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Current Sector Views & November 2021 Recap

The end of 2021 is in sight, casting a spotlight on 2022 forecasts. This report focuses on our expectations for the GICS sectors in the S&P 500 Index. Please also look out for our broader outlook for 2022. Overall, going into 2022, we have two broad views that apply to positioning across the S&P 500 GICS Sectors:

- Given peak liquidity, elevated valuations, and inflationary pressures, it is our view that investors should focus on segments of the market with pricing power.
- And ensure balance between growth and value.

Balancing Valuation and Pricing Power

With peak liquidity having been reached, we expect the market will now be paying closer attention to fundamentals. The market is contextualizing demand driven inflation, higher energy costs, expectations of when the supply chain will swing from tight to normal, and how the Federal Reserve (Fed) will respond to more sustained inflation pressures. In line with this, we believe equity markets are likely to be more selective in 2022 with a focus on valuations, fundamentals, and quality. Margins are expected to remain a key focal area into 2022 as investors dissect which segments have pricing power.

November started with news of U.S. inflation hitting a three-decade high, rising at a 6.2% annual rate in October and beating out the consensus estimate of 5.8%. This is the highest level of inflation we've seen since 1990 and it seems like the 'transitory' story is transforming into something a bit more peskily persistent. Q3 earnings came in stronger than expected with companies generally being able to pass along higher prices. But there’s only so much input cost a company can pass onto the consumer before higher costs begin hurting their financials. Margin pressure is forecast to impact Q4 earning with S&P 500 net profit margins expected to contract from 12.9% to 11.8%. This is slightly below the September estimate of 11.9%, with Consumer Discretionary and Industrials experiencing a reasonable contraction in their forecast net profit margin while the Energy sector is forecast to enjoy continued margin expansion into Q4 2021.[1]

Pricing pressure comes at a time when there will likely be less supportive monetary policy. The Fed started tapering their balance sheet purchases in November. They are currently reducing their $120 billion worth of monthly bond purchases by $15 billion each month. This places the projected end date for tapering around June, potentially opening the door to higher policy rates into the second half of next year. There is a reasonable chance that tapering is sped up and ends prior to June.

Against this backdrop of elevated inflation and the prospect of higher interest rates, we conducted a deeper analysis into the pricing power of different S&P 500 GICS sectors and industries relative to their respective valuations levels. This analysis was intended to understand the areas with pricing power and if there were segments with pricing power that remained at more attractive valuations.

Setting up the Analysis

Margin Analysis:

Analyzed the trends in operating profit margins and sales for all 11 GICS sectors and 63 GICS industry groups to determine where we were most and least concerned about margin pressures into the year ahead. This analysis looked at the historic operating profit margins and sales trends since 2018 to understand which industries have consistently seen improving margins as scale improves (Software) verse those that had a challenging 2020, but margins have recovered, and we believe the underlying companies are well positioned to benefit from higher yields and/ or commodity prices (Banks, Energy sector).

We developed a margin ranking and a valuation ranking to establish a combined ranking that considered the ability to pass on higher prices while being mindful of valuations. The tables below outline our key findings as well as the methodology behind the analysis. Our base case analysis provides a low weight on margin movements during 2020, focusing more on the ability to improve margins during 2021 and margin expectations for the year ahead. The base case emphasized how operating margins of each underlying industry are likely to react in a higher inflation environment with good demand. With the emergence of the Omicron variant, we also created a margin assessment that gave greater priority to margin stability during the challenges of 2020.

Valuations Analysis:

The valuation ranking looked at the current sector Price / Earnings (P/E) and Price to Book (P/Book Value), as of 10/31/2021, relative to its historic levels since 2018, as well as comparing the current P/E and P/Book Value relative to the S&P 500 Index. Within the valuation component, a 70% weight was placed on each sector relative to its historic prices to avoid substantially penalizing sectors that historically traded at a premium to the market.

Base Case

While the Omicron variant increased COVID-19 as a risk factor, our base case remains that Fed actions will be the focus of 2022. In this scenario, margins and valuations are both highly important. We shifted slightly towards the margins side with 60% of the combined ranking coming from margins and 40% from valuations. In a rising yield environment, we favor cyclical sectors with above average purchasing power. Financials, Energy, Industrials and Materials were the most positively correlated with rising real (inflation-adjusted) Treasury yields. These are cyclical sectors that are likely to benefit the most from improving economic growth and higher yields. Overall, Energy, Financials and Materials scored well in our analysis. These are cyclical sectors that are likely to benefit from higher yields and commodity prices while valuations are more moderate.

BASE CASE SCENARIO - SECTOR RANK

	60%	40%	
	Margin Analysis	Valuation Analysis	Combining Ranking
1	Energy	Energy	Energy
2	Information Technology	Financials	Financials
3	Financials	Materials	Materials
4	Materials	Utilities	Information Technology
5	Consumer Discretionary	Health Care	Industrials
6	Industrials	Consumer Staples	Communication Services
7	Communication Services	Communication Services	Real Estate
8	Real Estate	Industrials	Consumer Discretionary
9	Health Care	Real Estate	Health Care
10	Consumer Staples	Information Technology	Consumer Staples
11	Utilities	Consumer Discretionary	Utilities

See methodology here.

Balancing Growth and Value

During 2021, COVID-19 diminished as a risk factor. That is, until the Omicron variant raised the question of how the global economy and markets will respond to a highly contagious variant that potentially includes mutations that could help it evade the current vaccines. While cyclicals and positioning for higher inflation remain our base case position, we believe this should be balanced with exposures that are less reliant on strong underlying economic growth.

With travel bans spreading, the question on investor's minds is the probability of renewed lockdowns. Prior to the identification of the Omicron variant, select European countries had already starting reimposing restrictions, with Austria being the first western European country to reimpose nationwide lockdowns in response to the current wave of cases.[2] With its Zero-COVID policy, China remains a lockdown risk. And, as home to six of the ten busiest container ports, this remains a critical weakness in supply chain normalization.

At this stage, our base case scenario is that U.S. lockdowns remain highly unlikely, but heightened caution can still have an adverse impact on consumption. Albeit unlikely, should lockdowns occur we would likely see the Energy and Materials sectors react negatively while the Information Technology and Communication Services sectors would likely react positively. With the reimposition of some travel bans, WTI crude oil prices declined more than 10% on the 26th of November, dropping below $70 / barrel for the first time since early September.[3] The Energy sector is highly sensitive to global economic growth expectations and community mobility. While the initial list of countries on the current travel ban represent a small fraction of global travel, heightened COVID-19 concern may reduce willingness to travel and it may result in heightened caution and reduced community mobility.

Higher energy prices have been a substantial contributor to elevated inflation. As such, reduced energy prices may give the Fed some breathing room as they navigate through a higher inflationary environment and the shift from tapering their balance sheet to raising interest rates. This could reduce the focus on higher yields and valuations. In line with this, we repeated the margin analysis while placing a greater emphasis on margin stability during periods of reduced sales growth. Should economic growth come into question, valuations, inflation, and the Fed are likely to become lesser concerns. As such, the weighting between the margins and valuation ranking is shifted to further favor margins in the COVID-19-replay scenario (80%:20% vs 60%:40% in the base case).

Information Technology scored well on our base case margin analysis and as reflected in our COVID-19-replay case scenario, both Information Technology and Communication Services were segments that generally provided some stability during the challenging period. Part of the reason the Information Technology and Communication Services sectors screened well in the margin analysis is that the underlying industries have been less impacted by supply chain bottlenecks and tend to have strong balance sheets. While the U.S. supply crunch may have already peaked, we only expect supply chain issues to normalize in the second half of 2022. These industries that were less impacted by supply bottlenecks are also well represented in the work-from-home segments of the market that should benefit from increased COVID caution.

While it does not ensure a profit or guarantee against a loss, diversification is always an important strategy to any investment thesis. Given the delicate economic environment we are currently in, it is important to ensure a balance between market segments that are sensitive to economic growth and those that can grow despite the economy.

COVID-19-REPLAY CASE SCENARIO - SECTOR RANK

	80%	20%	
	Margin Analysis	Valuation Analysis	Combining Ranking
1	Information Technology	Energy	Financials
2	Communication Services	Financials	Information Technology
3	Financials	Materials	Energy
4	Energy	Utilities	Communication Services
5	Materials	Health Care	Materials
6	Consumer Discretionary	Consumer Staples	Industrials
7	Industrials	Communication Services	Consumer Discretionary
8	Real Estate	Industrials	Real Estate
9	Health Care	Real Estate	Health Care
10	Consumer Staples	Information Technology	Consumer Staples
11	Utilities	Consumer Discretionary	Utilities

See methodology here.

Segments that Scored Poorly

Utilities, Consumer Staples, and Real Estate are areas that historically are adversely impacted by higher real Treasury yields. While the business models in the Energy and Real Estate sectors generally allow companies to pass on higher prices, Utilities and Consumer Staples have generally reflected a weak ability to pass along pricing pressure. However, these are defensive sectors that will remain an essential part of consumption should consumers reduce discretionary spending. As such, though Utilities and Consumer Staples are currently our least favored sectors, they still provide potential diversification benefits should the economic environment deteriorate substantially.

The table below outlines our full sector views. These views are updated monthly.

CURRENT VIEWS ON U.S. SECTORS

All correlation references are based on monthly excess return of S&P 500 sectors over S&P500 Index over 3 years ending 9/30/2021.

	Positive Factors	Negative Factors	Overall View
Communication Services	Beneficiary of reasonably positive trends in subscription services including streaming. Potential future benefactor from development of augmented reality and metaverse. 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.[4] 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 11/16/2021) 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. 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. Supply chain logjam showing signs of easing.	Consumer Discretionary is a labor-intensive sector. Wage pressure combined with higher input costs in materials and shipping 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 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.	**Underweight**
Consumer Staples	Consumer Staples could be a good defensive hedge against rising winter COVID-19 cases. During the pandemic, spending patterns shifted to favor essential retail. If Omicron variant case increase 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.[5] Consumer Staples sector reported largest amount of top line earnings above estimates for Q3.	Consumer Staples are showing the lowest Q3 Revenue and Earnings growth out of all 11 sectors.[6] Inflation will negatively impact margins for companies who cannot pass through rising material costs to the end consumer. In our pricing power analyses, Consumer Staples generally scored poorly. Higher transport costs by air and sea may negatively impact company margins.[7] 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.	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 Omicron variant and travel restrictions are negative for this sector. A reduction in Chinese economic growth could reduce oil demand. President Biden's intentions raise the risk of increased regulation and secular headwinds from renewables	**Market Weight**

	Energy Sector benefits the most from higher WTI Crude prices Has a positive correlation with 10YR Treasury Yields. Reported highest amount of revenue growth out of all sectors for Q3 2021.	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.[8] Confidence in 'return to normal life' could lead to higher production - increasing supply and lowering prices. Sector concentrated with 2 major players making up about 40% of sector as of 11/18/2021.	
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. Higher than expected inflation could lead to faster Fed rate hikes, a benefit for Financials.	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.
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 recommending booster shots to combat Omicron variant 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 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] Re-shoring and automation structural trends will be a long-term benefit. Sector showing positive margin growth Q3 2021 vs. Q3 2020.[11]	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.[12] 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. Companies are issuing more negative than positive Q4 Guidance.	**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	Large Cap 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 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. If winter Covid surge causes lockdowns, then WFH names would likely benefit. 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.	**Overweight** Cloud Computing, Robotics/AI Cybersecurity, Clean Energy and CleanTech are major potential beneficiaries.
Materials	Clean energy and infrastructure bill could increase demand for industrial materials. Showing positive net margin growth Q3 2021 relative to	The Materials sector is highly sensitive to Chinese demand. This may pose a headwind soon especially considering the current shakeup in the Chinese property market.	**Market Weight** Increased focused on Electric Vehicle adoption, alternative energy sources and energy storage should be beneficial to Lithium

	Q3 2020, as of 11/12/2021.[13] Beneficiary of rising inflation leading to higher price for raw materials. Positively correlated with 10YR Treasury yields and WTI Crude Prices.	Significant supply chain bottlenecks could dampen economic growth. Increased regulations, especially those focused on preventing climate change, is a potential negative.	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. There is a growing push by corporations to return to the office, particularly in major cities, with pandemic-related restrictions relaxed or eliminated. 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.	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. 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.	**Market Weight** Life Sciences, technology focused REITs may be beneficiaries.
Utilities	Utilities valuations are in line with 5-year average levels. Utilities as a sector has an average dividend of around 3%.[14] Bank of America identified the Utilities sector as the highest quality sector. It benefits from resilient fundamentals including stable revenues.[15] Capex costs associated with the shift towards green power production may be partially offset by government support.	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. Utilities is negatively correlated with 10YR Treasury Yields and WTI crude prices.	**Underweight**

	Preferred sector in recessionary environment due to inelasticity of goods & services.		

Footnotes:

1. FactSet, Earnings Insight, 11/19/2021
2. Bloomberg, Austria imposes lockdown, Germany may follow as Covid rages, 11/19/2021
3. Bloomberg data as of 11/28/2021
4. WSJ, Fed Worried About Inflation Risk As It Firmed Up Tapering Plan, 10/13/2021
5. Schwab, Sector Insights: A View on 11 Equity Sectors, 8/19/2021
6. CME Group, CME FedWatch Tool, 11/1/2021
7. FactSet, Earnings Insight, 10/22/2021
8. CFA Institute, The Impact of the US Presidential Election and Covid-19 on US Equity Valuations, 10/21/2020
9. CDC, CDC Expands Covid-19 Booster Recommendations, 11/29/2021
10. BofA, The RIC Report: American is Still Exceptional, 9/14/2021
11. FactSet, Earnings Insight, 11/19/2021
12. BofA, The RIC Report: America is Still Exceptional, 9/14/2021
13. FactSet, Industry Data, 11/12/2021
14. Bloomberg data as of 11/30/2021
15. 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.

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