Sector Rotation Through the Eyes of Relative Rotation Graph (RRG)

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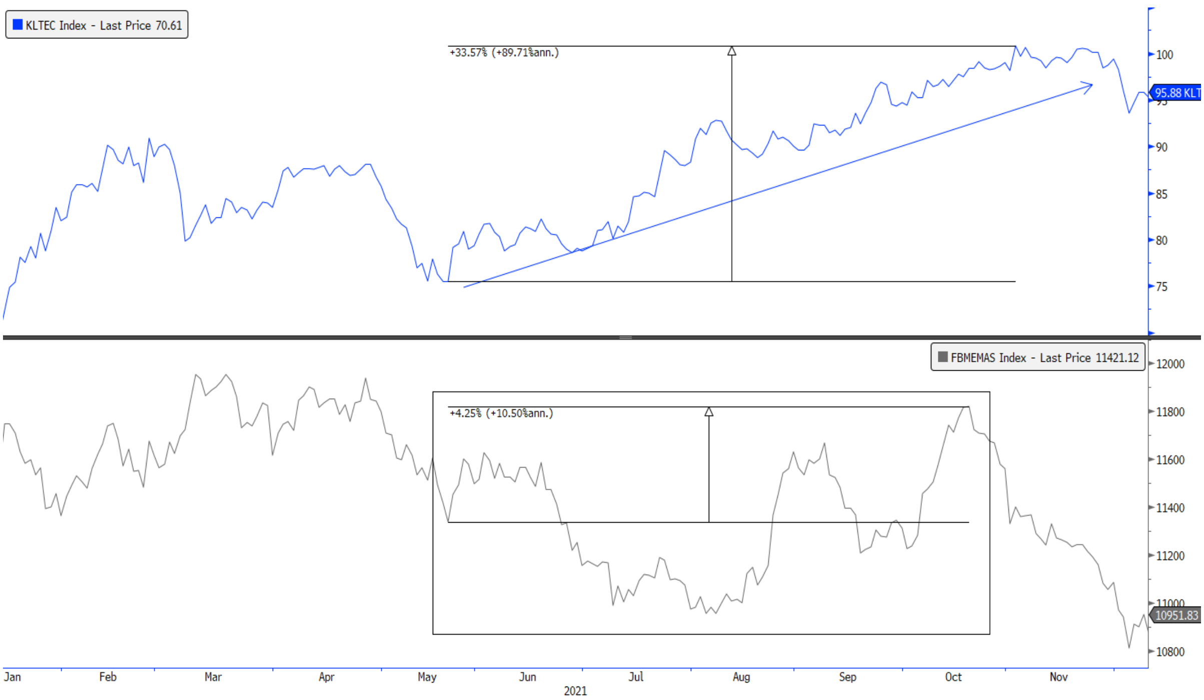
Rotation in a nutshell. Rotation is the movement of money from one asset class/sector/stock to another given a set of macro and micro considerations. During the period of market correction phase, rotations across and within sectors could happen as funds attempt to manage their downside risks while staying invested as per their investment mandates. Hence, rotation most often produces leaders/laggards across asset classes/sectors/stocks, thus generating investment/trading opportunities.

Volatile macro events are making the ability to rotate investments even more important. Global geopolitical events, increase in trade protectionism on the ground of national security, and also COVID-19 in recent years, have resulted in more volatile price movements across asset classes and sectors. As such, investors' ability to spot signs of rotation to adjust their portfolio has become even more crucial in determining their portfolio's return.

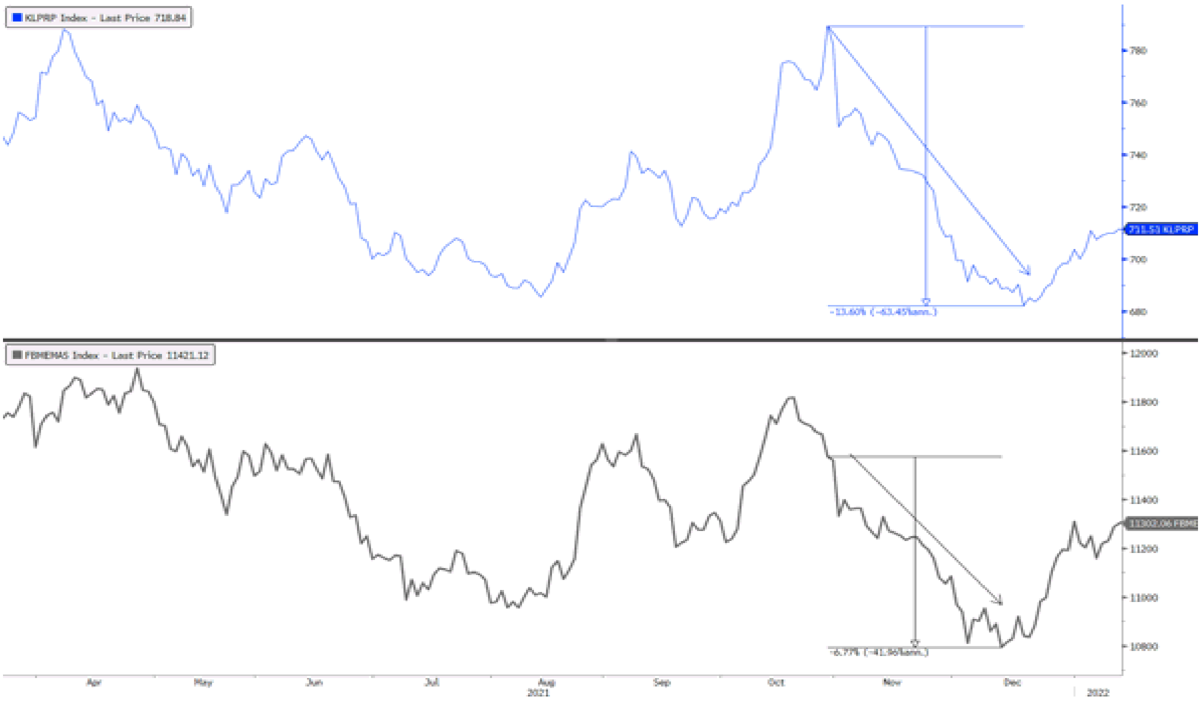
Sectorial rotation in the long-term sideways broad market to generate an above-benchmark return. On the local front, the benchmark FTSE Bursa Malaysia KLCI Index (FBMKLCI) and FTSE Bursa Malaysia Small Cap Index (FBMSC) have been traded sideways since 2014. Sectorial rotation under such market condition would be important in generating above-benchmark returns. Looking at the 13 sectorial sub-indices (this note largely focuses on sectorial rotation) maintained by Bursa Malaysia, only a handful of these indices are able to produce positive price returns (the 13 sectorial indices are price-only indices i.e ex-dividend) over a 3/5-year time horizon. However, on a closer look, these sub-indices are not always moving in a symmetrical fashion i.e they are not always trending in the same direction. Even if they do, their strength/momentum could be very much different, thus opening the possibility for sectorial rotation trades to take place.

Figure 1: Bursa Malaysia Technology Index (Blue line chart) outperformed the FTSE Bursa Malaysia Emas Index (Grey line chart) - non-symmetrical i.e positive absolute and relative returns vs the Benchmark that mostly traded in a negative zone during the May-Nov 2021 period.



Source: Bloomberg

Figure 2: Bursa Malaysia Properties Index (Blue line chart) trended lower as the FTSE Bursa Malaysia Emas Index (Grey line chart) – both produced negative absolute returns but the former underperformed the Benchmark with a negative relative return during the Nov-Dec 2021 period.



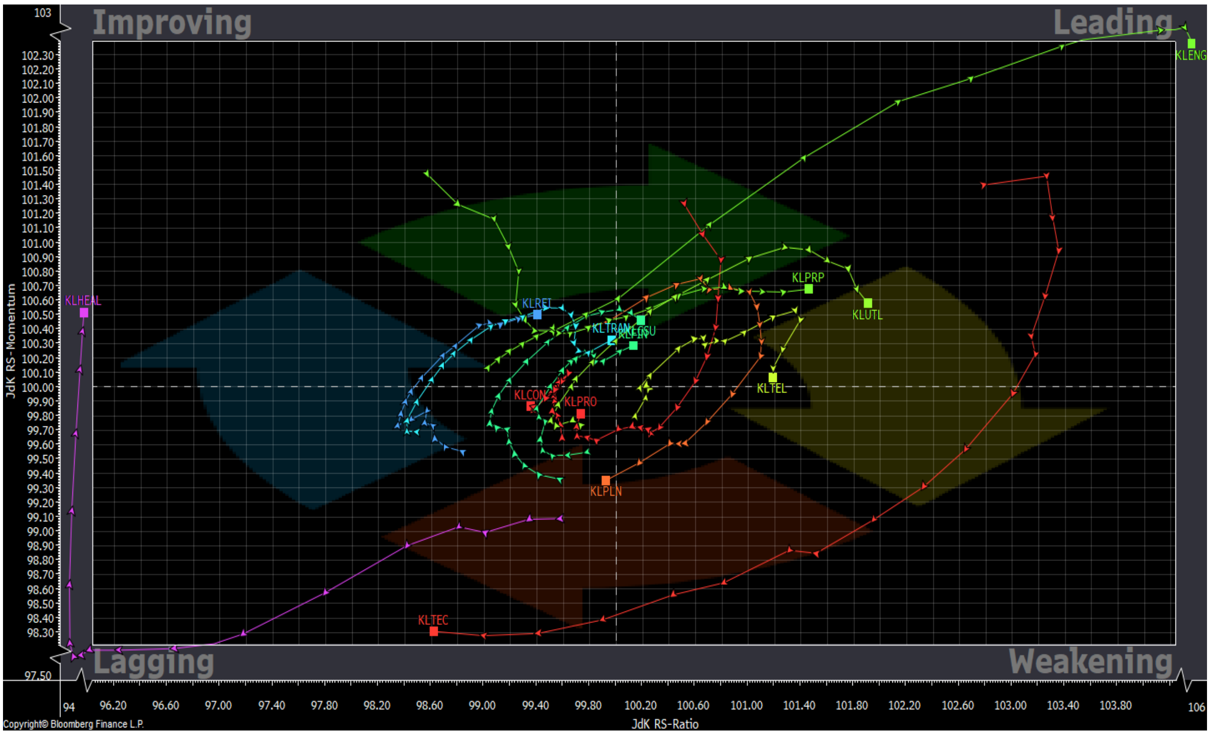
Source: Bloomberg

Relative Rotation Graph (RRG). One tool that technical analysts use in screening for signs of sector/stock rotations is the RRG. It is crucial for readers to understand the technicalities of RRG. Readers may understand more about RRG at here.

RRG is not a market timing tool. It is important to highlight that RRG is a lagging tool and by itself is not a market timing instrument. Our observations suggest investors would be better served by combining RRG analysis with market-timing systems in defining the entry/exit point and crucially, the risk management (risk/reward ratio) of a trade. Also, to re-iterate, RRG is used to visualise relative performance of a security vs a benchmark i.e in a declining broad market, RRG could show a declining sector/stock outperforming the benchmark if the Individual sector/stock's rate of decline is milder than the benchmark. This implies RRG could be used to screen for relative trade opportunities i.e long the "Leading" names and short the "Lagging" names concurrently.

Daily RRG of sectorial indexes – the Leading, Weakening, Lagging & Improving. The following depicts the daily RRG of 13 Bursa Malaysia Sectorial Indices vs the Benchmark - FTSE Bursa Malaysia EMAS Index (FBMEMAS). Sectorial indices located on the right quadrant (labelled as "Leading" and "Weakening" are the relative outperformers, whereas the ones in the left quadrants (labelled as "Lagging" and "Improving") are the ones that underperforming the Benchmark.

Figure 3: Daily RRG of 13 Bursa Malaysia Sectorial Indices vs FBMEMAS (benchmark) - data as of 2 September 2022



Source: Bloomberg

Figure 4: Daily RRG of 13 sub-indices vs FBMEMAS (benchmark) - table

<u>Improving</u>	<u>Leading</u>
Healthcare REIT Transportations & Logistics	Energy Utilities Property Telco & Media Consumer Finance
<u>Lagging</u> Technology Constructions Industrial Plantations	<u>Weakening</u> nil

Source: Bloomberg

Combining RRG with trend analysis. In the following section, we illustrate how to use RRG (cut-off: 2 September) as a sectorial rotation screening tool and combine it with trend analysis on selected individual sectorial indexes to highlight possible opportunities.

Case 1: Energy (RRG - Leading quadrant)

On the RRG, the Bursa Malaysia Energy Index has crossed into the Leading quadrant from the Improving quadrant. However, after the recent sharp outperformance, it is now showing early signs of curving down – indicating a possible consolidation.

On price chart (Figure 5), the index has been traded sideways since the pandemic's low. However, it experienced a relatively firm rebound between Mid-July to End-August. The rebound stalled around the 100- and 200-day SMA lines recently and the index has been developing a possible minor consolidation over the past sessions. For now, provided the index is keeping above the support line (green color), the index's immediate-term trend can still be seen as positive. Readers may also refer to our report: https://bit.ly/3PCwxJr issued on 23 August where we highlighted oil markets' macro development.

Figure 5: Bursa Malaysia Energy Index

Source: Bloomberg

Case 2: Technology (RRG – Lagging quadrant)

The Bursa Malaysia Technology Index (KLTECH) has been curving down on the RRG from Leading > Weakening and is now in the Lagging quadrant. The 20 days observation suggests the index's recent outperformance has peaked and it is now underperforming the Benchmark

On the index's price chart (Figure 6), it rebounded between Mid-July to Early-August and peaked around the 50- and 100-day SMA lines resistance zone. Price actions suggest it is more likely that the index has been rejected from the said resistance zone and that a pullback is taking place. Readers may also refer to our report: https://bit.ly/3pknO3M issued on 15 August where we highlighted consensus calls on the sector and the technical state of KLTECH.

Figure 6: Bursa Malaysia Technology Index

Source: Bloomberg

Case 3: Healthcare (RRG – Improving quadrant)

For the last 20 days, relative to FBMEMAS, the Bursa Malaysia Healthcare Index has travelled in a classic RRG clockwise fashion from Leading > Weakening > Lagging and now the Improving quadrant. The latest quadrant suggests that while the index is still trading in a weak trend, there are signs that the momentum of the weak trend is fading. A negative trend that is losing momentum could open the door for security prices to stabilise or even stage a counter-trend rebound. However, this possibility still has to be confirmed by price actions and supported by volume.

Looking at the index's price chart, indeed the price retracement has been less aggressive since Mid-August and the Daily RSI is also flashing out a positive divergence on the back of an oversold reading. For this index, what investors are likely looking for now are signs of a positive reversal (bullish candlestick patterns or recapturing of the previous lower highs) signal before eying for possible sideways trading opportunities.

Figure 7: Bursa Malaysia Healthcare Index

Source: Bloomberg

Conclusion. The fast-changing macro environment is likely to continue to cause asset prices to trade in a volatile trend. As such, sticking to the same investment ideas for far too long (emotionally attached to a sector or failure to reckon and accept changes in a sector's dynamics) could jeopardise the risk-return prospects of a portfolio. RRG is one of the methods where investors may consider in detecting changes in market's narratives and to trigger a re-assessment on their investment holdings. While this tool is useful in screening for rotation plays, for investors who are looking for trading signals/confirmations, separate market timing systems would be needed.