Sector Allocation Strategy

NDR
NED DAVIS RESEARCH

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U.S. Market Update

The S&P 500 Total Return Index continued its positive momentum into March with a gain of about 3.2%. Breadth remains bullish—10 of the 11 S&P 500 sectors posted positive price gains for the month. Energy was the standout with a double-digit gain, while Consumer Discretionary was basically flat.

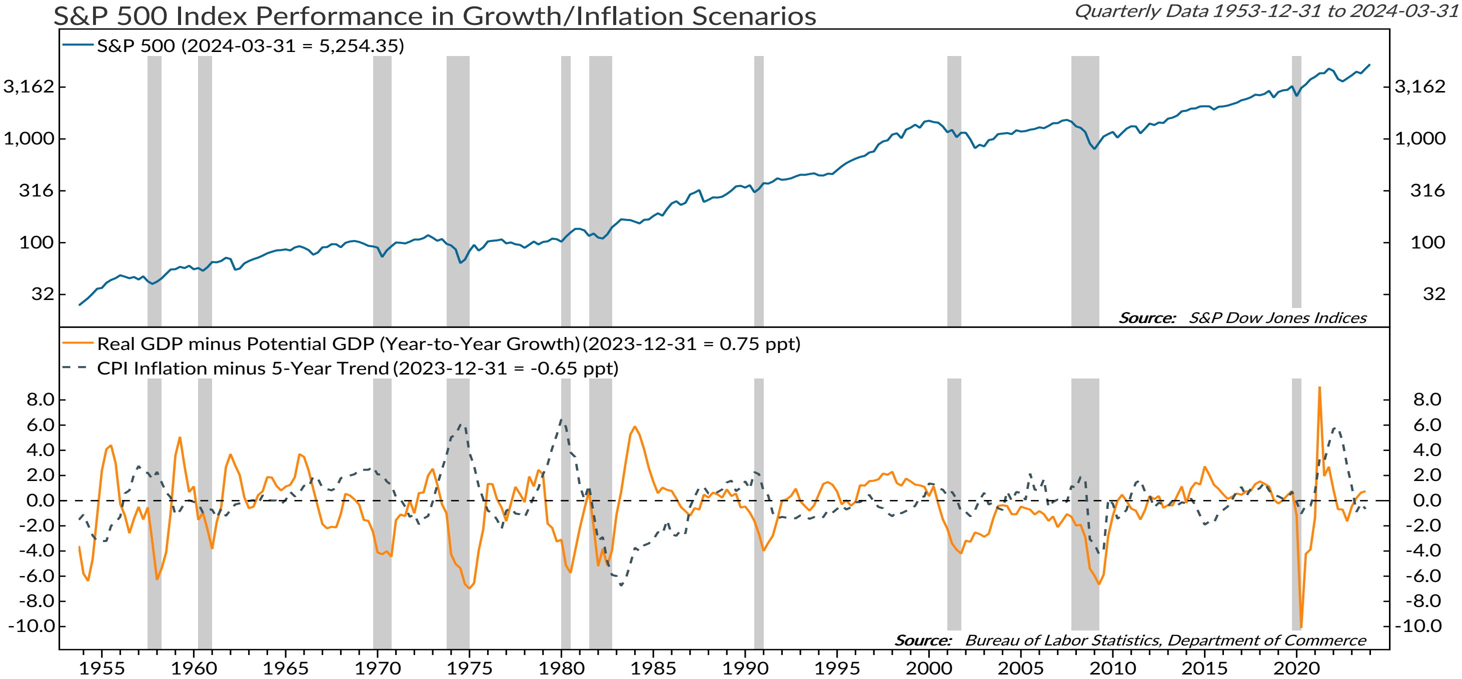
The U.S. economy has been experiencing strong growth and low inflation, a goldilocks environment that has historically been the most bullish scenario for the S&P 500 (chart below). The environment favors large-caps over small-caps and Growth over Value. With the S&P 500 Total Return Index up 10.6% in Q1, the market has priced in this scenario.

Investors should keep in mind that the Fed is openly trying to engineer a soft landing, which could put the economy in the slow growth/low inflation scenario. If they ease too much, Fed officials risk overheating the economy, but if they stay too tight, they could trigger a recession like in 2001 and 2007. For the S&P 500, a downshift to slower growth but still low inflation (a soft landing in Fed-speak) has historically coincided with slightly above-average returns. Gains have been smaller in an overheating scenario, with growth and inflation above trend. Stagflation, or high inflation and low growth, has been the worst backdrop for stocks.

The sector model recommended mixed leadership this month. Entering April, Financials, Information Technology, and Health Care are overweight. Real Estate, Communication Services, Materials, and Consumer Staples are underweight.

S&P 500 Index Performance in Growth/Inflation Scenarios

Quarterly Data 1953-12-31 to 2024-03-31



Shading indicates NBER-defined recessions.

Non-Recessionary Scenarios:
Overheating = GDP above trend, Inflation more than 1 ppt above trend
Strong Growth/Low Inflation = GDP above trend, Inflation less than 1ppt above trend
Slow Growth/Low Inflation = GDP below trend, Inflation less than 1 ppt above trend
Stagflation = GDP below trend, Inflation more than 1 ppt above trend

S&P 500 Performance
Full History: 1953-12-31 to 2023-12-31

Economic Scenario	% Gain/ Annum	% of Time
Overheating	3.31	7.15
Strong Growth/Low Inflation	10.85	37.88
Slow Growth/Low Inflation	8.70	27.49
Stagflation	-4.24	10.36
Recession	9.35	17.12

Buy/Hold = 7.80% Gain/Annum

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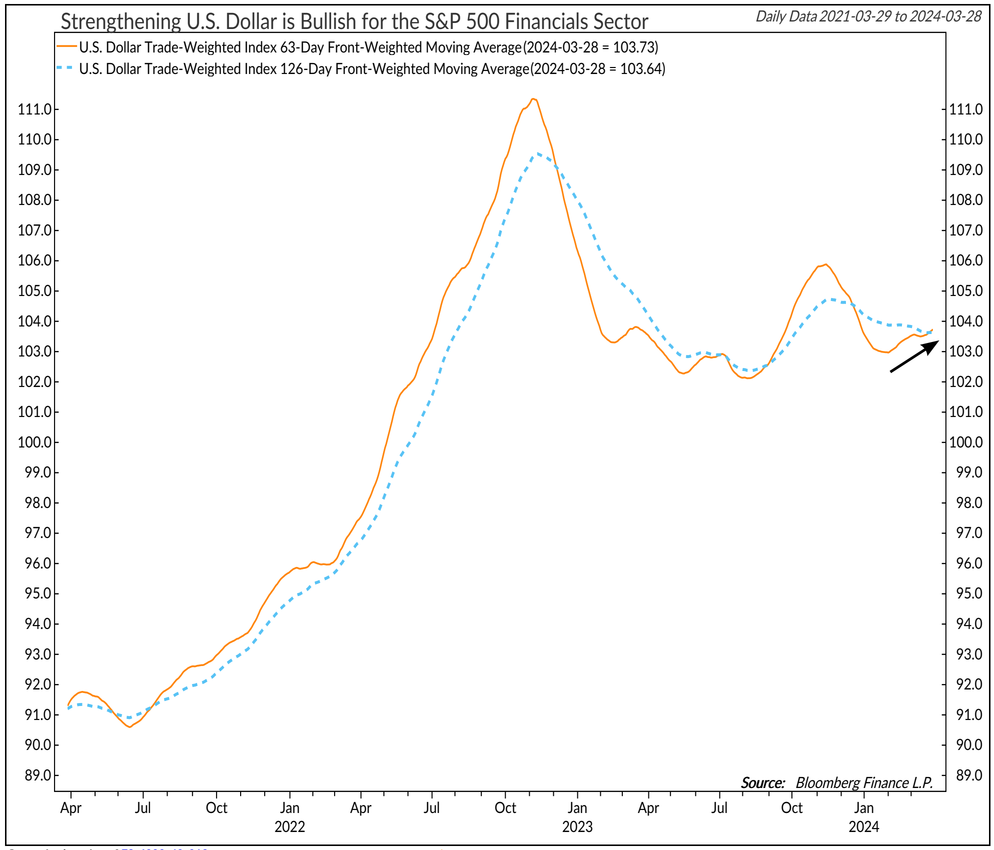
Financials' allocation remained at overweight. On a fundamental basis, a strengthening U.S. Dollar Index (chart right) joined bullish readings from economic surprises, business credit conditions, and Financials' investment grade option-adjusted spreads. However, bank loan growth and the 10-2 yield curve remained bearish. Technicals are confirming with four of the six measures on bullish signals including sector momentum, trend, volatility, and relative drawdown.



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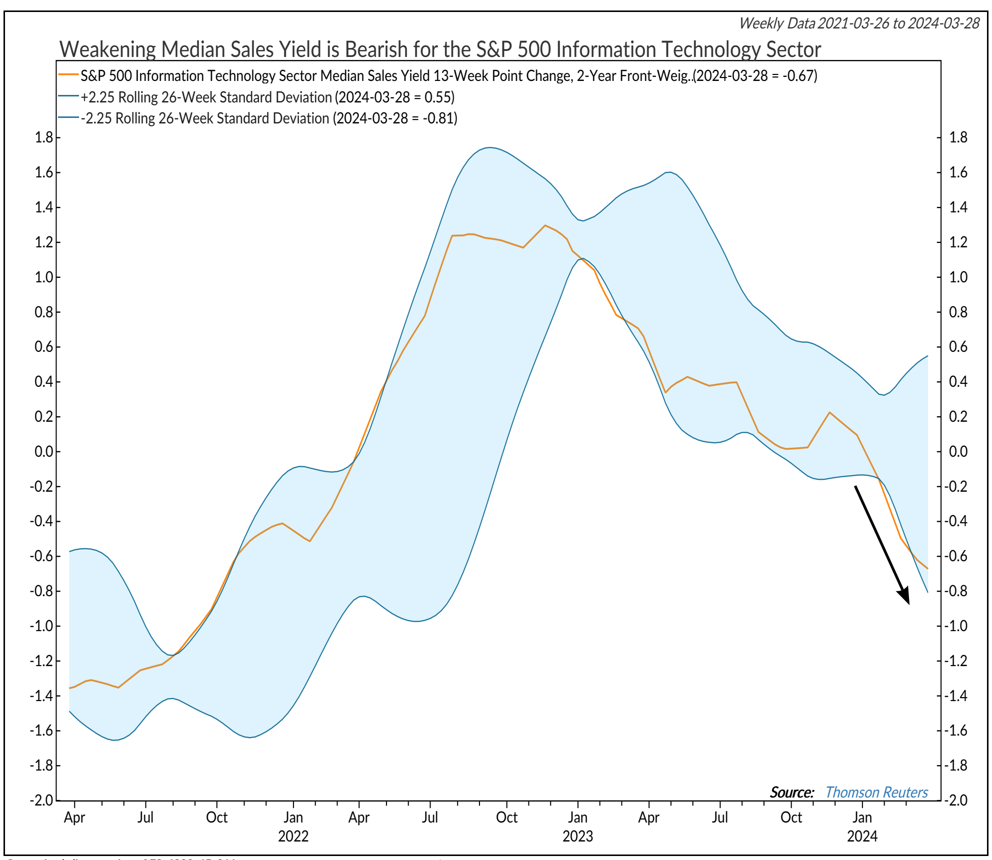

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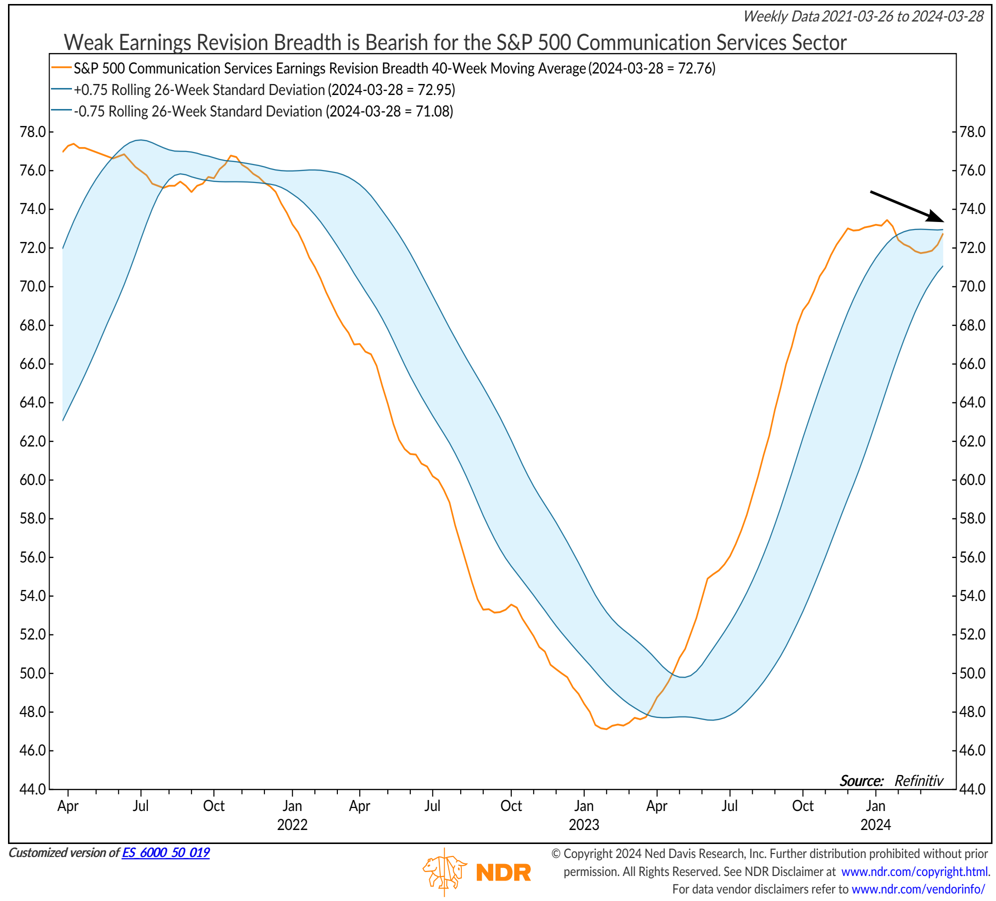
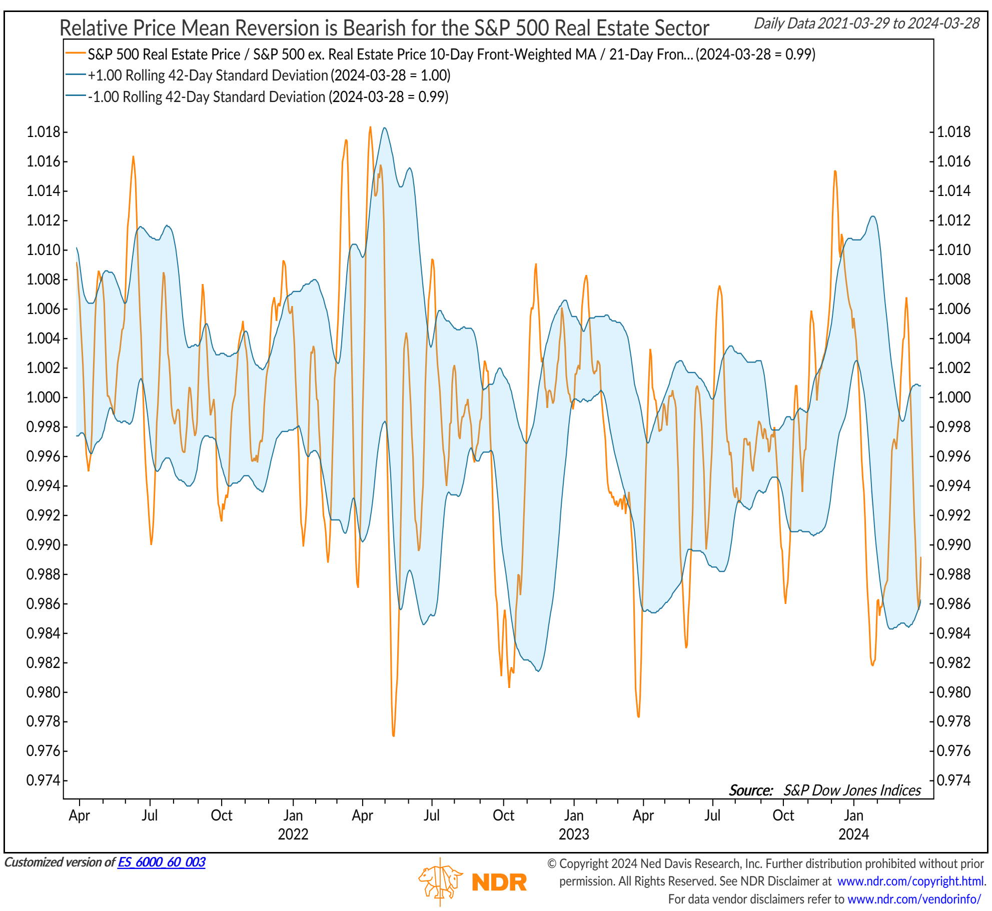
The Information Technology sector's allocation remained at overweight. On a fundamental basis, indicators deteriorated—valuation and inflation expectations moved bearish during the month (chart left), joining relative short interest. While the majority of internal measures remain bullish, the 50-day net new highs indicator continued its bearish reading.

Communication Services' allocation remained at a significant underweight. On a fundamental basis, the 10-2 yield curve and sales growth trends remained bullish. However, earnings revision breadth (chart right), relative valuation, option-adjusted spreads, and internet vs. retail sales trends remain bearish. Technicals remained weak—four of the six measures are bearish for the sector.



The Real Estate sector's allocation remained at underweight. On a fundamental basis, indicators improved slightly—the MBA Purchase Index joined the Homebuilders price index, business credit conditions, and economic surprises at a bullish reading during the month. However, unemployment, the 30-year yield, and industrial production of construction supplies remain headwinds for the sector. Furthermore, technicals weakened—all five measures are now negative for the sector—a short-term relative price mean reversion indicator moved bearish during the month (chart left).



Summary

The message from the sector model was a bit more mixed this month. Entering April, Financials, Technology, and Health Care are overweight. Real Estate, Communication Services, Materials, and Consumer Staples are underweight. The sector model uses sector-specific indicators to determine opportunities and identify risks in an objective, weight-of-the-evidence approach.

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