Not all equity sectors respond in the same way

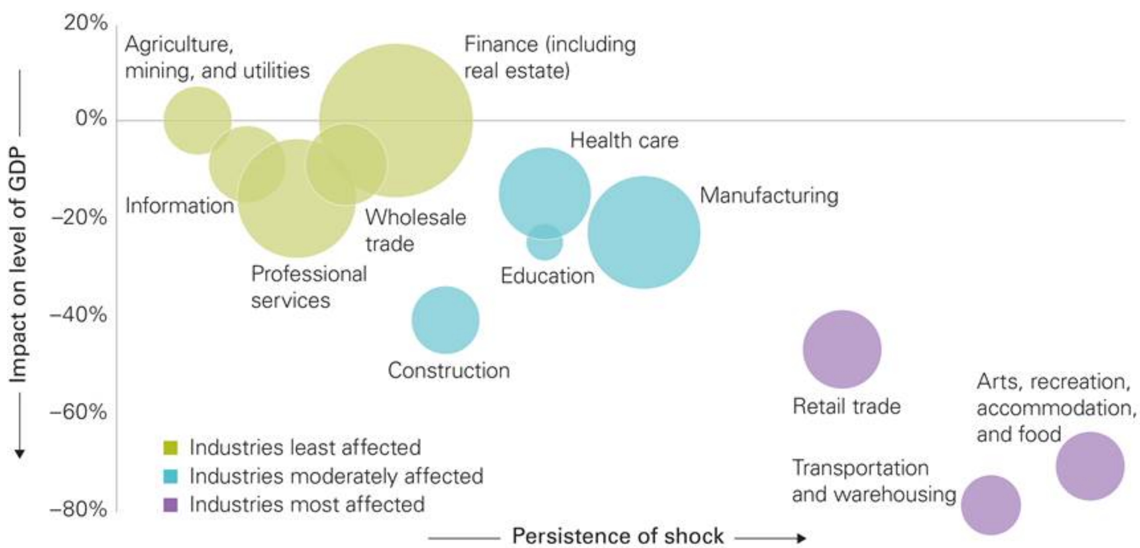
The recent sharp recovery in the global equity markets has represented a disconnect between the economy and the equity market. Despite the short-term negative macroeconomic outlook, there is an anticipation of a return to more normal economic conditions in the medium and long term.

What has this meant for sectors?

The response by various economic sectors has been uniquely different from previous market shocks. Historically, certain sectors of the market have performed better during specific types of market environments. However, the unusual global impact of the coronavirus, along with the various containment measures being implemented, has led to each economic sector being affected differently.

- Sectors that are highly reliant on face-to-face interactions, such as retail trade, hospitality, and transport, have experienced a large shock to activity.
- Sectors that can operate relatively well with social distancing in place, such as construction and manufacturing, are less affected.

The hit to U.S. economic activity varies by sector



Notes: The figure shows the estimated maximum impact on U.S. GDP in April 2020. The size of the bubble indicates the relative weight of each sector in U.S. GDP. Initial impact on the level of GDP and the persistence of shock estimated are based on a range of high-frequency indicators (such as mobility indexes, fuel consumption, retail foot traffic, and restaurant and hotel occupancy) and traditional economic indicators.

Sources: Google, Apple, Johnson Redbook Index, American Iron and Steel Institute, U.S. Department of Energy, Association of American Railroads, U.S. Bureau of Labor Statistics, ProdcoAnalytics, Smith Travel Research, OpenTable, Transportation Security Administration, and SimilarWeb.

While various factors drive sector performance, it’s possible that better-performing sectors were the result of market participants believing that these businesses (technology companies above all) can quickly adapt to new economic conditions without major disruptions to the supply chain.

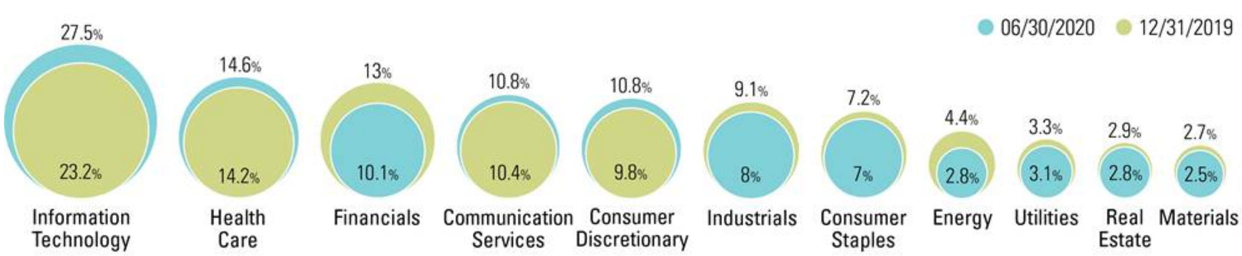
Cyclical sectors such as financials and real estate sustained losses in 2020 because of their sensitivity to these unusual market and macroeconomic conditions. The energy sector, which normally suffers in periods of economic downturns as a result of lower energy demand, has taken an extra hit from the oil-price drop, caused by geopolitical reasons, driving down most oil companies’ expected cash flows.

Sector tilts driving equity rally

The U.S. equity market has been one of the best performers on a relative basis since the beginning of the year. Sector tilts have been a significant reason for the rally in equities over the past few months with outperformance coming from primarily technology and health care stocks. In fact, these two sectors comprise over 40% of the broad U.S. market.

Behavioral changes resulting from various state’s shutdowns along with consumer reticence will continue to act as a drag on other sectors that usually see a boost from a market rally. By looking at the shift in sector weights within the S&P 500 Index, you get a sense for how things are going to be very different for industries as we progress along this health crisis.

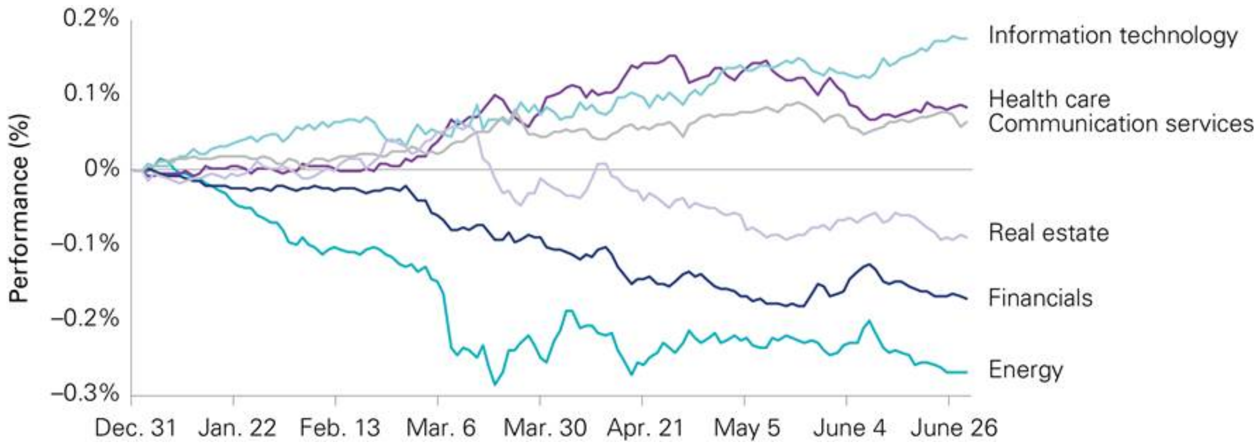
Shift in S&P 500 Index sector weights over the past six months



Source: FactSet as of December 31, 2019, and June 30, 2020.

As certain sectors have gained from this crisis, it has led many advisors and their clients to consider “tactical” sector allocations focused on technology, real estate, and healthcare. It also stresses the importance of a bottom-up approach to sector investing in this current environment.

On a relative basis, some sectors have gained from the crisis



Note: Performance is measured by the MSCI All Country World Index (USD). Data are from January 1, 2020, through June 30, 2020.

Source: Vanguard.

Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

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