Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

U.S. Equity Sector Allocation

February 13, 2025

REVIEWING OUR RECOMMENDATIONS WITH TRUMP 2.0 IN FULL SWING

There is nothing easy about forecasting financial markets, and it becomes even more challenging with a president that changes his mind in a matter of moments on policies that may have a lasting impact on sectors, industries, or individual sectors. Ultimately, we think being overweight the Financials, Industrials, Utilities, and Energy sectors is a prudent strategy. Below are some high level thoughts that inform our sector weightings:

Deregulation: If the deregulation story comes to fruition, Financial firms will operate in a less constrained environment and that will open up capital market activity.

Tariffs: There's no doubt that tariffs will play a large role in the Industrials sector, but that should be mitigated by funds from previous legislation, already approved by Congress, rolling out.

AI: Utilities, unlike at any previous point in the last 25 years, have a secular growth story with a significant need for additional power generation to run new data centers. And, like it or not, the Energy sector is going to play a bigger role than renewables in meeting those needs. Energy investments should likely be more focused on the natural gas side rather than oil. If non-traditional investments are to be made, nuclear seems like an attractive option.

Inflation: While consumers have been able to weather the inflation storm so far, price levels remain elevated and another wave of inflation would likely not be digested well by consumers.

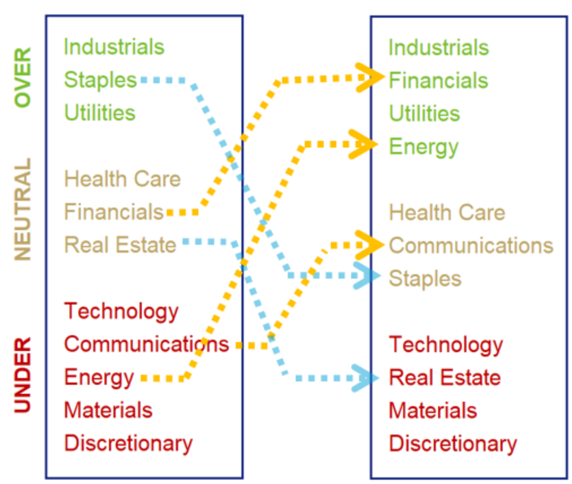
Mag 7: A slowdown in growth looks more likely to us than an outright decline in the Technology sector. Valuations are elevated, and it wouldn't be a bad idea to dial back exposure to the sector. The Communications sector is also tied to Mag 7 trends with the big Tech and media companies having the cash flow benefit most companies do not in a high interest rate environment.

February 2025 Allocation Changes

- We've moved **Financials** to overweight from neutral weight on the sector's strong fundamentals as well as secular tailwinds associated with the new administration.
- **Energy** has moved to overweight from underweight based on a favorable supply/demand outlook.
- **Communications** has bumped up to neutral from underweight based on a split outlook on the sector with elevated valuations but 73% of stocks in an uptrend and good cash flow from Mag 7 names.
- **Staples** is now neutral; it has defensive characteristics and attractive valuation profile but lacks much-needed momentum.
- **Real Estate** is now underweight (from neutral) on higher-for-longer mortgage rates and concerns over commercial real estate valuations.
- The remaining six sectors are unchanged in their allocations (more on our risks and rationale for all 11 S&P sectors is on the following page)

Strategas Recommended Allocations

February 2025



2 sectors moved to a lower-weighted allocation, and 3 sectors moved higher. The remaining 6 sectors are unchanged. 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 due to secular tailwinds from reshoring, defense spending, and electricity infrastructure demand. The sector sits at the center of deglobalization, which will have broad implications as long-held operating convestions (from trade and resource procurement to tech and IP partnerships and defense alliances) are reoriented. Lastly, fiscal spending on infrastructure is expected to rise, supported by bipartisan initiatives.	Certain globally-oriented subindustries, like Machinery, are more exposed to risks associated with potential trade tensions. Also, cost growth in many segments remains higher than nominal activity levels.
Overweight	**Financials**	We are Overweight given strong fundamentals and secular tailwinds associated with the new administration. The outlook for the sector has certainly improved post-election, particularly for capital markets activity, and material deregulation initiatives led by the Treasury Secretary are already underway.	Returns were pulled forward in anticipation of the deregulation story and perhaps the idea that the Fed may be done cutting rates could hinder economic activity.
Overweight	**Utilities**	We are Overweight given growth tailwinds from increased domestic power demand. While the sector does have some defensive hedge properties, it has become increasingly correlated with the AI story as future electricity demand has leapt higher.	Persistently high or rising bond yields would compete with the sector's dividend yield and weigh on its price action.
Overweight	**Energy**	We are Overweight due to our favorable supply/demand outlook for natural gas. Increased domestic power demand from semis / battery manufacturing / data centers/ AI should propel demand growth for natural gas while excess LNG export capacity comes online that will further skew supply/demand balances. We're less upbeat on the broader crude complex and believe that prices are rangebound between \$65 and \$75 given OPEC's excess supply levers.	Natural gas prices could drop if the power demand forecast fails to materialize; LNG exports could surpise to the downside from increased trade tensions and improved relations between Russia and the broader eurozone. A downdraft in global growth would also weigh on the energy complex.
Neutral	**Health Care**	We are Neutral weight given a recent spark in momentum and bullish earnings expectations for the extremely oversold sector, but we remain wary of headline risks associated with the Trump administration. While the GLP-1 secular growth story has slowed, the sector's defensive qualities remain strengths. The sector's earnings growth estimate for Q4 sits at an impressive 40% (well above where it was at the beginning of that quarter).	Health Care may continue to bleed relative outperformance if the market's risk-on characteristics persist. Policy concerns from the new administration may prove to be more bark than bite, presenting a comeback opportunity.
Neutral	**Comms**	We are Neutral weight given the split nature of the sector and the concentration risk it carries with its Mag 7 constituents. Earnings growth is less impressive when Mag 7 companies are omitted, and the remainder of the sector is riddled with industries in secular decline (legacy telecom and cable). Similarly the equal-weighted index relative to the cap-weighted index is near all-time lows. With that said, 73% of the sector is an uptrend and teh big tech and media companies have the cash flow benefit most companies don't in a high rate environment.	Cost-cutting initiatives coupled with a reacceleration in the top line would be a durable catalyst for free cashflow generation and ultimately relative performance.
Neutral	**Staples**	We are Neutral weight given the sector's defensive characteristics and attractive valuation profile, but lack of much-needed momentum. While consumers have been able to weather the inflation storm so far, price levels remain elevated and another wave of inflation would likely not be digested well by consumers. Staples' defensive nature should hedge these risks. The sector trades cheap with a forward PE ratio at levels historically associated with strong outperformance, and its combined weight now makes up only 5.4% of the S&P 500.	While valuation is attractive, growth prospects are underwhelming. Should today's "risk-on" environment persist, it would continue to weigh the sector down.
Underweight	**Technology**	We are Underweight given that an uncomfortably large part of the sector's allure stems from the Mag 7. The sector continues to exude lackluster relative performance and has an elevated valuation profile. Earnings growth is less robust when excluding Mag 7 companies.	Tech is likely to outperform should the market's high-risk appetite persist. Lower rates in the face of a liquidity surge could further inflate multiples.
Underweight	**Real Estate**	We are Underweight due to higher-for-longer mortgage rate expectations as well as ongoing uncertainty concerning commercial real estate valuations. A housing market freeze has taken shape and the outlook on rates means it will likely persist at least in the near term. High yields could also compete with opportunities for real estate interest and dividend income.	The return-to-office trend seems to be picking up steam and while it is unlikely it returns to pre-pandemic levels, it could provide a boost for office REITs. Liquidity influx post-debt ceiling could put downward pressure on mortgage rates, spurring more housing market activity.
Underweight	**Materials**	We are Underweight given the lackluster growth prospects for a cyclical upturn in China and global growth more broadly. The sector derives one of its highest portions of its revenue internationally relative to all other GICS sectors, putting it in the cross hairs of dollar strength. Global growth (excluding U.S.) was teetering prior to the election with tariffs now exacerbating the situation.	A about-face on trade policy would be dollar-bearish and ultimately a tailwind for global growth. A China pivot towards pro-growth stimulus would reaccelerate global growth and ultimately help relative performance for the sector (yet to be seen).
Underweight	**Discretionary**	We are Underweight on the backs of elevated CPI for must-buy essentials, below-market earnings growth expectations, and an underlying cloudy outlook for the consumer over the coming months. Rate cut expectations have come down significantly as inflation concerns re-emerge; should these concerns materialize, it could impact consumer health and spending.	Inflation could fail to materialize, spurring a continuation of the rate-cut cycle, which would reaccelerate economic growth and consumption. Concentration risk would be a drag on relative performance due to being underweight.

Allocations are labeled as over-, under-, and neutral weight compared to sector weightings in the S&P 500, an index of the largest U.S. publicly traded companies. The S&P 500 is market-cap weighted, giving larger companies greater influence on sector weights. The weightings in the 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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