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Topic: Sector Views

Sector Positioning Based on Economic Regimes

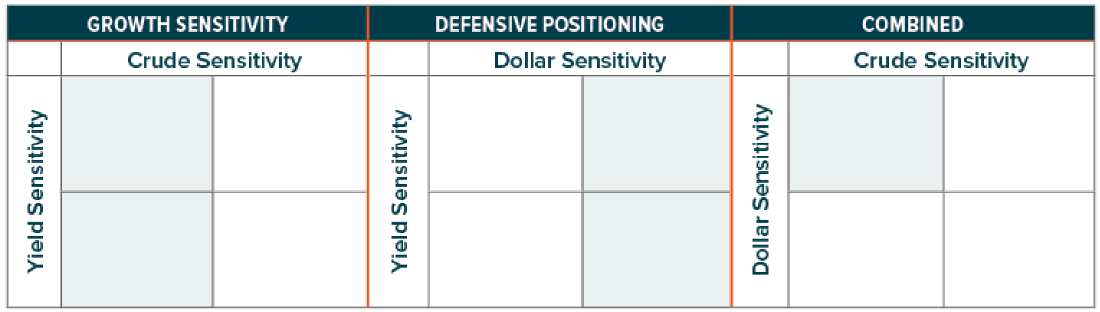
The Federal Reserve's July FOMC meeting potentially tilted the market's focus from interest rate sensitivity to economic growth sensitivity. Therefore, the prospect of slower interest rate rises has significant implications for market positioning. We maintain our view that inflation protection should be balanced with quality and defensive equity positioning, although the balance between cyclical value exposures and growth areas is starting to shift. Defensive growth focused areas could hold up better as the market looks for companies and segments that can grow despite economic weakness.

Positioning Overview

While navigating these transitions, we believe it is helpful to understand the historic relationship between sectors and economic factors including yields, the dollar, and crude oil prices. The tables below provide a broad template of portfolio positioning for an environment with rising economic risks and falling interest rate risks.

The analysis we conducted can be separated into two key areas: growth sensitivity and defensive positioning. The next two sections will provide more detail into these key areas followed by a section that combines these two ideas.

SETTING UP THE LANDSCAPE FOR ANALYSIS



Sector Economic Growth Sensitivity

Economic growth sensitivity is likely to become increasingly important as recession risks rise. For instance, U.S. GDP contracted for a second-straight quarter this year, which meets the unofficial definition of a recession.

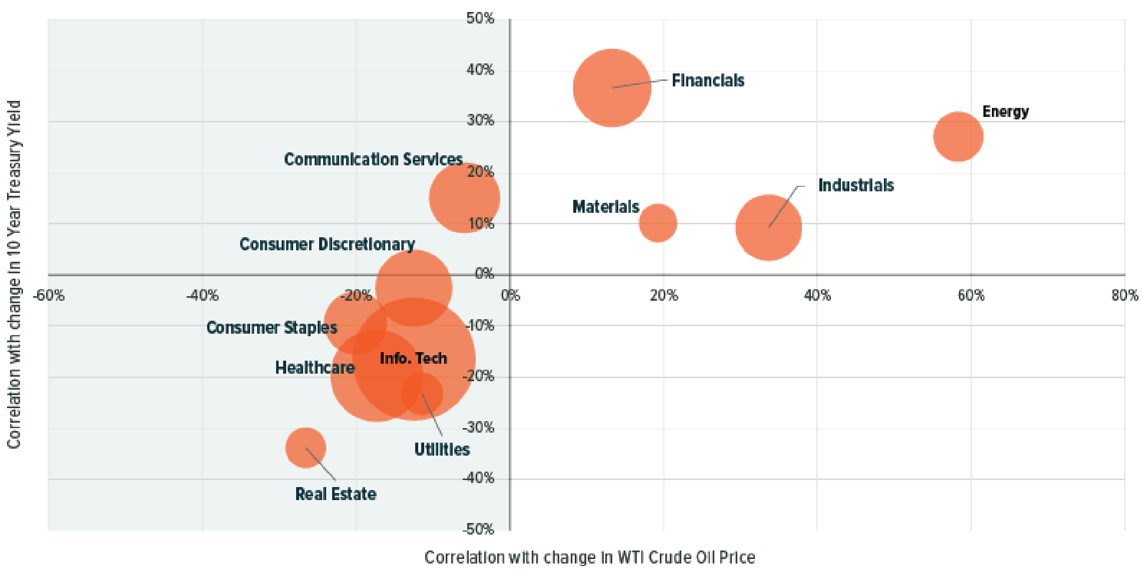
In our analysis, we examined the correlation between excess returns across sectors relative to changes in the WTI crude oil price to determine how sectors respond to shifting economic growth expectations. Crude and other growth sensitive commodities are typically highly sensitive to economic growth expectations. Additionally, the shape of the yield curve also reflects economic growth expectations. The yield curve is currently inverted, with the 2-year Treasury yield more than 20 basis points (bps) above the 10-year Treasury yield.[1]

Financials, Materials, Industrials and Energy are the key cyclical value sectors that are positively correlated with crude prices and the 10-year Treasury yield. Here are some additional relationships to consider.

- The shape of the yield curve has a direct impact on bank net interest margins. A weaker economy could weigh on loan growth and credit quality, which are headwinds for Financials.
- The Energy sector is highly sensitive to both crude prices and the 10-year Treasury yield.
- Slowing economic growth expectations weigh on Materials and Industrials. For example, over the past month, several regional manufacturing indices have plummeted, which points to a contraction in overall business activity.
- Real Estate has a negative correlation with Treasury yields, although, like Financials, economic growth is an important driver of the sector's excess return. Periods of sustained growth are typically conducive to higher property values and rental income if interest rates remain low. When yields rise, Real Estate companies are at risk of declining property values and higher borrowing costs.[2] That could make the relatively higher dividend yields generated by real estate investment trusts (REITs) less attractive compared with Treasury bonds.

S&P 500 SECTORS' EXCESS RETURN CORRELATIONS: 3 YEARS, WEEKLY DATA

Source: Bloomberg Data & Global X Analysis as of 27 July 2022



Note: Each sector's bubble size refers to its weight in the S&P 500 Index.

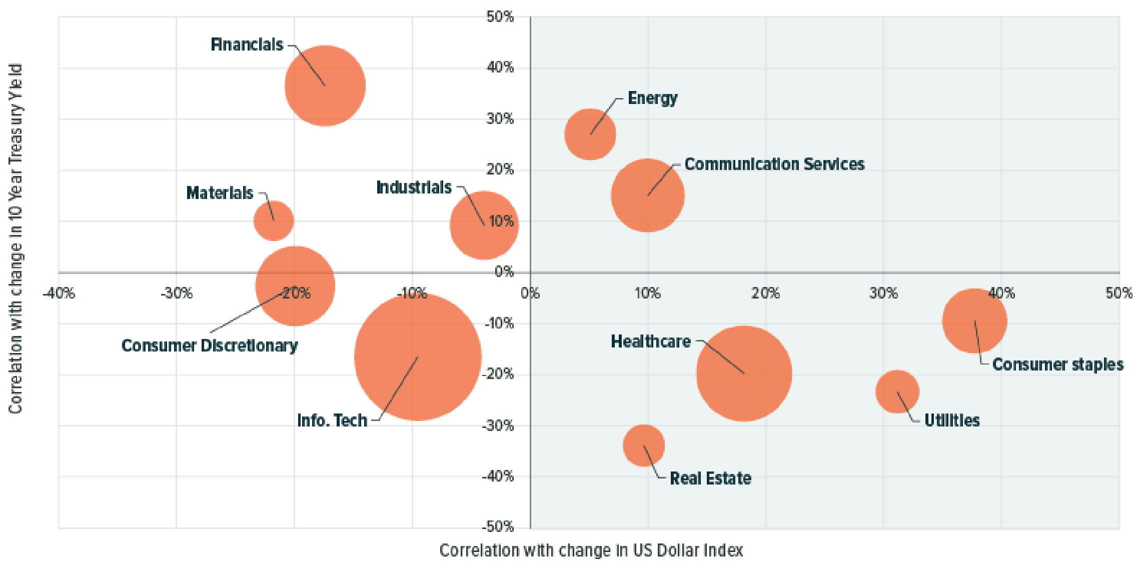
Defensive Positioning

Monetary policy divergence combined with economic growth concerns have strengthened the U.S. dollar relative to a basket of currencies. A flight to safety over the past few months favored defensive positioning.

- Consumer Staples, Utilities and Health Care have the highest correlation with the dollar. These defensive sectors provide exposure to segments of the economy where consumers have less ability to scale back as real disposable income declines.
- Consumer Discretionary and Materials have the lowest correlation with the dollar. These cyclical sectors benefit from greater spending among businesses and consumers, which occurs during the economic recovery and expansion phases.

S&P 500 SECTORS' EXCESS RETURN CORRELATIONS: 3 YEARS, WEEKLY DATA

Source: Bloomberg Data & Global X Analysis as of 27 July 2022



Note: Each sector's bubble size refers to its weight in the S&P 500 Index.

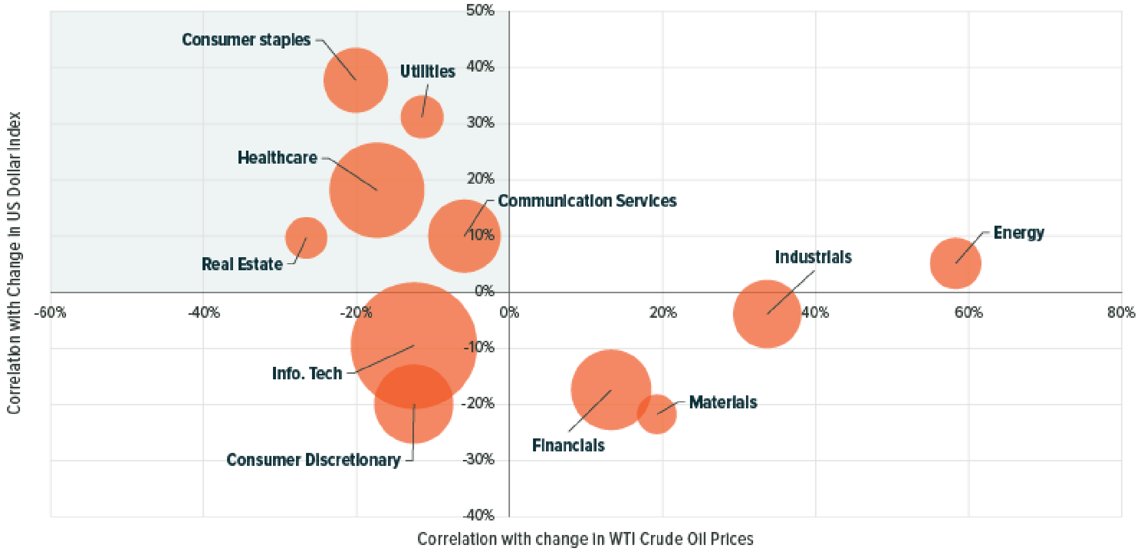
Combining Growth Sensitivity and Defensive Exposure

Removing the interest rate environment from consideration focuses attention on a single quadrant. While defensive sectors take the lead, growthier sections such as Communication Services and, to a lesser extent, Information Technology are just behind. Conversely, cyclical value sectors such as Financials and Materials stand out, challenged by a defensive environment with greater economic risks.

The Energy sector has been positively impacted by exogenous factors that remain in play. Typically, we would expect a negative relationship between Energy and the U.S. Dollar as a stronger dollar typically weighs on commodity pricing.

S&P 500 SECTORS' EXCESS RETURN CORRELATIONS: 3 YEARS, WEEKLY DATA

Source: Bloomberg Data & Global X Analysis as of 27 July 2022



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However, regime shifts from expansion to contraction can be volatile, which means deviating away from economically sensitive factors could help mitigate downside risk in equity portfolios. On the other hand, when the rise in yields and inflation slows, growth sectors such as Technology could be more receptive to a market rebound.

Our sector views table 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. Companies in this sector generally have resilient fundamentals.	Semiconductor chip shortage continues to negatively affect sector – could last until 2023.[3] An increase in interest rates will 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	Wage pressure combined with higher input costs in materials and shipping are	**Underweight**

	deliveries over the past two years, while greater savings and a tight job market could encourage spending.	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 and ongoing supply chain disruptions. Some companies have indicated plans to cut sales prices to 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 will negatively impact margins for companies that cannot pass through rising materials 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.[4]	**Market Weight**
Energy	Escalated tensions with Russia and greater natural gas demand from Europe could keep energy prices elevated globally, positively impacting the sector. A delayed supply response in terms of drilling and production 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, especially from China, thereby lowering energy prices. Rising COVID-19 cases during winter months could negatively impact mobility. Lower demand will reduce energy prices.	**Overweight**
Financials	The financial sector benefits from improving economic growth, higher	High cash levels and low loan demand are hampering revenues,	**Market Weight**

	interest rates and a steeper yield curve. Strong balance sheets and the potential for higher net-interest margins could underpin the case for bank performance.[5]	although loan growth has turned positive recently.[6] A deeper economic contraction could offset the favorable rise in interest rates. A flattening or inversion of the yield curve will likely hurt margins.	
Health Care	Aging demographics around the world combined with the growing middle class in emerging markets benefit health care demand. CDC recommending booster shots to combat Omicron variant could be a boon for both pharmaceutical manufacturers and care providers.[7]	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**
Industrials	Beneficiary of rising interest rates, inflation, and possible infrastructure spending. Re-shoring and a shift toward automation infrastructure spending will be a long-term benefit for Robotics & AI.	Elevated leverage, increasingly expensive valuations, and rising earnings volatility may detract from this sector's performance. Supply chain issues could be a major headwind. Companies are issuing more negative than positive earnings guidance.	**Market Weight**
Information Technology	Software names should benefit from higher CAPEX as firms look to boost productivity amid rising wage growth.[9] 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	Increased regulatory scrutiny is a risk for this sector. There is a 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**

	adapt to these new technologies.		
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.	Ongoing supply chain bottlenecks and a deeper economic contraction are headwinds for Materials. Increased regulations, especially those focused on preventing climate change, is a potential negative.	**Market Weight**
Real Estate	The Office, Retail, and Hotels segments in Real Estate could benefit from the reopening with increased focus on a return to normal. Residential REITs are seeing strong demand and rising rents, which is translating into higher multi-family rents.	Uncertainty surrounding a full return to the office may reduce demand for office space. A fast rise in interest rates could increase the cost of financing, and a deeper economic contraction could raise the risk of costs not being passed along to tenants.	**Market Weight**
Utilities	Bank of America identified the Utilities sector as the highest quality sector. It benefits from resilient fundamentals including stable revenues.[10] Preferred sector in recessionary environment due to the inelasticity of goods and services.	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.	**Market Weight**

Footnotes

[1] Bloomberg data as of 28 July 2022
[2] S&P Global, The Impact of Rising Interest Rates on REITs, 1 April 2017
[3] WSJ, Fed Worried About Inflation Risks As It Firmed Up Tapering Plan, 13 October 2021
[4] FactSet, Earnings Insight, 22 October 2021
[5] BofA, The RIC Report: Get Paid to Wait, 11 January 2022
[6] Schwab, Sector Views: Financials, 25 January 2022
[7] CDC, CDC Expands Covid-19 Booster Recommendations, 29 November 2021
[8] CNBC, 'Once-in-a-generation' Prescription Drug Pricing Reform Could be Coming, 29 July 2022

[9] BofA, The RIC Report: Get Paid to Wait, 11 January 2022
[10] BofA, The RIC Report: America is Still Exceptional, 14 September 2021

Definitions

Basis point (bps): A basis point is a hundredth of one percent. It is predominantly used to express differences in interest rates.

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.

FOMC: Federal Open Market Committee