Weekly Market Commentary

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Surprise: Cyclicals May Soon Come Back

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Highlights

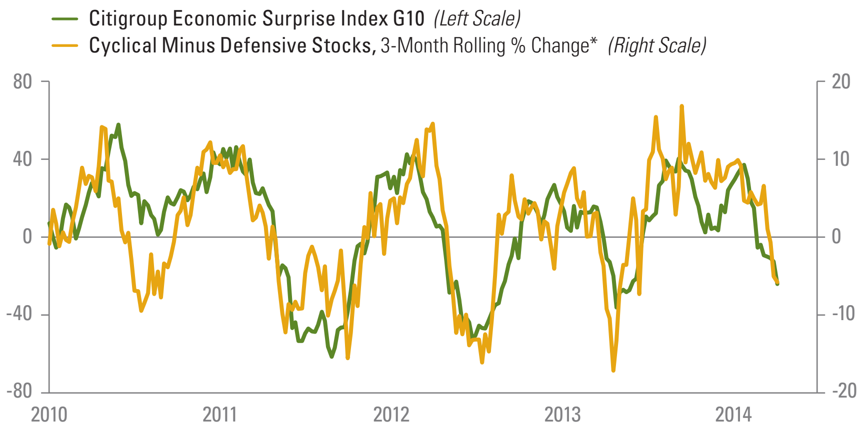
The very tight relationship between economic surprises and the performance of cyclicals suggests cyclicals may soon make a comeback relative to more defensive sectors.

So far this year, "defensive" stocks, those that are less sensitive to economic growth, such as utilities and health care stocks, have led the markets higher. However, we may soon be nearing a meaningful and durable shift in the market favoring the more economically sensitive sectors that we call "cyclicals," which include industrials, consumer discretionary, materials, and technology.

The Citigroup Economic Surprise Index for the 10 major world economies tracks how data are faring compared with expectations. It rises when economic data come in better than economists' estimates and falls when it is worse. This index has been falling in recent months, due in part to extreme weather conditions in the United States contributing to disappointing economic data. Historically, when economic data are weaker than expected, investors tend to favor defensive stocks, since they are more insulated from the slower pace of economic activity, and when data exceed expectations they favor cyclicals.

The very tight relationship between economic surprises and the performance of cyclicals suggests cyclicals may soon make a comeback relative to more defensive sectors [Figure 1]. If the disappointing economic data reported in the first quarter turn out to have been largely the result of

1 Economic Data Surprises May Soon Lead to a Revival for Cyclicals



Source: LPL Financial Research, Bloomberg data 04/07/14

*Rolling 3-month performance of S&P 500 cyclical sectors (technology, industrials, materials, consumer discretionary) less defensive sectors (utilities, telecommunications, health care, consumer staples).

Past performance is no guarantee of future results.

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extreme weather, as we believe them to be, then the economic readings may begin to surprise to the upside, taking the relative performance of cyclical stocks higher along with it. As indicated in Figure 1, such snapbacks in performance by cyclicals have been quick and powerful.

A key risk to a cyclicals comeback is that economists' expectations may have already rebounded ahead of the upturn in the data. For example, the March employment report from the Bureau of Labor Statistics released on Friday, April 4, was encouraging, with the creation of 192,000 jobs during March — the most since November 2013, before the extreme winter weather kicked in — yet it fell just short of the consensus economists' expectation of 200,000. Similarly, the widely watched report on manufacturing from the Institute for Supply Management (ISM) rose to 53.7 in March after dropping to a low of 51.3 in January 2014 — near the 50 level that marks the line between growth and contraction — but fell just short of the consensus expectation of 54.0.

We will be watching for surprises in the economic data in the coming weeks that may signal a turn in cyclicals' relative performance. ■

INDEX DESCRIPTIONS

The Citigroup Economic Surprise Index (CESI) measures the variation in the gap between the expectations and the real economic data.

The Institute for Supply Management (ISM) index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

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