Innealta CAPITAL SPECIALISTS IN ACTIVE MANAGEMENT OF ETF PORTFOLIOS

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# THE IMPACT OF DIVERGING PERCEPTIONS AND REALITIES OF ECONOMIC GROWTH

## KEY TAKEAWAYS

- Investor confidence following the November 2016 U.S. presidential election has increased dramatically; however, actual economic growth has not yet materialized.
- Estimated implied values for U.S. economic growth vary significantly depending on which macroeconomic variable is used; this dispersion indicates that economic growth/recovery is not yet robust.
- Return dispersion within U.S. sectors is high, and when returns are adjusted for volatility, the adjusted sector return dispersion is at a local maximum.

## INTRODUCTION

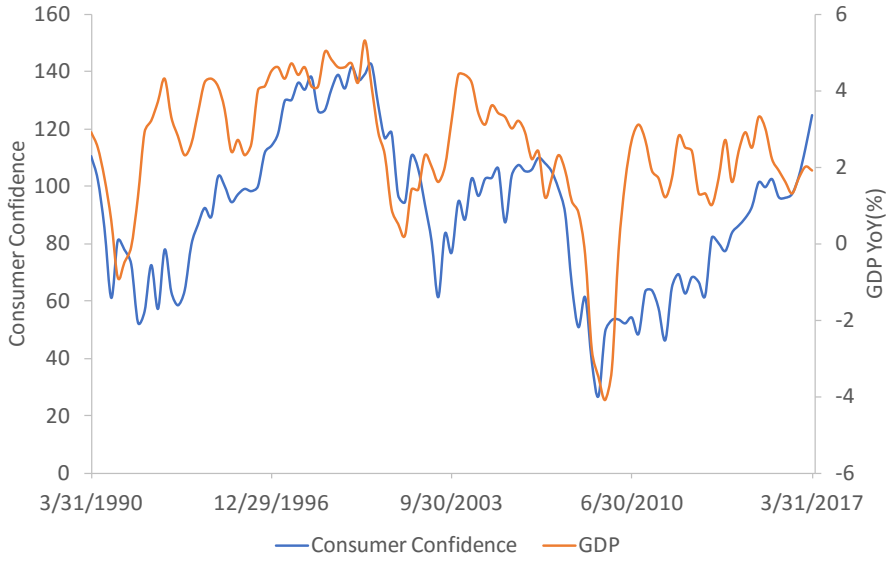
Since the U.S. presidential election in November 2016, markets have experienced a push of optimism that defied the pull of underwhelming macroeconomic and microeconomic data. The optimism, as measured by various sentiment indicators, began to increase and reached multi-year peaks by February 2017. Risky markets have responded alongside this increasing confidence in a traditional, risk-on fashion. From 11/8/2016 to 04/30/2017, within U.S. markets, equities, as measured by the S&P 500, returned +12.5%, fixed income, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, returned -1.9%, and commodities, as measured by the Goldman Sachs Commodity Index, returned +7.9%. Beginning in March, and lasting through April, the market began to question the elevated sense of optimism, and as of the end of April, the market remains conflicted on whether investor optimism has overestimated future growth.

## 'HARD' VERSUS 'SOFT' DATA

More recently, the divergence between "soft" data, information based on surveys, and "hard" data, information based on measurable outcomes, has reached a significant divergent level. Both data sets are useful to forecast economic growth and asset returns. For example, creating a univariate linear model using Industrial Production, a "hard" data set, since March 1990, implies annual U.S. GDP growth at 2.3%. However, creating a univariate linear model using Consumer Confidence, a "soft" data set, since March 1990, implies annual U.S. GDP growth at 3.5%. When we analyze other hard and soft data sets, we find a similar pattern. Figure 1 demonstrates the relationship between Consumer Confidence and U.S. GDP growth (YoY%). Moving forward only the actual results of economic growth, such as GDP or corporate earnings, will decide which data set more accurately forecasts economic growth.

**Figure 1**

**U.S. GDP & CONSUMER CONFIDENCE**




Source: Innealta Capital using data from 03.31.1990 to 03.31.2017 from Bloomberg. "Consumer Confidence" refers to the Consumer Board Consumer Confidence Index. "GDP" refers to year-over-year changes in seasonally adjusted Gross Domestic Product of the United States as calculated by the Bureau of Economic Analysis.

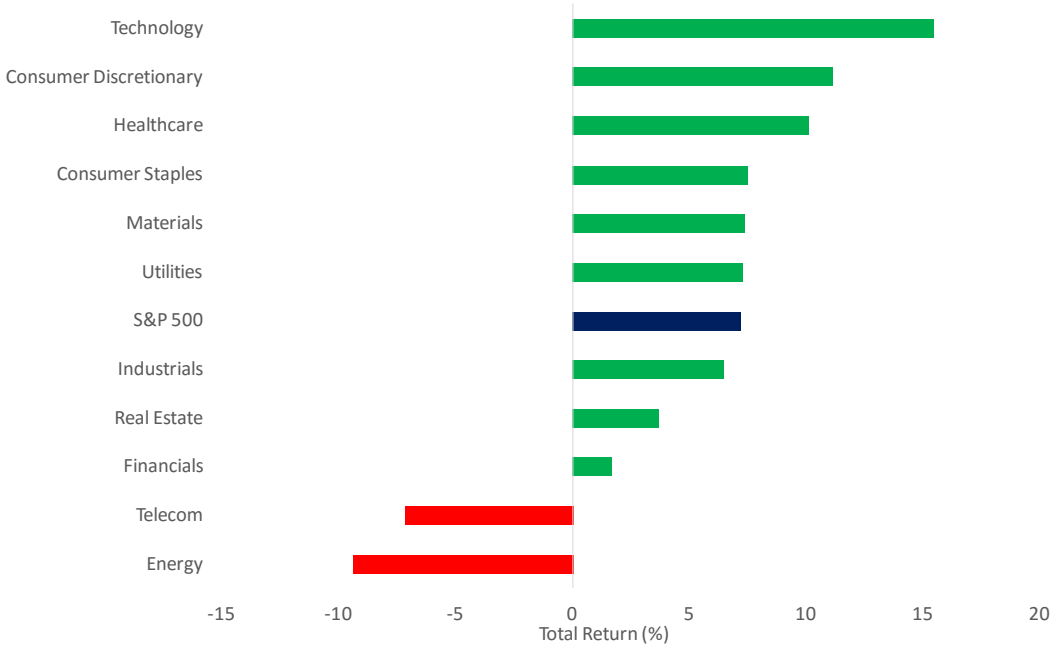
## SECTOR PERFORMANCE

The United States' economy and financial markets offer the most robust available data sets to perform quantitative analyses. Within U.S. sector returns, we currently see a significant return differential between the top performing sector, Technology, and the bottom performing sector, Energy. Figure 2 shows a snapshot of year-to-date S&P 500 sector returns, as of 04.30.2017.

**Figure 2**

**SNAPSHOT OF U.S. SECTOR RETURNS**

Source: Innealta Capital using data from 01.01.2017 to 04.30.2017 from Bloomberg.



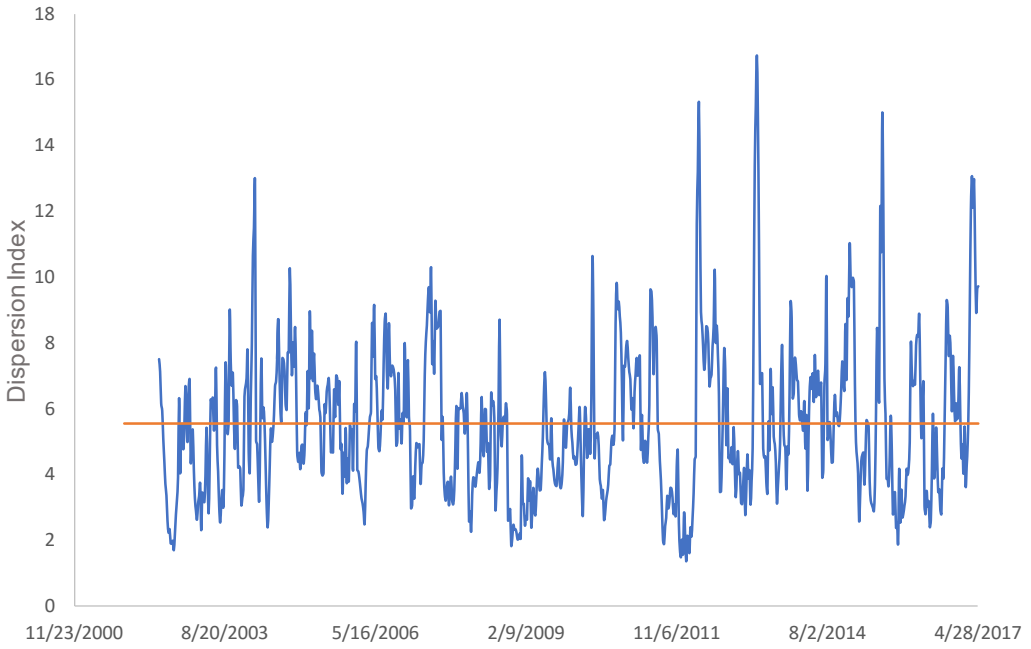

Taken in isolation the absolute return differential does not seem significant. However, by normalizing each sector's return by its volatility, we can create a risk-adjusted return dispersion index for the eleven S&P 500 sectors. Figure 3 shows this index rolling through time, and we can see the current level is significantly above average, measured since January 1st, 2000. At its current level, sector dispersion will continue to be a metric that we closely monitor to inform our investment decisions.

**Figure 3**

**ROLLING SECTOR DISPERSION INDEX**

Source: Innealta Capital using data from 01.07.2000 to 04.30.2017 from Bloomberg.

Please see disclosures section for Sector Dispersion Index description.

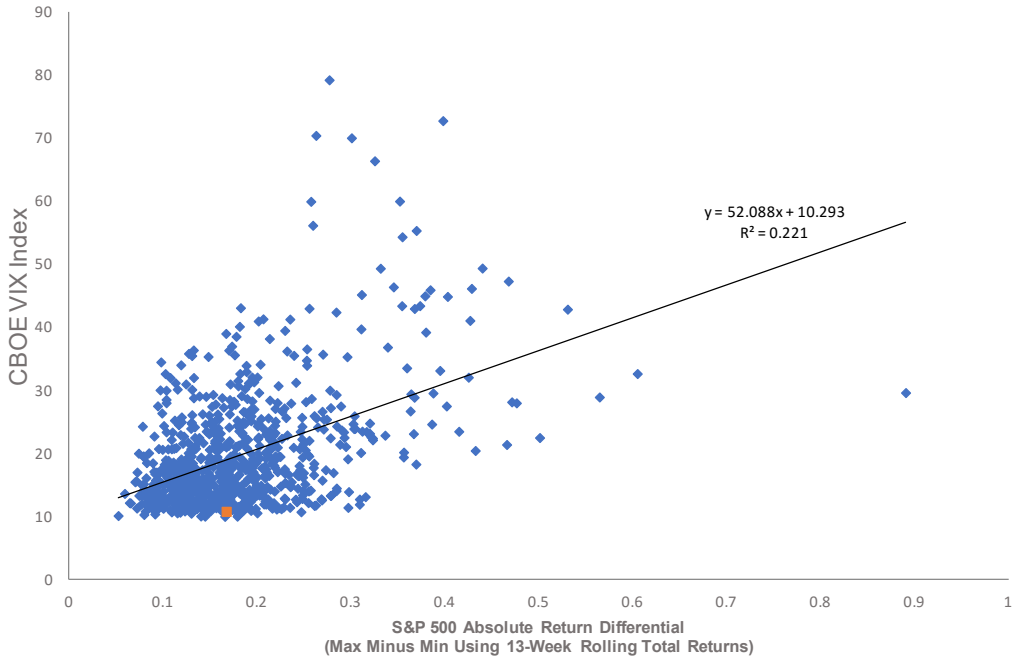


Heading into May, we have a more neutral view about the opportunities within the domestic equity market. The abnormally low level of market implied volatility as measured by the CBOE VIX index, and the fact that volatility tends to revert to the mean, gives us some pause. The aforementioned absolute return dispersion in S&P 500 sector returns provides some insight into a more appropriate level of volatility. The scatter plot shown in Figure 4 displays the relationship between the CBOE VIX index and the S&P 500 sector absolute return differential. Based solely on this relationship, at these levels of return dispersion we would expect a higher level of market volatility.

**Figure 4**

**CBOE VIX INDEX VERSUS S&P 500 ABSOLUTE RETURN DIFFERENTIAL**

Source: Innealta Capital using data from 01.07.2000 to 04.30.2017 from-Bloomberg.




## SUMMARY

U.S. equity markets concluded the first four months of 2017 exhibiting strong performance; however, the momentum started to wane by the beginning of March. Markets remain concerned about the likelihood of increased growth due to U.S. fiscal policy changes. Market sentiment, based primarily on investor surveys, remains elevated relative to the past ten years while actual measurements of economic growth – auto sales, retail sales, GDP – have not yet increased. This divergence between the sentiment data and economic growth data and the wide scope of potential outcomes for U.S. fiscal policy has created significantly large return dispersion within U.S. sectors. Comparing the S&P 500 sector return dispersion to the CBOE VIX index, the CBOE VIX index appears to be low. It is the confluence of these factors – increasing political uncertainty, large divergence between macroeconomic sentiment and macroeconomic growth, abnormally low market implied volatility, and increased S&P 500 sector return dispersion – that leaves us with a more cautionary, neutral stance towards U.S. equity markets.

## IMPORTANT INFORMATION

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**Chart Definitions**

**Consumer Confidence** refers to the Consumer Board Consumer Confidence Index. **Technology** refers to The S&P 500 Information Technology Index, which comprises those companies included in the S&P 500 that are classified as members of the GICS information technology sector. **Consumer Discretionary** refers to The S&P 500 Consumer Discretionary Index, which comprises those companies included in the S&P 500 that are classified as members of the GICS consumer discretionary sector. **Healthcare** refers to The S&P 500 Health Care Index, which comprises those companies included in the S&P 500 that are classified as members of the GICS health care sector. **Consumer Staples** refers to The S&P 500 Consumer Staples Index, which comprises those companies included in the S&P 500 that are classified as members of the GICS consumer staples sector. **Materials** refers to The S&P 500 Materials Index, which comprises those companies included in the S&P 500 that are classified as members of the GICS materials sector. **Utilities** refers to The S&P 500 Utilities Index, which comprises those companies included in the S&P 500 that are classified as members of the GICS utilities sector. **S&P 500** refers to the S&P 500 Index (Large Cap Equity), which measures the performance of the large capitalization sector of the U.S. equity market and is considered one of the best representations of the domestic economy. **Industrials** refers to The S&P 500 Industrials Index, which comprises those companies included in the S&P 500 that are classified as members of the GICS industrials sector. **Real Estate** refers to The S&P 500 Real Estate Index, which comprises stocks included in the S&P 500 that are classified as members of the GICS real estate sector. **Financials** refers to The S&P 500 Financials Index, which comprises those companies included in the S&P 500 that are classified as members of the GICS financials sector. **Telecom** refers to The S&P 500 Telecommunication Services Index, which comprises those companies included in the S&P 500 that are classified as members of the GICS telecommunication servicessector. **Energy** refers to The S&P 500 Energy Index, which comprises those companies included in the S&P 500 that are classified as members of the GICS energy sector. **VIX** refers to the CBOE Volatility Index® (VIX® Index®), which is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. Sector Dispersion Index is the

It is not possible to invest directly in an index.

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