U.S. Equity Sector Allocation

December 18, 2023

5 CHANGES IN SHIFT TOWARD PRO-CYCLICAL ALLOCATIONS

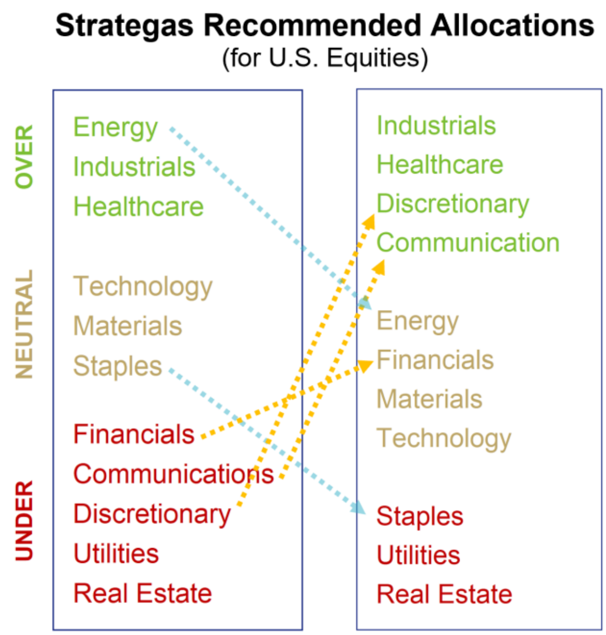
Stronger-than-expected corporate results, labor market strength, and an increasingly supportive fiscal backdrop have all fueled the Street's animal spirits and we don't see anything to discourage that bullishness in the near-term (barring an exogenous event). While we continue to be cautious regarding global and domestic disequilibrium, the present economic and market conditions warrant a more pro-cyclical portfolio construction.

Consumer Discretionary and **Consumer Staples:** Six weeks ago we downgraded Discretionary to Underweight and increased Staples to Neutral. While we don't want momentum alone to inform our views, it's hard to look past the relative strength of equal-weighted Discretionary vs. Staples. Cracks in the labor market have emerged but housing and wages remain favorable and the consumer feels confident to spend, especially on goods. **We now recommend an Overweight allocation to Discretionary and an Underweight position to Staples.**

Communications: Higher rates haven't impacted Alphabet and Meta commercially but made them operationally leaner and more efficient. This was an important test for the Magnificent 7 constituents, which are considered both long-duration (entrepreneurial growth equity) and short-duration (free cash flow generating) franchises. In contrast to the mega-caps, capital discipline will be even more imperative for the legacy operators. If a downturn in the economy comes sooner than the consensus expects, we believe the Content & Streaming segment of the sector may be more resilient than durable goods consumption. This is good example of a situation that requires granular portfolio selection. Streaming fatigue is real and not all services will be net subscription gainers (or be able to stem the tide of cancellations). **We recommend an Overweight allocation to Communications.**

Financials: The sector has regained some footing since the well-contained regional banking crisis last spring. Moreover, the equal-weighted performance has been strong. S&P Global is almost as large a weight in the sector as Wells Fargo. The sector is becoming more data- and exchange-oriented. Despite this, banks are banks, and while globally the group has been strong, domestically the regulatory overhang is real. **We recommend a Neutral allocation to Financials.**

Energy: We missed the opportunity to Underweight Energy for the intermediate term. While we continue to believe commodities in general and Energy in particular are an important part of deglobalization, relative performance has deteriorated. The anchor tenet of our prior Overweight call was Energy's improved capital stewardship, and that has been eviscerated by M&A activity. Non-OPEC supply growth has more than compensated for OPEC+ cuts and the durability of those cuts comes into question as the Saudis continue to lose their claim to being the swing producer. Input costs and wage inflation in oil field services are both elevated. **We recommend a Neutral allocation to Energy.**



2 sectors moved to a lower-weighted allocation and 3 sectors moved higher. Sectors are listed as over-, neutral-, or underweight relative to the S&P 500.

Strategas U.S. Recommended Sector Allocation Summary

	Sector	Rationale	Risks
Overweight	Industrials	We are overweight for exposure to cyclical reacceleration in pockets of the economy. The sector sits at the center of "deglobalization," which will have broad implications as long-held operating conventions are reoriented. Both near-shoring and re-shoring initiatives will continue to be a tailwind. Diversity of sector is a plus relative to concentrated sectors.	Cost growth in many segments remains higher than nominal activity levels. Elevated risk of a U.S. recession (in our view) and historically low probability that the Fed can engineer a soft landing for an already imbalanced economy. More cyclically, our SLIM survey indicates manufacturing choppiness.
	Health Care	We are overweight due to an increase in federal spending on healthcare as well as the sector's low valuation profile relative the broader market. The sector is in good shape with ACA growth of 35% over the past two years. Congress prevented $750 billion in Medicare cuts going into effect in 2023. Higher taxes appear unlikely.	The sector would likely lag behind the market in a protracted cyclical upswing and higher-for-longer rates is a headwind for Biotech. Congress failed to fix the R&D tax credit as part of last year's omnibus spending bill. Companies have to amortize expenses over 5 years which eats into cash flow. As a result, cost and margins likely remain pressured.
	Discretionary	We are overweight on the Favorable environment for the consumer is on the sector's resilience and outperformance as consumers continue to spend. This propensity to spend appears to be supported by the possibility of fiscal stimulus via expansion of the child tax credit, plus business tax cuts and resumption of the employee retention tax credit. Homebuilders remail resilient and are in a strong secular set up.	Anticipated fiscal stimulus may not come to pass. Weakness in Amazon's Cloud business and Tesla's leadership in the faltering EV space make sector behemoths susceptible to a pullback. A slowing economy would hamper consumer spending, and savings cushion from the pandemic appears depleted as interest rates sink and student debt payments return
	Communications	Shares likely to see a boost from increased ad-spending in a presidential election year, as well as completed cost-cutting measures from sector bellwethers Google and Meta (Facebook). We think streaming & content could function well in the event of a slowdown (as consumers will scale back other activities in favor of entertainment at home). Limited impact from higher rates.	Relative performance has cooled of late and the sector commands elevated valuations relative to the market. Legacy Telecom could be a drag given debt burden (discipline will be crucial) and the potential for class action lawsuits. Mounting pressure from higher interest rates and a deteriorating economic environment are likely headwinds that could severely impact core businesses.
Neutral	Energy	Capital stewardship has deteriorated with accelerated M&A activity. Non-OPEC supply growth has more than compensated for OPEC+ cuts. Those cuts may be called into question in 2024 as OPEC+ continues to lose market share to the U.S. and others. Input costs have risen as wage inflation in oilfield services is elevated.	Internal trends have been deteriorating lately. A global recession would impact demand negatively. Concentration risk is present with Exxon and Chevron composing nearly half the sector's market weight.
	Technology	We anticipate sector outperformance to cool as higher rates, liquidity erosion, and slower growth weigh on shares. AI emerging as a durable long-term target for capital. Sector bellwethers are no longer Growth darlings but are capable of leadership due to cash generation. USD strength is a headwind due to foreign revenue exposure.	Does the sector only look over-owned if you're underinvested or don't own it? Traditionally, Growth struggles in times of high interest rates and elevated inflation but Technology did work pre-QE--could it continue to outperform? Sector appears at risk of more "vanity" projects as AI trends continue within the space.
	Materials	We are Neutral given the mixed performance profile from the sector and the possible inflection of the U.S. dollar. Subindustry group performance is mixed. Debt maturity wall not an issue despite rising cost of capital. Further weakening of the U.S. dollar would be a positive for sector business. Commodity strength would be an asset for profits and relative performance.	A recession would hamper economic activity. A stronger U.S. dollar would hurt global revenue. Wage growth could accelerate and cramp company operating margins. While supply chains remain uninhibited for now, longer-term deglobalization trends could raise costs.
	Financials	We are Neutral given the improving number of stocks entering uptrends while the sector's earnings weight exceeds its market cap weight. Credit availability is slowing as banks' willingness to lend decreases and the sector tightens lending standards. If not for Fed intervention, banking crisis would likely have led to recession. No clear consensus with earnings, estimate revisions, reflecting ambiguous fundamental standing.	Capital market activity continues to drag through the upcoming quarters. Pressure remains from tighter financial conditions globally and the potential for higher capital requirements and regulation.
Underweight	Staples	We are underweight given persistent underperformance relative to Discretionary and the market. Sector has defensive attributes and a record of outperforming in the early stages of a slowdown, but the consumer seems undeterred by higher interest rates andof tighter lending standards. Rates are above dividend yield. Bellwethers trading poorly.	Consumer behavior and confidence can turn quickly if the job environment worsens, which could lead to a pare-back in spending. A growth slowdown or a spike in "risk-off" price action could boost shares.
	Utilities	The sector's dividend yield is facing competition from the fixed income asset class. Sector faces fundamental struggles like volatile natural gas prices and rising leverage.	A recession could give a bid to the sector. A sharp decline in yields could enhance the yield-attractiveness of the sector. Rubber band effect from being deeply oversold could lead to a bout of outperformance.
	Real Estate	Ambiguity re: commercial real estate valuations and broad sector weakness. Return to office jagged and commercial property valuations impacted. Similarly poor long-term trends in global real estate. One of the few groups to still trade below its 2007 highs.	A fall in yields could make interest and dividend income from Real Estate attractive. Cloud-based infrastructure needs to be built and housed. Elevated mortgage rates could be a tailwind for apartment REITs (rent vs buy). Sentiment is extremely negative. Low bar for office REITs to outperform depressed expectations.

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