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Current Sector Views & December 2021 Recap

The pace of Federal Reserve (Fed) balance sheet tapering, that started in November, accelerated in December, bringing forward the timing of the first expected interest rate increase to March 2022 from June 2022. As discussed in our 2022 outlook, we believe that 2022 will be the year of the Fed, with updated guidance and sentiments from the Fed being likely to dominate sentiment in the equities and fixed income markets.

Continuing our focus on the Fed, this month we looked at risk adjusted sector performance in the S&P 500 and analyzed which factors contributed to risk premiums for sector performance during the taper of 2013-2014 and what we can learn for the current period of reducing liquidity.

Key Takeaways

- Liquidity, Momentum, and Size contributed the most to positive performance in 2014.
- The sectors that currently display the highest level of these factors are Consumer Staples, Communication Services, and Real Estate.
- Finally, we discuss differences between economic environments and how those differences could impact the data we analyzed from 2014.

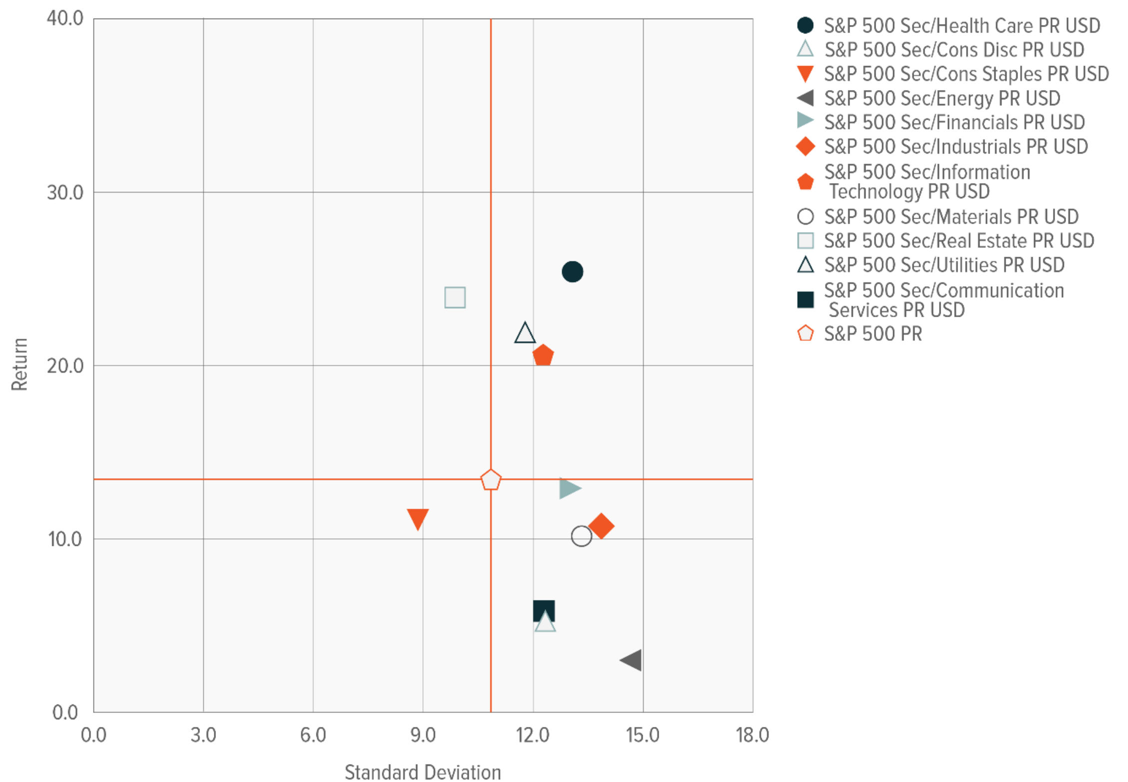
Taper, Hold the Tantrum

So, what does this mean for equity markets? Not long ago, in 2013, The Fed began a taper by removing liquidity provided to the market after the recession of 2008-2009. The taper began mid-December 2013 and lasted until end of October 2014. Historically similar events tend to rhyme, the economic landscape was quite different in 2013 and 2014 yet with a few similarities. Then, the Federal Funds rate was in the 0.00%-0.25% range, the price of oil was hovering around $100/barrel – not far from WTI Crude's 2021 high of $84.59, and discouraged workers were leaving the labor market[1]. The differences are also quite stark: there was no pandemic; inflation was well below the Fed's 2% target, not strongly above it (2021 Consumer Price Index was up 4.6%[2]); and valuations were stratified across the sectors. Because sectors and the underlying companies that drive them evolve over time, we do not believe it would be appropriate to compare sector performance from past to present. Instead, we analyzed the factors that contributed to the risk premiums within each sector during the taper of 2014, seeing which factors attributed positively, neutrally, and negatively. Then, we analyzed how those factors' risk premiums are distributed across the current period sectors, reviewed structural differences between then and now, and considered how this could help positioning in today's fluid environment. While the past can provide useful information, bear in mind that past performance is not a guarantee of future results.

The factors that encompass a company's risk premium are based on the Fama-French model: Style, and Size, with Liquidity, Volatility and Momentum included in this analysis.

- Style - A company either displays more value or growth tendencies.
- Size - A company's market capitalization (higher size factor means smaller market capitalization)
- Liquidity – Considers how easily shares are traded and bid-ask spreads
- Volatility- Considers swiftness and range of price changes
- Momentum - Factors in current trends in performance.

All these factors create a risk premium for each sector that is added to the 10-Year Treasury Yield and drives forecasted valuations.



S&P 500 SECTOR RISK-REWARD PLOT SUMMARY

	Below Average Risk	Above Average Risk
Above Average Return	Real Estate	Health Care Utilities Information Technology
Below Average Return	Consumer Statples	Financials Industrials Materials Communication Services Consumer Discretionary Energy

First, looking at the Risk/Reward chart based on return and standard deviation relative to the S&P 500 index during the time frame of the 2014 taper we see how each sector fared on a risk-reward basis:

- Real Estate provided above average return with below average risk.
- Health Care, Utilities, and Information Technology sectors provided an above average return for an above average level of risk.
- Consumer Staples provided a below average return for a below average level of risk.
- Financials, Industrials, Materials, Communication Services, Consumer Discretionary and Energy sectors provided below average returns for above average levels of risk.

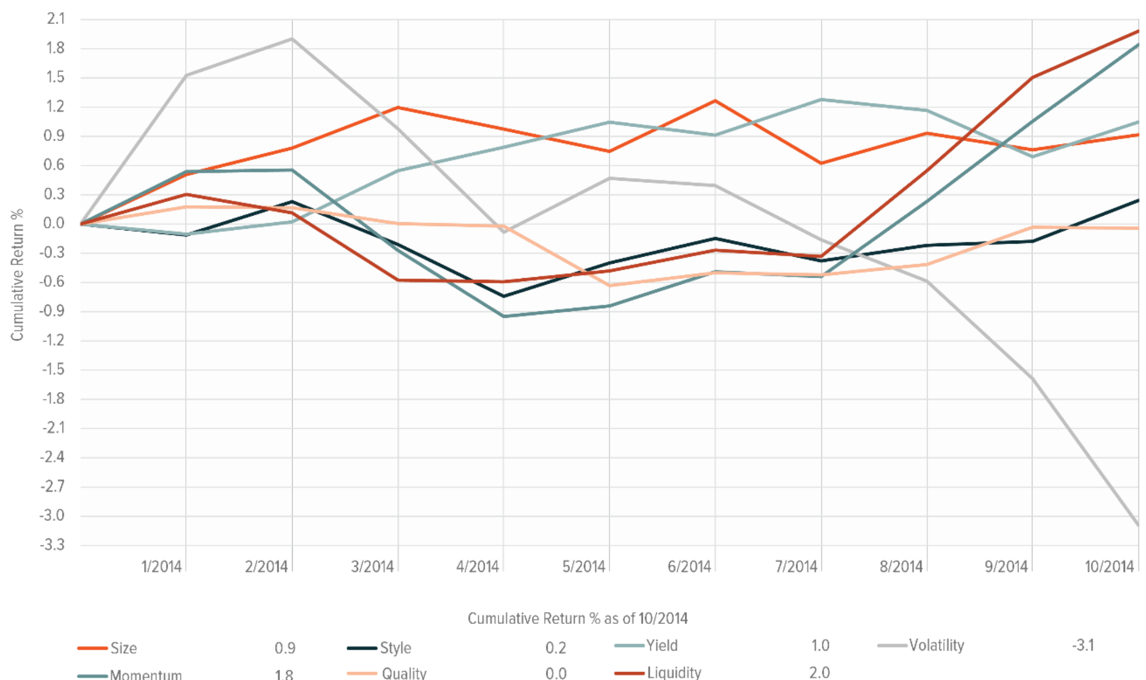
One goal when choosing an investment is to avoid taking on undue risk, which would have been done in 2014 by avoiding sectors in the bottom right quadrant where investors received a below average return with an above average level of risk. Although these sectors underperformed the broad S&P 500 Index during the 2014 taper doesn't mean they will do so again this time around.

Factor Focus

At the same time, the risk premium factors that contributed positively were Liquidity (2.0%) and Momentum (1.8%) and negatively was Volatility (-3.1%). What this means is that more liquid companies (liquidity), and short-term sentiment (momentum) had positive contributions to performance and more volatile companies (volatility) had negative contributions to returns. Style skewed slightly towards growth and size premiums rose towards small caps. This data echoes what we mentioned in our Outlook 2022 piece where we said investors will likely put a greater focus on fundamentals next year.

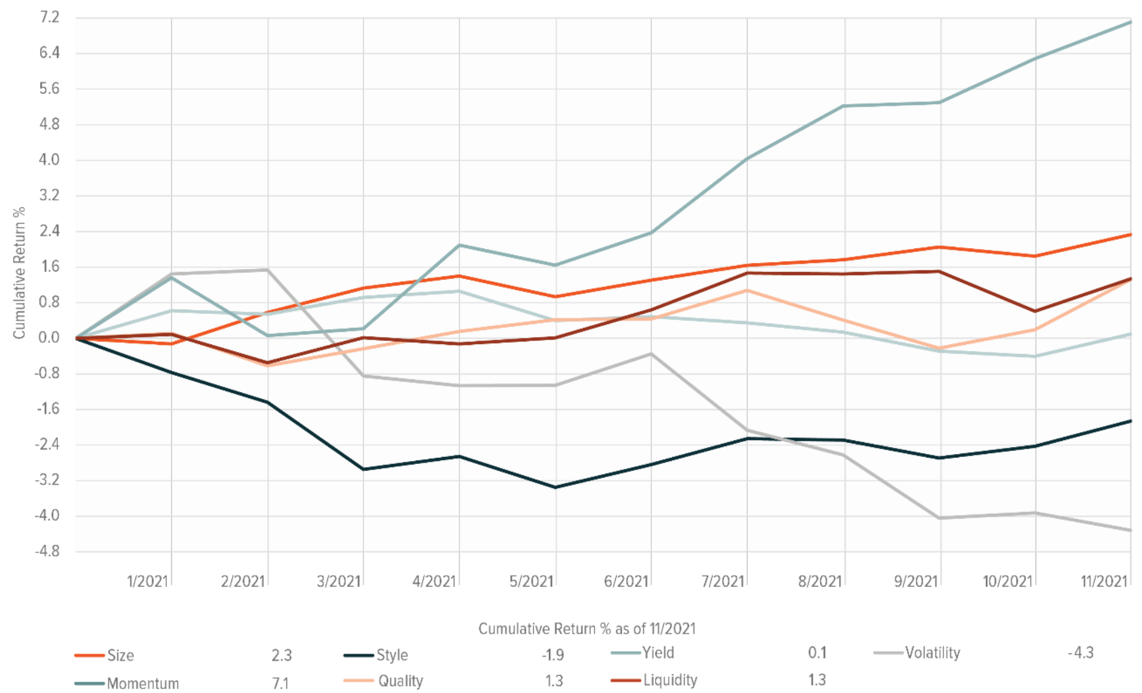
S&P 500 RISK PREMIUMS DURING 2014 TAPER

Source: Morningstar Direct - Risk Premium Monthly Data 1/1/2014 - 10/31/2014



S&P 500 RISK PREMIUMS FROM JAN-NOV 2021

Source: Morningstar Direct - Risk Premium Monthly Data 1/1/2021 - 11/30/2021



Because markets and companies grow and evolve, the allocation of factor risk premiums change over time across sectors. Looking at the risk factors that impacted returns the most, in 2014 there was Liquidity and Momentum on the positive side and Volatility on the negative side. For the most recent period in 2021, Momentum and Size contributed the most to positive returns and Volatility to negative returns. For the analysis we considered a 1 year period, 3 year period, and a combined data set. The last year provides a reasonable reflection of expectations for higher interest rates while the last three years provide greater historic context. The charts below, in order, reflect 1 year sector factor exposures, 3-year sector factor exposures, and a combination of the two. For the combination of the two, we multiplied the values of the 1-year data by two-thirds, then we multiplied the values of the 3-year data by one-third and added the two values together. This puts a heavier weight on the most recent lookback period while the 3-year is included to normalize the 1-year data.

1 YEAR S&P 500 SECTOR FACTOR EXPOSURE

Source: Morningstar Weekly Data From 12/1/2020 - 11/30/2021

	Style	Momentum	Volatility	Liquidity	Size
Communication Services	23.2	54.7	73.9	91.6	98.6
Consumer Discretionary	5.4	26.3	23.0	10.6	90.6
Consumer Staples	85.8	93.4	93.2	92.2	67.0

Energy	98.5	4.4	24.4	26.7	48.2
Financials	80.3	13.8	77.6	86.1	65.2
Health Care	74.5	74.0	54.5	81.2	65.9
Industrials	74.3	75.9	73.9	66.5	37.2
Information Technology	17.9	37.6	48.2	45.9	96.3
Materials	56.2	68.1	69.2	24.6	36.8
Real Estate	47.5	55.0	76.2	84.8	31.9
Utilities	95.3	96.8	89.7	81.8	30.9

Scaling 1-100 For factor definitions click *here*.

Looking at the data strictly for a one year look back period, for liquidity – Consumer Staples, Communication Services, and Financials scored highest. For momentum – Utilities, Consumer Staples, Industrials and Health Care scored highest. Since the style risk premium referenced in the 'S&P 500 Risk Premiums During 2014 Taper' skewed positive that meant growth just slightly outperformed value, so we look at which sectors have the lowest style factor (meaning more growth tendencies) – Communication Services, Technology, and Consumer Discretionary.

On an aggregate basis the Consumer Staples, Utilities, and Communication Services were the highest scorers across the analyzed metrics. Finally, for the growth over value component, Communications Services scored higher than the other sectors. This data also ties in with our Outlook 2022 piece as we discussed the importance of having a balance of both growth-oriented and value-oriented companies. From the data, the liquidity factor was the biggest contributor to return, which was prevalent in both value and growth focused names.

3 YEAR S&P 500 SECTOR FACTOR EXPOSURE

Source: Morningstar Monthly Data From 12/1/2018 - 11/30/2021

	Style	Momentum	Volatility	Liquidity	Size
Communication Services	22.6	26.1	67.6	75.4	98.6
Consumer Discretionary	5.3	71.3	28.1	11.5	89.8
Consumer Staples	87.5	92.2	94.2	90.6	68.2
Energy	99.7	4.4	18.9	12.6	49.8
Financials	77.9	11.4	69.3	78.6	68.4
Health Care	76.4	68.7	64.8	83.2	66.8
Industrials	73.8	71.1	70.9	52.6	38.0

Information Technology	19.1	66.6	63.7	62.4	95.8
Materials	62.9	70.7	62.1	20.8	36.3
Real Estate	47.1	54.3	79.7	81.8	31.8
Utilities	96.1	95.1	88.6	80.7	31.2

Scaling 1-100 For factor definitions click *here*.

When combining both time frames of data and weighing the 3-year historical at 1/3 and 1-year at 2/3 the results are below:

S&P 500 SECTOR FACTOR EXPOSURE - COMBINED PERIODS

Source: Morningstar. 2/3 1 Yr Weekly Data from 12/1/2020-11/30/2021 & 1/3 3 Yr Monthly Data from 12/1/2018-11/20/2021

	Style	Momentum	Volatility	Liquidity	Size
Communication Services	23.0	45.3	71.9	86.3	98.6
Consumer Discretionary	5.4	41.1	24.7	10.9	90.3
Consumer Staples	86.4	93.0	93.6	91.6	67.4
Energy	98.9	4.4	22.6	22.0	48.8
Financials	79.5	13.0	74.8	83.6	66.2
Health Care	75.1	72.2	57.9	81.9	66.2
Industrials	74.1	74.3	72.9	61.9	37.5
Information Technology	18.3	47.2	53.3	51.4	96.1
Materials	58.4	68.9	66.9	23.4	36.6
Real Estate	47.4	54.8	77.3	83.8	31.8
Utilities	95.5	96.2	89.3	81.4	31.0

Scaling 1-100 For factor definitions click *here*.

Highlighted cells are where we see notable differences between the two time periods of data on their own and when combined.

- As expected, we didn't see any material changes in Style or Size.
- We noted a rise in momentum for Communication Services and drops for Consumer Discretionary and Information Technology.

- Volatility dropped the most for Information Technology and Health Care and rose the most for Financials. Although these were the standouts, almost every other sector also experienced change in volatility. This is likely due to the impact of the "covid era", some sectors were positively impacted by COVID-19, while others benefitted from reopening plays. As surges and new variants arise, we expect leadership shifts.
- Liquidity, which accounted for the highest contribution to return from risk premium during the previous taper, rose strongly for Communication Services, Energy, and Industrials and dropped for Information Technology.

All in all, given the adjustment and based on the factor data from the previous taper Consumer Staples, Communication Services and Real Estate exhibit the highest levels of the liquidity factor. Utilities, Consumer Staples, and Industrials exhibit highest levels of the momentum factor. Communication Services, Information Technology, and Consumer Discretionary display highest levels of the size factor. Finally, Utilities, Real Estate, and Consumer Discretionary show highest levels of earnings and debt quality. When using the factor data from the previous taper and relating it to the current environment Consumer Staples, Communication Services, and Real Estate all seem to benefit the most.

What's Different Now?

No period is the same so this data must be contextualized given the current economic environment. For example, the economy of 2014 wasn't grappling with a supply chain crunch impacting profit margins of sectors like Consumer Staples, Consumer Discretionary, and Materials which is expected to persist through at least mid-year.[3] Or the extraordinary inflation the current U.S. economy is grappling with which has elevated prices for both producers and consumers across all sectors. Of course, another COVID-19 strain surge is always possible that would dampen economic growth and cause investors to rotate out of certain sectors into others, or worse, into cash.

Another consideration is composition. From a structural perspective the Communication Services sector prior to September 2018 was the Telecommunications Sector which had a stronger focus on value. Given this and taking into consideration the current environment where some of the larger growth focused Communication Services sector names are more immune to supply chain issues, we would expect this sector to provide different risk adjusted returns during today's taper.

Also, the high inflation environment we are currently in is plainly different from the inflation levels seen in the 2014 taper. This directly affects the forward-looking expected growth of the Financials sector. Because The Fed is readying itself to begin raising rates next year and because companies in the Financials sector benefit from rising rates by borrowing short term and lending long term this sector would also be expected to provide a different risk adjusted return during the current taper.

This brings to the final point that diversification across factors and sectors is increasingly important. Investors will likely place a higher focus on fundamentals as the Fed takes the necessary steps to complete its taper and begin raising rates to combat inflation. We believe investors should also have a balance between value and growth names which would provide them with the potential to weather stylistic pullbacks. For our current views please reference the sector 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 9/30/2021.

	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 12/27/2021) which can meaningfully impact the sector (positively or negatively).	**Market Weight**
Consumer Discretionary	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 continues to 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 analysis, 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	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. Reported highest amount of revenue growth out of all sectors for Q3 2021.	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 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 12/28/2021.	Market Weight
Financials	The Financial sector benefits from improving economic growth, higher interest rates and a steeper yield curve.	Sensitive to economic growth expectations. A decline in interest rates or a flattening of the yield	Overweight

	Financials are positively correlated with WTI Crude Prices. Higher than expected inflation could lead to faster Fed rate hikes, a benefit for Financials.	curve is detrimental to the Financials sector. Fed delaying interest rate increases if economy growth slows will likely negatively impact sector.	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.	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.	**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.

	Sector showed positive margin growth Q3 2021 vs. Q3 2020.[11]	Supply chain issues could be a major headwind for Industrials. Companies issued more negative than positive Q4 Guidance.	
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. Reported 2nd highest net revenue growth among all sectors for 2021.[13] 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 soon 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. There is a growing push by corporations to return to 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 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.

	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.	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. Utilities as a sector has an average dividend of around 3%. Bank of America identified the Utilities sector as the highest quality sector. It benefits from resilient fundamentals including stable revenues.[14] Capex costs associated with the shift towards green power production may be partially offset by government support. Preferred sector in recessionary environment due to inelasticity of goods & services.	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**

Footnotes:

1. Bureau of Labor Statistics, Civilian Labor Force Participation Rate, 12/22/2021
2. FactSet, CPI Inflation, 12/22/2021
3. WSJ, When will supply chain strains finally ease? 11/5/2021
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, Earnings Insight, 12/17/2021
14. 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.

Standard Deviation: Standard deviation is a statistical measure of the variation or dispersion within a set of numbers. In investing it is used to discuss the volatility in returns. Typically, fixed income returns are more stable while equity returns have a higher level of volatility.

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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