Sector Spotlight: XLF through the lens of Qi's Macro Factor Equity Risk Model (MFERM)

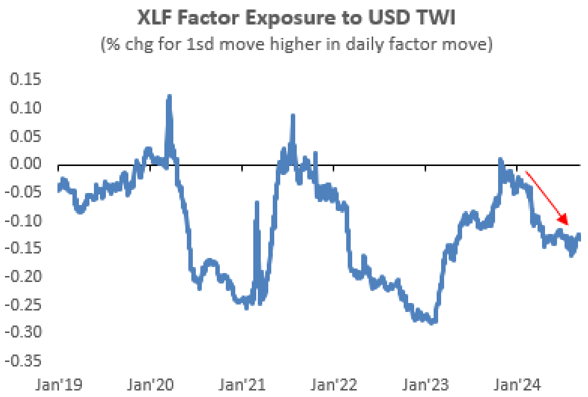
US Financials are the poster child of the rotation trade. They have led the rally over the last month and sit close to ATHs. In many ways the sector is a litmus test for US equities more broadly – as recession risks rise, navigating the trade off's between hard and soft landings whilst the Fed engineer easier financial conditions is critical.

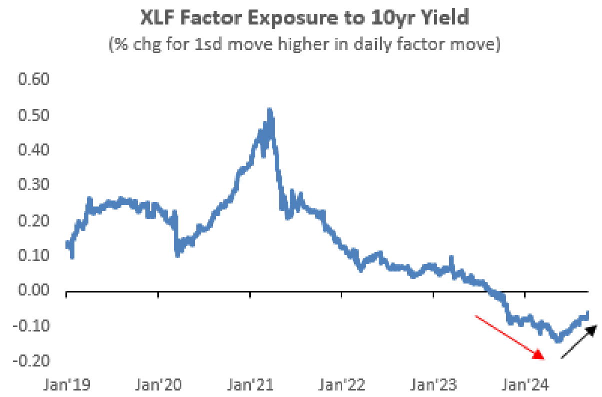
The first step in that process is understanding what factors XLF is exposed to. Both macro versus idiosyncratic, & then within macro which factors matter most. Thereafter, only by decomposing risk and returns can we understand what role macro will play over company fundamentals. And, more specifically, which macro factors will dictate Financials performance into year-end.

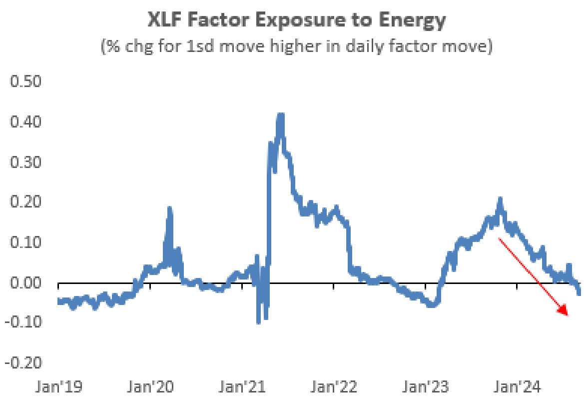
Thus far, XLF has demonstrated confidence in the credit cycle – HY credit spreads are not back at their tights despite XLF at the highs. It is likely we remain a macro-dominant regime through to year end.

What have been the major XLF macro exposures ytd?

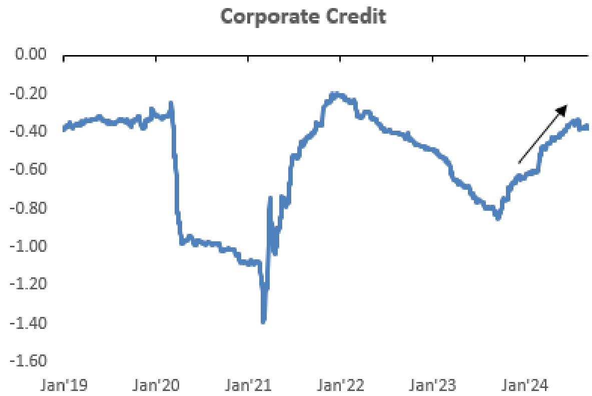
- Through 2024, XLF has benefited from a weaker dollar, falling 10yr yields and, since the Spring, falling energy prices and a steeper 5s30s curve; i.e. the focus ytd has been the easing in financial conditions.







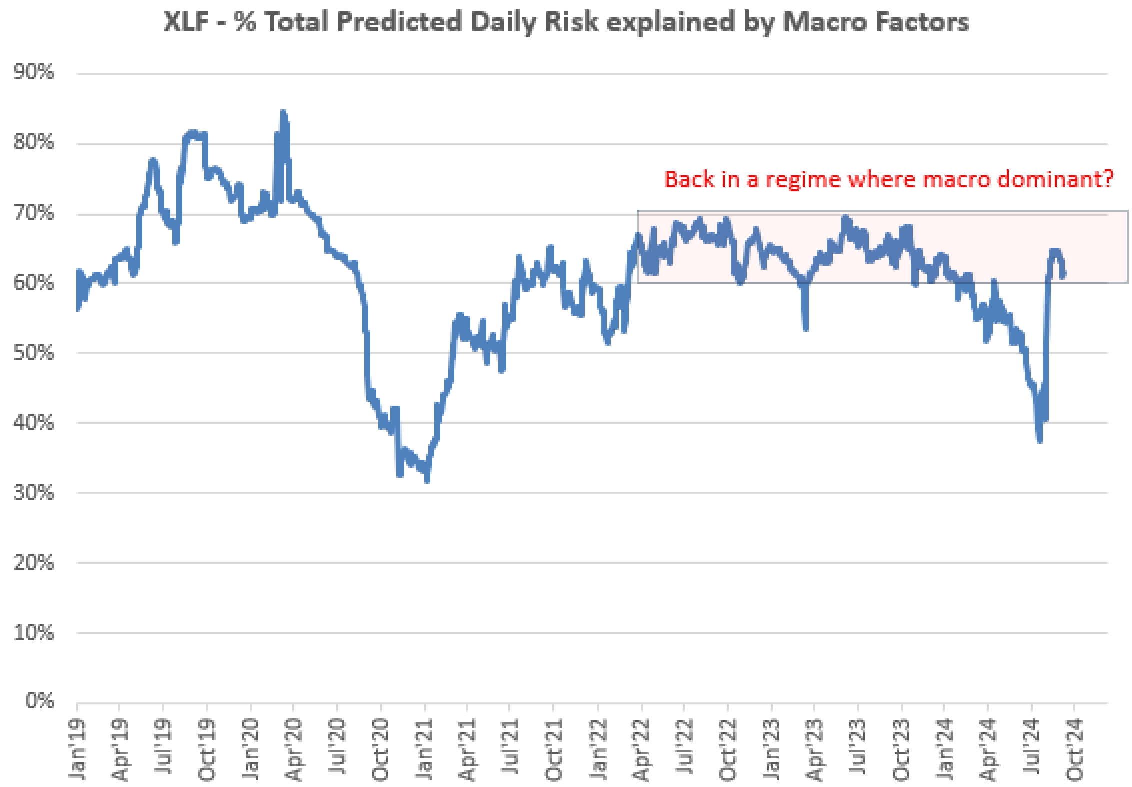
- This has also occurred in a backdrop where there is confidence in the credit cycle – the XLF factor exposure to risk aversion and HY credit spreads have dissipated to cycle tights.



<u>If the balance of risks shifts towards recession, what changes should we look out for?</u>

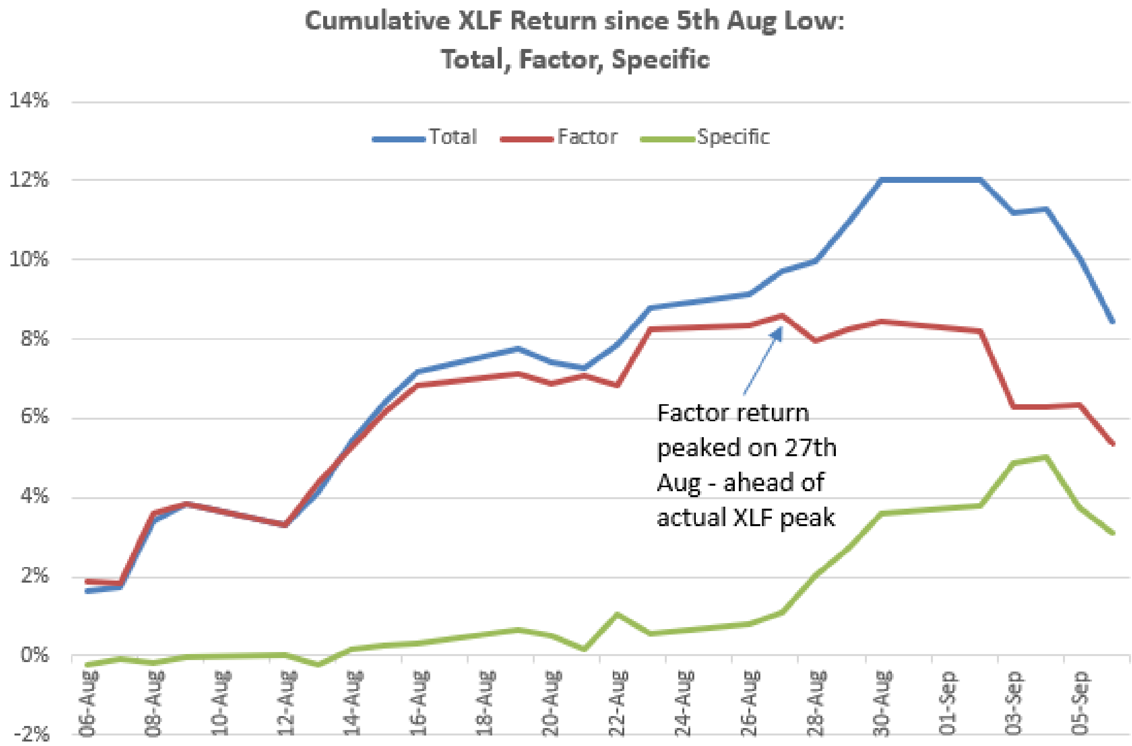
- With the balance of risks shifting towards to recession risks, we would expect to see in that backdrop:
    - the exposure to 10yr yields moving towards positive territory; i.e. higher yields / higher XLF
    - the positive exposure to a steeper 5s30s curve continue to rise; i.e. pressure remains high on the Fed to cut
    - the negative exposure to corporate credit and risk aversion to not be so sanguine but rather increase; i.e. credit cycle fears rise

- This would also manifest itself back to a regime where macro dominates XLF predicted risk. Early July reflected complacency. Today, we may have returned back to a macro dominant regime to understand risk.



Macro has dominated both XLF returns and risk since early July

- Macro has also the dominant driver of returns since early July. See the chart below, showcasing the close relationship of XLF to the attributable factor return over the last month (reflecting XLF's exposures to those factors and the underlying moves in the factors themselves). Like we have seen before, the XLF factor return seems to have peaked a few days before the actual ETF peak. If we suspect macro is to remain dominant, bulls want to see the XLF attributable factor return component trough and move higher.



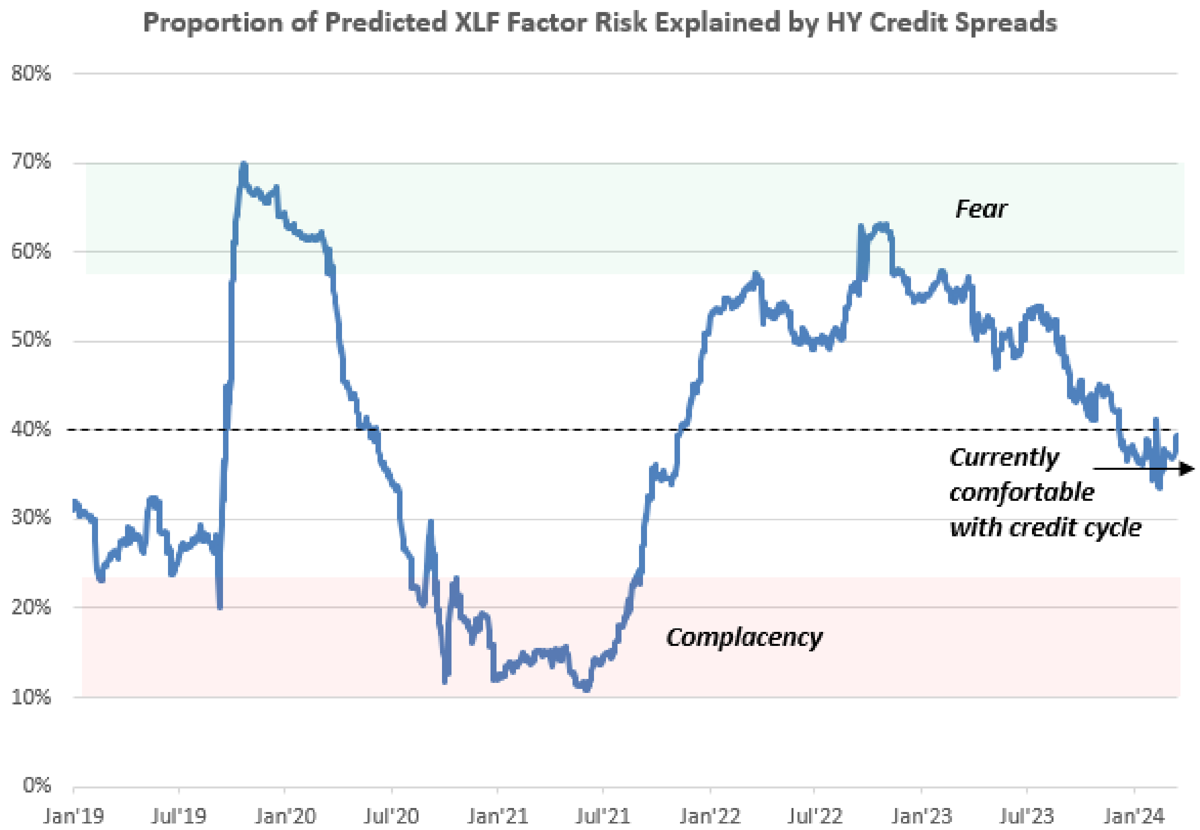
- What explains the descent in the XLF factor return from its peak on 27th August? The table below showcase the attributable return by individual macro factor. Reflecting slowdown fears - the jump in credit spreads and risk aversion, alongside dollar strength and the large drop in inflation expectations capture the bulk of the decline.

XLF Return Attribution: Aug 27th to 6th Sep			
FCIs	CB QT Expectations	-0.01%	
	CB Rate Expectations	0.01%	
	Corporate Credit	-1.48%	*Jump in HY credit spreads*
	DM FX	-0.19%	*Dollar strengthens*
	Real Rates	-0.07%	
	10Y Yield	0.15%	
Growth	Economic Growth	0.03%	
	Energy	0.12%	
	Forward Growth Expectations	0.05%	
	Inflation	-0.66%	*Large drop in infl exp*
	Metals	0.06%	
Risk	Risk Aversion	-1.05%	*Jump in VIX*
	Factor	***-3.04%***	
	Specific	***1.90%***	
	Total	***-1.14%***	

Watch the exposure and risk attributable to HY credit spreads – that may well tilt the scales

- Looking ahead, the Fed has never started an easing campaign with 50 basis points when credit spreads were this tight and unemployment this low. There is plenty of uncertainty: This point in the calendar is hard for risky asset assets – Will the Fed begin the rate cut cycle aggressively from the get go? Will we see a proper rise in the UE rate? Who will win the US election? There are 7 long weeks between Sep FOMC and Nov FOMC.

- We would say watch financial conditions – that will tilt the scales:
    - Watch if the XLF negative exposure to credit spreads becomes larger
    - Watch if the XLF predicted vol attributable to macro continues to rise and if HY credit spreads can explain a larger proportion of the risk. Currently, the factor vol attributable to HY credit spreads is in-line with its long run average contribution i.e. the market is still comfortable with the state of the credit cycle. We should stay alert if we see this start to lurch higher



This is a case study showcasing the power of Qi's *Macro Factor Equity Risk Model*. Qi clients can train any single security or portfolio of assets on the same framework. Thereby identifying their macro factor exposures, and decomposing both their risks & returns into macro versus idiosyncratic. Finally by revealing which specific macro risks they are running, clients are in a position to consider which hedging strategies may be required.