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Investment Institute

TIMELY GUIDANCE
Institute Alert

Timely guidance that may affect your investment strategy July 19, 2024

Global Investment Strategy Team

☑ **Guidance change**
☐ Forecast change
☑ **Allocation change**

Adjusting equity sector guidance

Guidance changes

- **Global equities:** We are upgrading the Financials sector from unfavorable to favorable and downgrading the Consumer Staples sector from neutral to unfavorable. These changes are based on our expectation that economic growth will improve and short-term interest rates will fall relative to long-term rates.

Allocation changes

- **Global equities:** We favor reallocating from either sectors we rate as unfavorable (including Consumer Discretionary, Utilities, Real Estate, and Consumer Staples) or those we rate as neutral that are held above market weight (such as Information Technology and Communication Services).

Summary

Since last December, we have been expecting the economy to pivot from slowing growth and an inverted yield curve (that is, with short-term rates exceeding long-term rates) to firmer, more sustained growth and short-term rates that drop to levels at or below long-term rates. This latter combination of rates typically accompanies an economic recovery.

As the economy nears a pivot to recovery and interest-rate reductions seem closer, we anticipate an opportunity for outperformance by the S&P 500 Index Financials sector, and we are taking this opportunity to upgrade the sector. We are downgrading a more defensive sector, Consumer Staples, in parallel. As the economic and credit-market outlook brightens, we anticipate further reallocations as our economic and rate outlook develops.

A growth-oriented sector upgrade

Our upgrade of the S&P 500 Index Financials sector from unfavorable to favorable closes out our unfavorable call from January 2024. We downgraded the sector because we expected that the interest-rate markets were too optimistic about rate cuts while inflation was sticky. As the rates markets have recalibrated, the Financials sector has lagged the S&P 500 Index.

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We believe that this underperformance by Financials has run its course, and we now see several tailwinds that should benefit performance going forward. One especially notable tailwind is the anticipated start of a Federal Reserve (Fed) easing cycle that we expect will make credit cheaper and more available and, in turn, should help spark a 2025 economic upturn. If confidence improves, we anticipate loan growth should pick up while deposit interest costs decline.

In addition, a strengthening economy should allow the banks to reallocate capital that has been set aside against loan losses during the economy's weak period. Operating efficiencies have accompanied the loan-loss reserves and, together, these steps should position bank margins to benefit as an economic rebound materializes. Meanwhile, Fed Chair Jerome Powell has suggested some reworked regulations that could favor expanded business opportunities for banks and other financial firms.

In parallel with the upgrade to Financials, we are downgrading the Consumer Staples sector from neutral to unfavorable. This typically defensive sector likely will struggle if consumers shift their spending focus from basics to discretionary items. Consumer Staples companies also should remain under pressure from stubbornly high wage costs and a recovery in raw-materials prices. Additionally, the same increase in long-term interest rates that helps loan profitability at banks is likely to create higher borrowing costs, another headwind for the Consumer Staples sector. On the margin, increased effectiveness and usage of weight-loss drugs could also dent demand as well as sentiment toward the sector.

The main risk to these defensive-to-cyclical sector rating changes would be a deeper slowdown than our outlook envisions. In particular, a recession would tend to favor Consumer Staples over Financials. However, we foresee a low risk of a recession during the next 18 months. The economy still has pockets of strength, especially the jobs market and wage growth, but also on the corporate side — manufacturing construction, for example — that we expect to lend support. We believe the most likely scenario is that of a soft landing and falling interest rates during the coming months, which should allow the earnings recovery to broaden.

We favor rebalancing among equity sectors

We favor reallocating to take exposure to the Financials sector from below market weight to above market weight. As sources of funds, we prefer to pull either from sectors we rate as unfavorable (including Consumer Discretionary, Utilities, Real Estate, and Consumer Staples) or from sectors that a portfolio holds in proportions above their market weights. Likely candidates in this latter case include Information Technology and Communication Services, which we rate as neutral but that are responsible for much of the S&P 500 Index gains this year.

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Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. Investments that are concentrated in a specific **sector** or industry may be subject to a higher degree of market risk than investments that are more diversified.

Definitions

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

S&P 500 Financials Index comprises those companies included in the S&P 500 that are classified as members of the GICS® financials sector.

An index is unmanaged and not available for direct investment.

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