

The Toothpaste Indicator:

Why the Market is More Fragile Than It Looks

By Gill Segal, UNC Kenan-Flagler

If you've been watching the screens lately, you've felt the shift. Bitcoin has stumbled below \$70k, shedding its "digital gold" narrative for the moment. Software stocks—the darlings of the last decade—are suddenly looking vulnerable. The market feels heavy.

Wall Street's favorite playbook for moments like this is **Sector Rotation**. The logic is simple: when investors get nervous, they sell "offense" (Consumer Discretionary) and buy "defense" (Consumer Staples). They dump the vacation bookings and buy the toothpaste.

But is this rotation just a backward-looking reaction, or does it create a forward-looking *prediction*?

I decided to test this by analyzing the relationship between **Consumer Staples and Consumer Discretionary** stocks. What I found wasn't just a trading signal—it was an (apparent) disconnect between the "headline" market and the real economy.

Before looking at the results, we have to understand the two competing academic views on what this ratio represents.

1. The Information Channel (Momentum)

In their seminal 2007 paper, *Do Industries Lead Stock Markets?*, Hong, Torous, and Valkanov argued that industries like retail contain vital macroeconomic information that diffuses *slowly* into the broad market. In their framework, strength in Discretionary stocks is a "tell" that the economy is stronger than the S&P 500 realizes, predicting *higher* future returns.

2. The Risk Premium Channel (Valuation)

Practitioners often take the opposite view. They see the relative strength of Staples as a "Fear Gauge." When investors flock to Staples (driving the Staples/Discretionary ratio up), it signals that risk premiums are resetting. Conversely, when investors ignore Staples to chase luxury and leisure, it signals complacency. In this world, a rotation into Staples (fear) should predict *higher* future returns.

So, who is right?

I ran a predictive regression for 1-year ahead S&P 500 returns using two different versions of the **Staples-to-Discretionary** ratio over the last 20 years. To ensure this wasn't just "data mining," I split the sample in half (estimating on the first decade,

forecasting on the second) and used Newey-West standard errors to account for overlapping data.

- **The "Whale" (Value-Weighted):** The standard Wall Street ratio using **XLP vs. XLY**. These ETFs are market-cap weighted. XLY is heavily influenced by a few mega-cap discretionary names (e.g., Amazon), and XLP by a few mega-cap staples names (e.g., Procter & Gamble).
- **The "Fish" (Equal-Weighted):** A ratio using **RSPS vs. RSPD**. This treats every stock the same—the \$5B regional retailer matters just as much as Amazon. It measures the *average* company, not the biggest.

The Results

1. The Value-Weighted Ratio (XLP/XLY) is Blind

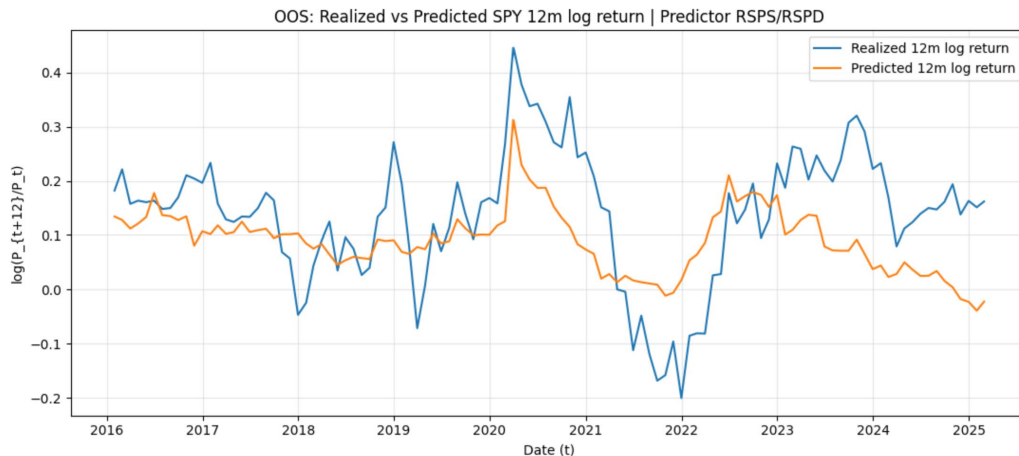
When I used the standard cap-weighted ratio, the model failed completely. The predictive power was non-existent, and the Out-of-Sample R^2 was negative (-37%), meaning you would have been better off just guessing the historical average. The "Whale" is too concentrated to see the turn.

2. The Equal-Weighted Ratio (RSPS/RSPD) is Clairvoyant

When I switched to the Equal-Weighted ratio—measuring the "average" economy—the signal lit up.

- **Sign:** Strongly Positive. When Staples outperform Discretionary (the ratio rises), future market returns are **high**.
- **In-Sample R^2 :** ~17%.
- **Out-of-Sample (OOS) R^2 :** 37%.

My data overwhelmingly supports the **Risk Premium Channel** over the Momentum Channel. When the average investor gets fearful and rotates into Staples, the market becomes cheap, setting the stage for a rally. When they ignore Staples, the market is fragile.



Why does the "Average" stock know the future while the "Index" stock doesn't?

This is a classic case of distortion. The Value-Weighted ratio (XLP/XLY) is dominated by idiosyncratic tech narratives. If Amazon has a blowout earnings call, the sector index spikes, masking the fact that 40 other smaller retailers might be warning of a slowdown. Investors watching the major ETFs are effectively blinded by the "Mag 7" noise.

The Equal-Weighted ratio strips away that noise. It captures the true, broad-based sentiment of the American consumer. It is a pure macroeconomic signal that the headline indices—and the investors watching them—are ignoring until it's too late.

The Forecast: Where are we now?

This brings us to today, February 2026.

While the headline indices have been fighting to stay near highs, the **Equal-Weighted Staples/Discretionary ratio** is flashing a warning—not because it is high, but because it remains stubbornly **low**. Despite the recent chop in Bitcoin and software, we have not yet seen a meaningful rotation into the "average" defensive stock. The "Greed" level in the broader economy is still elevated relative to the safety of Staples.

Based on data through the end of February 2026, my model's forecast for the S&P 500 over the next 12 months is:

-2.99%

The rotation into Staples hasn't been violent enough to reset the risk premium. Until the average investor starts panic-buying toothpaste and selling their vacation stocks (driving the Staples ratio higher), the path of least resistance for the broad market remains lower.