Macro indicators and sector exposures

March 2021

Research Signals

A year ago 16 March, US equity markets had one of the worst single-day sell-offs on record, with major indexes recording double-digit declines, as stocks headed to the 23 March pandemic low. Since that time, markets have risen dramatically, supported by near-zero interest rates and the expansion of the Federal Reserve's balance sheet coupled with two rounds of federal stimulus payments, with fresh highs continuing to be recorded as investors look forward to the post-COVID economic recovery. With this in mind, we review thematic trends and sector exposures in light of the current macro-economic setting.

- The recent record issuance level of SPACs suggests heightened speculation and froth in the market
- ETF trends confirm a rotation into small cap and value stocks as large cap and growth stocks are shunned
- Energy stocks have been supported by a tailwind of decreasing short interest, higher oil prices and increasing sector ETF flows, though are at higher risk to rising interest rates from a leverage perspective
- The Technology sector was the beneficiary of the pandemic driven economic downturn in 2020, but has given up ground this year as the shares lose favor from retail investors and short sellers

SPAC-ulation

First, we provide a quick note to highlight a segment of the market that has occupied headlines recently, namely special purpose acquisition companies (SPACs). SPACs, an alternative IPO system, are designed to enable their managers to have funds available to make acquisitions quickly and on an opportunistic basis and have risen in popularity over recent years.

SPAC IPOs differ from conventional IPOs given the lack of business or financial history for the entity being sold, nor a defined business case based on the firm's existing activities, business model and future plans. Its purchase is reliant on investors' trust in its management to select, obtain and manage the right acquisition targets in the future. For issuers, listing rules for SPACs offer the potential for an accelerated route to flotation by avoiding the lengthy disclosure of and need to supply a track record commonly associated with conventional IPOs.

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A recent 26 January IHS Markit capital markets **report** highlighted the elevated level of SPAC issuance during the record month for the IPO market in January 2021. As of the report date, 67 issuers sold shares in January, following 242 deals in 2020, reportedly accounting for almost half the total IPO volume, and outpacing the full-year SPAC total for 2019. This recent rush of deals suggests heightened speculation and froth in the market.

ETF trends

Next, we take a macroeconomic view of various segments of the market, spanning size, style and sectors, through the lens of the ETF market. We set the stage with an appraisal of the overall US economy based on economic forecasts from the recent IHS Markit US economic **outlook** (16 March) and **weekly update** (19 March).

The outlook for the economy is for continued recovery, with strong growth in 2021 following the BEA's second estimate for Q4 2020 real GDP growth of 4.1%. For the full year 2021, GDP is forecasted to rise 5.9% (the largest annual increase in GDP since 1984), as growth marks a 4.9% annual rate in the first quarter and accelerates to 7.0% in the second quarter, while the 2022 estimate stands at 4.1%, with further slowing to 2.3% in 2023. For now, investors appear more confident in the prospects for a strong recovery in GDP this year, with increasing faith in the Federal Reserve's commitment to promote a rise of inflation moderately above 2% for some time.

With this view in mind, our ETF analysis focuses specifically on the iShares Russell 1000 ETF (IWB), iShares Russell 2000 ETF (IWM), Invesco QQQ Trust (QQQ), iShares Russell 1000 Value ETF (IWD), iShares Russell 1000 Growth ETF (IWF), Energy Select Sector SPDR Fund (XLE) and Technology Select Sector SPDR Fund (XLK), sourced from the IHS Markit ETF Analytics database, to represent these themes.

We begin by reviewing cumulative performance of the ETFs from the start of 2020 through 15 March 2021 (Table 1). QQQ and XLK were the clear winners over the period with cumulative returns of 51.0% and 46.6%, respectively, followed by IWM (43.5%). Growth was also the preferred style over value, with IWF outperforming IWD by 24.5 percentage points. The energy sector, on the other hand, took the brunt of the pain from the economic lockdown, with XLE (-5.8%) in negative territory over the analysis period.

Table 1

NAV cumulative return, 31 Dec 2019 - 15 Mar 2021

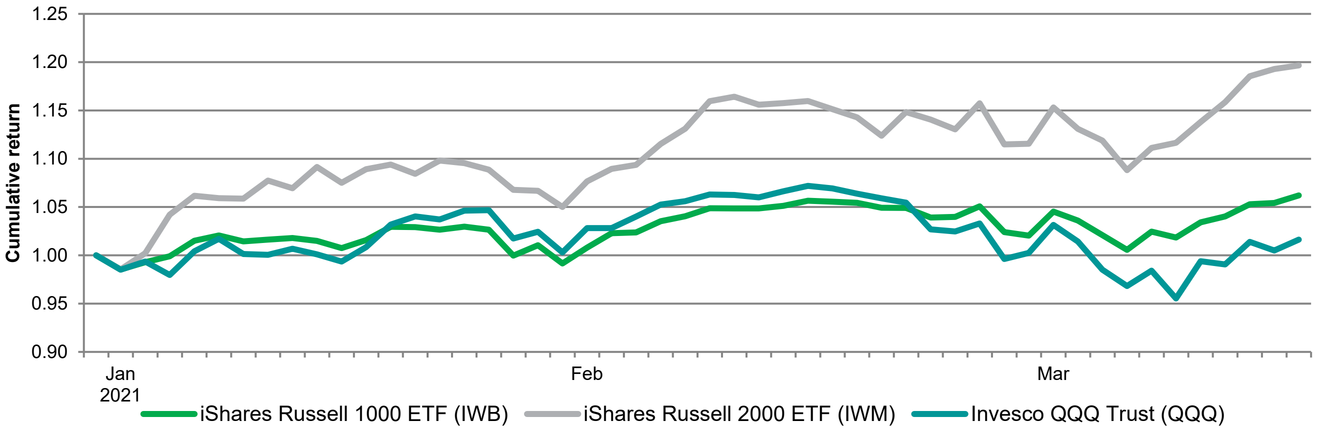
ETF	Return
iShares Russell 1000 ETF (IWB)	28.3%
iShares Russell 2000 ETF (IWM)	43.5%
Invesco QQQ Trust (QQQ)	51.0%
iShares Russell 1000 Value ETF (IWD)	14.9%
iShares Russell 1000 Growth ETF (IWF)	39.4%
Energy Select Sector SPDR Fund (XLE)	-5.8%
Technology Select Sector SPDR Fund (XLK)	46.6%

Source: IHS Markit

However, as we drill down to 2021 results, a different picture is unveiled. Since the start of the year, small caps (Figure 1) have far outpaced the other major benchmarks, with a 19.7% cumulative return, compared with 6.2% for large caps and just 1.6% for QQQ. Growth and value started off the year exchanging favor among investors (Figure 2), yet in mid-February performance noticeably diverged, with IWD outperforming IWF by 10.3 percentage points since 12 February, perhaps suggesting a more optimistic outlook on broad-based earnings growth, reducing the premium for growth stocks as growth becomes less scarce. At the same time, a similar divergence occurred between the energy and technology sectors (Figure 3), with XLE ultimately locking in an impressive year-to-date return of 39.6%, while XLK (2.0%) struggled to eke out a positive return as technology shares suffer under the weight of higher discount rates.

Figure 1

NAV performance



Source: IHS Markit

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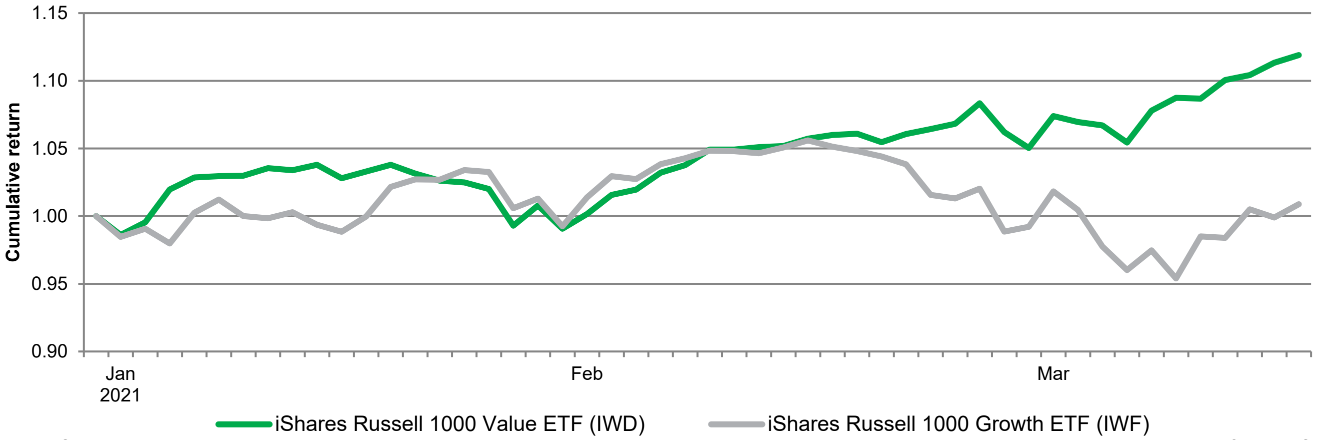
Figure 2

NAV performance



Source: IHS Markit

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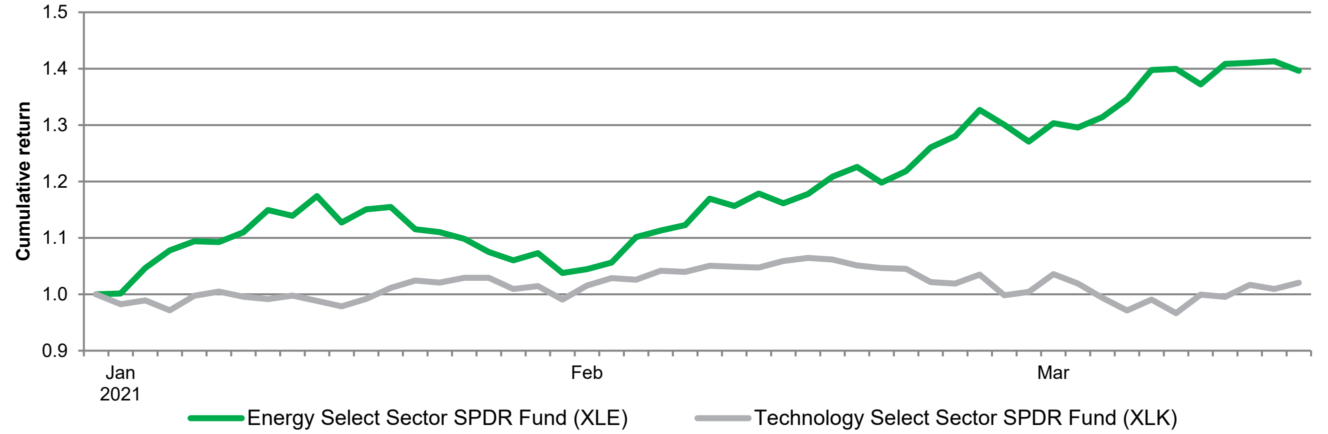
Figure 3

NAV performance



Source: IHS Markit

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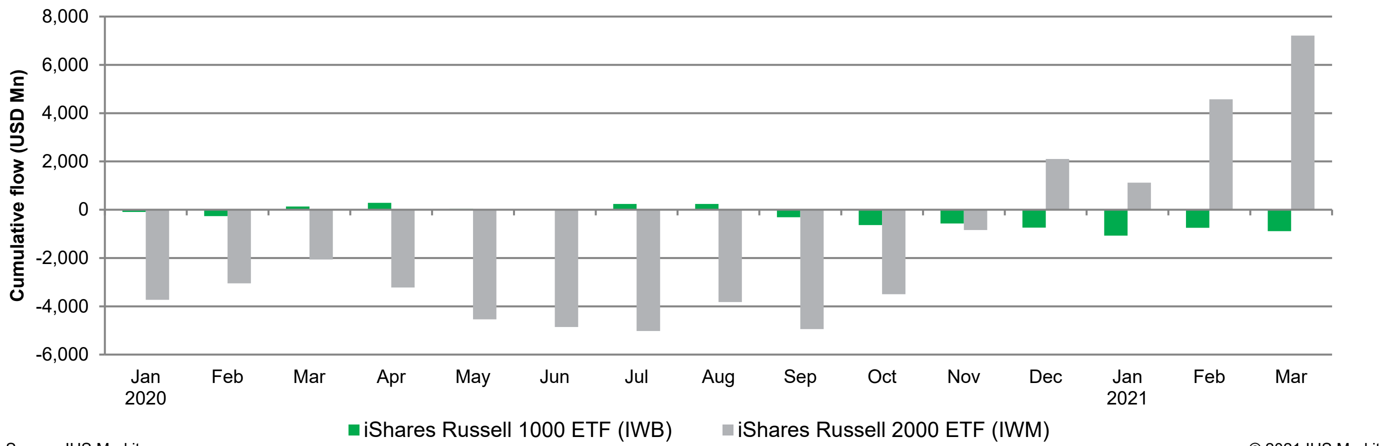
We add additional color to recent retail investor style preferences from the perspective of ETF flows. First, small caps were clearly favored over large caps (Figure 4), with IWM cumulative inflows for October 2020 through March more than doubling the level of outflows through September, while the rate of outflows in IWB over the same period was nearly three-fold the cumulative level as of September. This suggests greater investor optimism for smaller companies which are expected to be more directly tied to a domestic economic rebound.

The trend in flows in IWD compared with IWF (Figure 5) also points toward an investor preference for value over growth, which began in mid-2020 and expanded into 2021, indicating a rotation out of long duration proxies and into value shares. In the same vein, XLE was the beneficiary of retail investor dollars following the onset of the pandemic (Figure 6), while XLK tended to see outflows beginning in the second half of 2020.

Figure 4

ETF flows



Source: IHS Markit

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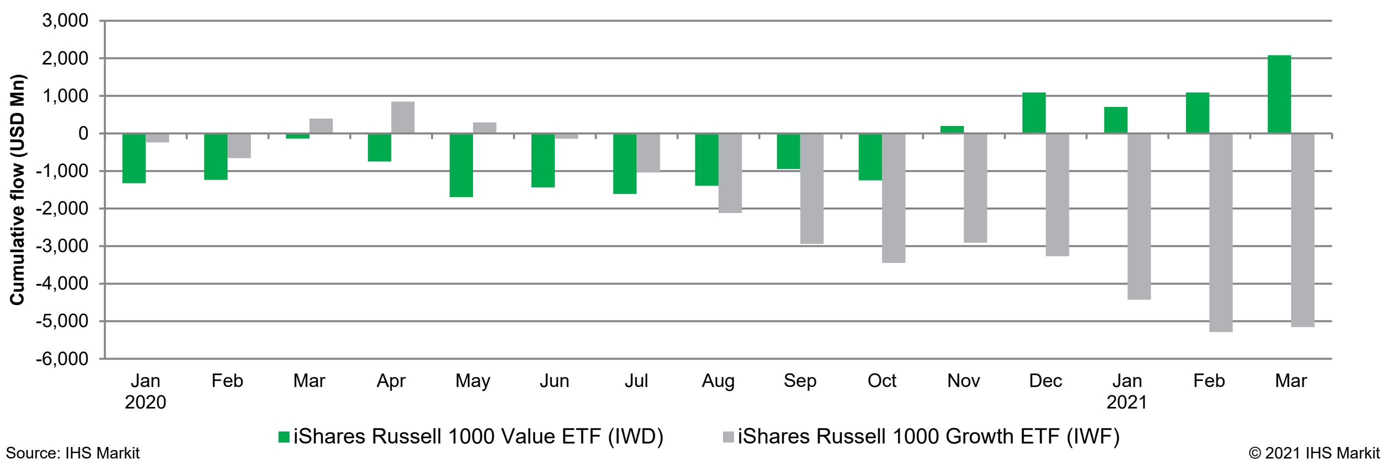
Figure 5

ETF flows



Source: IHS Markit

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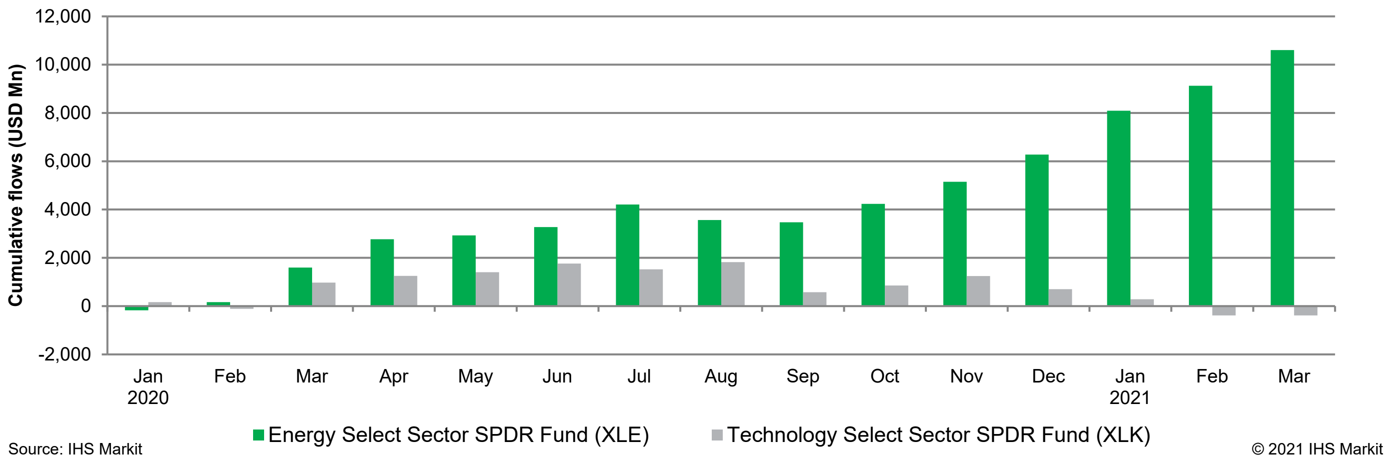
Figure 6

ETF flows



Source: IHS Markit

Sector exposures

Lastly, we review recent sector exposures beginning with that to expectations for select macroeconomic indicators based on detailed economic forecasts from the recent IHS Markit US economic outlook. First, we summarize the more pertinent forecasts.

The US dollar is now expected to appreciate moderately (prior estimate was for further depreciation), before then recovering, as term yields in the US rise. The 10-year T-note yield, which has risen 81 basis points since the end of December to 1.74% on 19 March, is forecasted to end the year just shy of that level (1.65%), while reaching 2% by late 2023 and 3% by 2028. The target for the federal funds rate is expected to remain at a range of 0% to ¼% for a few years, with policymakers keeping the highly accommodative monetary policies in place until mid-2024 (anchoring yields at the short end of the Treasury curve at low levels) and large-scale asset purchases will continue at current rates throughout 2021, followed by a gradual taper next year.

Brent crude oil prices have risen from $50/barrel at the start of the year to almost $70/barrel in early March, before dropping off closer to $60/barrel. The price of oil is forecasted to again surge to $65/barrel in the second quarter of this year, averaging $62 for the full year, then ease to $60 in 2022 before resuming a gradual secular rise. Core personal consumption (PCE) price inflation is expected to rise from 1.4% in 2020 to 1.9% in 2021 and 1.7% in 2022, with the trend surpassing 2.0% (quarterly, annualized) in mid-2023.

Following a decline of 6.6% in 2020, total industrial production should gain 7.4% in 2021, before tapering off to 4.1% in 2022 and 1.9% in 2023. Lastly, housing starts are forecasted to rise from 1.396 million in 2020 to 1.562 million in 2021, before slipping to 1.379 million in 2022.

Given these forecasts, we review current sector active (decile 1 - decile 10) exposures to the factors included in our Macro factor suite (Table 2). Some exposures that standout include Cyclical Goods & Services and Energy's high active exposures to increases in industrial production (10.15% and 15.27%, respectively) and oil prices (18.53% and 8.65%, respectively), while Healthcare has a negative active exposure to both industrial production (-22.30%) and oil prices (-13.68%), though a positive active exposure to increasing inflation (14.88%).

Financials (10.72%) have a positive active exposure to a firming US dollar, with the reverse for Basic Materials (-9.65%). A steepening in the yield curve is associated with a positive active exposure to Industrials (9.91%); however, we remark on Financials (-9.31%) negative active exposure which is driven by the inclusion of REITs in the sector and further note that Banks are prominent among the top decile ranks to this factor as expected.

Table 2

Sector active exposures (%), Feb 2021

	Housing Starts	Industrial Production	US Dollar Value	Yield Curve Slope	Credit Risk Premium	Inflation	Oil Prices
Basic Materials	-0.93	-3.02	-9.65	4.21	-3.31	0.00	-3.64
Cyclical Goods & Services	6.84	10.15	3.83	-5.11	12.55	2.66	18.53
Energy	-7.55	15.27	-5.45	-0.90	17.36	-2.12	8.65
Financials	4.13	2.97	10.72	-9.31	-18.33	-7.55	-0.08
Healthcare	-3.22	-22.30	2.50	0.00	-2.18	14.88	-13.68
Industrials	0.24	-1.22	0.55	9.91	-5.42	-1.22	2.65
Non-Cyclical Goods & Services	2.38	-1.50	-0.02	4.21	-1.80	-2.40	-3.33
Technology	-1.57	-0.34	-2.17	-3.30	3.26	-3.93	-1.56
Telecommunication Services	0.29	-0.30	-0.31	0.30	-0.60	-0.30	-2.71
Utilities	-0.60	0.30	0.00	0.00	-1.50	0.00	-4.82

Source: IHS Markit

We also take a look at sector active exposures to several factors of interest (Table 3) including Long-term Debt-to-Cash Flow, TTM EPS before Extra Items-to-Price, 3-M Revision in FY1 EPS Forecasts: Dispersion Relative and Short Interest.

First from a leverage perspective, we analyze sector exposures to Long-term Debt-to-Cash Flow. This factor is ranked with the most highly levered firms in decile 1, thus the highest (lowest) exposures are to sectors with relatively higher debt (cash flows). Technology (15.72%) has the largest negative active exposure to this factor, indicating that these firms are the best positioned to meet their debt obligations which is a desirable feature particularly in a recessionary environment, and they certainly were well rewarded in the pandemic-driven economic downturn in 2020. Financials (20.22%), as expected, sit at the opposite extreme, followed by Energy (6.34%) firms which are expected to be negatively impacted by a rise in interest rates.

From a valuation stance, measured by TTM EPS before Extra Items-to-Price, Healthcare (-23.78%) and Energy (-16.64%) currently have the highest active exposures, indicating overvaluation relative to earnings, while Financials (40.92%) are the most attractively positioned based on valuation. Analyst outlook is also favorable to Financials (28.48%), as gauged by active exposures to 3-M Revision in FY1 EPS Forecasts, with Healthcare (-15.54%) and Technology (-9.38%) tending to see downward revisions.

Finally, we evaluate investor sentiment toward sectors from the vantage point of the securities lending market, computed by active sector exposures to Short Interest. Financials (21.24%) are the least shorted firms, while Healthcare (-23.60%) has the greatest representation of highly shorted shares. We also draw attention to the positive active exposure to Energy (4.72%) shares compared with Technology (-6.19%), perhaps unexpected following a strong year for Technology stocks. However, focusing in further on decile 10 exposures (Figure 7), we find that, since mid-2020, Energy has seen a decrease in highly shorted shares, a substantial tailwind behind the recent rally in Energy stocks, while short sellers have increased their positioning in Technology shares.

Table 3

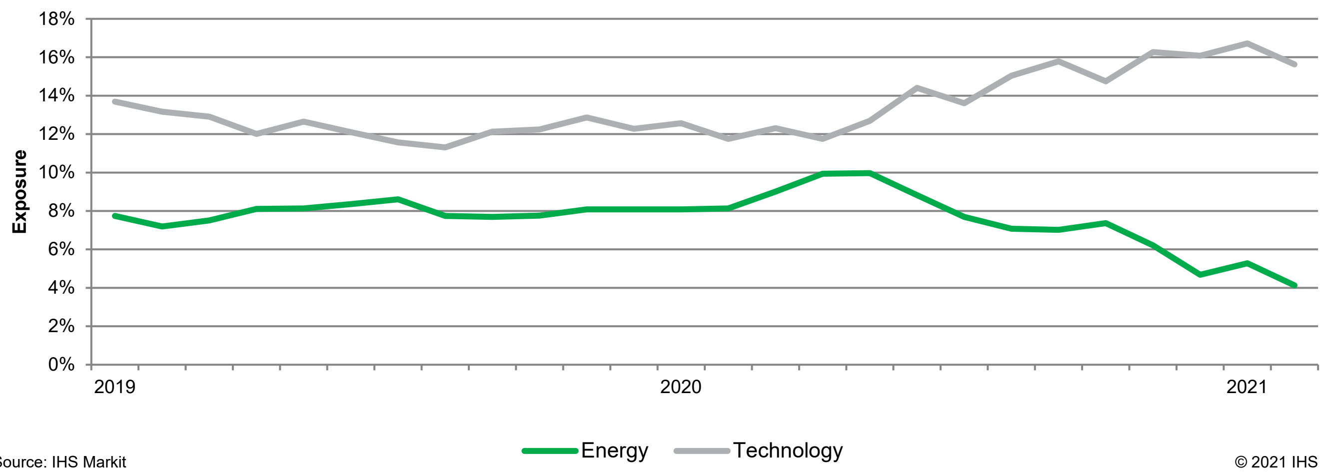
Sector active exposures (%), Feb 2021

	Long-term Debt-to-Cash Flow	TTM EPS before Extra Items-to-Price	3-M Revision in FY1 EPS Forecasts: Dispersion Relative	Short Interest
Basic Materials	-1.51	3.23	1.29	4.72
Cyclical Goods & Services	5.15	-2.73	-0.97	-8.26
Energy	6.34	-16.64	0.32	4.72
Financials	20.22	40.92	28.48	21.24
Healthcare	-9.10	-23.78	-15.54	-23.60
Industrials	-4.54	1.71	0.64	6.49
Non-Cyclical Goods & Services	-3.49	0.28	-1.94	-0.59
Technology	-15.72	-2.10	-9.38	-6.19
Telecommunication Services	1.32	-1.20	-0.32	0.59
Utilities	1.35	0.28	-2.59	0.89

Source: IHS Markit

Figure 7

Sector D10 Short Interest exposure



Source: IHS Markit

In summary, the start of 2021 has been characterized by a rotation out of market segments that benefitted during the initial rebound from the pandemic lows, as shifting macroeconomic expectations unfold. Investor sentiment has shifted from growth and Technology shares in favor of small caps and value stocks. While the same holds for the Energy sector, some risk is posed from competing forces from rising interest rates and high valuations versus positive trends in short coverings and oil prices.

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