GLOBAL X by Mirae Asset

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Date: December 2, 2022
Topic: Sector Views

Labor Market Stress to Impact U.S. Sectors

The news cycle shifted quickly from covering a labor shortage to rounds of layoffs. Although the U.S. labor market remains strong, cracks are starting to show with the number of news stories mentioning the term "layoffs" exceeding 2020 levels.

The strength of the labor market provides important information to investors from several perspectives:

- Lower profit margins due to higher wages
- Weak consumption could weigh on corporate topline growth, driven by labor market conditions
- Risk of a wage-price spiral as companies face a mismatch between labor supply and demand

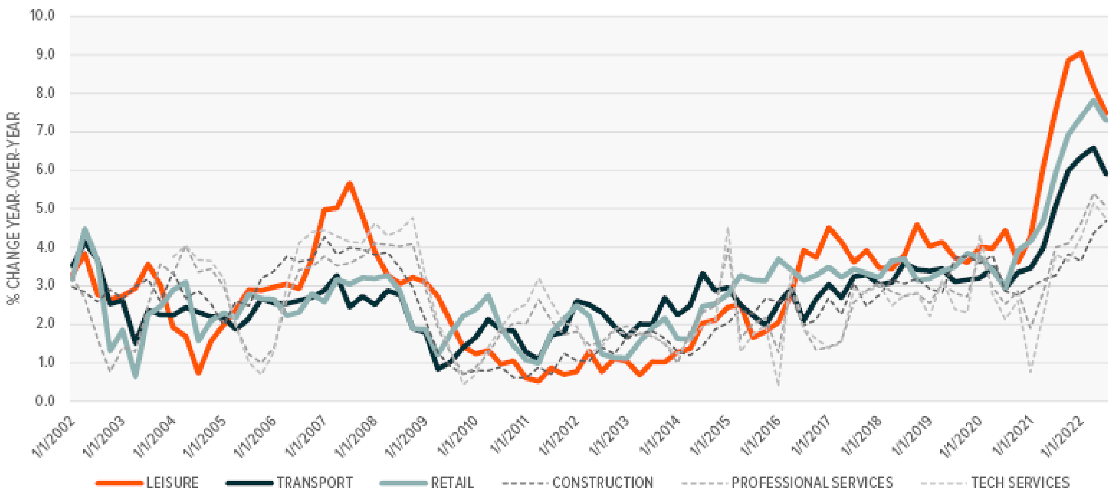
Earnings Drag from High Employment Costs

Most industries have experienced an increase in labor costs. However, as reflected in the graphic, service industries such as leisure and hospitality faced sharper wage increases due to a labor shortage as the economy reopened from COVID-19 lockdowns last year. The supply chain crunch in 2021 also contributed to rapid hiring in the transport industry, which accelerated wage growth. As a result, employment costs in cyclical sectors rose well above pre-pandemic levels. Revenue did not keep pace with the growth in operating costs, which has weighed on earnings this year.

EMPLOYMENT COST INDEX BY INDUSTRY

Rising Employment Costs Led by Leisure and Retail, Cooling Off

Source: FRED data as of November 1, 2022



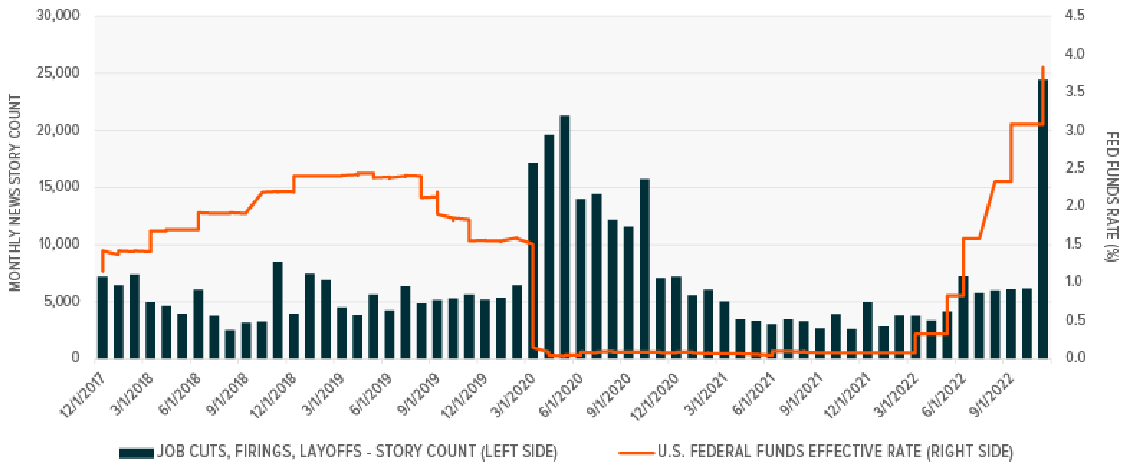
Q3 earnings were generally better than expected, although cyclical sectors such as Industrials, Materials, and Communication Services had the most earnings misses. Overall, companies have reported revenues that are 2.5% above estimates, which is above the five-year average of 1.9% and above the 10-year average of 1.2%, according to FactSet data. But the cost side of the equation continues to rise, contributing to the fifth straight quarter of declining corporate margins and below average EPS beats (Q3 earnings exceeded EPS estimates by 1.8% versus the five-year average of 8.7%).[1]

The Rising Tide of Layoffs

Weaker economic growth could accelerate an earnings contraction, especially as more companies announce job cuts. So far this year, service industries such as Automotive, Leisure, and Retail have seen more job cuts compared with last year, according to data from Challenger, Gray & Christmas. Even white-collar jobs have been cut, particularly in technology and financials. And news mentions of layoffs and job cuts rose in November as more companies cited business closures, cost-cutting, and declining economic conditions as key reasons for scaling back this year.

JOB CUTS AMID AGGRESSIVE RATE HIKES

More News Story Counts of Job Cuts, Firings, and Layoffs
Source: Bloomberg data as of December 1, 2022



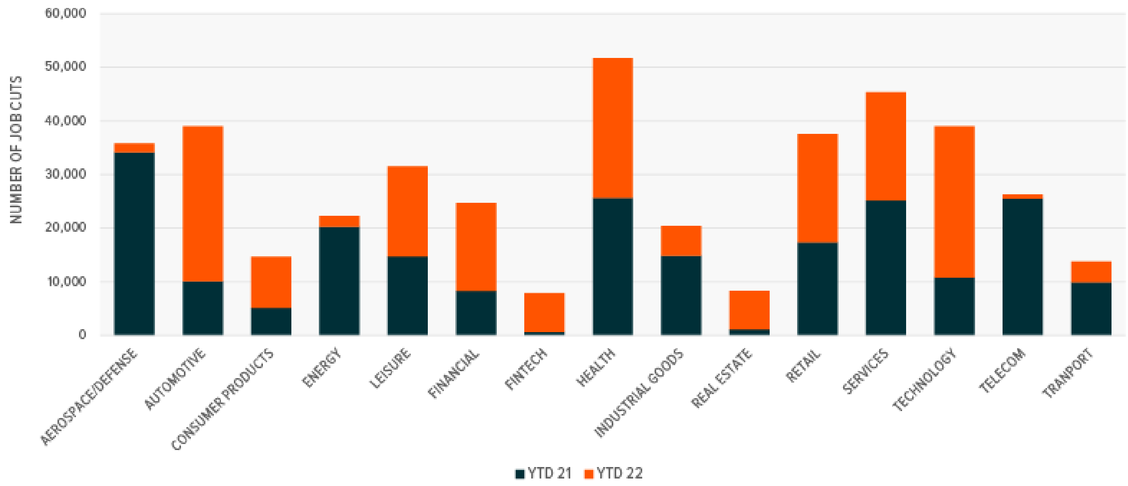
YTD JOB CUTS BY REASON

Source: Challenger, Gray, & Christmas, Inc., *Job Cuts Report*, October 2022

JOB CUTS BY INDUSTRY, 2021 vs 2022

Auto, Tech, Leisure, and Services Scale Back

Source: Challenger, Gray, & Christmas, Inc., *Job Cuts Report*, October 2022



Wages could decline as the job market cools. Private hiring increased by 127,000 jobs in November, well below 239,000 in October. Employee pay rose 7.6% from a year ago, versus 7.7% in October, according to the November ADP report. And wages are not keeping up with inflation, which could weigh on consumption. Workers may have less cash to spend next year as pandemic savings dwindle. Personal savings rates have already decreased to their lowest level since 2007, while credit card debt levels have risen.[2]

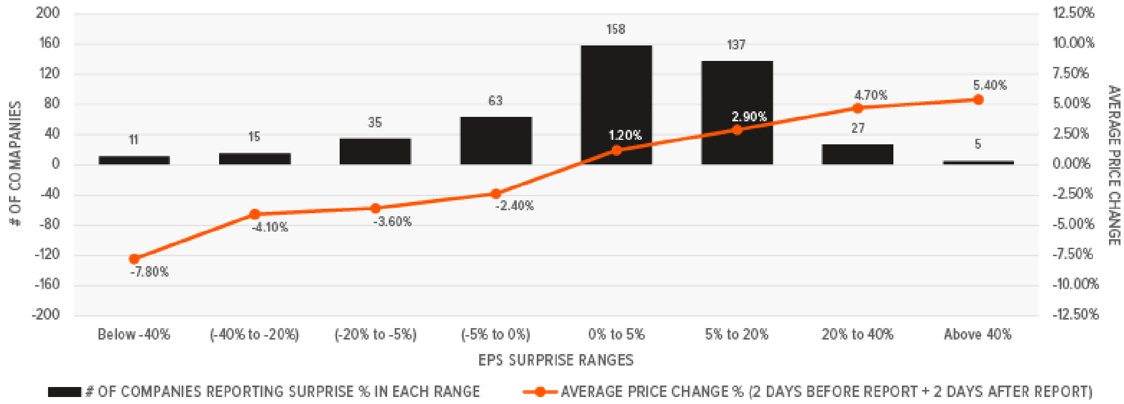
Market is Sensitive to Earnings Beats and Misses

Equity markets are increasingly sensitive to earnings announcements. So far, Q4 earnings growth expectations have fallen from 9.1% in June, to 3.9% in September, and -1% in November, led by Materials, Communication Services, and Consumer Discretionary.[3] The decline in earnings expectations could keep volatility elevated, which typically occurs when the economy shifts from late cycle to recession.[4]

On a positive note, companies that have reported positive EPS surprises have seen a larger price increase than average. In Q3, companies that beat earnings estimates saw a 2.4% price rise two days before and after their earnings release date, which is much larger than the five-year average price rise of 0.9% during the same time window.[5] However, companies that reported negative earnings surprises in Q3 witnessed a significant price decrease, especially in Communication Services.

S&P 500 EPS SURPRISE % vs. PRICE % CHANGE: Q3 2022

Stock Prices Are Sensitve to EPS Beats and Misses
Source: FactSet data as of November 11, 2022



We expect cyclical sector earnings to continue to disappoint as recession risks rise. Although less companies have mentioned “recession” in Q3 earnings calls compared with Q2, 67% of S&P 500 companies have issued negative guidance, above the five-year average of 60%, according to FactSet data. And on the sector level, Financials, Industrials, Real Estate, and Consumer Discretionary companies had the highest mentions of “recessions” in Q3 earnings calls, albeit lower than Q2 levels.

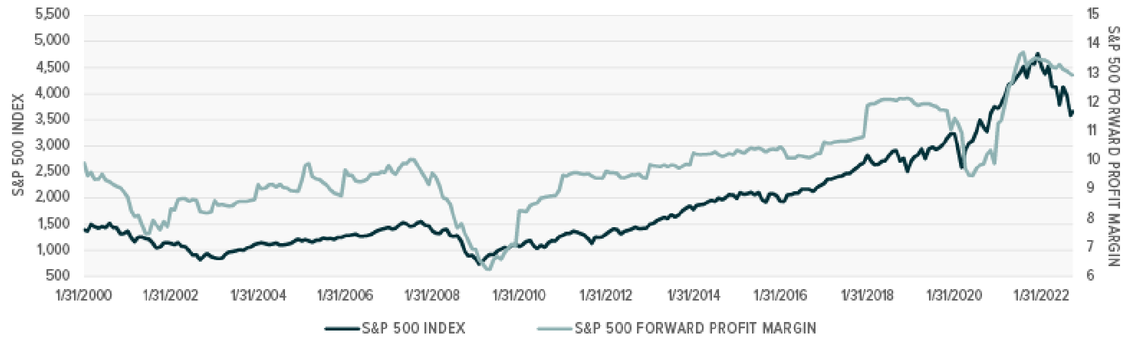
Positioning During an Earnings Contraction

The outlook for corporate profits is deteriorating, and conditions could get worse before a recovery takes place. The labor market is already cooling, which lowers employment costs, but increases recession risks. The level of job openings per unemployed persons is starting to decline, which typically leads to slowing wage growth. The employment cost index, which measures the total change in the cost of labor, peaked in Q2 on a year-over-year basis. And jobless claims have risen over the past month (employment data cited from the U.S. Bureau of Labor Statistics, as of November 2022).

Corporate margin expectations remain high despite the weaker economy. Q3 margin weakness was notable in Financials and Materials, while Energy margins were above their five-year average, boosted by high oil prices, according to FactSet data. In previous cycles, a trough in S&P 500 margin estimates has occurred around market lows.

MARKETS PRICING IN DECLINING MARGIN EXPECTATIONS

Source: FactSet data as of November 11, 2022



There is a silver lining. Over time, right-sizing staffing could lead to productivity gains, bolstering the case for quality sectors that produce stable earnings growth.

Our sector views table below provides more detail on sector positioning and the current tailwinds and headwinds for each sector.

CURRENT VIEWS ON U.S. SECTORS

	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.	Privacy overhang from major hardware providers could impact revenues for interactive media companies moving forward. Higher interest rates may adversely impact the discount rate applied to future earnings and cash flows. This has encouraged a rotation from growth to value this year.	**Underweight**
Consumer Discretionary	Consumers have increased their use of online ordering and deliveries over the past two years, while greater savings and a tight job market could encourage spending.	Wage pressure combined with higher input costs in materials are a risk to margins, especially if companies are unable to raise sales prices. And a deeper economic contraction could weigh on consumer spending. Adversely impacted by rising inventories. Some companies have indicated plans to cut sales prices to	**Underweight**

		get rid of excess inventories.	
Consumer Staples	Demand for consumer staples could remain steady for the remainder of the year, especially in the event of a deeper economic contraction.	Inflation is likely to negatively impact margins for companies that cannot pass through rising materials costs to the end consumer. In our pricing power analysis, Consumer Staples generally scored poorly.	**Overweight**
Energy	Escalated tensions with Russia and greater natural gas demand from Europe could keep energy prices elevated globally, positively impacting the sector. OPEC+ production cuts, and delayed supply response in terms of drilling could keep energy markets tight and prices high. Large, diversified oil and gas companies have ramped up buybacks along with record profits and healthy balance sheets.	A global economic contraction could weigh on demand. The rapid reduction in backwardation of the oil price futures curve indicates a less favorable supply/demand balance.[6] Ongoing COVID-19 lockdowns in China could reduce oil demand, and potentially lower earnings expectations.	**Market Weight**
Financials	The financial sector benefits from strong household and corporate balance sheets. Consumer spending remains robust, and, to a certain extent, rising rates are starting to benefit net interest margins.	A deeper economic contraction could offset the favorable rise in interest rates. A flattening or inversion of the yield curve will likely hurt margins.	**Market Weight**
Health Care	Aging demographics around the world combined with the growing middle class in emerging markets benefit health care demand. Health Care is a defensive sector that typically	Drug pricing pressure remains a risk factor. Senate proposals to grant Medicare powers to negotiate prices on some drugs could limit price increases on medicines.[8]	**Overweight**

	outperforms during severe economic downturns. Sector has attractive valuations on a forward P/E and relative P/E basis.[7]		
Industrials	Beneficiary of rising interest rates, inflation, and possible infrastructure spending. Re-shoring and a shift toward automation infrastructure spending will likely be a long-term benefit for Robotics & AI.	Elevated leverage, increasingly expensive valuations, and rising earnings volatility may detract from this sector's performance. Rising labor costs could pressure margins, particularly within the transport industry. Companies are issuing more negative than positive earnings guidance.	**Market Weight**
Information Technology	Sector displays quality factors and positive FCF growth. The increased adoption of certain key disruptive technologies such as cloud computing, cybersecurity, and CleanTech are likely to remain in a post-COVID-19 world as societies adapt to these new technologies.	Increased regulatory scrutiny is a risk for this sector. There is bipartisan support for increased regulation in this space. Rising interest rates and slowing economic growth would negatively impact long duration growth sectors such as Information Technology.	**Market Weight**
Materials	Increased focus on Electric Vehicle adoption, alternative energy sources and energy storage should be beneficial to Lithium miners and Battery producers. Beneficiary of rising inflation, leading to higher prices for raw materials.	A deeper economic contraction would be a big headwind for Materials. Increased regulations, especially those focused on preventing climate change, is a potential negative.	**Underweight**
Real Estate	Inflation protected yield.	A fast rise in interest rates could increase the cost of financing, and a deeper economic contraction	**Market Weight**

		could raise the risk of costs not being passed along to tenants.	
Utilities	Preferred defensive sector in recessionary environment due to the inelasticity of goods and services. Adoption of renewables could help transform sector in the long run.	The potential for increased climate-related regulations over time may detract from the appeal of this sector. Companies may not be able to pass through higher inflation related costs due to government regulations.	**Overweight**

Footnotes

1. FactSet, S&P 500 Earnings Season Update, November 4, 2022
2. Federal Reserve Economic Data as of November 29, 2022
3. FactSet, S&P 500 Now Projected to Report Year-Over-Year Decline in Earnings in Q4 2022, November 7, 2022
4. JPMorgan Private Bank, Investing in a Late-Cycle Environment, May 26, 2022
5. FactSet, Markets Rewarding Positive EPS Surprises More Than Average, November 11, 2022
6. Bloomberg, U.S. Oil Futures Point to Oversupply for First Time This year, November 18, 2022
7. Yardeni Research, S&P 500 Industry Briefing: Health Care, November 29, 2022
8. CNBC, 'Once-in-a-generation' Prescription Drug Pricing Reform Could be Coming, July 29, 2022

Definitions

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