Insights
Sector

January 2020

2020 Equity Themes or: How to Win with Sectors

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- After a substantial rise in equity markets throughout 2019, investors should now consider what might drive the stock market higher and selectively position to make the most of opportunities.
- We see five major themes for 2020, covering cyclicals, energy, fiscal policy, China and value.

Get a Head Start with Cyclicals

In the view of State Street Global Advisors, global growth will meet or exceed expectations in 2020. Such expectations helped drive the risk-on rally at the end of 2019 and investors' fear of missing out resulted in a switch to cyclical stocks, although investors are still underweight some of the related sectors. We expect the more economically sensitive sectors to continue to outperform early in 2020, but they could face difficulties as the year goes on if volatility picks up ahead of the US presidential election.

Confidence is helped by stabilisation of the manufacturing PMI figures from the US and China. Improved business confidence should provide a boost to the recovery in infrastructure investment after significant destocking over the last 12 months, which would benefit capital goods manufacturers and raw material suppliers (present in the Materials sector) in particular.

Renewed Energy: Hot Out of the Starting Blocks

Energy is a new theme. It was the worst-performing sector last year. Several factors turned in the sector's favour late in 2019, namely the outcome of the 7th OPEC+ meeting, the relative success of the Saudi Aramco IPO and improved forecasts for the global economic outlook. Institutional investors took notice and started to buy from underweight positions.

The recent US air strike on Iran raises fears around oil supply from the most important crude-producing region. This development follows the agreement from OPEC+ to reduce its output target by a further 500,000 barrels per day and, together with a slower rate of growth from US shale production, we are now more positive on the supply side of the oil price equation (although longer-term OPEC+ compliance must come with a word of warning given past violations).

On the demand side, we are heartened by better economic forecasts and possible resolution to the US-China trade war, which should revive international trade, demand from transport and industry and the use of raw materials for chemical products. China, which is an important determinant for global oil and gas demand, should continue to drive electrification.

In order to benefit from higher oil prices, the large E&P companies need to remain disciplined in their capacity response. Increasing shareholder value is reliant on the oil companies continuing to reduce capital expenditure. A better outlook is reflected in strong earnings growth for 2020 but not yet in Energy sector valuations.

Passing the Policy Baton from Monetary to Fiscal

The Riksbank's move, several weeks ago, to bring its repo rate up to zero was heralded as the first central bank move out of negative monetary policy. Other small central banks could follow, bringing relief to banks in particular, where rates have a direct impact on margins.

Nevertheless, 2020 could be a quieter year for monetary policy as none of the large central banks are forecast to make changes. Many investors hope that past action by the Federal Reserve will be sufficient to stabilise US growth and keep unemployment and inflation at reasonable levels.

Instead, we expect fiscal policy to take up the challenge of boosting economic growth. In particular, Japan, host of the 2020 Olympics, is planning a fiscal stimulus package supported by a record government budget. Elsewhere, we expect to hear about stimulus measures across Europe and the UK, India and China, and maybe elsewhere in emerging markets. This theme has the potential to benefit equities relative to government bonds, if not any one sector in particular.

China Keeping Up the Pace

Three news items suggest a better year for Chinese GDP growth: a Phase 1 trade deal between the US and China, manufacturing PMI figures for December staying above 50 and the PBOC cut to the reserve rate requirement (demonstrating a desire to boost liquidity and support growth). Economic data may continue to release positive signals in the coming months, supported by a low base from a year earlier.

A continued truce between the US and China would also allow investors to refocus on the massive shift taking place in global investor portfolios, as Chinese onshore assets become a larger part of international equity and bond indices.

This theme stands to be positive for equities broadly and thus could lift a variety of sectors. Of note, Chinese growth over the last couple of decades has enriched consumer and industrial sectors worldwide. Moreover, heavy metal miners in the Materials sector have shown a relatively high correlation with Chinese growth in the past.

A Race to Value?

It is not clear whether the value rally we saw in September 2019 will re-emerge. The rotation was sparked by an upturn in the Citi Economic Surprise Indicator and flamed by extreme valuations of value stocks and crowding in long-duration fixed income and low volatility equities.

For the value theme to meaningfully continue, we need to see re-acceleration of the business cycle, a pick-up in inflation and continued bond yield curve steepening. However, even without these prerequisites, there is still room for mean reversion and we have suggested, since the end of Q3 2019, that investors may want to reduce their underweight to value as a risk exercise.

A value market could favour equities in emerging markets and Europe versus the US. Financials and Energy, in particular, look interesting on various valuation measures.

Hurdles on the Horizon

Certain market themes could hurt sector performance. Our big Sector Pick at the start of 2019 was Technology, and whilst the sector may still be a productive long-term investment, it faces a lack of earnings growth and a backlash against expensive assets this year.

The Technology sector has been the main beneficiary of globalisation, with dispersed global supply chains and a broad range of consumers around the world, and thus is exposed by any retrenchment resulting from a harmful trade war. Other threats include rising regulation and potential legislation. An increase in stock market volatility caused by vociferous campaigning ahead of US election could also impact companies in the US Communication Services and Health Care sectors.

Read More About Sector Investing

For more information on our SPDR Sector Picks for Q1 2020, please see the *SPDR Sector Compass*, due for release in early January 2020. For investors looking to learn more about the fundamentals of sector investing, please see our recent white paper *Harness the Power of Sector Investing with ETFs*, available on spdrs.com/sectors.

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ID127413-2891433.1.1.GBL.INST 0120
Exp. Date: 06/30/2020