First Trust

Equity Newsletter

3rd Quarter 2024

Is it really different this time? Just say no to FOMO:

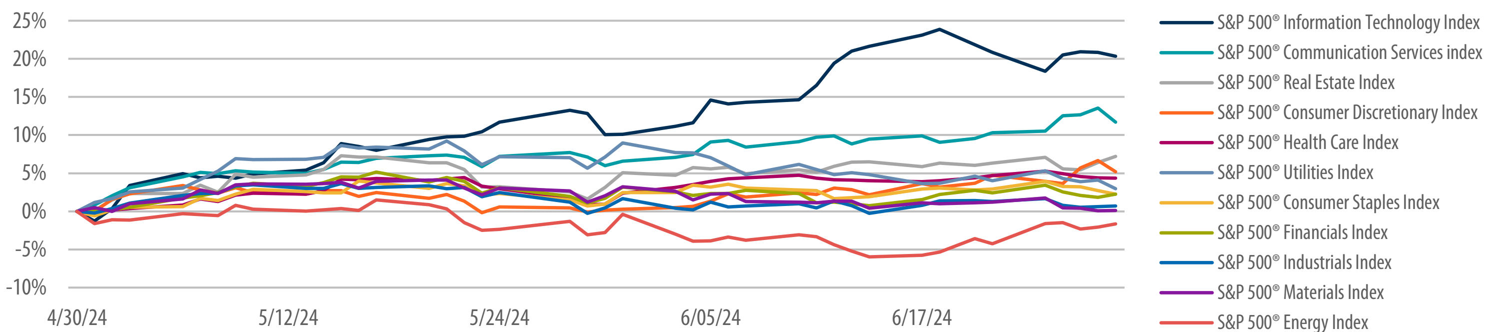
From May 1 until June 30, 2024, the information technology sector soared 20% and now tops the sector ranks with a 28.2% year-to-date return. A massive move in just 8 weeks (Chart 1). What changed in the last two months? It's hard to see anything substantial in earnings, much of the gains came from AI (Artificial Intelligence) related companies and simply increased their already high multiples.

We believe FOMO (fear of missing out) is again a big component of the narrow rally in the last two months. Investors with too little exposure to the Magnificent 7, AI stocks or the information technology sector are tempted to enter the space. They worry about missing out on future gains and falling even further behind their friends. And investors with huge gains in those areas are concerned about selling their winners in case they continue to climb. They don't want to leave the party too soon.

Absent a sharp increase in earnings expectations that, so far, has not accompanied the huge move in information technology in the last two months, the sector has priced in a lot of good news. If you look at 2022, just 18 months ago, all the momentum was going the other way. 2022 was a terrible year for information technology as the sector fell 28% and helped lead the S&P 500 Index down over 18%. The market can shift quickly...in both directions.

Forecasts currently point to a deceleration in the earnings growth rate of information technology earnings and an acceleration of earnings growth from many other sectors as we enter the second half of the year (Chart 2). Staying diversified across the equity markets and not chasing the FOMO trade, in our opinion, will be beneficial in the second half of 2024. **We expect the market to continue to broaden as earnings drive stocks throughout the rest of the year.**

Chart 1: S&P 500 Sector Returns



Source: Bloomberg. Data from 4/30/24-6/28/24. For illustrative purposes only and not indicative of any actual investment. See definitions on page 3.

Chart 2: Estimated Year-Over-Year % Earnings Per Share Growth

Sector	Q1 2024	Q2 2024	Q3 2024	Q4 2024
Communication Services	42%	22%	12%	16%
Consumer Discretionary	21%	5%	2%	17%
Consumer Staples	6%	0%	4%	7%
Energy	(24%)	9%	(4%)	0%
Financials	9%	3%	0%	41%
Health Care	(25%)	19%	16%	25%
Industrials	2%	(6%)	8%	7%
Information Technology	25%	16%	14%	16%
Materials	(21%)	(11%)	7%	23%
Real Estate	2%	(2%)	4%	5%
Utilities	28%	11%	9%	(2%)

Source: Factset. There is no assurance any forecasts will be achieved. See definitions on page 3.

Past performance is no guarantee of future results.

Sector Views

Communication Services
- Digital advertising spending is robust, and stands to benefit from election cycle tailwinds.
- After taking steps to rationalize costs in 2023, internet and streaming firms are investing in AI to increase monetization and improve efficiency.
- Risk of increasing regulation.
- Focus on quality within sector.

Consumer Discretionary
- Low unemployment and strong wages are positives for consumption, but declining job openings and a falling quit rate are early indications that the demand for workers may be slowing.
- Cumulative impact of inflation in recent years remains painful for consumers, especially on the lower end of income distribution.
- Dwindling excess savings, the impact of past monetary tightening, and still elevated interest rates are key risks to sector.
- Increasing e-commerce penetration, automation of warehouses are secular positives to profitability.
- Valuation not particularly attractive, in our view.

Consumer Staples
- Defensive sector but offers what we see as relatively meager growth.
- Consumer staples retailers and grocers face risk of reduced pricing power as inflation slows.

Energy
- We are becoming less positive towards energy than recent quarters, as the potential for a slowing U.S. economy presents risk to future oil market demand and energy equities.
- That said, sector currently provides strong free cash flow generation as exploration & production companies have maintained capital expenditure (capex) discipline.
- OPEC oil production cuts currently remain in place. We see downside risk if this policy changes, or if OPEC coalition fractures and compliance with cuts diminishes.
- Geopolitical risks to oil supplies are re-emerging.

Financials
- Loan growth is mixed, as tightening lending standards and higher interest rates have resulted in less commercial lending and mortgage borrowing, while consumers are increasing credit card utilization; loan growth may accelerate if Fed begins to cut rates.
- Net interest margin (NIM) on loans have been gradually compressing as deposit rates have increased; NIM may stabilize in upcoming quarters if deposit rates have peaked.
- Credit quality remains reasonable, and banks are increasing reserve provisioning for potential future loan losses. That said, any significant rise in unemployment would increase delinquencies.
- Investment banking has been improving after weak 2023.
- While risks remain in the sector, current valuations are attractive, providing a compelling long-horizon opportunity, in our view.

Healthcare
- Provides opportunity to invest in sector with growth potential that is less correlated to the business cycle.
- Healthcare providers and services industry stand to benefit from strong utilization and growth in elective procedures and office visits. Additionally, cost headwinds from contract healthcare workers may moderate over time.

Healthcare (continued)
- Biotechnology stands to benefit from secular innovation, and potentially increasing merger activity as cash rich Big Pharma is motivated to replenish their pipelines, additionally peaking interest rates may provide relief from currently tight funding environment for smaller biotechnology firms.
- Life science tools industry may benefit from progress made towards normalization of excess inventories.
- Relatively weak performance of sector offers valuation opportunity, in our view.

Industrials
- Demand for capex is a secular driver that may benefit sector, as firms are motivated to reshore supply chains and increase productivity in tight labor market.
- Sector stands to benefit from fiscal spending on infrastructure as well as national defense.
- ISM Manufacturing PMI index continues to indicate cyclical weakness in industrial activity, as firms reduce excess inventories.
- Weak international macroeconomic growth may impact industrial exports.
- Defense industry names may benefit from increasing geopolitical risk.
- We believe valuation in sector is reasonable.

Information Technology
- Key innovations such as AI and process automation offer substantial secular growth opportunities.
- We expect IT corporate spending to remain relatively stable in 2024, but a recession would negatively impact IT budgets. Additionally, we believe technology stocks are still too expensive relative to value stocks.
- Prefer quality within the sector, particularly firms with strong corporate balance sheets and reasonable valuation.
- Lower rates may improve access to risk capital for cloud software firms, while implementation of AI features within industry may improve value-added to clients.
- Key semiconductor (semi) end markets such as AI, high bandwidth memory, and vehicle electrification stand to benefit from secular tailwinds. Valuation is a risk for some well-known semis currently benefiting from investor enthusiasm towards AI, although earnings have been robust. Due to geopolitical tensions with China, increased export restrictions are a risk to the industry.

Materials
- On a cyclical basis, international economic weakness, especially weak Chinese construction, remains a key negative. Meanwhile, any emerging slowdown in U.S. economic growth would weigh on the sector as well.
- Incremental demand from clean energy grid infrastructure and electric vehicle transition is a secular positive.
- Materials sector stands to benefit over time from policies and investment designed to reshore supply chains amid geopolitical tensions.

Utilities
- Low growth sector but defensive, dividend paying nature is more attractive in times of macroeconomic uncertainty.
- Interest rate sensitivity less of a concern post Federal Reserve tightening cycle.
- Data center power consumption is a source of secular growth in electricity demand.

Real Estate Investment Trusts (REITs)
- Higher yielding sector and has been sensitive to rising interest rates, stands to benefit if rates have peaked.
- Data center REITs may provide strong secular opportunity, but any IT spending slowdown would impact the industry.

International Views

DEVELOPED MARKETS

Europe

- Inexpensive valuation in comparison to US stocks, but no clear near-term catalyst.
- Economic growth is improving but remains sluggish. Uneven industrial activity and soft exports are key areas of weakness.
- European Central Bank began easing policy in June as inflation continues to gradually soften; further rate cuts may occur later this year.
- Any re-acceleration of growth in China potentially stimulates demand for Europe's exports, but Chinese growth has recently been disappointing.
- Geopolitical risk from increased influence of populism on national politics within Eurozone, and Russia's war on Ukraine.

United Kingdom

- Manufacturing PMI surveys point to modest improvement in industrial activity.
- Stubborn core inflation has so far delayed the Bank of England from beginning to cut interest rate policy.
- Fiscal policy less supportive in 2024.
- Inexpensive valuation in comparison to U.S. stocks.

Japan

- Robust wage growth and improving near term domestic demand prospects, driving inflation and corporate pricing power.
- Rising wages and core inflation has led the Bank of Japan to embark on a monetary tightening cycle, potentially lifting the Yen.
- Japan stands to benefit from "friend-shoring" and increased secular demand for advanced technology exports such as automation equipment.
- Structurally low return on equities, although some corporate governance reforms have been implemented by the Tokyo Stock Exchange .
- Challenging demographics limit long-run potential economic growth.

Australia

- Commodity exporter which stands to benefit from higher commodity prices.
- Exports of raw materials to China key driver of economic growth.

Canada

- Energy and metals exporter which stands to benefit from higher oil prices and commodity inflation and would suffer from a U.S. recession.

EMERGING MARKETS

Emerging Asia

- Despite monetary easing and limited fiscal policy stimulus, recent Chinese economic growth remains underwhelming, raising the possibility that more stimulus may be needed to markedly improve economic conditions. The beleaguered Chinese property market continues to weigh on fixed asset investment and is a source of downside risk to growth, while exports have been improving.
- Rising geopolitical tensions between U.S. and China present risk to supply chains for key technologies and materials, and complicate U.S. firms' decisions to invest in China.
- India is experiencing robust economic growth, driven by strong consumption trends and infrastructure investment; we believe valuation is a risk.

Latin America

- Mexican economy stands to benefit from exports to U.S., but would be negatively impacted by US recession. Over time, supply chain diversification away from China may be a structural tailwind to exports.
- Populist election results impact sentiment towards the region, Mexico is recent example.
- Brazil and Latin America overall are sensitive to demand for commodity exports, and commodity price inflation.
- Multiple central banks have begun policy easing in the region, including the central banks of Brazil, Colombia, and Chile. That said, uncertainty about when the U.S. Federal Reserve will ease policy may limit scope for Latin American central banks to ease further without exacerbating currency weakness.

Definitions

The S&P 500 Index is an unmanaged index of 500 companies used to measure large-cap U.S. stock market performance. S&P 500 Sector Indices measure segments of the U.S. stock market as defined by GICS®. Earnings per share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock. The resulting number serves as an indicator of a company's profitability. EPS growth illustrates the growth of earnings per share over time.

References to specific securities should not be construed as a recommendation to buy or sell and should not be assumed profitable.

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