ARGUS

ARGUS ECONOMIC COMMENTARY

September 16, 2024

Stock Selloff Extends Sector Rotation

The stock market experienced July and August selloffs during 2024. The September selloff somehow felt worse, although so far it has not been. The July-August selling, which included a false rebound high bracketing the two months, sent the S&P 500 lower by 8.5% from peak to trough. As of this writing, the S&P 500 is down by 4.2% in September.

Why has this latest selling jag created such anxiety? The widely held sentiment was that the market in July and August had gotten any selling "out of its system" and that recession fears had been put to rest by GDP and corporate earnings. Then came the well-below-consensus August nonfarm payrolls report, which along with July and June revisions suggested that the labor market was weakening more rapidly than anticipated.

The Fed begins its rate-cutting program in mid-September, but the gnawing question has now become the following. Did the Fed wait too long?

Sectors that are Winning in 3Q24

Amid the selling that has impacted and even characterized the past three months, rotation into formerly out-of-favor sectors continues. With three weeks remaining in the third quarter, the chief beneficiaries of rotation have been interest-rate-sensitive and defensive sectors; cyclical sectors have also outperformed the broad market.

Clearly, the biggest winners have been the two smaller sectors with interest-rate sensitivity: Utilities and Real Estate. Based on the iShares US Real Estate ETF IYR, the Real Estate sector is up 14.3% for the third quarter to date (as of the market close on 9/6/24). REITS are up just 8.7% year to date, however, reflecting a 4.9% decline for ETF IYR in the first half of 2024.

The Real Estate sector encompasses many different real estate businesses sensitive to different market dynamics. These include office REITs, where occupancy has been pressured by secular changes related to hybrid work models created in response to the pandemic and post-pandemic periods; apartment REITs, which are sensitive to cyclical changes in interest and mortgage rates that impact the level of home purchases; and healthcare REITs, where physician practices and senior living centers respond to the demographics of aging boomers.

In the third quarter, the appeal of relatively higher interest rates is superseding these secular, cyclical, and demographic factors that affect different parts of the Real Estate sector differently. At the same time, the "big tent" nature of the sector likely means that many factors beyond the level of interest rates will continue to impact the business dynamics of the disparate companies in the sector. Argus continues to recommend a market-weight exposure to the Real Estate sector, or an approximately 2.5% weighting within balanced equity portfolios.

Based on the iShares Dow Jones US Utilities ETF IDU, the U.S. Utilities sector is the second-best sector, with a 9.8% gain to date, in the third quarter of 2024. The sector came into midyear with a much stronger performance than the Real Estate sector, however. As of 6/30/24, the Utilities sector ETF was up 9.9% for the year to date. On that basis, IDU was up 20.7% as of 9/6/24, which counts as the best performance of any sector year to date.

Utilities typically tend to do well in periods of declining interest rates, or even in advance of cuts in the fed funds rate by the central bank, as investors anticipate the changing environment. Utilities were the third-best sector in both 2007 and 2008, both years characterized by declining interest rates. Investors may have been skewing defensive in that highly challenging period that culminated in the 2008-2009 recession.

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In more "normal" years, Utilities were the best-performing sector in 2011 and second best in 2014; both years featured broad declines in interest rates. Utilities were the second-best sector in 2018, which interest rates were declining amid global banking woes. During the recent period of rising U.S. interest rates, Utilities were a bottom-five sector in 2021 and 2023, but outperformed in a crashing market in 2022 -–even though the Fed had finally begun its overdue rate-hiking campaign.

Utilities in the U.S. have other positives in their favor. These include strong sector investments on new capital plant, most notably to support the growing power needs of data centers in support of the AI revolution. We believe investors will continue to favor Utilities as the Fed's rate-cutting cycle plays out, and we recommend an overweight position of 0.5%-1.0% above the current 2.5% benchmark weight within balanced equity portfolios.

The other sectors that are outperforming the market (S&P 500) in the calendar third quarter have defensive or cyclical characteristics. Defensive sectors that are doing well include Consumer Staples, up 8.4% as of 9/6/24; and Healthcare, up 6.0%. Cyclical sectors that are outperforming include Financial, up 6.8%; and Industrial, up 4.8%.

Sectors that are Losing in 3Q24

Growth sectors led the market for most of 2024, even across the first half of the third quarter. But the technology sector in particular has been hammered in 3Q24. Investors are buying into areas, including higher-yield equity, seen as attractive in the current climate of imminent rate cuts. They are funding these sector shifts at least partially by taking profits on AI pure-play names and companies in a variety of segments (semiconductors, software, computing) perceived as sensitive to the AI boom.

In 2023, three growth sectors – Information Technology, Communication Services, and Consumer Discretionary - dominated the market and drove the S&P 500's 24.6% return for the year. The three sectors were up 65.3%, 49.5%, and 34.7%, respectively, and were the only sectors to beat the index return. So dominant were these three sectors that the eight remaining sectors had a simple-average return of 3.4% for 2023 – nowhere near the market return.

Exiting 1Q24, both Information Technology, up 10.0%, and Communication Services, up 11.9%, delivered strong quarter. Note, however, that the S&P 500 was also up a strong 10.2%. The Energy and Financial sectors (both up 12%) did better than 2023's winners did. Four other sectors were up in high single digit percentages; that included a 5.7% gain for Utilities. And Consumer Discretionary, which was top three in 2023, was bottom three in 1Q24, with a less than 3% gain.

In 2Q24, the AI trade reasserted itself, and Information Technology led with an 11.4% gain. Utilities was next with a 9.9% gain. The third place performer was Communication Services, up 4.9%. On a year to date basis at mid-year, Information Technology and Communication Services were the market leaders. Five other sectors – Consumer Staples, Energy, Financial, Healthcare, and Utilities – were up in high-single-digit percentages; and Utilities led that group with a 9.9% advance.

In 3Q24 to date, once-invincible Information Technology was down a startling 8.5% as of 9/6/24, much worse than the net decline of little more than 1% for the S&P 500 in 3Q. Communication Services was down more than 2% in quarter to date.

Two other sectors have struggled in 3Q24, but we believe their weakness has little to do with traditional sector rotation and more to do with the struggles of a superpower. The Energy sector is down about 6% and the Materials sector is down about 2% in 3Q24. The data from China shows an economy struggling to get past its property bubble and reignite industrial and consumer spending. COVID-19 lockdowns dragged on much longer in China than elsewhere, but investors expected growth to snap back as soon as restrictions ended. China lifted its last Zero-COVID lockdown in December 2022, yet the recovery has been tepid. We believe China is suffering from multiple challenges, including many more able competitive nations throughout Asia and rest of world. The biggest challenge for China may be demographic, as the generational toll from the one-child policy continues to impact industrial planning and output, while reducing consumer demand.

Conclusion

We typically regard a market with strong sector breadth as favorable to a narrowly advancing market relying on a few sectors – or, in the 2023-to early-2024 period, on Nvidia and a few adjacent stocks – for the bulk of gains. Still, the impact of the clear growth leaders getting their wings clipped has impacted the year-to-date gain for the overall market. The S&P 500 ended trading on 9/6/24, up 13.4% for the year on a capital appreciation basis, meaningfully down from an 18.8% gain as of 7/16/24.

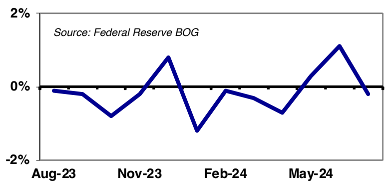
The year 2024 is a few weeks away being three-quarters done, but quite a bit lies ahead. This includes three meetings of the Fed's Open Market Committee (FOMC), which is expected to shift policy to accommodative after two-plus years of restrictive policy. And there is the general election, which occurs one day before the Fed hosts its November FOMC meeting. Performance analysis of the S&P 500 since 1980 suggests that when the market is up in double-digit percentages at the nine-month mark, the stock market tends to finish with a stronger than average fourth quarter as remaining bears capitulate and bulls double-down on winning trades.

History is not a reliable indicator of future performance; but it is often a good indicator. Assuming the Fed's succeeds in parsing out its rate cuts in a manner the market deems timely, we believe the U.S. stock market is poised to finish with recovery strength and maybe more across the fall months.

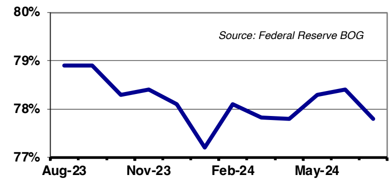
Jim Kelleher, CFA,
Director of Research

ECONOMIC TRADING CALENDAR

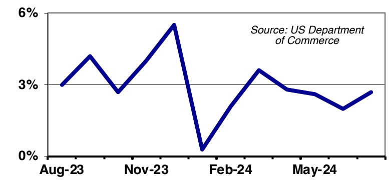
Release: **Industrial Production**
Date: 9/17/2024
Month: August
Previous Report: -0.2%
Argus Estimate: 0.2%
Street Estimate: NA



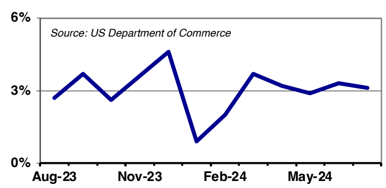
Release: **Capacity Utilization**
Date: 9/17/2024
Month: August
Previous Report: 77.8%
Argus Estimate: 77.6%
Street Estimate: 77.9%



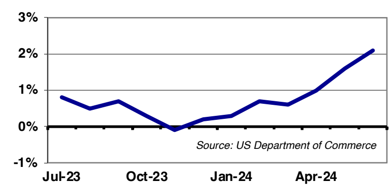
Release: **Retail Sales**
Date: 9/17/2024
Month: August
Previous Report: 2.7%
Argus Estimate: 2.4%
Street Estimate: NA



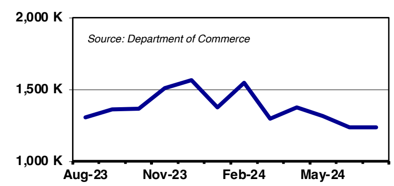
Release: **Retail Sales ex-autos**
Date: 9/17/2024
Month: August
Previous Report: 3.1%
Argus Estimate: 2.6%
Street Estimate: NA



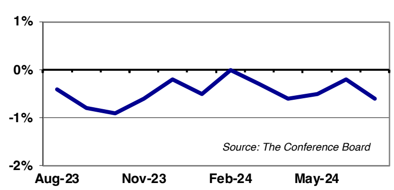
Release: **Business Inventories**
Date: 9/17/2024
Month: July
Previous Report: 2.1%
Argus Estimate: 2.4%
Street Estimate: NA



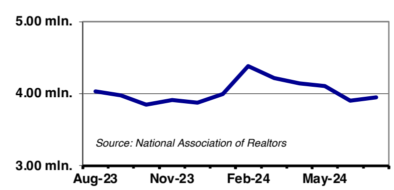
Release: **Housing Starts**
Date: 9/18/2024
Month: August
Previous Report: 1,238 K
Argus Estimate: 1,300 K
Street Estimate: 1,310 K



Release: **Leading Index**
Date: 9/19/2024
Month: August
Previous Report: -0.6%
Argus Estimate: -0.4%
Street Estimate: -0.3%



Release: **Existing Home Sales**
Date: 9/19/2024
Month: August
Previous Report: 3.95 mln.
Argus Estimate: 4.05 mln.
Street Estimate: 3.97 mln.



Previous Week's Releases and Next Week's Releases on next page.

Previous Week's Releases

Date	Release	Month	Previous Report	Argus Estimate	Street Estimate	Actual
9-Sep	Wholesale Inventories	July	**-0.1%**	0.6%	NA	**0.4%**
11-Sep	Consumer Price Index	August	2.9%	2.6%	NA	NA
	CPI ex-Food & Energy	August	3.2%	3.2%	NA	NA
12-Sep	PPI Final Demand	August	2.2%	1.8%	NA	NA
	PPI ex-Food & Energy	August	2.4%	1.9%	NA	NA
13-Sep	Import Price Index	August	1.6%	1.4%	NA	NA
	U. of Michigan Sentiment	September	67.9	69.0	NA	NA

Next Week's Releases

Date	Release	Month	Previous Report	Argus Estimate	Street Estimate	Actual
24-Sep	Consumer Confidence	September	103.3	NA	NA	NA
25-Sep	New Home Sales	August	739 K	NA	NA	NA
26-Sep	GDP Annualized QoQ	2Q "3rd est."	3.0%	NA	NA	NA
	GDP Price Index	2Q "3rd est."	2.5%	NA	NA	NA
	Durable Goods Orders	August	2.9%	NA	NA	NA
27-Sep	PCE Deflator	August	2.5%	NA	NA	NA
	PCE Core Deflator	August	2.6%	NA	NA	NA
	Personal Income	August	4.5%	NA	NA	NA
	Personal Spending	August	5.3%	NA	NA	NA

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