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Sector Views: Broader Performance in 2024

Markets believe the great Federal Reserve (Fed) pivot has happened; shifting expectations from a higher-for-longer consensus to expectations that at some point 2024, there will be cuts to the Fed Funds Rate. This shift in yield expectations came with softening economic data and the prospect of below trend economic growth in 2024. Both the yield and economic growth environment have implications for sector positioning.

These dynamics could support defensive and low-volatility sectors that have been out of favor this year, particularly bond proxy sectors such as Utilities. The shift from interest rate risk to economic growth risk favors growthier sectors such as Information Technology, which also stand to benefit from structural tailwinds related to artificial intelligence (AI). Conversely, reduced demand is likely to weigh on cyclical sectors.

Please review our 2024 Outlook for details on portfolio positioning.

Key Takeaways:

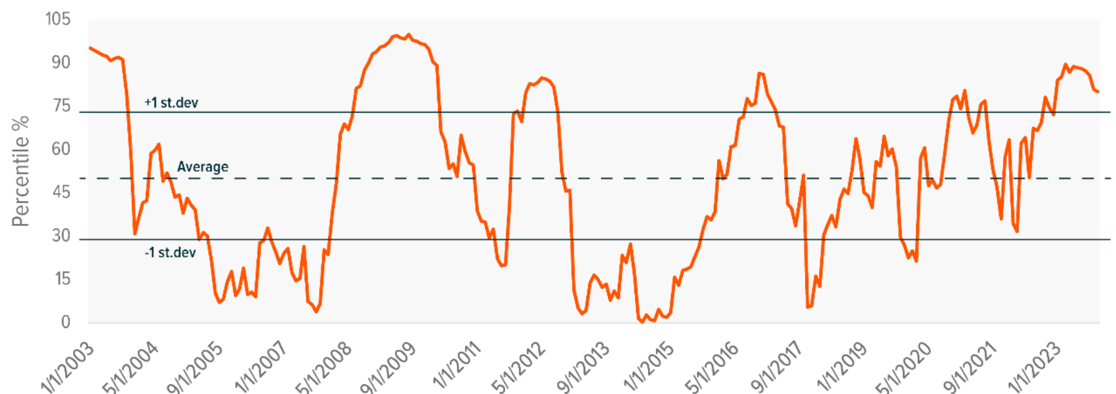
- Market breadth may continue to improve in 2024, favoring out of favor and interest rate sensitive areas.
- AI beneficiaries are likely to broaden as adoption continues.
- A slowdown in economic growth could weigh on cyclical sectors like Energy.

Dispersion Creates Opportunities

Market concentration dominated 2023, but we are already seeing expanding breadth as the yield environment improves. Phases marked by significant dispersion, characterized by a substantial performance gap between sectors, usually precede a more even return profile across sectors.

The chart below illustrates a heightened S&P 500 sector dispersion, currently hovering around the 80th percentile dating back to 2003. Consequently, we anticipate that sectors that have been lagging, like defensives, may outpace cyclicals, especially in the event of a slowdown in economic growth.

EXTREME S&P 500 SECTOR DISPERSION
Source: Bloomberg data as of December 7, 2023



Defensive Sectors Could Benefit from a Shifting Interest Rate Regime

Sectors serving as bond proxies, such as Utilities, could experience favorable conditions if policy interest rates decline in 2024. This year, investors found little solace in defensive sectors with the MSCI U.S. Defensive Sector Index's meager year-to-date total return of +2.3% versus +40.0% for the MSCI U.S. Cyclical Sector Index and +26.3% for the S&P 500 over the same period.[1] We expect defensives to outpace cyclicals in 2024, supported by the combination of slower economic growth and a shifting interest rate regime.

Going into 2024, our portfolio positioning preference is to balance between key growth areas and a resilient core comprised of quality and low volatility positions. This strategy prioritizes companies with robust balance sheets, strong cash flows, and lower beta, aligning well with emerging concerns about economic growth. The table below outlines our positioning rationale across defensive sectors.

DEFENSIVE SECTOR BECOMING MORE FAVORABLE (3-6-MONTH VIEWS):

Sector	Positioning	Rationale
Consumer Staples	**Market Weight**	Weaker economic growth could increase the focus on staples, which remains an important defensive sector, especially if consumers trade down and focus on necessities.
Health Care	**Overweight → Market Weight**	Health Care stands to benefit from structural trends. Aging demographics around the world combined with the growing middle class in emerging markets could benefit health care demand. We are more favorable on the growthier Biotech segment as interest rates decline.
Utilities	**Underweight → Overweight**	A lower interest rate environment could increase the sector's appeal as a bond proxy. Weaker economic growth could increase the importance of this defensive exposure.

Continued Tailwinds for Tech Focused Areas

While we expect market breadth to improve, we believe growthier tech-oriented areas remain well positioned. There are three main factors that we believe are likely to support continued resilience in these areas:

- A more favorable interest rate environment for growth-oriented equities.
- As economic growth slows, markets are likely to favor companies that can grow despite underlying economic weakness.
- Continued Artificial Intelligence (AI) adoption is likely to drive greater demand for tech products and potentially broaden the pool of AI beneficiaries.

Diving deeper into AI adoption, while generative AI took the world by storm in 2023, we anticipate the real opportunity in 2024 and beyond lies in the commercial applications of AI models and the industries positioned to benefit from their increasing adoption over the long term. Taking a page from the computer and cell phone revolutions, the AI revolution may well follow three phases.

1. **Building out computing power:** We witnessed this phase of AI adoption in 2023. Semiconductors, and particularly the leaders in AI-compatible semiconductor chips, dominated the initial phase of AI adoption.

2. **Digital Infrastructure and Cloud Computing Beneficiaries:** Cloud Computing democratizes access to AI, offering turnkey solutions that don't require significant upfront investments or specialized expertise. Concurrently, AI enhances cloud infrastructure by managing computing resources, streamlining workloads, and automating repetitive tasks without human intervention.

3. **Interface and Software Integration of AI Models:** This involves the development of new business models, such as model-as-a-service and application programming interfaces (APIs). Additionally, the commercialization of AI is making it more accessible and affordable for companies to engage with AI models, eliminating the need for substantial internal investments.

From a sector perspective, Information Technology and Communication Services are the most exposed to these technologies. However, Data Center REITS also stand to benefit from greater demand for Cloud services. As outlined in the table below, these three areas are also key beneficiaries of a more favorable interest rate environment.

YIELD ENVIRONMENT MORE FAVORABLE FOR LONG-DURATION SECTORS (3-6-MONTH VIEWS):

Sector	Positioning	Rationale
Communication Services	**Market Weight → Overweight**	Yield sensitive sector with reasonably positive trends in subscription services and several long-term growth opportunities.
Information Technology	**Market Weight → Overweight**	The sector displays quality factors and positive free-cash-flow growth. Stands to benefit from lower interest rates. AI adoption remains a tailwind. Some tech segments, beyond mega-cap leaders, could benefit from improving market breadth.
Real Estate	**Underweight → Market Weight**	The Real Estate sector could benefit from lower interest rates and improved market breadth, although commercial property remains a headwind.

On Track for a Soft Landing but Slowing Economic Growth Likely to Detract from Cyclicals

U.S. economic growth surprised to the upside in 2023, helping to support certain cyclical areas. Despite this, the Energy sector was one of the weakest sectors this year. While we expect market performance to broaden into 2024, the Energy sector may not benefit due to expectations for softer economic growth. While a soft landing is our base case scenario for the U.S. economy, downside risks to economic growth remain—after all, there's minimal difference between a soft landing and shallow recession.

The Fed pivot has also been celebrated by economic growth sensitive sectors as it reduces the probability of over tightening. However, while cyclicals sprinted into the end of 2023, as economic growth slows, these cyclical sectors are likely to face headwinds.

The performance of the Energy sector is closely tied to energy prices, which in turn are related to global energy demand. According to the U.S. Energy Information Administration (EIA), next year's oil market is expected to be relatively balanced, although outcomes are heavily reliant on potential production cuts from OPEC+ countries counteracting additional supply from non-OPEC nations.[2] In 2023, global oil production grew 1.5%, which offset voluntary OPEC production cuts. Rising supply in the U.S., Canada, and rest of the world, combined with weaker economic growth weighed on oil prices. We expect these dynamics to continue into 2024.[3] But geopolitical tensions remain the wildcard that may boost energy prices during 2024.

ECONOMICALLY SENSITIVE SECTORS MAY FACE HEADWINDS (3-6-MONTH VIEWS):

Sector	Positioning	Rationale
Consumer Discretionary	**Market Weight**	Consumer Discretionary typically troughs when short rates peak while having its strongest performance during the early cycle phase.
Energy	**Overweight**	Weaker global growth could weigh on oil demand amid continued supply growth from non-OPEC countries. However, oil prices remain sensitive to geopolitical tensions.
Financials	**Underweight**	Cyclical sector that remains vulnerable to slowing economic activity and a weak lending environment. Attractive valuations may provide some support.
Industrials	**Overweight → Market Weight**	The Industrial sector stands to benefit from reshoring activity and infrastructure investment. However, weaker economic growth could weigh on performance.
Materials	**Market Weight**	The Materials sector is likely to benefit from infrastructure investment. However, Chinese market weakness could weigh on sentiment.

Following three years of strong economic growth and rising market yields, the trend is expected to shift in 2024. Lower interest rate expectations have broadened market performance, boosting areas that underperformed in 2023. While quality typically outperforms in a slowing and recessionary environment, given the drawn-out nature of the slowdown and interest rates likely being at their peak, low volatility may help provide more support as economic growth slows.[4] Defensive, low volatility and quality-oriented core portfolio positioning paired with exposure to key growth areas is our main portfolio positioning view going into 2024.

Footnotes

1. Bloomberg data as of December 31, 2023
2. EIA, Short-Term Energy Outlook, December 12, 2023
3. Numera Analytics, YTD Global Oil Supply Calculations, December 12, 2023
4. Goldman Sachs, Outlook for 2024: Time for Balance – Modest Returns, Better Diversification, November 21, 2023

Definitions

MSCI U.S. Defensive Sector Index: Based on the MSCI ACWI Index, this index is designed to reflect the performance of the opportunity set of global defensive companies across various sectors. It consists of all constituents from Consumer Staples, Energy, Healthcare and Utilities.

MSCI U.S. Cyclical Sector Index: Based on the MSCI ACWI Index, this index is designed to reflect the performance of the opportunity set of global cyclical companies across various sectors. It consists of all constituents from Consumer Discretionary, Financials, Real Estate, Industrials, Information Technology, Materials and Communication Services.

S&P 500 Total Return Index: The index includes 500 leading U.S. companies and captures approximately 80% coverage of available market capitalization.

Investing involves risk, including the possible loss of principal. Diversification does not ensure a profit nor guarantee against a loss.

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