

Your Daily Guide to Markets, Data and Disruption

DATATREK MORNING BRIEFING

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IN TODAY'S EDITION

Thought Piece: Lots of fuss lately around the concentration of tech stocks in the S&P 500. At the moment, however, this doesn't matter much. Correlations for the other 10 sectors vs. the index are down to 37% (new lows for the decade!). This also feeds into lower overall market volatility as different sectors move, well, differently.

Daily Datapoint: More personal tech gadgets should be a boon for electric utilities, right? Nope – US household electrical consumption was down 2.7% from 2010 to 2016. We tell you why.

Daily Disruption Feature: Unless you work at Amazon, you've probably never been inside one of their warehouses. We've got two 4-minute videos that take you there, and they neatly illustrate both the promise – and limits – of robotics.

Plus our usual roundup of market action, curated links, and mind candy.

How Deep Is Your (S&P) Love?

"It is a truth universally acknowledged, that a single man in possession of a good fortune, must be in want of a wife." That, of course, is the opening line of Jane Austen's "Pride and Prejudice". She spends the next few hundred pages describing the trials and tribulations of pursuing that truth, but (spoiler alert) everything works out in the end.

For capital markets, the universal truth is that single men (and women, and married folk) with fortunes all really just want diversification. It is the only "Free lunch" in capitalism – the ability to manage risk by owning assets with different fundamental drivers of value. When some rise, others stagnate or decline, but over time they all do well enough.

Ever since the Financial Crisis, that free lunch has been more like a bag of stale airline pretzels. Correlations for the 11 sectors of the S&P 500 tell the story. Despite having radically different fundamentals, equities in Health Care, Utilities and Technology (plus all the others industries in the index) traded in lock step for years.

Some historical math on this point: prior to the Crisis, correlations for various sectors versus the S&P 500 would hover around 50%. From 2009 to 2016, they were regularly 75-95%. And unlike the amps in Spinal Tap, there is no 11... One hundred percent is as high as correlations go, and they pretty much went there. And stayed.

There were many explanations for this phenomenon, including:

- The rise of index-based passive investing, which allocates capital across sectors based on current weightings and therefore locks in high correlations.
- The accompanying decline of active management, where fundamental stock picking would drive non-correlated capital flows.
- The rise of algorithmic trading, which often uses historical correlation patterns to arbitrage individual stocks (and therefore keep them moving in similar patterns).
- The aftershocks of the Financial Crisis, which made investors wary to own equities at all and therefore treat them as an "Asset class" rather than a collection of individual securities.
- Aggressive central bank monetary policy, which created a global scramble for yield. As with the prior point, this pushed capital into "Equities" rather than individual securities.
- Incremental government regulation of the private sector during the Obama administration, which served to dampen investor expectations of specific company/sector performance.

But here's the good news: equity sector correlations just made a new post-Crisis low, at just 41%. That's below the magic 50% level, and locks in a trend that started earlier this year. In short, US equity markets are actually behaving like the proverbial "market of stocks" rather than a "stock market".

Here are some other takeaways from this data, also including data on non-US stock asset classes (feel free to email us if you want the spreadsheet):

- That average monthly price correlation of 41% needs a bit of unpacking, because the S&P 500 is market cap weighted by sector, not even-weighted.
- Do that analysis, and you get even more good news: excluding Technology (still at an 81% correlation), the remaining 10 sectors show an average correlation of just 37%. There's been a lot of buzz around Tech's dominance in terms of returns this year, but this math gives some comfort on that score. A sudden decline, or more likely a stagnation of price action, for the group is not a death knell for the current market rally.
- No other sector shows price correlations over the last 30 days of higher than 75%. At the top of the list are Materials (73%), Financials (68%), Consumer Discretionary (62%) and Industrials (61%). At the bottom are rate-sensitive groups like Utilities (-17%) and Real Estate (+10%).
- Even high yield bonds, typically an equity substitute in fixed income land, have broken free of their price linkage to the S&P 500. Correlations for this asset class were just 47% this past month, down from 76% in the prior month.
- Non-US equities in both developed and emerging markets are also showing declines in price action linkages to US large cap stocks. Monthly price correlations for developed EAFE (Europe, Asia, Far East) market equities are down to 57% from 67-81% over the prior three months. Emerging market equity correlations versus US stocks were just 63% last month, down from 74-78%.
- Lower correlations also drive lower volatility, because individual sectors serve to diversify market-wide price action. It is no coincidence that the CBOE VIX Index seems to live around 10 just now, rather than its historical average closer to 20.

Now, is this purely a "Glass half full" analysis? Of course not. If your proclivity is to worry about everything (ours certainly is), then consider these final points:

- A 41% average S&P sector correlation is an outlier versus the last decade. As the old Japanese saying goes, "The nail that sticks out gets hammered down". And since this correlation drop has coincided with a long streak of higher highs for US stocks, we worry that if markets drop correlations will rise.

- Identifying the actual reason for the structural decline in correlations this month – and to some degree this whole year – is difficult. Yes, the Fed is on a tightening track, but the Bank of Japan and European Central Bank are still in the middle of large-scale asset purchases. Still, the fact that rate-sensitive groups like Utilities and Real Estate show very low correlations does support the idea that the US rate cycle is forcing investors to differentiate between various industries.

It is also hard not to notice that sector correlations fell right after the US elections last year and this month's low reading is just the culmination of that move. The real "Trump trade", therefore, may well be all about removing the threat of incremental regulation. A surprising conclusion, yes. But that's what the data seems to show.

- Since the data we've presented is for the prior month, it may represent investor positioning ahead of quarterly earnings. That would explain the drop to all-time lows after many months of 55-60% readings.

In the end, however, lower correlations – regardless of why they exist – are fundamentally good. They show active societal capital allocation finally at work again, and give active managers a better shot at outperforming if they pick the right groups. Markets are less volatile under this regime as well.

Given our constructive view on US stocks we naturally hope this trend will continue. But even when markets hit a bump in the road (and they always do), lower correlations should act to absorb some of the damage.

DAILY DATAPOINT

One of the most popular electronic items on Amazon – just after the company's own tech offerings – is the humble power strip. I am sure you have several of these in your own home, with your phone/computer/tablet/video games plugged in every night for recharging.

The growth in personal electronic devices over the last 5 years must be a huge windfall for electric utilities around the US, right? As it turns out, not so much. Here's the data, courtesy of the US Energy Information Agency:

- "Peak electricity" for US households was back in 2010, at 1,446 million megawatt hours.
- Over the last six years (2010 to 2016), consumption fell by 2.7% to 1,407 million megawatt hours.
- For the last 12 months ending July 2017 (latest data available), consumption has been relatively flat (up 0.8%).
- Don't worry about electrical utility profitability too much, though: dollar sales to households were up 5.9% from 2010 to 2016, and 2.3% for the last 12 months ending July 2017.

So what's going on? Lightbulbs. Back in 2007, President Bush signed the "Energy Independence and Security Act". This mandated a 25% decrease in energy consumption for many typical household bulbs. Starting in 2012 the regs went into effect, and the result is plainly visible in the data outlined here.

You can see the EIA data, in the "Monthly retail sales" and "Revenue from retail sales" sections, here: <https://www.eia.gov/electricity/data.php#sales>

DAILY DISRUPTION FEATURE

There's something in the world of AI/robotics called "Moravec's Paradox". Basically it says that replicating human physical capabilities is far harder than matching human intellectual abilities. Computer algorithms may be good at telling you what book you might like based on your other purchases, but a robot will still have trouble pulling it off the shelf and packing it up for you.

That challenge is on full display in these two videos of Amazon warehouses. The robots manage the physical inventory and minimize the floor space needed to hold it. But it is still a human that pulls an item from a bin, packs it, puts a label on, and sends it on its way.

First video (No narration, just 3:40 minutes of oddly hypnotic robots):
<https://www.youtube.com/watch?v=cLVCGEmkJs0>

Second video (an excellent Cory Johnson/Bloomberg interview with Amazon's head of ops in a working warehouse): <https://www.youtube.com/watch?v=g6DIFpaol6A>

TODAY'S MARKET FOCUS

Large cap Consumer Staples stocks were big winners today, which is not something we get to write too often. The group was up 0.9% versus an S&P 500 move of just 13 basis points. Mondelez is the largest component of that group, with a 3.6% weighting, and its 2% pop at the open seemed to help the whole group.

Could this be the start of a rotation into the group, which is only up 4.7% on the year? We'll need to see more to be convinced. Here's why:

- FactSet data shows this to be the 3rd most expensive group in the S&P 500, behind only Energy and Consumer Discretionary, at 19.3x forward 12-month earnings.
- Q3 2017 earnings growth is only slated to come in at 1.6%, although analysts have been bumping their numbers higher over the last month.

- A stronger dollar could be a headwind for the group, since many companies here have large international operations.

If you missed today's market action, click [here](#) for a useful summary by CNBC.

TODAY'S CURATED LINKS

Financial Times

Ripple's new customers and role in cross-border payments: [Blockchain Company Ripple Says it has \\$15bn War Chest](#)

Top 10 S&P 500 stocks as a % of the index: [Head of ETF Provider Warns on Concentration of Holdings in Bigger Stocks](#)

Zero Hedge

Quant funds have underperformed actively managed equity funds during the first 9 months of this year given the low volatility environment: [Human Traders Are Trouncing The Machines](#)

Spoiler alert - the S&P 500 bested 38 global assets since the last market peak: [10 Years After The Last Market Peak, This Is How Assets Have Performed](#)

Wolf Street

The changing landscape for who has to collect sales taxes, either Amazon or third party sellers: [The Big Amazon Subsidy is Doomed](#)

Results from an AI equity research analyst: [Wells Fargo's Artificial Intelligence Defies Analysts, Slaps "Sell" on Google and Facebook](#)

Business Insider

Widespread concern about the Fed unwinding its balance sheet: [We Asked 6 Big-Money Investors About Their Biggest Fears — and They All Had the Same Answer](#)

MIND CANDY

Forty years on, there hasn't been a nightclub quite like Studio

54. Frequented by everyone from Andy Warhol and Karl Lagerfeld to Debbie Harry and Liza Minelli, anyone who was somebody at the time was on the guest list to party till dawn. Despite his notorious refusal to do interviews for quite some time, co-owner Ian Schrager recently published a 396-page book, "Studio 54," replete with photographs and his stories of the club's heydays.

You can read more and see some vintage photos of the club in this [CNN article](#), or purchase the book [here](#) on Amazon.

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