Next
Weekly Macro Strategy Report
Friday, July 15

- The rebound in U.S. stocks post-Brexit has been primarily led by cyclical sectors.
- Sector leadership in non-U.S. markets has been mixed, underscoring that confidence in the economic outlook remains tentative.
- Stay defensive on a 0-3 month horizon, favoring health care and telecom stocks in U.S. and global portfolios.
- We anticipate upgrading the technology sector to overweight once there is clarity that the moderately positive global growth outlook remains intact.

Sector Performance Post-Brexit

Global equity markets have enjoyed a relief rally following an initial sell-off in the wake of the Brexit vote. The rebound in risk asset prices has been strong in the U.S. where equities have broken out to a new high. In contrast, ex-U.S. equities, while up from their recent lows, have yet to decisively break their downtrend. The composition of the rally has varied across major regions, with the U.S. equity advance driven to a greater extent by cyclical sectors, whereas the rebound in non-U.S. markets has been led by a mix of cyclical and defensive stocks, underscoring that beneath the surface of the broad equity indexes, markets have not fully embraced the notion that global growth is on a clear positive trajectory.

Below, we examine sector performance across major regions in the aftermath of the U.K. referendum. Equity markets gapped sharply lower on the morning following the “leave” victory in a knee-jerk reaction to the referendum results. Therefore, it is appropriate to examine sector performance relative to both the June 23 and June 24 market close to gain a better understanding of equity market leadership following Brexit.

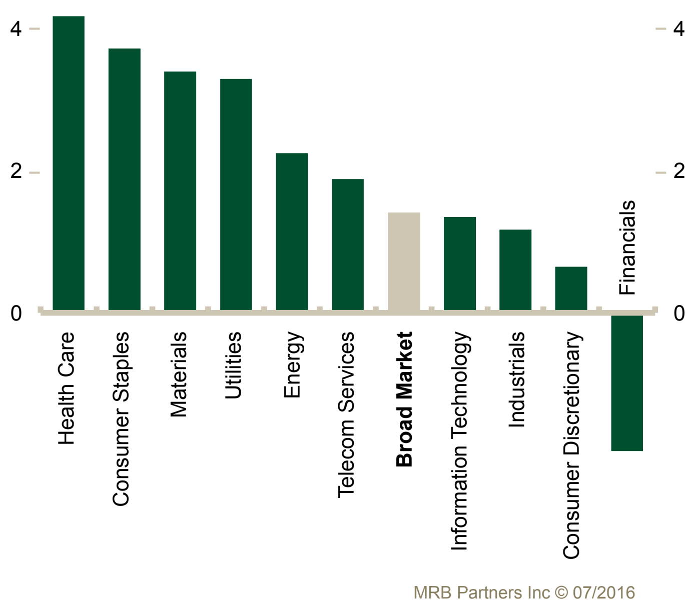
The composition of the equity rally has varied across regions

Global

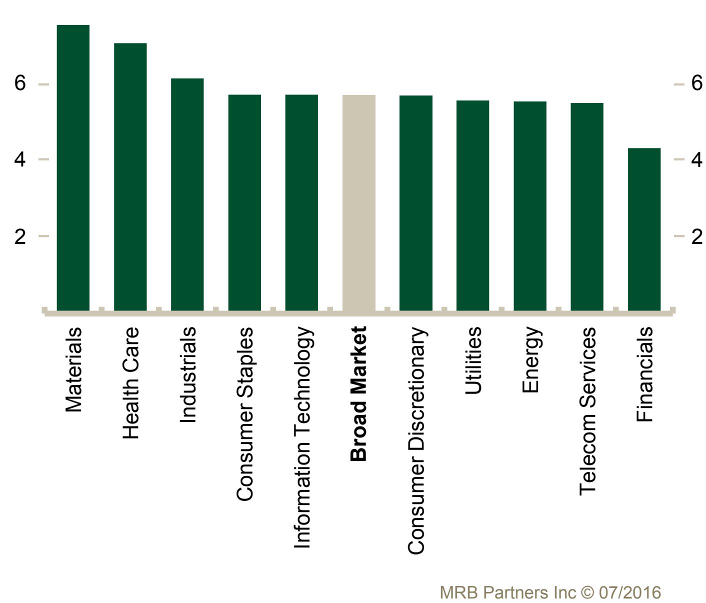
The charts on the following page highlight that global sector leadership has been mixed when measuring performance from the close on June 23. All four defensive sectors have outperformed the global equity benchmark, with health care and consumer staples leading to the upside. However, cyclical sectors such as energy and materials have also beaten the market. Industrials and consumer discretionary stocks have been mild laggards, while financials have been the worst-performing sector as interest rates have fallen.

Global Sectors

Price Returns* (%, from June 23)

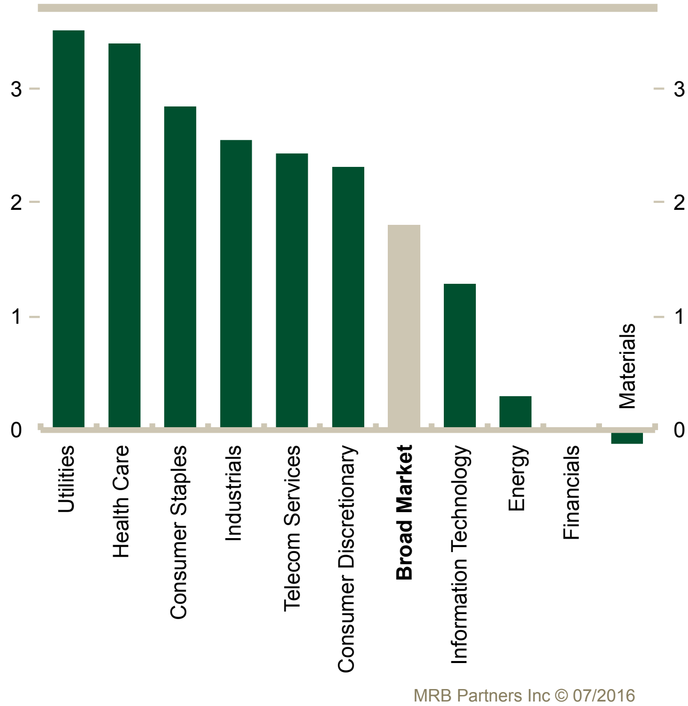


Price Returns* (%, from June 24)

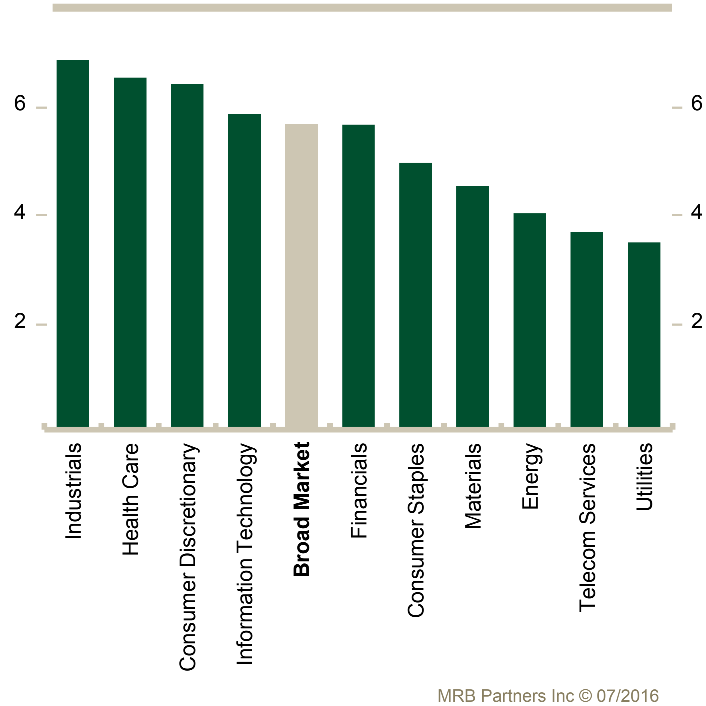


U.S. Sectors

Price Returns* (%, from June 23)



Price Returns* (%, from June 24)



* Local currency; data as of July 13, 2016; source: MSCI

The picture changes when looking at performance from the June 24 close, with a larger number of cyclical sectors beating the benchmark. Bond proxies have slightly lagged, while industrials and technology stocks have mildly outperformed. Materials is the best performing sector. Its outperformance has been largely driven by the metals & mining sub-group, which has benefited from the surge in precious metals prices post-Brexit, as well as firmer base metals prices. Chemical stocks, the other main constituent of the materials sector, have significantly underperformed.

The metals & mining sub-group has benefitted from the surge in precious metals prices

U.S.

In the U.S., defensive sectors have led to the upside when measuring performance from the June 23 close (see the charts on the previous page). Cyclical sectors such as consumer discretionary and industrials have also outperformed. On the flip side, materials, financials, and energy have been the worst-performing sectors.

When measuring performance from the June 24 close, the list of outperformers is dominated by cyclical sectors such as consumer discretionary, industrials, and technology. Health care is the only defensive sector that has outperformed. Financials have performed broadly in line with the benchmark, while bond proxies and other dividend plays such as consumer staples have lagged. The energy and material sectors have also underperformed. Sector performance broadly conforms with trend-like economic growth and a moderate improvement in the earnings outlook.

Global Ex-U.S.

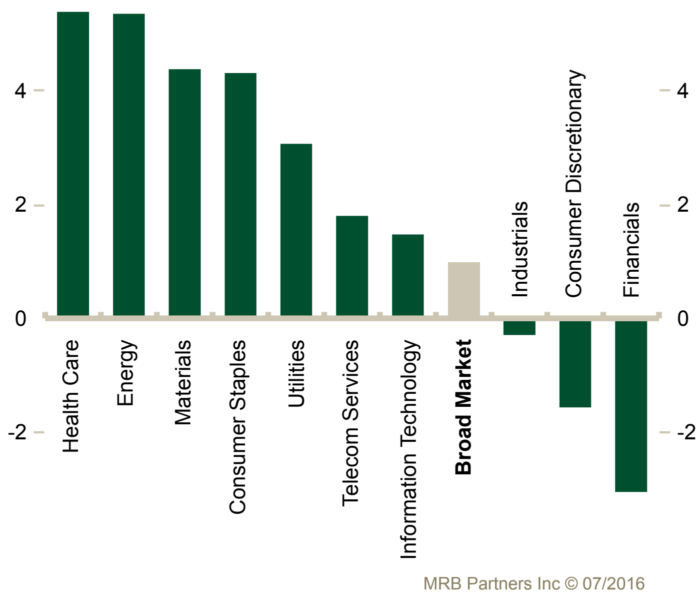
The underperformance of financials has been a major drag on non-U.S. equity markets

The charts on the following page show that sector leadership in global ex-U.S. equities has been mixed when measured from the June 23 market close. All four defensive sectors along with resource and technology stocks have outperformed the benchmark. Laggards include industrials, consumer discretionary, and financial stocks. The significant underperformance of financials reflects negative investor sentiment towards banks outside the U.S. due to the pressures of negative interest rates on bank net interest income, and uncertainties regarding asset quality and credit growth, particularly in Europe. Financials comprise 25% of the market capitalization of non-U.S. equities. Their underperformance has been a major drag on the performance of non-resource equity markets outside the U.S.

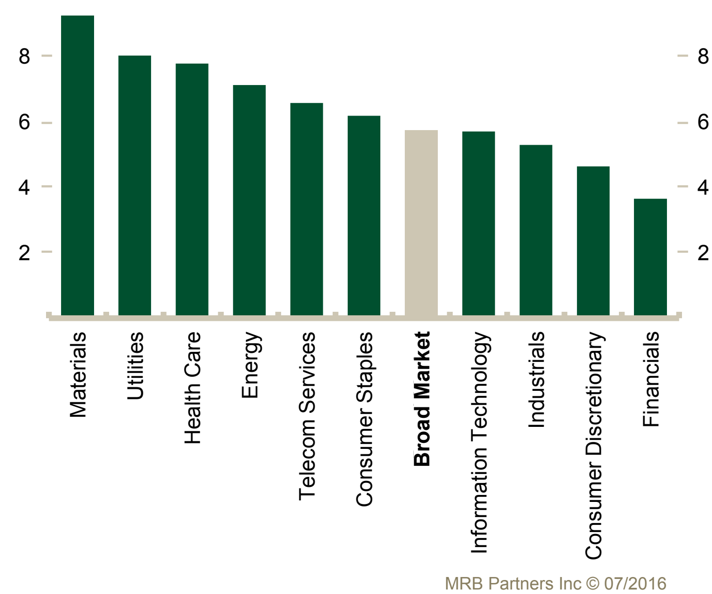
In contrast with the U.S. experience, the composition of sector leadership in non-U.S. equities is not materially different when measuring performance from the market close on June 24.

Global Ex-U.S. Sectors

Price Returns* (%, from June 23)

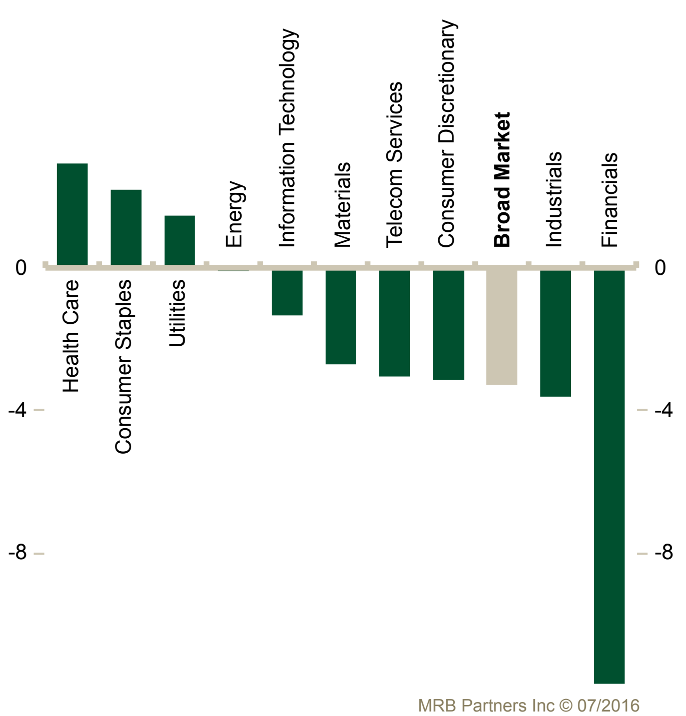


Price Returns* (%, from June 24)

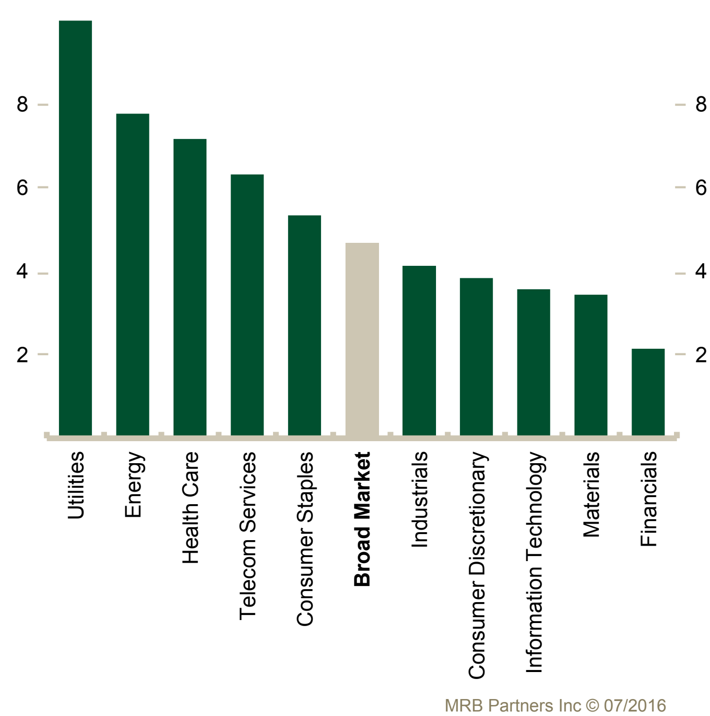


Euro Area Sectors

Price Returns* (%, from June 23)



Price Returns* (%, from June 24)



* Local currency; data as of July 13, 2016; source: MSCI

Euro Area

In the euro area, all four defensive sectors have outperformed the regional benchmark from the market close on June 23, with health care and consumer staples leading to the upside (see the charts on the previous page). Financials and industrials are the only two sectors that have underperformed the broad regional market. Other cyclical sectors have mildly outperformed.

Euro area energy stocks are getting some support from their relatively high dividend yields

The main difference when looking at returns from the June 24 market close is that energy is the only cyclical sector that has outperformed the regional benchmark. The outperformance of energy stocks is interesting to note. With defensive sectors such as consumer staples and health care offering inferior dividend yields to the broad equity market, and bond proxies such as utilities facing ongoing structural headwinds, there is a scarcity of "safe" yield plays in the euro area equity market. As a result, energy stocks may be getting some support from their relatively high dividend yields, which look more sustainable against the backdrop of oil prices that have significantly recovered from their lows earlier this year.

U.S. Industry Sub-Groups

Table 1 provides the performance of U.S. industry sub-groups post the Brexit vote. When measuring performance from the June 23 close, metals & mining is by far the best-performing sub-group. Real estate, road & rail, pharmaceutical and food product stocks are also among the top-performing sub-groups. In addition, lower-beta cyclical plays such as industrial conglomerates and media have also beaten the benchmark. The same is true of domestically-oriented sub-groups such as retailing and consumer durables & apparel, although the latter's outperformance has been mostly driven by household durable stocks, which are beneficiaries of lower mortgage rates resulting from the post-Brexit decline in bond yields. Capital markets, banks, auto component suppliers, and chemical stocks have been the big laggards.

U.S. household durable stocks are beneficiaries of lower mortgage rates

From the June 24 close, the list of outperformers includes a number of cyclical sub-groups such as automobiles, construction & engineering, electrical equipment and machinery. The list of underperforming sub-groups does not change materially except for the addition of bond proxies (i.e. utilities and telecoms) and consumer staples stocks, such as tobacco and food & staples retailers.

Investment Conclusions

Prior to Brexit, we were constructive on the outlook for global economic growth and risk assets. However, Brexit presented an adverse macro shock that is a clear negative for the U.K.

Table 1 Post-Brexit U.S. Industry Sub-Group Price Returns

Post-Brexit: Stock Price Change (%)			
Sub-Group	June 23, 2016	Sub-Group	June 24, 2016
Metals & Mining (MT)	11.2	Metals & Mining (MT)	15.5
Real Estate (FN)	5.3	Road & Rail (ID)	9.9
Road & Rail (ID)	5.2	Consumer Finance (FN)	8.8
Pharmaceuticals (HC)	4.5	Consumer Durables & Apparel (CD)	8.4
Food Products (CS)	4.2	Automobiles (CD)	8.2
Industrial Conglomerates (ID)	3.8	Construction & Engineering (ID)	8.1
Biotechnology (HC)	3.6	Semiconductors & Semi Equipment (IT)	7.9
Utilities (UT)	3.6	Biotechnology (HC)	7.9
Consumer Finance (FN)	3.2	Industrial Conglomerates (ID)	7.8
Retailing (CD)	3.1	Electrical Equipment (ID)	7.8
Beverages (CS)	3.1	Real Estate (FN)	7.0
Media (CD)	3.1	Media (CD)	7.0
Health Care Equipment & Supplies (HC)	3.1	Machinery (ID)	6.9
Consumer Durables & Apparel (CD)	3.1	Pharmaceuticals (HC)	6.8
Food & Staples Retailing (CS)	2.9	Food Products (CS)	6.8
Tobacco (CS)	2.7	Communications Equipment (IT)	6.5
Air Freight & Logistics (ID)	2.6	Health Care Equipment & Supplies (HC)	6.4
Semiconductors & Semi Equipment (IT)	2.4	Retailing (CD)	6.1
Telecom Services (TL)	2.4	Capital Markets (FN)	6.0
Aerospace & Defense (ID)	1.9	Air Freight & Logistics (ID)	5.9
S&P 500	***1.9***	Software & Services (IT)	5.8
Automobiles (CD)	1.8	Beverages (CS)	5.7
Household & Personal Products (CS)	1.7	***S&P 500***	***5.7***
Health Care Providers & Services (HC)	1.5	Banks (FN)	4.9
Software & Services (IT)	1.4	Insurance (FN)	4.9
Electrical Equipment (ID)	1.3	Aerospace & Defense (ID)	4.8
Communications Equipment (IT)	1.1	Auto Components (CD)	4.7
Computers & Peripherals (IT)	1.0	Computers & Peripherals (IT)	4.3
Construction & Engineering (ID)	0.9	Energy Equipment & Services (EN)	4.3
Energy Equipment & Services (EN)	0.7	Household & Personal Products (CS)	4.3
Machinery (ID)	0.6	Tobacco (CS)	4.2
Hotels, Restaurants & Leisure (CD)	-0.1	Food & Staples Retailing (CS)	3.9
Insurance (FN)	-1.1	Health Care Providers & Services (HC)	3.8
Oil, Gas & Consumable Fuels (EN)	-1.8	Hotels, Restaurants, & Leisure (CD)	3.6
Chemicals (MT)	-2.1	Utilities (UT)	3.5
Banks (FN)	-2.2	Telecom Services (TL)	3.3
Capital Markets (FN)	-3.4	Chemicals (MT)	2.7
Auto Components (CD)	-3.6	Oil, Gas, & Consumable Fuels (EN)	2.5

Note: Data as of July 13, 2016 close; source: Standard & Poor's economy and has potential contagion effects for the still fragile euro area economy. While economic reports have been positive in recent weeks, this reveals that growth momentum was solid heading into the U.K. referendum. Equity investors have been relieved that the fallout from Brexit appears to be well contained. However, it is still premature to draw any definitive conclusions on this front. Consequently, it is appropriate to remain cautiously positioned on a 0-3 month horizon. To this end, we favor health care and telecom stocks, while remaining underweight on financials and commodity-linked plays.

Technology stocks are an upgrade candidate if policy reflation keeps the global recovery on track

We are currently neutral on technology stocks, but this is a sector that we would look to upgrade if policy reflation keeps the global economy on its pre-Brexit trend. Business momentum for high-beta tech industries such as semiconductors and hardware equipment was improving prior to Brexit and appears to be holding up well in its aftermath, as indicated recently by companies operating in these areas.

It is too early to buy financial stocks in both the U.S. and the euro area. While risks to bond yields are tilted to the upside given their depressed levels, interest rates are unlikely to rise much until global growth uncertainties lift and the Fed signals it is prepared to resume tightening policy. In the euro area, we expect policymakers to respond with initiatives that will strengthen the Italian banking system, but the timing and size of any bailout program for Italian banks remains unknown.

It is also premature to increase exposure to industrial stocks, as many indicators of cyclical activity in the sector remain subdued despite recent better readings for the U.S. ISM manufacturing index.

It is too early to increase exposure to financial and industrial stocks

To the extent that global investors wish to tilt towards cyclical sectors, they should first do so in the U.S., which is relatively well insulated from Brexit shocks and has stronger economic fundamentals. Although we are neutral on the U.S. consumer discretionary sector, media and housing-related stocks remain attractive opportunities[1]. We also favor consumer finance companies, which are leveraged to the healthy U.S. consumer.

Final Word: *The composition of sector leadership in non-U.S. equities has been mixed in the aftermath of the Brexit vote, underscoring that confidence in the global economic outlook remains tentative despite the rally in equity prices. We remain cautiously positioned on a 0-3 month view, but anticipate becoming more constructive once there is greater clarity that the moderately positive growth outlook is intact. The resilience of the U.S. and euro area economies in recent years indicates there is scope for a return to a moderately pro-growth investment stance beyond the near run.*

Salvatore Ruscitti

[1] MRB ***Equity Sectors Research Highlight***, "U.S. Sector Positioning In The Aftermath Of Brexit", June 28, 2016

MRB – The Macro Research Board is a privately-owned independent research firm providing integrated, global, multi-asset investment strategy as well as actionable, absolute-return ideas. Our views incorporate a long-term outlook based on in-depth theme research, together with rigorous forecasting models and indicators that drive 6-12 month asset market performance. MRB's team of analysts and strategists leverage the firm's robust research engine and their extensive experience to ensure that investment strategy is developed and articulated in an integrated, coherent and client-friendly manner.

For more information, please contact:
Client Relations
clientrelations@mrbpartners.com

London Token House
12 Tokenhouse Yard
London, EC2R 7AS
United Kingdom
Tel+44 (0) 20 7073 2792

Montreal 2001, boul. Robert-Bourassa
Suite 810
Montreal, Quebec
Canada H3A 2A6
Tel+1 514 558 1515

New York 122 East 42nd Street
Suite 2310,
New York, NY 10168
USA
Tel+1 212 390 1148

www.mrbpartners.com

Recent *Research Reports*

For copies of all our previous research, please click here (www.mrbpartners.com/my_mrb) or contact client relations.