Wealth Management Market Commentary

REGIONS
ASSET MANAGEMENT

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Be Careful Playing "Defense"

Over the past month, as trade rhetoric has ramped up to a fever pitch, we've witnessed pockets of the equity market commonly thought of as being defensive in nature catch a bid. But all "defensive" sectors aren't created equal. Case in point, consumer staples. The consumer staples sector entails household products companies such as Colgate-Palmolive, Clorox, and Kimberly-Clark, tobacco companies such as Phillip Morris International, consumer packaged goods companies such as Hershey and General Mills, and even Costco and Walmart. Consumer staples as a sector has historically been thought of as defensive because we as consumers have an affinity with these brands and use many of their products on a daily basis, thus leading to a greater inelasticity of demand relative to many other sectors, along with greater earnings visibility and stability – both characteristics investors seek out in more uncertain times. It also doesn't hurt that the sector carries a dividend yield of over 3%, versus the S&P 500's trailing 12-month yield of just 1.9% – yet another characteristic valued by income-seeking investors looking to de-risk.

The S&P 500 consumer staples sector has rebounded 5.6% since the start of June, as cautious optimism surrounding trade negotiations over time evolved into widespread pessimism. It's notable that year-to-date through last week, the consumer staples sector had posted a negative 7.2% total return, while the S&P 500 is up 4.2%. Staples had become oversold, leading contrarian capital into the sector which precipitated its recent recovery. But, as we noted at the outset of this commentary, all "defensive" sectors aren't created equally, and sometimes market shifts are driven by "smart money" turning dumb, and flocking to safety en masse. In the case of consumer staples, the sector has rebounded alongside other traditionally defensive sectors such as telecommunications and utilities, both sectors also known for high earnings stability and visibility, but consumer staples' best days might be behind it at this point due to a number of potential headwinds we see materializing over the coming quarters.

High-dividend yielding sectors have rallied as interest rates on the long end of the yield curve have come down. The decline in rates after a sharp move higher from the start of the year through mid-May has since increased demand for stocks that look and feel more like bonds. Long-term yields have moved lower due to a potentially more hawkish FOMC, the European Central Bank (ECB) delaying monetary policy normalization until 2019, stubbornly low wage growth domestically, and trade war fears dragging down non-energy related commodity prices. All of the above serve to lower inflation expectations to varying degrees, increasing the appetite for and value of income-generating assets.

While we recommend maintaining exposure to defensive sectors as part of a broadly diversified equity portfolio, we find it difficult to believe that the consumer staples, utilities, and telecommunications sectors can continue to serve as market leadership beyond catching bids during flights to safety. The consumer staples sector trades at 17.6 times projected 2018 earnings, while 2018 earnings are expected to grow 8.5% year over year. For comparison purposes, the S&P 500 trades at 17.4 times projected 2018 earnings, earnings projected to grow 20% over 2017. How can one justify paying a market multiple or thereabouts for exposure to sectors expected to generate less than half of the earnings growth projected for the broader market this year? Investors seek stability and familiarity when they look for a port in the storm, and are willing to pay up to get it. Sometimes it's that simple.

The consumer staples sector derived just 56% of total trailing 12-month revenue from the U.S. With our outlook calling for robust U.S. economic growth to persist through year-end, and with developed markets abroad taking a step or two backward over the past couple of quarters, earnings variability could be far greater than anticipated for consumer staples, especially with the U.S. dollar rallying of late. Add into the equation rising input costs from tariffs, specifically steel, aluminum, and cardboard, which could weigh on margins, and you have a scenario in which recent positive price action may not be sustainable. Admittedly, we're painting consumer staples with a broad brush here, and there are undoubtedly some attractive investment opportunities in the sector, but a discerning eye is warranted.

Sometimes playing defense is the best way to sleep at night, and given daily news flow, we understand why some may be inclined to focus more on capital preservation for now, but the recent rally in defensive sectors reminds us of the phrase, "Scared money never makes money." We remain positive on equities, especially those with a more domestic focus over those garnering a larger percentage of revenues from abroad. We continue to view the recent sell-off in financial services, industrials, and emerging markets, among other pockets of the equity market, as opportunities, but we are also cognizant that global equity markets may remain range-bound until clarity on trade policy is attained.

Source: Bloomberg

	Price/Yield	Total Return (%)					
	7/6/2018	1 Week Ago	1 Month Ago	Year to Date	1 Year	3 Years	5 Years
Dow Jones Industrial Average	24456.48	0.82	-2.62	0.09	17.33	14.22	12.79
S&P 500	2759.82	1.56	-0.31	4.25	16.74	12.39	13.40
NASDAQ	7688.39	2.40	0.07	11.99	27.59	16.82	18.56
Russell 2000 Index	1694.05	3.12	1.22	11.02	22.47	12.31	12.51
MSCI World ex US	1966.70	0.05	-1.89	-1.81	8.25	6.02	6.76
MSCI EM	1059.97	-0.67	-7.22	-7.14	8.10	6.78	5.74
Bloomberg Barclays US Aggregate	3.28	0.24	0.89	-1.38	0.11	1.70	2.53
Bloomberg Barclays Global Aggregate	1.98	0.48	0.51	-0.99	2.35	2.83	1.83
Bloomberg Barclays US Corporate Index	3.99	0.49	0.80	-2.80	-0.07	3.07	3.80
Bloomberg Barclays 10-Year Muni Index	2.63	0.11	0.26	-0.61	1.08	2.81	3.67
Bloomberg Barclays High Yield Index	6.52	0.01	0.01	0.17	2.67	5.53	5.53

	Price/Yield						
	7/6/2018	1 Week Ago	1 Month Ago	12/31/2017	1 Year Ago	3 Years Ago	5 Years Ago
1 Month LIBOR (rate)	2.09	2.09	2.03	1.56	1.22	0.19	0.20
30 Year Mortgage (average rate)	4.37	4.40	4.46	3.86	3.94	4.09	4.37
2 Year Treasury (yield)	2.53	2.52	2.52	1.88	1.40	0.59	0.40
10 Year Treasury (yield)	2.82	2.85	2.97	2.41	2.37	2.29	2.74
30 Year Treasury (yield)	2.93	2.99	3.13	2.76	2.85	3.08	3.71
WTI Crude (closing price)	73.79	74.13	64.75	60.46	45.52	52.48	103.22
Brent Crude (closing price)	77.14	77.44	73.23	66.73	48.53	57.19	105.38
Gold (NYM $/oz)	1254.30	1251.30	1297.10	1306.30	1222.20	1172.90	1212.90

Source: Bloomberg

Disclosures

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