

Sector Watch

Our Expectations For Upcoming Relative Performance

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Executive Summary

We use our sector analysis as a means to corroborate and confirm our broader expectations for the US stock market and US interest rates via the relationships that exist between *the relative performance of these sectors versus the US broad market and the direction of the US stock market and benchmark US interest rates.*

The latest momentum and asset-flow based data indicate favorable conditions for:

- a continuation of recent *relative outperformance* by the **Industrials Sector**
- a new trend of *relative outperformance* to emerge in the **Technology Sector** during Q1 2012, and
- the recent trend of *relative underperformance* by the **Consumer Staples and Utilities Sectors** to extend into early 2012.

The *positive correlation* between the Industrials Sector and the Dow Jones Transportation Index, the tendency of the Technology Sector *to lead* US broad market advances, the statistical tendency of Consumer Staples *to underperform* during US broad market rallies, and the *inverse correlation* between the relative performance of the Utilities Sector and the yield of the US 10-Year Note **all corroborate our broader expectations for a US stock market advance amid rising benchmark US interest rates during Q1 2012.** Economically, this suggests a continuation of recently-improving US economic data into early 2012, and/or an improvement in the prospects for an eventual solution to the sovereign debt issues in Europe.



Current versus Historic Intra-Sector Asset Flows

Chart 1 displays *the percentage* of sector bet-related assets, as represented by the Rydex Sector Funds, that were invested in each sector of the S&P 500 as represented by the iShares Select Sector SPDR ETFs, **through December 16th.**

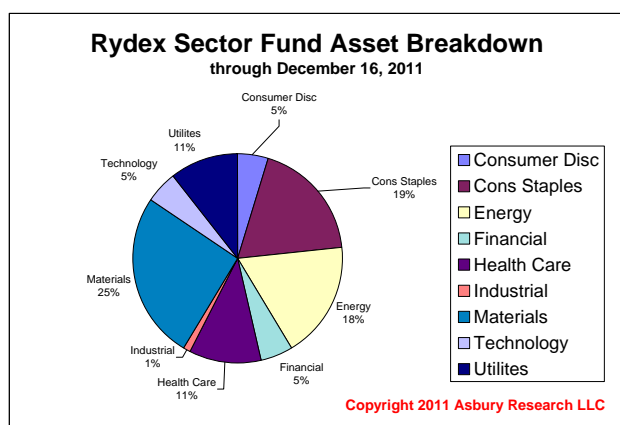


Chart 1

We compare **Chart 1** with **Chart 2** in the next column, the latter which displays the *daily historic average* percentage of investor assets invested in each sector **since 1998** (when the iShares Select Sector SPDR ETFs began trading), **to determine current over-invested and under-invested extremes in specific sectors.**

We have found that historically *over-invested* sectors *lead into* one to several month periods of *relative underperformance*, while historically *under-invested* sectors *lead* similar periods of *relative outperformance*.

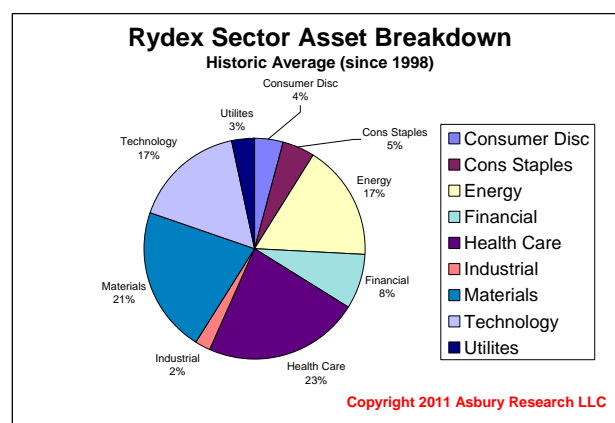


Chart 2

These charts indicate that the **over-invested** sectors of the S&P 500 currently are (in order, according to degree): 1) **Consumer Staples**, 2) **Utilites**, 3) **Consumer Discretionary**, 4) **Materials** and 5) **Energy**. The **under-invested** sectors are: 1) **Technology**, 2) **Health Care**, 3) **Industrials**, and 4) **Financials**.



The Industrial Sector: Favorable Conditions For September Outperformance To Extend Into Q1 2012

Asset Flow-Based Investor Sentiment

Charts 1 and 2 on Page 2 of this report show that, through December 16th, just 1% of all sector bet-related assets were being allocated to the Industrials Sector – which is *one half the daily historic average of 2%* since 1998.

This metric indicates that **Industrials are historically extremely under-invested versus the other sectors of the S&P 500**, and thus amid favorable conditions for upcoming outright *strength* and relative sector *outperformance* while the percentage of assets invested in Technology eventually moves back toward its historical norm of 2%.

Momentum and Relative Performance

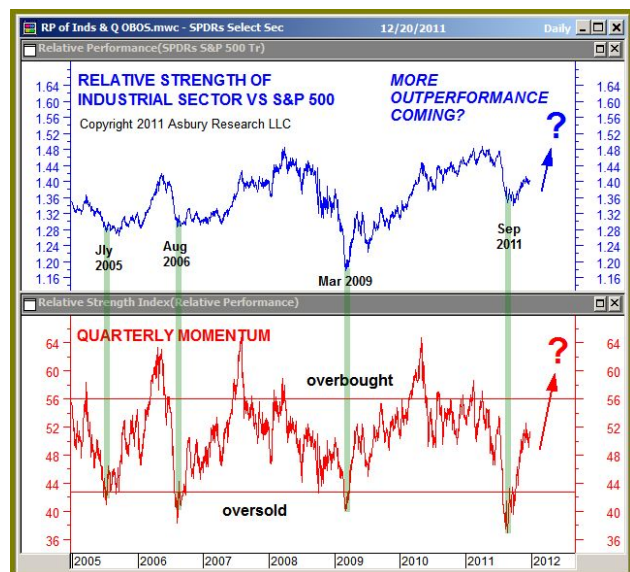


Chart 3

The blue line in the upper panel of **Chart 3** plots the relative performance of the Industrial Sector SPDR ETF (XLI) versus the S&P 500 Depository Receipts ETF (SPY) since 2005. The red line in the lower panel plots quarterly momentum in that relative performance line (via a 63-day [Relative Strength](#)

[Index or RSI](#)), which indicates intermediate term overbought and oversold extremes *by Technology versus the US broad market*.

The green vertical highlights between both panels, and the arrows on the right edge of the chart, show that Industrials are in the process of working off September quarterly *oversold* extremes versus the market, but are only about two-thirds of the way to reaching opposite *overbought* extremes which have historically coincided with most of the peaks in relative outperformance during this period. Accordingly, **these data suggest that the recent trend of relative sector outperformance (+5% since September 22nd) is uncompleted and likely to extend into Q1 2012.**

US Financial Market Implications

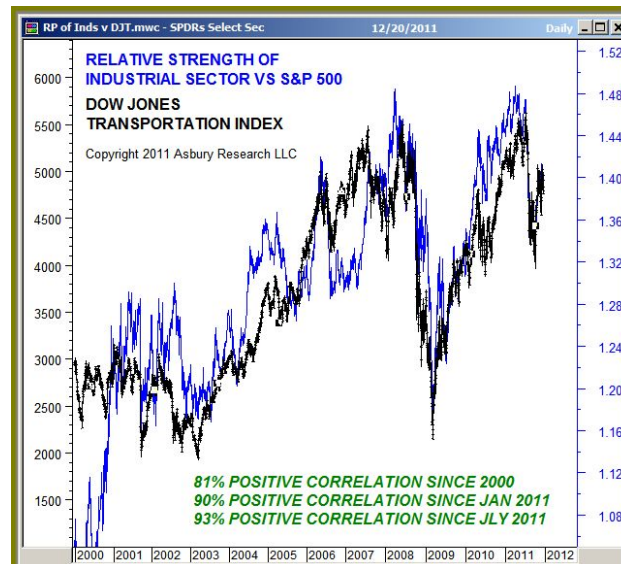


Chart 4

Chart 4 plots the daily relative performance of the Industrials Sector versus the S&P 500 (blue line) alongside a daily bar chart of the Dow Jones Transportation Index (black bars), both since 1999. The green highlights point out that these two series have been 81% positively correlated to one another



since 2000, 90% positively correlated since January, and 93% positively correlated since July, driven by the relationship between the manufacturing and shipping of finished goods.

Per the correlation, **upcoming relative outperformance by the Industrials Sector as suggested by Charts 1-3 indirectly suggests a coincident upcoming rise in the Dow Jones Transportation Index**, and also in the broader US market.



The Technology Sector: Under-Invested, Oversold, And Poised to Outperform During Q1 2012

Asset Flow-Based Investor Sentiment

Charts 1 and 2 on Page 2 of this report show that, through December 16th, just 5% of all sector bet-related assets were being allocated to Technology -- which is less than one third the daily historic average of 17% since 1998.

This metric tells us that the **Technology Sector is extremely under-invested versus the other sectors of the S&P 500** according to historical standards, and thus amid favorable conditions for upcoming outright *strength* and relative sector *outperformance* while the percentage of assets invested in Technology eventually moves back toward its historical norm of 17%.

Momentum and Relative Performance



Chart 5

Chart 5 uses quarterly market momentum to determine intermediate term overbought and

oversold extremes by Technology versus the US broad US market. The blue line in the upper panel plots the relative performance of the Technology Sector SPDR ETF (XLK) versus the S&P 500 Depository Receipts ETF (SPY) since 2005, while the red line in the lower panel plots quarterly overbought and oversold extremes by XLI versus SPY via a 63-day Relative Strength Index .

The green vertical highlights between both panels show that the **Technology Sector is closing in on quarterly oversold extremes versus the US broad market**, and that previous similar extremes have either coincided with or led every one to several month trend of relative sector *outperformance* in recent history. These data suggest that Technology is within weeks of beginning another similar period of relative outperformance, probably by early Q1 2012.

US Financial Market Implications

The Technology Sector typically outperforms the S&P 500 during broad US stock market advances as investors shift their assets *into* more aggressive areas that will give them their best bang for the buck during periods of economic health and/or expansion. Conversely, investors typically move assets *out* of aggressive areas like Technology and into more defensive places like health Care or Consumer Staples when the US economy is struggling and the broad US stock market is declining.

Considering that the Technology Sector is severely under-invested versus the other sectors of the S&P 500 while losing in on technically oversold extremes versus the S&P 500 itself, **this “sets the table” for an upcoming period of relative economic strength during Q1 2012 during which time more aggressive sectors like Technology will outperform the US broad market while leading it higher.**



The Consumer Staples Sector: Favorable Conditions Exist For More Sector Underperformance During Q1 2012.

Asset Flow-Based Investor Sentiment

Charts 1 and 2 on Page 2 of this report show that, through December 16th, 19% of all sector bet-related assets were being allocated to Consumer Staples -- which is almost quadruple the daily historic average of 5% since 1998.

This tells us that **Staples are historically severely over-invested versus the other sectors of the S&P 500** and vulnerable to upcoming relative sector underperformance while the percentage of assets invested in the sector migrates back to its historical norm of 5%.

Momentum and Relative Performance



Chart 6

Chart 6 utilizes market momentum to determine quarterly overbought and oversold extremes by Consumer Staples versus the US broad market. The red vertical highlights between both panels show that the Consumer Staples Sector ETF (XLP) is in the process of working off October quarterly overbought extremes versus the S&P 500 ETF (SPY), extremes that have previously marked the

beginning of every multi-month trend of relative sector underperformance during the past decade. However, the arrows on the right edge of the chart point out that this October trend of sector underperformance *still appears to be in its early stages*, and nowhere near the opposite quarterly oversold extremes that have coincided with the end of previous similar trends as shown by the green highlights on the chart.

Accordingly, this metric indicates **favorable conditions for the October trend of relative underperformance by Consumer Staples (-3% since October 3rd) to continue from here and to potentially extend through much of Q1 2012.**

More Asset Flow Based Data

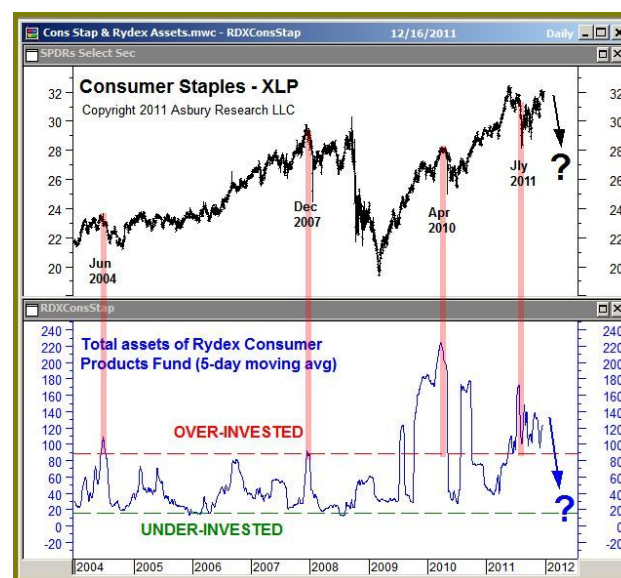


Chart 7

Charts 1 and 2 measure investors' relative interest in Consumer Staples versus the other sectors of the S&P 500. Chart 7 (next page) measures relative investor interest in the Consumer Staples versus "itself", by plotting the (5-day moving average of the) daily assets invested in the Rydex Consumer Products Fund (RYCIX) since 2004.



The chart shows that the total assets invested in RYCIX is currently hovering at a 7-year over-invested extreme that had previously coincided with or led what have been the most important *peaks* in XLP in recent history. This metric corroborates the message of the other charts in this report by again indicating that **Consumer Staples are over-extended, over-invested and vulnerable to a quarterly period of relative underperformance** and outright weakness as this sector works off current overbought, over-loved extremes.

US Financial Market Implications

Chart 8 plots the daily relative performance of the Consumer Staples Sector versus the S&P 500 in the upper panel (blue line) along with a daily chart of the S&P 500 by itself (SPX, black bars), both since 1999.

The green highlights show that these two series have been 70% inversely correlated to one another since 1999 and, more recently, have been 84% inversely correlated since the beginning of the year, driven by Staples' status as a defensive choice of investors when the US economy is weak and/or the US broad market is declining.

Per the correlation, **favorable conditions for upcoming relative underperformance by the Consumer Staples Sector indirectly suggest the likelihood of an upcoming US broad market advance during Q1 2012.**

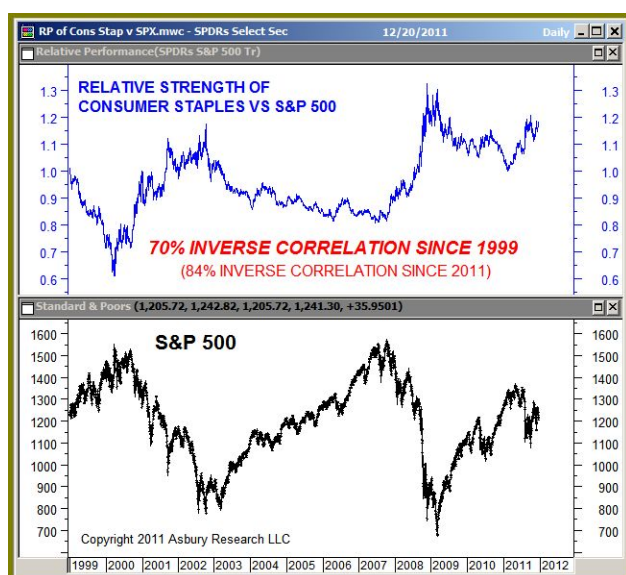


Chart 8



The Utilities Sector: Look For New Trend Of Relative Underperformance Amid Rising Benchmark US Interest Rates

Asset Flow-Based Investor Sentiment

Charts 1 and 2 on Page 2 of this report show that, through the end of last week, 11% of sector bet-related assets were being allocated to Utilities -- which is almost quadruple the 3% historic daily average since 1998. This indicates that **Utilities are over-invested versus the other sectors of the S&P 500** and susceptible to a continuation of recent relative underperformance (-9% since October 3rd) as the percentage of assets invested eventually moves back toward its historical norm of 3%.

Momentum and Relative Performance

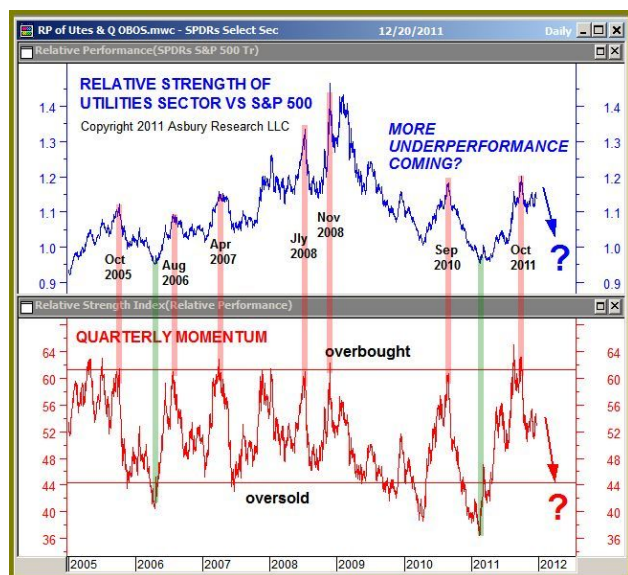


Chart 9

The blue line in the upper panel of **Chart 9** plots the daily relative performance of the Utilities Sector SPDR ETF (XLU) versus the S&P 500 Depository Receipts ETF (SPY) since 2005, with quarterly overbought and oversold extremes by the Utilities Sector versus the US broad market index plotted in the lower panel (red line).

The red vertical highlights on the chart show that Utilities are currently in the process of working off October quarterly *overbought* extremes versus the S&P 500, extremes which have previously coincided with the

beginning of every multi-month period of relative sector underperformance by Utilities in recent history. However, the arrows on the right edge of the chart point out that the blue relative performance line in the upper panel is only about halfway to reaching opposite quarterly oversold extremes which have historically coincided with the beginning of new trends of relative sector *outperformance* (green highlights).

Accordingly, and especially considering that Utilities are also historically *over-invested* versus the other sectors of the S&P 500, this metric suggests that **the current October trend of relative sector underperformance is probably only around halfway completed and amid favorable conditions to extend into Q1 2012.**

More Asset Flow Based Data



Chart 10

Unlike **Charts 1 and 2**, which measure over- and under-invested extremes in each sector of the S&P based on its current percentage of the "sector pie" relative to historical norms, **Chart 10** uses our Rydex Utilities Ratio to display the same information in a different way. The Rydex Utilities Ratio is the total assets invested in the



Rydex Utility Sector Fund (RYUIX) *divided by* the combined total assets invested in all Rydex sector funds.

The red highlights on the chart show that our ratio is currently hovering at 6-year over-invested extremes, one which has previously coincided with or led most of the important *peaks* in XLU (black bars, upper panel) since 2006.

US Financial Market Implications

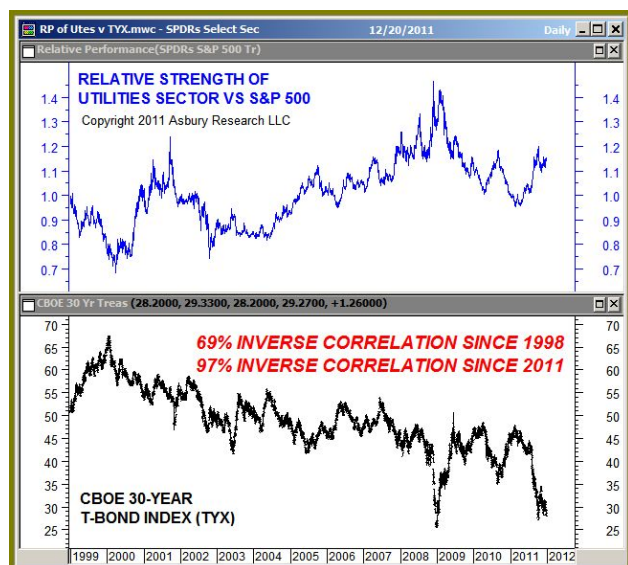


Chart 11

Chart 11 displays the relative performance of XLU versus SPY in the upper panel (blue line), and the CBOE 30-Year T-Bond Index (TYX, representing *yield*, black bars) in the lower panel, both since 1999.

The red highlights point out that these two series have been *69% inversely correlated to one another for the past decade* and, more recently, *97% inversely correlated since January*. Considering the previously

discussed favorable conditions for a continuation of recent relative sector underperformance during Q1 2012, **this inverse correlation** -- driven by the competition between Utilities and Treasuries for yield-seeking investor assets -- **indirectly suggests an upcoming period of rising benchmark US interest rates as long dated US Treasury prices decline**.

Moreover, considering the tight and stable positive correlation between the yield of the US 10-Year Treasury Note and the S&P 500 at various intervals during the past 15 months as shown in **Chart 12** below, these implications for rising long term US interest rates in Q1 2012 also support and corroborate our sector analysis-derived expectations for a coincident US stock market advance during the upcoming quarter.

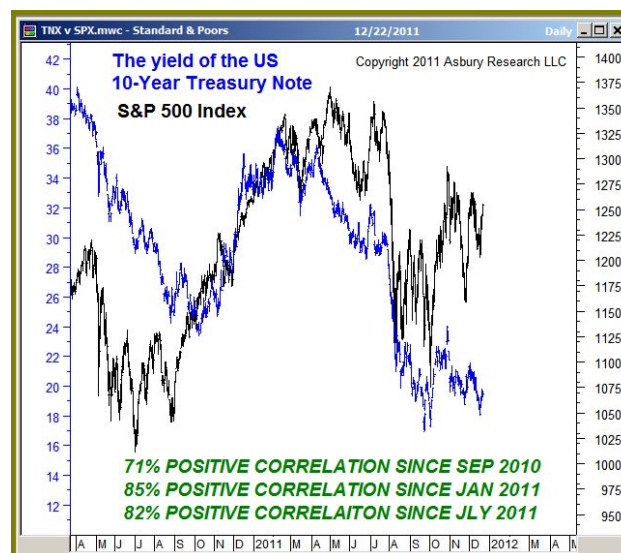


Chart 12

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