Is it Time for a Heat Check?

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Key takeaways:

- Equities rebounded, producing gains in January. However, sentiment remains cautious as many areas are still down double digits over the past 12 months
- Equity-focused ETFs had net outflows in January, the first time for that month since 2016
- Fixed income ETFs gobbled up more than $15 billion last month, pushing flows over the last three months to the highest…*ever*
- Sector equity ETFs lost $9 billion, the fourth consecutive month of outflows —the longest stretch ever—and more evidence of a risk-off mentality

With global equities rallying to start 2019, after more than 71% of global stocks closed out the 2018 season in a bear market, it might be time for a heat check. A "heat check" is a basketball term that refers to a player with a hot hand taking a shot to gauge just how "hot" they are. Or, as some would say, taking an impossibly difficult, super-low-percentage shot from a YOLO range with no strategy at all.[i]

Equities' 6%-plus January gain is similar to a New York Knicks player who has gone scoreless for the entire game coming off the bench in the 4th quarter to drop 14 points in four minutes against the Golden State Warriors, then celebrating by doing the James Harden "Home Cooking,"[ii] even though the Warriors still lead by 12.[iii]

Not trying to throw shade on the rally. The rally may have legs, but this month's pop may not be repeatable, given it started from such a low point as the markets sold off so fast and furious last quarter, that if you said Vin Diesel was involved, it would be believable. One catalyst for the January hot hand, however, is that with markets entering 2019 on a somber note, valuations became noticeably attractive. US equities entered 2019 trading 7% below their 30-year median Next Twelve Months Price-to-Earnings Ratio, after starting 2018 20% above it.

But the market ails from 2018 have not gone away just because the calendar flipped to 2019. I mean, if you can't defend the high screen pick-and-roll in the first three quarters, it's unlikely you'll shut it down in the fourth. Sure, 71% of global equities are no longer in a bear market, but 59% still are. Not to mention 40 of the 47 (88%) countries in the MSCI ACWI Index remain in a technical correction, down by more than 10% from their 52-week highs.

Given the recent post-correction gains, February will present a few "heat check" moments, providing some tangible information on how strong the 2019 rally will be.

The first heat check is US earnings, given that the 2018 sell-off was predicated on the fears of slowing economic and corporate profit growth. And those concerns were correct, as with half of the S&P 500 reporting results, only 70% of firms are exceeding expectations, the lowest level in two years and below the 5-year average. Additionally, guidance is weak, as earnings upgrade-to-downgrade ratios are falling. With that, forecasts for Q1 2019 growth are now hovering around 2%, breaking a five quarter double-digit growth streak.

Another heat check will be how the market handles the confluence of macro and geopolitical events sitting out on the schedule. February will bring a plethora of data releases that were not disseminated because of the recent US Government shutdown, providing more information on economic sentiment in the US. Given economic sentiment outside the US has waned, notably in Europe and China, if the US has a similar trajectory, it may not bode well for risk assets. Beyond the shutdown delayed data releases, markets will also have to maneuver past another shutdown fight. Note, too, that a debt ceiling debate will be thrown in for fun, as the suspension period for the nation's debt limit ends March 1st.

Finally, we have the most prolonged and dysfunctional break-up since Shaq and Kobe in Brexit, ongoing political strife in the Eurozone (e.g. Italy) and an emerging crisis in Venezuela with ramifications for the oil markets. The outcomes, or even the latest news, could either put more points on the rally board or send global equity markets to the bench.

A more "patient" Federal Reserve will likely serve as a short-term adrenaline rush, like being on the dunking end of a half court alley-oop. More importantly, the US market is returning to normal bouts of volatility; 30% of S&P 500 January trading days had a greater than 1% move in either direction, following 25% in 2018. Therefore, rather than focus on the recent hot hand, something traditional momentum strategies ignore as recent month's returns are removed, seek out those two-way players who have scoring potential and can play defense when the offense isn't clicking.

To be clear, we don't expect an imminent recession. However, the recent rally will get a "heat check" soon, and that may bring more volatility. Therefore, we are constructive on defensive equities that trade at inexpensive valuations but have quality balance sheets, as well as defensive short-duration bond strategies that generate income similar to broad exposures, given how flat the yield curve has become.

Bonds from Way Downtown

Even with the market's sizeable gains to start 2019, equity fund flows were net negative, pushing down the entire US-listed ETF industry into net outflows (out $970 million). Some of this may be attributed to the less-than-positive market sentiment, evidenced by certain technical indicators not flashing the all clear sign. While the S&P 500 Index has broken past its 50-day moving average, it sits below the 100- and 200-day moving averages. Additionally, the 100-day crossed through the 200 in the month of January. When the 100-day moving average goes below 200-day moving average, the intermediate trend is said to be bearish. This notion is underscored by the S&P 500 historically posting lower returns over the next 30 days when the 100- day sits below the 200- day, than when it is above, dating back to 1960.

The other part of these outflows is cyclical rebalancing, as January has had outflows 52% of the time over the last 20 years – the highest percentage for any month in the year. One element of the cyclicality can be attributed to new allocations, after using placeholders to end the year, reversing December inflows, a month that has had *inflows* 95% of the time – the most of any month.

With a certain amount of these equity flows not market related, drawing full scale conclusions on positioning can be a bit like three dimensional chess. Fixed income flows, on the other hand, indicate a higher degree of market positioning intelligence. Fixed income ETFs took in over $15 billion last month, notching their third consecutive 11 digit month of flows. Occurring at the same time equity markets are frazzled, this activity underscores investors' desire to de-risk portfolios and mitigate drawdowns – the textbook use case for bonds.

Commodity funds, led by gold exposures, witnessed inflows once again, taking in 3% of their asset base. That is the second highest flows figure as a percent of start-of-year assets for any of these broad-based asset class categories, behind specialty funds which amassed 8.9%, where that was led by strategies seeking to benefit from a rise in volatility.

The outflows in equities, the inflows in bonds and the inflows into non-traditional areas that may benefit in an environment of increased idiosyncratic volatility all point to investors continuing to position more cautiously, even as equity markets have moved higher on the year.

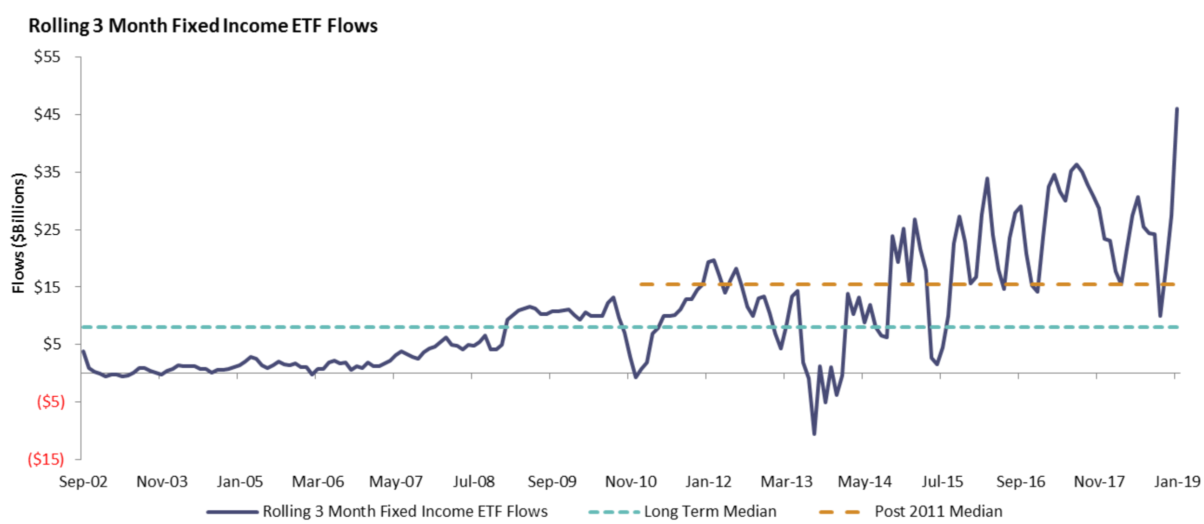
Figure 1: Asset Class Flows

In Millions	January	Trailing Three Months	Trailing Twelve Months	Month to Date (% of Start of Month AUM)
Equity	-17,950	48,256	132,649	-0.7%
Fixed Income	15,307	43,448	103,499	2.3%
Commodity	1,878	3,338	1,969	3.0%
Specialty	256	-38	-217	9.0%
Mixed Allocation	-428	889	2,075	-3.8%
Alternative	-34	513	1,111	-0.9%

Top two and bottom two categories per period are highlighted. Source: Bloomberg Finance L.P., State Street Global Advisors, as of January 31, 2019.

Figure 2: Fixed Income Pops, Rolling 3 Month Fixed Income ETF Flows

The chart below depicts the massive the rotation into bond strategies as investors sought the potential defensive properties of bonds during the recent bouts of equity volatility.



Source: Bloomberg Finance L.P., State Street Global Advisors, as of January 31, 2019.

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Emerging, But Still No Euro Step from Investors

US equity exposures led the decline in equity flows, posting more than $20 billion of outflows, for a 1% loss in assets. The January outflows completely offset the inflows from December. And, as stated above, one of the culprits of these outflows, even as the market rallied, can be the cyclical nature of flows, particularly those in the US given that US equity exposures make up 56% of US-listed ETF assets. If January is more often than not in outflows for the industry, then the perpetrator is likely US-focused funds.

Emerging market (EM) ETFs, however, amassed inflows for what appears to be market-driven reasons. EM funds have had inflows for three consecutive months. And those three months rank as the highest three month fund flow total *ever*. This is also first time that EM funds have led our geographical flow analysis – *ever*. But if markets are inherently volatile and geopolitical risk is elevated, why are there allocations to EM?

Value. EM equities sold off for most of 2018 while the rest of the market chugged along in the first nine months of the year. At one point EM equities were in 26.6% drawdown. This precipitous decent, like an NBA team tanking for Zion Williamson[iv], led to valuations on EM stocks becoming too attractive to ignore.

At the end of September, valuations, on a relative basis to the US sat, on average across four metrics,[v] in the bottom three percentile versus its historical relative valuations in the past 15 years. So, as the US equity markets have fallen by 7% since the end of September 2018, EM stocks have been flat, posting a 0.2% return as their attractive valuations have acted as a backstop to the market volatility. A sideways trending US dollar has also benefited sentiment over the past three months, as a gauge of EM currencies has appreciated 3% since the end of September.

Single country funds were the only other geographical segment with inflows on the month, led by China. Much like the broader EM flows; valuations for Chinese equities became attractive after stocks in that region fell by 33% peak-to-trough. Recent fiscal stimulus measures enacted, as well as thawing trade tensions – albeit with no resolution yet –, can be attributed to a positive shift in sentiment on Chinese equities and the 12% rally since October 2018's trough.

Lastly, European or eurozone based regional funds continued their streak of outflows, notching their 11th straight month – one shy of the record registered after Brexit occurred.

Figure 3: Equity Geographical Flows

In Millions	January	Trailing Three Months	Trailing Twelve Months	Month to Date (% of Start of Month AUM)
US	-22,636	15,357	82,735	-1.2%
Global	-839	3,100	13,526	-1.0%
International-Developed	-1,544	13,299	41,802	-0.5%
International-EM	7,823	16,591	15,366	4.8%
International-Region	-641	-276	-12,925	-1.4%
International-Single Country	1,253	4,430	6,102	1.5%
Currency Hedged	-1,366	-4,246	-13,957	-6.3%

Top two and bottom two categories per period are highlighted. Source: Bloomberg Finance L.P., State Street Global Advisors, as of January 31, 2019.

Stars on a Losing Team

Yikes. Sector related strategies had net outflows of $9 billion in January, pushing flows negative for the fourth month in a row – the longest stretch *ever*. The negativity was felt by almost every sector, as only four had inflows: Staples, Utilities, Health Care and Communication Services.

Communication Services flows appear to be a result of two factors: positive earnings sentiment and an ongoing rebalance from the Technology sector, as a result of the GICS remap where certain Consumer Discretionary, Technology, and Telecom stocks merged to form the newly minted Communication Services segment. Not surprisingly, Technology and Discretionary were in outflows, and have been for the last three months for both market and operational rebalance reasons.

For Utilities, Staples, and Health Care this is a continuation of defensive positioning within sector strategies witnessed recently. Those three areas being favored, from a positioning standpoint, is not a surprise given the historical performance trends during slowdowns, as we highlighted in a recent research piece on business cycle behavior amongst sectors. Momentum strategies would likely favor those areas as well, not only from a cross-sectional (e.g. 12 – 1 months return) but also from a relative momentum (sector versus T-Bills return) in the past year.[vi]

Looking ahead, expect this trend to continue unless the market rallies significantly and there is a change in leadership where cyclical sectors take the ball. But as stated earlier, this earnings season will serve as a proper "heat check" for anyone trying to fake the funk on the rally dunk.

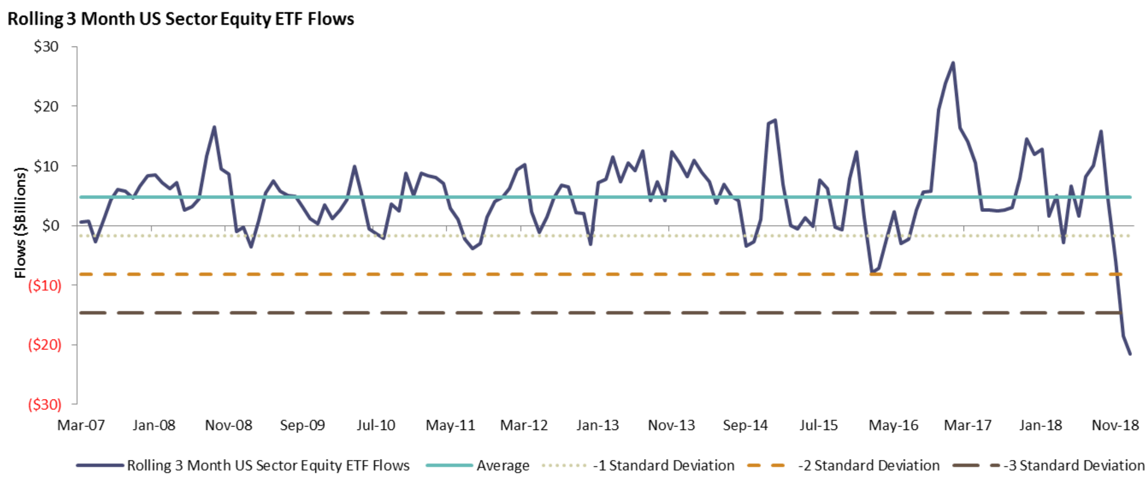
Figure 4: Equity Sector Flows

In Millions	January	Trailing Three Months	Trailing Twelve Months	Month to Date (% of Start of Month AUM)
Technology	-2,628	-5,834	3,763	-1.9%
Financial	-1,745	-8,022	-12,031	-3.7%
Health Care	48	774	6,808	0.1%
Consumer Discretionary	-883	-2,404	-2,500	-4.6%
Consumer Staples	251	1,451	3,412	1.6%
Energy	-3,308	-1,168	-4,522	-7.8%
Materials	-999	-1,470	1,688	-3.0%
Industrials	-846	-3,889	-6,241	-3.8%
Real Estate	-339	-505	-2,910	-0.6%
Utilities	89	1,504	1,630	0.7%
Communications	1,018	479	4,688	20.6%

Top two and bottom two categories per period are highlighted. Source: Bloomberg Finance L.P., State Street Global Advisors, as of January 31, 2019.

Figure 5: Sector Deluge, Rolling 3 Month US Sector Equity ETF Flows

The chart below illustrates how many tactical sector rotation strategies have likely rotated out of the "market" and into a more defensive exposure. The rolling three-month flow figure for US equity sector focused strategies has now registered a three standard deviation event! Watch for mean reversion.



Source: Bloomberg Finance L.P., State Street Global Advisors, as of January 31, 2019.

No Style Moves

Given US equities were in net outflows, the size and style category was gutted. Mid caps were the only segment to receive meaningful inflows on the month. However, they still remain in the bottom in terms of asset gathering over the last twelve months, keeping up the tradition of being the Jan Brady of market-cap segments.

In November and December, we witnessed a rotation into value and out of growth, and it appears that when exiting positions, investors redeemed out of growth more than value. And overall, the intermediate trend still holds as value strategies have taken in $17 billion more than growth over the last three months.

Figure 6: US Size and Style

In Millions	January	Trailing Three Months	Trailing Twelve Months	Month to Date (% of Start of Month AUM)
Broad Market	143	10,248	29,964	0.1%
Large-Cap	-14,061	18,630	28,875	-2.8%
Mid-Cap	842	4,612	12,006	0.5%
Small-Cap	-525	1,175	21,815	-0.3%
Growth	-5,591	-7,326	13,747	-3.2%
Value	-2,130	10,378	26,748	-1.1%

Top two and bottom two categories per period are highlighted. Source: Bloomberg Finance L.P., State Street Global Advisors, as of January 31, 2019.

No Government Shutdown Here

It was back to the basics in fixed income. With investors seeking to mitigate equity drawdowns, Government bond exposures took in 41% of flows. Adding to this notion of investors seeking downside risk mitigation, interest rate sensitive mortgage-backed strategies had inflows as well; the $2 billion of inflows represented a 9% increase in assets – the largest out of any fixed income sector we track.

Even though market sentiment is tinged with an auspice of defensiveness, there were sizeable allocations to credit, mainly in the investment-grade (IG) space, and away from Aggregate funds. Given how quick IG spreads widened out to end 2018, rising by 47 basis points in the fourth quarter (a 44% spike) to sit 9% above their 20 year median, it's not a surprise to see investors seek out the elevated levels of income after such a sharp move.

Taking these flows in concert with the fact that investors were de-risking within equities, one may be able to conclude that investors were willing to swap equity risk for credit risk in our current environment.

But it wasn't all defensive within bonds. After posting sizeable outflows in 2018, high yield snapped back. And likely for the very same reason the IG space did. Spreads widened out past long-term median and the valuation case became attractive.

This is also evident with emerging market debt. One month after posting over $1 billion of outflows, EM debt took *in* more than $1 billion in January. With yields widening past 6% to start 2019, investors were more amenable to taking on the macro risk associated with the segment, as the elevated coupon had the potential to act as backstop for any increased risk regime.

Figure 7: Fixed Income Sectors

In Millions	January	Trailing Three Months	Trailing Twelve Months	Month to Date (% of Start of Month AUM)
Aggregate	-3,771	10,693	26,518	-1.8%
Government	6,303	27,574	56,537	5.0%
Inflation Protected	-8	-1,461	2,071	0.0%
Mortgage-Backed	2,053	3,203	6,420	9.0%
IG Corporate	7,281	4,931	13,615	5.6%
High Yield Corp.	3,248	161	-4,061	8.9%
Bank Loans	-447	-2,770	-2,348	-4.6%
EM Bond	1,410	699	1,755	7.1%
Preferred	-277	-2,068	-2,928	-1.1%
Convertible	-170	-305	-30	-4.0%
Municipals	-316	2,791	5,948	-0.9%

Top two and bottom two categories per period are highlighted. Source: Bloomberg Finance L.P., State Street Global Advisors, as of January 31, 2019.

Tenor to Tenor, like Coast to Coast

All four segments of the maturity band took in assets. Longer term government bonds took in the most as a percent of assets, taking in over 12% on the month. This sizeable asset raise on a relative basis is indicative of investors positioning quite defensively, given that long-term Treasuries outperform short-term in times of equity drawdowns. Since 1976, when the S&P 500 has registered a quarterly decline of more than 5%, Treasuries with a maturity greater than 10 years outperformed maturities of less than 5 years by 2.7% on average, in the quarter.

Investors continue to allocate to the shorter tenors as a way to boost income, however. Short term is still attractive given the rise in short-term interest rates from tighter monetary policy and the segment's defensive properties, as the example earlier still reveals positive returns in risk-off markets (+2.41% return for short-term Treasuries), combined with undertaking limited duration risk.

Figure 8: Fixed Income Maturity Flows

In Millions	January	Trailing Three Months	Trailing Twelve Months	Month to Date (% of Start of Month AUM)
Ultra Short	338	9,079	21,888	1.0%
Short Term	2,528	12,136	22,187	5.2%
Intermediate	1,824	3,934	8,870	6.5%
Long Term (>10 yr)	1,662	2,865	4,908	12.9%

Top two and bottom two categories per period are highlighted. Source: Bloomberg Finance L.P., State Street Global Advisors, as of January 31, 2019.

Gold-Trotters

Gold-related positions led commodity flows, another aspect of investors positioning more defensively. Gold flows have now been positive for four consecutive months, reversing a trend where the precious metal segment had been in net outflows for five months in a row.

With increased volatility as well as macro uncertainty this trend is likely to persist. Most other commodity segments were in net outflows, likely a by-product of the reduction in inflation mitigating exposures in light of the sanguine outlook for inflationary spirits.

Figure 9: Commodity Flows

In Millions	January	Trailing Three Months	Trailing Twelve Months	Month to Date (% of Start of Month AUM)
Precious Metals	2,308	3,750	1,540	4.4%
Industrial Metals	2	-23	-114	0.9%
Energy	-155	515	-562	-5.3%
Broad Based	-267	-833	1,204	-4.1%
Agriculture	-10	-70	-99	-1.5%

Top two and bottom two categories per period are highlighted. Source: Bloomberg Finance L.P., State Street Global Advisors, as of January 31, 2019.

Low Risk and Quality Chemistry Players

Smart beta funds, which took in over $40 billion in 2018, continue to see elevated interest – posting over $4 billion of inflows in January. Within factors, the allocations have been consistent with other positioning trends above, with defensive-oriented factor exposures like quality, dividend yield and minimum volatility taking in the most. Quality funds saw an over 20% increase in their asset base.

For more information on how we break out factor flows, check out our latest blog post on the classification conundrum.

Active funds saw muted inflows last month, but remain an area of growth for the industry as over $26 billion has been allocated to this area in the last twelve months. At this rate active ETFs will surpass the $100 billion mark in 2019.

Figure 10: Strategy Type

In Millions	January	Trailing Three Months	Trailing Twelve Months	Month to Date (% of Start of Month AUM)
Active	476	4,877	26,027	0.7%
Smart Beta	4,184	18,915	36,483	1.2%
Sector Smart Beta	-355	-835	-1,697	-3.3%
ESG	-171	269	1,763	-2.0%

Top two and bottom two categories per period are highlighted. Source: Bloomberg Finance L.P., State Street Global Advisors, as of January 31, 2019.

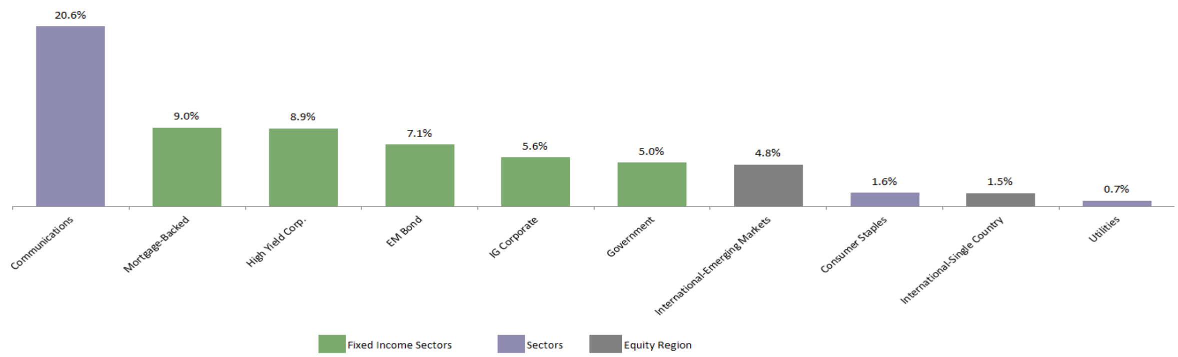
Emerging Leaders

When dissecting flow patterns, flow as a percent of assets helps us discern noticeable shifts in buying behavior. Figure 12 summarizes the top 10 areas that witnessed the largest flow totals as a percent of start of year assets in 2019 in the Equity Region, Style, US and Fixed Income Sectors categories.

As it's just one month, there is limited intelligence to glean from this visual. However, one trend to watch is how the EM space evolves in 2019. Given the valuation arguments made earlier, it's not a surprise to see both EM equity and EM debt as the two areas with large shifts.

Figure 11: Flows as a Percentage of AUM

2018 Flows as % Start of Year AUM)



Source: Bloomberg Finance L.P., State Street Global Advisors, as of January 31, 2019.

Definitions

YOLO
The acronym of "you only live once". Along the same lines as the Latin "carpe diem" ("seize the day"), it is a call to live life to its fullest extent, even embracing behavior which carries inherent risk

Euro Step
A two-step, or long lateral is a basketball move in which an offensive player picks up his dribble, takes a step in one direction, and then quickly takes a second step in another direction

BofA Merrill Lynch US High Yield Master II Index
The BofA Merrill Lynch US High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch).

Bloomberg Barclays U.S. Aggregate Bond Index
The Bloomberg Barclays U.S. Aggregate Bond Index is a market weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most US-traded investment grade bonds are represented. Municipal bonds and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues.

GICS
The Global Industry Classification Standard (GICS) is an industry taxonomy developed in 1999 by MSCI and Standard & Poor's (S&P) for use by the global financial community.

Bloomberg Commodity Index
A broadly diversified commodity price index distributed by Bloomberg Indexes that tracks 22 commodity futures and seven sectors. No one commodity can compose less than 2 percent or more than 15 percent of the index and no sector can represent more than 33 percent of the index.

Bloomberg Dollar Spot Index (DXY)
The Bloomberg Dollar Spot Index tracks the performance of a basket of 10 leading global currencies versus the US Dollar.

Bloomberg Barclays Corporate US High Yield Bond Index
A rules-based, market-value-weighted index to measure the performance of publicly issued non-investment grade USD fixed-rate, taxable and corporate bonds.

CBOE SPX Volatility Index (VIX)
A measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

The MSCI EAFE US Dollar Hedged Index
Designed to represent a close approximation of the return that can be achieved by hedging the currency exposures of the index in the one-month Forward market at each end of month.

Earnings Per Share (EPS)
A profitability measure that is calculated by dividing a company's net income by the number of shares outstanding.

MSCI EAFE Index
An equities benchmark that captures large- and mid-cap representation across developed market countries around the world, excluding the US and Canada.

MSCI Emerging Markets Index
The MSCI Emerging Markets Index captures large and mid-cap representation across 23 emerging markets countries. With 834 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI ACWI Index
The MSCI ACWI Index captures large and mid-cap representation across developed and emerging markets countries.

MSCI ACWI Ex-US Index
The MSCI ACWI Ex-US Index captures large and mid-cap representation across developed and emerging markets countries outside of the USA.

Russell 2000 Index
The Russell 2000 Index is comprised of the smallest 2000 companies in the Russell 3000 Index, representing approximately 8% of the Russell 3000 total market capitalization.

S&P 500 Index
Standard and Poor's 500 Index is a capitalization-weighted index of through changes in the aggregate market value of 500 stocks representing all major industries.

S&P/LSTA Leveraged Loan Index
The S&P/LSTA Leveraged Loan Index is a market value-weighted index designed to measure the performance of the U.S. leveraged loan market based upon market weightings, spread and interest payments.

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[i] The Ringer, www.ringer.com
[ii] Celebration dance by Houston Rockets James Harden
[iii] With the latest Knicks trade this they are more likely to be by down 32
[iv] https://fivethirtyeight.com/features/zion-williamson-is-the-best-college-basketball-player-in-at-least-a-decade/
[v] Price-to-Earnings, Price-to-Book, Next Twelve Months Price-to-Earnings, Price-to-Sales
[vi] Health Care, Utilities, and Staples are also trading above their 50 and 200 day moving averages

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