Insights
Sectors

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Address Key Risks in 2022 with Energy and Health Care

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Amid persistent uncertainty, investors could stand to benefit from diversifying their portfolios. In this paper, we outline how the energy and health care sectors might help investors to grapple with inflation and further COVID challenges.

Taking Advantage of Sector Characteristics

There are many unknowns about the Omicron variant, but an important side-effect is to remind investors of the need to prepare for changing scenarios. Given the uncertain pace of economic growth and a lack of clarity around interest rate responses next year, it is unlikely that one size will fit all or that investors will be able to call growth versus value (or any other factor dominance) for the whole year.

An uncertain environment demands diversification and investors need a good understanding of the exposures in their investment portfolios. One way of achieving diversification is through sectors representing different characteristics.

We explore the different aspects of two contrasting sectors in this note, namely health care and energy. Energy, the top performer in 2021, is no longer a sector that can be ignored because of its small size and threat from climate actions to its main revenue stream. The sector has benefited most from this year's top investor concerns: inflation and rapid economic reopening. Meanwhile, health care has continued its steady path, with relatively low volatility this year (second only to consumer staples in both the US and Europe). Time and again, health care products — from COVID tests, vaccines and potential cure pills, to advances toward curing Alzheimer's disease — show how important its operations are.

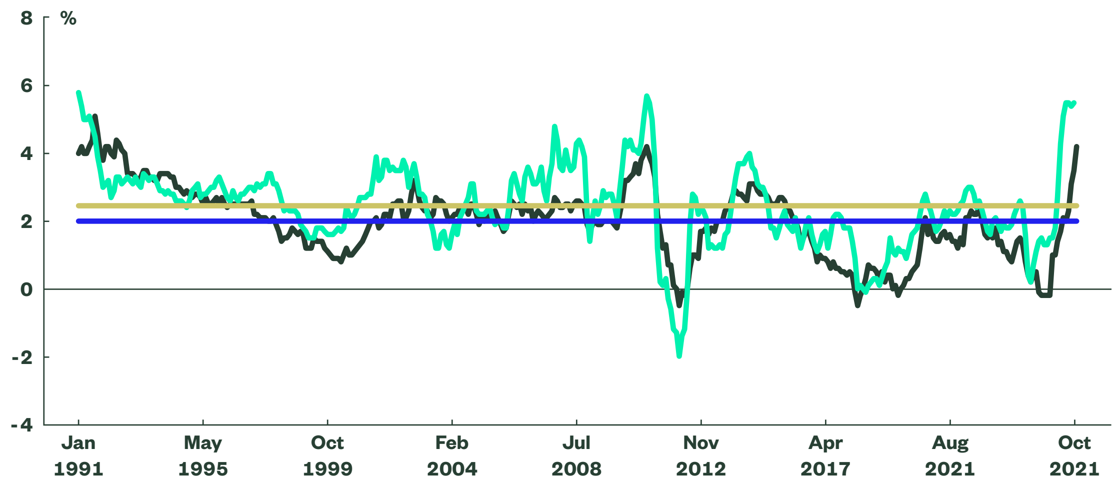
A barbell strategy could help investors to take advantage of these differences. Our results show that adding these two sectors to an equity portfolio could increase returns in a high inflation scenario.

The Importance of Inflation to Returns

Price rises are not going to disappear into Q1 2022. As in any period of elevated inflation and low interest rates, investors are likely to favour equities over other asset classes. Within equities, investors need to consider which sectors may benefit and/or provide a hedge. The supply/demand balance for each sector's goods and services is key, providing the ability to pass on higher raw material, labour and transportation costs.

Figure 1
Evolution of US & Euro Consumer Price Index YOY (%)

EUR CPI YOY (%)
US CPI YOY (%)
Average US CPI
Average Eurozone CPI

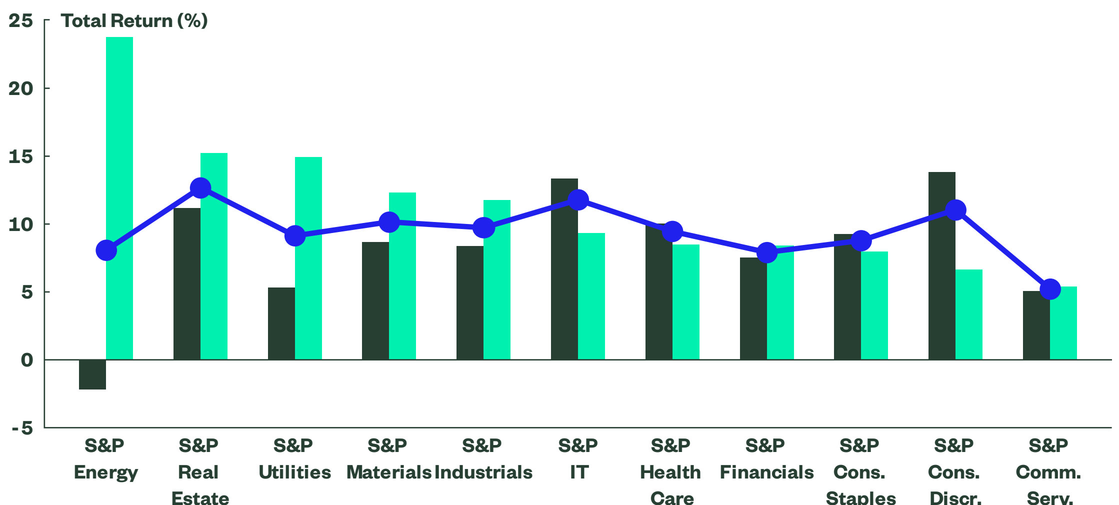


Source: Refinitiv, between January 1991 and October 2021. YOY figures, not seasonally adjusted.

We considered the total returns of all 11 GICS Level 1 sectors in the S&P 500 and MSCI Europe indices in two different inflation regimes. For the US, we assume low inflation to be below 2.5% and high inflation above 2.5%. For the euro area, we assume a 2.0% inflation cutoff in line with the almost 0.5% lower average over the past 30 years (see Figure 1).

Figure 2
S&P 500 Sector Average Annual Performance in Low & High Inflation Regimes (January 1999 to October 2021)

Low Inflation (<2.5%)
High Inflation (>2.5%)
All Regimes

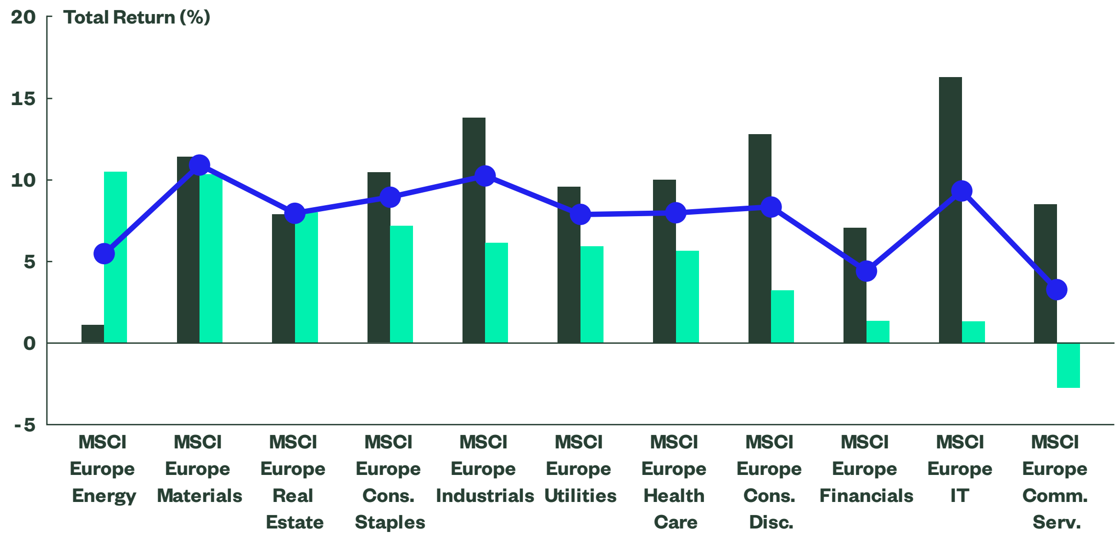


Source: Refinitiv. Returns are measured for all sectors between January 1999 to October 2021 with the exception of S&P Real Estate data where data is only available from October 2001 to October 2021.

As could be expected, given the integral nature of crude oil prices to CPI figures and the high correlation between crude oil prices and the performance of oil and gas companies, the energy sector has produced the highest total returns (23%) in periods of high inflation. This return is significantly greater than any other sector, as shown in Figure 2. However, as long-term investment cases go, energy suffers from having the lowest returns in times of low inflation (-1.5%). The large difference between the regimes' performance helps explain why the sector is often used to position for macroeconomic outlooks.

By contrast, health care, consumer staples and financials have produced similar returns under both inflation regimes. The result for the financials sector may come as a surprise, as it is often considered a play for inflationary times. But in reality, interest rates have more impact than price rises. Communication services, which for much of its history was predominantly comprised of telecommunications operators, had the lowest returns under high inflation.

Figure 3
MSCI Europe Sector Average Annual Performance in Low & High Inflation Regimes (January 1999 to October 2021)



Source: Refinitiv. Returns measured for all sectors between January 1999 to October 2021.

Among European sectors, energy still shows the highest return during inflationary regimes (10.5%), followed closely by materials, which includes mining companies with their sensitivity to metal prices. Unlike energy, materials also does well during low inflation regimes. Unlike the US sectors, technology returns showed a large difference between low and high inflation regimes.

Consumer discretionary surprised with its relatively low performance in times of low inflation. This could be explained by the sector's significant change in constituents. While the sector now benefits from the pricing power of its luxury goods producers, historically there was a greater weight in retailing and leisure activities. Health care lies between the extremes.

What Else to Factor in?

In order to position portfolios for different market backgrounds, understanding an investment's characteristics is crucial. Our focus on energy and health care shows how investment profiles differ on several factors, including quality, value, market sensitivity and volatility considerations.

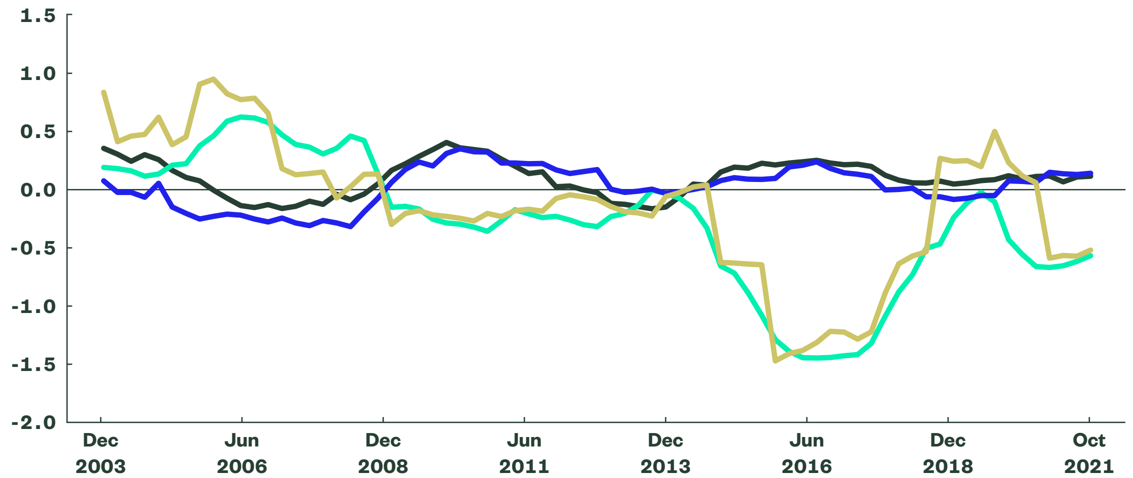
Quality

Given market uncertainty, it is likely that quality-style investments will be in demand in 2022. For quality, the measures are stability of earnings growth, profitability (including return on equity and return on assets) and earnings yield. Figure 4 shows how health care and energy compare on one of these: earnings growth. The divergent profile is similar for the other two measures.

The non-discretionary pharmaceuticals and services industries within the health care sector have helped maintain relatively low earnings volatility. During the COVID pandemic, operations were paused and hospital visits avoided, which reduced revenues; however, these disruptions were not as severe as those faced by other sectors. By contrast, energy sector activities were significantly depressed last year as lockdown greatly affected demand from transport providers as well as heavy energy users in industrial operations. The cyclical nature of demand for energy helps explain why the sector has reacted nervously to the Omicron scare.

Figure 4

Health Care & Energy Exposure to Earnings Growth Factor



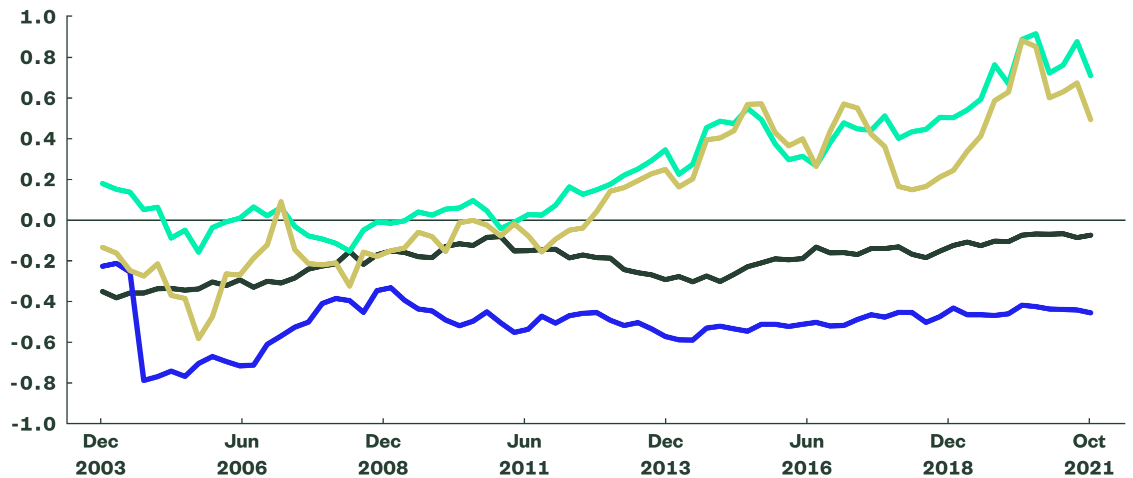
Source: FactSet, as of 30 October 2021.

Value

The value factor also varies considerably between the two sectors. Being an extreme value sector at the start of 2021 was one reason that investors started to return to energy. Figure 5 shows how value exposure has increased over time for both the US and European sector. Health care's value exposure has remained fairly consistent.

Figure 5

Health Care & Energy Exposure to Value Style Factor

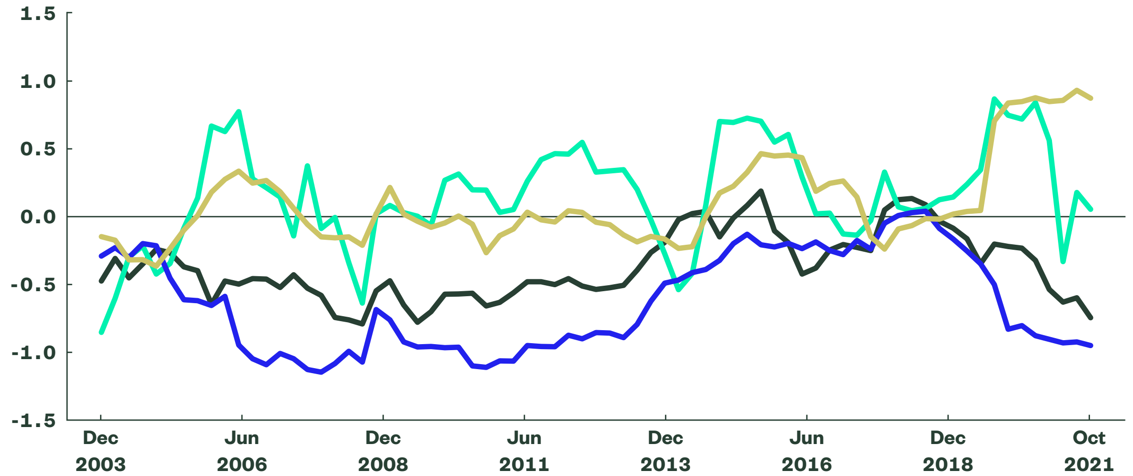


Source: FactSet, as of 30 October 2021.

Market Sensitivity

Last we consider market sensitivity to measure each sector's beta to the broader market. Health care's sensitivity has been mostly negative, consistent with its beta relative to the market cap weighted index of below 1. Energy has a different profile in the US sector (see Figure 6), with the changes possibly reflecting its greater sensitivity to the crude oil price from upstream operations, whereas the European energy sector has seen a rise.

Figure 6
Health Care & Energy Exposure to Market Sensitivity Factor

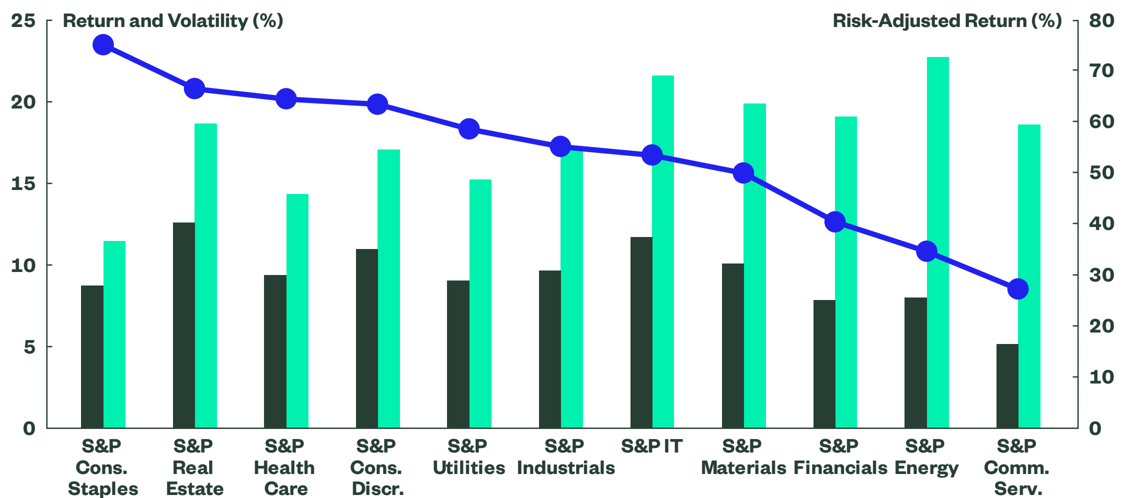


Source: FactSet, as of 30 October 2021.

Volatility Considerations

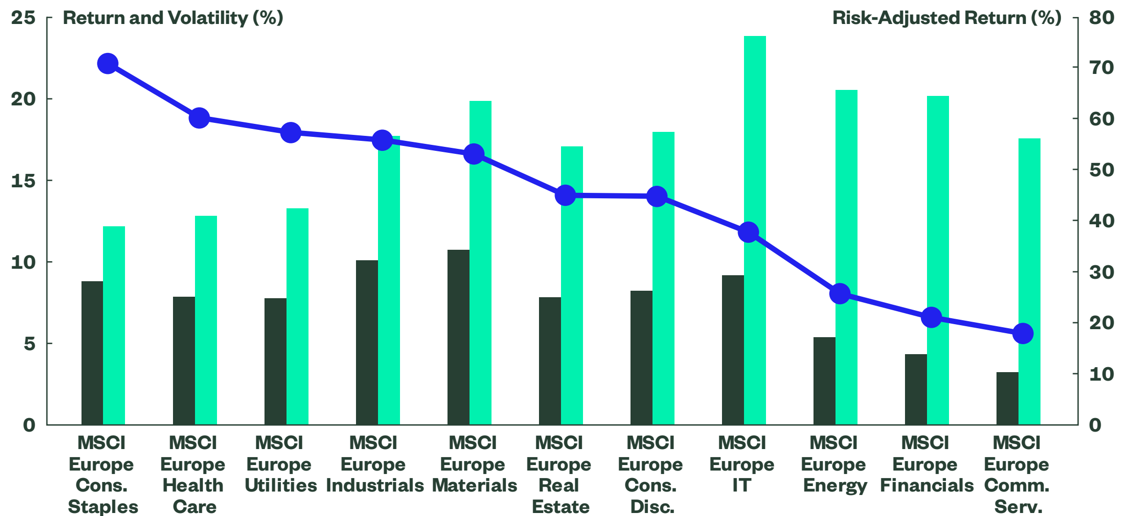
Looking at long-term risk-return allows us to further illustrate the benefits of the health care sector. Over the period January 1999 to October 2021, health care ranks highly on risk-adjusted return, alongside real estate and consumer staples, as seen for the US in Figure 7 and similarly in Europe in Figure 8.

Figure 7
Risk-Return for S&P 500 Sectors



Source: Refinitiv, as of 30 October 2021 for the period January 1999 to October 2021. Risk-adjusted return is return/volatility.

Figure 8
Risk-Return for MSCI Europe Sectors



Source: Refinitiv, as of 30 October 2021 for period January 1999 to October 2021. Risk-adjusted return is return/volatility.

Tactical Positioning: Adding Sectors to Equity Portfolios

Finally, given the desire for diversity, we consider the impact of a core-satellite equity portfolio for both the US and Europe. We have looked at the opportunity offered by a hypothetical portfolio of equities with 60% invested in a broad benchmark plus 20% in health care and 20% in energy. In both cases, the results may help investors who wish to position tactically with regard to inflation.

S&P 500 (60%) + S&P Energy (20%) + S&P Health Care (20%)

Figure 9 shows no difference in portfolio return or volatility over the full 20-year+ period. However, we find portfolio outperformance of 3% p.a. in higher inflationary times and 2% underperformance during low inflationary regime periods.

Figure 9
Core-Satellite Portfolio for S&P Universe

Annualised	S&P 500 (%)	Hypothetical Portfolio (60/20/20) (%)	S&P Energy (%)	S&P Health Care (%)
Total Return (all regimes)	8.8	0.0	-0.7	0.7
Low Inflation (<2.5%)	8.8	-2.0	-11.0	1.2
High Inflation (>2.5%)	8.7	3.1	15.2	-0.2
Volatility	14.4	14.4	22.9	14.5
Risk-Adjusted Return	61.1	61.1	35.1	65.2

Source: Refinitiv, as of 30 October 2021 for the period January 1999 to October 2021.

MSCI Europe (60%) + MSCI Energy (20%) + MSCI Health Care (20%)

Combining these three investments for European equitites produces similar realised returns over the long term with somewhat lower portfolio volatility regardless of regime. In the higher inflationary regime, the hypothetical portfolio outperforms by 2.0% p.a. and underperforms by 1.5% annually in lower inflation periods.

Figure 10
Core-Satellite Portfolio for the MSCI Europe Universe

Annualised	MSCI Europe TR (%)	60/20/20 (%)	MSCI Europe Energy (%)	MSCI Europe Health Care (%)
Return (all regimes)	6.5	0.1	-1.0	1.5
Low Inflation (<2.0%)	9.2	-1.5	-8.1	0.8
High Inflation (>2.0%)	3.3	2.0	7.2	2.3
Annual Volatility	14.4	13.7	20.9	13.0
Risk Adjusted Return	44.7	48.2	26.2	61.3

Source: Refinitiv, as of 30 October 2021 for the period January 1999 to October 2021.

Beyond the immediate Omicron impact, and looking into 2022, markets will likely continue to grapple with geopolitical and economic concerns weighing on market volatility. Inflation could remain a dominant theme, with even Fed Chair Jay Powell admitting it is no longer transitory. In this case, investors could employ a barbell strategy. One such approach would be invest in the energy sector, for value exposure, positive inflation sensitivity and cash distributions, alongside health care as a diversifier, offering quality exposure from relatively stable earnings growth, lower market sensitivity and impressive long-term, risk-adjusted returns.

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