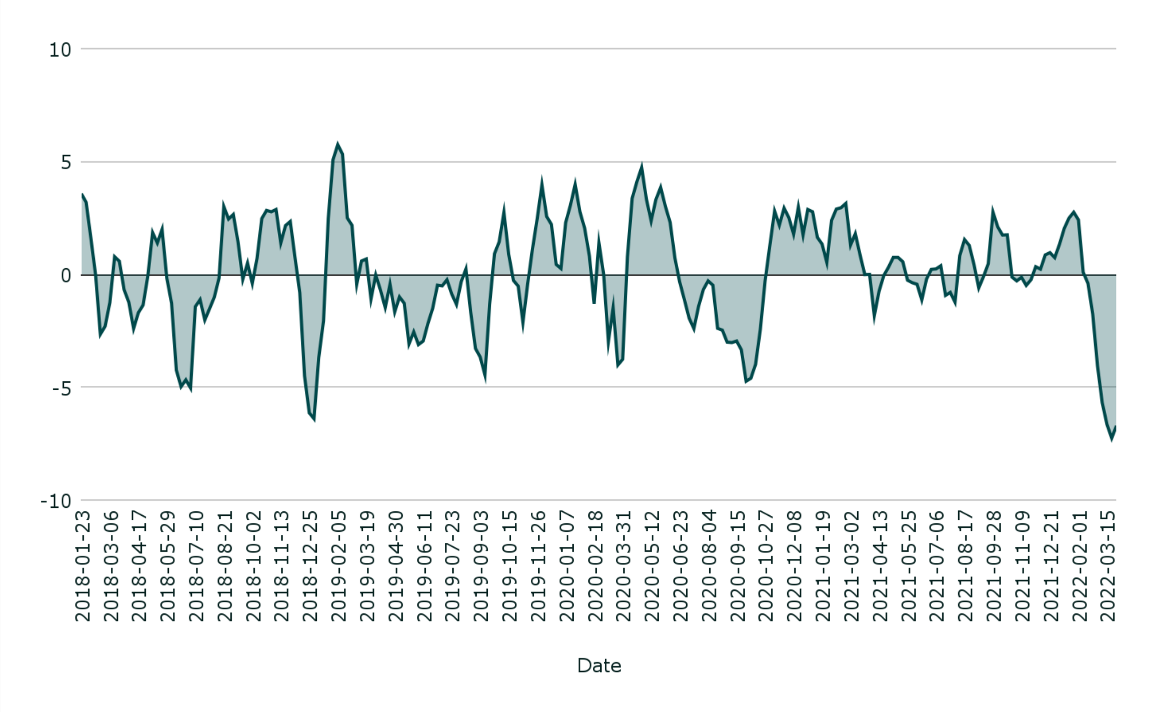
Source: S&P Global, Federal Reserve Bank of Saint Louis

The sentiment index also points to falling growth

Figure 3 shows a weekly sentiment gauge that's similar to a cyclical-defensive portfolio. This cyclical–defensive sentiment gauge depicts equally weighted defensive sector sentiment subtracted from equally-weighted cyclical sector sentiment. Even more extreme than the broader market, the gauge is now showing a very strong rotation into defensive sectors. This is in fact the strongest reading we've seen since we began tracking the index. The cyclical–defensive sentiment gauge remains moderately correlated (.4) with the broader cyclical–defensive market portfolio over the same time frame.

Figure 3: Cyclical–Defensive Sector Sentiment

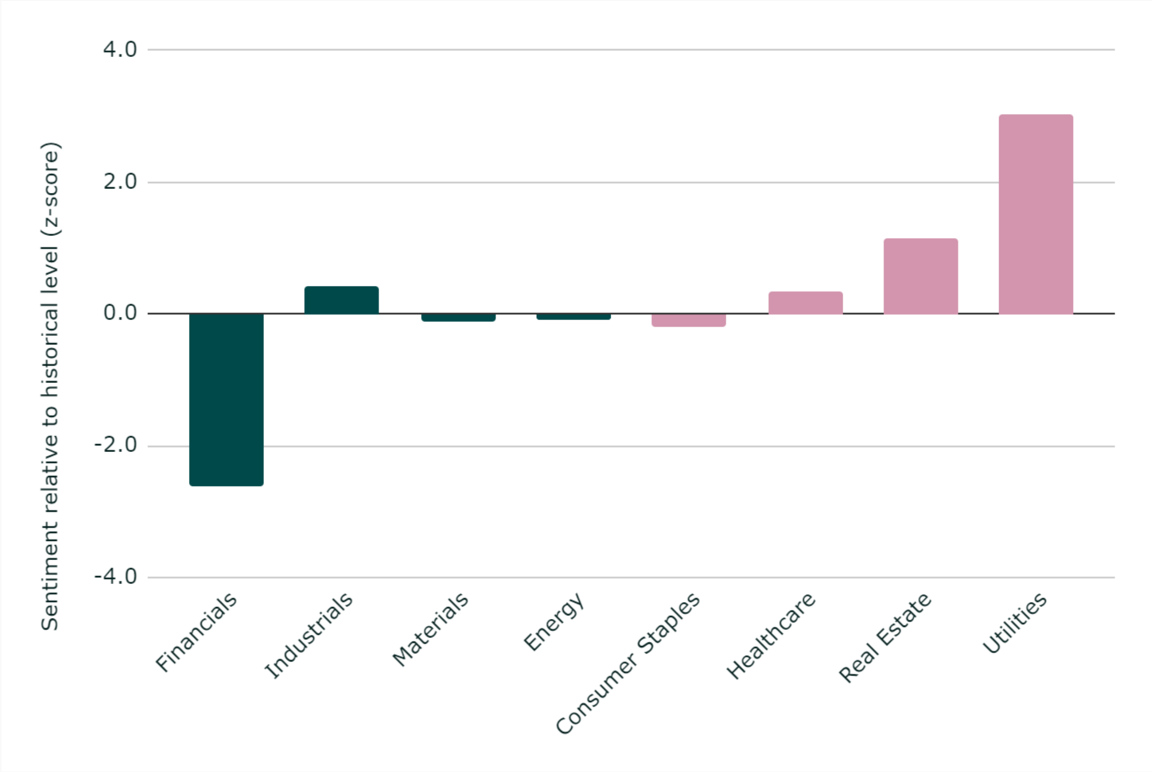
January 2018–March 2022



Source: Addepar

In attributing the most recent data point from figure 3 to the individual sectors, we see that defensive sectors, particularly utilities, have become quite bullish (figure 4), while cyclical sectors other than financials are neutral. In particular, the utilities sector is now showing its highest reading since we started tracking sector sentiment.

Figure 4: Cyclical–Defensive Sector Sentiment
February 22, 2022–March 15, 2022

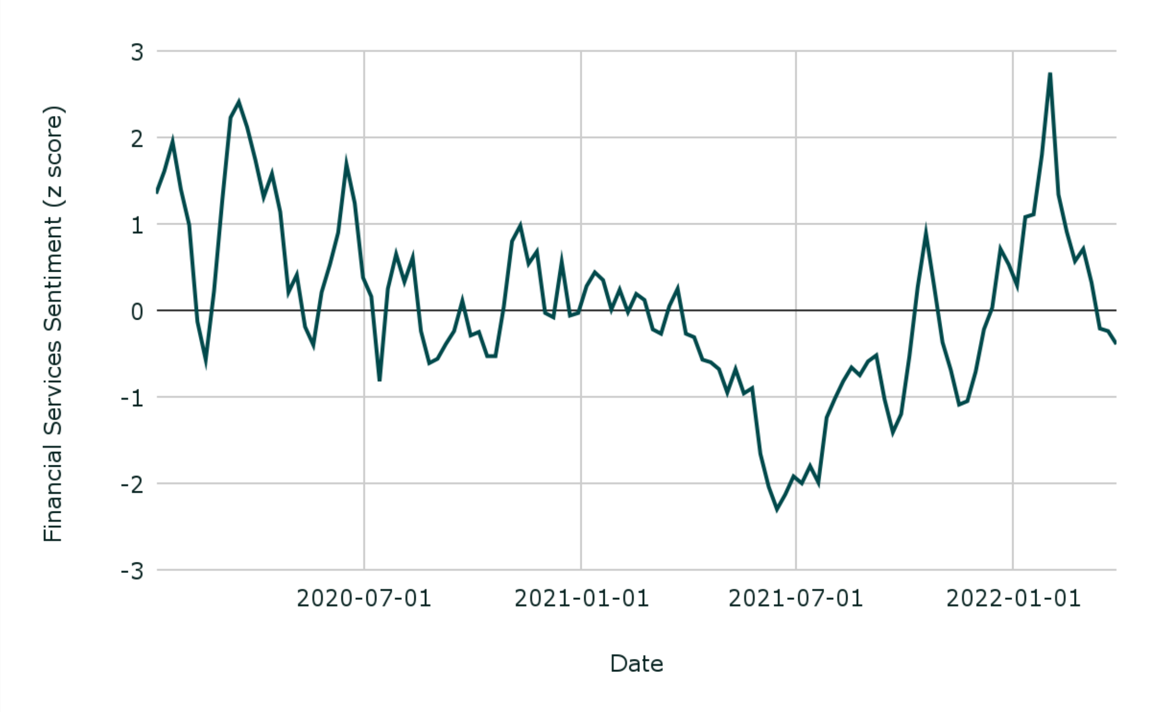


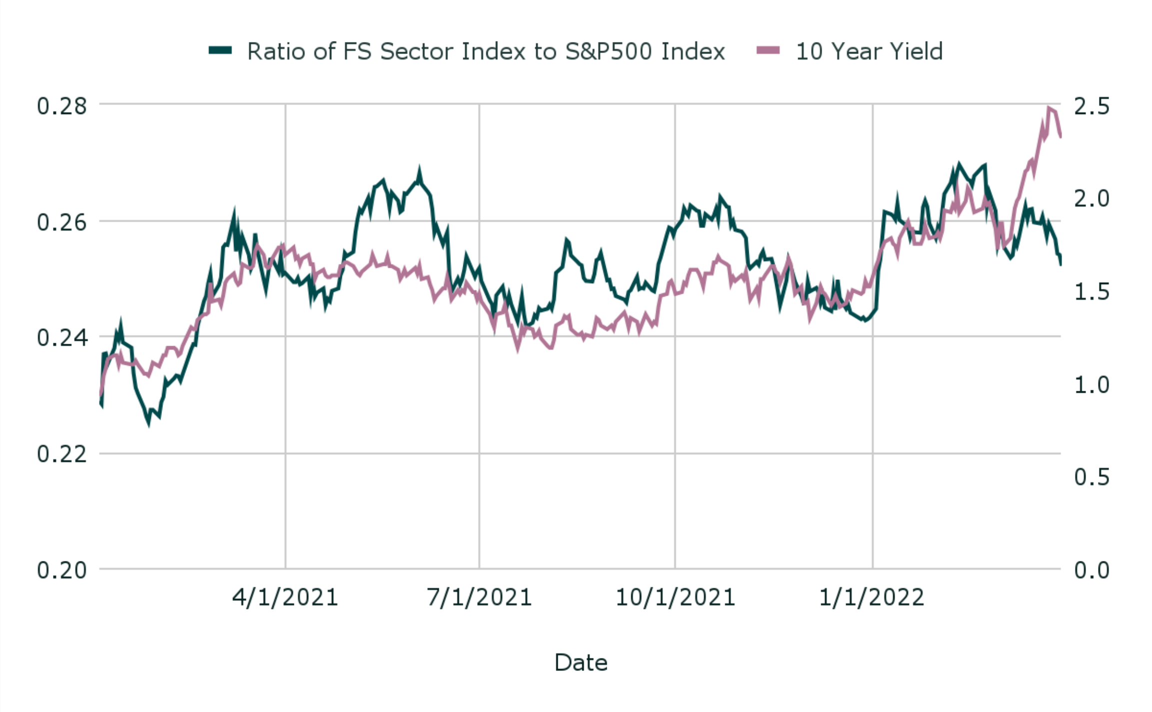
Source: Addepar

Some sectors are especially sensitive to interest rates. In recent editions of this note, we've observed that investors in the financial services sector responded to changes in Treasury yields. Generally, when yields would go up, sentiment increased, and the opposite happened when yields declined. Recently, however, financial services sentiment is also shifting in the bearish direction, just like other cyclical sectors, despite rising rates (figure 5). The broader market for financial services sentiment appears to be breaking its traditional tie to long-term interest rates as well.

Figure 5: Financial Services Sentiment

January 2021–March 2022





Source: Addepar, S&P Global

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.

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