NUMERA ANALYTICS

US Equity Sector Strategy

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US Equity Sector Strategy offers positioning and analysis for the 11 GICS sectors and main sub-segments comprising the S&P 500. Our sector models are consistent with the same set of macro views underlying our US Asset Allocation report.

January 30, 2025

The DeepSeek affair: Rocking the AI narrative

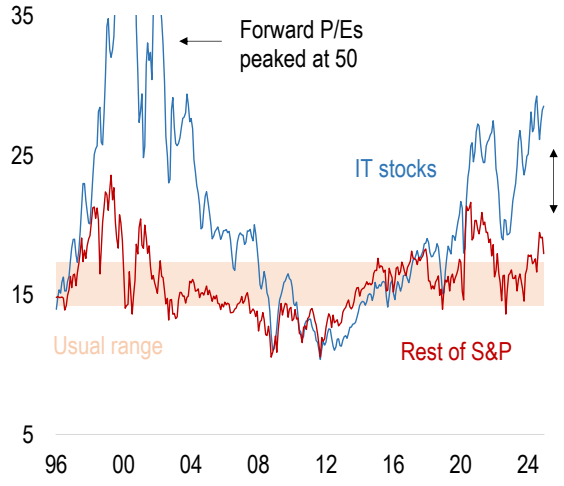
Rotate or double down? – US tech fared exceptionally well last year, rising 38% versus 14% for the rest of the S&P. Big tech benefited from strong profit growth and rapid multiples expansion amid AI and macro optimism. This caused tech's valuation premium to widen, raising questions over its vulnerability to a reversal in investor sentiment (F1).

This is in fact a key factor behind one of our top 'contrarian calls' for 2025, when we called for a gradual rotation towards value despite Fed easing. The emergence of low-cost AI start-up DeepSeek earlier this week fast-tracked this rotation, by casting doubt over the lasting dominance of mega-caps and the need for huge investments in AI infrastructure (F2).

Does this competitiveness threat worsen tech's risk-reward profile, or does the DeepSeek sell-off simply improves the entry point into a multi-year rally? An important aspect to consider, in this respect, is the highly concentrated nature of recent gains. While mega-caps went up 55% in 2024, other large tech firms fared only slightly better than value cyclicals.

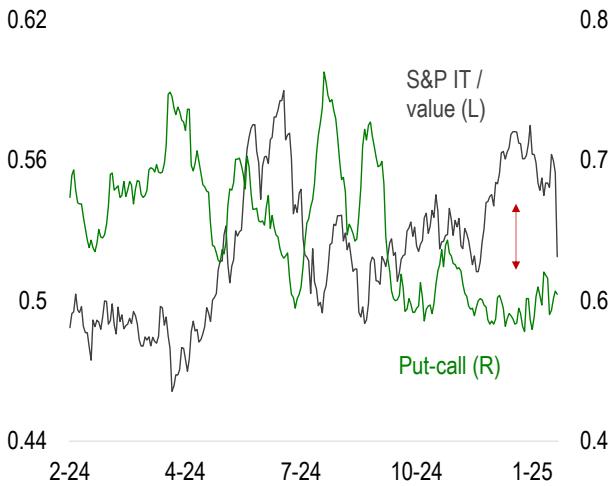
Indeed, other large-caps have mirrored the performance of lower quality tech mid-caps since 2023 (F3 below), highlighting the 'winner-takes-all' nature of the technology space. In particular, network effects have given mega-caps ample market power, allowing them to amass large cash holdings to invest in products that exploit disruptive technologies like AI.

F1: Is it time to diversify equity holdings?
S&P 500 forward P/E ratios by sector



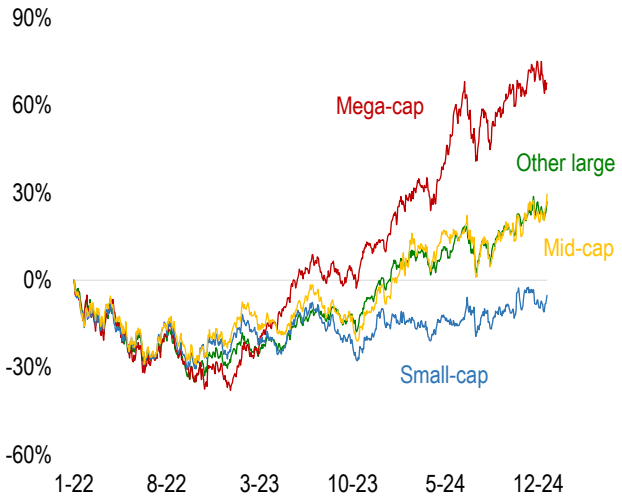
Note: Chart compares forward P/E ratios for large-cap IT stocks and the rest of the S&P 500. Shaded area is the interquartile range for the rest of the market. Source: Standard & Poor's; Numera calculations.

F2: DeepSeek sell-off exposed weak spots
S&P 500 IT / value vs. equity put-call ratio



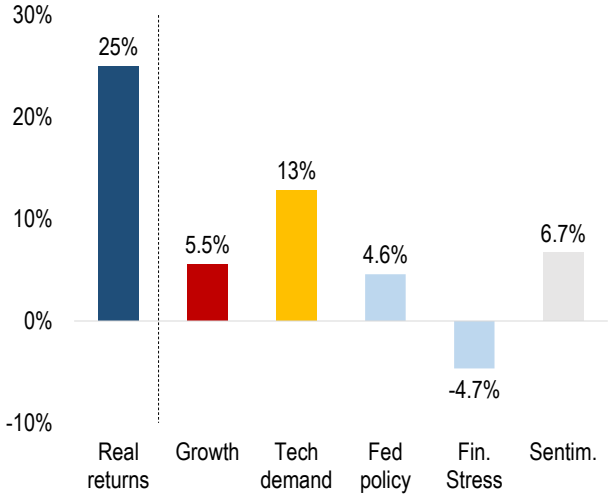
Note: Chart compares the relative performance of IT and value stocks in the S&P 500 versus the US equity put-call ratio, a proxy of investor sentiment. Source: Standard & Poor's, CBOE; Numera calculations.

F3: Tech returns are hugely concentrated
US technology stock returns by size



Note: Cumulative returns on IT and communication services by size since 2022. Other large-cap are S&P 500 firms excluding Mag-7. Source: S&P.

F4: Strong demand fueled last year's gains
Drivers decomposition - Nasdaq (2024)



Note: Chart breaks down the estimated contribution of selected drivers to real returns on the Nasdaq composite in 2024. Source: Numera Analytics.

In contrast, their competition faces significant barriers to entry through R&D and switching costs, giving mega-caps a clear edge as AI adoption grew after the launch of ChatGPT. Importantly, AI interest is not only fueling tech returns via investment flows, but by driving profitability: Earnings in the cloud and AI segments of big tech have grown 31% per year since 2019, and posted operating margins of 47% last year versus 16% in their other businesses (T1).

The most important development so far is the extremely rapid growth in cloud computing needs, propelling investments in data centers and chip sales. Last year, US investment in IT equipment grew 16%, versus a 4% CAGR for the post-GFC period. Demand for integrated circuits, in turn, grew by a staggering 46% in the US and 14% abroad.

In addition, tech demand benefits from a strong US economy, driving household tech spend and fueling business optimism. F4 isolates the estimated contribution of various drivers to real returns on the Nasdaq in 2024. We find that tech demand (including cloud and AI spending) and broad growth explain 70% of last year's gains. Sentiment amplified tech returns, but played a much smaller role than in 2023, when public interest in generative AI first started.

T1: Major AI tech firms Profitability by sector	CAGR, 2019-24 (%)		2024 share (%)		Operating margin (%)	
	Revenue	Earnings	Revenue	Earnings	2019	2024
Cloud and AI	23%	31%	30%	55%	35%	47%
Other segments	10%	11%	70%	45%	16%	16%

Note: Real revenue and profit growth and average operating margin by sector for AMZN, GOOGL, IBM, MSFT, NVDA, and ORCL. Cloud and AI refers to revenue from cloud services or the sale of software or hardware for AI computing needs. Source: Numera Analytics on 10k / 10q SEC filings.

T2: IT demand and activity Average growth by regime	IT demand	Hardware	Software	Semis	MC weight
Strong growth	*14%*	*14%*	*11%*	*24%*	*14%*
Weak growth	*8%*	*9%*	*9%*	*5%*	*10%*
Multiplier	*1.3*	*1.5*	*1.0*	*2.0*	*1.5*

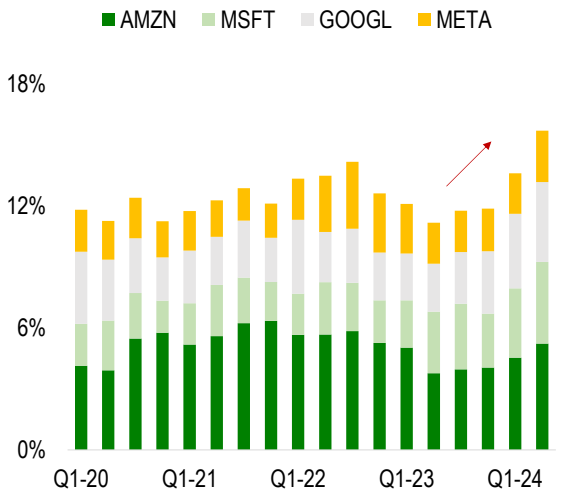
Note: Table compares growth in real US spending on technology in periods of above and below-potential GDP growth. The last column shows the rate of growth for a market-cap weighted index, while the last row shows the sensitivity of tech demand to the US economy. Source: Numera Analytics.

For tech to maintain its momentum, then, it is critical that demand for technology continues growing at a rapid clip. At the macro level, US spending should slow in 2025, with our models picking up a high probability of below-trend growth. This curbs the upside for tech demand, particularly for growth-sensitive hardware and semis. Historically, when the US grows below trend, chips consumption grows 5 times slower than in a cyclical upswing (T2).

Naturally, continued AI adoption is also important, as this would continue to drive cloud revenues and AI infrastructure. Big AI tech firms have already ramped up capex as a share of revenues (F5), and are pledging even more investments in 2025. Meta and Microsoft, for instance, plan to invest $140B on AI-enabled data centers and related technologies, while the recently announced Stargate joint venture is looking to allocate $100B immediately on AI infrastructure.

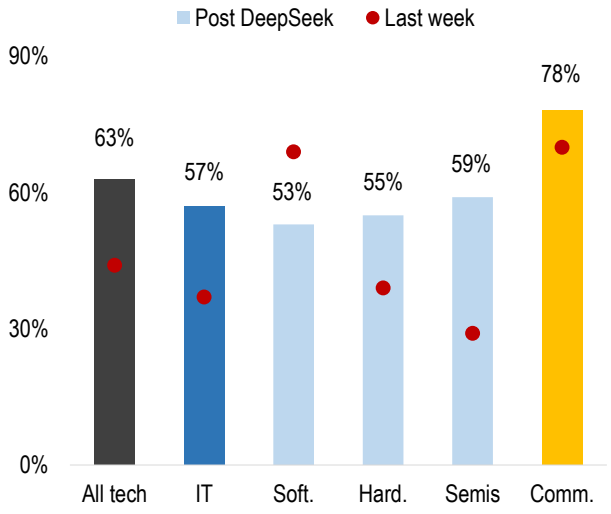
DeepSeek's cost efficiencies create opportunities and threats. If the new platform drives business adoption by cutting AI inference costs, this may prove beneficial to cloud providers. Yet productivity gains might also allow users to run AI models on end-user devices rather than relying on cloud infrastructure, potentially offsetting these gains.

F5: Mega-caps are ramping up AI spend
AI tech capital spending / revenues (%)



Note: Chart tracks capital spending for mega-cap AI firms as a share of total revenues by quarter. Source: Numera Analytics on 10Q filings.

F6: DeepSeek sell-off improves entry point
Likelihood of tech outperformance - 12M out

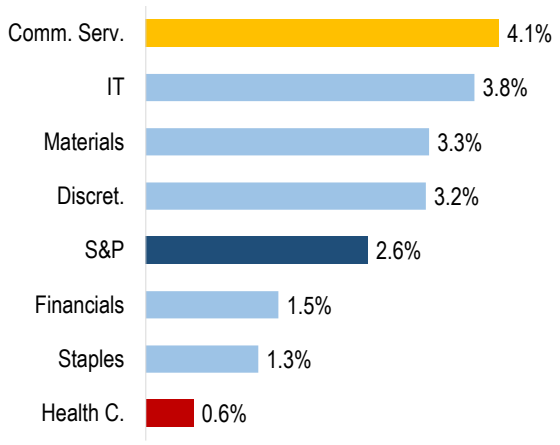


Note: Chart compares the probabiltiy that tech stocks by category outperform the broad S&P 500 over the next 12M. Source: Numera Analytics.

Cost gains also cast doubts on the need for massive computing resources, potentially slowing the pace of growth in GPUs and IT equipment sales. At the same time, if tech firms are able to use AI more efficiently (like for targeted ads, online media or devices), this could improve the bottom line of at least some mega-cap players.

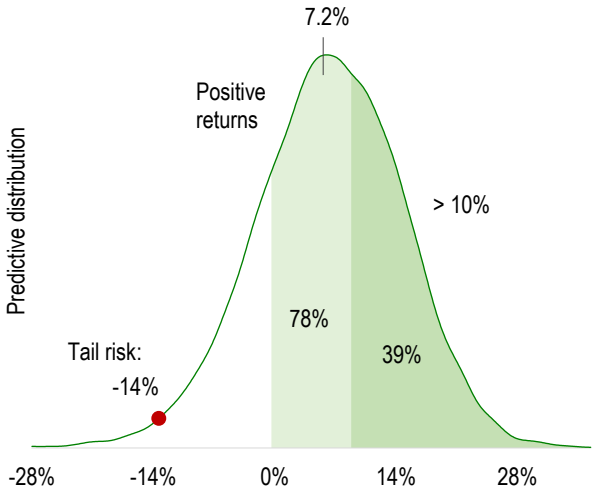
From a quantitative standpoint, this increases uncertainty around the earnings outlook. Before this week's DeepSeek affair, our models identified a reduced probability that tech would keep beating the market this coming year (red dots in F6). Yet this hid significant differences by segment, with much lower probabilities for growth-sensitive hardware and semis (which looked attractive in December, but quickly realized sizeable expected gains).

F7: Online media is very rate sensitive
Impact of Fed easing on equity returns



Note: Chart compares the simulated response of a 25 bps drop in the Fed funds rate on real expected returns across equity sectors. Source: Numera Analytics.

F8: Tech upside still lower than last year
S&P real tech returns - 12M ahead (%)



Note: There is a 78% probability that S&P tech stocks deliver positive real returns in 2025, and a 39% chance of double-digit gains. The worst potential outcome is a 14% year-on-year drawdown. Source: Numera Analytics.

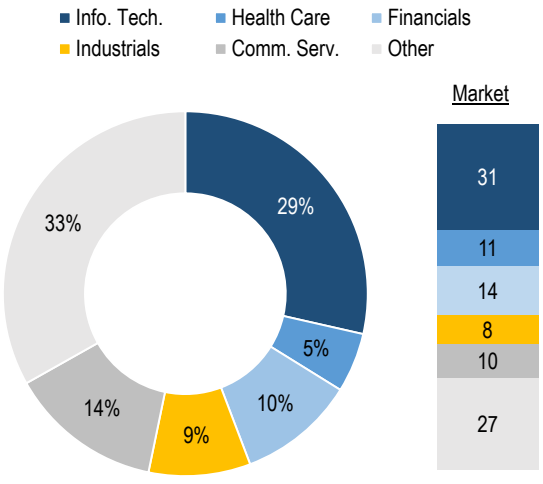
Software and online media, in contrast, had a better risk-reward because of a lower sensitivity to a growth slowdown, and a high responsiveness to a projected decline in US yields (F7). Notice from F6, however, that the outlook changes significantly after the DeepSeek correction. The reason for this is that the valuation adjustment makes for a much better entry point by pushing tech closer to 'fair' value, more than compensating for greater uncertainty in earnings.

The probability that chip stocks outperform jumps 30 points to 59%, whereas software (flat on Monday) lost upside as investors look for 'buy-the-dip' opportunities. What does this mean for positioning? In general, we find a higher tech allocation improves the risk-reward profile of US equity portfolios versus last month, favouring cyclicals overall.

Even so, the upside is not high enough to call for an all out tech tilt. In absolute terms, there is less than a 40% chance that tech posts double digit gains 12M out (F8), when over the past decade this has been commonplace. Rather, we favour a more diversified approach, with some defensives to mitigate risks to spending, an OW on energy to limit inflation risks, and selected exposure to value cyclicals to exploit potential gains from a shift in economic policy.

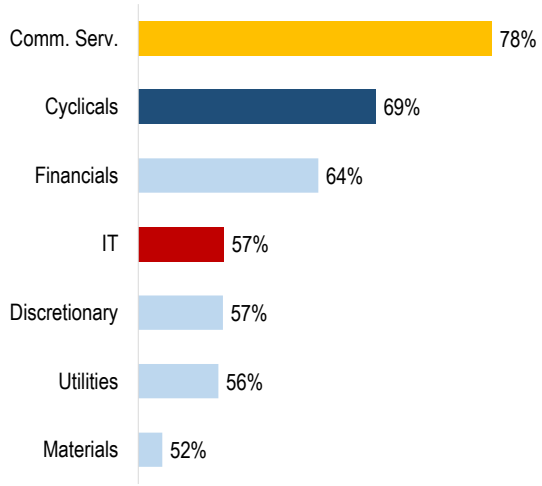
T3: Strategic allocation Positioning by sector	Strategic rotation	Change (vs. Dec.)	Sector view and key macro factors
Information Technology	●	–	Continued AI enthusiasm and lower projected yields remain two important sources of 'alpha'. Semis have a much better entry point after DeepSeek.
Health Care	●	▼	We are UW health care, mainly because staples and utilities have a higher upside and are an equally effective hedge against a potential slowdown.
Financials	●	–	We are neutral since a wider term spread and a normalization in lending standards improves bank appeal. Regionals stand to gain from deregulation.
Consumer Discret.	●	▲	Upgrading because of a sizeable improvement in the risk-reward profile of broadline retail (e-commerce). Durable goods still vulnerable to slowdown.
Industrials	●	–	Industrials are vulnerable to negative growth surprises as the year progresses. Yet downside risk is contained by a likely pick-up in domestic manufacturing.
Communication Serv.	●	▲	We favour online media over IT for two main reasons: it is more sensitive to a likely decline in yields, and is more resilient to growth fluctuations.
Consumer Staples	●	–	Improving volume growth, and expenditure share to rise as consumers deplete savings. FMCG producers also benefit from resilient mark-ups.
Energy	●	–	Higher inflation risks with the Trump administration improve energy's appeal (E&P in particular) in a multi-asset setting as a well priced inflation hedge.
Materials	●	–	USD strength worsens near-term appeal. Energy is a more effective inflation hedge, partly because higher oil prices would hurt chemical margins.
Utilities	●	–	Fed easing and AI investments improve risk-reward profile. As a defensive sector, it also offers a hedge against a likely slowdown in H2/25.
Real estate	●	–	CRE prices are picking up, increasing upside for a sector that still trades at a deep discount. Fed cuts also help, especially given a low risk of a deep recession.

F9: Optimal vs. market sector weights
Strategic portfolio weights



Note: Optimal versus market weights for Numera strategic portfolio. Optimal weights are constrained to +/- 50% of their market caps. Source: Numera Analytics, S&P.

F10: Probability of outperforming S&P 500
Likelihood by GICS sector - 12M ahead



Note: Chart compares the probability of positive real returns on selected equity sectors and styles over a 12M holding period. Source: Numera Analytics.

T4: Sector rotation Optimal weights (%)	Market Weights	Positioning[1] (%) Current	Positioning[1] (%) Strategic	Strategic rotation	Change (vs. Dec)
Information technology	31%	32%	29%	●	–
Software	12%	8.7%	8.8%	●	▼
Hardware	8.6%	11%	4.3%	●	–
Semiconductors	10%	13%	15%	●	▲
Health Care	11%	7.9%	5.3%	●	▼
Equipment	2.7%	2.1%	1.4%	●	▼
Services	2.5%	1.8%	1.2%	●	▼
Pharmaceuticals	5.4%	4.0%	2.7%	●	–
Financials	14%	11%	10%	●	–
Banks	3.6%	2.7%	5.1%	●	–
Financial services	8.4%	6.8%	4.2%	●	–
Insurance	2.1%	1.6%	1.0%	●	▼
Consumer Discret.	11.4%	12.0%	12.5%	●	▲
Auto & components	2.6%	1.9%	1.3%	●	–
Consumer services	1.3%	1.0%	0.6%	●	▼
Retail & distribution	6.8%	8.5%	10%	●	▲
Industrials	8.4%	9.7%	9.0%	●	–
Capital goods	5.4%	6.6%	6.0%	●	–
Transportation	1.5%	1.2%	0.7%	●	–
Communication Serv.	9.7%	12%	14%	●	▲
Consumer Staples	5.6%	5.9%	8.3%	●	–
Food & beverages	2.3%	2.9%	3.5%	●	–
Energy	3.3%	2.4%	4.6%	●	–
Materials	2.0%	1.5%	1.0%	●	–
Utilities	2.3%	2.9%	3.5%	●	–
Real Estate	2.1%	2.6%	3.2%	●	–
Cyclicals	82%	83%	83%	●	–
Defensives	18%	17%	17%	●	–

1. Weights maximize risk-adjusted returns for a US equity portfolio for the current macro context and over the coming year. Current weights are constrained to +/-25% of their respective market cap shares.

Our methodology:

We rely on macro-econometric models for 35 GICS segments adding up to the S&P 500, combining top-down economic forecasts and sector-specific views. To ensure consistency, each framework controls for our outlook on key macro variables like Fed policy, long-term yields or the US dollar. We also incorporate a wide range of market-specific variables influential to earnings.

Model choice depends on an economic assessment of industry dynamics and on predictive ability, based on rigorous back-testing. We also rely on model combinations rather than single specifications to hedge against model uncertainty.

We forecast industry returns jointly via stochastic simulation, generating alternative paths based on economic, financial and sector-specific shocks. We then conduct a portfolio optimization exercise to find sub-sector weights that maximize risk-adjusted returns. By controlling for broad macro factors, sector rotation depends on the likelihood of economic scenarios like a recession.

Unlike a standard Sharpe-ratio optimization, the weights maximize upside risk and minimize downside risk over a given horizon. Upside (downside) risk is the probability of positive (negative) returns over the risk-free rate times expected gains (losses). Our recommendations are based on a 'constrained' version allowing for a +/-20% switch against market-cap shares.

As an example, the table below shows the inputs for our oil & gas refining equity model, a sub-segment of the S&P energy:

	Crude oil			
Market drivers	Model 1	Model 2	Model 3	Model 4
Brent spot price	X	X	X	X
World oil consumption				X
World ESI index				X
Comm. activity index		X	X	
Fed funds rate				X
US dollar index	X			X
CAD per USD		X	X	
World oil production				X
World oil rig count		X	X	
OECD commercial stocks	X	X	X	X
Stock draw (inc. SPR)				X

→

Modelled variables	Data source
Brent crude oil	ICE
US dollar index	ICE
Fed funds rate	Federal Reserve
US 10Y Treasury yields	Dep. of Treasury
ISM new orders	ISM

Endogenous variables	Data source
Refinery sales	US EIA
Product inventories	US EIA
'Crack' spread	EIA; Numera
S&P 500 O&G refining TR	Standard & Poor's

The model controls for oil prices, the dollar, the Fed funds rate, 10Y Treasury yields, and ISM new orders. The block on the left breaks down the inputs in our oil price forecast, typically the most important determinant of model performance.

We forecast oil prices by switching across four different specifications, with the weights varying over time based on their predictive ability. Not every sub-model features the same variables, or employs the same structure. Beyond these macro forecasts, we model demand and inventories of finished petroleum products, and a weighted average of gasoline and distillate 'crack' spreads.