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Should we take cues from the bond market or the equity market?

July 2021 was quite interesting for the market, as it featured a micro-correction followed by a swift rebound in the second half of the month. First, restrictions in the U.S. were largely lifted, then came the excitement of doing what used to be normal, such as going to a restaurant or seeing a movie. In hindsight, perhaps we moved a bit too quickly to revert to our 2019 lives. As mobility increased, so too did the spread of the delta variant, especially among unvaccinated populations. Concern about delta and the subsequent tripling of COVID cases in the U.S. caused a brief risk-off trade.[1] And with concerns of a third wave in the U.S. running high, the yield on the 10 year-Treasury fell from its peak in March from 1.75% to 1.18% in mid-July.

Perhaps the bond market saw what's happening across the pond and thought the U.S was next. The delta variant has the U.K. experiencing its third wave of COVID infections, though there are signs that cases have peaked. Domestically, rising delta case counts could pose challenges to the reopening, at least regionally. The bond market is known for being more contemplative and forward-looking than its brasher sibling, the equity market. If the bond market is correct, the U.S. economy may face slower growth and inflation that isn't so transitory. But as yields start to move higher again, including the 10-year Treasury now at 1.3% (as of 7/23/2021), we are in the camp that the bond market may have drawn a faulty conclusion.

On the positive side, we see some easing in the supply chain constraints that caused prices to jump to their highest levels since before the 2008 financial crisis.[2] Freight costs remain stubbornly high, which affects smaller companies, the lifeblood of the economy, more than larger multinationals. However, we expect the Federal Reserve (Fed) to maintain its dovish stance for the foreseeable future.

Significantly, the consumer is healthy and strong. Now, consumer spending is starting to shift from goods to services as life returns to something more normal.[3] We believe that as services spending rises, goods consumption could slow but remain at an elevated level. It was estimated that a 10% increase in time spent at home during the pandemic was a 3.1 percentage point headwind to consumer spending.[4] This pivot should help ease supply disruptions and mitigate some inflationary pressures over the next few months.

Of course, tail risks now include the highly transmissible delta variant. Beyond mask advisements, we do not expect mandatory measures placed on the U.S. population, but even voluntary social distancing poses moderate downside to the economic outlook.

Sector Views

In the second half, we expect the market to focus more on valuations across sectors and become more selective. In that sense, perhaps the often-brash equity market is growing up.

Supply chains constraints are a particularly important consideration in the reopening economy, but numerous factors shape our current sector views.

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 preferences are in this sector's Gaming & Esports and Social Media segments.
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.[5] High valuations make this sector vulnerable to rising rates. Higher taxes will have an effect on this sector. Online retail and household durables could be adversely affected by the full reopening of the economy. Overall, the reopening is likely to be negative, due to the scale of these industries relative to the segments that should benefit from the reopening, such as hotels and brick & mortar retail.[6] 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	**Market weight**

		and platform operations from their private label business.[7]	
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. Secular shift into e-commerce. This sector has benefited from higher demand for household products, PPE, and disinfection products.	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.[8] Travel, hotels, and brick & mortar stores can benefit from the re-opening. The negative is that they are too small to drive the sector. Spending is likely to shift away from necessities towards discretionary as vaccine distribution continues. We believe the abundance of choice is likely to weigh on this sector unless pricing pressure reach 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.	**Underweight**
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.	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 regulatory shifts, the market is leaning into cleaner alternatives.[9]	**Market weight**
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, faster economic growth is likely to benefit cyclical sectors such as Financials.[10]	Declining rates are a risk, as seen in the first half of July. Disinflationary pressures from disruptors including fintech. This sector remains highly exposed to the impacts of COVID-19.	**Overweight** Our preferences in this space is financial technology.

	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.		
Health Care	The Health Care sector remains a defensive hedge against increased COVID-19 cases. The social portion of ESG could drive increased corporate spending on health care. Largely a domestic story. Democrats only have a small majority in Congress, so an increase in health care coverage is likely. Less likely is any aggressive legislation that could adversely affect pharma or other segments of the health care market.[11]	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**
Industrials	The Industrials sector combines cyclicality with a quality orientation.[12] Potential tailwinds for this sector include: • A possible Infrastructure bill of around $2 trillion. • Reshoring of supply chain. • Automation • Improved certainty about tariffs and taxes could unleash pent-up capex in non-tech sectors.[13] • Increased investment to expand productivity and raise productivity, should elevated inflation become permanent.[14]	Leverage in the sector may pose a risk. The Biden administration may impose tougher emissions requirements on airlines.	**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.[15] 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.	**Market weight** Cloud Computing, Robotics/AI Cybersecurity, Clean Energy and CleanTech are major potential beneficiaries.
Materials	Chinese growth is positive for commodity prices. A comprehensive infrastructure plan is a positive.	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 climate change, is a potential negative.	**Market Weight** Increased focused on alternative energy sources and energy storage should be beneficial to Lithium and Battery Technology (LIT). This theme also stands to benefit from increased Electric Vehicle adoption.
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 reduced 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.	Another wave of 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 focuses REITs may be beneficiaries.

	Not highly impacted by higher corporate taxes.		
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. Bloomberg data as of 7/30/21
2. DOL, Consumer Price Index News Release– 7/13/2021
3. BofA, BofA on USA: Look at who is spending on service, 7/1/2021
4. BofA Global Research, How will the Delta curve bend?, 20 July 2021
5. BofA, The RIC Report: The good news about bad prices, 5/11/2021
6. BofA, The RIC Report, 4/13/2021
7. The Journal, Congress's case to break up Amazon, 6/17/2021
8. WSJ, Food supply chains are stretched as Americans head back to restaurants, 5/21/2021
9. CFA Institute - Webinar, The Impact of the US Presidential Election and COVID-19 on US Equity Valuations, 10/21/2020
10. BofA, The RIC Report: The good news about bad prices, 5/11/2021
11. BofA, IG Healthcare Election Impacts, 11/4/2020
12. BofA, The RIC Report, 4/13/2021
13. BofA, The RIC Report, 4/13/2021
14. BofA, The RIC Report: The good news about bad prices, 5/11/2021
15. 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.

Investing involves risk, including the possible loss of principal. Narrowly focused investments may be subject to higher volatility. Technology-themed investments may be subject to rapid changes in technology, intense competition, rapid obsolescence of products and services, loss of intellectual property protections, evolving industry standards and frequent new product productions, and changes in business cycles and government regulation.

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