Week in Review

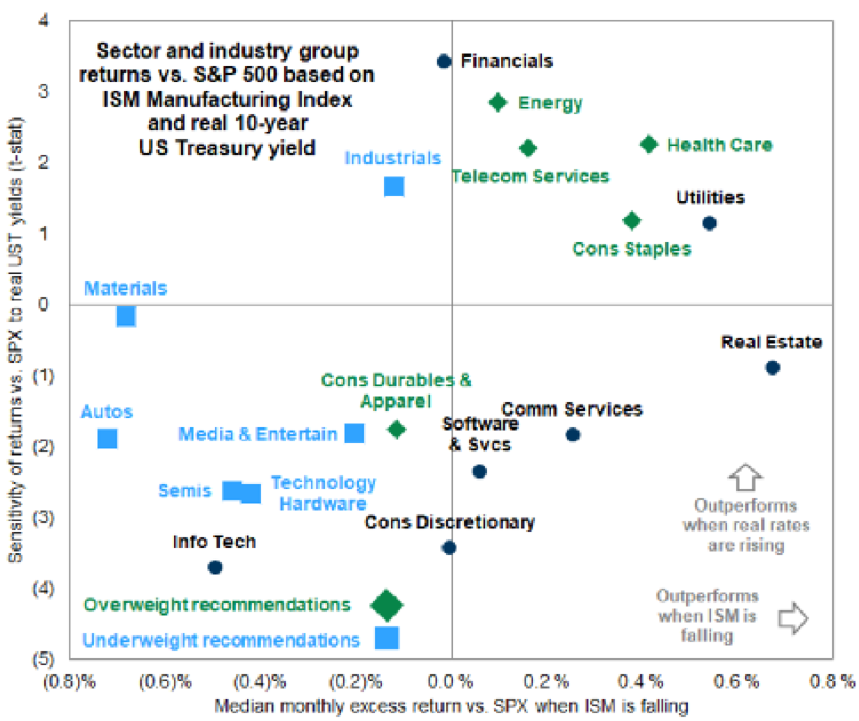
Friday, October 21, 2022

Stagflation is here: Does sector positioning matter?

- Stagflation periods have seen better relative performance by healthcare, energy, and financials and lower relative performance by industrials, information technology, and materials
- The consideration of sector exposure during periods of economic and interest rate inflection is a useful exercise

Based on the twin metrics of higher rates slower economic growth, frameworks are often utilized to aid investment positioning. Given the current higher rate and slower growth environment, visibility and consistency of earning is a favorable trait that supports positive relative performance. Conversely, high dependence on future earnings and cash flow is a headwind for the relative performance. The following table and recommendations are an example of this analysis put out by Goldman Sachs research this past week.

Sector Framework – Economic Growth and Interest Rate Risk - Recommendations Based on Goldman Sachs Analisis

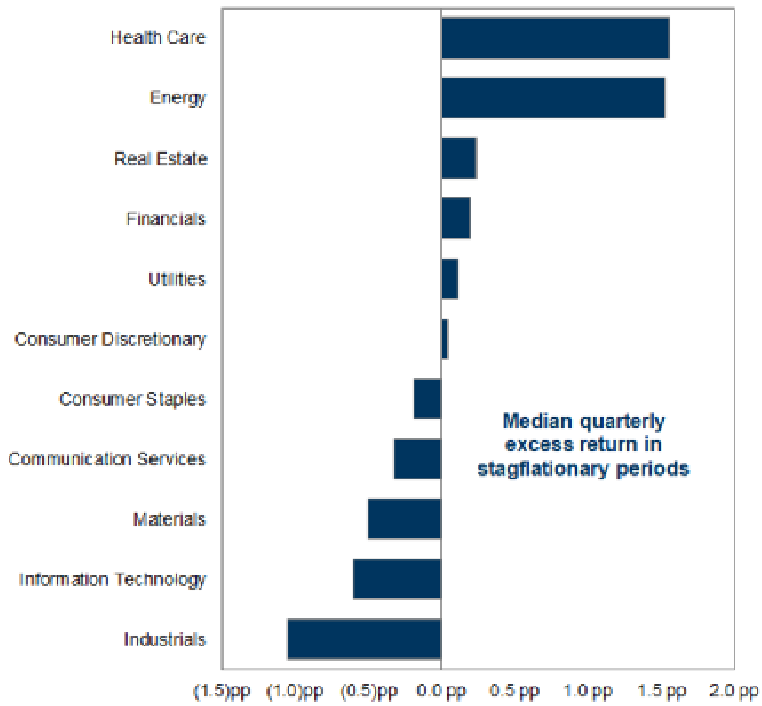


Performance during ISM cycles since 1974. Real Estate returns only since 2002. Rates betas calculated on a quarterly basis since 2015, controlling for breakeven inflation.

Source: FactSet, Compustat, Goldman Sachs Global Investment Research

The validity of Goldman Sachs' table is supported by the observation of historical relative sector returns in periods of stagflation – a period seeing both stubborn inflation and below trend economic growth. Historically, stagflation periods have seen better relative performance by healthcare, energy, and financials and lower relative performance by industrials, information technology, and materials.

Historical Relative Sector Returns in Periods of Stagflation



1960 - 2020; returns measured with 1-quarter lead relative to econmic data; returns measured relative to the Russell 3000.

Source: Goldman Sachs Global Investment Research

Positives and Negatives

The drivers of relative performance, however, vary by sector. On the positive relative side, healthcare fundamentals tend to be very defensive. Energy on the other hand tends to be somewhat subject to more cyclical demand but has historically been a beneficiary of inflationary forces such as rising energy prices. Financials, in particular traditional banks, may see credit risk in a slower economy but the risk is offset by the benefit of expanding lending spreads in a rising rate environment.

On the negative side, business models subject to cyclical demand as well as margin pressure from rising costs have historically been the weakest relative sector performers. Industrials, information technology, and materials have fallen into this category. This trend has been particularly true for business subject to capital equipment and consumer product spending. Businesses in these sectors with more leverage to services and recurring revenue have shown a greater degree of resilience.

Dividing investments into these industry exposure buckets is a useful template. However, valuation and investment timeframe are also important considerations. For example, while healthcare, consumer staples and utilities screen well, their current valuations are also high relative to history. Healthcare, consumer staples (e.g., household and personal products), and utilities currently trade at 80%, 76%, and 94% relative to the long-term average valuations levels for their sector and even higher relative levels of 86%, 87%, and 98% to their long-term average valuations versus the overall market. High current relative valuations for some sectors/industry groups may have an impact on their future relative returns.

Absolute and Relative Valuations of S&P 500 Industry Groups

	Consensus FY2 P/E		P/E premium vs. S&P 500	
Industry group	Current	30-year %ile rank	Current	30-year %ile rank
Telecom Services	8x	0 %	(48)%	1 %
Energy	9	3	(41)	2
Banks	9	11	(44)	5
Media & Entertainment	15	14	(1)	1
Consumer Durables & Apparel	11	17	(28)	19
Materials	13	26	(12)	20
Capital Goods	15	27	1	10
Real Estate	15	30	(2)	25
Pharma & Biotech	15	44	(4)	34
Diversified Financials	13	48	(13)	46
Semiconductors	14	49	(10)	33
Software & Services	21	62	35	63
Tech Hardware	19	62	25	56
Food & Staples Retailing	20	68	30	72
Food Bev & Tobacco	18	71	14	73
Insurance	12	74	(21)	80
Household & Personal Products	22	76	42	86
Transportation	13	78	(15)	67
Health Care Equipment & Services	17	80	13	87
Retailing	24	84	57	88
Autos & Components	20	92	30	92
Consumer Services	21	92	38	92
Commercial & Professional Services	24	93	55	98
Utilities	17	94	9	98
S&P 500	**15x**	**54 %**		

Source: FactSet, Compustat, Goldman Sachs Global Investment Research

While caution is warranted for some sectors trading at premium relative valuation levels, the outlook for sectors trading at the lower end of their historical valuation range should be assessed for longer term fundamental attractiveness. The telecom services sector is inexpensive on a relative basis, but the long-term fundamentals have been challenged due to high fixed costs and eroding pricing pressure.

On the other hand, energy is trading at relatively attractive valuation levels and years of under investment and a shake-up of the global supply chain are supportive from a fundamental perspective. Banks also look attractive from a historical perspective on valuation with operating tailwinds from a higher rate environment and balance sheet strength likely dampening the risk from credit in a recessionary environment.

Sector positioning around a rising yield and slower growth environment taking relative valuation into consideration is useful, but an investment time horizon is also important. Overtime dynamics such as changing yields and growth rates tend to normalize and metrics such as normalized earnings and growth rate for businesses tend to become the key determinants for financial performance. Businesses with competitive advantage and secular growth opportunities, that are also profitable and disciplined in terms of capital structure, ultimately tend to provide attractive risk adjusted returns through cycles. We believe an investment portfolio should have a foundation in these types of businesses and seek out such businesses across sectors to buffer the impact economic and interest rate cycles that may favor certain sector positioning attributes on a shorter-term basis.

In conclusion, the consideration of sector exposure during periods of economic and interest rate inflection is a useful exercise, particularly when overlayed with valuation considerations. However, over time, superior businesses with quality operational and financial characteristics acquired with valuation discipline and owned in a diversified portfolio drawing across sectors should be the overriding goal.