GLOBAL X
by Mirae Asset

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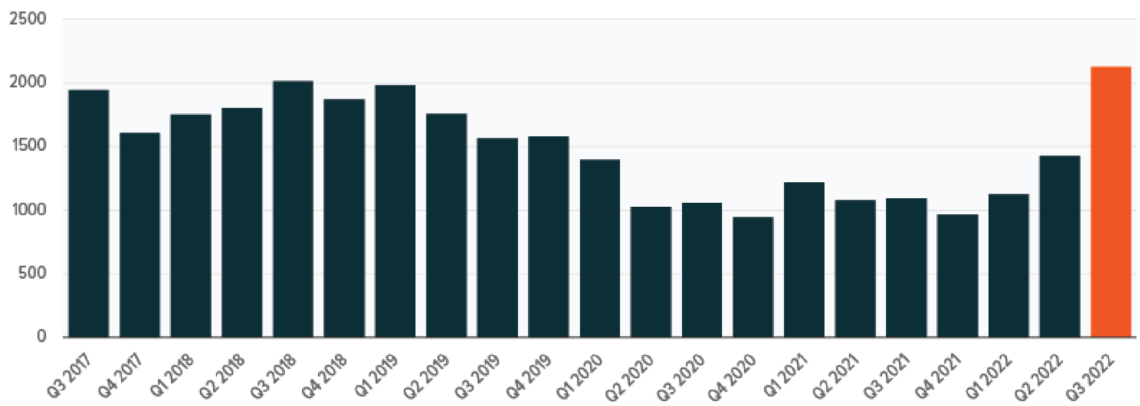
Sector Views: S&P 500 Sensitivity to Global Factors

Macroeconomic shifts have stirred global markets this year, and the U.S. is no exception. Tighter monetary policy in response to higher inflation and Russia's war in Ukraine have triggered a flight to safety, boosting the U.S. dollar and devaluing risk assets. We expect macro headwinds will continue to pressure U.S. corporate earnings in the coming months, which warrants a lower exposure to global factors, particularly those stemming from a strong dollar and Europe.

A Strong Dollar Could Weigh on Corporate Earnings

The dollar's 20% rally over the past year (as of September 28, 2022) means that foreign earnings of U.S. domiciled firms are worth less when translated back into dollars. While it is reasonable to assume that currency hedging will mitigate some of the losses from currency translation, there will be some negative impact on multiples as a result. Mentions of foreign exchange among S&P 500 companies ticked higher during the third quarter of this year, which was greater than 2018 when the dollar rallied nearly 12%, according to data from Bloomberg.

TOTAL MENTIONS OF "FOREIGN EXCHANGE" IN S&P 500 EARNINGS CALLS
Source: Bloomberg data as of September 29, 2022

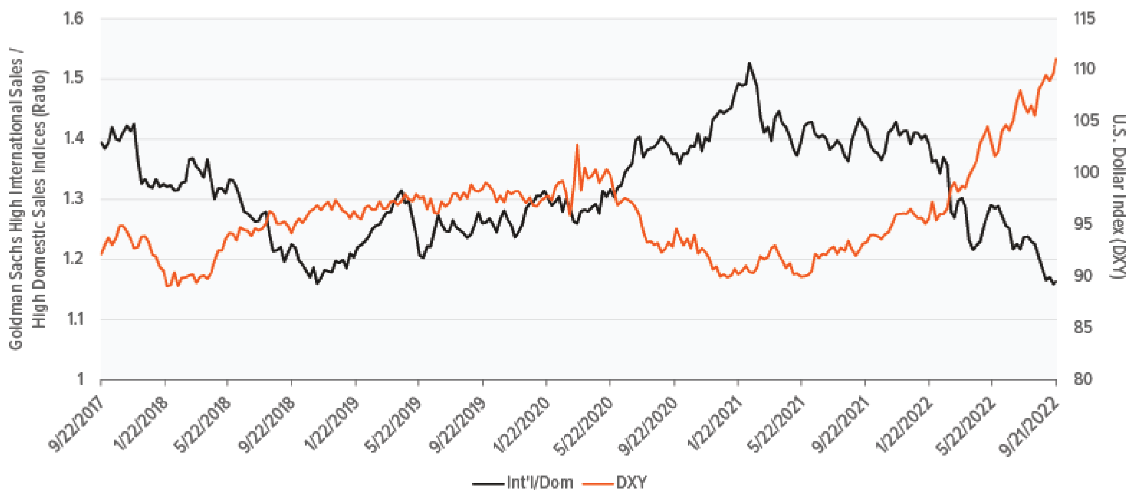


Companies that generate a substantial part of their revenue from outside of the U.S. could experience additional earnings compression, albeit with a lag. Roughly 40% of S&P 500 revenues are generated outside of the U.S., and about 58% of Information Technology company sales were sourced from abroad.[1] Many S&P 500 companies have warned about the negative impacts of a strong dollar. For example, during the second quarter earnings season, some U.S. multinational firms forecasted lower profit growth because of the strong dollar, and the rise in currency volatility could disrupt some hedging programs.[2]

We expect earnings expectations to decline as multinational firms realize foreign exchange headwinds that accelerated over the past year. So far, markets have started to price in negative impacts of a strong dollar. Goldman Sach's index of S&P 500 stocks with the greatest share of non-US revenues has significantly underperformed S&P 500 stocks with high domestic revenues over the past year. And problems in Europe could exacerbate the eventual earnings hit from abroad.

DOLLAR RALLY CONTRIBUTED TO UNDERPERFORMANCE OF S&P 500 STOCKS WITH HIGH INTERNATIONAL SALES VS. HIGH DOMESTIC SALES

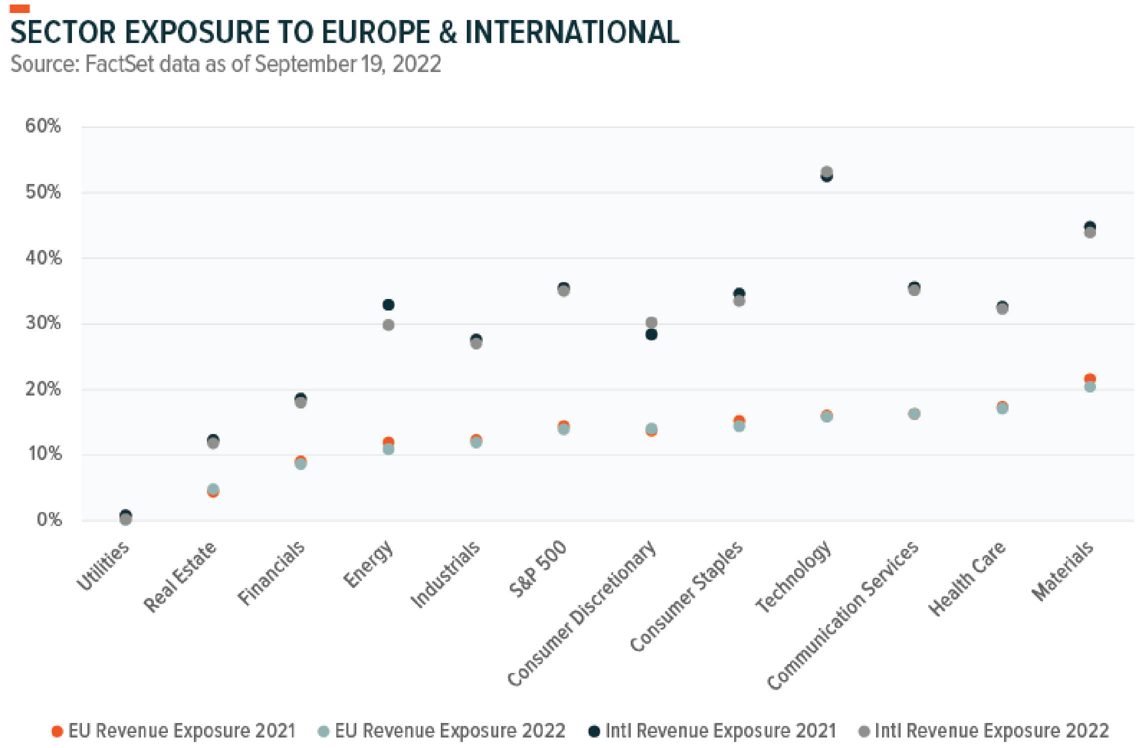
Source: Bloomberg data as of September 21, 2022



Sector Revenue Exposure to International Economies

The energy crisis in Europe could intensify as winter sets in. The August year over year energy component of Consumer Price Index (CPI) in the Eurozone has risen 38.6%, while the July 2022 year over year energy component of Producer Price Index (PPI) in the Eurozone has risen 97.2%.[3] This has a profound impact on the economy and growth potential of the region as soaring energy prices have also forced some energy-intensive companies to begin shutting down production. Steel, aluminum, fertilizer, and power plants have closed because the cost-benefit of such high energy prices makes them no longer profitable.[4]

Problems in Europe extend beyond borders though and also impact U.S. companies. Utilizing FactSet's GeoRev function, which displays revenue exposures by geographic region, the S&P 500 has about a 14% revenue exposure to Europe. On a sector level, exposures range from 0% to about 20%. The sector with the greatest exposure is Materials, followed by Health Care while on the low-end Utilities has almost no exposure owing to its home bias, and Real Estate about 5%.



Investors can avoid undue international risk by focusing on the sectors with little to no European revenue exposure like Utilities. If that is unavoidable, then focusing on lower concentration to European revenue exposure like Consumer Staples and Health Care could be warranted. These sectors are also the same defensive sectors that could likely outperform in a recessionary environment.

Relative Upside for Domestic-Focused, Defensive Sectors

This brings us back to currency risk as the transition from late cycle to recession will have a negative impact on earnings, especially within cyclical sectors. For example, Industrials, Materials, and Consumer Discretionary are negatively correlated with the dollar index, while defensive sectors such as Consumer Staples, Health Care, and Utilities exhibit a positive correlation with the dollar index. This aligns with the S&P 500's -0.43 correlation with the dollar over the past five years, which means a strong dollar is typically associated with a declining equity market.

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	Privacy overhang from major hardware providers could impact revenues for	**Underweight**

	subscription services including streaming. Potential future benefactor from development of augmented reality and metaverse.	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.	
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 and shipping 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 and ongoing supply chain disruptions. Some companies have indicated plans to cut sales prices to get rid of excess inventories.	**Underweight**
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. A delayed supply response in terms of drilling and production could keep energy	A global economic contraction could weigh on demand.	**Market Weight**

	markets tight and prices high. Large, diversified oil and gas companies have ramped up buybacks along with record profits and healthy balance sheets.		
Financials	The financial sector benefits from strong household and corporate balance sheets. Consumer spending remains robust.	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 outperforms during severe economic downturns. Sector has strong fundamentals relative to the S&P 500 on a Forward P/E basis.[5]	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.[6]	**Overweight**
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. Supply chain issues could be a major headwind. 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,	Increased regulatory scrutiny is a risk for this sector. There is a bipartisan support for increased regulation in this space.	**Market Weight**

	cybersecurity, and CleanTech are likely to remain in a post-COVID-19 world as societies adapt to these new technologies.	Rising interest rates and slowing economic growth would negatively impact long duration growth sectors such as Information Technology.	
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.	**Market Weight**
Real Estate	Inflation protected yield.	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	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, Earnings Insight, September 10, 2022
2. Barron's, Inflation is Yesterday's News. A Strong Dollar is Next Big Threat for U.S. Multinationals, July 20, 2022
3. Eurostat, Industrial Producer Prices up by 4.0% in the euro area and 3.7% in the EU, September 2, 2022
4. BNE, Energy Crisis: Europe's Industry Shutting Down, September 20, 2022
5. BofA, When Alternatives Go Mainstream RIC Report, August 9, 2022.
6. CNBC, 'Once-in-a-generation' Prescription Drug Pricing Reform Could be Coming, July 29, 2022

Definitions

Consumer price index (CPI): CPI measures the average change in prices that consumers pay for a defined basket of goods and services.

Dollar Index: The index measures the value of the United States Dollar relative to a basket of foreign currencies.

Producer Price Index (PPI): PPI measures the average change in the selling prices received by domestic producers for their output.

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