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Sector Views: Positioning for Yields Remaining Higher for Longer

During August, higher interest rates were a major driver of market sentiment. Factors including surprisingly strong economic data, an increase in Treasury debt issuance, Fitch's downgrade of U.S. debt, and a rise in Japanese yields all played a role in moving the 10-year Treasury yield higher over the summer months. The current strength of the U.S. economy can be attributed to the resilience of the consumer, a tight labor market, and the economy's lower sensitivity to higher yields. While a soft landing has become the consensus view, how this cycle plays out has implications for long-term yields and market positioning. This piece will discuss positioning primarily from a U.S. sector perspective.

Key Takeaways:

- The U.S. economy's lower sensitivity to yields has factored into its resilience, but we believe it's too early to lean fully into cyclicals.
- Monetary policy's lower effectiveness is likely to keep policy yields elevated for an extended period.
- Increased importance of diversification and balance between interest rate and economic growth sensitive market areas. Capex and infrastructure investment remain key growth drivers for cyclical areas while Q2 earnings season confirmed an acceleration in Artificial Intelligence (AI) adoption.

U.S. Economy Reflects Reduced Interest Rate Sensitivity Than Prior Cycles

The U.S. economy is in a vastly better position than expected at the beginning of the year. Unlike prior rate hiking cycles, the U.S. economy has been far less sensitive to policy interest rates. Extremely low yields in the aftermath of the pandemic provided consumers and businesses an opportunity to refinance prior to the start of the rate rising cycle.

From a household perspective, consumer balance sheets remain solid, with excess pandemic savings likely to remain a support until the end of Q3, while consumer debt as a percentage of GDP has continued to decline since its peak in 2001.^{1,2} The housing market has not played its typical role in slowing down U.S. economic activity. While the tight labor market contributed to this resilience, the housing market was in a far less sensitive position relative to the last rate raising cycle. Around 42% of U.S. owner-occupied houses didn't have mortgages at the start of the current rate raising cycle, this compares with 32% during the 2006 – 2008 cycle. Additionally, around 85% of mortgages are fixed rate, with 75% being 30-year fixed at rates below 4%.^{3,4}

The high level of fixed rate mortgages dramatically reduced the sensitivity of U.S. households to yields as the effective mortgage rate remains below pre-Covid levels, while the marginal mortgage rate is above 7%.^{5,6} The lower effective mortgage rate reflects that the average consumer is less vulnerable to higher interest rates. This also implies a reduced effectiveness of monetary policy to impact consumption. As such, the "long and variable" lag in the effectiveness of monetary policy may have become longer.

A Start of a New Cycle or Consumption Brought Forward

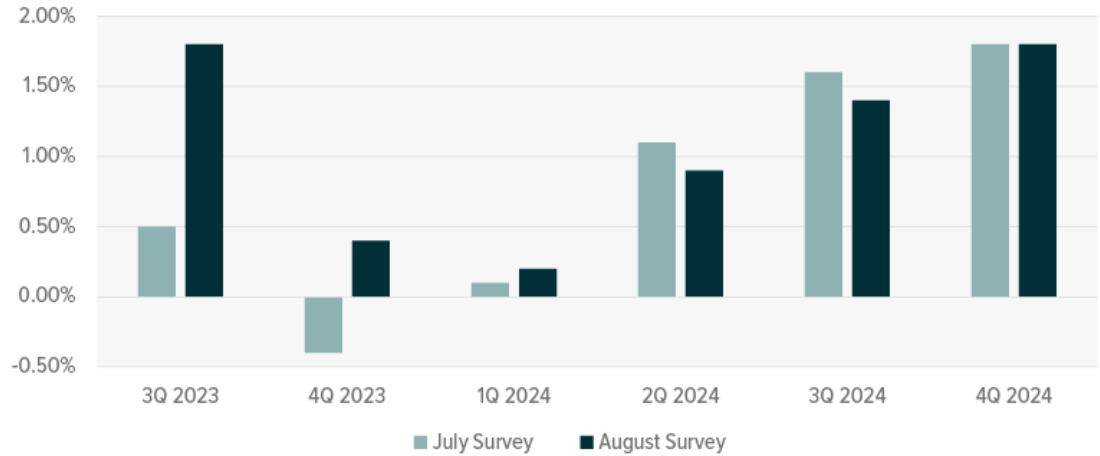
India's Chandrayaan-3 successfully executed a soft landing at the moon's south pole. Is it possible for the U.S. economy to replicate this achievement? This summer, market consensus expectations shifted to pricing in a soft landing. Current real GDP growth projections have been revised up for Q3 2023 – Q1 2024, removing near-term recession risks. This raises questions if the U.S. could be approaching the start of the



early cycle recovery phase where cyclical market areas typically perform well. Should this be the case, we could see a broadening of market performance and a shift in market sentiment towards higher risk opportunities. Nonetheless, the most pressing question remains the sustained resilience of the consumer. In our opinion, it may be somewhat premature to claim victory for a successful soft landing.

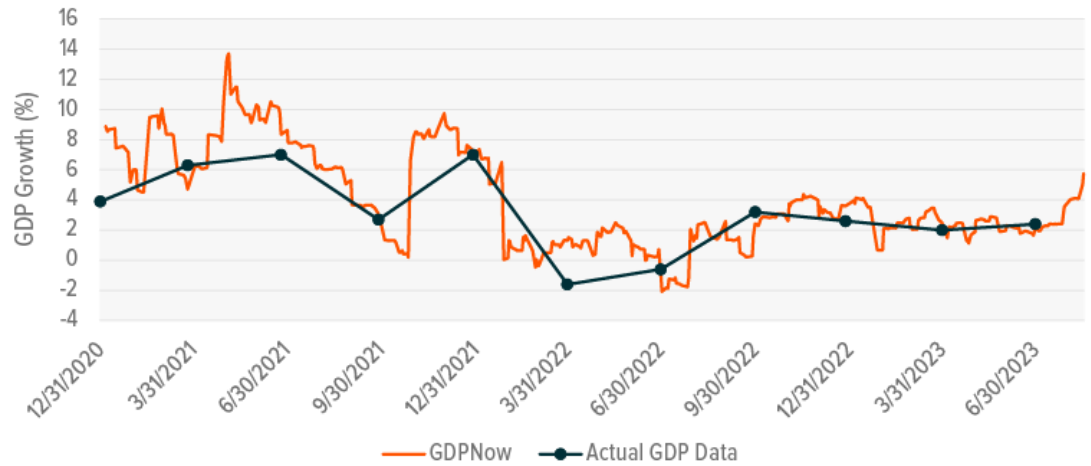
IMPROVED U.S. ECONOMIC GROWTH EXPECTATIONS

Source: Bloomberg Monthly Survey: Data as of August 16, 2023



GDPNOW RELATIVE TO ACTUAL GDP DATA

Source: Bloomberg Data between December 31, 2020 and August 16, 2023



Current economic activity remains robust, with consumer resilience supported by labor market tightness. Economic data has generally come in hotter than expectations this summer, helping support a sharp increase in Q3 GDP growth expectations. The table below illustrates key areas supporting economic activity and where there may be cracks forming in the consumer narrative.



CURRENT RESILIENCE BUT GROWING CAUTION

<p>Q3 GDP Expectations Exceptionally Strong</p>	<p>According to GDPNow, Q3 GDP growth is on track to increase 5.8% following exceptionally strong retail sales, housing starts, and industrial production data.⁷</p> <p>Although GDPNow typically overshoots the official reading, directionally it's generally correct.⁸</p>
<p>But Q2 Earnings Season Reflected Growing Caution</p>	<p>Although the Consumer Discretionary sector has generally led positive earnings surprises in Q2, companies have been more cautious in their guidance.</p> <p>The Q2 earnings season reflected that some major retailers struggled to attract thrifty shoppers as spending shifted toward discount items and necessities and away from high priced goods.⁹</p>
<p>With Discretionary Purchases Slowing</p>	<p>On the goods side we're starting to see reduced demand for big-ticket discretionary purchases, while service spending will be lacking the Taylor Swift boost for the next 14-months.^{10,11}</p>
<p>While Consumer Balance Sheets Remain Strong, There Are Pockets of Weakness</p>	<p>Financial obligations as a percentage of disposable income remains below the long-term trendline, indicating healthier consumer balance sheets relative to previous cycles.¹²</p> <p>We are starting to see pockets of weakness, particularly in auto loans and credit card debt. This is a potential concern as student debt repayment is set to restart. However, it's good to keep in mind that most student debt is held by higher income quartiles, which typically also have higher deposit buffers.</p>
<p>Labor Market Remains Tight</p>	<p>While the pace of hiring has slowed, the labor market remains strong.</p> <p>Yet, downward revisions to non-farm payrolls could reflect that economic activity is running slightly below expectations.¹³</p>
<p>Availability of Private Credit has Reduced the Impact of the Reduction in Bank Lending</p>	<p>The U.S. Senior Loan Officer Survey (SLOS) reflected tighter credit standards and reduced loan demand at U.S. banks during the second quarter. Additionally, banks expect further tightening during the rest of 2023.¹⁴</p> <p>Historically, tighter credit conditions have been associated with reduced economic growth; however, the availability of private credit has made more funding sources available to U.S. companies.</p> <p>Reduced dependence on bank loans has shielded U.S. companies and the labor market from the pullback in lending activity following the regional banking crisis.¹⁵</p>
<p>Leading Economic Indicators Remain Weak, But They May Have Bottomed</p>	<p>Leading economic indicators declined 0.4% in July, marking the 16th consecutive month of negative readings.</p> <p>Weak new orders, a decrease in manufacturing hours worked, and a reduction in consumer perceptions for future business conditions weighed on the monthly reading.¹⁶</p> <p>Although current conditions are still catching up with expected conditions, leading economic indicators are potentially already approaching a bottom.</p> <div data-bbox="743 1507 1510 1843"> <p style="text-align: center;">LEADING ECONOMIC INDICATORS SHOWING SIGNS OF BOTTOMING Source: Bloomberg Data as of August 24, 2023</p> <p>The chart displays the annual percentage change in leading economic indicators from January 1990 to July 2023. The y-axis ranges from -30% to 20%. The data shows a general upward trend from the early 1990s, peaking around 2007, followed by a sharp decline to a low of about -20% in late 2009. It then recovers to around 10% by 2014, followed by another period of volatility with a low around 2016. A significant decline begins in early 2022, reaching a low of approximately -10% in July 2023, which is noted as the 16th consecutive month of negative readings.</p> </div>



Weighing the Balance Between Interest Rate and Economic Growth Sensitivity Market Areas

While we may be approaching the trough, we believe it's too early to lean fully into cyclical market areas that require continued consumer resilience. Consumers and businesses have been more resilient this cycle, entering the higher rate environment well prepared. However, given the reduced effectiveness of monetary policy, the "long and variable" lag of monetary policy may have gotten even longer. As such, yields may need to remain elevated for an extended period, potentially drawing out the length of time before the economy bottoms and markets broaden out.

These factors increase the importance of diversification between both interest rate and economic growth sensitive areas of the market. On the one hand, fiscal support and strong capex remain a key driver for certain cyclical market areas while exceptionally strong demand for AI chips reflects a growing trend in AI adoption.

Cyclical Equity Exposure – Economic Growth Sensitive	Growth Equity Exposure – Interest Rate Sensitive
<p>Regardless of if consumer strength persists, fiscal impulse remains a key support to GDP growth. Q2 GDP grew at a 2.4% pace, which topped expectations of 2%.¹⁷ Greater nonresidential fixed investment supported economic growth. Capex increased by 9% year-over-year driven by manufacturing and reshoring.¹⁸ Infrastructure was also a bright spot as machinery and equipment companies benefitted from high demand and the ability to pass on costs to customers.</p> <p>Going forward, the Inflation Reduction Act and CHIPS Act could support additional infrastructure spending, focusing on domestic manufacturing of semiconductors, renewable energy, transport systems, and electric vehicle batteries. While business investment comprises 13% of nominal GDP, it has a larger impact on future economic growth potential due to fostering job creation. Please visit our blog for more information on manufacturing investment's role in boosting Q2 GDP and how this investment can provide longer term economic benefits.</p> <p>Sector highlight: Industrials</p>	<p>Should economic growth disappoint, markets are likely to search out companies and market areas that can grow despite the economy.</p> <p>AI technology has the potential to revolutionize and improve the efficiency of a wide array of commercially important activities. Similar to internet and smartphone technology, AI is a pivotal technology. However, unlike the early adopters phase of the internet, the key companies that currently stand to benefit from AI adoption are large and profitable.</p> <p>Q2 earnings season reflected that AI adoption remains strong. High-end AI capable semiconductor demand has accelerated. Data center demand was a key driver of stronger than expected chip demand. Growth in this area provides benefits into several related themes including Cloud Computing.</p> <p>Sector highlight: Information Technology (focus on profitable high growing areas)</p>

Our sector views table below provides more detail on positioning.

SECTOR POSITIONING (3-6 MONTH VIEWS)

Sector	Positioning	Rationale
Communication Services	Market Weight	Yield sensitive sector with reasonably positive trends in subscription services and several long-term growth opportunities.
Consumer Discretionary	Market Weight	Consumer Discretionary typically troughs when short rates peak while having its strongest performance during the early cycle.



Consumer Staples	Market Weight	Robust economic activity reduces the focus on staples, but this remains an important defensive positioning should economic activity slow as student debt repayments resume and consumers trade down and focus on necessities.
Energy	Overweight	OPEC+ production cuts and a delayed supply response in terms of drilling could keep energy markets tight and prices high. Large, diversified oil and gas companies benefit from healthy balance sheets.
Financials	Underweight	Cyclical sector that benefits from strong lending activity and a positive spread between yields on loans and deposits. Attractive valuations may provide some support.
Health Care	Overweight	Health Care remains our top defensive pick as it also stands to benefit from broad structural trends. Aging demographics around the world combined with the growing middle class in emerging markets could benefit health care demand.
Industrials	Overweight	The industrial sector stands to benefit from reshoring activity, infrastructure investment, and continued economic activity.
Information Technology	Market Weight	The sector displays quality factors and positive free-cash-flow growth. However, yield sensitivity is likely to increase in the second half.
Materials	Market Weight	The materials sector is likely to benefit from infrastructure investment. However, Chinese market weakness is likely to weigh on sentiment.
Real Estate	Underweight	The real estate sector is adversely impacted by rising real interest rates. Commercial property remains a headwind.
Utilities	Underweight	A higher for longer interest rate environment could reduce the sector's appeal as a bond proxy. Improved economic growth prospects reduce the importance of this defensive exposure.

Footnotes

1. Factset, Credit Card Data Strong in Last Full Month of Taylor Swift Tour Stimulus, 21 August 2023
2. BofA Securities, Sector Focus: Let's Get Cyclical: 10 Reasons to Double Upgrade Consumer Discretionary, 14 August 2023
3. Blackstone, Joe Zidle: Friedman's Lag Suggests Vigilance, 31 July 2023
4. BofA Securities, Sector Focus: Let's Get Cyclical: 10 Reasons to Double Upgrade Consumer Discretionary, 14 August 2023
5. BofA Securities, Sector Focus: Let's Get Cyclical: 10 Reasons to Double Upgrade Consumer Discretionary, 14 August 2023
6. BofA Securities, Global Economic Viewpoint: Is Refinancing the Kryptonite of Monetary Policy, 14 August 2023
7. Federal Reserve Bank of Atlanta, GDPNow: Estimate for 2023: Q3, 18 August 2023
8. Economist, America's Astonishing Economic Growth Goes up Another Gear, 23 August 2023
9. WSJ, Walmart Lifts Sales Outlook, Fueled by Consumers Looking for Deals, August 17, 2023
10. Barron's, Retailers are Sounding Alarms of a Consumer Slowdown, 22 August 2023
11. Factset, Credit Card Data Strong in Last Full Month of Taylor Swift Tour Stimulus, 21 August 2023



12. Federal Reserve Bank of St. Louis data as of August 17, 2023
13. Bloomberg, What Payroll Revisions Say About Stocks and Bonds: Macro Man, 24 August 2023
14. Reuters, US Banks Report Tighter Credit, Weaker Loan Demand, Fed Survey Shows, 31 July 2023
15. Bloomberg Surveillance Podcasts, 21 and 23 August 2023
16. The Conference Board, LEI for the U.S. Fell Again in July, 17 August 2023
17. U.S. Bureau of Economic Analysis (BEA) data as of July 27, 2023
18. BofA Securities, Earnings Tracker, August 6, 2023

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.

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