MILL STREET RESEARCH

US SECTOR STRATEGY

October 9, 2023

Sam Burns, CFA Chief Strategist

Sticking with positions, including Energy underweight

- We maintain our sector allocation positions this month, while noting some shifts at the industry level. Rising bond yields have pressured equities in recent weeks, but this has produced oversold conditions in both stocks and bonds.

- We remain overweight in Technology, Communications Services (mostly the largest caps), Consumer Discretionary, Industrials, and Consumer Staples. Revisions are mostly above-average in these sectors and they are higher-beta/cyclical areas that align with our overweight stance on equities.

- We remain underweight in Materials, Utilities, and Energy. We have maintained our underweight in Energy despite its high current rankings based on the trends we see in the underlying energy commodities (p. 8). Utilities are still an underweight despite mixed revisions trends due to their interest rate sensitivity and low market beta (p. 9).

- The industry ranks show continued strength in the building/ construction theme (both commercial building and housing). It also shows some surprising strength in selected areas of Real Estate, including Office REITs. Meanwhile, several transportation-related industries are weak right now on higher fuel prices and slowing demand in some areas.

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US Sector Outlook

Key points from our indicators:

- Analyst revisions activity overall has slipped somewhat since last month as we approach Q3 earnings reporting season. Rising rates and energy price volatility are the latest macro drivers to raise concerns and drive rotation among industries. The Fed remains a worry, but our view is that the FOMC will find ways to avoid further rate hikes while keeping up its hawkish rhetoric. Renewed violence in the Middle East may cause more market volatility near-term.

- We maintain our sector allocations for now as we await Q3 results. Technology and Communication Services remain overweights, though mostly in the mega-caps for Communication Services. We also remain overweight in Consumer Discretionary, Industrials, and Consumer Staples.

- We maintain our underweight in Energy despite its high ranking based on the trends we see in the underlying energy commodity indicators, as discussed more on page 8. We also maintain our underweight in Materials, which has been diverging heavily from Energy amid weak prices for non-petroleum commodities and the higher input costs of energy.

- We also remain underweight in Utilities, which have lagged lately despite mixed revisions readings as the macro influence of rising interest rates is weighing heavily on the rate-sensitive sector. We discuss this further on page 9. We are neutral on Real Estate but see relative strength in selected industries in the sector, and the same is true in Financials.

- The industry ranking (p. 3) shows the housing/building/construction theme still intact, led by Building Products, Household Durables, Trading Companies & Distributors, and Construction & Engineering all among the top eight ranked industries. Notably, Office REITs has taken the top rank, showing sharp improvement from earlier severe negativity, along with Industrial REITs and Residential REITs. Beverages and Household Products are the leading area with Staples, while Insurance is still the strongest area in Financials, with Mortgage REITs showing signs of improvement. Higher oil prices and labor unrest are hurting transportation-related industries.

EXHIBIT 1: Energy is at the top of the ranks, but macro trends argue against an overweight. Industrials remains strong, Real Estate has improved. Health Care and Materials remain weak.

US Sector Aggregate MAER Rankings 6 Oct 2023

Sector	Mean Rank	Median Rank	Combined Rank	Rank 1M Ago	Rank 2M Ago	Revisions Rank	Price Rank	Valuation Rank
Energy	68.6	72.8	1	1	5	1	1	3
Industrials	54.4	58.2	2	4	2	3	2	9
Real Estate	53.8	56.1	3	6	7	9	3	2
Financials	52.3	50.5	4	3	10	10	4	1
Cons. Discretionary	51.6	51.4	5	2	6	6	6	5
Utilities	48.4	51.6	6	7	3	5	11	4
Cons. Staples	48.5	50.5	7	5	1	8	7	6
Technology	46.8	45.8	8	8	4	2	8	10
Comm. Services	43.4	42.4	9	10	9	7	10	8
Materials	43.3	44.2	10	11	11	11	5	7
Health Care	41.5	36.5	11	9	8	4	9	11

Source: Mill Street Research, Factset

Industry Ranking

Exhibit 8 below shows the full ranking of all US industries with sufficient constituents to be ranked. It includes rankings for each of the three major components of the MAER stock ranking (Revisions, Price, and Valuation) to better identify the drivers of each industry's ranking. The ***US Sector & Industry Chartbook*** has charts for all sectors and industries.

Key highlights of the Industry Ranking are described on the following page.

EXHIBIT 2: Building/construction theme still strong in the ranks, transportation-related areas are weak

US Industry Aggregate MAER Rankings 6 Oct 2023

Industry	Sector	Mean Rank	Median Rank	Combined Rank	Rank 1M Ago	Rank 2M Ago	Revisions Rank	Price Rank	Valuation Rank
Office REITs	Real Estate	77.7	83.0	1	8	53	24	2	1
Building Products	Industrials	75.4	82.5	2	1	2	1	3	40
Energy Equipment & Services	Energy	72.3	76.3	3	16	34	30	1	7
Household Durables	Cons. Discretionary	65.8	78.0	4	4	4	6	10	17
Trading Companies & Distributors	Industrials	67.9	68.6	5	10	10	10	5	28
Oil, Gas & Consumable Fuels	Energy	67.4	69.5	6	6	30	16	7	16
Beverages	Cons. Staples	66.2	72.1	7	7	9	2	13	38
Construction & Engineering	Industrials	62.2	66.7	8	12	3	14	6	53
Insurance	Financials	61.3	68.4	9	9	16	9	26	23
Diversified Consumer Services	Cons. Discretionary	62.0	64.6	10	15	42	3	31	29
Household Products	Cons. Staples	60.5	68.2	11	5	1	7	22	45
Industrial REITs	Real Estate	62.8	61.5	12	27	5	5	15	44
Residential REITs	Real Estate	60.9	64.7	13	17	25	23	23	13
Mortgage Real Estate Investment Trus	Financials	59.4	67.7	14	42	56	51	4	4
Diversified REITs	Real Estate	61.9	61.5	15	2	29	39	16	2
Retail REITs	Real Estate	60.0	63.1	16	19	17	40	9	8
Financial Services	Financials	59.7	62.5	17	14	14	25	20	18
Machinery	Industrials	59.4	62.8	18	18	6	12	11	46
Broadline Retail	Cons. Discretionary	58.8	57.3	19	3	46	8	47	12
Commercial Services & Supplies	Industrials	57.0	58.3	20	39	38	15	12	56
Electric Utilities	Utilities	52.6	54.3	21	28	20	22	57	11
Software	Technology	52.0	56.4	22	20	8	4	49	58
Automobile Components	Cons. Discretionary	52.0	53.7	23	21	31	17	30	54
Technology Hardware, Storage & Perip	Technology	51.5	54.9	24	37	21	31	14	55
Aerospace & Defense	Industrials	51.6	51.5	25	22	11	19	21	62
Specialty Retail	Cons. Discretionary	50.1	52.3	26	26	52	37	34	31
Multi-Utilities	Utilities	49.6	53.5	27	23	15	36	61	10
Electrical Equipment	Industrials	50.7	50.2	28	52	35	21	27	64
IT Services	Technology	50.5	49.7	29	35	24	11	50	52
Capital Markets	Financials	50.8	46.4	30	11	13	44	17	19
Health Care REITs	Real Estate	50.1	49.6	31	30	33	50	25	9
Consumer Finance	Financials	48.7	49.8	32	47	54	48	28	15
Interactive Media & Services	Comm. Services	45.4	53.3	33	43	19	27	59	51
Food Products	Cons. Staples	46.2	50.5	34	25	18	38	53	30
Hotels, Restaurants & Leisure	Cons. Discretionary	50.7	43.7	35	29	22	33	42	20
Health Care Providers & Services	Health Care	49.2	47.5	36	13	28	18	44	47
Personal Care Products	Cons. Staples	46.9	49.5	37	60	7	28	54	42
Professional Services	Industrials	47.7	46.7	38	45	45	35	41	43
Containers & Packaging	Materials	46.4	48.4	39	55	63	45	33	26
Pharmaceuticals	Health Care	48.9	40.9	40	31	50	29	32	49
Hotel & Resort REITs	Real Estate	40.9	50.0	41	46	47	60	48	3
Entertainment	Comm. Services	45.3	44.8	42	24	26	13	65	57
Banks	Financials	45.9	42.2	43	40	64	59	18	5
Independent Power and Renewable Elec	Utilities	47.4	35.4	44	58	37	34	40	35
Metals & Mining	Materials	42.3	44.2	45	51	39	46	45	32
Health Care Equipment & Supplies	Health Care	43.5	40.1	46	36	23	20	55	61
Electronic Equipment, Instruments &	Technology	43.5	39.9	47	44	40	43	24	60
Textiles, Apparel & Luxury Goods	Cons. Discretionary	43.6	37.0	48	33	32	47	64	6
Media	Comm. Services	41.6	39.2	49	48	55	42	56	25
Diversified Telecommunication Servic	Comm. Services	36.0	45.3	50	59	62	55	62	37
Gas Utilities	Utilities	38.1	39.7	51	41	36	49	63	21
Biotechnology	Health Care	40.1	34.4	52	50	44	26	38	66
Communications Equipment	Technology	37.4	39.5	53	65	48	52	58	24
Chemicals	Materials	39.9	32.2	54	63	60	54	29	39
Semiconductors & Semiconductor Equip	Technology	38.3	34.5	55	54	43	41	43	63
Real Estate Management & Development	Real Estate	40.2	22.6	56	34	58	58	8	41
Automobiles	Cons. Discretionary	37.7	35.3	57	32	27	56	39	34
Ground Transportation	Industrials	40.0	25.0	58	49	61	57	19	50
Consumer Staples Distribution & Reta	Cons. Staples	38.3	28.6	59	57	57	53	51	22
Health Care Technology	Health Care	36.3	29.7	60	56	51	32	66	59
Specialized REITs	Real Estate	36.2	19.9	61	61	41	63	35	27
Leisure Products	Cons. Discretionary	33.1	19.3	62	64	59	62	52	36
Air Freight & Logistics	Industrials	33.7	8.8	63	62	65	61	46	48
Marine Transportation	Industrials	33.6	17.1	64	38	49	65	37	33
Passenger Airlines	Industrials	27.1	19.1	65	53	12	66	36	14
Life Sciences Tools & Services	Health Care	22.0	7.8	66	66	66	64	60	65

Industries are equal-weighted aggregates based on the US MAER universe constituents within each GICS industry. Industries must have at least six constituents to be ranked.

The MAER universe includes all stocks with at least: 3 estimates for FY1 and FY2; $200 million market cap; $2 million/day average trading value; 6 months of valid history (24 months to be ranked)

Source: Mill Street Research, Factset

Industry Ranking

Exhibit 8 on the previous page shows the current US industry ranking based on the bottom-up aggregation of the MAER stock rankings for all stocks in our broad US MAER universe.

Here we highlight some of the highest ranked or most improved industries and some of the highest ranked stocks within them. We also flag some low-ranked industries that may be candidates for underweights.

- Top-ranked industries and top-ranked stocks within those industries include:

  Office REITs: Boston Properties, Inc. (BXP), Kilroy Realty Corporation (KRC), Easterly Government Properties Inc (DEA)

  Building Products: American Woodmark Corporation (AMWD), Owens Corning (OC), Gibraltar Industries, Inc. (ROCK), Masco Corporation (MAS)

  Energy Equipment & Services: Helix Energy Solutions Group, Inc. (HLX), Oceaneering International, Inc. (OII), NOV Inc. (NOV)

  Household Durables: Toll Brothers, Inc. (TOL), PulteGroup, Inc. (PHM), M.D.C. Holdings, Inc. (MDC), Taylor Morrison Home Corporation (TMHC)

  Trading Companies & Distributors: FTAI Aviation Ltd. (FTAI), Boise Cascade Co. (BCC), AerCap Holdings NV (AER), Beacon Roofing Supply, Inc. (BECN)

  Oil, Gas & Consumable Fuels: CVR Energy, Inc. (CVI), Par Pacific Holdings Inc (PARR), Civitas Resources, Inc. (CIVI), PBF Energy, Inc. Class A (PBF)

  Beverages: MGP Ingredients, Inc. (MGPI), Molson Coors Beverage Company Class B (TAP), Constellation Brands, Inc. Class A (STZ), Celsius Holdings, Inc. (CELH)

  Construction & Engineering: Fluor Corporation (FLR), Construction Partners, Inc. Class A (ROAD), WillScot Mobile Mini Holdings Corp. Class A (WSC), Arcosa, Inc. (ACA)

- The building/construction theme remains strong, as the top eight industries include Building Products, Household Durables, Trading Companies & Distributors, and Construction & Engineering.
- Both Energy industries are highly ranked, and some companies have seen improved revisions activity and are still screening as cheap, but our view of the macro commodity backdrop suggests these improvements may not be sustainable and thus we have avoided chasing the Energy industries in these particular conditions.
- As noted last month, some (but not all) REIT industries have improved, with Office REITs (somewhat shockingly) taking the top ranking this month. Industrial REITs, Residential REITs, and Mortgage REITs (in Financials) have all also improved.
- The low end of the industry ranks shows several transportation-related industries being hurt by higher fuel prices, slower demand, and in some cases labor issues: Passenger Airlines, Marine Transportation, Air Freight & Logistics, Ground Transportation, and Automobiles. Life Sciences Tools & Services and Health Care Technology also remain weak, along with Leisure Products and Specialized REITs.

S&P 500 Sector Allocations

Below are our current allocation recommendations for the widely-used cap-weighted S&P 500 sectors and their corresponding ETFs. The views below are expressed in two ways to accommodate the differences in implementation and benchmarks among clients. Clients who are managing funds benchmarked to the S&P 500 (or a similar cap-weighted US large-cap index) and have constraints on deviations from benchmark sector weightings can focus on the first three columns for **Constrained Allocation**. The recommendations are made relative to the benchmark sector weightings and are generally limited to +/- 3% for sectors (typically +/- 5-6% for the broader style groups), since the smallest sectors have weights of only about 3% (and we assume a long-only constraint).

The **Unconstrained Allocation** figures in the three columns to the right in the table are based on the assumption that managers are not constrained to benchmark weights and treat all 11 sectors as equal potential holdings, and thus consider the benchmark to be an equal-weighted basket of the 11 sector ETFs. These allocations are allowed to deviate more substantially from the baseline weights and may include zero weights in some sectors at times.

EXHIBIT 3: We keep our sector allocations intact this month: overweight in Technology, Communication Services, Consumer Discretionary, Industrials, and Consumer Staples; underweight Energy, Materials, Utilities

Sector (ETF)	S&P 500 Weight	Constrained Allocation	Over/Under	EW Benchmark	Unconstrained Allocation	Over/ Under
Growth	***50.6***	***52.6***	***2.0%***	***27.3***	***33.3***	***6%***
Technology (XLK)	28.1	29.1	1.0%	9.1	12.1	3%
Health Care (XLV)	13.4	13.4	0.0%	9.1	9.1	0%
Comm. Svcs. (XLC)	9.1	10.1	1.0%	9.1	12.1	3%
Value	***19.6***	***15.6***	***-4.0%***	***27.3***	***15.3***	***-12%***
Financials (XLF)	12.7	12.7	0.0%	9.1	9.1	0%
Energy (XLE)	4.45	2.45	-2.0%	9.1	3.1	-6%
Materials (XLB)	2.42	0.42	-2.0%	9.1	3.1	-6%
Cyclical	***18.9***	***21.9***	***3.0%***	***18.2***	***27.2***	***9%***
Cons. Discretionary (XLY)	10.6	12.6	2.0%	9.1	15.1	6%
Industrials (XLI)	8.3	9.3	1.0%	9.1	12.1	3%
Defensive	***11.0***	***10.0***	***-1.0%***	***27.3***	***24.3***	***-3%***
Cons. Staples (XLP)	6.33	7.33	1.0%	9.1	12.1	3%
Utilities (XLU)	2.33	0.33	-2.0%	9.1	3.1	-6%
Real Estate (XLRE)	2.33	2.33	0.0%	9.1	9.1	0%

Source: Mill Street Research, Factset, Bloomberg

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Tech and Industrials still lead over Materials and Real Estate amid narrower sector revisions dispersion

Our updated table of revisions breadth at right shows the **net proportion of positive versus negative estimate revisions** by analysts within each US sector, with each stock equally weighted.

Estimate revisions in the US have been quieter as analysts await Q3 earnings reports due to start soon.

And the table at right shows that dispersion among revisions readings across sectors is relatively narrow now, with many sectors showing similar readings not far from zero.

The key message remains that Technology and Industrials are holding up best on revisions, while Materials and Real Estate are weakest.

The Energy sector has been improving thanks to higher oil prices, but is not as strong as one might expect due to cross-currents within the broader energy market (more on p. 8), and oil prices have most recently been pulling back from their latest peaks.

Real Estate's relatively weak aggregate reading hides some signs of improvement within selected industries within the sector, like Office REITs.

The cap-weighted aggregated sector MAER rankings for the S&P 500 constituents (lower table, right) look notably different than the equal-weighted sector revisions indicators above. Energy and Communication Services are the leaders, thanks to their heavy concentration and higher rankings in the two big names in each sector.

Conversely, the S&P Technology sector is weakest despite good equal-weighted revisions thanks to weakness in its two dominant mega-caps.

These divergences between the top two stocks in certain sectors and the rest of the sector can always occur but are exceptionally wide right now. Valuations are also a significant influence on both Energy and Technology in the ranks.

EXHIBIT 4: Equal-weighted sector revisions breadth again shows Technology and Industrials leading, and Materials and Real Estate lagging. The aggregate S&P 500 sector MAER rankings again look different due to weightings and valuations.

US Sector Avg. Revisions Breadth
06 Oct 2023

Sector	Current	1m Ago	3m Ago	6m Ago
Technology	10.3	13.5	12.2	6.7
Industrials	8.5	10.7	15.2	-6.8
Cons. Discretionary	4.5	8.8	4.2	-10.9
Energy	3.4	3.4	-14.2	-15.2
Cons. Staples	2.4	6.5	9.7	-11.3
Health Care	1.9	4.8	4.5	-10.9
Utilities	1.4	7.6	1.7	-16.6
Comm. Services	-6.7	-5.5	1.9	-12.5
Financials	-6.9	-2.1	-22.5	-30.4
Real Estate	-14.1	-6.3	-6.8	-32.6
Materials	-23.7	-23.3	-10.4	-23.0

Sector ETF Aggregate MAER Rankings
06 Oct 2023

Sector (ETF)	Aggregate MAER Rank	1 Month Ago	2 Months Ago
Energy (XLE)	76.2	63.4	48.4
Comm. Services (XLC)	62.0	74.5	76.2
Financials (XLF)	58.0	60.2	54.0
Industrials (XLI)	55.6	53.8	55.7
Cons. Discretionary (XLY)	55.2	62.3	58.1
Materials (XLB)	53.3	47.6	55.7
Cons. Staples (XLP)	47.3	51.1	58.9
Real Estate (XLRE)	46.4	43.9	45.2
Utilities (XLU)	42.5	41.4	49.2
Technology (XLK)	36.5	36.4	46.3
Health Care (XLV)	35.0	44.4	43.6

Source: Mill Street Research, Factset

Growth and Cyclical sectors still strongest style groups

Reviewing our revisions indicators calculated on a **cap-weighted basis**, we continue to see significant differences compared to the equal-weighted metrics.

The mega-cap influence remains strong in certain sectors, causing wide differences between cap-weighted and equal-weighted revisions readings.

Communication Services is again a key example. Strength in META, GOOGL, and CMCSA is outweighing weakness in many of the smaller names in the sector that are hampering the average MAER rank for the sector (p. 2).

Consumer Discretionary remains strong on this metric, led by AMZN and HD, followed by Consumer Staples. Industrials, Financials, and Technology are all clustered together at solidly positive readings.

Energy is somewhat below average despite higher oil prices, while Real Estate has turned back down again along with Health Care.

Note the new table below showing revisions breadth among the top 20 mega-caps within the S&P 500 and highlighting the strongest right now.

EXHIBIT 5: Growth and Cyclical sectors continue to lead, with cap-weighted readings much stronger than equal-weighted readings again.

US Sector-based Style
Average Revisions Breadth

Style Category	Avg CW Sector Revisions Breadth	Avg EW Sector Revisions Breadth
Cyclical	23.9	6.5
Growth	21.3	1.8
Value	6.8	-9.1
Defensive	3.1	-3.4

US CW Sector Avg. Revisions Breadth
06 Oct 2023

Sector	Current	1m Ago	3m Ago	6m Ago
Comm. Services	53.1	60.6	37.0	-2.8
Cons. Discretionary	31.6	42.3	13.2	-8.5
Cons. Staples	19.3	28.0	19.1	-6.5
Technology	17.5	25.7	26.9	-12.9
Industrials	16.2	19.5	18.4	1.4
Financials	13.2	21.9	-7.6	-11.1
Energy	5.9	1.8	-9.9	-20.6
Utilities	1.5	3.5	1.3	-16.8
Materials	1.4	2.0	9.2	-9.9
Health Care	-6.9	-0.3	6.4	-8.7
Real Estate	-11.5	-2.1	1.3	-21.6

Revisions Breadth for Top S&P 500 Weights
6 Oct 2023

TICKER	NAME	SECTOR	REVISIONS BREADTH	INDEX WEIGHT (%)
AAPL	Apple Inc.	Technology	-10	7.1
MSFT	Microsoft Corporation	Technology	7	6.5
GOOGL	**Alphabet Inc. Class A**	**Comm. Services**	**80**	**4.0**
AMZN	**Amazon.com, Inc.**	**Cons. Discretionary**	**80**	**3.2**
NVDA	**NVIDIA Corporation**	**Technology**	**85**	**3.0**
TSLA	Tesla, Inc.	Cons. Discretionary	-46	1.9
META	**Meta Platforms Inc. Cl**	**Comm. Services**	**83**	**1.9**
BRK.B	**Berkshire Hathaway Inc**	**Financials**	**81**	**1.7**
XOM	Exxon Mobil Corporatio	Energy	-16	1.3
UNH	UnitedHealth Group Inc	Health Care	-13	1.3
JPM	**JPMorgan Chase & Co.**	**Financials**	**80**	**1.2**
LLY	Eli Lilly and Company	Health Care	32	1.2
JNJ	Johnson & Johnson	Health Care	-93	1.0
V	Visa Inc. Class A	Financials	13	1.0
AVGO	Broadcom Inc.	Technology	34	1.0
PG	Procter & Gamble Compa	Cons. Staples	18	1.0
MA	Mastercard Incorporate	Financials	-6	0.9
HD	**Home Depot, Inc.**	**Cons. Discretionary**	**59**	**0.9**
CVX	Chevron Corporation	Energy	48	0.8
ABBV	AbbVie, Inc.	Health Care	10	0.7

The table at left shows the 20 largest weights in the S&P 500 along with each stock's sector and current revisions breadth reading.

Stocks highlighted in bold have the strongest revisions breadth within the top 20, and are thus likely among the drivers of the cap-weighted revisions for their sectors and the overall index.

Source: Mill Street Research, Factset, Bloomberg

Still not chasing Energy stocks amid mixed trends in energy commodities

Despite outperformance since mid-July and improved rankings, we maintain our intermediate-term underweight stance in Energy. We expect recent outperformance to ease before too long, as it seems to have started doing already.

Energy stocks have been outperforming on higher crude prices caused by OPEC supply cuts.

But other indicators are much less supportive, and analyst activity has been uninspiring given the move in crude. And most recently, crude has already reversed sharply from its latest peak. Some key points:

1) Crude prices have risen due to aggressive OPEC supply cuts, but natural gas prices (which have no global cartel, and are a growing part of the energy industry's output) have not moved much and remain quite low.

2) Refining margins, which had been quite high, have recently plunged to their lowest in 18 months amid weaker gasoline demand, providing a headwind to profitability for refiners.

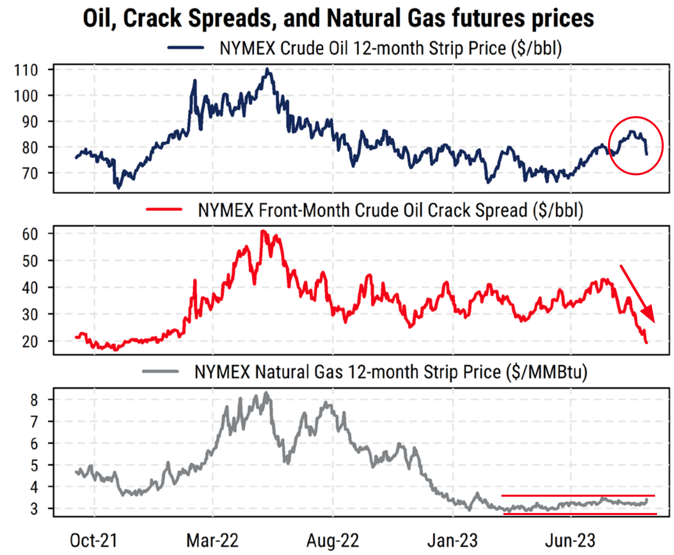
3) The crude oil futures curve remains heavily backwardated. That is, long-term prices are much lower than current prices. This makes long-term investments less attractive to oil companies and investors than current oil prices might make it seem.

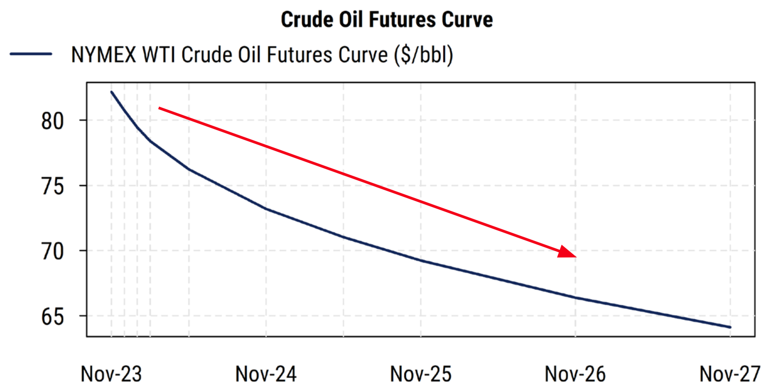
4) Earnings revisions for the cap-weighted global energy sector (since oil is a global commodity) have improved but thus far been unimpressive given the rise in crude prices. Even after three months of rising crude prices, revisions are only about average globally, and only at or slightly above average in the US.

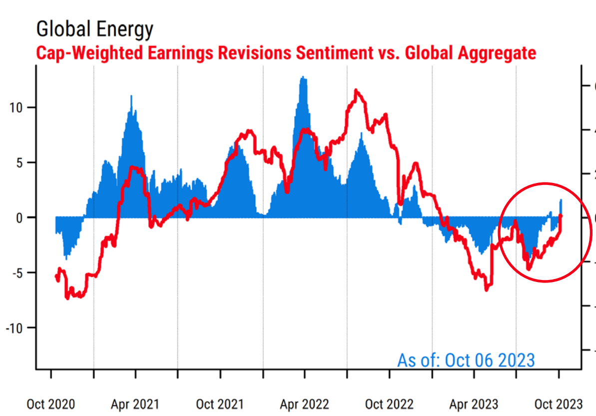
5) Other non-petroleum commodities remain in downtrends overall, interest rates have risen globally, and China's weakness remains a drag on global demand.

Cheap valuations and recent outperformance are the key reasons for the Energy sector's higher rankings recently (though valuations have deteriorated from earlier extreme levels), but without clear signs of sustainable fundamental support and a very cloudy long-term outlook for fossil fuels, we think chasing Energy stocks here looks risky and we remain underweight.

EXHIBIT 6: Several energy market indicators are diverging from the recent trend in crude, keeping us underweight







Source: Mill Street Research, Factset, Bloomberg

Utilities getting hit (as usual) as bond yields rise

We have been underweight Utilities since January, which has been consistent with our underweight position in bonds and our overweight in stocks.

Notably, however, relative earnings estimate revisions have not been especially weak lately in the Utilities sector (red line, top chart at right), after significantly weak readings earlier in the year.

But **the sector has nonetheless underperformed the market significantly, and this reflects its low equity market beta and its sensitivity to movements in bond yields.**

Unlike the Technology sector that many people believe to be hurt by higher yields (historically, it has not, including this year), the Utilities sector has long been quite sensitive to movements in bond yields. This is generally ascribed to two features of the sector:

1) the higher debt levels carried by many utilities, which make earnings more sensitive to interest costs,

2) the sector's tendency to be an income-oriented holding, paying high dividend yields but having low growth rates. Thus income-seeking investors may shift away from Utilities toward fixed income when rates rise.

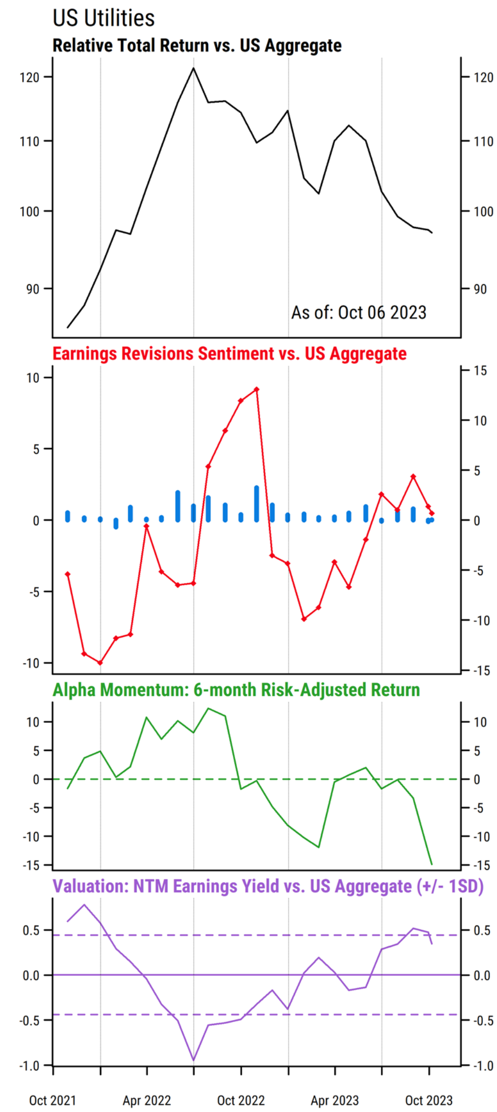
We have updated our basic study comparing the monthly relative returns of the S&P 500 Utilities sector (versus the S&P 500) against the monthly return of the ICE Long-term (10yr+) Treasury bond index (bottom chart, right).

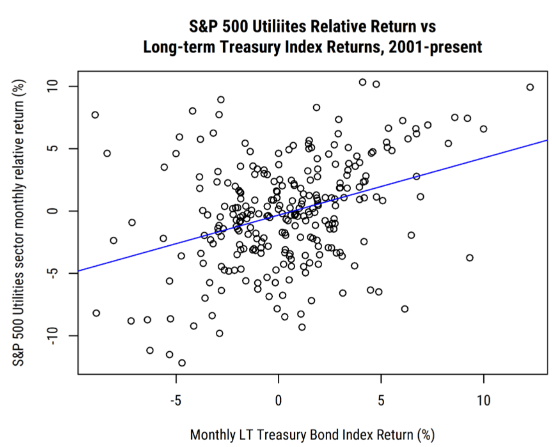
It shows **the clear positive relationship between bond returns and Utilities sector relative returns**, so that in months when bond prices rise (yields fall), Utilities have tended to outperform, and vice versa.

Since 2001, those months with positive bond returns coincided with an average Utilities sector relative return of +0.72%. Months when bond returns were negative coincided with an average relative return for Utilities of -1.21%. So the big rise in bond yields (fall in bond prices) recently can easily explain the movements in Utilities, and such big moves can overwhelm modest shifts in earnings estimate activity.

We remain underweight Utilities for both interest rate and market beta reasons, since mixed earnings revisions and valuations are not sufficiently strong drivers to override the macro influences.

EXHIBIT 7: Utilities have been lagging badly lately, mostly due to rising bond yields rather than underlying earnings activity





Source: Mill Street Research, Factset, Bloomberg

Sector return analysis

The tables at right show recent returns for the 11 GICS sectors based on our broad US stock universe.

The top table shows **the 1/3/6/12 month returns for the equal-weighted sector aggregates**, along with the overall US aggregate, and is sorted by six-month returns. Equal-weighted returns are much less skewed by a handful of mega-caps than cap-weighted figures are.

The lower table shows the six-month Alpha Momentum readings for each sector, both on an equal-weighted (EW) and a cap-weighted (CW) basis. Alpha Momentum is based on sector returns that have been adjusted for each sector's beta, size, and style tendencies.

The equal-weighted US return stats show widespread negative returns in the last one- and three-months, but not much "beta" effect among sectors (i.e., defensives still lagged).

Energy is still at the top of the tables, helped by higher crude prices, but as discussed on p. 8, we do not expect the trend to persist longer-term.

Industrials, Financials and Technology have outperformed on absolute returns over the last six months, with Financials and Industrials also having positive Alpha Momentum. Health Care, Materials and Utilities are generally weakest.

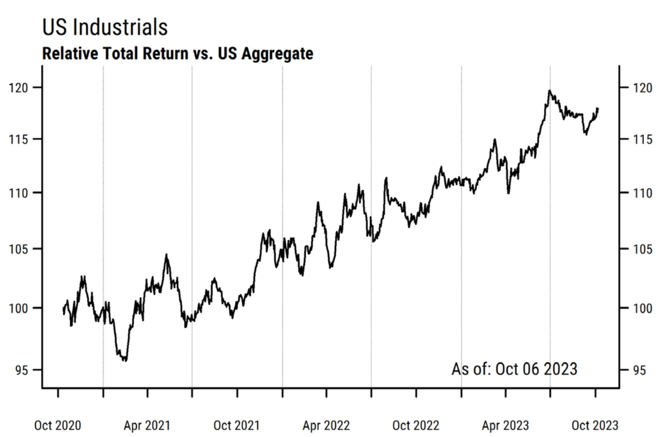
EXHIBIT 8: Energy has outperformed on higher crude prices, followed by Industrials and Technology. Health Care, Materials, and Utilities are lagging.

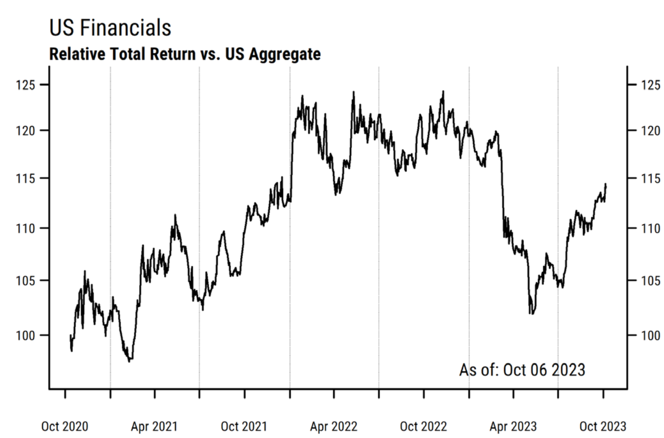
US Equal-Weighted Sector Returns
06 Oct 2023

Sector	1mth	3mth	6mth	12mth
Energy	-5.5	10.0	**11.2**	16.3
Industrials	-6.1	-7.3	**5.3**	14.1
Technology	-7.4	-5.5	**4.5**	15.6
Financials	-3.8	1.6	**3.4**	0.7
Cons. Discretionary	-8.7	-9.2	**-3.4**	6.9
Real Estate	-9.9	-8.8	**-4.3**	0.7
Comm. Services	-6.0	-6.5	**-6.1**	2.0
Materials	-7.1	-8.8	**-11.0**	6.7
Health Care	-10.3	-13.8	**-11.2**	-11.7
Cons. Staples	-8.1	-11.4	**-12.3**	-2.2
Utilities	-7.2	-13.1	**-16.9**	-7.7
US Aggregate	-7.3	-6.6	**-1.8**	4.5

US Sector 6-month Alpha Momentum
06 Oct 2023

Sector	AlphaMo (EW)	AlphaMo (CW)
Energy	22.7	14.4
Financials	8.1	7.7
Industrials	5.5	6.3
Real Estate	-2.4	-7.4
Materials	-5.5	0.8
Technology	-7.9	-0.5
Cons. Discretionary	-9.0	-2.7
Comm. Services	-12.1	0.7
Cons. Staples	-13.3	-8.5
Utilities	-14.9	-15.8
Health Care	-18.0	-3.7





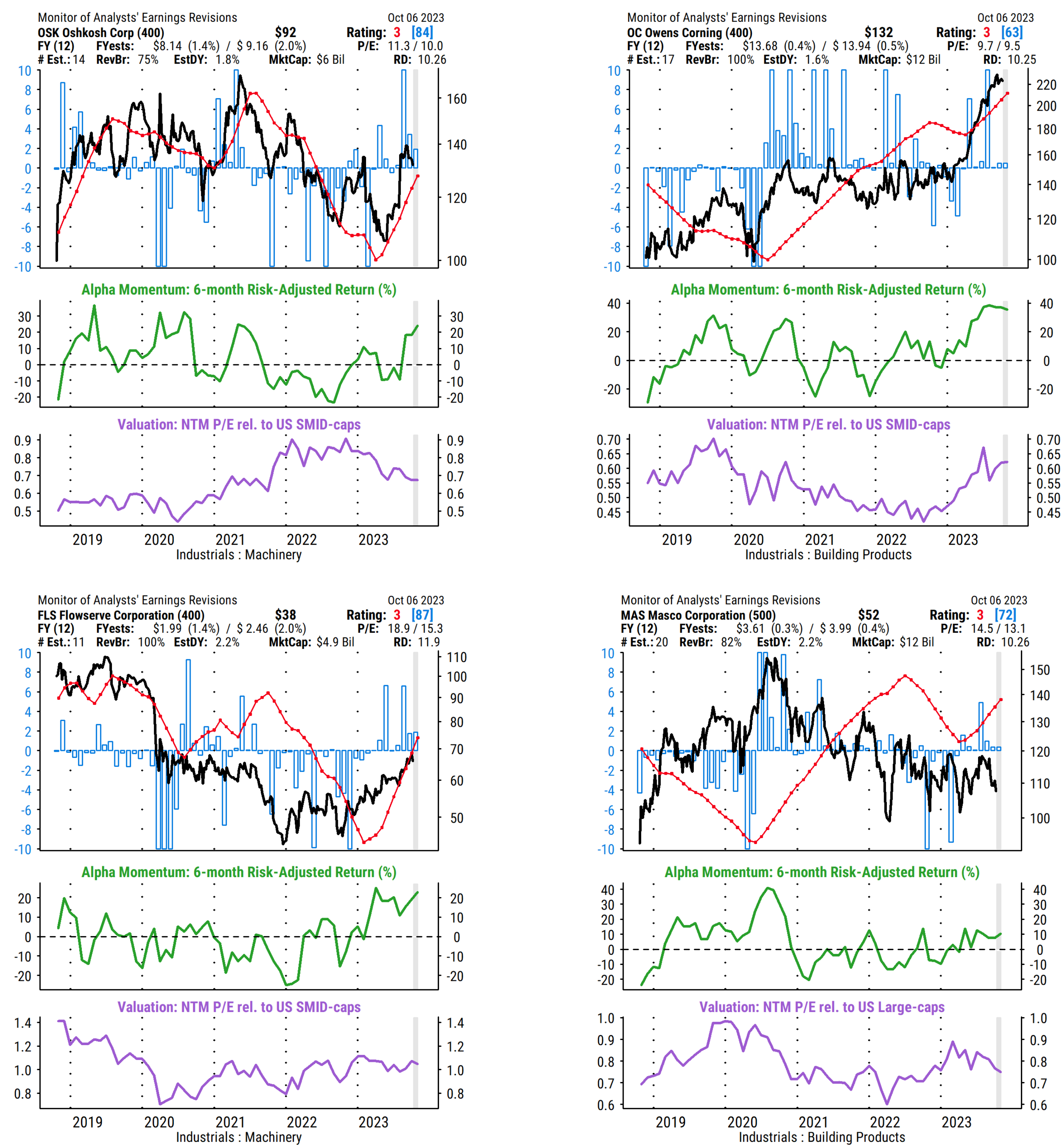
Source: Mill Street Research, Factset, Bloomberg

Mill Street Research

Top-ranked stocks in overweight sectors

Below are the MAER profiles for four large-cap Industrials stocks that rank highly in the composite MAER ranking within the sector. Machinery and Building Products contribute many of the top-ranked Industrials stocks within the Russell 1000 index constituents, reflecting the ongoing boom in manufacturing construction and better-than-expected homebuilding activity.

EXHIBIT 9: Selected highly-ranked large-cap US Industrials stocks



Source: Mill Street Research, Factset

Top-ranked stocks in overweight sectors

Below are the MAER profiles for four Technology stocks that rank highly in the composite MAER ranking within the sector. The relative strength in Software and IT Services industries compared to hardware-related industries remains intact in our ranks, though valuations remain a concern for some names with strong revisions activity.

EXHIBIT 10: Selected highly-ranked US Technology stocks

Source: Mill Street Research, Factset

Our Sector/Industry Methodology

A key differentiating factor in our sector and industry views is the use of our bottom-up aggregation of stock-level MAER rankings – see page 17 for a brief description of MAER.

Construction:

- The six-factor composite MAER ranking captures: estimate revisions (both breadth and magnitude, 50% weight), price action (risk-adjusted price momentum and short-term mean-reversion, 30% weight), and valuation (absolute and relative forward earnings yields, 20% weight).
- We rank each stock within our broad US universe each month, and then find the average and median percentile rank (0 = worst, 100 = best) for the stocks within each of the GICS sectors and industries. We only rank industries with six or more constituents.
- To get the combined rank of the sectors and industries, we use a combination of the average and median MAER ranks to reduce the impact of skewed ranking distributions that can appear in certain industries at certain times.
- We also produce aggregated cap-weighted rankings for the narrower S&P 500 index sector constituents to align with the sector ETFs that are the most popular tradeable vehicles for sector allocation.

It is therefore a **direct aggregation of the signals from our stock-level MAER rankings to industries and sectors**. Clients often look at these indicators as "bottom-up macro" inputs, meaning that we are viewing industry- and sector-level drivers based on individual company inputs rather than purely by traditional top-down macroeconomic indicators (e.g. retail sales, CPI, etc.).

Historical testing

- Our backtesting shows that the process works much like the MAER rankings themselves: top-ranked industries outperform bottom-ranked industries on average. We find it is more effective for industries than sectors due to the greater number of industries (~60 industries vs 11 sectors) and the greater correlations among stocks within industries than within broader sectors (some sectors are quite broad and heterogeneous and thus true common drivers are harder to isolate and use for predictive purposes). We also show the two previous months rankings to make it easier to see the latest changes in rank.

- The rankings show a similar pattern of persistence to what we find in the stock-level MAER rankings. Historically the correlation between consecutive monthly rankings is about 78%, a significant level of persistence. On average this means that among the top 10 ranked industries this month, we would expect to see six to seven of them remaining in the top 10 the next month. A sector or industry might thus be expected to remain near the top or bottom of the ranks for three to four months on average (sometimes longer), and our tests show that excess returns can persist for three to six months after their ranking on average.

- In addition to the results of the aggregated MAER rankings, we also monitor the long-standing four-panel indicator charts to help refine the views and identify potential extremes in analyst or investor sentiment. We can also look at macroeconomic and other fundamental indicators to help identify drivers of the rankings and the likelihood that trends will persist or reverse.

This report includes the current rankings and selected charts for US sectors and industries, along with commentary. We also include examples of highly ranked stocks in highly ranked industries as potential buy ideas – further analysis of both buy and sell ideas can be done on request.

Our Sector/Industry Methodology

In addition to the sector and industry rankings, each month we update our **allocation recommendations for the widely followed S&P 500 sectors and their corresponding ETFs**. We also group the sectors within four broad style-oriented categories to help highlight our higher-level preferences. **The table on page 3 shows the breakdown and the current allocation recommendations**.

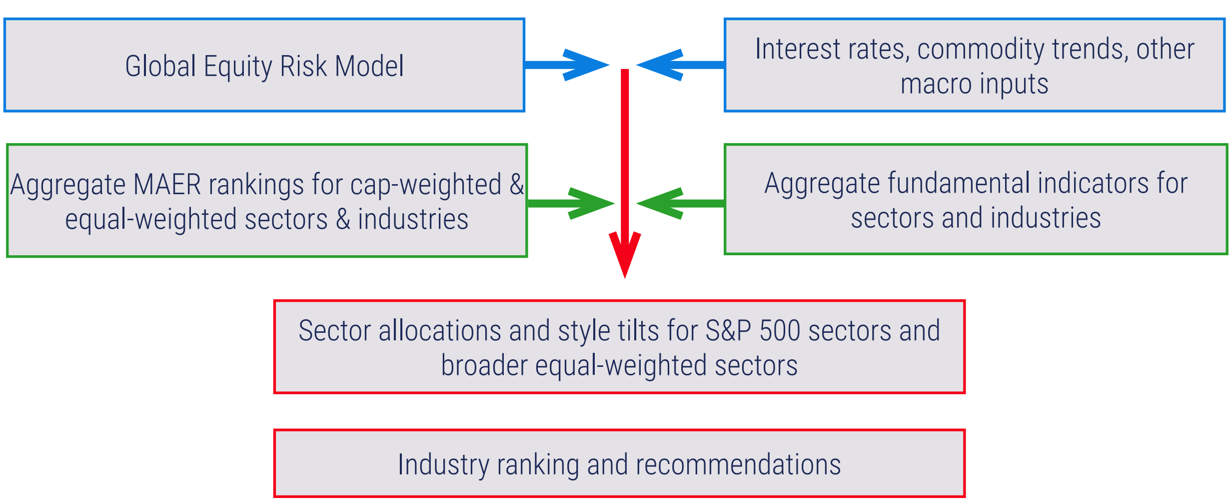
These allocations are based on a combination of our top-down views and bottom-up aggregated stock rankings, and will be shown in two “flavors”. One is for unconstrained investors who treat all 11 sectors (ETFs) as equal potential holdings (i.e. the benchmark is equal holdings in all 11 sectors, not index sector capitalization weights), and who can deviate from equal weighting by larger margins (including zero weights or very large weights in some sectors at times). The other is scaled for more traditional constrained investors who allocate relative to the benchmark weightings of each sector within the S&P 500 and typically limit deviations from benchmark sector weightings to +/- 3-5% to maintain tracking error constraints.

The primary top-down driver of these sector views will be risk, which will be **tied to our overall equity market risk recommendations derived from the Global Equity Risk Model** and the Implied Growth Model. The beta and volatility of the sectors will be considered in light of our risk preferences and allocations tilted accordingly. More details about the Global Equity Risk Model and other macro indicators are available on request and discussed in our Portfolio Strategy reports.

The other top-down drivers will be factors such as **interest rates and commodity prices**, both for their direct impact on certain sectors and their broader messages about the economic backdrop. This report will include a discussion of the indicators that are guiding the views.

Within the four broader style groups, we will then **look to the aggregated bottom-up indicators for each sector** to help identify stronger or weaker sectors within a style group. We will consider both the standard broad equal-weighted metrics we have long used as well as the cap-weighted metrics based on the actual constituents and weights of each S&P 500 sector.

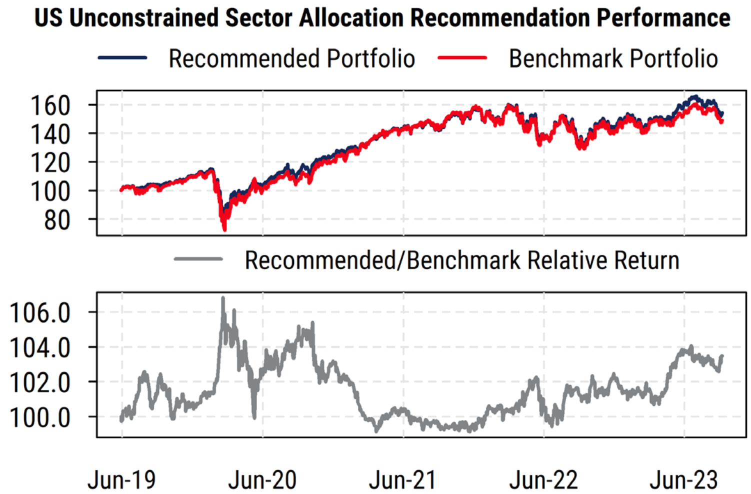
We track the hypothetical performance of these allocation recommendations over time and update the results in each monthly report.



Hypothetical performance tracking

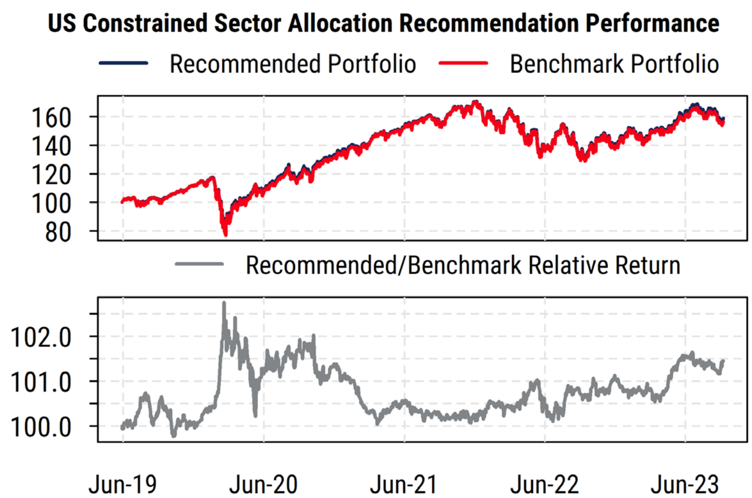
Below are hypothetical results of our recommended sector allocation recommendations, based on the published weightings and S&P 500 sector ETF total returns.
The figures show results since the first weightings were published on June 27th, 2019.

EXHIBIT 12: Hypothetical sector recommendation performance since inception



US Unconstrained Sector Allocation Recommendation Summary Statistics

27 June 2019 - 06 October 2023	Recommended Portfolio	Benchmark Portfolio
Ann. Return (%)	10.28	9.43
Ann. Volatility (%)	20.79	21.40
Sharpe Ratio	0.43	0.37



US Constrained Sector Allocation Recommendation Summary Statistics

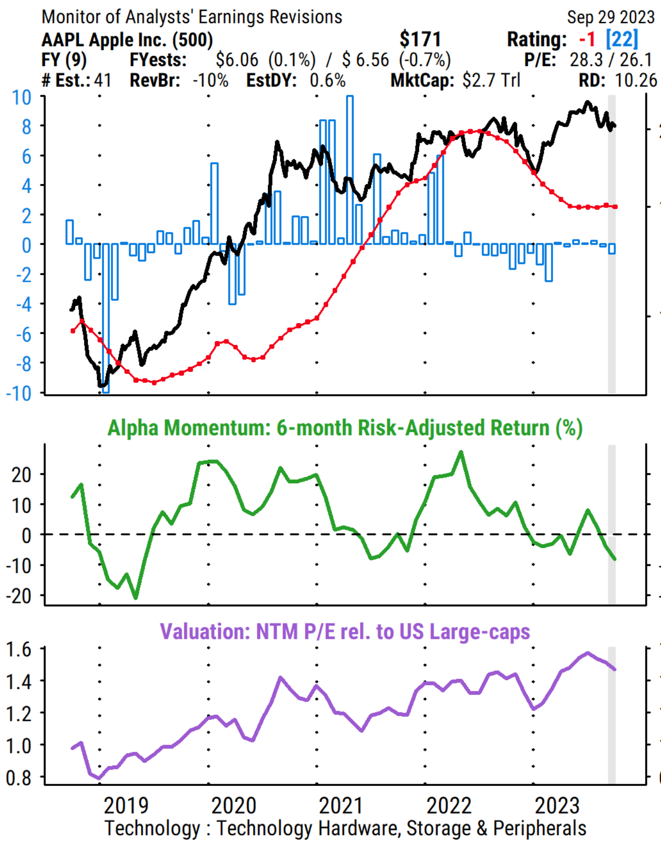
27 June 2019 - 06 October 2023	Recommended Portfolio	Benchmark Portfolio
Ann. Return (%)	11.00	10.64
Ann. Volatility (%)	21.85	22.01
Sharpe Ratio	0.44	0.42

Results assume allocation into S&P 500 sector ETFs based on the recommended weightings and benchmark weightings as shown on page 4 of this report. Returns are total returns and indexed to 100 as of June 27th, 2019. No transactions costs included, though ETF management fees are embedded in the returns shown.

Source: Mill Street Research, Factset

What is MAER?

The Monitor of Analysts' Earnings Revisions (MAER) is Mill Street's proprietary cornerstone graphical and quantitative stock selection tool. Clients can use MAER to analyze trends in revisions to consensus earnings estimates, alongside price and fundamental information. It is a resource to help institutional investors incorporate an objective, transparent quantitative overlay into their stock selection process. It also includes a six-factor ranking model driven by the inputs shown on the MAER charts.



The primary drivers of MAER are breadth of analyst revisions and the magnitude of changes to the mean NTM estimate. Current readings can be viewed in the context of the last five years of historical readings.

The **red line** is a cumulative Revisions Breadth series based on the monthly net number of analysts' upward earnings revisions minus downward revisions over the prior 100 calendar days – a rising line indicates more positive than negative revisions over the last quarter (scale not shown).

The **blue bars** represent the magnitude of the monthly percent change in the consensus NTM earnings estimate (left scale).

The **heavy black line** represents the stock's relative total return versus its benchmark (S&P 500 or S&P 1000 in the U.S., the MSCI ACWI ex US Index for non-US stocks), indexed to 100 at the beginning of the chart (right scale).

The **green line** in the middle section plots our proprietary measure of price momentum, which is the stock's cumulative risk-adjusted return (or alpha) over the last six months, adjusted for market sensitivity (beta) as well as size and style (large/small-cap, value/growth).

The **purple line** in the bottom section plots the stock's relative valuation, based on its forward (NTM) P/E relative to its cap-weighted MAER universe aggregate.

Below the chart is the stock's GICS sector and industry classification.

Header information:

First row: Ticker (+ country code for non-US stocks) / Company Name / S&P Major Index classification (US companies only) / Month-end stock price (in primary exchange currency) / MAER breadth rating / Monthly revision magnitude percentile

Second row: Month of fiscal year end / Current FY1 & FY2 consensus estimate and monthly % change / Current P/E based on FY1 and FY2 estimates

Third row: Number of estimates in the consensus / Current Revisions Breadth (net % of analysts raising estimates) / Consensus next-12-month estimated dividend yield / Current market cap / Next expected earnings report date (mth.day)

The ratings in the top right corner of the chart can be used to quickly identify promising stocks for further research.

The first number, the **breadth rating (in red)**, is based on the direction of the Revisions Breadth series in the chart. It is focused on helping identify nascent turns in analyst sentiment as well as established trends, and reflects the number of months the series has been rising or falling, up to three. Thus it ranges from -3 (established negative trend of 3 months or more) to +3 (established positive trend), with readings of -2/-1/+1/+2 helping identify the first month or two of a reversal in analyst sentiment. The **second number (in blue brackets)** shows the percentile ranking of the most recent monthly percent change in the NTM estimate relative to the stock's own five-year history. So, for example, a percentile of 80 would indicate that this month's change in the consensus NTM estimate is higher than 80% of the readings over the last five years.

Favorable patterns would include a positive breadth rating and a high magnitude percentile, along with positive or improving alpha momentum and supportive relative valuations (unfavorable patterns would show the reverse conditions).

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