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Current Sector Views & October 2021 Recap

As we move past the doldrums of September into the Q3 earnings season, there is optimism amid concerns. But can that optimism be sustained? We are well into earnings season, with 56% of companies in the S&P 500 Index having reported their Q3 earnings, as of 10/29/2021, with many delivering comfortably above expectations despite lingering macro-economic concerns circulating throughout the market. Companies across industries have highlighted a robust level of demand and are managing to pass on higher input costs resulting from supply chain bottlenecks.

The S&P 500 Index returned 7.0% for the month, bringing its year-to-date total return to 24.0%. The Nasdaq Composite meanwhile returned 7.3% for the month, bringing its year-to-date total return to 20.9%. Consumer Discretionary (+10.9%), Energy (+10.4%) and Information Technology (+8.2%) were the top performing S&P 500 GICS sectors during October.

Fed Chatter

Shifting language from the Federal Reserve (Fed) brought forward expectations for the first interest rate increase. The market is bringing forward the probability of interest rate increase as early as June 2022. Currently CME Group is placing a 46.5% probability of an interest rate increase at the June 2022 Federal Open Market Committee (FOMC) meeting. Focusing on the same FOMC meeting date, this probability has increased from only 15.6% a month earlier.[1]

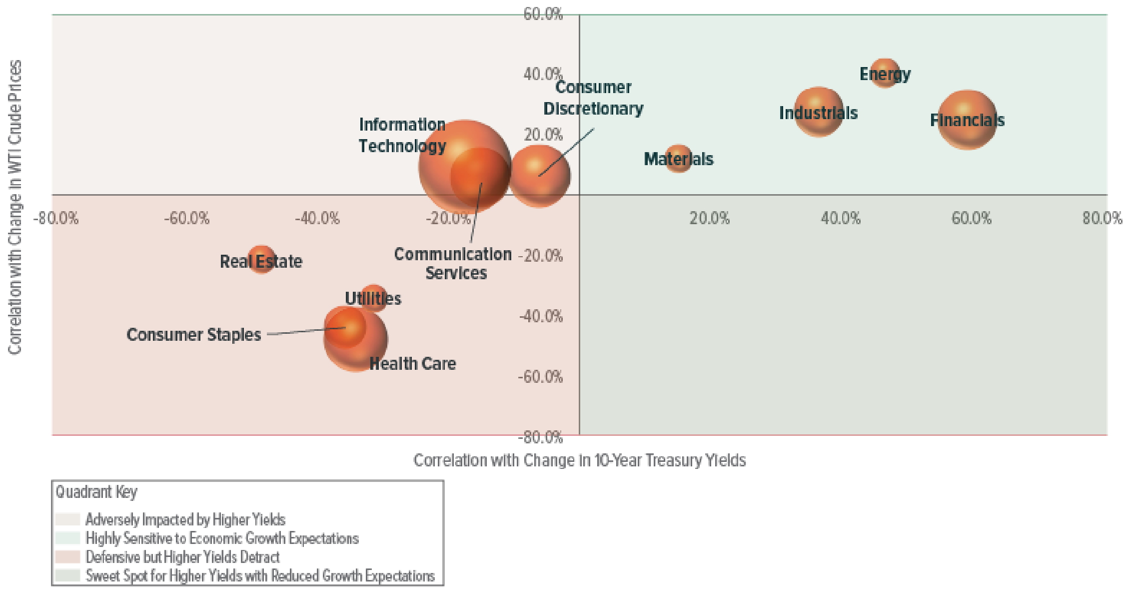
The market has placed greater focus on the June meeting as Fed officials have also mentioned that they would rather not add stimulus while at the same time as raising rates - meaning that the door to interest rate hikes won't open until the tapering door closes. According to the Fed's plan, they're expected to reduce their $120 billion worth of monthly bond purchases by $15 billion each month, potentially starting in November. This places the end date around June, potentially opening the door to higher policy rates into the second half of next year.

Sector Performance in a Higher Yielding Environment

We believe higher yields are coming, it's likely just a matter of time. Depending on how the Fed's statements shape expectations, the November FOMC meeting may result in further steepening of the yield curve. If this scenario comes to pass, from a portfolio management perspective, it's important to understand which sectors typically perform well during a rising rate environment and why.

In chart 1, we looked back over 3 years of data, plotting the correlations of S&P 500 sector excess returns against changes in 10-year treasury yields and WTI crude oil prices. The period under review was dominated by the COVID crisis where crude prices were highly sensitive to global economic growth expectations. The analysis shows that some sectors experienced compounding effects to the downside while others were beneficiaries.

CHART 1: S&P 500 SECTOR SENSITIVITIES* 3 YEAR MONTHLY DATA
Source: Bloomberg Data, Global X Analysis, Data and Analysis as of 9/30/2021



* The chart plots the correlation of excess returns on S&P 500 Sectors relative to the broader S&P 500 Index compared with changes in 10-year Treasury Yields and WTI Crude Prices.

Index returns are for illustrative purposes only. Past performance does not guarantee future results. Results over longer periods may vary.

Sectors that are Sensitive to Economic Growth Expectations

Financials have historically been the biggest beneficiary of higher interest rates as a result of a steeper yield curve and greater willingness to lend. As rates trend upwards, banks tend to benefit from higher lending activity and higher interest rates charged to their consumers. In addition, the steepness of the yield curve is important for bank's net interest margin as they typically lend at long-term rates while borrowing short-term. Stemming from this, a steeper yield curve is also likely to encourage greater lending activity.

Higher yields and an upward sloping Treasury yield curve are associated with higher economic growth. These growth expectations are highly important for certain key sectors including Energy, Industrials and Materials. Referring to Chart 1, these three sectors and Financials are in the quadrant that is most sensitive to changes in economic growth expectations. This has pros and cons as the economy navigates the shift from a highly stimulatory environment, to standing on its own.

Sectors that are Sensitive to Economic Growth Expectations but Adversely Impacted by Higher Yields

The Information Technology, Communication Services, and Consumer Discretionary sectors fall into the top left quadrant where they are favorably impacted by economic growth expectations but adversely impacted by higher Treasury yields. As growth focused market segments, they benefit from future earnings being discounted at a lower interest rate. As yields rise, valuation concerns are likely to weigh on these three sectors.

In an environment where yields are likely to rise, but economic growth could be called into question, the sectors that fall into this quadrant are at increased risk. On a positive note, these three sectors had only minimal sensitivity to crude prices. Typically, these three sectors have held up well during periods where economic growth has come into question, as they benefited from the resulting decline in yields. However, they may be vulnerable to the impact of supply chain constraints as seen in recent earnings reports.

Potential Protection in the Storm but Higher Yields may be a Headwind

The Health Care, Consumer Staples, Utilities, and Real Estate sectors had a negative correlation to both higher interest rates and higher WTI crude prices. Consumer Staples, Health Care and Utilities are considered defensive sectors. They typically perform relatively better in the later parts of the economic and business cycle when interest rates and inflation have peaked.

The Consumer Staples, Utilities and Real Estate sectors typically offer a high dividend yield. As bond yields rise, these bond proxy sectors appear less attractive. The Real Estate sector has a large negative correlation with interest rates. The sector's high level of leverage means that their borrowing costs rise while the higher discount rate adversely impacts the valuations on their assets.

What is on the Horizon?

Yields and economic growth are likely to be a key focus as the market navigates the Fed tapering their monthly bond purchases. As tapering begins, we expect the yield curve to steepen in response and be a positive for the Financials sector. But it does seem that the market is reacting well to the slow-moving actions of the Fed, which is allowing markets to adapt slowly to the new market paradigm.

Will the market have the same reaction to higher crude prices? Crude prices have been a reasonable proxy for global economic growth expectations during the depth of the COVID crisis and into the reopening phases. But with mounting supply chain pressures, higher fuel prices could undermine the economic recovery – detracting from discretionary consumption and real GDP growth. While the Energy sector benefits from higher crude prices, this is an inflationary force that flows through the entire economy and could bring forward interest rates.

Diversification across the quadrants is likely to be increasingly important as markets internalize higher yields but also revise down economic growth expectations due to supply chain disruptions and greater inflationary pressures. Unfortunately, there are no sectors that are likely to benefit from higher yields but lower economic growth.

Please refer to our current sector views table on the next page.

CURRENT VIEWS ON U.S. SECTORS

All correlation references are based on monthly excess return of S&P 500 sectors over **S&P 500 Index** over 3 years ending 9/30/21.

	Positive Factors	Negative Factors	Overall View
Communication Services	Beneficiary of reasonably positive trends in subscription services including streaming. Positively correlated with 10-year treasury yields. Companies in this sector generally have resilient fundamentals.	Ad revenue drives Social Media company revenues and large phone producer's change in Ad tracking has shown it should impact other players in Social Media who rely on ad data. Semiconductor chip shortage continues to negatively affect sector – could possibly last until 2023.[2] An increase in interest rates will 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 (3 major players make up 50%, as of 10/26/2021) which can meaningfully impact the sector (positively or negatively).	**Market weight**
Consumer Discretionary	The Consumer Discretionary sector stands to benefit from the upcoming holiday shopping season.	Consumer Discretionary is a labor-intensive sector. Wage pressure combined with higher input costs in materials and shipping are a risk to margins	**Underweight**

	High demand may offset increased cost pressures, allowing rising costs to be passed onto consumers without broad margin compression. Consumers adapted to the pandemic environment by increasing their use of online ordering and delivery and instore pickup. Minimal positive correlation with 10YR Treasury yields.	should companies not be able to pass along inflation pressures. Negatively correlated with WTI crude prices. Adversely impacted by supply chain disruptions, especially the semiconductor shortage in Automotive Industry. Delays in shipping by sea and heightened costs in air freight are headwinds. Higher taxes will negatively impact this sector. Antitrust or increased regulations remain a potential risk factor but are not a near term threat.	
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 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.[3] Reopening of restaurants are helping wholesale food demand.	Consumer Staples showing worst net profit margin compression out of all sectors when comparing Q3 2021 to Q3 2020. 75% companies reporting lower margins and 25% reporting higher, as of 10/22/2021. Inflation will negatively impact margins for companies who cannot pass through rising material costs to the end consumer. Higher transport costs by air and sea may negatively impact company margins.[4] As the economy improves and we move back to full employment, historically this defensive sector becomes less appealing to investors. Sector is negatively correlated with 10YR treasury yields and WTI crude prices.	**Underweight**

Energy	Demand for Crude has risen sharply due to people re-engaging with society and traveling more. While the U.S. has largely reopened and continues to make progress against covid, crude demand stands to benefit from a global reopening and improved growth. Energy Sector benefits the most from higher WTI Crude prices Has a positive correlation with 10YR Treasury Yields 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.[5] Showing highest net profit margin growth out of all sectors Q3 2021 relative to Q3 2020.[6]	A reduction in Chinese economic 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. Numerous risks to global growth stemming from COVID or geopolitical flareups. President Biden's intentions raise the risk of increased regulation and secular headwinds from renewables through 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.[7] Confidence in 'return to normal life' could lead to higher production - increasing supply and lowering prices.	**Overweight**
Financials	The Financial sector benefits from improving economic growth, higher interest rates and a steeper yield curve. Financials are positively correlated with WTI Crude Prices.	Sensitive to economic growth expectations. A decline in interest rates or a flattening of the yield curve is detrimental to the Financials sector. Fed delaying interest rate increases if economy growth slows will likely negatively impact sector.	**Overweight** Our preferences in this space are financial technology and banks.

	Federal Reserve policy changes are likely to benefit the sector. Tapering, which will likely start in November 2021, 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.[8]		
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. Non-medical device industries within sector will likely avoid supply chain constraints. CDC approved JNJ and Moderna Boosters. Vaccine booster shots look to be a boon for both pharmaceutical manufacturers and care providers.[9]	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. Healthcare has been found to have a strongly negative correlation with 10YR treasury yields and a negative correlation with WTI crude prices.	**Overweight** Our preferences in this space are Biotech and Genomics.

Industrials	Beneficiary of rising GDP, interest rates, inflation, and possible Infrastructure spending. Sector has a positive correlation with 10YR yields and WTI Crude prices. 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.[10] Sector CAPEX growth up 15% from 2020 but still 13% below 2019 figures.[11] Re-shoring and automation structural trends will be a long-term benefit. Sector showing positive margin growth Q3 2021 v.s. Q3 2020.[12]	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. Elevated leverage, increasingly expensive valuations, and rising earnings volatility may detract from this sector's performance.[13] The Biden administration may impose tougher emissions requirements on airlines. Fuel costs may be a challenge for Transports and Air Freight industries. Supply chain issues could be a major headwind for Industrials.	**Market Weight** 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 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	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.	**Market weight** Cloud Computing, Robotics/AI Cybersecurity, Clean Energy and CleanTech are major potential beneficiaries.

	post-COVID-19 world as societies adapt to these new technologies. This shift will likely continue. Tech as a sector is showing higher net profit margins Q3 2021 v.s Q3 2020.[14] 10YR Treasury yields have shown light positive correlation with Information Tech Sector. Infrastructure spending would benefit the cybersecurity industry.	Rising interest rates would negatively impact long duration growth sectors like technology. Tech had negative correlation with WTI Crude prices.	
Materials	Clean energy and infrastructure spending, if passed, could increase demand for industrial materials. Showing positive net margin growth Q32021 relative to Q3 2020, as of 10/26/2021. Beneficiary of rising inflation leading to higher price for raw materials. Positively correlated with 10YR Treasury yields and WTI Crude Prices.	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 reopening with increased focus on a return to normal.	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 estate, but is unlikely to negate the long-term structural trend away from brick & mortar and towards e-commerce.	**Market Weight** Life Sciences, technology focused REITs may be beneficiaries.

	There is a growing push by corporations to return to the office, particularly in major cities, with pandemic-related restrictions relaxed or eliminated. Q3 U.S. office market data showed signs of improving, quarterly leasing activity up 12.8% from Q2 2021 and 45% YTD.[15] 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.	A fast rise in interest rates, which increase the cost of financing, are a risk if costs cannot be passed along to tenants. Real Estate as a sector has a historically negative correlation to 10 YR Treasury yields and WTI crude prices.	
Utilities	Utilities valuations are in line with 5-year average levels. Bank of America identified the Utilities sector as the highest quality sector. It benefits from resilient fundamentals including stable revenues.[16] Capex costs associated with the shift towards green power production may be partially offset by government support. Preferred sector in recessionary environment	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. Companies may not be able to pass through higher inflation related costs due to government regulation.	**Underweight**

	due to inelasticity of goods & services.	Utilities is negatively correlated with 10YR Treasury Yields and WTI crude prices.	

Footnotes:

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4. FactSet, Earning Insight, 10/22/2021
5. Bloomberg, China Orders Top Energy Firms to Secure Supplies at All Costs, 9/30/2021
6. Factset, Revenue & Earnings, 10/25/2021
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8. Fortune, M&A activity has already blown past the $2 trillion mark in a record-breaking 2021, 6/2/21
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11. FactSet, Industry Data, 10/25/2021
12. Factset, Revenue & Earnings, 10/25/2021
13. BofA, The RIC Report: America is still exceptional, 9/14/2021
14. Factset, Revenue & Earnings, 10/25/2021
15. JLL, US office market statistics, trends & outlook, 10/21/21
16. 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.

Correlation: Correlation indicates the strength of the linear relationship between two different variables. A correlation that is greater than zero indicates a positive relationship. A value that is less than zero signifies a negative relationship. A value of zero indicates no relationship between the two variables.

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

West Texas Intermediate (WTI) Cushing Crude Oil Spot Price Index: Designed to track the spot price of WTI.

Investing involves risk, including the possible loss of principal. Diversification does not guarantee a profit or ensure against a loss. 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.

Shares of ETFs are bought and sold at market price (not NAV) and are not individually redeemed from the funds. Brokerage commissions will reduce returns.

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