Sitting On Fourth Street, You Ready?

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Key takeaways:

- Developed ex-US outperformed US equities in September, breaking a streak of four consecutive months of US dominance
- This performance gap didn't deter investor interest, as US equity-focused ETFs took in over 100% of all equity category flows on the month
- At the sector level, flows into Health Care showed defensive growth posturing, while the newly-minted Communication Services sector announced itself with authority, taking in over $1 billion on the month
- Fixed Income ETFs notched their 38th consecutive month of inflows, with this month's haul once again fueled by aggregate and government exposures

Fourth Street, otherwise known as the turn, is a pivotal point in any poker game. It's the fourth community card dealt right after the Flop, and the last card before hitting the River to finalize one's hand. It's where things get real, and you either know you have something or you don't. The odds of winning change, as does one's strategy. If you are not in a good position on Fourth Street, it's a high risk move to keep going. Many poker hands have been decided on Fourth Street. Just ask Teddy KGB from the high-stakes poker movie *Rounders.*[1]

Global capital markets now sit on Fourth Street, with their hand, or entire year, hanging in the balance as macro risk dominates market sentiment, obfuscating fundamental data. With little fundamental news, but a full calendar of macro events left to impact market sentiment, September once again proved to be a challenging month for global equities. On the year, however, it has been a completely different story as asymmetrical return patterns have created visible winners and losers. The US is the only major region with noticeably positive returns for the year, outperforming Japan, the Eurozone, China, and all of emerging markets by 8.4%, 15.2%, 19.8%, and 18.6%, respectively. But US stocks might have gotten tired of all this winning, as developed ex-US equities, led by a rally in Japanese shares, outperformed the US in September for the first time in four months.

To quote *Rounders'* hustler Worm,[2] when he finds himself dealing at a local game with more than just money on the line, "Fourth Street. Yeah everybody ready?"

To evaluate our hand as we approach Fourth Street, let's look at the three flop cards on the table impacting our strategy going forward: valuations, earnings trends and geopolitics.

Valuations*:* With such a run-up in US stocks this year, valuations have become extended once again. Using Price-to-Book, the US currently trades in the 93rd percentile relative to global ex-US equities over the last 25 years. If September's performance shift is the start of value investors turning an eye towards international assets, the leaves might not be the only thing changing this fall. Regional allocations may as well.

Earnings Trends: With Q3 earnings season kicking off in earnest in October, investors will finally have some company-specific data to help guide investment decisions, potentially drowning out the latest tweetstorm. So far Q3 earnings growth for US equities is expected to register the third straight month of 20%-plus growth. However, eight sectors have lower growth rates today than what was forecasted back in June due to more negative guidance than usual.

While that might indicate a preference to look overseas, earnings trends across the pond are still less favorable. Even with Japanese growth estimates being revised higher, broad developed ex-US and emerging market equities have witnessed a reduction in both 2018 and 2019 estimates. The US, conversely, has had 2018 and 2019 estimates increase. So the US might still have the brighter growth prospects, with sectors like Tech, one of the few sectors with higher Q3 growth estimates today, leading the charge.

Geopolitics: US midterm elections are likely to splash the pot, distracting investor sentiment away from the latest quarterly earnings reports. If the elections result in a split Congress, gridlock will likely increase, as the debt ceiling debate and budget negotiations to fund partisan policies become more contentious. This could curtail any positive sentiment from earnings data. But the US isn't the only player at the table splashing the plot with geopolitical chips. Brexit, Italy's budget, Brazil's elections and the ongoing trade negotiations are all upping the ante. It is no wonder, then, that the CBOE SKEW Index, otherwise known as the Black Swan Index, has registered its highest yearly average ever.

Strategies to make it past Fourth Street may be to consider higher quality growth exposures with little macro sensitivity, such as Tech and Health Care, while adding portfolio ballast with short-duration bonds that offer an attractive yield per unit of duration. Outside the US, Japan may be one international segment to consider more than others, given its appealing relative valuations and improving growth prospects against still uber-accommodative policy.

Jackpot

The pace quickened on equity bets during September. Like a player aggressively raising the pot when eyeing a jackpot, equity focused ETFs took in $29 billion last month. Following a $20 billion haul in August, this raised the year-to-date total to north of $140 billion. While the notional value is eye-popping, on a relative basis these flows represent just 5% of start-of-year assets under management for equity funds. And while the pace may have quickened, it still remains behind last year's torrid run. At this time last year, equity ETFs had amassed a staggering $223 billion on their way to a record $334 billion.

This slower pace is likely a function of a rocky start to the year for global equities and the uneven regional recovery since then, where only US stocks are noticeably positive on the year. After all, it's hard to shoot the moon twice.

Some can try, however. Fixed income ETFs continued their stellar performance at the table after a record-setting 2017. Notching their 38th consecutive month of inflows last month, bond ETFs show no signs of folding their hand.

As a result of their strong run, fixed income ETFs have noticeably increased their market share. They now represent 17.2% of industry assets compared to 15.9% when this "heater" like stretch run of positive flows began back in June of 2015.

Looking ahead, it is unlikely 2018 will be the year that this run of consecutive inflow months will be broken. Investor interest in fixed income exposures will likely persist for three reasons:

1) Equity gains from a decade-long bull market will require ongoing rebalancing to bring portfolios back in line to standard asset allocation, such as a 60/40 equity/fixed income mix
2) The full macro calendar will provide an undercurrent of demand for portfolio ballast, a trait bond exposures carry quite well
3) Income is still a need, and with rising short-term rates even ultra-short term exposures such as US 1-month Treasury Bills now yield more than stocks!

Figure 1: Asset Class Flows

In Millions	September	Year to Date	Trailing Three Months	Trailing Twelve Months
Equity	29,114	140,673	65,075	254,179
Fixed Income	6,426	69,364	23,651	93,579
Commodity	126	-1,204	-3,055	-1,982
Specialty	-59	819	175	-92
Mixed Allocation	292	1,393	574	1,950
Alternative	142	598	208	829

Top two and bottom two categories per period are highlighted. Source: Bloomberg Finance L.P., State Street Global Advisors, as of September 28, 2018.

The US: A Shark at the Table

Flows followed returns, for the most part. With the S&P 500 Index rising more than 7% in Q3, US equities posted their best quarterly return since Q1 of 2013. Unsurprisingly, the US has been the most heavily allocated to over the same period, by a ratio of 15 to 1 compared to non-US equity focused exposures, taking in over $60 billion versus just $4 billion for the other regions. Interestingly, almost half of the US's $60 billion haul was in September, the first time in four months where US stocks underperformed the rest of the world.

Outside the US, regional funds again saw outflows north of $700 million. Ongoing but unfruitful Brexit negotiations and the budget drama in Italy drove outflows in the European region. This is the seventh consecutive month of outflows for the region, the longest such stretch since the Brexit vote. With renewed concerns over a no-deal Brexit combined with slowing economic momentum, this trend may be unlikely to reverse course in the near term.

At the single country level, Japan had the most outflows of any other country. This is an indication of where investors are not currently chasing performance, as this is an inverse of the country's return for the month. Japanese equities had some of the best returns for developed nations in September.

After having surprised with inflows in August, emerging markets (EM) once again saw muted inflows, losing $6 million. These sanguine flows come despite increasing trade tensions between the US and China, with the US now levying tariffs on $250 billion of Chinese goods. While EM trades at a steeper discount to US equities than usual – a 54% discount today versus a 25-year median discount of 45%, based on Price-to-Book – muted flow patterns are likely to continue as a strong US dollar and trade rhetoric may constrain any optimism emanating from a value opportunity.

Figure 2: Equity Geographical Flows

In Millions	September	Year to Date	Trailing Three Months	Trailing Twelve Months
US	28,611	105,423	60,779	178,614
Global	113	13,521	2,033	19,979
International-Developed	1,864	31,341	3,484	52,706
International-Emerging Markets	-6	7,611	1,614	15,388
International-Region	-727	-9,105	-1,786	-6,887
International-Single Country	-451	2,979	1,068	6,116
Currency Hedged	-291	-11,096	-2,116	-11,737

Top two and bottom two categories per period are highlighted. Source: Bloomberg Finance L.P., State Street Global Advisors, as of September 28, 2018.

Anteing Up

September saw the largest restructuring of the GICS classification system ever. Existing Telecommunications stocks were combined with well-known media and tech giants from the Consumer Discretionary and Technology sectors to form the Communications Services sector. This change set a lot of money in motion, given that the newly-minted sector makes up 10% of the S&P 500's market value.

Investors rightfully took an interest in the sector's introduction, anteing up more than $1 billion on the month, which trailed only Health Care. Rebalancing activity is likely to distort overall sector flow patterns going forward, with outflows from Technology and Consumer Discretionary into Communication Services resulting from investors rebalancing their portfolios to obtain exposure to the new sector.

Market based sentiment flows were led by Health Care, which saw $2.2 billion of inflows in September as investors sought defensive growth exposures.

Energy sector ETFs had the greatest outflows on the month, pushing them even further into last place year to date, despite Brent reaching its highest closing price since 2014 amid fallout from Iranian sanctions and President Trump's rebuke of OPEC in his UN General Assembly speech. It's worth noting, however, that this negative sentiment may be reversing. Energy sector ETF flows in the last week of September were vastly positive, coming in second behind the new Communication Services sector. This positive flow momentum coincided with an uptick in futures positioning on oil contracts and a nearly 5% rise in oil.

Figure 3: Equity Sector Flows

In Millions	September	Year to Date	Trailing Three Months	Trailing Twelve Months
Technology	36	14,298	4,363	20,027
Financial	-84	4	-1,646	4,533
Health Care	2,573	5,600	6,874	3,900
Consumer Discretionary	260	384	1,628	1,777
Consumer Staples	227	732	769	758
Energy	-160	-1,073	-1,753	772
Materials	-127	4,487	1,930	6,763
Industrials	-4	966	574	2,357
Real Estate	395	-185	2,250	852
Utilities	292	308	145	-1,201
Communications	1,563	2,351	2,123	2,184

Top two and bottom two categories per period are highlighted. Source: Bloomberg Finance L.P., State Street Global Advisors, as of September 28, 2018.

A Straight Flush

Like a having a straight flush, the full slate of size and style exposures were in net inflows for the month of September. Large caps led in terms of the notional size of flows, with nearly $15 billion for the month. But small caps' $4 billion haul represents the largest growth, equating to 1.8% of start-of-month assets. This trend is a continuation of the flow patterns for 2018, where small-cap exposures have taken in the most flows as a percent of start-of-year assets with 12%, a likely by-product of the economic environment featuring trade tensions and fiscal stimulus aimed at generating domestic-oriented growth.

Growth and value flows were evenly split in September, as they have been on a trailing three-month basis. Both styles have taken in roughly $7 billion.

So far in 2018, however, the $28 billion investors have added to growth-focused exposures represents a roughly 9% increase to the segment's asset base, and nearly three times the amount they have allocated to value exposures in the same period. This is occurring as growth trades at a 21% premium to the broader market, a figure that is in the 90th percentile over last the last 25 years. A late cycle indicator if there was one.

Figure 4: US Size and Style

In Millions	September	Year to Date	Trailing Three Months	Trailing Twelve Months
Broad Market	2,765	17,656	6,194	25,771
Large-Cap	14,290	33,959	25,683	74,926
Mid-Cap	2,797	9,615	5,391	14,898
Small-Cap	3,920	21,693	7,965	28,045
Growth	1,216	28,144	7,468	37,861
Value	1,507	11,421	7,413	20,459

Top two and bottom two categories per period are highlighted. Source: Bloomberg Finance L.P., State Street Global Advisors, as of September 28, 2018.

Two of a Kind

Fixed income ETF flows continued to be dominated by aggregate and government exposures, defensive-oriented segments that balance out equity risk in portfolios. September continued a year-long trend, with aggregate and government exposures now accounting for 66% of the $70 billion that have flowed into bond ETFs this year.

Investment grade (IG) rated debt is having its worst year of performance since 2013 when bond markets were gripped by a "Taper Tantrum." Nonetheless, investors poured $2.5 billion into the segment in September, raising the 2018 total to just under $10 billion. Interestingly, investors fled high yield ETFs, even as the segment posted positive returns.

High yield ETFs which took in $1.6 billion in August saw the equivalent level of outflows in September.

Bank loan and emerging market bond funds may be the substitute income-generating asset class for those leaving high yield. Bank loans, whose floating rate structures allow their income potential to increase with Federal Reserve (Fed) rate hikes, took in $358 million last month. Given that the Fed appears to remain steadfast in continuing to hike rates for the foreseeable future, bank loan inflows may persist. EM bonds also returned to favor last month, taking in over $800 million as investors sought out potential value in the sector, considering spreads had widened out by over 70% in the past year, but peaked during the month.

Figure 5: Fixed Income Sectors

In Millions	September	Year to Date	Trailing Three Months	Trailing Twelve Months
Aggregate	2,376	20,426	5,803	31,829
Government	1,863	25,122	5,654	24,823
Inflation Protected	297	5,076	676	7,386
Mortgage-Backed	144	3,826	1,000	5,366
IG Corporate	2,497	9,936	4,390	15,975
High Yield Corp.	-1,506	-3,539	2,328	-3,960
Bank Loans	358	1,267	70	973
EM Bond	821	3,123	1,987	4,839
Preferred	-543	19	579	471
Convertible	65	543	349	384
Municipals	55	3,566	814	5,493

Top two and bottom two categories per period are highlighted. Source: Bloomberg Finance L.P., State Street Global Advisors, as of September 28, 2018.

The Long Game

For the first time this year, long duration exposures (+10 years) led maturity segment inflows on a monthly basis, taking in $2.2 billion, nearly doubling their year-to-date haul in just a month. Given that the segment has the lowest asset base of any duration segment, with just $12 billion in assets, this reflected 20% asset growth in September alone.

Flows on the long end indicate income-seeking or liability-driven investors' appetite for yield when rates spike over 3%, as they did in September. This trend supports a curve inversion in 2019, as the long end remains constrained by secular forces while the short end is impacted by monetary policy.

Figure 6: Fixed Income Maturity Flows

In Millions	September	Year to Date	Trailing Three Months	Trailing Twelve Months
Ultra Short	-58	9,560	728	11,972
Short Term	369	7,904	1,922	8,355
Intermediate	-16	4,732	679	4,055
Long Term (>10 yr)	1,778	3,437	2,610	1,014

Top two and bottom two categories per period are highlighted. Source: Bloomberg Finance L.P., State Street Global Advisors, as of September 28, 2018

A Dry Board

Despite the uptick in geopolitical tensions, precious metals, led by gold-backed funds, again saw outflows. However, the $153 million of outflows in September was a steep deceleration from August's $1.9 billion outflows. The year-to-date outflows for gold-backed ETFs, even with rampant uncertainty, are likely due to the outsized appreciation of the dollar, as gold and the dollar have an inverse relationship.

This backdrop for gold is like playing a hand against a dry poker board, where the cards on the table mean a strong hand is unlikely, no matter what is held in the pocket.

Broad-based commodities, as a result, now lead year-to-date. Positive flows into this segment may be another indication of late cycle positioning, as producer price input prices have risen and investors are positioning accordingly.

Figure 7: Commodity Flows

In Millions	September	Year to Date	Trailing Three Months	Trailing Twelve Months
Precious Metals	-153	-2,139	-2,627	-2,623
Industrial Metals	-28	-70	-96	-64
Energy	-68	-1,598	-306	-2,345
Broad Based	410	2,592	83	3,104
Agriculture	-35	12	-109	-54

Top two and bottom two categories per period are highlighted. Source: Bloomberg Finance L.P., State Street Global Advisors, as of September 28, 2018.

An Active Player

After growing assets by more than 50% in 2017, active ETFs have grown their assets by 43% so far this year, adding another $2.6 billion in inflows in September. The bulk of this remains in fixed income exposures, which account for 70% of active ETF assets.

Smart beta funds, which have taken in $20 billion this year and $3.6 billion in September alone, continue to see elevated interest as investors take an increasingly factor-based investment approach, though applying a smart beta lens to sector based strategies is less sought after.

ESG funds continue to see heightened allocations, taking in $1.4 billion in 2018, representing 18% asset growth. And ESG funds' AUM is approaching the $10 billion mark.

Figure 8: Strategy Type

In Millions	September	Year to Date	Trailing Three Months	Trailing Twelve Months
Active	2,622	20,125	7,597	25,062
Smart Beta	3,919	20,867	7,669	34,294
Sector Smart Beta	-118	522	430	732
ESG	258	1,404	450	1,882

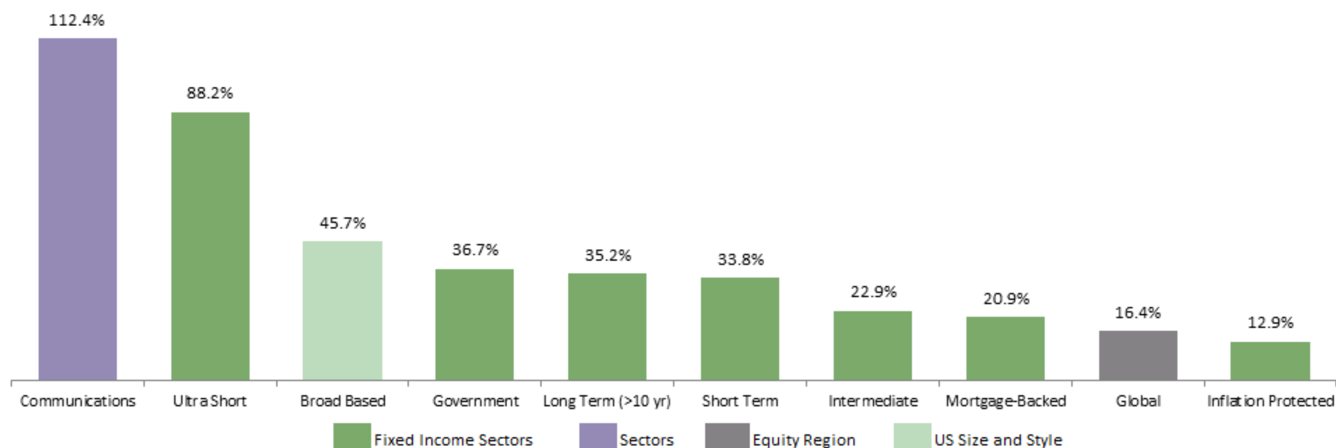
Top two and bottom two categories per period are highlighted. Source: Bloomberg Finance L.P., State Street Global Advisors, as of September 28, 2018.

A Big Bet Game

Throughout this piece I have referenced flows as a percentage of start-of-year assets. When dissecting flow patterns, this metric helps us discern noticeable shifts in buying behavior. For instance, equity flow totals will more likely than not be higher than fixed income throughout a given period, purely based on their size of AUM. However, showing the growth rate indicates adoption and usage.

Figure 9 summarizes the top 10 areas that witnessed the largest flow totals as a percent of start of year assets in 2018 in the Equity Region, US Sectors and Fixed Income Sectors categories. Not surprisingly, fixed income sectors are well represented. However, they trail the massive interest into the new GICS sector, Communication Services. Given the size of the sector change, this is likely only the beginning.

Figure 9: Flows as a Percentage of AUM
Year-to-date (% Start of Year AUM)



Source: Bloomberg Finance L.P., State Street Global Advisors, as of September 28, 2018.

References & Definitions

1 Teddy KGB is a fictional character played by John Malkovich in the 1998 poker movie *Rounders*
2 Worm is a fictional character played by Edward Norton in the 1998 poker movie *Rounders*

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. The index includes Treasury, government agency bonds, mortgage-backed

bonds, corporate bonds and a small amount of foreign bonds traded in the US.

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 USD High Yield Corporate Bond Index
The Bloomberg USD High-Yield Corporate Bond Index is 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.

Dow Jones Industrial Average
The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

CBOE SKEW Index
An index derived from the price of S&P 500 tail risk. Similar to VIX, the price of S&P 500 tail risk is calculated from the prices of S&P 500 out-of-the-money options. SKEW typically ranges from 100 to 150.

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 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-caps 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.

Spread
The difference between a securities yield and the yield on a reference security.

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.

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