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Sector Views: The State of the U.S. Consumer

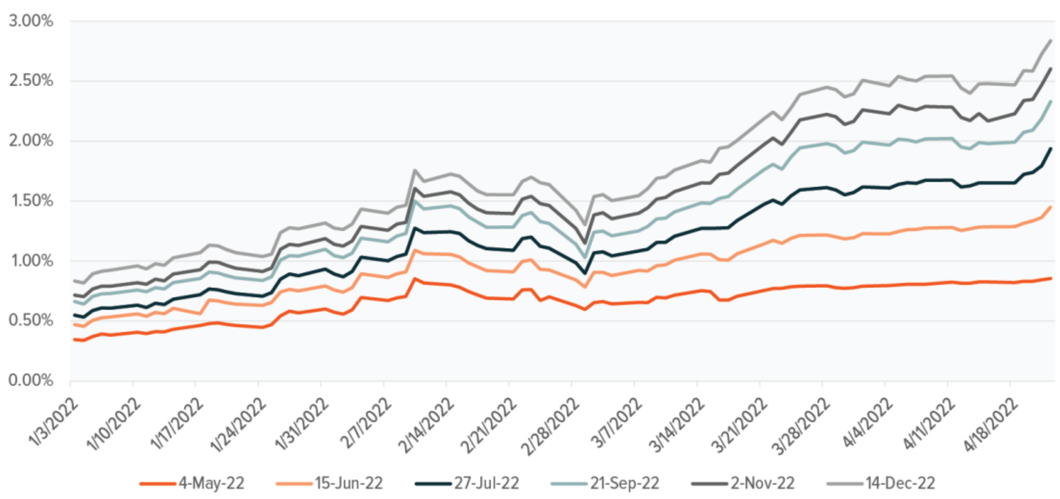
Inflation and rising interest rates create an uphill journey for the consumer and the economy. U.S. real disposable income has been declining since mid-2021. Although nominal wages are rising, real average hourly wages have been in negative territory for the last 12 months. Real retail sales are starting to reflect these headwinds. Given that consumption accounts for around 68.7% of U.S. nominal GDP, the state of consumer affects far more than just the consumer-focused sectors, with economic growth being closely related to demand for Materials and Energy as well as impacting the Industrial, Financial and Real Estate sectors.

End of the Easy Money Era

Over the last month, the economic tail risks have shifted from the Russia-Ukraine war to global recession concerns and more hawkish central banks.[1] According to BofA's Michael Harnett, the inflation shock is worsening while the interest rate shock has only just begun.[2] Gone are the days of free money. Treasury yields rose quickly in response to stronger commitments from the Federal Reserve (Fed) to regain control of inflation. The implied policy rate for after the December FOMC meeting has risen to 2.8%, after starting the year at 0.8%. Additionally, the 10-year real Treasury yield is close to 0% after two years in negative territory.[3]

U.S. IMPLIED POLICY INTEREST RATES

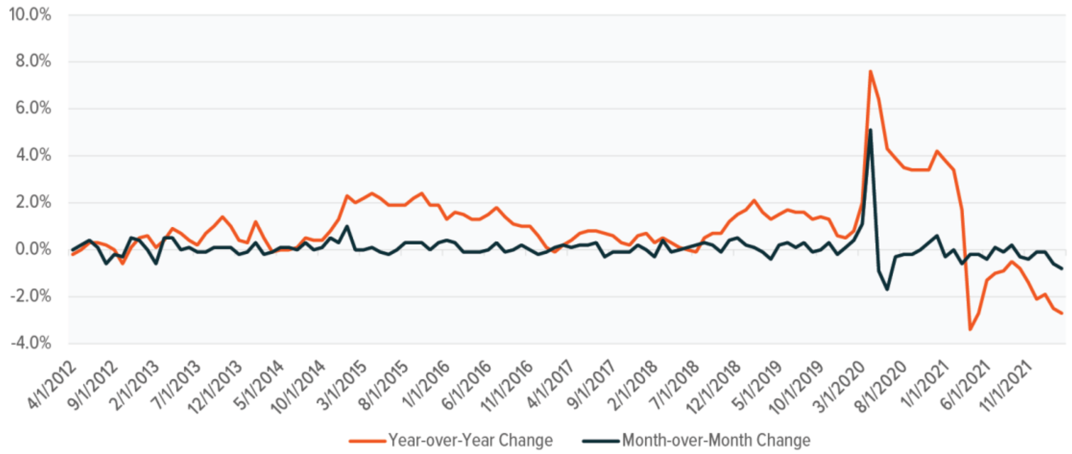
Source: Bloomberg data as of 22 April 2022



Spending patterns are impacted by borrowing costs, with the Fed using higher yields to help reduce demand. This impact is likely to be amplified by the declining trend in real average hourly earnings as wage growth lags inflation.

U.S. REAL AVERAGE HOURLY EARNINGS

Source: Bloomberg data as of 31 March 2022



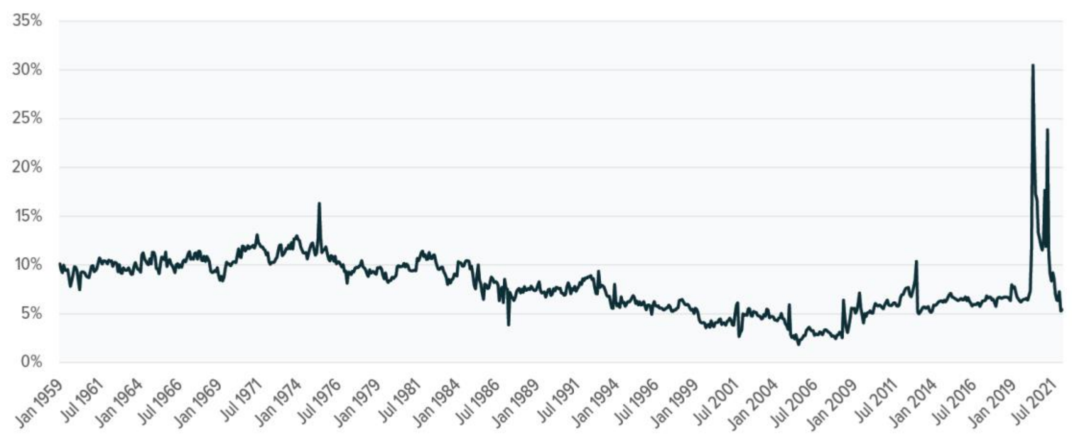
Consumer price inflation (CPI) was initially expected to peak around March 2022. We expect CPI inflation to remain elevated for the next few months due to the extended war in Ukraine, worse than expected lockdowns in China and higher than expected producer price inflation (PPI). With strong underlying consumer demand, firms have generally been able to pass along higher prices. Overall, companies expect further price increases in the coming months as input costs continue to rise.[4] But as lower real disposable income and higher borrowing costs weigh on spending, companies may face more margin pressure. Currently consumer spending is skewed towards goods. As demand normalizes back towards services, demand for goods may weaken just as companies rebuild inventories and supply-chain bottlenecks start to alleviate. This could dampen the profitability of goods-producing companies.[5]

Reduced Savings + Higher Debt = Current Consumption Cushion

Stimulus provided a savings cushion and boosted consumption and retail spending over the last year. Though it should be noted that the personal savings rate has declined to 5.4%, its lowest level since 2013.[6] Against this backdrop, it is not surprising that retail sales growth has begun to slow, rising 0.5% m/m on a nominal basis in March while declining 0.7% when adjusted for CPI.[7]

U.S. SAVINGS RATE

Source: Federal Reserve Economic data as of 22 April 2022



Bank of America card spending data reflects that consumption remains robust across income groups, growing 23.2% on a 3-year basis. Despite higher energy prices, lower income consumers are showing spending resilience. Though this could reflect short lived revenge post lock-up spending. But it's worth noting that sales purchased on credit cards have increased over the last year while debit card sales declined.[8] Overall, credit card debt bottomed in January 2021 and has just surpassed pre-pandemic levels.[9] According to the Beige Book, there has been a weakening of financial conditions; however, loan demand has remained strong.[10] In line with this weakening, during Q1 earnings season certain banks started to increase provisions against loan losses. This may reflect the economic challenges faced by cyclical sectors as real economic growth slows.

Defensive Takes the Lead as Volatility Returns

Rising treasury yields, elevated inflation and slowing real economic growth are factors being watched by both equity and fixed income investors. But thus far, the level of volatility in U.S. equity and fixed income markets are telling different stories despite reacting to similar factors. Interest rate volatility is near its 2020 highs while equity market volatility has been more subdued.

Year-to-date, equity market volatility spiked with expectations for higher Treasury yields and the Russia-Ukraine war, but generally there has been an uneasy calm in equity markets. The correlation of excess returns between S&P 500 Index and different sectors reflects the market's focus on defensive positioning, inflation protection and concerns about higher interest rates.

CORRELATION OF EXCESS RETURNS BETWEEN S&P 500 SECTORS AND THE S&P 500 INDEX (YTD, DAILY DATA)

Source: Bloomberg data as of 22 April 2022

	VIX	10-Year Treasury Yield	Implied December 2022 Policy Rates	WTI Crude Prices	YTD Performance
Consumer Staples	64.0%	-9.0%	-7.9%	-5.2%	3.7%
Utilities	58.2%	-22.4%	-18.2%	13.4%	4.6%
Industrials	49.7%	-5.1%	-19.6%	10.1%	-6.6%
Health Care	45.3%	-2.2%	-1.1%	-6.2%	-4.8%
Real Estate	34.9%	-22.2%	-14.5%	-1.5%	-4.3%
Energy	34.0%	-19.6%	-20.3%	60.5%	38.5%
Materials	17.6%	12.6%	9.1%	2.6%	-5.0%
Financials	12.5%	37.7%	30.4%	-17.2%	-7.0%
Communication Services	-23.7%	-1.3%	-3.6%	-3.1%	-22.5%
Consumer Discretionary	-40.9%	5.5%	1.0%	-0.8%	-14.1%
Information Technology	-56.8%	-2.4%	5.5%	-13.9%	-17.7%

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	The sector is a potential future beneficiary of the development of augmented reality and metaverse.	Higher interest rates adversely impact the discount rate applied to future earnings and cash flows.	**Underweight**
Consumer Discretionary	Consumers adapted to the pandemic by increasing their use of online ordering and delivery and in-store pickup.	Consumer Discretionary is a labor-intensive sector. Wage pressure combined with higher input costs in materials and shipping is a risk to margins if companies are not able to pass inflation pressures to the end consumer. This sector is adversely impacted by supply chain disruptions, especially the semiconductor shortage in the automotive industry. Delays in shipping by sea and heightened costs in air freight are headwinds.	**Underweight**
Consumer Staples	High inflation and slower real economic growth may force consumers to prioritize staples over discretionary purchases.	Inflation may negatively impact margins for companies that 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.[11]	**Overweight**
Energy	Escalated tensions with Russia, a large natural gas exporter to Europe, could lead to elevated energy prices globally for an extended period.	Renewed COVID-19 lockdowns in China and reduced economic growth expectations may reduce oil demand.	**Overweight**

		The Energy sector is sensitive to the economic cycle. Should elevated energy and food prices detract from real economic growth, reduced demand pressures may shorten the commodity cycle.	
Financials	The Financial sector could benefit from higher interest rates with the Fed starting their interest rate rising cycle.	Russia's invasion of Ukraine increased inflation expectations while reducing expectations for real economic growth. Flatter yield curve and elevated inflation weighs on sector.	**Market Weight**
Health Care	Demographics favor the Health Care sector due to the aging global population and the growing middle class in emerging markets. Sector is showing strong fundamentals, quality, and record discounts vs. the S&P 500 on a forward P/E basis.[12]	Drug pricing pressure remains a risk, though the legislative process is slow, and no meaningful legislation is currently expected to be passed.	**Overweight**
Industrials	The Industrials sector is a beneficiary of rising GDP, interest rates, inflation, and possible infrastructure spending. Re-shoring and a shift towards 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 performance.[13] Supply chain issues could be a major headwind.	**Market Weight**
Information Technology	Software names should benefit from higher CapEx as firms	Increased regulatory scrutiny is a risk, and there is	

	look to boost productivity amid rising wage inflation.[14] The increased adoption of key disruptive technologies like cloud computing, cybersecurity, and cleantech are likely to continue after the pandemic.	bipartisan support for increased regulation. Rising interest rates negatively impact long-duration growth sectors like Technology.	**Market Weight**
Materials	Increased focus on electric vehicle adoption, alternative energy sources, and energy storage should be beneficial to lithium and battery technology. The Materials sector is a beneficiary of inflation, higher raw materials prices and increase CapEx and infrastructure spending.	Chinese lockdowns are likely to weigh on global demand. Earnings growth likely to be weighed down by the strong dollar.[15]	**Market Weight**
Real Estate	The Real Estate sector has the potential to be a source of inflation-protected yield. The focus on real assets and locking in mortgages before yields rise provided a short-term increase in property pricing with inflation pressures building on rents. Strong demand for residential REITs is translating into higher single family and multi-family rents.	Uncertainty about a full return to the office and flex working situations may reduce demand for office space. A fast rise in interest rates, which increases the cost of financing, is a risk if costs cannot be passed along to tenants.	**Market Weight**

Utilities	Benefits from resilient fundamentals and is a defensive hedge.[16] The preferred sector in recessionary environments due to the inelasticity of goods & services.	The potential for increased climate-related regulations over time may detract from the sector's appeal. Companies may not be able to pass through higher inflation-related costs due to government regulations.	**Overweight**

Footnotes

[1] BofA Securities, *Global Fund Manager Survey: Fast & Furious*, 12 April 2022
[2] BofA Securities, *The RIC Report: Resources for Realists*, 12 April 2022
[3] Bloomberg data as of 22 April 2022
[4] Federal Reserve, *Beige Book*, 2 March 2022
[5] Morgan Stanley, *Can the Fed Engineer a Soft Landing?*, 22 March 2022
[6] Federal Reserve Economic Data as of 22 April 2022
[7] Seeking Alpha, *Real Retail Sales are Trending Flat*, 15 April 2022
[8] BofA Securities, *BofA on USA: Lower Income Resilience and Higher Income Pessimism*, 7 April 2022
[9] Federal Reserve Economic Data as of 22 April 2022
[10] Federal Reserve, *Beige Book*, 2 March 2022
[11] FactSet, *Earnings Insight*, 10/22/2021
[12] BofA Securities, *The RIC Report: Resources for Realists*, 12 April 2022
[13] BofA Securities, *The RIC Report: Resources for Realists*, 12 April 2022
[14] BofA, *The RIC Report: Get paid to wait*, 11 January 2022
[15] BofA, The RIC Report: Peace Through Strength, 8 March 2022
[16] BofA, *The RIC Report: Bullish Stock Splits, Bearish Rate Hits*, 8 February 2022

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.

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

Producer Price Index (PPI): The index measures the change in the price of goods as they leave their place of production.

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

VIX: The Chicago Board Options Exchange SPX Volatility Index, commonly referred to as VIX, reflects a market estimate of future volatility, based on the weighted average of the implied volatilities.

West Texas Intermediate (WTI) Cushing Crude Oil Spot Price Index: Designed to track the spot price of WTI.