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Sector Opportunities for Q2 2024

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- **Insurance** A strong growth outlook, attractive valuations, and lower volatility profile suggest quality growth at attractive valuations.
- **Homebuilders** While potential lower mortgage rates support valuations, the demand increase from millennials likely will strengthen industry fundamentals over the next few years.
- **Biotech** The combination of R&D-focused small firms driving innovation in medicine and big pharma companies showing increased appetite for M&A deals indicates potential growth opportunities.

The S&P 500® Index extended the rally it began in late October, adding 10.6% gains in Q1 and refreshing all-time highs 22 times.[1] Market breadth widened with certain value and cyclical sectors, such as Energy and Financials, outperforming.[2] While investors dialed back rate cut expectations amid firmer inflation and strong labor markets, higher yields have hurt bonds more than stocks as earnings and economic outlooks hold.

However, equity valuations have become more stretched. And double-digit expected earnings growth for this year and next seems lofty given a cooling economy and lower inflation. Therefore, we favor industries with attractive valuations that have either strong earnings outlooks supported by solid industry growth trends (Insurance and Homebuilders) or long-term growth potential (Biotech).

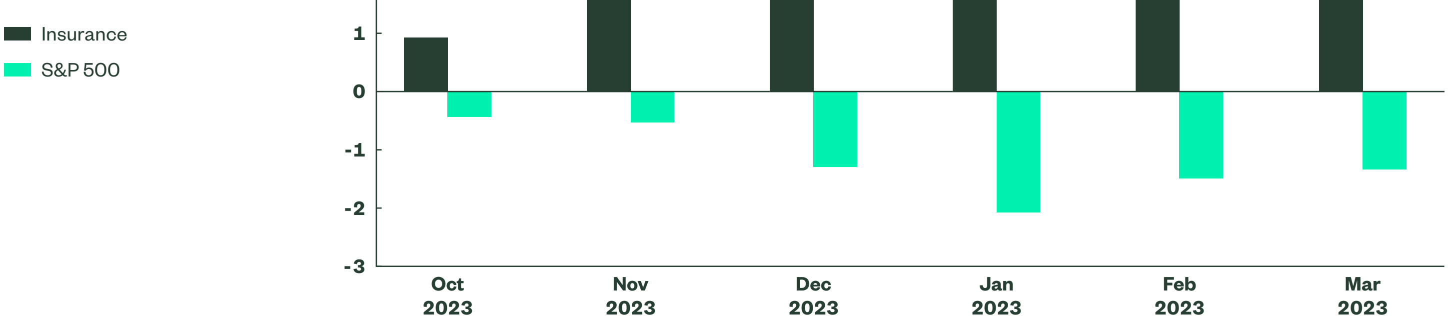
Insurance: Quality Exposure with Attractive Valuations

The insurance industry's strong price momentum continues. After outperforming the broad market in the second half of 2023, insurance has outperformed the S&P 500 and the Financial sector by more than 5% year to date, thanks to continued improvement in industry fundamentals and attractive valuations.[3]

While the Property & Casualty (P&C) insurers' profits faced headwinds from significant natural catastrophes and persistent inflation in the first half of last year, positive profit momentum emerged in the second half. P&C insurers' earned insurance premium increased 9% in the third quarter, outpacing incurred claims by 3%[4] Driven by strong demand and pricing power in personal lines and commercial properties, net written premium — a key indicator of earned premium for the following year — is expected to grow by high single digits in 2024, more than the industry's long-term average of just under 5%.[5] Furthermore, as reinvestment yields remain above average yields on maturing securities, insurers' investment yields are expected to continue rising in 2024 and 2025, supporting growth in investment income — the second-largest part of their revenues. On the cost side, continued disinflationary trends should keep insurers' claim costs in check, supporting their margin expansion.

Given these tailwinds, the industry's earnings outlook has been upgraded since the beginning of the year, compared to downgrades for the broad market (Figure 1). The insurance industry is projected to post 15.9% EPS growth in 2024, compared to 10.7% growth for the S&P 500.[6]

Figure 1
Insurance Industry's 2024 EPS Upgrades Outpace Broad Market



Source: FactSet, as of March 14, 2024. The insurance industry is represented by the S&P Insurance Select Industry Index.

Despite its stronger growth outlook, the industry's forward price-to-earning (P/E) is trading 10% below its 10-year average. Its absolute and relative P/E are in the bottom decile over the past 10 years, pointing to a growth opportunity at attractive valuations.[7]

The insurance industry has exhibited a market beta of 0.67 and lower volatility than both the broad market and the Financial sector over the past three years,[8] when equity markets had big ups and downs driven by rate volatility and economic uncertainty. Still, investors tend to overlook insurance companies because they don't grab headlines or have glamourous growth stories. Nevertheless, the industry's strong pricing power and stable cash flows from premiums collection, combined with below-average valuations, make insurance a quality value exposure.

To pursue the insurance industry's quality growth at attractive valuations, consider the SPDR® S&P® Insurance ETF [KIE].

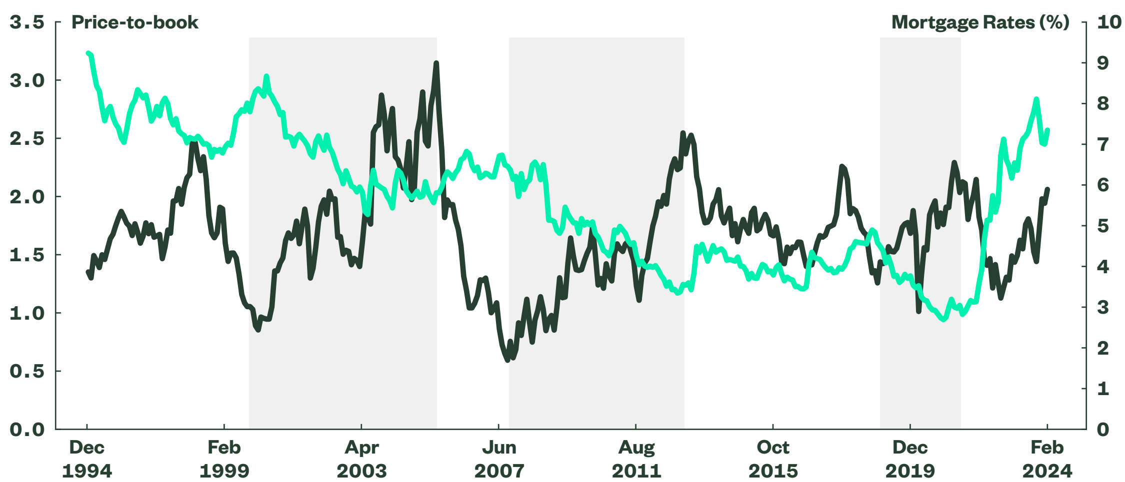
Homebuilders: If You Build It, They Will Come

Thanks to stable mortgage rates, robust housing demand, and multi-decade low existing home inventory, the homebuilder industry has shown great resilience even though the market has dialed back rate cut expectations for this year.

We believe mortgage rates reached the cycle peak last year and likely will continue to drift lower, driven by lower Fed funds rates and the tightening of the yield spreads with Treasuries. While hotter-than-expected inflation sent 10-year Treasury yields up 52 basis points (bps) to 4.4%, 30-year mortgage rates have settled around 7% thanks to tighter spreads between the two.[9] After reaching a record wide spread last May, the spread between 30-year mortgage rate and 10-year Treasury yields has tightened, but is still well above the long-term average of 200 bps. Further normalization in spreads will put downward pressure on mortgage rates, improving housing affordability and attracting more buyers to the housing market.

Historically, homebuilder price-to-book (P/B) multiples have tended to expand when mortgage rates trended downward (Figure 2). Admittedly, given more than 40% of gains since the October trough, homebuilder valuations have become less attractive than six months ago when we highlighted this opportunity. Nevertheless, the industry's current P/B multiples are at least 27% below their historical peaks when mortgage rates were at the cycle low. Since we are still at the early innings of declining mortgage rates and housing demand outpaces supplies, the industry valuations may have further room to expand.

Figure 2
Lower Mortgage Rates Support Homebuilder Valuations



Source: Bloomberg Finance, L.P., FactSet, as of February 29, 2024. The shaded area highlights the historical declining mortgage rate cycle. The homebuilder industry is represented by the S&P 1500 Homebuilders Index.

Some investors may question whether lower mortgage rates will increase the existing housing inventory, hurting demand for new construction. Even assuming four rate cuts this year — a very bullish rate outlook at the moment — mortgage rates likely will remain above 5.5% this year. Given that 80% of homeowners locked in a mortgage rate below 5% and 60% locked in below 4%,[10] existing housing supply likely will be constrained.

This structural housing shortage will continue supporting housing prices and increasing demand for new construction. Currently, 72 million millennials — now the largest generation group in the US — are near the peak of new household formation and first-time homebuyer age. But the baby boomers — accounting for 38% of total homeowner households — are expected to exit homeownership slowly.[11] Therefore, overall US homeownership is expected to increase over the next few years.[12] Meanwhile, as housing starts have lagged household formation over the past decade, the gap between the two continues to expand, reaching 2.5 million units in 2023.[13]

Against this backdrop, homebuilders have shown upbeat earnings sentiment with earnings and sales estimates revised up by 5%,[14] as housing starts and permits are on an upward trend. Homebuilder confidence also rose for the fourth consecutive month in March to above the neutral level, supported by strong demand.[15]

To capture the ongoing recovery in the structurally under-supplied housing market, consider the SPDR® S&P Homebuilders ETF (XHB).

Biotech: Revived M&A Activity and an Innovation Boom

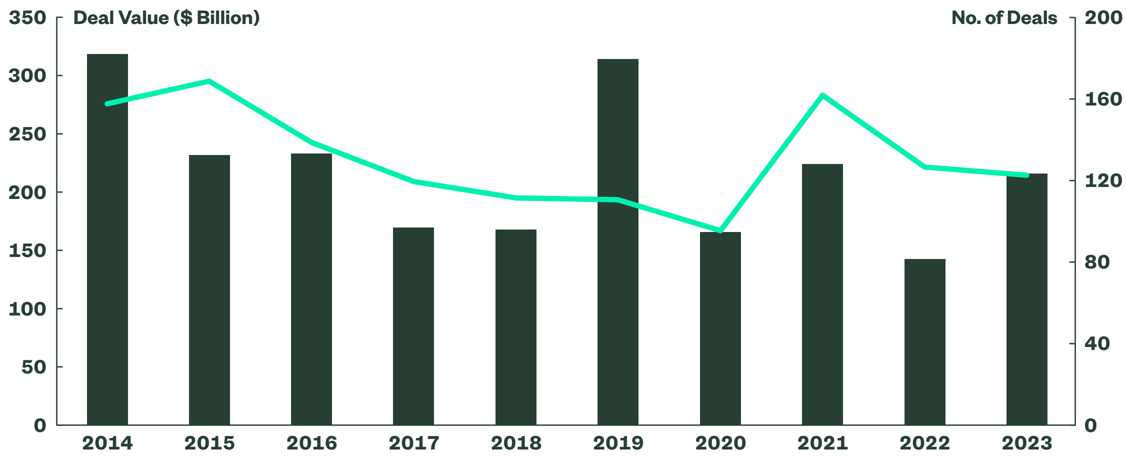
The historic aggressive rate hikes of the past two years have taken a toll on biotech stocks, but the industry's commitment to innovation based on medical research remains strong. Fifty-five innovative therapies were approved by the FDA in 2023 compared to 37 in 2022 and a 20-year average of 36.[16] Tackling challenging health issues that impact millions, these approvals include weight-loss drugs, Alzheimer's treatments, mRNA-based vaccines to prevent respiratory syncytial virus (RSV), and advanced diagnostic tools for early cancer detection and new treatments.

Smaller, more nimble firms focused on R&D are driving this innovation in medicine; 55% of new drug approvals between 2011 and 2020 were developed by companies with less than $500 million in revenue.[17] Meanwhile, the top 25 global pharmaceutical companies are facing an impending deep patent cliff that puts $300 billion of revenue at risk between 2024 and 2028.

Additionally, many of the larger firms' high revenue products will face drug price negotiation in the coming years under the Inflation Reduction Act (IRA). Given that the IRA allows large-molecule biologics drugs five more years of exemption from mandated drug price negotiation than small-molecule drugs, development of large-molecule biologics drugs could become more valuable for big pharma.

Despite the strong rebound since late October, biotech valuations still appear attractive — close to their lowest level in the past 12 years, barring the recent rate hike cycle. Given the urgency to find new sources of growth, near-record levels of cash on hand,[18] and attractive biotech valuations, big pharma has shown increased appetite for M&A deals (Figure 3). Biotech M&A activities picked up in Q4 2023, increasing the total M&A deal value for 2023 by 51% year-over-year and closer to 2021 level, despite there being fewer deals.[19] The momentum has continued this year, with a flurry of deals announced in January.[20]

Figure 3
Can Life Sciences' 2023 M&A Deal Momentum Continue?



Source: 2024 EY M&A Firepower Report, January 8, 2024.

Although heightened rate uncertainty has weakened the industry's price momentum, biotech remains at the center of scientific breakthroughs, delivering solutions that transform our lives. The strong M&A appetite of big pharma companies may support biotech valuations.

To pursue the increased momentum in biotech innovation and M&A activities, consider the SPDR® S&P® Biotech ETF (XBI); its modified equal-weighted index methodology provides greater exposure to small caps.

To learn more about emerging sector investment opportunities, visit our sectors webpage.

Endnotes

1 Bloomberg Finance, L.P., as of March 31, 2024.

2 Bloomberg Finance, L.P., as of March 31, 2024.

3 Bloomberg Finance, L.P., as of March 31, 2024.

4 Swiss Re Institute, January 2024.

5 CFRA Property and Casualty Insurance Survey, Swiss Re Institute, January 2024.

6 FactSet, as of March 18, 2024.

7 FactSet, February 29, 2024.

8 FactSet, February 29, 2024.

9 Bloomberg Finance, L.P., as of April 5, 2024.

10 Redfin, Barclays Research, as of December 2023.

11 Freddie Mac, Economic Housing and Mortgage Market Outlook, February 2024.

12 Freddie Mac, Economic Housing and Mortgage Market Outlook, February 2024.

13 Realtor.com, US Housing Supply Gap Grows in 2023, February 2024.

14 FactSet, as of March 20, 2024.

15 NAHB, as of March 18, 2024.

16 U.S. Food & Drug Administration, February 26, 2024.

17 Bio.News, December 2022.

18 2024 EY M&A Firepower Report, EY, January 8, 2024.

19 The Twists and Turns in Biopharma Dealmaking: 2024 Trends, PharmaExec.com, January 26, 2024.

20 The Twists and Turns in Biopharma Dealmaking: 2024 Trends, PharmaExec.com, January 26, 2024.

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* Pensions & Investments Research Center, as of December 31, 2022.
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Glossary

Earnings Per Share (EPS) A profitability measure that is calculated by dividing a company's net income by the number of shares outstanding.

Equal Weighted Index A benchmark that weights its constituent stocks equally and rebalances on a periodic basis (such as quarterly) to maintain the equal weighting.

Forward Price-to-Earnings Ratio The price of a security per share at a given time divided by its projected earnings per share over the coming year. A forward P/E ratio is a way to help determine a security's stock valuation — that is, the fair value of a stock in a perfect market. It is also a measure of expected, but not realized, growth.

Inflation Reduction Act The Inflation Reduction Act, passed in 2022, aimed to curb inflation by possibly reducing the federal government budget deficit, lowering prescription drug prices, and investing in domestic energy production while promoting clean energy. It achieved these goals by investing in domestic energy production and manufacturing, aiming to reduce carbon emissions by roughly 40% by 2030. The bill also allowed Medicare to negotiate for prescription drug prices and extend the expanded Affordable Care Act program for three years, through 2025.

Mergers and Acquisitions (M&A) A general term that refers to the consolidation of companies or assets such as one entity buying another. Industries that are experiencing M&A activity can see rising stock profits in smaller companies that may become acquisition targets.

Price-to-Book Ratio (P/B Ratio) A valuation metric that compares a company's current share price against its book value, or the value of all its assets minus intangible assets and liabilities. The P/B is a ratio of investor sentiment on the value of a stock to its actual value according to the Generally Accepted Accounting Principles (GAAP). A high P/B means either that investors have overvalued the company, or that its accountants have undervalued it.

Property and Casualty insurers Property and casualty (P&C) insurers collectively refers to insurance companies that offer coverage on assets, and liability insurance for accidents, injuries, and damage to others or their belongings.

S&P Insurance Select Industry Index The S&P Insurance Select Industry Index is a modified equal-weighted index. It is currently comprised of leading companies active in the US insurance industry that are listed on the NYSE, or another US national securities exchange, or NASDAQ®/NMS.

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Biotechnology Companies Risk: Biotech companies invest heavily in research and development which may not necessarily lead to commercially successful products. These companies are also subject to increased governmental regulation which may delay or inhibit the release of new products. Many biotech companies are dependent upon their ability to use and enforce intellectual property rights and patents. Any impairment of such rights may have adverse financial consequences. Biotech stocks, especially those of smaller, less-seasoned companies, tend to be more volatile than the overall market. Biotech companies can be significantly affected by technological change and obsolescence, product liability lawsuits and consequential high insurance costs.

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