Market Commentary Blog

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2/25/25

Defensive Sectors and Elevated Inflation

S&P 500 Defensive Sectors vs. S&P 500 Index: Total Returns

(Years In Which Trailing 12-Month CPI ≥ 3.0%)

Year	CPI Rate	S&P 500	S&P 500 Health Care	S&P 500 Consumer Staples	S&P 500 Utilities
2025 (2/21)	3.0% (1/31)	2.42%	6.53%	6.50%	6.06%
2023	3.1%	26.26%	2.06%	0.52%	-7.08%
2022	6.5%	-18.13%	-1.95%	-0.62%	1.56%
2021	7.0%	28.71%	26.13%	18.63%	17.67%
2011	3.0%	2.11%	12.73%	13.99%	19.91%
2007	4.1%	5.49%	7.15%	14.18%	19.38%
2005	3.4%	4.91%	6.46%	3.58%	16.84%
2004	3.3%	10.88%	1.68%	8.16%	24.28%
2000	3.4%	-9.10%	37.05%	16.78%	57.19%
1996	3.3%	22.96%	21.04%	25.90%	5.68%
1991	3.1%	30.47%	53.69%	41.66%	23.89%
1990	6.1%	-3.10%	17.29%	15.32%	-0.63%

Source: Bloomberg. **Past Performance is no guarantee of future results.**

View from the Observation Deck

Given their non-cyclical nature, defensive sectors may offer better performance than their counterparts during periods of heightened volatility. For today's post (and the previous posts in this series), we set out to determine if that outperformance also exists during periods of elevated inflation. The table above begins in 1990 and includes calendar years where inflation, as measured by the Consumer Price Index (CPI), increased by 3.0% or more on a trailing 12-month basis. We chose 3.0% as our baseline because the rate of change in the CPI averaged 3.0% from 1926-2024, according to data from the Bureau of Labor Statistics. We then selected three defensive sectors (Health Care, Consumer Staples, and Utilities) and compared their total returns to those of the S&P 500 Index over those periods.

First, a word about last year.

In 2024, the pace of price increases (as measured by the 12-month change in the CPI) slowed from 3.5% at the end of March, to 2.4% in September before ending the year at 2.9%, just below our 3.0% target for this post. Inflation's end-of-year reacceleration dampened expectations for steep rate cuts in 2025. As of 2/21/25, the federal funds rate futures market revealed that investors anticipate the federal funds rate will fall to just 4.32% in March 2025. On 9/30/24, the same futures market implied a 3.55% federal funds rate at the close of the same month. For comparison, the federal funds target rate (upper bound) currently stands at 4.50%.

The final observations for 2024 were as follows (December trailing 12-month CPI and calendar year total returns):

- **CPI Rate:** 2.9%
- **S&P 500:** 25.00%
- **S&P 500 Health Care:** 2.58%
- **S&P 500 Consumer Staples:** 14.87%
- **S&P 500 Utilities:** 23.43%

Of the eleven time frames in the table where inflation increased by 3.0% or more on a trailing 12-month basis, there were only two (2021 and 2023) where the S&P 500 Index outperformed each of the Health Care, Consumer Staples, and Utilities sectors.

Don't fight the Fed.

As mentioned above, it is unlikely that interest rates will decline as steeply as previously expected in 2025. With that in mind, the rapid deterioration in the implied probability of rate cuts, combined with the outperformance of the defensive sectors highlighted in today's table begs the question: are investors beginning to hedge against rate hikes this year? We can't know, but should the pace of rising prices continue upwards, the Fed may find itself grappling with that decision.

Takeaway

As today's table reveals, the S&P 500 Health Care, Consumer Staples, and Utilities Indices each outperformed the broader S&P 500 Index year-to-date (YTD) thru 2/21/25. Inflation, as measured by the 12-month change in the CPI, regained momentum in Q4'24, increasing from its most recent low of 2.4% at the end of September 2024 to 3.0% by the end of January 2025. In response, investors appear to be positioning themselves defensively. Of the 11 sectors that comprise the broader S&P 500 Index, the Health Care, Consumer Staples, and Utilities Indices are the top performers YTD, with total returns of 6.53%, 6.50%, and 6.06%, respectively, thru 2/21. For comparison, the three worst sectors and their total returns over the period were as follows: Industrials (2.23%), Information Technology (-0.19%), and Consumer Discretionary (-3.35%). Notably, expectations surrounding rate cuts diminished significantly in recent months. Investors currently expect fewer than two rate cuts in 2025 (as of 2/21/24), down from more than seven on 9/30/24.