Market Strategy
by STRATEGAS A BAIRD COMPANY

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Private Wealth Management

U.S. Equity Sector Allocation

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CYCLICAL TRADE UNSETTLED; CYCLICAL RECOVERY INTACT

For most of 2021, the economic landscape has been defined by reacceleration in growth, the gnawing persistence of covid, and the policy mix prescribed to manage both. The Omicron variant has emerged to unsettle markets just as investors were coming to terms with weaker growth, more inflation, a slow return to daily routines, and a more progressive policy mix. As we head into the New Year, we don't know whether this variant will intensify disequilibrium or primarily cause heightened concern and increased diligence. As we wrote last month, corporations' pandemic adaptations may become one of the organic drivers of growth that the economy needs to transition from recovery to expansion. Perhaps Omicron is just enough, at just the right time, to make the Covid disruption to our daily lives and operating norms more permanent. At the moment we're on hold as we await more information on the variant.

A return to shelter-in-place mandates seems socially and politically untenable at this point, even as governments throw travel restrictions and mask mandates at the wall in these uncertain early days of a new variant. Segments of the economy that have adapted to the new normal may be well positioned if Omicron extends pandemic conditions. Segments more reliant on a return to an old normal may have their hopes dashed. Although short-term volatility will continue to discomfit investors, the Fed's chosen path toward policy normalization may cause more substantial concern than Omicron when the dust settles.

Among U.S. equity sectors, we continue to recommend above-benchmark exposure to the Consumer Discretionary, Energy, Industrials, Financials, and Materials sectors on an equal-weighted basis. This leaves our U.S. equity sector portfolios with Neutral exposure to Health Care, Technology and Real Estate. We are underweight Staples and Utilities—the lackluster performance of these two sectors during recent uncertainty has strengthened our bias toward Cyclicals over Defensive stocks. We are also maintaining below-benchmark exposure to Communications**.**

Strategas U.S. Recommended Sector Allocation Summary

		Rationale	Risks
Overweight	Discretionary	Amazon and Tesla are ~45% of the sector. The pandemic ushered in a shift to ecommerce; Amazon and Alibaba leadership is giving way to competitive strategies from smaller players. The largest tech stocks are being sold in favor of more specialized companies. Autos and Travel names are breaking out.	"K-shaped" recovery has shown lower income and unemployed consumers have led in spending while higher income consumers have held back. Is this trend reversing?
	Energy	Exxon and Chevron are 46% of the sector. The Biden / Dem green initiatives are restricting traditional fossil fuel investment as rising inflation expectations increases the appetite for commodities.	OPEC+ cuts and blatant reopening headwinds potentially disruptive to near-term demand. Auto OEM push into electric is irreversible.
	Financials	Despite a near-term growth soft patch, cyclical trends remain positive. Recent backup in rates supportive across the sector. We're watching commercial Real Estate and non-performing loans exposure.	We expect heightened volatility from Fed personnel turnover heading into Calendar 2022. Longer-term, non-financial "financials" are taking share.
	Industrials	This is the sector most correlated to the broader market (and global cyclical recovery) and is a direct beneficiary of the weaker US dollar. Economic reopening and the Biden infrastructure plan could be a multiyear tailwind for Industrials.	Covid-19 persistence has softened economic reacceleration; Supply chain issues are likely to continue through the first quarter of 2022. Near-term risks are fiscal drag, proposed tax increases and US dollar breakout.
	Materials	Auto 2.0 + China 3.0 + Biden infrastructure proposals provide structural demand for commodities. Weaker dollar tailwind on longer-term inflation concerns.	Demand going back offline from staggered lockdowns globally. The recent rally in the dollar is uncomfortable and could develop into a sustained headwind for the sector. Sector cost pressures are a risk to profits.
Neutral Weight	Healthcare	The Biden administration is looking to expand and build upon ACA. Narrow Democratic Senate majority prevents large-scale disruptions to sector.	Narrow Democratic Senate majority raises potential for directed attack on drug prices but this appears to be delayed for now.
	Real Estate	Performance mix within the sector is shifting. Heavily weighted tower REITs are rolling over with growth stocks; Residential and mall REITs are catching a bid along with value stocks in other sectors.	Cloud-based infrastructure is being built and need warehousing. Apartment REITs can benefit from inclination to rent vs. buy. "Reopen" REITs could outperform.
	Technology	Apple and Microsoft make up ~43% of the sector. Sector appears to be positioned for average revenue growth in a low-nominal-growth world. Software-as-a-service (SaaS) companies are somewhat insulated from the broader halt in consumption and semiconductors remain strong.	Secular trend of digital content and advertising remains positive; We expect the arms race for content to continue. Non-digital segments should rebound as vaccine comes online and the economy reopens.
Underweight	Communications	Facebook and Alphabet are ~56% of the sector. Liquidity-driven price recovery has outpaced revenue and earnings. Upward pressure on long rates catching up with the sector. We expect social media to come under regulatory scrutiny from the Biden administration.	The secular trend of digital content and advertising remains positive. We expect the arms race for content to continue. Non-digital segments should rebound as more widespread vaccination is achieved and the economy reopens.
	Staples	Valuations remain extended on an absolute and relative basis. Limited pricing power. Spike in sales from "hoarding effect" was temporary. Staples lagging broader market, typically lag in rising interest rate environments. Higher inflation likely in the near term.	Yield compression could cause investors to search for yield in the sector. Broader risk-off move could see significant bid in sector.
	Utilities	Despite summer "growth scare," traditional defensives underperformed. Valuations remain extended. Limited pricing power. Poor performance in current rate environment. Underperforming cylical peers.	Less exposure to foreign business and global supply chains. Yield compression could cause investors to search for yield in the sector. An extended "soft patch" could bring a bid to this 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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