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High-Stakes Deadlines and Debt: September Sector Views

September markets are typically rocky as summer's calm fades. This September was no different with markets sifting through slowing economic growth and data showing that pandemic-related inflation, supply chain disruptions, and labor market woes are real. Washington stressed markets as government funding, the debt ceiling, and infrastructure bills bubbled up to the surface amid contentious party politics. Then there's China. The ripple effects of Beijing's regulatory crackdown continued to fluster markets. So now as deadlines converge and with votes set to commence, it seems like last month's rockiness may continue.

The S&P 500 Index returned -4.65% for the month, and 0.58% in Q3, bringing its year-to-date total return to 15.91%. The Nasdaq Composite Index returned -5.27% for the month, bringing its Q3 return to -0.22%. There was significant divergence across sectors, highlighting the importance of considering the positioning of specific sectors for the current macroeconomic environment.

The Debt Ceiling Spectacle

Like clockwork, the U.S. will run up against its annual statutory debt limit in mid-October. The Biden administration asked Congress to raise the debt ceiling, which should be nothing more than a formality, as money for projects approved by the previous administration has already been spent. But thus far Republicans have refused to give their consent on what should always be a bipartisan action. If the government can't borrow money to meet its obligations, the markets won't react well in the short term and the risks of a recession rise, a remarkably self-induced one at that. Treasury Secretary Janet Yellen warned that the debt ceiling must be raised or there will be terrible consequences.

We can opine on the political machinations, but this posturing is now something of an annual rite of fall. Markets know that the debt ceiling will be raised. The question is whether it comes at a significant cost. While it would be better if the increase is passed sooner rather than later, the deadline isn't until some fuzzy date in October (likely October 18th), depending on how creative the Treasury can be. Congress moved on Thursday to prevent a government shutdown before the midnight deadline. Both chambers of Congress passed a bill that would fund the government through December 3, averting a government shutdown.

Infrastructure Both Hard and Social

The Senate passed a bipartisan bill to authorize $550 billion in new spending on hard infrastructure including roads, bridges, and tunnels. Now it goes back to the House, where prospects of the bill's passage are murky amid moderate and progressive demands on the Democratic side.

The fate of the bipartisan infrastructure package is linked to the Biden administration's ambitious $3.5 trillion reconciliation package for social initiatives, which includes spending for child and elderly healthcare and climate change. Progressives want to delay the infrastructure bill until the

$3.5 trillion package is ready. Moderates want the infrastructure bill enacted first. Democratic leadership promised centrists a vote on the bipartisan infrastructure bill on September 27, but it is unlikely these bills will be passed in the near future.

On the Positive Side: Financials, Health Care, and Industrials

We expect some of the challenges currently facing the markets may improve through into year-end, with certain sectors poised to benefit. The market reacted well to Federal Reserve Chair Jerome Powell signaling that the start of tapering their asset purchases is likely to be announced at their upcoming November meeting. We expect tapering to be positive for Financials because it will likely steepen the yield curve, encouraging banks to lend more broadly. Following the September Federal Open Market Committee (FOMC) meeting, the 10-year Treasury yield rose from 1.3% on the 22nd of September to end the quarter at 1.5%.[1]

Other sectors for which we have a more positive view include Health Care, the sector may benefit from social components of the budget reconciliation package. The bill may include investment in the U.S.' aging population, which the Biden administration wants to keep in good health by implementing extensive drug protocols that keep drug prices in check. Legislation to control drug prices or raise corporate taxes could negatively impact Health Care, though we expect moderate Democrats to thwart any major changes.

With or without a comprehensive infrastructure package, the Industrials sector combines cyclicality with a quality orientation. We expect the sector to benefit from a reshoring of supply chains and increased automation, among other factors that support increased spending on infrastructure in the years ahead.

Here are our current views on all 11 sectors.

CURRENT VIEWS ON U.S. SECTORS

	Positive Factors	Negative Factors	Overall View
Communication Services	We believe there is still room to run in Social Media as digital ad spend continues to increase and network effects of platforms are increasingly monetized. Beneficiary of reasonably positive trends in subscription services including streaming. Companies in this sector have resilient fundamentals.	Adversely impacted by the semiconductor chip shortage. An increase in interest rates should adversely impact the discount rate applied to future earnings and cash flows. This could encourage a rotation from growth to value, which should negatively impact sentiment. 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. Sector is highly concentrated in a few companies which can meaningfully impact the sector (positively or negatively).	**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, allowing rising costs to be passed on to consumers without broad margin compression. Consumers adapted to the pandemic environment by increasing their use of online ordering and delivery and instore pickup.	The Consumer Discretionary is a labor-intensive sector. Wage pressure combined with higher input costs are a risk to margins should companies not be able to pass along inflation pressures. Adversely impacted by supply chain disruptions, especially the semiconductor shortage. High valuations make this sector vulnerable to rising interest rates. Higher taxes will negatively impact this sector. Antitrust or increased regulations remain a potential risk factor but are not a near term threat.	**Underweight**
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 into the fall and winter, this sector could see steady demand in the event of an economic downturn, due to its low level of correlation with economic cycles. Companies have engaged in aggressive cost-cutting.[2] Reopening of restaurants are helping wholesale food demand.	The sector had the highest percentage of companies citing “inflation” on Q2 earnings calls at 87%.[3] As a sector, Consumer Staples are facing higher input costs, which may put pressure on margins. As the economy improves and we move back to full employment, historically this defensive sector becomes less appealing to investors.	**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. Valuations are attractive relative to other sectors.	A reduction in Chinese growth could reduce oil demand. 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. Numerous risks to global growth stemming from COVID or geopolitical flareups. President Biden’s intentions raise the risk of increased regulation and	**Overweight**

	Hurricane related supply disruptions have driven crude oil prices to three-year highs. Near term, crude price may benefit from China restocking to secure their energy supplies for the winter.[4]	secular headwinds from renewables though the implementation of new regulations will likely be slow. ESG thinking is increasingly incorporated into corporate governance, so even without regulatory shifts, the market is leaning into cleaner alternatives.[5]	
Financials	The Financial sector benefits from improving economic growth, higher interest rates and a steeper yield curve. Federal Reserve policy changes are likely to benefit the sector. Tapering will likely steepen the yield curve, inducing banks to lend more broadly. Treasuries have moved since Powell's taper communication in late September. Strong financial markets have spurred a renaissance in M&A activity.[6]	Sensitive to economic growth expectations. A decline in interest rates or a flattening of the yield curve is detrimental to the Financials sector.	**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 further drive innovation and adoption of advanced technologies such as genomics for years to come. Demographics favor this sector owing to a global population that is aging and a growing middle class in emerging markets. Vaccine booster shots look to be a boon for both pharmaceutical manufacturers and care providers.[7]	Drug pricing pressure remains a risk factor, though the legislative process is slow and nothing meaningful is currently expected to be passed. 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	Beneficiary of rising GDP, interest rates, inflation, and possible Infrastructure spending.	U.S. economic growth is likely to be more subdued in the next stage of the recovery. Given sector valuations are on the high side, this makes the industrials sector more sensitive to shifting sentiment on economic growth.	**Market Weight** Robotics & AI stand to benefit from reshoring and increased automation.

	Sensitive to the capex cycle. The U.S. is potentially at the beginning of a capex cycle, with capex guidance from S&P 500 companies being elevated.[8] Re-shoring and automation structural trends will be a long-term benefit.	Elevated leverage, increasingly expensive valuations, and rising earnings volatility may detract from this sector's performance.[9] The Biden administration may impose tougher emissions requirements on airlines. Fuel costs may be a challenge for Transports and Air Freight industries.	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 should the infrastructure bills move forward.
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. 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. Infrastructure spending would benefit the cybersecurity industry.	Market cap weighting concentrates exposure into a few stocks. 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	Clean energy and infrastructure spending, if passed, could increase demand for industrial materials.	The Materials sector is highly sensitive to Chinese demand. This may pose a headwind in the near future especially considering the current shakeup in the Chinese property market. Significant supply chain bottlenecks could dampen economic growth. Increased regulations, especially those focused on preventing climate change, is a potential negative.	**Market Weight** Increased focused on Electric Vehicle adoption, alternative energy sources and energy storage should be beneficial to Lithium and Battery Technology (LIT).
Real Estate	Shift from financial asset inflation to real asset inflation. The Office, Retail, and Hotels segments in Real Estate could benefit from the	Uncertainty surrounding a full return to the office and how flex working situations may reduce demand for office space. A return to normal should be beneficial for retail focused real	**Market Weight** Life Sciences, technology focused REITs may be beneficiaries.

	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. Q2 U.S. office market data showed signs of improving, as leasing activity increased for the first time since the onset of the pandemic.[10] Demographics support interest in assisted-living facilities. Residential REITs seeing strong demand and rising rents, which is translating into higher multi-family rents. Not highly impacted by higher corporate taxes.	estate, but is unlikely to negate the long-term structural trend away from brick & mortar and towards e-commerce. A fast rise in interest rates, which increase the cost of financing, are a risk if costs cannot be passed along to tenants.	
Utilities	Utilities valuations are in line with average levels. Bank of America identified the Utilities sector as the highest quality sector. It benefits from resilient fundamentals including stable revenues.[11] 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 9/30/2021
2. Schwab Sector Insights: A View on 11 Equity Sectors -8/19/2021
3. FactSet, Highest Number of S&P 500 Companies Citing "Inflation" on Q2 Earnings Calls in Over 10 Years, 9/17/21
4. Bloomberg, China Orders Top Energy Firms to Secure Supplies at All Costs, 9/30/2021
5. CFA Institute - Webinar, The Impact of the US Presidential Election and COVID-19 on US Equity Valuations, 10/21/2020
6. Fortune, M&A activity has already blown past the $2 trillion mark in a record-breaking 2021, 6/2/21
7. Reuters, Pfizer, Moderna seen reaping billions from COVID-19 vaccine booster market, 8/13/2021
8. BofA, The RIC Report: America is still exceptional, 9/14/2021
9. BofA, The RIC Report: America is still exceptional, 9/14/2021

10. JLL, US office market statistics, trends & outlook, 7/21/21
11. BofA, The RIC Report: America is still exceptional, 9/14/2021

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.

NASDAQ Composite: The NASDAQ Composite Index is the market capitalization-weighted index of over 2,500 common equities listed on the Nasdaq stock exchange.

REITs: Real Estate Investment Trusts are companies that own or finance income-producing real estate ranging from office spaces and warehouses to hospitals and shopping centers.

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