SEPTEMBER 2024

Key Themes Across Market Sectors

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Stock markets have bounced back from the selloff that spooked investors in late July and early August. By mid-August, the S&P 500 index had risen 8% in just eight trading days, moving within 1% of the all-time high reached just a month prior. The index essentially went from extremely overbought in mid-July to extremely oversold in early August and then back to overbought in late August. Since World War II, there have only been 10 other periods when the S&P 500 moved from overbought to oversold and back to overbought in less than five weeks.

Throughout the market turmoil, investors have had to digest not only the implications of these swings but also Q2 2024 earnings reports, which were largely mixed relative to expectations for S&P 500 companies.

Investors still seem cautiously confident, as there's no definitive sign that the economy is plunging towards recession. However, recent volatility has forced equity investors to be more discriminate—to reexamine key economic fundamentals, including corporate earnings projections, in an environment where high interest rates, a slowing economy and a softening labor market all serve as pressure points.

In this issue of CIO Perspectives, we peer into different sectors of the economy to gain a better sense of the key bottom-up themes at work and how they may be evolving. Bringing this insight together with the top-down macro-economic data, helps us get a more complete picture of the main drivers for economy and markets.

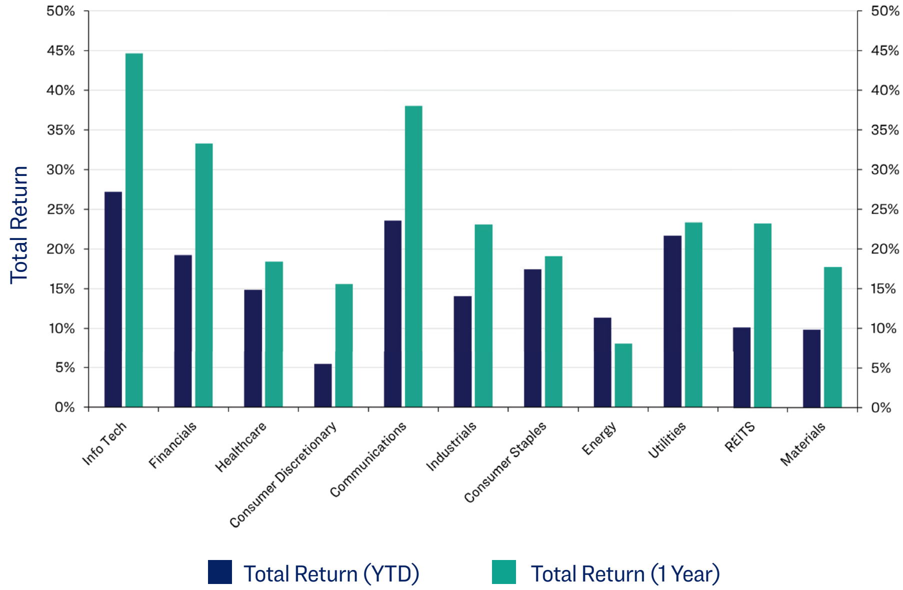
Q2 earnings performance

As of September 6, tailwinds for the broad equity market are evident: The S&P 500 reported a year-over-year (YoY) blended earnings growth rate of 11.4%, which marks the highest YoY earnings growth since Q4 2021 (31.4%). Seventy-nine percent of companies reported a positive surprise in earnings per share (EPS), while 60% reported a positive surprise in revenue. That said, headwinds exist too. Strong earnings growth has created high expectations for S&P 500 companies, as the forward 12-month price-to-earnings ratio (P/E) for the S&P 500 is 20.6, which is above both the 5-year average (19.4) and the 10-year average (17.9).

Q2 earnings performance continued...

FIGURE 1

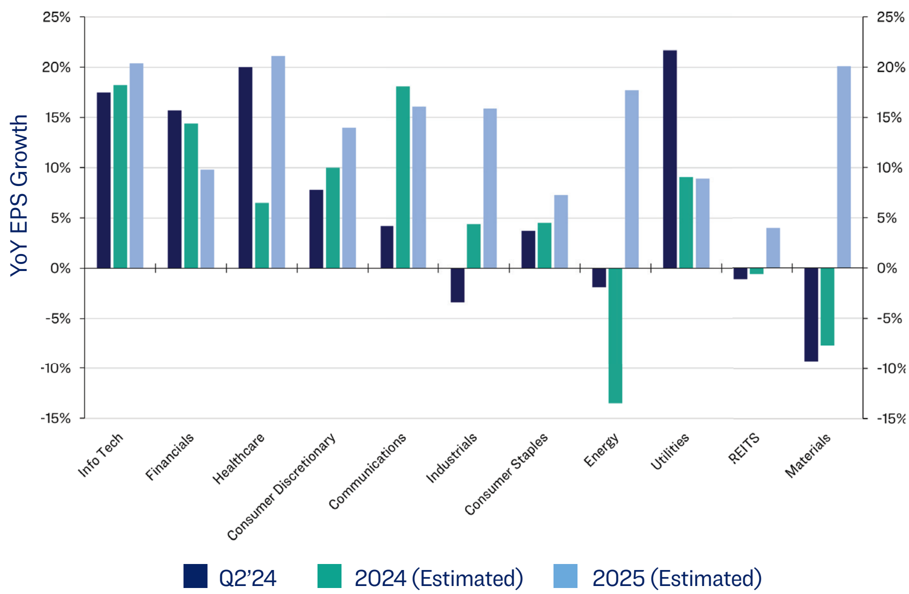
For most sectors, YTD performance (total return) is trailing rolling 1-year performance.



Source: Bloomberg, TIAA Wealth CIO

FIGURE 2

YoY EPS growth by sector.



Source: FactSet Financial Data and Analytics, TIAA Wealth CIO

Consumer Sectors

The Consumer sectors encompass both discretionary items and staples. "Discretionary" refers to companies that sell goods and services people want but don't necessarily need, such as high-end apparel, entertainment, leisure activities and automobiles. Companies operating in this space include Starbucks, Nike, and General Motors. Consumer staples cover a set of essential products used by consumers such as foods and beverages, household goods and hygiene products. Companies operating in this space include Walmart, Unilever, and Kraft Heinz.

As we wrote in May, the health of the U.S. consumer is generally robust even though spending is cooling at a gradual pace. Within retail, we continue to see a widening gap between lower- and higher-end consumers. This is translating to fewer one-off shopping trips and more bundling of purchases. This dynamic has helped the three largest retailers: They've accounted for nearly two-thirds of incremental U.S. retail sales growth over the last several quarters. Excluding those market leaders, many smaller and specialty retailers have experienced more muted growth. Several other sub-industries are being affected by shifts in consumer preferences tied to the residual impact of COVID. Restaurants were an example in the first half of 2024 as eating out normalized off heightened levels. The travel industry now appears to be following a similar pattern: With memories of lockdowns fading, people are no longer so desperate to travel.

Investors have rewarded the companies in the discretionary sector that benefit most from shifting consumption patterns and from the likelihood of lower interest rates in 2025. Home improvement companies, for example, seem poised to benefit from the large housing deficit and the likely rate cut cycle ahead. In other categories, the election presents some risk, with the near-term potential to distract the consumer. Demand for discretionary products is highly elastic. Longer term, the sector may be affected by higher prices from increased tariffs or by consumers' willingness to spend.

Fundamental trends in the consumer staples sector have been lackluster. Many food, beverage and household products companies have seen sales growth decelerate; price increases have slowed while unit volumes have remained largely stable. We believe this reflects incremental pressure on the lower- and middle-income consumer. As noted above, the big-box retailers have performed well. Their value propositions are more appealing in an environment where consumers are more budget conscious. We have seen consumers shift purchases from convenience stores to large chains and clubs as they prioritize value. Longer term, these products are considered necessities, and people are likely to buy them regardless of their personal finances or the economy. However, value-seeking behavior can benefit those retailers that cater to budget-conscious consumers.

Financial Services

The financial sector is comprised of companies that provide banking, investments and other financial products and services to retail and commercial customers. Companies operating in this space include Visa, Bank of America, and Citigroup.

Within the Financials sector, large cap, money-center banks have significantly outperformed their small cap peers year to date (YTD) as regional bank profitability has been hindered by higher funding costs due to restrictive monetary conditions and by concerns about credit and commercial real estate (CRE) exposure. High interest rates have kept loan growth fairly muted, and many banks have instead focused on solidifying their balance sheets. While balance sheets for larger banks tend to be stronger given the benefit of fee activities in their business models (and thus more stringent regulatory requirements), smaller banks tend to have much more exposure to lending and are more dependent on the spread business. (Spread refers to the difference between the rates banks charge customers and the rates they pay other banks to borrow.) However, optimism has been building for smaller banks since the beginning of the second quarter as investors have begun to contemplate the implications of the Federal Reserve (Fed) easing cycle.

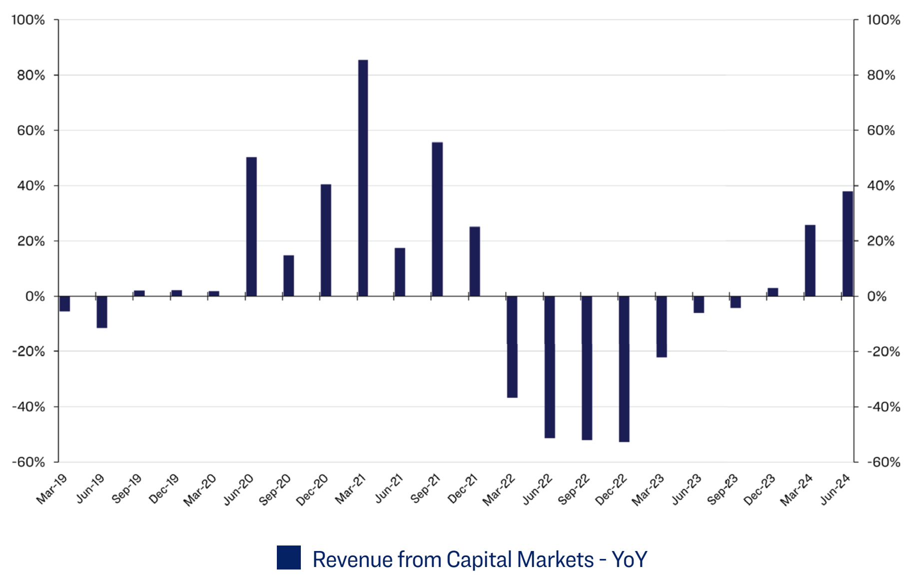
Financial Services continued...

While 2022 and 2023 were poor years for capital markets[1], we have begun to see signs of recovery in capital markets activity in 2024. Mergers and acquisitions, initial public offerings (IPOs), etc. are an emergent theme now gaining traction. We believe support for the capital markets recovery is partly due to the length of the downturn we have witnessed, as we are approximately three years past the previous peak in activity. Optimism continues to build that we are nearing the end of the historic Fed monetary tightening cycle. (Higher rates make it harder to issue IPOs, bonds and finance acquisitions on behalf of clients.)

Although IPOs in the U.S. have come off the lows and appear to be moving towards the pre-COVID range, the number of companies actually going public still lags far behind the number of companies filing to go public. Commentary by managements during Q2 2024 earnings calls suggested that key capital market participants are expecting a continuation of recent positive trends across mergers and acquisitions, IPOs, and debt issuance (Figure 3).

FIGURE 3

Cumulative investment banking fee revenue by Goldman Sachs, Citi, JP Morgan, Bank of America, and Morgan Stanley.



Source: Company filings, TIAA Wealth CIO

September should provide some incremental insights for investors as many banks provide mid-quarter updates at various industry conferences. As we move into the remainder of the year, investors remain sensitive to the direction of economic growth and the path forward for monetary policy. Additionally, any signs of credit deterioration will be carefully scrutinized.

Global cyclicals

Global cyclicals include the Industrials, Energy, and Materials sectors. Industrial sector are companies that provide materials and equipment used in the manufacturing, construction, and production of goods and services; subsectors of the industrial goods sector include aerospace, construction and home building . Companies operating in this space include General Electric, Caterpillar, and Boeing. Companies within the Energy sector produce or supply energy, with many involved in the exploration and development of oil or gas reserves, oil and gas drilling, and refining. Companies operating in this space include Exxon Mobil, Kinder Morgan, and Halliburton. The materials sector is comprised of businesses engaged in the discovery, development, and processing of raw materials, including those in forestry, chemicals, and mining and metal refining. Companies operating in this space include Vulcan Materials, Celanese, and Sherwin-Williams.

The industrial sector seems poised to benefit from the most important trends shaping the global economy—climate transition, infrastructure investments and the artificial intelligence (AI) -driven surge in electricity demand. Electrical suppliers continue to see growth from datacenters, mega projects, and utility spending, while aerospace suppliers are benefitting from continued growth in global passenger traffic and a shortage of new aircraft. However, other sectors like heavy trucks, construction, and agriculture are either in a downturn or entering one.

The environment for industrials also varies by geography. In the U.S., business sentiment remains subdued due to headwinds from interest rates, geopolitics, global elections and general economic uncertainty. Despite the challenges, the U.S. is still the preferred destination for investment, as Europe remains stable at best, and China continues to be mostly weak.

The energy sector has been impacted by countervailing forces. Headwinds have included soft natural gas prices and lower margins for downstream oil refiners. Tailwinds have included strong summer energy demand in the developed world (although demand in China has remained disappointing). Elevated geopolitical risk has provided some support to prices, as tensions and risk of escalation in the Middle East threaten to disrupt global supplies. Looking ahead, all eyes are on the OPEC cartel[2] and whether it follows through with plans to increase production levels later this year, which could drive down consumer prices and impact producer margins.

The materials sector is caught between the risk of a more significant economic slowdown and the potential boost that impending Fed rate cuts—investors are predicting four cuts totaling 115 basis points (bps) by the end of the year (as of September 9)—could exert on global demand. The drawdown of inventories that negatively impacted industries like chemicals and packaging looks to be largely complete, but any recovery looks muted. Mining companies have lost some luster given persistent economic weakness in China. Companies providing construction materials have been negatively impacted by inclement weather and subdued housing construction activity.

Communications and Technology sectors

The communication sector is comprised of companies that make communication possible, through phone, Internet, airwaves, or cables. Companies operating in this space include Verizon, Disney, and Comcast. The technology sector includes businesses that sell products and services in electronics, software, computers, and artificial intelligence, as well as other companies involved in information technology [IT]. Companies operating in this space include Apple, Microsoft, and Advanced Micro Devices.

In the communications space, the large digital platforms continue to post strong earnings growth while the legacy media companies (i.e., cable TV) continue to struggle. As the large internet companies continue to grow engagement, advertisers are shifting dollars away from legacy outlets and to those platforms. The overall digital advertising market remains healthy, which has hurt legacy media companies, which continue to struggle with challenged engagement and highly levered balance sheets.

- The technology space is now divided into two groups: those exposed to artificial intelligence (AI) and those that are not (yet) (Figure 4). AI spending remains strong. The mega-cap "hyperscalers"—companies operating massive global networks of data centers and cloud computing—keep increasing capital expenditures (capex) in order to incorporate next-generation technologies (Figure 5). Anecdotally, they are indicating that this incremental AI processing capacity is being built to meet ever-growing and tangible demand—not being built on spec.

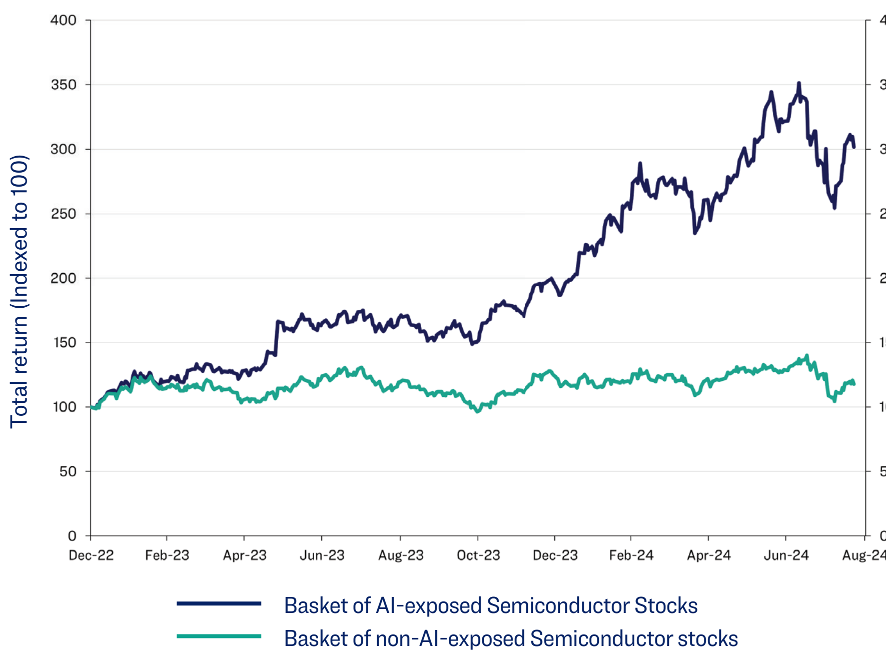
Communications and Technology sectors continued...

While the dollars being spent are large in an absolute sense, they are consistent with historical capital expenditures as a percentage of operating cash flow. The world's largest semiconductor fabricator reported that July sales rose +44% YoY, driven by AI-related chip demand. Producers of products that are used by AI data centers (such as ethernet, liquid cooling, connectors, GPUs and high-capacity memory) are seeing revenue growth accelerate. Cybersecurity companies continue to report solid growth, driven by a threat environment that may be worsened by AI.

Away from AI, the tenor of business in tech is more subdued. Enterprise software vendors report that demand has stabilized after a period of spending cuts by customers. Commodity semiconductor players levered to sectors such as PCs and autos are reporting sluggish sales growth as higher rates have weighed on consumer demand.

FIGURE 4

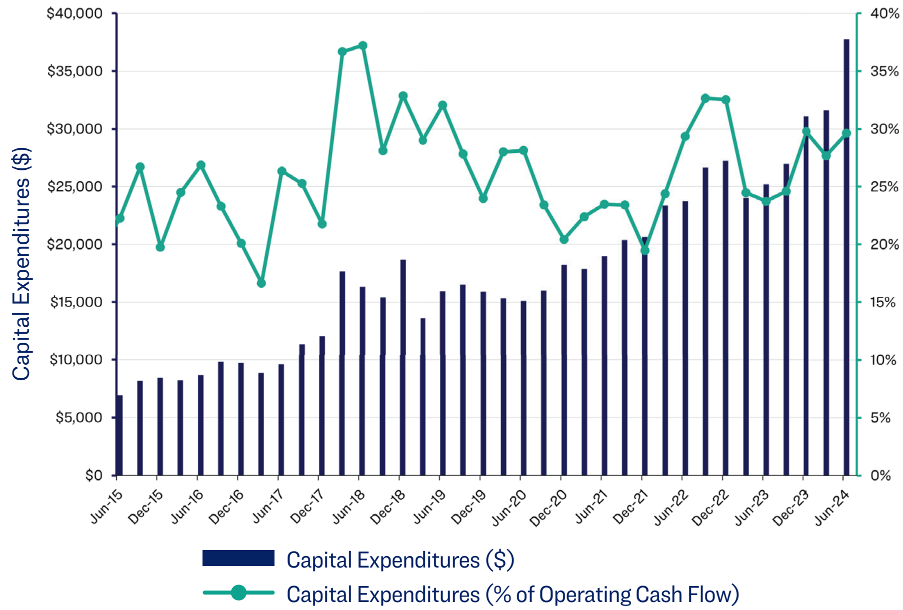
AI exposed semiconductor companies are outperforming non-AI exposed companies.



Source: Bloomberg, UBS, TIAA Wealth CIO

FIGURE 5

Quarterly capital expenditures by Apple, Microsoft, Nvidia, Meta and Alphabet have risen steadily over the last decade.



Source: Company filings, TIAA Wealth CIO

Healthcare

The healthcare sector consists of all businesses involved in the provision and coordination of medical and related goods and services. Companies operating in this space include Eli Lilly, Johnson & Johnson, and HCA Healthcare.

Healthcare fundamentals have varied by sub-sector. Overall, market growth has been lackluster post-COVID due to the significant spending that occurred during the pandemic. Thematically, investors have focused on few key themes in 2024. The interest in therapies for obesity has carried over from 2023 as the GLP-1 class of therapies demonstrated strong results in areas such as cardiovascular risk reduction. This has driven the total addressable market (TAM) much higher than original expectations. Expectations are that the market for GLP-1 obesity and diabetes drugs will grow to $150B by 2029, which is a +30% CAGR from 2023-2029. Importantly, the class has seen minimal safety issues as of now.

Moving forward, we believe the industry is turning a corner, with particular improvement in bioprocessing spending driven by conventional antibodies, recombinant proteins, new antibodies, anti-drug conjugates and cell and gene therapy. There has also been an improvement in the life-science tools industry, which provides the "picks and shovels" for drug discovery and commercialization. That said, the sector has historically experienced elevated volatility during election years as investors brace for potential policy changes. Thus far, the good news surrounding potential policy changes is that, outside the implementation of drug pricing reform from the Inflation Reduction Act (IRA), the political rhetoric has been somewhat benign as candidates focus on larger macro-economic and social issues.

Utilities

The utilities sector includes water, electric, and gas utilities as well as companies that produce or distribute electricity. Companies operating in this space include Duke Energy, PG&E, and Edison International.

Utilities' performance perked up in the spring as the potential for rate cuts came into clearer view. Utilities have outperformed the S&P 500 YTD (+21% total return with dividends vs. +18%) as the prospect of rate cuts made their dividend yields relatively more attractive. Perhaps more importantly, AI-related data center demand is beginning to have a material impact on U.S. power consumption. This, potentially, is a sea change as the country has seen flattish power demand for nearly two decades. The consensus view on the sector is coalescing around a mentality of "heads I win" (AI demand playing out) and "tails I don't lose" (defensive group in the event of a recession). The sector's forward P/E has expanded to 17x, which is roughly in-line with its long-term average. Historically, the utilities sector outperforms the broader market leading into a first rate cut and in the three months thereafter, but then underperforms six months post cut. While still early, the sector is adhering to this playbook so far.

Conclusions

As we discussed in our August CIO Investment Spotlight and CIO Perspectives, we expect market volatility to be more elevated as we enter the final quarter of 2024 and prepare for 2025. Our risk-aware investment approach is informed by the continued, albeit gradual, softening of the economy and also by uncertainty surrounding the election. Against this backdrop, we favor high quality assets —e.g., U.S. large cap equities over international equities, investment grade bonds over high yield bonds, etc.

Longer term, however, we are excited about the prospects that many equity sectors present thanks to AI, climate transition and other secular trends. They are likely to drive significant demand for physical, and digital infrastructure, boost productivity and improve the discovery process for new drugs and vaccines. As volatility picks up, we expect investors to become more discerning and to focus on those sectors and companies that exhibit strong fundamentals and are positioned to benefit from the trends described above.

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[1] Capital markets refer to venues where funds are exchanged between suppliers and those who seek capital.
[2] The Organization of the Petroleum Exporting Countries (OPEC) is a group of oil-rich countries that together control nearly 40% of the world's oil supply.

CIO PERSPECTIVES

TIAA Wealth Management

IMPORTANT DISCLOSURES

GWP-3850955CR-Y0924W (9/24)