PERCENTAGE PLAY
Actionable insights

NUMERA ANALYTICS

EMBRACING UNCERTAINTY

Outperforming the market requires accurately estimating opportunities and risks: it's about identifying favourable odds through probability analysis. ***Percentage Play*** *offers high conviction calls based on our cutting-edge probability forecast models.*

THIS WEEK'S PLAY: LONG COMMUNICATION SERVICES

THE OPPORTUNITY: Last week's DeepSeek correction improved the upside for tech, by pushing stocks closer to fair value. Within tech, online media is especially appealing, owing to AI productivity gains and attractive macro features.

THE ACTION: We currently find a 78% probability that communication services will outpace the S&P 12M out, and a 40%+ chance of double digit gains. Unlike IT, upside risk is in line with the sector's historical performance.

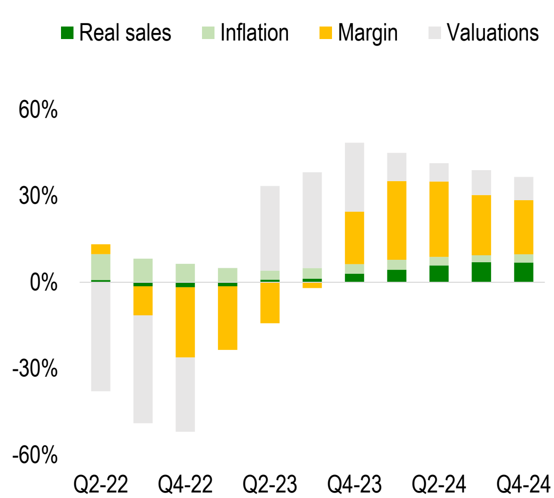
AI winners – In our latest *US Equity Sector Strategy* report, we explored how the risk-reward profile of big tech changed after the DeepSeek correction. While lower costs cast doubts on the need for large investments in AI infrastructure, we find that the valuation adjustment more than compensates for heightened uncertainty around earnings.

In general, this improves the likelihood of positive returns on tech. Yet we find that the upside varies considerably at the sector level. In particular, we find investors should favour online media (ETF: XLC) over IT. Both segments had very strong returns in 2024, but the former largely benefited from strong earnings, not multiples expansion (F1).

The key reason for this was cost consolidation, as AI efficiency gains allowed leading firms in the space to reduce headcount. The fact that valuation gains played a modest role makes for a much better entry point. Online media is trading at a 45% discount versus IT, and forward P/Es are only marginally higher than their normal range.

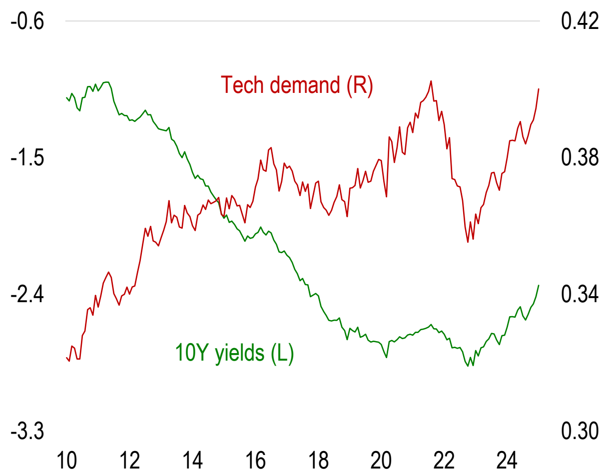
More fundamentally, the possibility of increased accuracy in advertising and streaming services through AI improves their revenue potential. Productivity gains should also allow for further cost reductions, and revenues are generally less reliant on AI infrastructure spending than IT.

F1: Cost consolidation fueled 2024 returns
S&P comm. service returns by source (YoY)



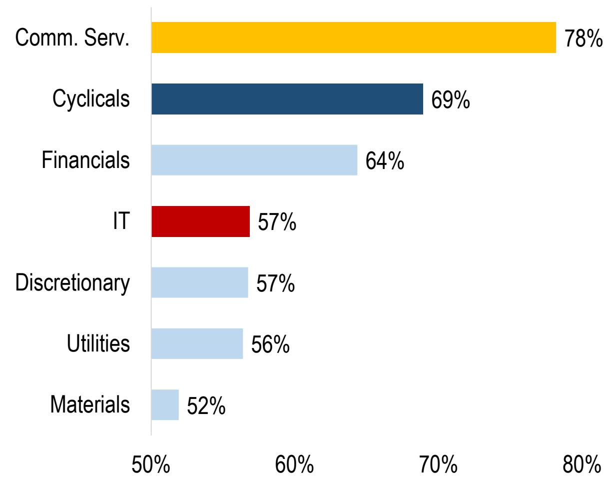
Note: Chart breaks down contribution of sales, margins and valuations to yearly returns on S&P 500 comm. services. Source: Numera Analytics.

F2: Lower yields would prop up returns
Sensitivity to US yields and tech demand



Note: Chart tracks the time-varying sensitivity ('betas') of comm. services to US 10Y yields and US tech demand. Betas are Kalman filter estimates from a multivariate state-space model. Source: Numera Analytics.

F3: Media retains great upside potential
Likelihood of outperforming S&P - 12M out



Note: Chart compares the probability of out performance (vs S&P 500) on selected equity sectors and styles over a 12M holding period. Source: Numera Analytics.

In terms of macro, online media is better equipped to navigate a late cycle than hardware and semis. Traditionally, ad spending is very sensitive to economic fluctuations. Yet over time, internet adoption has made demand for digital media a necessity to households and firms. This has made returns more reliant on fast growing tech demand vis-à-vis overall private spending (red line in F2), a useful feature as US GDP growth normalizes in 2025/26.

We also find the sector's interest rate sensitivity has increased noticeably over time. This applies to both long-term yields (green line in F2) and Fed policy. For example, a 100 bps reduction in Fed rate expectations improves sector returns by close to 10%, higher than for any other equity segment. This is a helpful feature in the current context, given a high probability that the market will price in more cuts over the course of the year as activity slows.

F3 compares the probability that various equity categories outperform the broad S&P 12M out. At 78%, the likelihood is much higher for communication services than for IT and cyclicals overall. In absolute terms, the upside is lower than in 2024, but we still find a 40%+ chance the sector delivers double-digit gains, in line with its historical average.

In case you missed it ...

- **Percentage Play** (28/01): Smart inflation hedging
- **US Macro Strategist** (04/02): The tariff macro handbook

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