GLOBAL X
by Mirae Asset

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Sector Views – Industrial Bright Spots During Cycle Shift

Industrial firms are the lifeblood of the economy. Manufacturing accounts for 20% of U.S. capital investment, 60% of exports, and 70% of research and development spending.[1] For such an important economic role, the sector's outlook has vital implications for portfolio positioning.

While declining growth prospects are unfavorable for cyclical stocks, over time, investors could find bright spots in emerging themes. Years of underinvestment in infrastructure and a focus on factory productivity could deliver the long-awaited U.S. industrial renaissance.

Key Takeaways:

- A potential recession is negative for Industrials, stressing the need for increased productivity.
- The use of robotics and automation coupled with infrastructure spending could bolster a modern industrial revolution.
- Although structural drivers are intact, current market uncertainty warrants downside protection.

Industrials Lag, But Watch Spending Intentions

The industrial sector had an impressive run during the second half of 2022, aided by the passage of the U.S. Inflation Reduction Act. Spending appropriations on clean energy and infrastructure fueled investor optimism, but the sector's rally was short lived. Industrials have since lagged the S&P 500 index by roughly -720 basis points (bps) this year as of May 16, 2023, driven by weakness in machinery, aerospace, and defense stocks.[2] Performance dispersion increased in March around the time of the regional banking crisis.

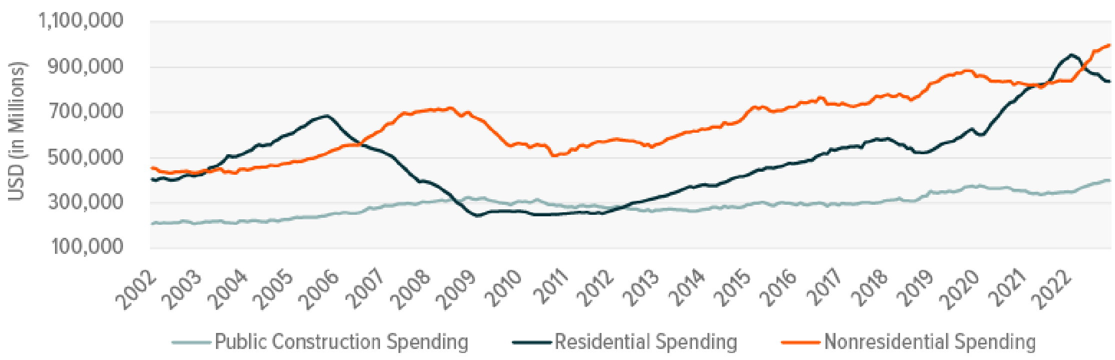
Underperformance could reflect growing recession concerns. Historically, lower residential spending, accounting for nearly half of the construction market, preceded industrial contractions.[3] The residential space is more sensitive to interest rates, so the reduction in housing affordability shifted spending toward nonresidential construction.

On a positive note, public construction spending, which is less cyclical than private spending, could gradually increase as clean energy and infrastructure projects materialize. Stimulus spending during a recession could also be a tailwind for some industrial stocks.

SPENDING FOCUSED ON NONRESIDENTIAL & PUBLIC CONSTRUCTION

While the dip in residential spending could precede an industrial slowdown

Source: Federal Reserve Bank of St. Louis as of May 16, 2023



An Upcycle in “Smart Manufacturing”

Beyond a possible recession, the next turnaround for industrials could be powered by digitization. Enter the new era of “smart manufacturing.”

Most manufacturers surveyed by Deloitte plan to increase operational efficiencies over the next 12 months using new technology. Robotics, automation, and internet of things (IoT) were the top three technologies favored by respondents.[4]

The use of “smart manufacturing” could provide substantial improvements in sustainability, factory output, and labor productivity – potentially boosting earnings. In the meantime, late cycle dynamics could merit defensive positioning.

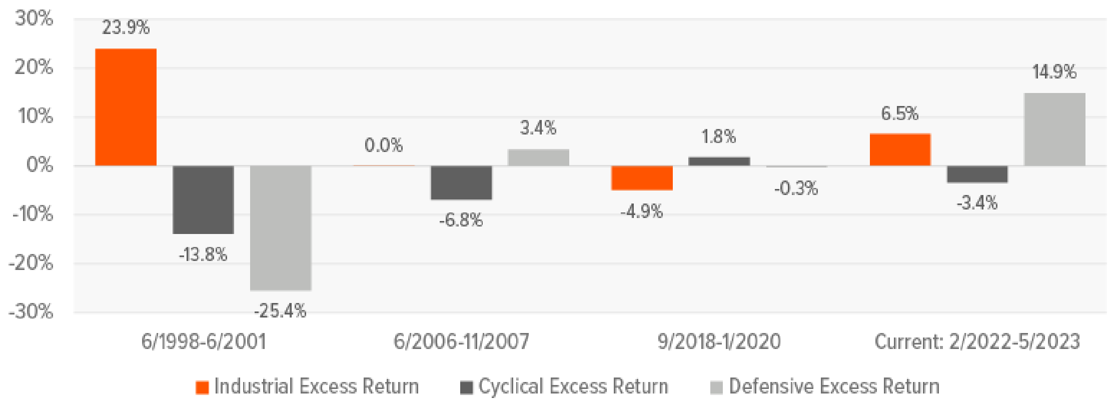
Positioning in the Current Environment

Market uncertainty will likely weigh on industrials, especially if the U.S. enters a recession. Historically, cyclical stocks, particularly industrials, underperform the broader market during recessions. However, the sector’s relative performance is typically mixed during late cycle phases.

LATE CYCLE EXCESS RETURNS

MSCI Industrial, Cyclical, and Defensive Indices vs. MSCI USA Index

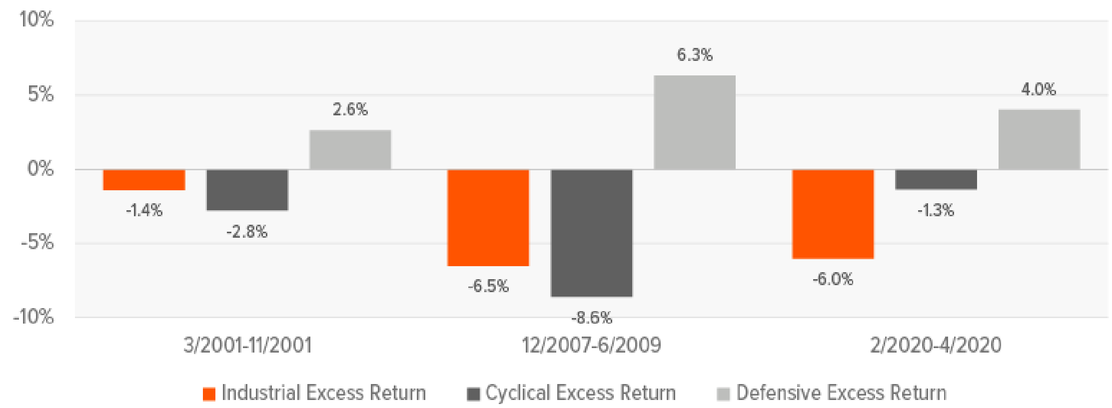
Source: Bloomberg data as of May 16, 2023



RECESSION CYCLE EXCESS RETURNS

MSCI Industrial, Cyclical, and Defensive Indices vs. MSCI USA Index

Source: Bloomberg data as of May 16, 2023



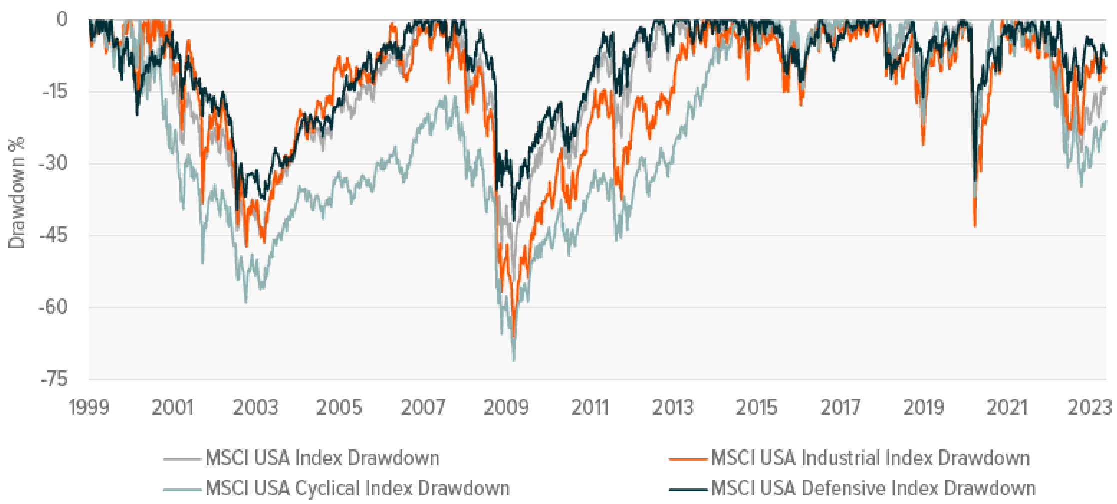
Economic growth can remain positive during late cycles, albeit near peak expansion. As demand remains robust, the supply of goods and services is slow to adjust to an eventual late cycle slowdown. Rising prices are a consequence of a supply/demand mismatch, providing a sweet spot for some Energy, Materials, and Industrial firms, typically during the first stage of a late cycle peak.

The late cycle launch was on full display in 2022 as commodities rallied and industrials had periods of outperformance. But the rally diminished. So far, Industrials and other cyclical sectors have experienced drawdowns of roughly -30% since peak performance in 2021, which is still above the -40% drawdown in 2020 and -70% in 2009, according to Bloomberg data as of May 16, 2023.

INDUSTRIALS EXPERIENCE SHARP DRAWDOWNS DURING MARKET STRESS

Comparison of peak-to-trough declines by market segments

Source: Bloomberg data as of May 16, 2023



Maintaining flexibility is important during cycle shifts. Recessions warrant downside protection, while cyclical sectors and themes can provide diversification benefits over the long term. Our sector views table below provides more detail on positioning.

CURRENT VIEWS ON U.S. SECTORS

	Positive Factors	Negative Factors	Overall View
Communication Services	Reasonably positive trends in subscription services, including streaming, benefit the sector. The development of augmented reality and the Metaverse may provide positive benefits in the long run.	The privacy overhang from major hardware providers could impact revenues for interactive media companies. Slower advertising spending remains a drag on social media earnings.	**Underweight**

Consumer Discretionary	Ecommerce remains resilient despite declining consumer spending.	Highly cyclical. Typically lags the broader market during the recessionary phase. Wage pressure combined with higher input costs in materials are a risk to margins, especially if companies are unable to increase sales prices.	**Underweight**
Consumer Staples	Demand for consumer staples could remain steady, especially in the event of a deeper economic contraction. Could benefit from consumers trading down.	Performs well during the recession but is likely to lag in the recovery phase.	**Overweight**
Energy	Escalated tensions with Russia and greater natural gas demand from Europe could keep energy prices elevated globally. 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 ramped up buybacks along with record profits and healthy balance sheets.	A global economic contraction could weigh on demand.	**Market Weight**
Financials	Attractive valuations. Large financial institutions may benefit from the challenges that are currently facing regional banks.	A deeper economic contraction could slow lending growth and increase credit risk. A flattening or inversion of the yield curve will likely hurt margins. Pressure within the commercial real estate market could have negative spillover effects within the banking system.	**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.	Drug pricing pressure remains a risk factor. Senate proposals to grant Medicare powers to negotiate prices on certain drugs could limit price increases on medicines.[5]	**Overweight**
Industrials	Reshoring and a shift toward automation infrastructure spending will likely be a long-term benefit for Robotics & AI. An increase in U.S. public construction spending from fiscal packages could boost demand for tools and machinery for the foreseeable future.	Elevated leverage, increasingly expensive valuations, and rising earnings volatility may detract from performance. High labor costs could pressure margins, particularly in the transport industry.	**Market Weight**
Information Technology	The sector displays quality factors and positive free cash flow growth. The increased adoption of cloud computing, cybersecurity, and cleantech are likely to remain in a post-COVID-19 world as societies adapt to these key disruptive technologies. Beneficiary of secular themes related to onshoring, automation & CapEx.	Increased regulatory scrutiny is a risk, and there is bipartisan support for increased regulation in this space.	**Market Weight**
Materials	Could benefit from China's economic reopening as well as infrastructure and CapEx spending. Increased focus on electric vehicle adoption, alternative energy sources, and energy storage may benefit disruptive materials such	A deeper economic contraction could be a big headwind. Increased regulations, especially those focused on preventing climate change, is a potential negative.	**Market Weight**

	as lithium, copper, and battery producers.		
Real Estate	The sector can offer inflation-protected yield.	Typically underperforms during recessions. Adversely impacted by rising real interest rates.	**Market Weight**
Utilities	A preferred defensive sector in recessionary environments due to the inelasticity of goods and services. Adoption of renewables could help transform the sector over the long run.	The potential for increased climate-related regulations over time may detract from this sector's appeal. Companies may not be able to pass through higher inflation-related costs due to government regulations.	**Market Weight**

Footnotes

[1] McKinsey & Company, Delivering the U.S. Manufacturing Renaissance, August 29, 2022
[2] Bloomberg data as of May 16, 2023
[3] World Construction Network, U.S. Residential Construction Weakness Bears Down on Construction Spending, February 6, 2023
[4] Deloitte, 2023 Manufacturing Industry Outlook, September 15, 2022
[5] CNBC, 'Once-in-a-generation' Prescription Drug Pricing Reform Could be Coming, July 29, 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.

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