2020 Equity Sector Outlook: Stay the Course

Wells Fargo Advisors
Advice & Research
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Overview

A number of themes impacted positive equity market performance in 2019. These included a strong U.S. economy for most of the year, which buttressed corporate earnings power, a decline in global interest rates and incrementally dovish monetary policy which buoyed valuations, and volatile trade negotiations with China that acted as a governor on the cycle. Sector and style leadership rotated throughout 2019, with historically defensive sectors leading the way through the third quarter and cyclical sectors gaining favor in the fourth quarter. Broadly speaking, equity markets proved resilient but have remained 'range-bound' in recent quarters.

Looking ahead to what 2020 might bring, we would anticipate many of the same macro factors mentioned above to remain in place. As a result, our overriding theme in 2020 is “Stay the Course.” This message implies sticking more than ever to basic investing principles such as proper diversification, focusing on high quality investments and seeking out reliable income stories given the relatively low level of interest rates. The aggregate dividend yield of the S&P 500 Index remains modestly above that of the U.S. 10-year Treasury yield. Traditionally more defensive sectors, such as Utilities, Real Estate, and Consumer Staples along with the more cyclically-oriented Energy, Financials, and Materials sectors continue to offer yields above that of the broader market and many fixed income alternatives.

### S&P 500 Index Dividend Yield by Sector

<table>
<thead>
<tr>
<th>Sector</th>
<th>Dividend Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>Energy</td>
<td>4.0%</td>
</tr>
<tr>
<td>Utilities</td>
<td>3.2%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>3.1%</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>2.8%</td>
</tr>
<tr>
<td>Financials</td>
<td>2.1%</td>
</tr>
<tr>
<td>Materials</td>
<td>2.1%</td>
</tr>
<tr>
<td>S&amp;P500 Index</td>
<td>1.9%</td>
</tr>
<tr>
<td>Industrials</td>
<td>1.8%</td>
</tr>
<tr>
<td>U.S. 10-Year Treasury Yield</td>
<td>1.8%</td>
</tr>
<tr>
<td>Health Care</td>
<td>1.7%</td>
</tr>
<tr>
<td>Information Technology</td>
<td>1.4%</td>
</tr>
<tr>
<td>Consumer Discretionary</td>
<td>1.4%</td>
</tr>
<tr>
<td>Communication Services</td>
<td>1.3%</td>
</tr>
</tbody>
</table>

Source: FactSet. Dividends represent the last twelve months’ total dividends for the index constituent companies divided by the price for the S&P 500 Index or the corresponding S&P 500 sector indexes. Data through 11/15/2019.

Our overall view is that replicating the broad equity returns of 2019 could prove difficult due to relatively elevated valuations. The chart below shows that nine out of the eleven S&P 500 sectors trade above their 5-year average forward price-to-earnings multiple. Based on forward earnings expectations, growth-oriented and traditionally defensive sectors trade at a premium to the S&P 500, while generally more cyclical sectors trade at a discount. That said, wide valuation disparities between quality/defensive/secular growth and value/cyclicals and the possibility for a swing in either direction in multiple geopolitical and macroeconomic drivers suggest a vigilant stance toward style orientation and equity selection.

### Price-to-Earnings Multiples by Sector

<table>
<thead>
<tr>
<th>Sector</th>
<th>Current Next-Twelve-Months P/E</th>
<th>5-Year Average Next-Twelve-Months P/E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer Discretionary</td>
<td>21.6x</td>
<td>29.0x</td>
</tr>
<tr>
<td>Information Technology</td>
<td>19.2x</td>
<td>17.0x</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>19.8x</td>
<td>16.4x</td>
</tr>
<tr>
<td>Real Estate*</td>
<td>19.7x</td>
<td>15.5x</td>
</tr>
<tr>
<td>Utilities</td>
<td>19.3x</td>
<td>15.8x</td>
</tr>
<tr>
<td>Communication Services</td>
<td>18.1x</td>
<td>12.9x</td>
</tr>
<tr>
<td>S&amp;P500 Index</td>
<td>17.1x</td>
<td>12.9x</td>
</tr>
<tr>
<td>Energy</td>
<td>18.5x</td>
<td>17.4x</td>
</tr>
<tr>
<td>Industrials</td>
<td>18.1x</td>
<td>16.6x</td>
</tr>
<tr>
<td>Health Care</td>
<td>17.6x</td>
<td>16.4x</td>
</tr>
<tr>
<td>Financials</td>
<td>17.0x</td>
<td>15.8x</td>
</tr>
</tbody>
</table>


*Price/Funds From Operations used for the Real Estate sector.
Above-average valuations can be supported by a rebound in earnings growth. Current bottom-up consensus estimates imply nearly 10% earnings growth for the S&P 500 over the next year. However, we would note that the Wells Fargo Investment Institute’s earnings outlook is more modest in comparison.

### S&P 500 Earnings Per Share Growth Estimates by Sector

<table>
<thead>
<tr>
<th>Sector</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Energy</td>
<td>-27%</td>
<td>-0%</td>
</tr>
<tr>
<td>Industrials</td>
<td>-16%</td>
<td>0%</td>
</tr>
<tr>
<td>Materials</td>
<td>12%</td>
<td>3%</td>
</tr>
<tr>
<td>Consumer Discretionary</td>
<td>7%</td>
<td>6%</td>
</tr>
<tr>
<td>Communication Services</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>S&amp;P 500 Index</td>
<td>4%</td>
<td>0%</td>
</tr>
<tr>
<td>Information Technology</td>
<td>13%</td>
<td>7%</td>
</tr>
<tr>
<td>Health Care</td>
<td>10%</td>
<td>7%</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>6%</td>
<td>6%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>8%</td>
<td>3%</td>
</tr>
<tr>
<td>Utilities</td>
<td>10%</td>
<td>5%</td>
</tr>
<tr>
<td>Financials</td>
<td>17%</td>
<td>5%</td>
</tr>
</tbody>
</table>

**Source:** FactSet Earnings Insight. Data through 11/15/2019. 2019 and 2020 earnings per share estimates are FactSet consensus estimates for the S&P 500 Index and its corresponding sectors.

### 2020 Equity Sector Sub-Industry Guidance

<table>
<thead>
<tr>
<th>Sector</th>
<th>More Favorable</th>
<th>Less Favorable</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Most favorable</strong></td>
<td>Information Technology Services; Systems Software; Semiconductors; Semiconductor Capital Equipment; Technology Hardware Storage &amp; Peripherals</td>
<td>__</td>
</tr>
<tr>
<td>Consumer Discretionary</td>
<td>Apparel, Accessories &amp; Luxury Goods; Footwear; Restaurants; Internet Retail; General Merchandise Stores; Apparel Retail; Home Improvement Retail; Automotive Retail</td>
<td>Distributors; Automobile/Motorcycle Manufacturers; Diversified Consumer Services; Leisure Products; Department Stores; Home Furnishing Retail</td>
</tr>
<tr>
<td><strong>Favorable</strong></td>
<td>Financials; Diversified Banks; Property &amp; Casualty Insurance</td>
<td>Mortgage Real Estate Investment Trusts (REITs); Business Development Co's (BDCs); Credit Cards</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>Beverages; Beauty and Personal Care; Household Products</td>
<td>Packaged Food</td>
</tr>
<tr>
<td>Energy</td>
<td>Integrated Oil; Midstream C-Corps</td>
<td>Exploration &amp; Production (E&amp;Ps) companies with High Leverage; Master Limited Partnerships (MLPs) with Low Distribution Coverage or High Leverage; Offshore Drillers; Oilfield Services; Royalty Trusts</td>
</tr>
<tr>
<td>Healthcare</td>
<td>Health Care Technology; Life Sciences Tools &amp; Services; Medical Devices/Equipment</td>
<td>Generic Pharmaceuticals; Health Care Facilities</td>
</tr>
<tr>
<td>Industrials</td>
<td>Aerospace &amp; Defense; Long-Cycle Multi-Industrials; Railroads</td>
<td>Agricultural &amp; Farm Machinery; Construction Machinery &amp; Heavy Trucks; Trucking</td>
</tr>
<tr>
<td>Real Estate</td>
<td>Health Care REITs; Industrial REITs; Residential REITs; Specialized REITs</td>
<td>Shorter-Lease term REITs; Hotel &amp; Resort REITs; Office REITs</td>
</tr>
<tr>
<td>Utilities</td>
<td>Electric; Multi</td>
<td>__</td>
</tr>
<tr>
<td><strong>Neutral</strong></td>
<td>Communication Services</td>
<td></td>
</tr>
<tr>
<td><strong>Unfavorable</strong></td>
<td>Cable &amp; Satellite; Integrated Telecommunication Services; Interactive Home Entertainment; Interactive Media &amp; Services; Movies &amp; Entertainment</td>
<td>Publishing; Wireless Telecommunication Services</td>
</tr>
<tr>
<td>Materials</td>
<td>Specialty Chemicals; Industrial Gases</td>
<td>Metals and Mining</td>
</tr>
</tbody>
</table>

**Source:** Favored sub-industries by Wells Fargo Advisor’s Advice & Research Group. Favored sectors by Wells Fargo Investment Institute. As of 10/15/2019.
Communication Services

Sector drivers and themes for 2020

The way people communicate and consume data is constantly evolving. Rather than gathering around the television to watch their weekly shows, customers are consuming content whenever and wherever they want via over-the-top (OTT) subscriptions on smartphones, tablets, and other streaming devices. This development may disrupt company business models within the Communication Services sector, as they will need to adapt in order to reach the ever-changing end-user.

As additional users of media stream content and access an increased amount of data, the existing network may experience substantial bottlenecks and transfer speeds could slow considerably. However, the buildout of the fifth-generation wireless network (5G) should expand the “pipes” so more data and information can pass through simultaneously. 5G should be a super-fast, very high capacity network that supports advanced technologies, like OTT video distribution, at remarkably higher speeds with high reliability and low latency.

U.S. Cable Subscribers Continue to Fall After Peaking in 2012

After peaking in 2012, the number of traditional U.S. cable subscribers has declined annually. However, cord cutting appears to be gaining traction as new streaming platforms come online and many of the traditional cable subscriber losses are offset by OTT subscriber additions.
Where to invest in 2020

For investors with a preference toward income, we favor the telecommunication services industry group with a bias toward the integrated telecommunication services sub-industry. Companies within the telecommunication services industry historically have offered attractive and generally stable dividends. Income oriented investors could utilize integrated carriers as a cornerstone of their portfolios, as they should be able to leverage their massive size and scale to attract customers to their platforms. Conversely, we believe growth investors should focus on the media & entertainment industry group, with a preference toward the interactive media & services and entertainment sub-industries. Companies within these sub-industries have historically grown earnings at a faster pace versus the broader market.

Cord cutting has gained traction and may weigh on traditional TV services. This evolution has blurred the lines between traditional telecom services, cable, media, and internet-based firms. We expect this trend to continue and believe that stand-alone streaming services and broadband providers should benefit from this development. Although new streaming platforms could emerge, consumer budgets will likely only allow for a handful of successful players. In our view, companies offering competitive pricing, diverse content, and a large distribution network are best-positioned going forward.

As video subscriber losses rise, cable operators must focus on expanding the broadband customer base. Major cable operators should be able to increase broadband market share as consumers seek higher connection speeds, notably customers with slower Digital Subscriber Line (DSL) connections. Although the carriers are funding a large portion of the 5G-infrastructure build-out to counter this threat, it may prove cost-prohibitive in the short-term. Yet, the build-out is a multi-year process and network owners should be able to develop new revenue opportunities down the road.

Valuation and Risks

as of November 15, 2019

- The Communication Services sector currently trades at 18.5x the next twelve months (NTM) consensus earnings per share (EPS) estimate of $9.63; a premium to the sector’s average five-year historical valuation of 13.8x. Relative to the S&P 500, the Communication Services sector is trading at 1.0x times relative to is historical level of 0.8x. Historical valuations are skewed and not directly comparable due to the fact that only the Telecommunications industry is accounted for prior to September 21, 2018.
- The way people communicate and consume data is continuously evolving, which could lead to disruption among incumbent business models. Within the Telecom, Media, and Cable industries, cord cutting is weighing on traditional TV services and affecting how media firms approach customers. Telecom companies are subject to extensive regulation, and an adverse regulatory environment could possibly hinder innovation while adding heightened levels of uncertainty and risk.
Consumer Discretionary

Sector drivers and themes for 2020

Consumer spending faces a mix of headwinds and tailwinds going into 2020. Consumers have benefited from a healthy labor market and rising incomes due to benefits from 2018 Tax Cuts and Jobs Act. The economy added over 170,000 nonfarm jobs per month, on average, through October 2019, and unemployment is at a 50-year low. Consumers, however, may face some economic and policy headwinds. While the cost of borrowing remains muted relative to prior years, the impact of tax cuts on incomes will likely fizzle out in 2020, and tariff impacts remain uncertain but could add to price pressures. While gains in the equity market have been relatively consistent over recent years, the potential for greater volatility and lower returns could weigh on consumer wealth for certain portions of the population.

Inventory Growth has Outpaced Sales Growth While Same-Store-Sales Growth has Decelerated

The combination of rising inventory levels and decelerating same-store sales provide an ominous cloud for future profitability if sales trends do not begin to reverse. In prior periods when these forces converged, promotional activity increased, resulting in pressure on merchandise margin rates.

Source: FactSet, Wells Fargo Advisors. Data through 6/30/2019. The composite is sales weighted and includes companies in the Consumer Discretionary sector of the S&P 1500 Index that also report same-store-sales. Restaurants were excluded from the composite.

S&P 1500 Index is a market capitalization-weighted index that is based on the S&P 500, S&P MidCap 400 and the S&P SmallCap 600 Indices and represents approximately 90% of the entire U.S. equity market. S&P MidCap 400 Index is a capitalization-weighted index measuring the performance of the mid-range sector of the U.S. stock market, and represents approximately 7% of the total market value of U.S. equities. S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the U.S. stock market. S&P SmallCap 600 Index consists of 600 domestic stocks chosen for market size, liquidity (bid-asked spread, ownership, share turnover and number of no trade days) and industry group representation. It is a market value-weighted index (stock price times the number of shares outstanding), with each stock’s weight in the index proportionate to its market value.
Where to invest in 2020

Similar to 2019, we see a backdrop supporting a more defensive posture towards the Consumer Discretionary sector in calendar 2020 as strengthening headwinds prevail over minimal tailwinds, some of which are fading fast. Wage growth accelerated 18 months ago, about the same time that the tax cut took effect. In the past, tax-induced stimulus has driven a disproportionate gain for durable goods that often produced a multiplier effect. This time around the cuts arrived when there was little pent-up demand in the system for appliances, furniture and cars. Some provisions like reduced mortgage interest deductibility and smaller property tax deductions actively steered consumers away from durables. The net effect was that the stimulus propped up demand for more conspicuous forms of consumption; which we do not see repeating in the coming years. Thus, making year-over-year comparisons more challenging. Additionally, with inventories beginning to back up, the earnings algorithm is not shaping up favorably for the sector in the near-term.

Retailers and restaurants were among the biggest beneficiaries of the Tax Cuts and Jobs Act. With the tax cut in the rear view mirror and no multiplier effect in sight, trade concerns riding high and interest rates falling anew, we continue to favor a more defensive posture to investing in consumer stocks. Low-end focused consumer discretionary stocks make sense in that environment provided they have a modicum of pricing power. Therefore, we see discounters, mass-merchants and off-price retailers as our favored Consumer Discretionary sub-industries for 2020. Middle-inning cyclicals like retailers and restaurants are likely to grapple with tough comparisons in addition to existential fears that took a back seat when the tide was strong enough to lift all boats.

Valuation and Risks

as of November 15, 2019

- The Consumer Discretionary sector currently trades at 21.6x the NTM consensus estimate of $44.06. The current price-to-earnings (P/E) ratio is above the five-year historical valuation of 19.2x. Relative to the S&P 500, the Consumer Discretionary sector is trading at 1.2x, in line with historical levels of 1.2x. Historical valuations are skewed by the fact that the Media and Digital Streaming & Internet Services industries left the Consumer Discretionary sector and moved into the Communication Services sector as of September 21, 2018.
- A strong job market generally provides consumers more financial comfort and increased disposable income. However, rising wages can bring both headwinds and tailwinds. On one hand, higher wages are positive tailwinds for consumer spending. However, sub-industries with a high labor component (Restaurants, Hotels/Resorts/Cruises, and Retail) will likely receive less incremental benefit given the increased operating expense impact on profits. Additionally, rising logistics, gas prices and interest rates coupled with potentially lower federal tax refunds are headwinds to consumer spending trends.
Consumer Staples

Sector drivers and themes for 2020

We believe there are two factors likely to drive performance in the Consumer Staples sector: relative stability of the group and attractive total returns including the generous dividend yields these companies generally offer. The sector has historically offered relatively stable earnings growth opportunities across economic cycles and the high-return nature of these businesses has generally delivered excess free cash flow after funding operations. Consumers are staples purchasers regardless of the state of the economy, making Consumer Staples minimally cyclical. Therefore, we generally expect the stocks to afford countercyclical relative price performance, providing rationale to own the sector for both absolute total return and diversification, in our opinion. The benefits from high consumer confidence, higher minimum wage rates and improving employment should all bode well for sustainable consumer spending trends. Low interest rates could also help sector appeal given the sector’s healthy dividend yields.

Consumer staples kept pace with the broader markets in 2019 as investors often favored defense, perceived safety and yield given increased trade tensions, geopolitical risk and falling interest rates.

Past performance is no guarantee of future results. An index is unmanaged and not available for direct investment.
The S&P 500 Sector Indices measure the performance of the widely-used Global Industry Classification Standard (GICS®) sectors and sub-industries. Each index (Consumer Staples) comprises those companies included in the S&P 500 that are classified as members of their respective GICS® sectors. The S&P 500 is a market capitalization-weighted index generally considered representative of the U.S. stock market.
Where to invest in 2020

Broadly speaking, we remain selective in our views across the Consumer Staples sector. Our selective/cautious view is due to adequate valuations, sales growth that has stemmed primarily from higher prices and not volume and finally potential market share disruption from the likes of private label competition and e-commerce threats. The ongoing domestic economic expansion, rising wages and low unemployment all argue for consumer spending growth and should help boost consumer spending trends.

Sub-industries that could fare well in 2020 are those with stronger sales growth potential aided by pricing power and whose products could benefit from the ongoing interest in overall health and wellness. We believe the beverage sector could benefit given its emphasis in growing noncarbonated beverages (water, teas, sports drinks, and juices) that represent healthy choices over carbonated sodas. Household product companies, while currently at high valuations, have seen relatively stronger sales growth too versus consumer staples peers, particularly those in the beauty and personal care categories which tie in closely to increased health and wellness awareness. After a difficult 2019 due to heightened Food and Drug Administration (FDA) focus on e-cigarettes and slowing growth of reduced risk products, tobacco valuations trail the overall Consumer Staples group and remain contrarian, value-oriented securities in our view. We remain cautious on packaged food stocks given their structural challenges as consumers seek healthier food options. Although some of the laggards in the group have moved up off their lows, P/E multiples in food remain relatively compressed perhaps leading to merger and acquisition potential.

Valuation and Risks

as of November 15, 2019

- The Consumer Staples sector currently trades at 19.8x the NTM consensus estimate of $31.78. The current P/E ratio is slightly above the five-year historical valuation of 19.2x. Relative to the S&P 500, the Consumer Staples sector is trading at 1.1x, slightly below historical levels of 1.2x.
- Risks to companies within the Consumer Staples sector include intense competitive conditions, geopolitical risk and rising interest rates causing additional dollar strength hurting multinationals reported sales and earnings. Other risks could include fluctuating commodity costs, labor cost pressures and potential pricing compression from private label competition. Higher interest rates could make staples less valuable as bond proxies with their above average dividend yields.
Energy

Sector drivers and themes for 2020

We believe that most Energy companies are in the early stages of a transition to a more disciplined business model focused around reaching cash flow stability in a lower oil price environment, a goal that has largely proven elusive in 2019. The sector’s continued underperformance reflects investor concerns that Energy commodity pricing is settling into a range where returns on capital are viewed as uncompetitive. Despite the poor returns, it remains economical for most companies to continue producing, keeping the U.S. at near record high levels of Energy production. In this environment of abundant supply, slowing global economic data is taking its toll on the future demand outlook for Energy, making the sector especially vulnerable to global trade dynamics.

Despite being the highest yielding sector in the S&P 500, investors don’t view the Energy sector as a reliable source of income. This year’s move lower in interest rates has failed to attract capital to the sector due to the highly cyclical nature of Energy.

Despite Being the S&P 500’s Highest Yielding Sector, Energy Stocks Moved Lower with Interest Rates in 2019


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Where to invest in 2020

For broad exposure to the sector, we continue to favor integrated oil companies which tend to have sustainable cash flows, solid dividend yields, and well diversified business lines across a variety of end markets and geographies. We view diversification as an attractive attribute for companies within the Energy sector as many of the risks faced by Energy companies tend to be idiosyncratic in nature. We also maintain a selectively positive outlook on midstream companies, where we favor companies that we expect to drive growth by providing critical infrastructure needs and have a simplified corporate structure with adequate distribution coverage.

The refining sub-industry is exiting 2019 under the interesting backdrop of new rules mandated by the International Maritime Organization (IMO) which requires overseas shipping tankers to use cleaner fuels starting on January 1, 2020. We expect the “IMO 2020” mandate to benefit the refiners as higher demand for cleaner fuels should improve the margins on these products. However, we cannot assume that this will benefit all refiners equally as there are many moving parts to this dynamic — compliance rates, installation of fuel scrubbers, inventory levels of compliant fuel, and individual refiners’ logistical and technical capabilities will all have a role in how this plays out.

For investors seeking a more direct commodity exposure, we would look to well capitalized exploration and production (E&P) companies operating in low cost U.S. shale basins with a very important caveat—the E&P industry, as well as the oilfield services sub-industry, have vastly underperformed in 2019 given the deteriorating outlook for energy commodities. Absent a rebound in commodity sentiment, we expect this underperformance to continue for the foreseeable future.

Valuation and Risks

as of November 15, 2019

- The Energy sector is currently trading at price-to-book value (P/B) of 1.5x. The current P/B ratio is slightly below the five-year average for the group of 1.8x. Relative to the S&P 500, the energy sector has been trading at 0.5x P/B, near the five-year historical average of 0.6x.

- Risks include weakness in the economy world-wide, commodity price exposure, slow macro-economic recovery, reserve replacement, exploration risk, and a slow approval process for liquid natural gas (LNG) projects by regulatory and government agencies. Additionally, Master Limited Partnerships (MLPs) can be exposed to volumetric risk, commodity price exposure, potential customer concentration risks, asset depletion, and even seasonality in the case of propane.

Favorable
- Integrated Oil Co’s
- Midstream C-Corps

Neutral
- Refiners
- Large-Cap MLPs
- Large-Cap E&P

Unfavorable
- E&P with High Leverage
- MLPs with Low Distribution Coverage/High Leverage
- Oilfield Services
- Offshore Drillers
- Royalty Trusts
Sector drivers and themes for 2020

Even as we think company-specific commentary on credit may prove relatively more informative to judging the appeal of the Financials sector in 2020, recent market conditions have been unhelpful to Financials investors and make the sector outlook for next year even more uncertain. While the flattening of the yield curve has loomed large over the equity appeal of Financials for months now, the recent whipsawing expectations on the trajectory of interest rates (including a temporary inversion of the 2-year and 10-year U.S. Treasury yields) has proven even more unnerving for companies and investors. Though there is a keen focus on interest rates heading into 2020, it is not the whole story. Credit matters too, a point we highlight in the accompanying chart.

While credit ratings are not infallible, it is interesting how the option adjusted spread (OAS) has widened for the Bloomberg Barclays U.S. High Yield ex Financials “CCC” Index, perhaps signaling the reemergence of concern about lower-rated credits.

Source: Bloomberg. Data through 10/15/2019. An index is unmanaged and not available for direct investment. The option-adjusted spread (OAS) is the spread relative to a risk-free interest rate. Past performance is not a guarantee of future performance.
Where to invest in 2020

Considering the outlook for 2020, we are reminded of the advice from a terrific company executive (and capital allocator) who observed, and we are paraphrasing, “if you have to choose between strategy and liquidity, take liquidity.” For investors in the Financials sector in 2020, we might suggest that if you have to choose between strategy and underwriting quality, take underwriting quality.

No surprise then, given the probable lateness of this credit cycle, we reiterate our preference for strong underwriters, whether they be banks, insurance companies, or asset managers. By industry, we favor the universal banks and select property and casualty (P&C) insurance companies.

We appreciate those universal banks which view loan growth as an outcome of the credit process. Whether due to management decision-making, or guidance from regulators, the major banks have looked to avoid the excessively risky terms and structures found in some areas of lending today, and seem willing to cede that business to the non-bank lending community, which has an abundance of credit funds vying for the work.

Additionally, in the later stages of a market cycle, merger & acquisition (M&A) activity could perk up, which we believe could benefit universal banks, which have businesses focused on debt and equity capital raising, advisory, and trading. Should market conditions worsen, these lines of business could see greater activity, even more if workout or recapitalization actions become more common.

Aside from individual universal banks, we favor select P&C insurers that look to underwrite for a profit, and we note how pricing has started to improve for parts of the industry, a feature that enhances its investment appeal.

Valuation and Risks

as of November 15, 2019

- The Financials sector currently trades at 12.9x the NTM consensus EPS estimate of $38.15. The current P/E ratio is in line with the five-year historical valuation of 12.9x. Relative to the S&P 500, the Financials sector is trading at 0.7x which is slightly below historical levels of 0.8x.
- Key risks to the Financials sector include maturation of the credit cycle resulting in higher credit losses and tighter lending standards, lower interest rates leading to a reduction in profitability, and capital markets weakness, which may reduce assets under management, as well as constrain access to growth capital.
Health Care

Sector drivers and themes for 2020

Health Care has consistently been one of the worst performing sectors in 2019, as sector-specific concerns emerged early in the year, driven in large part by a significant ramping of political rhetoric. The managed care sub-industry, in particular, has been negatively impacted by the continued discussion of “Medicare for All”, a potential government-run health care system advocated by many of the Democratic candidates for President. With less than a year to go before the 2020 election, political risk will almost certainly remain a key headwind for the sector, with specific focus on Medicare for All and ongoing efforts with respect to controlling drug prices.

We continue to favor the medical device sub-industry, despite the significant outperformance during 2019. We believe the managed care and pharmaceutical sub-industries will remain subject to continuing political risk for the foreseeable future, leading up to the 2020 election.

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Where to invest in 2020

Despite the poor performance in 2019, we continue to believe the outlook for the Health Care sector remains favorable for long-term investors. Sector-specific issues should continue to make the near-term challenging, however, at least until we get more clarity on the 2020 political landscape. We believe Medicare for All will remain front and center as a talking point among the leading Democratic candidates for President, presents a headwind for managed care stocks. We continue to believe the odds are extremely low of a single payer health care system being adopted in the United States, but we expect this will remain a headwind until after the 2020 election.

Looking at sector positioning in 2020, we continue to favor the medical device sub-industry, we view fundamentals as favorable and the group remains relatively insulated from the macro risks and the sector-specific headwinds impacting some of the other Health Care sub-industries. Medical device stocks are, in general, are not particularly cheap, but we believe the premium valuations are deserved at this point, as organic growth has remained quite strong. Meanwhile, we continue to suggest a neutral stance on managed care and the pharmaceutical sub-industries, reflecting ongoing concerns over elevated political risk, specifically Medicare for All and potential legislation aimed at lowering drug pricing. Importantly, we see little chance for a Medicare for All plan to be enacted, given what we believe are insurmountable fiscal hurdles to adopting such a program. As a result, we believe eventual clarity on the 2020 election and the waning of the Medicare for All focus could present an opportunity in the managed care sub-industry in the future.

Valuation and Risks

as of November 15, 2019

- The Health Care sector is currently trading at 15.5x the NTM consensus EPS estimate of $72.62. The current P/E ratio remains below the five-year average for the group of 15.8x. Relative to the S&P 500, the Health Care sector has been trading at 0.9x, modestly below the 1.0x five-year historical average level.

- Risks to companies within the Health Care sector include competition on branded products, sales erosion due to cheaper alternatives (such as generic pharmaceuticals and/or biosimilar products), research & development risk, and dependence on regulators such as the FDA to approve products anticipated to enter the market. Additionally, companies can be exposed to cuts in Medicare reimbursements (either based on yearly review or due to sequestration) as well as uncertainty surrounding healthcare reform efforts in the U.S.
Industrials

Lawrence Pfeffer, CFA®
Equity Sector Analyst
Industrials

Sector drivers and themes for 2020

We expect the most important driver of the Industrials sector in 2020 to remain the status of the U.S.-China trading relationship. Successive rounds of tariffs and restrictions have weighed on corporate confidence and capital spending, not just in the U.S. and China but globally. Reflective of this, short cycle end markets have been decelerating for multiple quarters. We would also note that an increasing number of end markets in the Industrial sector appear to be relatively late stage. We remain cognizant of the continued dampening effect of broader policy uncertainty, but are hopeful that a partial trade deal and more stimulative monetary policy could prevent further material deceleration in fundamentals.

Near-term industrial production indicators continued to soften throughout 2019.

Source: FactSet. Data through 9/30/2019. Purchasing Managers Indices (PMIs) are surveys of purchasing managers that are used to measure sentiment and predict demand in the near future. 50 represents the breakeven between expansion and contraction in overall conditions.
Where to invest in 2020

We believe investors are actively debating whether or not the industrial cycle has reached a near-term peak or is in fact about to recover out of the trough. We point to this seemingly wide range of opinions being driven by the divergence between short-cycle end markets and long-cycle end markets. We do believe a stabilization in short-cycle trends could occur at some point in 2020, while we would also note that near term fears of a broad-based recession appear to have abated somewhat in the wake of more dovish monetary policy and a potential truce in U.S. – China trade relations. We believe that valuations within the sector have now largely come to reflect this dynamic, with absolute multiples for those sub-industries tied to longer-cycle end markets holding at high levels and those tied to shorter cycle end markets bouncing from their lows in anticipation of a cyclical recovery. Our base case scenario remains that the industrial landscape remains sluggish overall in the intermediate term. Given the high levels of uncertainty inherent in predicting a cyclical trough, and relatively elevated valuations, we believe the sector could remain volatile in 2020.

We are making some modest changes to our posture toward the sector in 2020. Overall, we continue to advocate a preference for those companies that are exposed to longer-cycle end markets, are strong generators of free cash flow, garner their revenues from multiple areas, and return cash to shareholders in a relatively predictable fashion. We therefore remain favorably disposed toward long-cycle multi-industrials, and are broadening our list of favorable sub-industries to include aerospace and defense (previously defense only), and railroads. We are narrowing our list of unfavorable sub-industries to include trucking and construction, farm, and truck machinery. We are concerned that valuations may have expanded too rapidly in these areas and should a short-cycle recovery fail to take hold early in 2020, estimates and valuations could come under renewed pressure. We would note that we have removed trading companies and distributors, air freight and logistics, and industrial machinery from our list of unfavorable sub-industries.

Valuation and Risks

as of November 15, 2019

• The Industrials sector currently trades at 17.0x the NTM consensus estimate of $40.78. The current P/E ratio is above the five-year historical valuation of 16.4x. Relative to the S&P 500, the Industrial sector is trading at 1.0x, in line with historical levels of 1.0x.
• The industrials sector is heavily influenced by underlying conditions in the global economic environment. Many companies in the sector are also heavily tied to government policy in multiple jurisdictions, covering topics such as trade, taxes, interest rates, and fiscal spending. The pace of technological change also appears to be accelerating which could make incumbent business models more challenging in the future.
Information Technology

Amit Chanda
Equity Sector Analyst
Information Technology

Sector drivers and themes for 2020

We see a number of demand related secular tailwinds converging simultaneously, including the proliferation of cloud computing, a dramatic increase in the number of connected devices (Internet of Things), artificial intelligence/machine learning and big data, augmented/virtual realities, the cloud-based data center, autonomous driving and the buildout of the fifth generation (5G) wireless network. In our view, these technologies are intertwined on many levels. Although there may be short-term disruptions in demand, we believe investors should generally benefit from the secular tailwind of digital transformation amongst enterprise customers, 5G, as well as cloud computing.

We are likely in the early stages of this multi-decade progression of enterprise workloads to the cloud and think that most enterprises will adopt a hybrid cloud and multi-cloud architecture.


Source: Credit Suisse, Company Reports and Wells Fargo Advisors. Data as of 7/31/2019. E – Estimates from Credit Suisse. Capital expenditures represented by the aggregate capital expenditures investments for Information Technology equipment and data center infrastructure from company reports.
Where to invest in 2020

In our view, the multi-year 5G network buildout should provide the infrastructure to support many long term technology trends including smart manufacturing, smart cities, autonomous driving, telehealth, in addition to various commercial and consumer applications. 5G is designed to be a significantly faster network than 4G, with high capacity and lower latency. Although we are in the early stages, we believe 5G activity should accelerate as we progress through 2020. We caution that the ongoing export restrictions against a major multinational Chinese telecom provider, as part of the ongoing U.S./China trade dispute, may slow worldwide traction in upgrading to 5G networks. We believe the Federal Reserve is likely to combat any slowdown in the U.S. economy impacted by a prolonged U.S./China trade war with a more accommodative interest rate policy.

Our favored sub-industries within the construction of the 5G network are networking, hardware, semiconductor and infrastructure providers. Within networking and hardware, companies that provide equipment used in mobile networks or 5G handsets are favored as the 5G network expands.

Although visibility within the semiconductor industry remains limited given the U.S./China trade dispute, we expect fundamentals to improve in 2020 following a downturn in the cycle during 2019. We expect the semiconductor capital equipment manufacturers may benefit from foundry logic investments in cutting edge manufacturing and a recovery in memory spending in 2020.

Following outsized growth in 2018, hyperscale cloud capital expenditures showed a sharp deceleration in the fourth quarter of 2018 as the cloud market slowed and semiconductor component suppliers faced a situation of burning through excess amounts of inventory throughout the first half of 2019. We expect a modest recovery in cloud capital expenditure spending in 2020.

Valuation and Risks
as of November 15, 2019

- The Information Technology sector currently trades at 20.8x the NTM consensus EPS estimate of $73.66. The P/E ratio is above the five-year historical valuation of 17.3x. Relative to the S&P 500, the Information Technology sector is trading at 1.2x, which is modestly above historical levels of 1.0x. Historical comparisons are skewed as a result of the Internet Services and Home Entertainment & Software industries which left the Info Tech and moved into the Communication Services sector as of 9/21/18.

- Risks for the Technology sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products and the departure of key members of management.
Sector drivers and themes for 2020

Global industrial production rates have continued to weaken and a lack of clarity of the U.S./China trade dispute is likely to result in heightened uncertainty for many commodity/chemical markets. We expect the interplay between capacity expansion and input cost pressures is likely to result in a persistently fluid margin dynamic for the sector as a whole.

Input cost pressures are likely to ease somewhat for many in the materials space, although concerns could now turn to the ability to increase prices.

ISM Manufacturing PMI Prices Paid Index

Source: Institute for Supply Chain Management. Data through 9/30/2019. The ISM PMIs (Purchasing Managers’ Index). Prices Paid Index is a diffusion index reflecting the change in the prices paid by industry representatives for the products and or services they receive. Readings above 50 indicate purchasing managers are paying higher prices, while readings below 50 indicate the inverse. An index is unmanaged and not available for direct investment.
Where to invest in 2020

We continue to favor the specialty chemicals and industrials gases sub-industries, as we see heightened M&A activity in recent years driving increased industry consolidation, company-specific synergies, as well as upgraded (i.e. higher margin) portfolios of assets. Input cost pressures could moderate in the coming quarters, but the demand picture remains choppy and difficult to project. With significant capacity expansion underway in several areas of the Materials sector, we believe investors will continue to allocate toward what we view as the more stable sub-industries we favor. We continue to view metals and mining less favorably, as despite a more benign commodity price backdrop, companies in this sector generally have continued to post underwhelming financial results. Additionally, we remain concerned that the performance of the metals and mining group will continue to be materially impacted by difficult-to-predict government policy.

The sector is sensitive to fluctuations in and relationships among commodity prices, particularly crude oil, natural gas and NGLs, metals, and agricultural products. China has been a major factor in driving demand and therefore pricing for many commodities. A global economic slowdown would weigh on the Materials sector’s performance. Many materials companies have significant operational exposure to foreign currencies. Additionally, many commodities are priced in U.S. dollars. Strength in the U.S. dollar could negatively impact reported results within the sector.

Valuation and Risks

as of November 15, 2019

- The Materials sector currently trades at 18.1x the NTM consensus EPS estimate of $20.95. This P/E ratio is above the average five-year historical valuation of 16.1x. Relative to the S&P 500, the sector is trading at 1.0x in line with historical levels of 1.0x.
- The Materials sector is highly cyclical and therefore tied to the health of the global economy. Operating conditions are heavily influenced by commodity prices and levels of business confidence. Rising input costs can negatively impact margins. Certain subsectors can be particularly exposed to individual country regulations pertaining to mineral rights, environmental restrictions, or rules of origin.
Sector drivers and themes for 2020

As in the past several years, we believe a significant influence on 2020 Real Estate Investment Trust (REIT) total returns will be the interest rate environment, given the solid performance of REITs during the first three quarters of 2019 as the Federal Reserve was reducing interest rates. Another major factor will likely be the ability of REITs to access attractively priced capital. Finally, we believe REITs have likely benefited from investor concerns regarding the potential impacts from tariffs and international trade tensions. We view the vast majority of REITs as insulated from these concerns given the majority of REIT properties generate their income streams from domestic tenants that we believe should not be significantly impacted by international trade issues. Should investors remain concerned about tariffs and international trade in 2020, we believe REITs would likely benefit.

Recently, the Real Estate Sector has Moved in the Opposite Directions as Interest Rates

As the 10 Year U.S. Treasury yield increased throughout 2018, the S&P 500 Real Estate Sector returns trailed returns from many sectors of the S&P 500. However, as investor expectations regarding the Federal Reserve lowering interest rates in 2019 became stronger, Real Estate sector returns improved as 2019 unfolded.


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Where to invest in 2020

In our opinion, REITs that may outperform during a period of declining interest rates and lower inflation would include REITs with longer lease terms such as health care and freestanding retail/net lease REITs. REITs with longer lease terms are generally viewed as providing stable cash flow and as a result these REIT sectors often generate attractive total returns in lower interest rate or low inflation environments. On the earnings growth front, we expect specialty REITs (particularly technology-related REITs such as cell tower REITs) and industrial REITs to produce strong growth due to robust underlying demand from their tenants. Cell tower REITs have benefited from growth in mobile data usage while tenant demand for industrial buildings has been positively impacted by supply chain investments. Additionally, earnings growth from the manufactured housing REITs is anticipated to remain strong given consistent tenant demand combined with very low levels of new property construction. Conversely, we expect sub-industries with shorter lease terms such as several residential property classes, hotels and self-storage may lag the broader Real Estate sector if the Federal Reserve implements a higher number of interest rate reductions than investors expect and inflation expectations decline in the coming quarters. The cash flow streams from REITs with shorter lease terms are viewed as less stable relative to the longer lease term real estate sectors and as a result REITs with shorter lease terms can be less desirable in a lower interest rate and low inflation environment.

Valuation and Risks

as of November 15, 2019

• The Real Estate sector is currently trading at a price-to-funds from operations ratio (P/FFO) of 19.7x NTM FFO based on consensus estimates of $12.10. The current P/FFO ratio is above the five-year average of 18.1x. Relative to the S&P 500, the Real Estate sector has been trading at 1.1x, in line with its five year average of 1.1x. The current common dividend yield for the Real Estate sector is 3.1% compared with the two year average common dividend yield of roughly 3.4%.

• Risks to companies within the Real Estate sector include: changes in economic growth in key markets, competition from new property developments, larger tenants encountering financial difficulties lessening their ability to pay rental obligations, a rapid rise in interest rates that makes other income-oriented investments more attractive, potential unexpected common dividend reductions and changes in the cost or availability of attractively priced capital that is necessary for REITs to complete acquisitions and new property developments.
Utilities

Joseph Buffa
Equity Sector Analyst
Utilities

Sector drivers and themes for 2020

We expect drivers and themes within the Utilities sector to remain relatively static throughout 2020 relative to 2019. At the sector level, we believe the overall market’s risk appetite will be a major driver of sector performance. As global trade concerns linger, geopolitical tensions rise, economic growth wanes, and the U.S. election season gets into full swing, the Utilities sector will reflect investor sentiment. Absent a major pullback in the overall market, we believe the low interest rate environment could support the sector’s elevated valuation multiple. At the company level, we expect renewable generation, regulatory outcomes, and, of course, earnings and guidance to be drivers of stock performance.

As shown in the chart, Utilities sector valuation tends to move in relation to interest rates, in this case, the 10-Year U.S. Treasury yield. While many factors influence interest rates, an important driver is market sentiment—pessimism increases demand for “safe” assets, driving down the yield.

Utilities Sector Valuation and U.S. 10-Year Treasury Yield


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Where to invest in 2020

Our view is that elements that could derail the long-term bull market cycle are increasingly present. We point to the ongoing trade war with China, increasing volatility in the Middle East, slowing global economic growth, and an upcoming political showdown in the U.S. as factors skewing our view to the downside. On the flipside, low interest rates and a dovish Federal Reserve could provide support for the stock market assuming the status quo regarding the aforementioned (and other) risks. Against this backdrop, we recommend investors focus Utilities sector exposure on high quality, consistent, defensive utilities in supportive regulatory jurisdictions. This is generally where we believe investors should focus across economic cycles but believe this exposure can be beneficial during periods of heightened market volatility. From these utilities, we expect to see the expected—steady, reliable earnings and dividend growth—i.e. no surprises. Unfortunately, utilities that fit the above profile also tend to trade above sector-average multiples.

Let’s walk through two scenarios: Status Quo and Downturn. Status Quo assumes current conditions continue with slow but positive growth and a supportive Federal Reserve and interest rates. In this case, the Utilities sector likely continues to chug along but could very well underperform the broader market (low beta sector). Assuming a downturn, the overall market heads south due to some reason or another, Utilities included. In this case, we believe the sector should benefit from its defensive characteristics and outperform the broader market on a relative basis. Our favored Utilities should enable participation in the chug-along Status Quo environment (growthy utilities) and hold up well on a relative basis in the Downturn scenario (higher quality and reliability compared to the overall sector).

Valuation and Risks

as of November 15, 2019

- The Utilities sector trades at approximately 19.3x the NTM consensus EPS estimate of $16.44, which is above its five-year historical average of about 17.4x. Relative to the S&P 500, the Utilities sector is trading at 1.1x, modestly above historical levels of 1.0x. The Utilities sector pays an annual dividend of about 3.2%, compared to the yield of 1.9% within the S&P 500 Index.

- Regulatory risk remains the key uncertainty for the Utilities sector, both at the federal and state levels. Additionally, Utilities typically carry high debt levels, and rising rates could impact their overall borrowing costs. High debt levels could also put a strain on credit ratings, which would also limit the ability to finance capital expenditures. As M&A activity increases, companies may face challenges when integrating those acquired businesses.

Favorable
- Electric Utilities
- Multi-Utilities

Neutral
- Gas Utilities
- Water Utilities
- Independent Power Producers & Energy Traders

Unfavorable
—
Other risk considerations:

Business Development Companies

Investing in a Business Development Company (BDC) involves economic, credit, and liquidity risks in addition to the special risks associated with investing in a portfolio of small and developing or financially trouble businesses. BDCs are exposed to high credit risk amplified through leverage. The use of leverage can magnify any price movements resulting in high volatility and potentially significant loss of principal.

Equity Securities

Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. Investments in equity securities are generally more volatile than other types of securities. Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market. There is no guarantee that dividend-paying stocks will return more than the overall stock market. Dividends are not guaranteed and are subject to change or elimination.

Master Limited Partnerships

Investments in Master Limited Partnerships (MLPs) involve certain risks which differ from an investment in the securities of a corporation. MLPs may be sensitive to price changes in oil, natural gas, etc., regulatory risk, and rising interest rates. A change in the current tax law regarding MLPs could result in the MLP being treated as a corporation for federal income tax purposes which would reduce the amount of cash flows distributed by the MLP. Investment in real estate securities include risks, such as the possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions.

Real Estate

Investment in real estate securities have certain risks, including the possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions.