Market Strategy
by STRATEGAS A BAIRD COMPANY

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Private Wealth Management

# U.S. Equity Sector Allocation

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**Strategas – a Baird Company** provides market strategy and perspective to help you better understand what is happening in the world today and how it impacts your portfolio and plans. Exclusive to Baird, these premier market, macroeconomic, and government policy insights complement the planning and investment strategy work of your Financial Advisor.

## CYCLICAL ROTATION UNDERWAY I MARKET STRUCTURE KEY

As we quickly approach presidential election, we find it increasingly likely that market volatility tied to political events (e.g. stimulus negotiations, the SCOTUS nomination, and the election itself) will increase. Further, the uneveness of the recovery (with goods being stronger and services weaker) will continue to color our view of markets, economics and, ultimately, sector recommendations.

Near-term, however, the path of the virus and how effectively we deal with it should continue to dictate returns. The general trend appears to be improving as society learns to live with the virus and the medical community learns to treat it—this is moderately favorable for the markets in our view. **But as we've said, the easy part of the recovery may be over.** The recovery in demand is likely to be softer moving forward, particularly when compared to the dramatic bounce in activity, output, and productivity off the Spring lows. For this reason, we remain comfortable with a *gradual* rotation in positioning towards cyclical sectors as a more durable economic recovery develops.

We also increasingly believe that market structure will be an important consideration moving forward. Despite the sharp sell-off in "Big Tech" stocks at the beginning of September, the wide gap in market-cap weight between the largest companies and the rest of the S&P 500 is likely to remain for years. Although we don't cover individual stocks, it is difficult to imagine what could dislodge these companies from their dominant positions. This will affect not only sector returns, but broad market performance, as well.

Between these market structure dynamics, the Federal Reserve's pledge to remain accomodative for years, and investors' increasing reliance on cap-weighted ETFs, sector recommendations going forward are as likely to be about fund flows as they are actual underlying fundamentals. As always, investors should be mindful of what they're building their portfolio(s) for and what goals they're trying to reach—given the set-up described above, we believe that long-held norms on portfolio construction could be tested going forward. Work with your Baird Advisor to attack these problems head on and build portfolios to succeed over the long-term.

**Sector Allocation Summary U.S. Equities**

| | |
|---|---|
| OVER | Communications |
| | Industrials |
| | Technology |
| | Materials |
| | Healthcare |
| NEUTRAL | Financials |
| | Energy |
| | Discretionary |
| UNDER | Utilities |
| | Real Estate |
| | Staples |

Strategas' sector allocations are labeled as over-, under-, and neutral weight compared to sector weightings in the S&P 500 index. See the full table on the following page for rationales and risk factors for these allocations.

## Strategas U.S. Recommended Sector Allocation Summary

| | Sector | Rationale | Risks |
|---|---|---|---|
| Overweight | Communications | This sector's weight is dominated by two large tech/social media companies. Secular trend of digital advertising (streaming & social media) under pressure, but still intact; more insulated than broader ad industry to the cyclical slowdown in this downturn. | Politicization of boycotting ad spend on social media platforms. Heavy skew to select sector bellwethers that will be subject to bipartisan litigation/regulation. Slowdown in broader ad spend. |
| | Industrials | Direct beneficiary of the weaker dollar. Poised to benefit from increased government spending. Fiscal stimulus focused on infrastructure could provide a tailwind for the sector moving forward with monetary policy being exhausted. | Global growth negative from Covid-19 disruptions. Little visibility on when global economies will fully reopen and allow for supply chain synchronization. |
| | Technology | This sector's weight is dominated by two large tech firms. An important part of the barbell that offers above-average revenue growth in a low nominal growth world. SAAS (software as a service) companies are insulated to a degree from the halt in consumption. | High multiples and could be susceptible to contraction in a broader risk-off move, earnings have held up. Continued tensions with China could be a headwind. "Stay at home stocks" could be rotated out of for cyclicals. |
| | Materials | Direct beneficiary of the weaker dollar. Early signs of reflation appear to be taking place and have created a bid for the sector. | Demand going back offline from a re-closure of the economy. Dollar strength, albeit unlikely, could have a negative impact on sector. |
| | Healthcare | Timely entry point given recent fund outflows and rolling relative return versus broader market. Drug pricing appears to have taken a backseat in D.C. | Democratic sweep in November of 2020. Drug pricing coming back to the forefront of policy makers. |
| Neutral Weight | Financials | NIM (net interest margin) outlook negative. Nonperforming loans should rise. Weak consumer profile. Total return play for the sector (dividends/buybacks) impaired from Fed Stress Test. | Trading & Investment Banking has performed well. Fed backstop has allowed corporate issuance to flourish year-to-date. We are skeptical on the sustainability of this, though. The curve still remains compressed relative to historical standards. |
| | Energy | Over-supply. Concentration risk (two stocks compose half the index). Oil has rallied, but we're hovering around $40 a barrel. Pricing environment is not conducive for U.S. shale producers. Bankruptcy cycle for the sector running rampant. | Production cuts from OPEC+ oil producing countries coupled with market-driven shut-ins in the U.S. could diminish the current supply glut rapidly. Demand coming back sooner than expected from Covid-19 Shutdowns. Weaker dollar bullish for prices. |
| | Discretionary | Brick & mortar impaired but ecommerce thriving and is a net beneficiary form the lockdowns. Leisure, lodging, and restaurants will be structurally challenged until a vaccine is widely available. | Online retail giant Amazon.com makes up more than 40% of the weight of thi sector. Ecommerce is thriving but consumption lacks visibility as to when we achieve pre-pandemic levels again. Savings rate remains elevated (consumers not spending). Elevated unemployment. |
| Underweight | Utilities | Valuations remain extended for the sector. Limited pricing power. Poor performance in the face of bond yields being depressed – not encouraging. Utilities are underperforming cyclical peers. | Less exposure to foreign business and global supply chains. Further yield compression could cause investors to search for yield in the sector. Broader risk-off move could see significant bid in sector. |
| | Real Estate | Mall and Retail REITs hurting from the failure of traditional retail venues as consumers prefer to shop online. Commercial Real Estate is at the scene of the Covid-19 accident. High profile commercial tenants asking for rent relief and future rent payments remain in jeapordy. | Cloud-based infrastructure being built and needs warehousing. Apartment REITs can benefit from inclination to rent vs. buy. |
| | Staples | Valuations remain extended for the sector on both an absolute and relative basis. Limited pricing power. Americans rushed to stock up for the shutdown but unlikely that this will continue over the next few quarters. | Further yield compression could cause investors to search for yield in the sector. Broader risk-off move could see significant bid in sector. Sector bellwethers performing well. |

Recommended sector allocations are labeled as over-, under-, and neutral weight compared to sector weightings in the S&P 500 index. The Standard & Poor's 500 is an index of the 500 largest U.S. publicly traded companies. It is market-capitalization weighted, giving very large companies greater influence over the index's movement. This also contributes to the balance of sector weights, as is noted in a few places in the table above. The exact sector weightings in the S&P 500 index can float from day to day as normal trading causes shares within the index to rise or fall in price. It is not possible to invest directly in an index.

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