

SECTOR VIEWS FEBRUARY 11, 2021

Schwab Sector Insights: A View on 11 Equity Sectors



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“Schwab Sector Insights: A View on 11 Equity Sectors” provides detail on our three- to six-month outlook for 11 stock sectors, which represent broad sectors of the economy. It is published on a monthly basis, and is designed for investors looking for tactical ideas. For more information on our current views, read the latest [Schwab Sector Views](#).

Sector Overview

S&P 500 Sector	Schwab Sector View: Relative Performance to S&P 500 Index	Macro	Value	Fundamental	Relative Strength
Communication Services	Marketperform	Neutral	—	+	+
Consumer Discretionary	Marketperform	+	—	Neutral	+
Consumer Staples	Underperform -11.08% since 11/12/2020	—	Neutral	+	—
Energy	Marketperform	+	+	—	Neutral
Financials	Outperform +4.81% since 6/18/2020	+	+	+	Neutral
Health Care	Outperform -5.93% since 11/12/2020	Neutral	+	+	Neutral
Industrials	Marketperform	+	Neutral	Neutral	Neutral
Information Technology	Marketperform	+	—	+	+
Materials	Marketperform	+	Neutral	Neutral	+
Real Estate	Marketperform	—	+	—	—
Utilities	Underperform	—	—	—	—

-17.4% SINCE 10/2020

Source: Schwab Center for Financial Research, as of 02/8/2021. See "Important disclosures" for an explanation of the Macro, Value, Fundamental and Relative Strength factors. The relative performance of the "Outperform" and "Underperform" Schwab Sector Views is total return of the respective sectors relative to the total return of S&P 500 index since the announced inception date of our view through 2/08/2021. A positive (negative) total return reflects outperformance (underperformance) of the sector relative to the overall S&P 500 Index. **Past performance is no guarantee of future results.**

Communication Services: Marketperform





The Communication Services sector includes telecommunication services providers, media (e.g., television, radio, print publications, advertising), entertainment (e.g., movie production, sports teams, streamed content), and interactive media (e.g., social networking websites, video games).

Pandemic-related stay-at-home behaviors have been good for some of the companies in the sector, as it has led to increased use of social media and demand for streaming entertainment. However, the shift from traditional TV and cable has dropped, hurting advertising revenues. Additionally, wireless service revenue growth is at risk if high unemployment persists. While the larger companies (Alphabet/Google and Facebook) enjoy significant competitive advantages due to their dominance in their respective business lines—search engine, social media and telecom— they also face emerging antitrust risks, as well as potential market saturation.

Longer term, we believe the rollout of fifth-generation (5G) cellular wireless technology could further increase demand within the sector, as 5G is expected to increase both speeds and growth potential. However, upgrading networks will require substantial capital investment, and the pandemic has slowed progress.

Positives for the sector:

- The competitive advantage for social media;
- 5G rollout should boost growth potential, but companies face near-term high capital expenditures;
- Social distancing has accelerated a shift toward streaming entertainment content.

Negatives for the sector:

- Antitrust regulatory trend is negative for the search engine and social media companies;
- Potential for increased social media regulation (for example, Section 230 legal shield under scrutiny);
- Streaming service market saturation;
- Valuations are difficult to assess.

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Risks for the sector:

- Sector market capitalization is heavily concentrated in the top five stocks, whose movement can significantly influence the sector.

Consumer Discretionary: Marketperform





The Consumer Discretionary sector includes internet retailers, automobiles and parts, household durable goods (e.g., refrigerators, washers/dryers), consumer durable goods (e.g., televisions, home audio equipment), leisure products (e.g., sports equipment, bicycles, toys), apparel, luxury goods, footwear, casinos, hotels, fitness centers, restaurants and bars.

The Consumer Discretionary sector, as the name implies, includes companies that produce or sell non-essential products that consumers often do without when they are under financial stress or worried about job security. These industries within the sector tend to do best when the economy is growing and consumers feel confident about spending money. Low interest rates also tend to be a positive, as this encourages people to borrow and spend.

The sector has a number of industries with a high degree of exposure to

COVID-19 business shutdowns and shelter-in-place orders—particularly the hotels & leisure and apparel industries. Many of the travel-related hotel and cruise liner stocks remain well below year-ago levels, but other COVID-sensitive retailers have fully recovered amid stimulus to households and businesses—despite still-high unemployment. However, those industries are often overshadowed by bigger companies in the sector, many of which were boosted by COVID-19-related restrictions, such as home improvement stocks and the internet retail equities—Amazon in particular, which constitutes about 33% of the sector’s market cap. And the addition of Tesla late in 2020 further concentrated the sector, with these two stocks constituting nearly half of the market cap. The ongoing trend away from brick-and-mortar retail business and toward electric vehicles is likely to continue, but investor enthusiasm may have pushed valuations too high, despite the strong fundamentals in the sector heavyweights.

Positives for the sector:

- Online and home-improvement retailers benefit from social distancing;
- The shift away from brick-and-mortar is likely to continue to support

online retailers;

- Economic recovery is positive for many of the more traditional discretionary industries.

Negatives for the sector:

- COVID-19 uncertainty likely to continue to weigh on travel and leisure activities;
- The sector is overly concentrated in internet retail and automobiles;
- Valuations and investor enthusiasm appear stretched.

Risks for the sector:

- Antitrust action is possible for the largest online retailer;
- Renewed weakness in the economy and/or stay-in-place orders likely would hurt traditional retailers.

Consumer Staples: Underperform



The Consumer Staples sector includes food, beverage and tobacco products; and food distributors (e.g., supermarkets, hypermarkets); non-durable household goods (e.g., detergent and diapers) and personal products (e.g., shampoo and cosmetics).

The ongoing recovery in the economy and shift toward cyclical sectors has resulted in underperformance of the sector since the market low in March 2020—as would be expected for a defensive sector whose constituents are less affected by changes in the business cycle. However, there have been winners and losers within the sector as ongoing—albeit more modest—social-distancing behaviors continue to bolster grocery and big-box discount retailers, while some food wholesalers that service restaurants face continued headwinds. In general, retailers within the sector have aggressively cut costs, leaving them in reasonable financial condition. But limited pricing power in a low-interest-rate environment gives them less-than-exciting top-line growth potential.

With additional fiscal stimulus, rollout of the vaccines, and accommodative monetary policies, we think the economic recovery has a better chance of

maintaining traction—though some choppiness is expected early in the year. At this stage of the business cycle, the consumer staples sector typically underperforms the overall market. We think growing confidence in the economy will continue to weigh on relative performance going forward.

Positives for the sector:

- It typically has a stable earnings profile;
- Companies have engaged in aggressive cost-cutting.

Negatives for the sector:

- An improving economy and strong stock market historically typically make this defensive sector relatively less attractive to investors;
- Companies tend to have limited pricing power in a low-inflation environment.

Risks for the sector:

- Additional government fiscal stimulus and the future availability of a COVID-19 vaccine could further support the economy and reduce stay-at-home food and staples demand.

Energy: Marketperform

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The Energy sector includes oil and gas drilling, equipment, exploration, refining, marketing, storage and transportation; and coal mining and production.

The price of oil has risen above what it was entering the COVID-19 crisis and is now greater than the price that is generally profitable for many oil companies, despite still-low demand. The oil rig count has been slow to rise amid slashed capital expenditures by oil companies, inventories have declined, and OPEC has been in general agreement to hold production down, supporting oil prices. The energy sector continues to face heightened uncertainty due to the supply/demand imbalance perpetuated by COVID-19-related economic shutdowns, and OPEC agreements could fail now that the price of oil has risen sharply. This paints a challenging fundamental backdrop for the sector, given questions as to when the oil market will rebalance.

However, with relatively stronger balance sheets and access to cash, large energy companies are in a much better place than the entire oil patch, which is

facing high insolvency risk. And cash flow should improve if the higher price of oil persists. However, an increasingly onerous regulatory environment and clean-energy initiatives may be a significant headwind to the sector—though this may be more of a long-term issue, as there is likely little bipartisan

appetite to erode U.S. energy independence. Additionally, larger oil and gas companies—which have the resources to navigate a more complex regulatory environment—will likely gain market share from smaller companies.

Positives for the sector:

- Oil is priced above the level at which the average company can cover expenses;
- Supply has declined with lower production and OPEC compliance;
- Large diversified energy companies have strong balance sheets and access to capital;
- The ongoing recovery of the global economy bodes well for returning oil demand

Negatives for the sector:

- Oil demand is still down significantly;
- Dividends are at risk, losses are still mounting, and valuation are opaque;
- Weak long-term stock price momentum.

Risks to the sector:

- New or expanded regulations could inhibit company growth potential—though this would favor larger oil & gas companies that can better navigate the regulations than small companies;
- OPEC's current supply agreement could fail if prices rise much higher;
- Clean-energy initiatives eventually may dampen demand for oil.

Financials: Outperform



The Financials sector includes banks, savings and loans, insurers, investment banking, brokerages, mortgage finance companies and mortgage real estate investment trusts.

With the Democrats' slim majority in Congress, an expansion of the recent fiscal stimulus package becomes more likely. Combined with a Federal Reserve that is likely to maintain hyper stimulus for years to come and the rollout of effective vaccines, longer-term interest rates could continue to rise—augmenting solid fundamentals in the Financials sector.

Banks' balance sheets came into the pandemic crisis relatively strong, thanks in part to stringent regulations put in place since the financial crisis of 2008. The two recent stress tests conducted by the Federal Reserve confirmed this. Under the most rigorous scenario—a W-shaped double-dip recession—banks' aggregate capital reduction would leave them with still-adequate capital ratios. Fiscal and monetary stimulus measures—which have contributed to the recovery—have softened the expected wave of bankruptcies and defaults. This

is allowing banks to release loan loss reserves that were increased dramatically early in the crisis—effectively reversing previous expenses, which increases profits.

The Fed's commitment to keeping short-term interest rates low likely opens the possibility for the yield curve (the difference between short-term and long-term interest rates) to continue to steepen, which would help net interest margin revenues. The sector tends to outperform in the early expansion phase of the business cycle, and we think that quite attractive valuations and strong financial positions are enough to lead to outperformance. Risks would include: The surge in COVID infections could result in renewed stringent stay-at-home orders—stalling the economic recovery—or there could be significant increase in regulations on the sector under the new administration. But stacking up the positives, negatives and risks, we think the sector is more likely to outperform the overall market in the coming months.

Positives for the sector:

- Strong financial position due to stringent post-2008 regulations;
- Economic recovery and fiscal stimulus are tailwinds for loan demand, and likely will limit defaults;
- Cautious Fed along with improving growth prospects has started to steepen the yield curve;

- The sector has attractive valuations relative to its historical average and other sectors;
- High loan loss reserves being released (supports earnings growth).

Negatives for the sector:

- Despite long-term interest rates trending higher, rates in general are expected to remain low by historical standards;
- Longer-term price momentum has been weak, though it has improved recently.

Risks for the sector:

- A renewed economic shutdown due to spike in COVID-19 cases could result in higher loan defaults;
- Not enough fiscal stimulus needed to foster a continued recovery;
- Increased banking regulations.

Increased Regulatory Requirements

Health Care: Outperform



The Health Care sector includes hospitals, nursing homes, health care equipment and supplies, health care services (e.g., dialysis centers, lab testing) managed-care plans (e.g., health maintenance organizations, or HMOs), health care technology, pharmaceutical, biotechnology and life sciences companies.

We recently initiated an outperform rating for the Health Care sector. Heading into the 2020 election, the Democratic Party's health care proposal seemed to be major source of the angst. Biden's proposed "public option"—a more affordable, or free, alternative to private health insurance—and enhancements to the Affordable Care Act (ACA) raised questions about the sustainability of profit growth in the health care sector.

However, the Democrats have a razor-thin majority in the new Congress, and division between progressive and moderate Democrats could very well result in many of the more contentious health-care initiatives being much tamer or

blocked altogether.

These more benign scenarios open the potential for renewed outperformance based on the long-term positives, including an aging global population and a growing middle class in emerging markets, all of whom will demand more

extensive drug treatments and medical care over time. Balance sheets in the sector are solid, increasing the possibility of higher dividend payments, share-enhancing stock buybacks, and M&A.

There are still risks, however. Any legislation to control drug prices could weigh on pharmaceutical companies' profits. Additionally, the Supreme Court is expected to rule on the constitutionality of the individual mandate provision of the ACA in 2021, and that could lead to the entire ACA being repealed.

However, in the opening arguments heard in November 2020, the majority of the justices indicated that a total repeal was unlikely, and there is little political appetite to allow chaos throughout the health-care system.

Positives for the sector:

- Strong balance sheets, with ample cash for dividends and M&A.

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- Positive long-term demographics trends, including an aging global population and a growing middle class in emerging markets;
- Return in demand for elective procedures, drug sales, medical equipment and diagnostics;
- Valuations are attractive relative to the sector's historical average.

Negatives for the sector:

- Hospitals have been squeezed by high COVID-19 preparation expense (although they received some stimulus relief);
- High unemployment reduces health care insurance enrollment;
- Extended-care facilities are likely to see higher costs related to virus mitigation requirements.

Risks for the sector:

- Supreme Court ruling on constitutionality of the Affordable Care Act (ACA);
- Bipartisan support for prescription drug price controls;
- Reversal of the 2017 corporate tax cut;
- Surge in COVID-19 could reduce demand for elective medical care;
- Unclear impact from any enhanced ACA legislation.

- **Significant impact from any enhanced ACA legislation**

Industrials: Marketperform



The Industrials sector includes aerospace and defense (e.g., airplanes, defense equipment) building products, electrical components and equipment, construction machinery, and services including transportation (e.g., airlines, railroads, trucking), construction, engineering and professional services.

With the economic recovery, the markets have begun to trade as would be typically seen in an early stage of the business cycle—which can be positive for this historically pro-cyclical sector. Additionally, prospects for an increase in infrastructure and clean-energy investment has supported the machinery and building materials industries. Transportation and air freight have benefited from a return in demand as economies reopen, in addition to low fuel prices and interest rates. The aerospace and defense industry continues to face significant headwinds amid expected low airliner demand and uncertainty surrounding the political appetite for defense spending. While the path of the

economy remains highly uncertain, the recovery provides a nice macroeconomic tailwind for the sector.

Positives for the sector:

- Capital expenditures are likely to increase if global growth continues to improve;
- The sector tends to outperform early in the business cycle;
- Many companies in the sector have cash-heavy balance sheets.

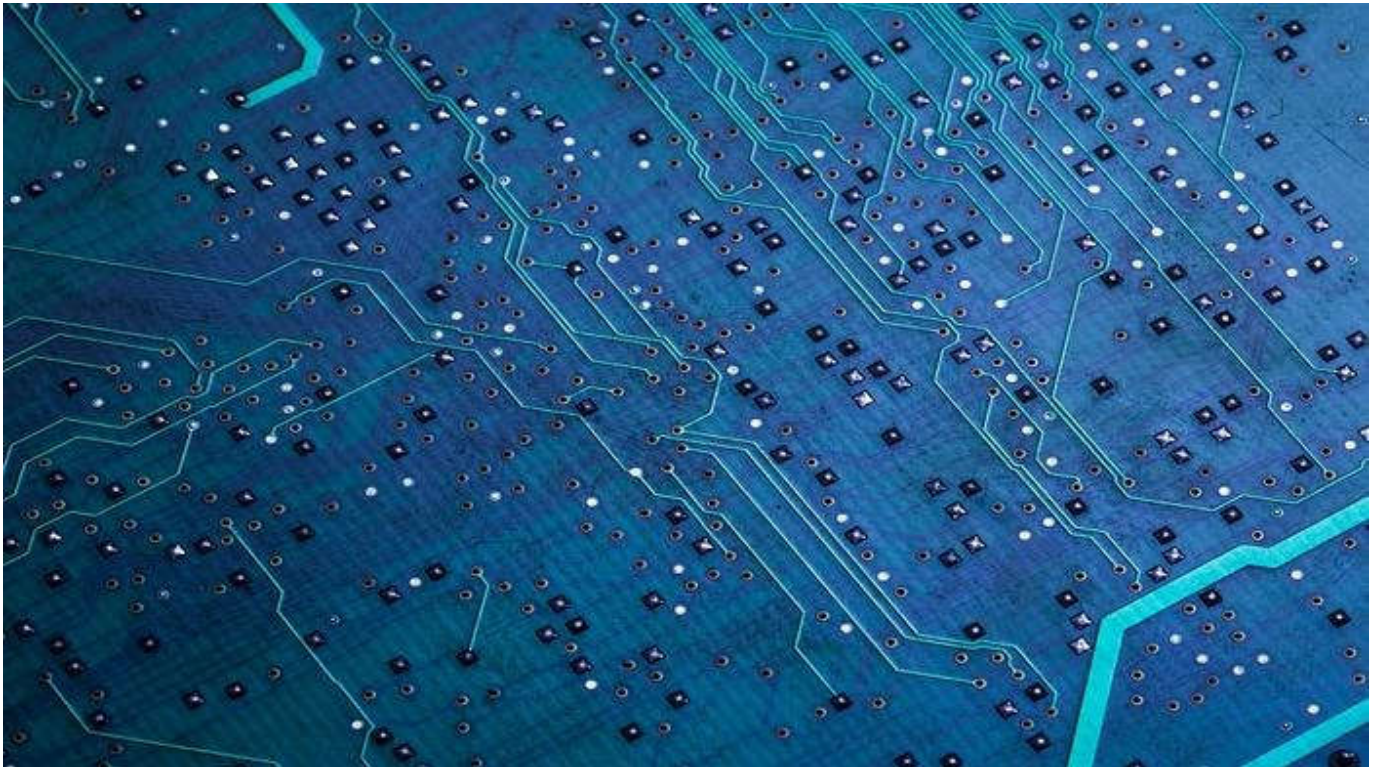
Negatives for the sector:

- Capital expenditures have been tepid;
- Delays in COVID-19 vaccine distribution is a headwind for airlines;
- Aircraft demand is likely to be weak until business and leisure travel resumes.

Risks for the sector:

- While we're currently neutral on the sector, if there is a stronger-than-expected surge in global growth or massive infrastructure stimulus, then it could perform better than expected.

Information Technology: Marketperform



The Information Technology sector includes software and services, technology hardware and equipment (e.g., mobile phones, personal computers), semiconductors and semiconductor equipment.

Information technology is a highly concentrated sector, with just a handful of companies representing more than 50% of the sector's weight—including the two behemoths Apple and Microsoft. While those are typically the primary driver of sector performance, impacts related to COVID-19 have been broad-based and positive for much of the sector, increasing consumer demand for PCs, gaming hardware, software, personal devices and online payment services (at the expense of traditional credit card services by Visa and MasterCard).

Despite a surge in spending to accommodate remote working, weak capital expenditures—as well as trade tension and COVID-19-related supply chain issues—has been a concern. However, there are signs that investment in cloud and networking equipment is picking up, which could persist if the economic recovery continues. Also, the ongoing rollout of 5G wireless infrastructure is

likely to accelerate—increasing demand for telecommunication components and semiconductors.

Longer term, a trend away from globalization and pent-up demand for productivity-enhancing technologies are likely to improve the already solid financial position for much of the sector. Counterbalancing the strong

fundamentals and price momentum, investor optimism about future growth potential has pushed valuations to well above the historical average, and there are rising legislative and antitrust risks for some of the largest companies in the sector.

Positives for the sector:

- Generally strong balance sheets and earnings growth potential with low funding costs;
- Home office, financial services technology, and surging online retail are supporting cloud computing infrastructure and software;
- Long-term growth tailwinds, as businesses enhance productivity with tech investment.

Negatives for the sector:

- Valuations are stretched relative to the historical average;
- Capital expenditures are weak—albeit improving;
- Semiconductor prices are rising amid low supply and hoarding;
- The sector is highly concentrated in a few stocks.

Risks for the sector:

- Continued high unemployment could weigh on consumer technology revenues;
- Potential antitrust suits in the U.S. and Europe;
- Reversal of the 2017 corporate tax cuts that had greatly benefited the sector.

Materials: Marketperform



The Materials sector includes companies that make or process chemicals, construction materials (e.g., bricks, cement), containers and packaging (e.g., metal, glass, plastic, cardboard), forest products (e.g., lumber, paper), and metals and mining (e.g., aluminum, steel, copper, gold, silver).

The Materials sector is sensitive to fluctuations in the global economy and the U.S. dollar, concerns about the U.S.-China trading relationship, and the COVID-19 pandemic. Accommodative monetary and fiscal policies are improving the prospects for global economic growth. This has allowed the U.S. dollar to trend lower, which historically provides a strong tailwind for the sector.

The sector still faces challenges, however. Global growth is not necessarily expected to provide an enduring tailwind to industrial metals or demand for chemicals (the largest industry in the sector). With that said, any traction on

the Biden administration's clean energy and infrastructure initiatives could spark a boom for industrial metals and materials.

Positives for the sector:

- Optimism for an improving economy and weakening trend in the U.S. dollar;
- Improving global economic growth has the potential to support chemical demand;
- Strong gold demand is supporting precious metals mining;
- Improving relative strength;
- U.S. clean energy and infrastructure spending could create a surge in demand for industrial materials.

Negatives for the sector:

- Longer-term global growth is expected to be tepid, proving only modest growth in demand;
- The slow recovery in the oil rig count is a headwind for oil fracking chemicals.

Risks for the sector:

- Lack of further stimulus amid a pickup in global COVID-19 cases:

- lack of further stimulus amid a pickup in global COVID-19 cases,
- Potential stringent environmental regulations and reversal of the 2017 corporate tax cuts

Real Estate: Marketperform



The Real Estate sector includes equity real estate investment trusts (REITs) that invest primarily in commercial properties (e.g., office buildings, retail centers, apartment buildings), and companies engaged in real estate development and operation, such as real estate agents, brokers and appraisers.

The COVID-19 pandemic continues to be a significant headwind to the overall REITs sector. Commercial property demand remains well below pre-crisis levels, as segments of the economy have yet to fully recover—which increases the risk of lease defaults, particularly for retail and hotel REITs. The outlook for office REITs is highly uncertain, and will likely stay so until we know if there will be an enduring shift toward remote working. While net debt for the sector is low by historical standards, the risk to cash flow puts many REITs in a difficult position.

There are some exceptions, however. Warehouse/distribution center demand appears to be outstripping supply—resulting in sharply rising rents. And with the rapid rise in home prices amid low rates and de-urbanization, REITs specializing in single-family home rentals and manufactured homes stand to benefit. If the economy recovers more quickly, people get back to work, and interest rates stay low as the Federal Reserve maintains accommodative monetary policy, the Real Estate sector could do very well. In a low-interest-rate environment combined with renewed demand for office and retail space, investors' search for yield and attractive valuations could be a strong tailwind for the sector.

Positives for the sector:

- Optimism for improving economic growth and vaccine distribution;
- Low interest rates are positive for funding and make REITs dividends more attractive to investors;
- Industrial and single-family residential REITs segments are seeing strong demand and rising rents;
- Valuations have become more attractive.

Negatives for the sector:

- High unemployment can lead to multi-family lease defaults;
- A sharp turn higher in home-ownership rates is a negative for multi-family housing;
- An accelerated shift to internet from brick-and-mortar stores puts retail REIT revenues at risk;
- Behavioral shift away from long-term care and shared office space.

Risks for the sector:

- A quicker-than-expected rise in interest rates could be a sharp headwind.

Utilities: Underperform





The Utilities sector includes electric, gas and water utilities; independent power producers and energy traders; and companies that produce electricity using renewable sources (e.g., solar, wind, hydropower).

The Utilities sector has tended to perform relatively better when concerns about slowing economic growth resurface, and to underperform when those worries fade. That's partly because of the sector's traditional defensive nature and steady revenues—people need water, gas and electric services during all phases of the business cycle. Meanwhile, the low interest rates that typically come with a weak economy provide cheap funding for the large capital expenditures required in this industry.

However, valuations have been driven up in recent years as investors have reached for yield in this new era of low interest rates; this may decrease the sector's traditional defensive characteristics. And while interest rates are expected to remain generally low, they could edge higher as the economy continues to expand. On the flip side, there is the potential for a renewed decline in the economy to push rates even lower, or there could be significant government funding to Utilities as part of clean-energy initiatives that would benefit the sector's profit outlook.

Positives for the sector:

- Generally stable revenues;
- Investors often turn to utilities for dividend income when prevailing interest rates are low;
- Low yields provide low funding costs for this capital-intensive sector.

Negatives for the sector:

- The sector has not acted as defensively during recent periods of market weakness as in the past;
- Valuations are high relative to the sector's historical average;

- Economic recovery makes the sector less attractive relative to other sectors.

Risks for the sector:

- Uncertainty regarding potential clean-energy legislative funding;
- Higher interest rates due to unexpected rise in inflation.

What do the ratings mean?

The sectors we analyze are from the widely recognized Global Industry Classification Standard (GICS[®]) groupings. After a review of risks and opportunities, we give each stock sector one of the following ratings:




- Outperform: likely to perform better than the S&P 500 index
- Underperform: likely to perform worse than the S&P 500 index
- Marketperform: likely to track the S&P 500 index

Our view on individual sectors

Schwab Sector Views can be useful in identifying stocks by sector for potential purchase or sale. Schwab clients can use the Portfolio Checkup tool to help ascertain and manage sector allocations. When it's time to make adjustments,

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What you can do next

- Review your sector allocation. If you aren't sure how to analyze your sector weightings, a Schwab Financial Consultant can help.
- Explore more about sectors in [Sector Views](#).
- Talk to us about the services that are right for you. Call us at 800-355-2162, [visit a branch](#) , [find a consultant](#)  or [open an account online](#) .

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Past performance is no guarantee of future results and the opinions presented cannot be viewed as an indicator of future performance.

Each of the sector lenses shown in the Sector Overview table—Macroeconomic, Value, Fundamental and Relative Strength—is both intuitive and evidenced-based in nature. Within each, there are a varying number of factors. The **Macroeconomic** lens includes sector sensitivities to interest rates, stocks and the value of the U.S. dollar; the outlook for each of these is determined by the Schwab Center for Financial Research (SCFR)'s Asset Allocation Working Group, which uses a mosaic approach of quantitative and qualitative considerations. **Value** includes six different valuation metrics that provide a holistic perspective on current valuations relative to each of

the sectors' own historical valuations, as well as relative to the other sectors. **Fundamental** provides insight as to how efficiently the companies within each sector use invested capital to produce earnings; this historically has been informative as to future relative performance of the sectors. Finally, **Relative Strength** measures momentum of the individual sectors against all of the other sectors. We also consider the data in the context of factors outside the scope of these indicators—for example, geopolitical risk or central bank policy changes.

Investing involves risk including loss of principal.

Currencies are speculative, very volatile and are not suitable for all investors.

Commodity-related products, including futures, carry a high level of risk and are not suitable for all investors. Commodity-related products may be extremely volatile, illiquid and can be significantly affected by underlying commodity prices, world events, import controls, worldwide competition, government regulations, and economic conditions, regardless of the length of time shares are held.

Risks of the REITs are similar to those associated with direct ownership of real estate, such as changes in real estate values and property taxes, interest rates, cash flow of underlying real estate assets, supply and demand, and the management skill and credit worthiness of the issuer.

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