Market Strategy
by STRATEGAS A BAIRD COMPANY

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# U.S. Equity Sector Allocation

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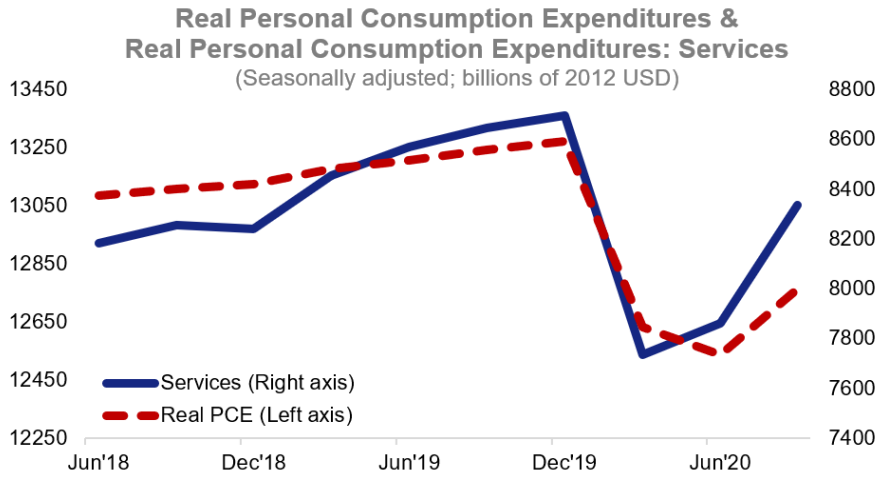
## CLARITY WILL DEFINE APPROACH TO COVID AND STIMULUS

Despite Q3 GDP strength, we are still wary of the recovery's durability absent a wider re-opening of the economy or additional fiscal support from Congress. With new daily cases surging in Europe and the U.S., economic activity now looks more likely to zag lower for a stretch. We have considered progress toward the containment and cure of the virus as an important precursor to a durable economic recovery (and the emergence of a broad-based cyclical expansion). This thinking has informed positioning in both our global tactical allocation and U.S. equity portfolios—which remain unchanged.

It may seem stale to reiterate it, but the encouragement we get from recent data is tempered by our awareness **that the easier part of the recovery is likely behind us.** This outlook underpins our patience in rotating fully into cyclicals until there's greater clarity. The composition of the Senate—which we won't know until after two run-off elections in Georgia in January—is critical to understanding the likely trajectory of a recovery increasingly reliant on fiscal stimulus and income replacement over organic drivers of growth. We will revisit this point in a post-election Asset Allocation update next week.




**Sector Allocation Summary**
**U.S. Equities**

| | |
|---|---|
| OVER | Communications |
| | Industrials |
| | Technology |
| | Materials |
| | Healthcare |
| NEUTRAL | Financials |
| | Energy |
| | Discretionary |
| UNDER | Utilities |
| | Real Estate |
| | Staples |

Strategas' sector allocations are labeled as over-, under-, and neutral weight compared to sector weightings in the S&P 500 index. See the full table on the following page for rationales and risk factors for these allocations.

## Strategas U.S. Recommended Sector Allocation Summary

| | Sector | Rationale | Risks |
|---|---|---|---|
| Overweight | Communications | This sector's weight is dominated by two large tech/social media companies. Digital content and advertising (streaming & social media) remain a secular uptrend. We expect the "arms race" for content to continue. | Is there a tipping point for passive concentration? Liquidity-driven price recovery has outpaced revenue and earnings recovery. We expect social media to come under increased scrutiny in the wake of the election. Non-digital segments face stiff headwinds until a vaccine is available. |
| Overweight | Industrials | This is the sector most correlated to the broader market and is a direct beneficiary of the weaker US dollar. It should benefit from an increase in fiscal spending (more true of infrastructure provisions than income replacement). The recovery remains fragile, but watch for synchronized global recovery tailwind. | A mixed government (if Republicans win the Georgia Senate run-off elections in January) provides less fiscal boost. Recent surges in Covid case numbers in Europe and the U.S. could soften the demand curve through the rest of the winter. Supply chain dislocation remains a global issue. |
| Overweight | Technology | This sector's weight is dominated by two large tech firms. An important part of the barbell that offers above-average revenue growth in a low nominal growth world. SAAS (software as a service) companies are insulated to a degree from the halt in consumption. | Is there a tipping point for passive concentration? We remain focused on valuation: liquidity-driven price recovery has outpaced revenue and earnings recovery. Ongoing tensions with China could be a headwind. "Stay at home" stocks could be rotated out for cyclicals. |
| Overweight | Materials | Materials are a direct beneficiary of the weaker dollar. Early signs of reflation appear to be taking place and have created a bid for the sector. | Demand could go back offline from a re-closure of the economy if Covid cases continue to surge. Dollar strength, albeit unlikely, could have a negative impact on sector. |
| Overweight | Healthcare | Timely entry point given recent fund outflows and rolling relative return versus broader market. Drug pricing appears to have taken a backseat in D.C. relative to stimulating economic growth. | If Republicans fail to hold on to their Senate majority through the January run-off elections in Georgia could heighten the possibility of reform measures. Drug pricing could return to the forefront of policymakers' minds. |
| Neutral Weight | Financials | NIM (net interest margin) outlook negative. Nonperforming loans should rise. Weak consumer profile. Total return play for the sector (dividends/buybacks) impaired for the immediate future. | We are skeptical that positive performance by Trading & Investment Banking is sustainable. Fed backstop has allowed corporate issuance to flourish year-to-date, but the curve remains compressed relative to historical standards. |
| Neutral Weight | Energy | Over-supply. Concentration risk (two stocks compose half the index). Oil is volatile with seasonal negativity ahead. Pricing environment is not conducive for U.S. shale producers. Bankruptcy cycle for the sector running rampant. | Production cuts from OPEC+ oil producing countries coupled with market-driven shut-ins in the U.S. could diminish the current supply glut rapidly. Demand coming back sooner than expected from Covid-19 shutdowns. A weaker dollar is bullish for prices. |
| Neutral Weight | Discretionary | Brick & mortar impaired but ecommerce thriving and is a net beneficiary form the lockdowns. Leisure, lodging, and restaurants will be structurally challenged until a vaccine is widely available. | Online retail giant Amazon.com makes up more than 40% of the weight of this sector. Ecommerce is thriving but visibility is low as to when we achieve pre-pandemic levels of consumption. Savings rate remains elevated (consumers not spending). Elevated unemployment. |
| Underweight | Utilities | Valuations remain extended for the sector. Limited pricing power. Poor performance in the face of bond yields being depressed is not encouraging. Utilities are underperforming cyclical peers. | Less exposure to foreign business and global supply chains. Further yield compression could cause investors to search for yield in the sector. Broader risk-off move could see significant bid in sector. |
| Underweight | Real Estate | Mall and Retail REITs are hurting from the failure of traditional retail venues as consumers prefer to shop online. Commercial Real Estate is at the scene of the Covid-19 accident. High profile commercial tenants asking for rent relief and future rent payments remain in jeopardy. | Cloud-based infrastructure being built and needs warehousing. Apartment REITs can benefit from inclination to rent vs. buy. |
| Underweight | Staples | Valuations remain extended for the sector on both an absolute and relative basis. Limited pricing power. Americans rushed to stock up for the shutdown but it's unlikely that the same level of bulk-buying will continue over the next few quarters. | Further yield compression could cause investors to search for yield in the sector. Broader risk-off move could see significant bid in sector. Sector bellwethers performing well. |

Recommended sector allocations are labeled as over-, under-, and neutral weight compared to sector weightings in the S&P 500 index. The Standard & Poor's 500 is an index of the 500 largest U.S. publicly traded companies. It is market-capitalization weighted, giving very large companies greater influence over the index's movement. This also contributes to the balance of sector weights, as is noted in a few places in the table above. The exact sector weightings in the S&P 500 index can float from day to day as normal trading causes shares within the index to rise or fall in price. It is not possible to invest directly in an index.

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