GLOBAL X
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Date: 9/9/2021
Topic: Sector Views

Inflation and Delta Make Their Mark on the Recovery

Earnings in Q2 were strong, but rising labor costs and lingering supply chain issues were big topics of conversation on earnings calls. These inflation indicators are two major reasons why the market consensus currently expects earnings per share (EPS) growth in the S&P 500 to slow from 27% in Q2 to 17% in 3Q and 22% in 4Q on a 2-year basis.[1] One of the central questions for the market right now is whether the recent acceleration in inflation is transitory or not. If it is something else, how will the Federal Reserve (Fed) proceed?

By sector, companies in the Staples and Materials sectors had the most inflation mentions during Q2 earnings calls. Industrials and Consumer Discretionary, two of the most labor-intensive sectors in the S&P 500, accounted for the most labor inflation mentions. Industrials firms spoke about supply chain inflation the most, while Materials firms referenced inflation in raw material and transportation the most. Looking ahead, the latest consideration for Industrials and Materials is the passage of the $1.2 trillion bipartisan infrastructure bill, as both sectors should be direct beneficiaries over the next decade.

Wage pressure remains a tailwind for earnings, with prices and unit volume growth still outpacing wage costs. However, the dynamics could change if economic growth slows, or companies can't pass through costs. The Consumer Discretionary sector is at most risk from rising wage inflation.

Lingering supply-side constraints continue to hover over the U.S. recovery. The Port of Los Angeles has set a new record for backlogged container ships, with 44 vessels waiting to unload their goods. Hurricane Ida may further stretch supply chains. There will be inevitable disruption owing to the need for building materials which are already in short supply, as well as complications for energy companies whose production, refining and transport infrastructure was directly in the path of the storm. Roughly 4.4 million barrels of crude refining and 6.5 million tons of ethylene production annual capacity is located within the storm's path.[2]

Should the supply side languish further, and the COVID Delta variant increasingly affect consumer behaviors, the risk is that consumer spending slows while precautionary savings rise. This may already be playing out, as retail sales fell 1.1% month-over-month (m/m) in July while the savings rate ticked up slightly.[3] Bank of America aggregated credit card data shows that consumers pulled back on their spending during the month, especially for leisure services.[4] August's Consumer Sentiment rating was the weakest in over a decade as expectations slumped and personal financial prospects worsened. Delta is clearly weighing on the minds of consumers who remember their quarantine lifestyles all too well.

Despite weakening consumption data, the minutes from July's Federal Open Market Committee's (FOMC) meeting indicated that a majority of members want to start tapering the Fed's monthly $120 billion bond purchases this year. Powell indicated at Jackson Hole that the Fed could begin slowing down asset purchases but is not in a rush to raise interest rates owing to stubborn employment data.

Powell said tapering should not be interpreted as a direct precursor to rate hikes. The plan remains to hold the federal funds rate "until the economy reaches conditions consistent with maximum employment, and inflation has reached 2% and is on track to moderately exceed 2% for some time." On that front, Powell said the economy has much more to prove. The markets jeered the guidance, but we feel Powell is playing with fire and is at risk of reinforcing inflation.[5]

Sector Views

As we distill down our sector calls for August, the main points we incorporate concern rising rate exposure, consequences of lasting inflation, and valuation risks amid a quickly nearing stimulatory event consisting of trillions in additional infrastructure spending.

CURRENT VIEWS ON U.S. SECTORS

	Positive Factors	Negative Factors	Overall View
Communication Services	Communications Services continues to benefit from COVID-19 disruption increasing the adoption of digital communication, entertainment, and advertising. The potential for reinstituted COVID-19 restrictions due to the delta and other variants could also benefit this sector. Companies in this sector have resilient fundamentals. Improved economic growth sentiment may shift attention to value-focused segments, but we believe that the balance between growth and value is likely to improve into the second half.	Adversely impacted by the semiconductor chip shortage. Value rotation If interest rates rise, there could be risk to margins and/or access to capital. There is bipartisan support for increased regulation in this space. The start of antitrust investigations into mega-cap internet companies is also a risk factor for the sector. However, this likely is not a near term threat.	**Market weight** Currently, our preference is the Social Media segment.
Consumer Discretionary	The Consumer Discretionary sector stands to benefit from pent-up demand and an elevated savings rate. High demand may offset increased cost pressures. Consumers adapted to the pandemic environment by increasing their use of online ordering and delivery and instore pickup.	We believe that the Consumer Discretionary sector is likely to be the sector impacted the most by the current supply chain bottlenecks. Additionally, as the most labor-intensive sector, it has a lot to lose from wage pressure.[6] Supply chain bottle necks have not dissipated as many expected, with the late summer seeing the Port of L.A. reaching a new record for backlogged container ships.[7] A sharp decline in Consumer Sentiment and disappointing retail	**Market weight**

		sales suggest consumer demand is weakening. High valuations make this sector vulnerable to rising interest rates. Higher taxes will have an effect on this sector. Antitrust or increased regulations have the potential to negatively affect large e-commerce players. Large companies in this space may be forced to separate their logistic and platform operations from their private label business.[8]	
Consumer Staples	Consumer Staples could be a good defensive hedge against rising COVID-19 cases. During the pandemic, spending patterns shifted to favor essential retail. If Delta variant case increases persist, this sector could see steady demand in the event of an economic downturn, due to its low level of correlation with economic cycles. Secular shift into e-commerce. This sector has benefited from higher demand for household products, PPE, and disinfection products. Staples have less valuation risk in the event rates move higher.	Consumer Staples have been impacted by higher input costs and labor shortages. Higher prices have started to be passed onto consumers while labor shortages remain a constraint to restoring full production capacity.[9] Consumer spending is likely to shift away from necessities and towards discretionary as vaccine distribution continues. We believe the abundance of choice is likely to weigh on this sector unless pricing pressure reaches the point where consumers need to prioritize staples. While there is pricing pressure, at this stage we do not believe that this risk is likely to be realized.	**Market weight**
Energy	The Energy sector benefits from increased community mobility. As people start re-engaging in society, whether commuting, traveling, or simply getting on with their normal lives, demand for crude products should rise. While the U.S. has largely reopened, crude demand stands to benefit from a global reopening and improved growth. Damage from Hurricane Ida will likely reduce oil production and refining for	The Energy sector is dependent on global demand and mobility. Consequently, this sector is one of the most sensitive to rising COVID-19 cases. The increased spread of the Delta variant is a risk to improved global mobility. President Biden's intentions raise the risk of increased regulation and secular headwinds from renewables. ESG thinking is increasingly incorporated into corporate governance, so even without	**Market weight**

	some time, increasing energy costs.	regulatory shifts, the market is leaning into cleaner alternatives.[10] Damage from Hurricane Ida may increase distribution disruption and repair costs.	
Financials	The Financial sector benefits from transitory inflation that is good for GDP. Provided the spike in inflation readings reflects the faster-than-expected improvement in economic activity and temporary supply challenges can be resolved.[11] The sector stands to benefit from the shift from growth to value as the market looks forward to the economy reopening more in the second half. This sector benefits from higher interest rates and a steeper yield curve. Incoming Federal Reserve policy changes are likely to benefit the sector.	Declining rates are a risk, as seen in the first half of July, but we believe rates have already bottomed. Disinflationary pressures from disruptors including fintech. This sector remains highly exposed to the impacts of COVID-19.	**Overweight** Our preferences in this space are financial technology and banks.
Health Care	The Health Care sector remains a defensive hedge against increased COVID-19 cases. Pandemic related R&D spending increases may drive innovation and spur adoption of advanced technologies such as genomics for years to come. Upcoming vaccine booster shots look to be a boon for both pharmaceutical manufacturers and care providers.[12]	Drug pricing pressure remains a risk factor. The Biden platform advocates lowering the Medicare qualification age and reducing reimbursement rates for hospitals, two policies that could potentially reduce revenue for hospitals, although volume increases may offset.	**Overweight** Our preferences in this space are biotech and genomics.

Industrials	The Industrials sector combines cyclicality with a quality orientation.[13] Potential tailwinds for this sector include: • Reshoring of supply chain. • Automation • Improved certainty about tariffs and taxes could unleash pent-up capex in non-tech sectors.[14] • Increased investment to expand productivity and raise productivity, should elevated inflation become permanent.[15] Both infrastructure bills are advancing through congress and currently look to have sufficient support to pass, which should benefit this sector for years to come.	Leverage in the sector may pose a risk. The Biden administration may impose tougher emissions requirements on airlines. The withdrawal of troops from Afghanistan may spur a reduction in military and arms spending.	**Overweight** Robotics & AI stand to benefit from reshoring and increased automation. Infrastructure, and especially green infrastructure, are key focus areas. As such, we believe that PAVE and CTEC are likely to be key beneficiaries within this space.
Information Technology	Companies in the Information Technology sector typically have strong balance sheets and solid fundamentals. Secular themes (cloud, telecommuting) accelerated by COVID-19 and onshoring of supply chains. Tech hardware and tech-focused industrials stand to benefit from productivity and capex potentially becoming dominant trends.[16] The pandemic increased the role technology plays in our lives. The increased adoption of certain key disruptive technologies is likely to remain in a post-COVID-19 world as societies adapt to these new technologies. This shift will likely continue.	Increased regulatory scrutiny is a risk for this sector. There is bipartisan support for increased regulation in this space. Increased taxes would hurt margins. The continuing semiconductor shortage may limit hardware sales despite demand. Rising interest rates would negatively impact long duration growth sectors like technology.	**Market weight** Cloud Computing, Robotics/AI Cybersecurity, Clean Energy and CleanTech are major potential beneficiaries.
Materials	Chinese growth is positive for commodity prices. Both infrastructure bills are advancing through congress and currently look to have sufficient support to pass, which should benefit this sector for years to come.	A stronger dollar is a negative for the Materials sector. We expect commodity prices to normalize as supply chains mean-revert. Increased regulations, especially those focused on preventing	**Market Weight** Increased focused on Electric Vehicle adoption, alternative energy sources and energy storage should be beneficial to Lithium

		climate change, is a potential negative.	and Battery Technology (LIT).
Real Estate	The Office, Retail, and Hotels segments in Real Estate could benefit from the reopening with increased focus on a return to normal. There is a growing push by corporations to return to the office, particularly in major cities, with pandemic-related restrictions relaxed or eliminated. U.S. Office vacancy rates continue to rise, but at a moderating pace in most markets. Shift from financial asset inflation to real asset inflation. Not highly impacted by higher corporate taxes.	More and sustained COVID-19 cases in the U.S. could have negative impacts on the Real Estate sector, especially retail and office-focused real estate in densely populated areas. Though there has been an increase in office-using employment, levels remain below pre-pandemic levels, as remote work continues. A return to normal should be beneficial for shopping malls, but it does not negate the long-term structural trend away from brick & mortar retail towards e-commerce. Rising interest rates, which increase the cost of financing, are a risk if costs cannot be passed along to tenants.	**Market Weight** Life Sciences, technology focused REITs may be beneficiaries.
Utilities	Utilities valuations are in line with average levels. Capex costs associated with the shift towards green power production may be partially offset by government support.	A Biden presidency is likely to be negative for this sector. The potential for increased climate-related regulations over time may detract from the appeal of this sector. Rising inflation expectations and expectations for higher future interest rates can negatively impact the sector.	**Underweight**

Footnotes:

1. BofA, S&P 500 EPS Outlook, 8/26/20201
2. WSJ, Oil Industry Surveys Damage After Hurricane Ida Slams Louisiana, 8/30/2021
3. Trading Economics data as of 8/30/2021
4. BofA, Morning Market Tidbits: Twin engines slowing, 8/20/2021
5. Bloomberg, Powell Says Taper Could Start in 2021, With No Rush on Rate Hike, 8/27/2021
6. BofA, The RIC Report: The good news about bad prices, 5/11/2021

7. Business Insider, A record-breaking 44 container ships are stuck off the coast of California, 8/30/2021
8. The Journal, Congress's case to break up Amazon, 6/17/2021
9. WSJ, Food supply chains are stretched as Americans head back to restaurants, 5/21/2021
10. CFA Institute - Webinar, The Impact of the US Presidential Election and COVID-19 on US Equity Valuations, 10/21/2020
11. BofA, The RIC Report: The good news about bad prices, 5/11/2021
12. Reuters, Pfizer, Moderna seen reaping billions from COVID-19 vaccine booster market, 8/13/2021
13. BofA, The RIC Report, 4/13/2021
14. BofA, The RIC Report, 4/13/2021
15. BofA, The RIC Report: The good news about bad prices, 5/11/2021
16. BofA, The RIC Report: The good news about bad prices, 5/11/2021

Definitions

Capital Expenditures (Capex): Funds used by a company to acquire, update, and maintain physical assets such as buildings, technology, and equipment; often used to undertake new investments/projects.

S&P 500 Total Return Index: The index includes 500 leading U.S. companies and captures approximately 80% coverage of available market capitalization.

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