EQUITY STRATEGY INSIGHTS

Summer Rental or Extended Stay?

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Jeffrey Buchbinder, CFA
Equity Strategist

Matthew Whitehurst, CFA
Analyst

EXECUTIVE SUMMARY

- Markets have struggled with the risk that the Federal Reserve may over-tighten monetary policy to fight inflation and drive the economy into recession.
- While acknowledging this risk, the view of the Strategic and Tactical Asset Allocation Committee (STAAC) is that this is a growth scare, not a precursor to a recession.
- In this environment, some investment ideas may only be attractive for the short-term, i.e., summer rentals, while for others, extended stays might make more sense.

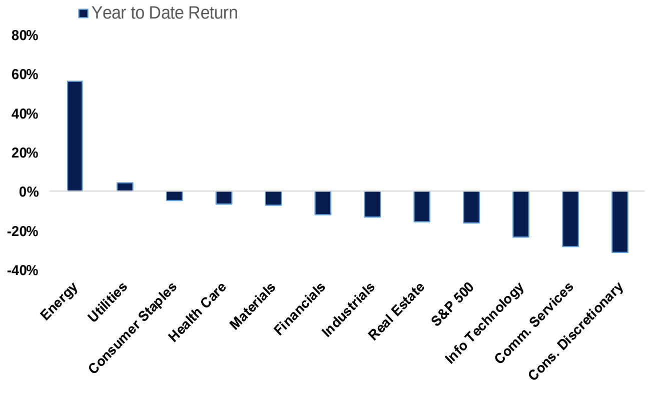
As markets continue to try to regain their footing after recent stumbles, the economic outlook remains uncertain. As we know, markets have struggled with the risk that the Federal Reserve may over-tighten monetary policy to fight inflation and drive the economy into recession. While acknowledging this risk, the view of the Strategic and Tactical Asset Allocation Committee (STAAC) is that this is a growth scare, not a precursor to a recession.

In this environment, some investment ideas may only be attractive for the short-term, while uncertainty is highest. Beyond the next few months, if markets begin to gain confidence that economic growth will continue, the door may be opened to a change in market leadership. Here we identify equity sectors that we think may be summer rentals, i.e., very short term ideas, and others that might make more sense as longer-term holds.

What's Been Working

Essentially, defensive sectors and inflation plays have been the places to be this year within the equity market. On the defensive equity side, consumer staples, healthcare, and utilities have outperformed nicely, with utilities actually in the green this year **[Figure 1]**.

1 Inflation Plays and Defensive Sectors Top 2022 Sector Return Rankings



Source: LPL Research, FactSet data as of 05/26/2022
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But all sectors have been overshadowed by energy, with its 56% gain year to date as oil prices have surged on improving demand and Russia sanctions. Meanwhile, the materials sector has also outperformed year to date and fits into the theme of inflation beneficiaries. A 7% decline is not anything to get excited about, especially next to energy's surge, but it is still well ahead of the S&P 500's 16% decline (as of May 26, 2022).

A Mix of Summer Rentals and Potential Extended Stays

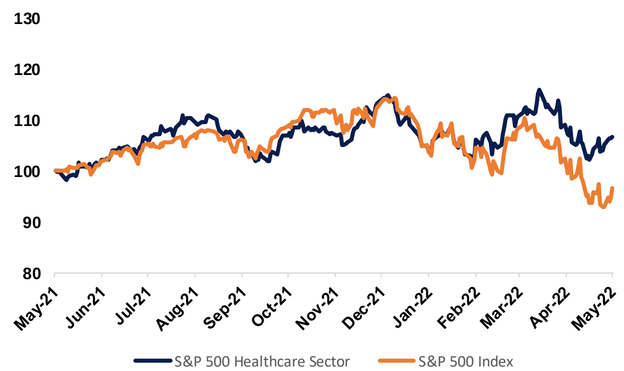
In last month's *Equity Strategy Insights* publication, we discussed our outlook for the defensive equity sectors, noting that we did not believe recession was necessary for those groups to continue to outperform in the near term. But given our expectation that the economy will avert recession over the next 12-18 months, a return to prior market leadership over the next few months seems quite possible. As a result, we want to be careful not to overstay our welcome in defensive equities, as they will likely struggle to keep up with a broad market rally if recession fears abate.

We believe healthcare and real estate have enough secular tailwinds to potentially perform well beyond this summer.

Our Favorite Defensive Sectors are Currently Healthcare and Real Estate

We believe these sectors have enough secular tailwinds to potentially perform well beyond this summer. Healthcare has demographic tailwinds and prospects for solid long-term spending growth, while we are comfortable with the risk associated with drug price reform given the stalemate in Washington, D.C. **[Figure 2]**.

2 **Healthcare Sector vs. S&P 500**



Source: LPL Research, FactSet 05/26/22
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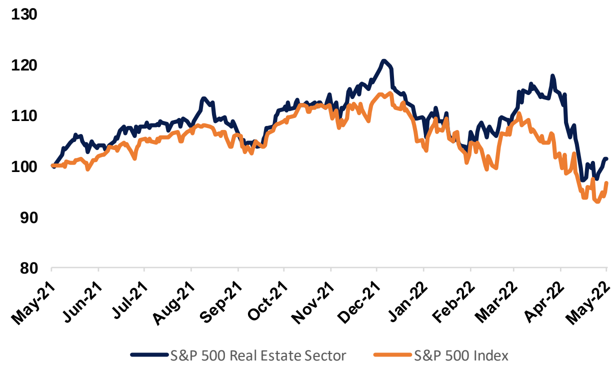
Real estate offers healthy dividend yields along with exposure to attractive secular demand stories in the wireless tower and data center segments, which may help offset the impact of pricing pressure on the office sector which is challenged by the work from home trend. While retail faces a similar set of challenges as the pandemic effects linger, we see some upside potential as the last stage of the economic reopening occurs. Finally, the sector has a relatively good long-term track record managing through inflationary periods **[Figure 3]**.

3 Real Estate Sector vs. S&P 500



Source: LPL Research, FactSet 05/26/22
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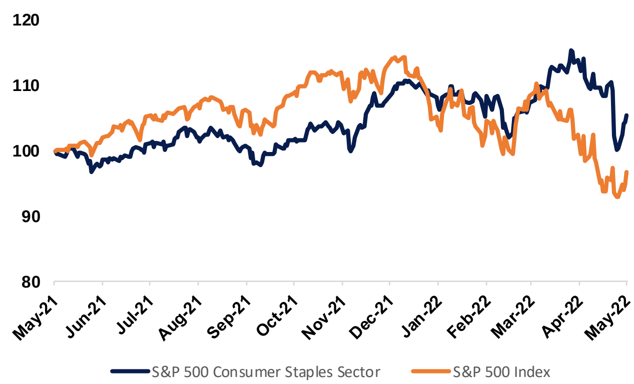
Consumer Staples Looks More Like a Summer Rental

Consumer staples' valuation looks rich, with a forward price-to-earnings ratio above that of the technology sector, following recent out-performance.

While consumer staples companies should benefit from easing supply chain pressures and lower inflation, muted growth prospects may hold the sector back as economic growth likely improves in the second half of the year. We saw with some of the results from staples retailers during first quarter earnings season how difficult the profit margin environment is. Once margin pressures ease, we anticipate other areas of the market will perform better. Finally, the sector's valuation looks rich, with a forward price-to-earnings ratio above that of the technology sector, following recent outperformance [Figure 4].

4 Consumer Staples Sector vs. S&P 500



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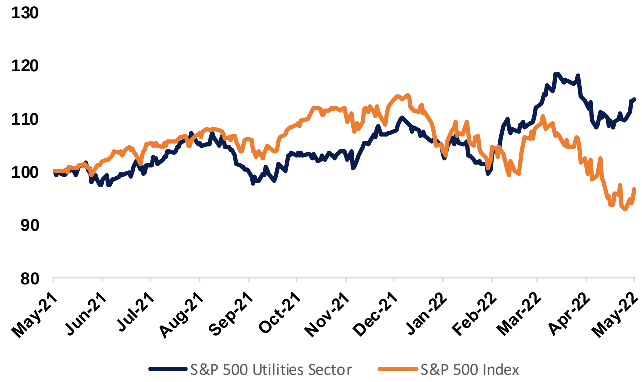
Utilities Likely A Summer Rental

Utilities tend to perform well around recessions and are generally able to pass through higher energy costs.

Utilities tend to perform well around recessions and are generally able to pass through higher energy costs, making them relatively good inflation hedges. As such, with recession fears bubbling and energy prices rising, utilities still make sense. The 10-year U.S. Treasury yield has come down off its recent high of 3.1% down to around 2.75%, making the sector's 2.9% dividend yield appear relatively more attractive. But if lower inflation and an improving economic outlook help fuel a market rebound, we would anticipate better performance from the more economically sensitive sectors such as technology [Figure 5].

5 **Utilities Sector vs. S&P 500**



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Consider Renting Energy, But With An Option For A Longer Stay

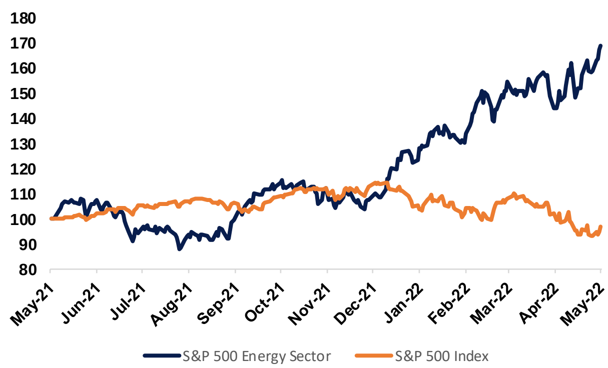
Oil and gas producers have been disciplined with capital investment in recent years, improving profitability.

We have been viewing energy as a short-term trade and a hedge against a sustained disruption to Russian oil supplies. It's certainly been that, and more. With the war in Ukraine tragically showing no signs of resolution, we think investors can stick with overweight allocations to the energy sector for the next couple of months, if not longer.

Oil and gas producers have been disciplined with capital investment in recent years, improving profitability even as high prices increase the temptation to take on more capital intensive drilling projects. Supply is not keeping up with demand, putting continued upward pressure on oil prices. Meanwhile, natural gas prices are at their highest levels since 2008.

From a technical analysis perspective, strong trends for crude oil and the shares of oil and gas producers suggest the sector's strong run could continue into the fall despite historical seasonal weakness. Removal of sanctions on Russian energy exports is the primary risk but looks like a long shot to come anytime soon.

6 **Energy Sector vs. S&P 500**



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Conclusion

Energy and defensive sectors have been working this year. Over the next several months, however, an inflection point may come that opens the door to reversals in market leadership. It makes sense to us to stick with energy stocks as a hedge against geopolitical risk, while the LPL Research STAAC Committee sees improved profitability and favorable technical analysis trends as support for an overweight allocation. So, we would rent the sector this summer but maintain the option for an extended stay into the fall.

Healthcare and real estate could warrant extended stays due to secular tailwinds, while consumer staples and utilities look more like summer rentals. If markets begin to come around to the LPL Research view that inflation can come down to a manageable level without a recession, defensive sectors will likely struggle to keep up with the broad market in a possible recovery to prior highs. In a recovery, we would look to technology as a potential winner. So, squatting in defensive sectors is fine for the short term, but be careful not to overstay your welcome.

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The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet.

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