During the quarter there was further escalation in trade tensions between the U.S. and China, the yield curve inverted raising worries of a looming recession, and a jump in political turmoil with the House launching a formal impeachment inquiry. Despite the uptick in uncertainty, all three of the major market indices produced positive total returns. For the quarter, the S&P 500® Index produced a total return of 1.70 percent, the NASDAQ Composite gained 0.18 percent and the Dow Jones Industrial Average tacked on 1.83 percent.¹

Sector Snapshot

Through the first three quarters, the S&P 500 has gained 20.55 percent, the best performance during the first nine months of the year since 1997, according to Dow Jones News.² Gains during the quarter were generally widespread with eight of the eleven S&P sector groups finishing in positive territory. Sectors with defensive characteristics posted the strongest returns with the utility sector (+9.33 percent) leading the way followed by real estate (+7.71 percent) and consumer staples (+6.11 percent). On the flip-side, the energy (-6.30 percent) sector was the worst performer for a second straight quarter reflecting a 7.53 percent decline in the price of oil.³

A Cautious View Remains in Place

As we enter into the last months of the year, Guggenheim's tactically cautious view on the market remains in place. As laid out in mid-July, Guggenheim shifted to a more neutral outlook for the domestic equity market, reflecting the solid year-to-date performance in the face of building uncertainty surrounding the trade tensions with China and signs the global economy is slowing. Guggenheim's views are not bearish on the market, but the current risk/reward outlook is not particularly compelling. The strong year-to-date gains have been solely from the expansion in the market's price-to-earnings (P/E) multiple, potentially leaving the market

While earnings growth last year benefitted from lower corporate taxes, fiscal stimulus and the solid economy, growth in 2019 is shaping up to be much more modest as the positive drivers have faded and the global economy has slowed. According to consensus expectations from FactSet, earnings are forecast to rise by 1.4 percent in 2019 and 10.3 percent in 2020.⁴

—Q4 2019 Equity Market Outlook

Two Sector Categories

Based on how sectors react to different market environments and economic phases, Guggenheim divides sectors into two categories: cyclical and defensive.

Understanding how sectors react to different market environments and economic phases is important for investors. Guggenheim divides sectors into two categories: cyclical and defensive.

Cyclical sectors are highly sensitive to business cycle peaks and troughs. They include industries such as consumer discretionary, energy, financials, industrial, and information technology. These sectors tend to perform well during economic expansions and may underperform during recessions.

Defensive sectors, on the other hand, are less sensitive to business cycle fluctuations. They include sectors such as consumer staples, communication services, health care, materials, and utilities. These sectors tend to provide stability and often outperform during periods of market stress.

Past performance does not guarantee future results.
vulnerable to earnings disappointment or negative developments in trade. Guggenheim believes earnings growth will need to be the key driver of forward performance and until revisions begin to move higher, upside from current levels will likely be limited. Better buying opportunities are likely to emerge down the road, but now is not the time to be chasing the market higher.

Sector Review

Cracks Appear in the Manufacturing Sector ...

The Institute for Supply Management (ISM) recently reported that manufacturing activity fell to a 10-year low. The ISM Purchasing Managers’ Index fell to 47.8 in September from 49.1 during the prior month (note—readings below 50 signal contraction). These back-to-back readings were the first to fall below 50.0 since 2016, although the ISM was quick to point out that the latest readings don’t signal a recession: ‘A PMI above 42.9 percent, over a period of time, generally indicates an expansion of the overall economy. Therefore, the September Purchasing Managers’ Index (PMI) indicates growth for the 125th consecutive month in the overall economy. The past relationship between the PMI and the overall economy indicates that the PMI for September corresponds to a 1.5 percent increase in real gross domestic product (GDP) on an annualized basis.’

... But Consumer is King

The trend in the ISM Manufacturing Index is certainly not encouraging, however, it seems a bit premature to get overly concerned about a looming recessionary environment. The manufacturing sector only represents approximately 10 percent of the U.S. economy, a mere fraction of the nearly 70 percent of the economy that is driven by consumer spending. Importantly, the U.S. consumer remains in good shape: Initial jobless claims remain near their lowest level in 50-years— signaling that the job market remains healthy. Not only are people working, but wages are also rising. According to the Atlanta Fed, median wage growth has gone from about 1.5 percent growth in 2010 to the current reading of just under 4 percent growth; the Census Bureau recently reported that median household income has surpassed $63K for the first time ever—so people are working, and they are taking home more money. Bottom line—while overall economic growth is slowing, we appear to be entering into more of a “muddle through” environment than an outright contraction.

Fed to the Rescue?

The Fed has telegraphed that they are likely to maintain an easing bias and will reduce rates at a future Federal Open Market Committee (FOMC) meeting as an insurance policy against downside risks to the economy from trade wars, softening business investment and weak inflation. While another 25 or even 50 basis point reduction in rates probably won’t have much of a near-term impact on the economy, from a market point of view, the confidence that the Fed is ready and willing to act, should be supportive of investor confidence.

Ultimately, money is greedy and will always seek out the best return opportunities. Regardless of what the Fed does or doesn’t do, Guggenheim believes the market is in the later stages of the business cycle and positioning in Quality, more defensive type investments have often proven to be a good late-cycle strategy.

Real Estate Investment Trusts

REITs have outperformed the S&P 500 amid a sharp decline in long-term rates, solid fundamentals (real estate supply levels are healthy and occupancy levels are near long-term average) and a relatively better growth trajectory. Given these favorable factors, along with a safe haven status due to much of its cash flow being contractual via long-term leases, the “wall of capital” chasing yield will likely continue the way of REITs. However, Guggenheim believes,
the absolute valuation of REITs is extended and the relative earnings yield of REITs compared with the S&P 500 index trade at rich levels. Valuation should only be a concern if relative earnings depresses significantly.

**Utilities**

An uneven economic outlook led investors to the defensiveness of utilities. By doing so, the sector’s price-to-earnings multiple spiked above 20 to the highest level on record with data going back to 1990, despite below market forward growth rates in 2020 and 2021. Any weakness to the sector’s fundamentals (i.e. instability in cash flow compounds higher net debt) could lead flows to other defensive sectors. Guggenheim believes there are likely better segments of the market to capture total return in a low yield environment.

**Consumer Staples**

From a pure defensive equity standpoint, Guggenheim believes, the consumer staples sector is uniquely positioned with favorable fundamentals and a relatively cheaper valuation to other defensive equities. Elevated economic uncertainty has acted as a tailwind for overall non-discretionary retail sales but hasn’t yet translated to similar performance of other defensive sectors. Furthermore, dividend growth companies typically move opposite of yields (consumer staples are a good blend of dividend growth and yield), yet the recent bid in the 10-year Treasury did not result in a staples rally. While the sector's valuation compared to the long-term average is elevated, examining the multiple relative to other defensive sectors is necessary given investors constant reach for yield and the historical relationship of bond yields to dividend growth equities. Currently the forward price-to-earnings multiple of consumer staples relative to utilities is 17 percent below average, which doesn’t substantiate better fundamental prospects for staples and a similar yield.
GICs Sector Review and Relative Strength Indicator as of September 30, 2019

Review recent sector performance and Relative Strength Indicator (RSI) highlights. The relative strength indicator can provide insight into sector performance and help identify trends. RSI measures the velocity of a security’s price movement to identify overbought and oversold conditions and is calculated from closing prices. Some investors use RSI indicators to recognize potential turning points for making entry/exit decisions. An RSI indicator falling below a value of 30 indicates an oversold condition, and a buy signal is usually triggered when the indicator crosses 30 from below. Similarly, an RSI value greater than 70 indicates an overbought condition. A sell signal is usually triggered when the indicator crosses 70 from above.

Consumer Discretionary

Even with the manufacturing sector exhibiting weakness, the consumer discretionary sector has remained resilient. In particular, home improvement, restaurant, and hotel stocks have beaten same-store-sales comparisons in 2019. However, U.S.-China tariffs could significantly affect the earnings going forward despite the relative strength of consumer activity.

Energy

Valuation remains near undervalued levels and the sector is a strong late-cycle performer given its strong correlation to inflation. Conditions have improved for a more balanced market in 2019, inventory has decreased despite higher production, and OPEC has signaled production cuts to the market. Economic growth and more importantly demand trajectory will be the determinant factor.

Financials

As a result of a downward tilt in the Federal Reserve’s path of interest rate hikes, the outlook for financials has deteriorated. A substantial recovery in the global economy would be necessary to support yields and thus fundamentals. Fundamentals are not driven by the shape of the yield curve, but it does affect the valuation of financials.

Sector performance is represented by sub-indices of the S&P 500 Index that are classified as members of the related Global Industry Classification Standard (GICS) sector. Past performance does not guarantee future results. Source: Bloomberg 9.30.2019.
This sector is a beneficiary of sustained economic growth, increased capital expenditures, mergers & acquisitions and fiscal policy action. However, there’s been some evidence that capital expenditures have peaked and continue to slow. Valuation has corrected as a result of trade tensions and is already discounting slower growth, certainly the best positioned sector in an economic recovery.

- Beneficiary from increases in CAPEX or pick-up in construction
- Low earnings risk, despite its high beta
- Performance of the sector is typically reliant on improving manufacturing data—Global PMI is exhibiting a sight contraction.

The sector’s sensitivity to economic growth and interest rates has declined as a result of lower volatility in earnings and sales. Given a flatter yield curve, volatility and economic growth uncertainty, secular growth profiles are more desirable.

- Cash available for buybacks and increased dividends.
- Some components of technology are defensive—mature, cash-rich, cash-flow generating, dividend-paying, and high-margin.

Inflation has been subdued but could pick up in the latter stages of the economic recovery, given cycle-low unemployment, elevated consumer confidence, and signs of labor shortages and wage pressures; best hedge in periods of rising inflation.

- Performance of this sector will depend considerably on global economic growth factors. Policy easing in China has the potential to spark economic activity and materials demand.
- Dividend Yield: 2.27% vs. the S&P 500 of 1.98%

REITs have outperformed the S&P 500 amid a sharp decline in long-term rates, solid fundamentals (real estate supply levels are health and occupancy levels near long-term average) and relatively stronger growth rate than the overall equity market. Given these favorable factors, along with being a safe haven because much of its cash flow are contractual via long-term leases, the “wall of capital” chasing yield will likely continue the way of REITs.

- REITs offer defensive characteristics amid an uncertain macro environment with stable earnings and high dividend yields, but not immune to broader market weakness.
From a pure defensive equity posture, the consumer staples sector is uniquely positioned with favorable fundamentals and a relatively cheaper valuation to other defensive equities. Rising economic uncertainty has acted as a tailwind for overall non-discretionary retail sales, and the export of U.S. consumer goods' trajectory is positive, satisfying a growing middle class in the emerging markets.

- Currently the forward price to earnings multiple of consumer staples relative to utilities is 17% below average, which doesn't substantiate better fundamental prospects for staples and a similar yield.

Communication services exhibits attributes suitable for a volatile late market cycle. The sector has defensive qualities that would hold up well during higher volatile periods and significant market exposure with idiosyncratic growth business models that rely little on the trajectory of the economy. The sector’s sales growth is expected to outpace the S&P 500 index at 10%.

- The new sector is comprised of telecommunications, media, and high growth technology.
- The sector is no longer a bond-proxy and will have a higher long-term growth rate than the old telecommunications sector.

According to BCA Research, the S&P 500 index on average has had gains of 24.8% from ISM to SPX peak with energy (inflationary pressures), real estate (inflationary pressures), and health care (biotechnology performance) leading all sectors. In addition, following the peak of the market to the official beginning of the recession, the S&P 500 index exhibited losses of -11.6% on average with health care, consumer staples, and materials leading all sectors.

- Relative growth metrics to the S&P 500 index have not kept pace with the historical valuation premium. As a result of the sector’s expected growth rate, the valuation should be higher than current levels.

Given the attractiveness to yield-oriented investors, utilities have a sustained buyer in a low long-term yield environment. Valuation remains high and comparable earnings growth relative to the market should give investors pause from becoming bullish on the sector.

- At the end of bull markets, momentum and long-term growth perform the best, giving way to defensive sectors as a recession approaches.
S&P 500® GICs Sector Performance as of 9.30.2019

S&P 500® GICs Sector Performance—YTD

S&P 500® GICs Sector Performance—1-Year

S&P 500® GICs Sector Performance—3-Year

S&P 500® GICs Sector Performance—5-Year

S&P 500® GICs Sector Performance—10-Year

Source: Guggenheim Investments. Sector performance is represented by sub-indices of the S&P 500 Index that are classified as members of the related Global Industry Classification Standard (GICS) sector.

Past performance does not guarantee future results. Index performance is for illustrative purposes only and is not meant to represent any particular investment product. Returns do not reflect any management fees, transaction costs or expenses. The index is unmanaged and not available for direct investment.
Rydex Sector Mutual Funds

Guggenheim makes it convenient to implement a sector strategy with our wide selection of 18 Rydex sector mutual funds, many with a 20-year performance history. Rydex funds offer unlimited exchange privileges, with no holding periods or transaction fees, among equivalent share classes of Rydex funds, as well as transparency through daily holdings listed on our website.

Rydex Sector Funds
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