23 March 2023, 4:51PM UTC
Chief Investment Office GWM
Investment Research

US equity sectors

CIO View

David Lefkowitz, CFA, CIO Head of US Equities, UBS Financial Services Inc. (UBS FS)
Nadia Lovell, CIO Senior Equity Strategist, US Equities, UBS Financial Services Inc. (UBS FS)
Matthew Tormey, CIO Equity Strategist, US Equities, UBS Financial Services Inc. (UBS FS)

- This month, we become more defensive in our sector positioning. The combination of still-high inflation, a very inverted yield curve, and tightening bank lending standards (which will likely only get worse due to the turmoil in the banking sector) suggests increased risks of difficult economic conditions later this year.
- The main risk to our current defensive posture is that it may take more time for the economic risks to materialize. Our most preferred sectors are consumer staples, industrials, and utilities. Our least preferred sectors are consumer discretionary, financials, and information technology.

Source: gettyimages

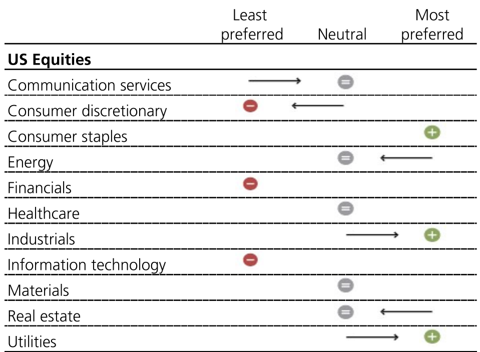
CIO six-month tactical view

This month, we become more defensive in our sector positioning based on indications that the economy is facing challenges ahead. The yield curve is heavily inverted (although less so over the last week), banks are tightening lending standards (and will likely only get incrementally tighter due to the recent turmoil in the banking sector), and inflation remains too high. Taken together, these are conditions that suggest investors should expect continued headwinds that will cap equity market upside and present downside risks in the months ahead. But the headwinds may not exert more sustained downward pressure on corporate profits and equity markets until later this year, and quite possibly late in the year, especially considering that consumers are still sitting on about USD 1 trillion of excess savings accumulated during the pandemic.

We upgrade communication services, industrials, and utilities. We downgrade consumer discretionary, energy, and real estate. Our most preferred sectors are now consumer staples, industrials, and utilities. Our least preferred sectors are consumer discretionary, financials, and information technology.

Fig. 1: Shift to a more defensive bias in sectors

Tactical preferences from benchmark (S&P 500)



Source: UBS, as of 23 March 2023

Most preferred

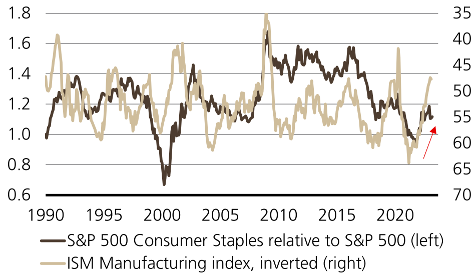
Consumer staples: We think earnings for this defensive sector should hold up better than the market as economic growth slows. In addition, we expect further declines in the ISM Manufacturing index, which typically drives outperformance for this sector (Fig. 2). Relative valuations are back near historical averages which makes them attractive, in our view, given the sector's defensive growth profile in a potentially challenging macro environment.

Industrials *(upgrade from neutral)*: The sector's exposure to a few secular growth drivers is attractive, in our view. Defense companies should benefit from higher defense budgets in the years ahead, although we acknowledge near-term uncertainty about defense spending heading into the debt ceiling negotiations. In addition, the infrastructure law should support nonresidential construction, while aerospace manufacturers should benefit from large backlogs, even if air travel begins to cool off. Investments in energy supply (fossil and renewable) and reshoring/onshoring trends should provide further support for the sector. Finally, segments of the sector offer some cyclical exposure relative to our two other most preferred sectors, which are more defensive.

Utilities *(upgrade from neutral)*: Similar to consumer staples, this defensive sector should offer ballast in a portfolio, especially given some of the headwinds that we see ahead and arguably cheap valuations for a late-cycle environment (Fig. 3). Our fixed income team's outlook for lower long-term interest rates over the balance of the year should make the sector's high dividend yield more appealing.

Fig. 2: Staples should outperform as economic activity cools

S&P 500 Consumer Staples relative performance vs. ISM Manufacturing index



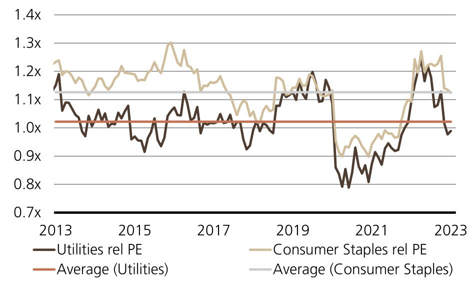
Source: Bloomberg, UBS, as of 22 March 2023

Neutral

Communication services *(upgrade from least preferred)*: Competition in digital advertising, video streaming, and broadband continues to intensify. New threats are emerging with the integration of artificial intelligence (AI) into internet search queries that will usher in a heavier investment cycle for mega-cap incumbents and pressure margins. At the same time, digital ad spending could be at risk if the US economy slips into recession later this year. However, in the near term, economic uncertainty may continue to drive investors to seek safety in high-quality mega-cap growth companies for protection. The defensive nature of telecom companies (around 15–20% of the sector) provides incremental support in an uncertain environment. Investors should be aware that the market-cap-weighted version of the sector is highly concentrated, with Alphabet and Meta accounting for roughly 60% of the total.

Fig. 3: Classic defensives offer protection at a lower valuation

Utilities and Staples relative NTM P/E



Source: FactSet, UBS, as of 22 March 2023

Energy *(downgrade from most preferred)*: Valuations aren't demanding, but in the near term, oil markets are better supplied than we anticipated. Risks of an economic slowdown later this year may limit oil price appreciation over the next several months. Long term, we still think the outlook for the sector appears constructive given structurally tight oil markets due to substantial underinvestment in oil exploration and production since 2014.

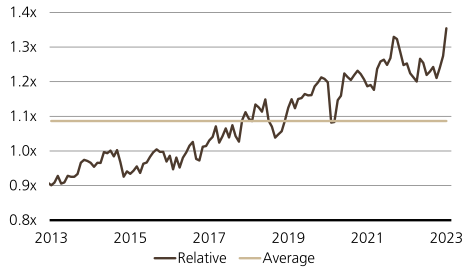
Healthcare: The relative valuation gap with the broader market is near historical averages, making the risk-reward more balanced. Drugmakers are facing patent expiration on several large products, but promising new drug therapies in large, untapped end-markets—such as Alzheimer's and obesity—might provide some cushion. Labor shortages are easing, aiding a recovery in utilization and medical procedure volumes. Still, policy uncertainty remains a bit elevated pending the implementation of drug-pricing provisions in the Inflation Reduction Act, as well as in managed care on 2024 Medicare Advantage payment rates and potential clawback of overpayments after the government’s recent audit of the industry.

Materials: A potential peak in the US dollar and the reopening of the Chinese economy are positives for the sector. However, the lagged effects of central bank tightening in the US and Europe could weigh on end-demand.

Real estate *(downgrade from most preferred)*: Turmoil in the banking system has made financing more difficult. Companies in the sector are generally more highly indebted and rely on easy access to capital, which could be more challenging. The sector is cheap and offers a good mix of secular and cyclical exposure. But uncertainties around access to capital may linger and lead to higher costs that could prevent the sector from outperforming.

Fig. 4: Tech valuations are now higher than in 2021

S&P 500 Information Technology forward P/E vs. S&P 500 forward P/E



Source: FactSet, UBS, as of 22 March 2023

Least preferred

Consumer discretionary *(downgrade from neutral)*: The sector has been a strong performer this year despite continued questions about consumer demand for goods and high sector valuations. Elevated mortgage rates and poor homebuyer affordability are headwinds for the housing-related segments of the sector. The sector would be particularly vulnerable if hard-landing fears become more prevalent. Investors should be aware that the market-cap-weighted version of the sector is highly concentrated, with Amazon and Tesla accounting for roughly 40% of the total.

Financials: It is possible that as the banking stress eases, the sector could experience a rebound. But fundamental headwinds will still be present such as rising funding costs as banks compete for deposits, slower loan growth if there is a broader slowdown, and increased regulatory scrutiny that could mean less return of capital to shareholders. Recession risks remain elevated, and credit costs could rise substantially if the unemployment rate climbs.

Information technology: The sector has seen a spike in its relative valuation following the recent turmoil in the banking system (Fig. 4). Our outlook for a decline in S&P 500 profits in the quarters ahead will likely be a fundamental headwind for the sector. Enterprise tech spending tends to be correlated with overall corporate profits. Finally, semiconductor demand is also slowing in some segments, and this industry tends to be correlated with the ISM Manufacturing index, which will likely continue to be under pressure.

Appendix

UBS Chief Investment Office's ("CIO") investment views are prepared and published by the Global Wealth Management business of UBS Switzerland AG (regulated by FINMA in Switzerland) or its affiliates ("UBS").
The investment views have been prepared in accordance with legal requirements designed to promote the **independence of investment research**.
Generic investment research – Risk information:
This publication is **for your information only** and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. The analysis contained herein does not constitute a personal recommendation or take into account the particular investment objectives, investment strategies, financial situation and needs of any specific recipient. It is based on numerous assumptions. Different assumptions could result in materially different results. Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis and/or may not be eligible for sale to all investors. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness (other than disclosures relating to UBS). All information and opinions as well as any forecasts, estimates and market prices indicated are current as of the date of this report, and are subject to change without notice. Opinions expressed herein may differ or be contrary to those expressed by other business areas or divisions of UBS as a result of using different assumptions and/or criteria.
In no circumstances may this document or any of the information (including any forecast, value, index or other calculated amount ("Values")) be used for any of the following purposes (i) valuation or accounting purposes; (ii) to determine the amounts due or payable, the price or the value of any financial instrument or financial contract; or (iii) to measure the performance of any financial instrument including, without limitation, for the purpose of tracking the return or performance of any Value or of defining the asset allocation of portfolio or of computing performance fees. By receiving this document and the information you will be deemed to represent and warrant to UBS that you will not use this document or otherwise rely on any of the information for any of the above purposes. UBS and any of its directors or employees may be entitled at any time to hold long or short positions in investment instruments referred to herein, carry out transactions involving relevant investment instruments in the capacity of principal or agent, or provide any other services or have officers, who serve as directors, either to/for the issuer, the investment instrument itself or to/for any company commercially or financially affiliated to such issuers. At any time, investment decisions (including whether to buy, sell or hold securities) made by UBS and its employees may differ from or be contrary to the opinions expressed in UBS research publications. Some investments may not be readily realizable since the market in the securities is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS, into other areas, units, divisions or affiliates of UBS. Futures and options trading is not suitable for every investor as there is a substantial risk of loss, and losses in excess of an initial investment may occur. Past performance of an investment is no guarantee for its future performance. Additional information will be made available upon request. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. Changes in foreign exchange rates may have an adverse effect on the price, value or income of an investment. The analyst(s) responsible for the preparation of this report may interact with trading desk personnel, sales personnel and other constituencies for the purpose of gathering, synthesizing and interpreting market information.
Tax treatment depends on the individual circumstances and may be subject to change in the future. UBS does not provide legal or tax advice and makes no representations as to the tax treatment of assets or the investment returns thereon both in general or with reference to specific client's circumstances and needs. We are of necessity unable to take into account the particular investment objectives, financial situation and needs of our individual clients and we would recommend that you take financial and/or tax advice as to the implications (including tax) of investing in any of the products mentioned herein.
This material may not be reproduced or copies circulated without prior authority of UBS. Unless otherwise agreed in writing UBS expressly prohibits the distribution and transfer of this material to third parties for any reason. UBS accepts no liability whatsoever for any claims or lawsuits from any third parties arising from the use or distribution of this material. This report is for distribution only under such circumstances as may be permitted by applicable law. For information on the ways in which CIO manages conflicts and maintains independence of its investment views and publication offering, and research and rating methodologies, please visit www.ubs.com/research-methodology. Additional information on the relevant authors of this publication and other CIO publication(s) referenced in this report; and copies of any past reports on this topic; are available upon request from your client advisor.
Options and futures are not suitable for all investors, and trading in these instruments is considered risky and may be appropriate only for sophisticated investors. Prior to buying or selling an option, and for the complete risks relating to options, you must receive a copy of "Characteristics and Risks of Standardized Options". You may read the document at https://www.theocc.com/about/publications/character-risks.jsp or ask your financial advisor for a copy.
Investing in structured investments involves significant risks. For a detailed discussion of the risks involved in investing in any particular structured investment, you must read the relevant offering materials for that investment. Structured investments are unsecured obligations of a particular issuer with returns linked to the performance of an underlying asset. Depending on the terms of the investment, investors could lose all or a substantial portion of their investment based on the performance of the underlying asset. Investors could also lose their entire investment if the issuer becomes insolvent. UBS does not guarantee in any way the obligations or the financial condition of any issuer or the accuracy of any financial information provided by any issuer. Structured investments are not traditional investments and investing in a structured investment is not equivalent to investing directly in the underlying asset. Structured investments may have limited or no liquidity, and investors should be prepared to hold their investment to maturity. The return of structured investments may be limited by a maximum gain, participation rate or other feature. Structured investments may include call features and, if a structured investment is called early, investors would not earn any further return and may not be able to reinvest in similar investments with similar terms. Structured investments include costs and fees which are generally embedded in the price of the investment. The tax treatment of a structured investment may be complex and may differ from a direct investment in the underlying asset. UBS and its employees do not provide tax advice. Investors should consult their own tax advisor about their own tax situation before investing in any securities.
Important Information About Sustainable Investing Strategies: Sustainable investing strategies aim to consider and incorporate environmental, social and governance (ESG) factors into investment process and portfolio construction. Strategies across geographies and styles approach ESG analysis and incorporate the findings in a variety of ways. Incorporating ESG factors or Sustainable Investing considerations may inhibit the portfolio manager’s ability to participate in certain investment opportunities that otherwise would be consistent with its investment

objective and other principal investment strategies. The returns on a portfolio consisting primarily of sustainable investments may be lower or higher than portfolios where ESG factors, exclusions, or other sustainability issues are not considered by the portfolio manager, and the investment opportunities available to such portfolios may differ. Companies may not necessarily meet high performance standards on all aspects of ESG or sustainable investing issues; there is also no guarantee that any company will meet expectations in connection with corporate responsibility, sustainability, and/or impact performance.

External Asset Managers / External Financial Consultants: In case this research or publication is provided to an External Asset Manager or an External Financial Consultant, UBS expressly prohibits that it is redistributed by the External Asset Manager or the External Financial Consultant and is made available to their clients and/or third parties.

USA: Distributed to US persons by UBS Financial Services Inc. or UBS Securities LLC, subsidiaries of UBS AG. UBS Switzerland AG, UBS Europe SE, UBS Bank, S.A., UBS Brasil Administradora de Valores Mobiliarios Ltda, UBS Asesores Mexico, S.A. de C.V., UBS SuMi TRUST Wealth Management Co., Ltd., UBS Wealth Management Israel Ltd and UBS Menkul Degerler AS are affiliates of UBS AG. **UBS Financial Services Inc. accepts responsibility for the content of a report prepared by a non-US affiliate when it distributes reports to US persons. All transactions by a US person in the securities mentioned in this report should be effected through a US-registered broker dealer affiliated with UBS, and not through a non-US affiliate. The contents of this report have not been and will not be approved by any securities or investment authority in the United States or elsewhere. UBS Financial Services Inc. is not acting as a municipal advisor to any municipal entity or obligated person within the meaning of Section 15B of the Securities Exchange Act (the "Municipal Advisor Rule") and the opinions or views contained herein are not intended to be, and do not constitute, advice within the meaning of the Municipal Advisor Rule**

For country information, please visit ubs.com/cio-country-disclaimer-gr or ask your client advisor for the full disclaimer.

Version A/2023. CIO82652744