Strategic Sector Selector
A cycle in transition

The rally in global equities stalled in the third quarter of 2021 after a bout of disappointing economic data pointed to a slowdown in the pace of growth. At the same time, supply bottlenecks and surging energy prices contributed to concern about higher inflation. We believe the economic cycle is going through an adjustment phase to more sustainable growth rates and expect inflationary pressures to peak in the next 12 months. Therefore, we remain biased towards cyclical assets with the caveat that we expect limited returns over the next 12 months. While we increase our allocation to cyclical sectors, we seek a balance between early- and late-cyclicals and exposure to growth and value factors. With this in mind, we tilt late-cyclicals to a slight Overweight, while we selectively shift to Overweights in consumer discretionary and technology. Finally, we reduce our allocations to defensive sectors, which we expect to underperform.

Changes in allocations:

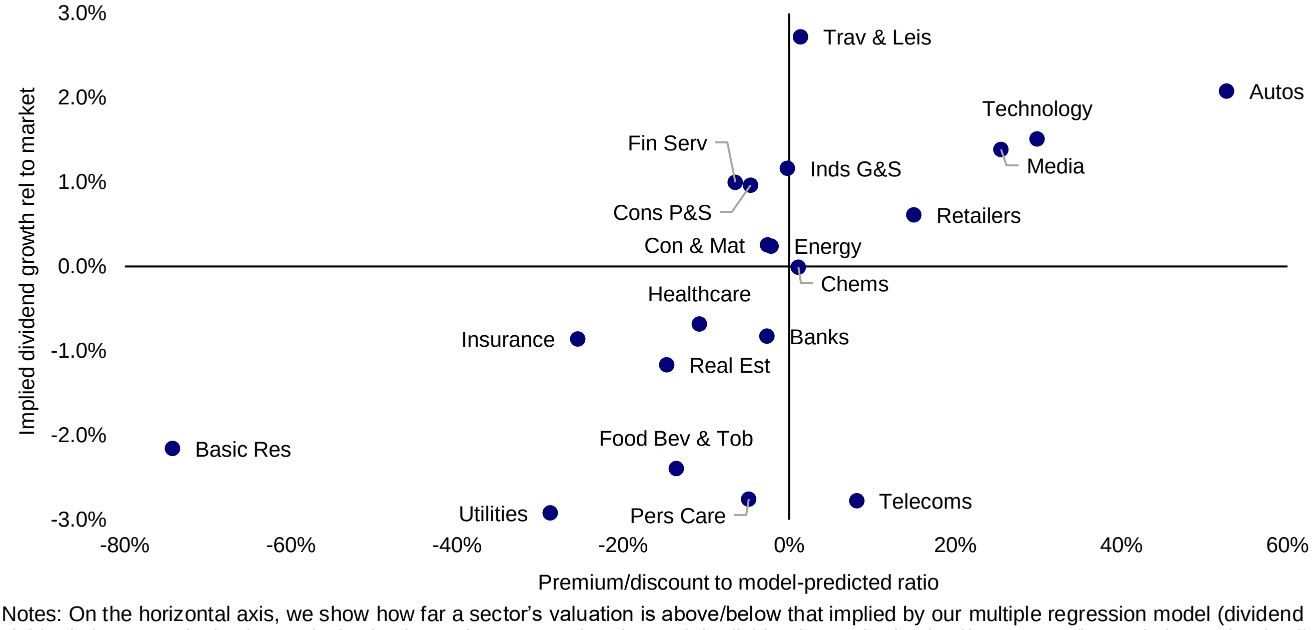
- Upgrades: energy, travel & leisure (UW to N), basic resources, industrial goods & services, (N to OW), retailers, financial services (UW to OW)
- Downgrades: telecommunications, utilities (N to UW), food, beverage & tobacco, healthcare (OW to N), media (OW to UW)

	Most favoured	Least favoured
Sector	US technology European basic resources	US automobiles & parts European utilities

Sectors where we expect the best returns:

- Basic resources: high yield, undervalued, play on infrastructure investment and green transition
- Real estate: exposure to mid-cycle expansion, attractive valuations, play on increasing demand for logistics
- Technology: resilient demand for products and services, high margins, exposure to growth factor

Figure 1 – Global sectors valuation matrix



Notes: On the horizontal axis, we show how far a sector's valuation is above/below that implied by our multiple regression model (dividend yield relative to market). The vertical axis shows the perpetual real growth in dividends required to justify current prices relative to that implied for the market. We consider the sectors in the top right quadrant expensive on both measures, and those in the bottom left are considered cheap. See appendices for methodology and disclaimers. Source: Refinitiv Datastream and Invesco

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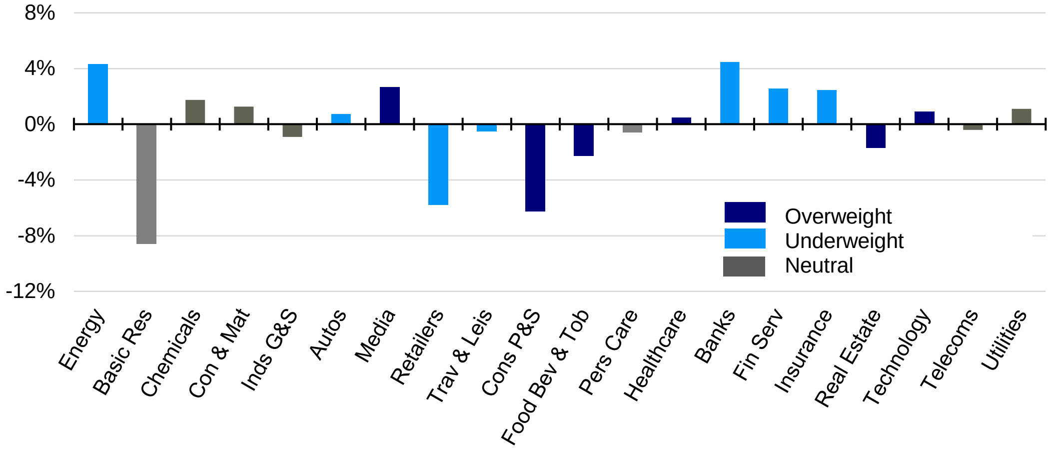
Summary and conclusions

Since the last time

Global equity returns were broadly flat in the third quarter of 2021 in local currency terms (using the MSCI All-Country World Index). Disappointing economic data suggested a slowdown in growth, which kept the rise in sovereign yields limited, despite increasing concerns about inflation and Fed tapering. Rising oil and natural gas prices, added to supply chain disruptions, highlighted the short-term risks the global economy.

Figure 2 – 3m Global sector returns relative to market in USD



Notes: See appendices for methodology and disclaimers. Returns shown between 30th June 2021 and 30th September 2021. Colours indicate allocations in period considered. **Past performance is not a guarantee of future results.** Source: Refinitiv Datastream and Invesco

Figure 2 .highlights how challenging it is to position for increasing uncertainty amid the transition towards a more stable expansionary phase of the economic cycle. Indeed, only five sectors outperformed or underperformed by more than 3%. We underestimated how much the energy sector would be boosted by rising prices (in fact we expected prices to rise less) and we were too cautious on financials in the face of challenging macroeconomic data. However, we were right to move retailers to underweight and to keep our Overweight in media, technology and healthcare. We suspect the slowdown in the Chinese economy may have been the main driver behind the underperformance of basic resources and, to a certain extent, consumer products & services (mostly luxury goods).

Asset allocation backdrop

After rebounding strongly, the global economy is showing signs of hesitancy. We think this is a transition to a more sustainable rate of growth, rather than the start of a recession but suspect that financial markets could experience some volatility until that is confirmed. If anything, we feel that central banks are now starting to withdraw the generous support offered during the pandemic. There are several risks that could change the outcome we are expecting, most importantly that recession arrives sooner than we thought or that conversely inflation proves to be more than a transitory phenomenon. A number of geopolitical issues could also impact markets: political volatility in Germany, negotiations with Iran, Afghanistan centred tensions (including the potential re-emergence of Donald Trump), China-US rivalry and COP-26 failure (see The Big Picture for the full details).

We show our latest forecasts in **Figure 3**, the 10-year US treasury yield rising to 2.20% being perhaps the most important and that consequently the US dollar will strengthen slightly. This suggests to us a re-emergence of some earlier trends (outperformance of value versus growth, weakness of gold and defensive fixed income assets). However, it also suggests that commodity prices may find it harder to advance from here (especially given that many of them are now expensive, in our view) and that EM assets may consequently face a headwind, despite being among our favourites.

In determining our Model Asset Allocation, we follow the optimisation results where they are clear cut, except that we have chosen to reduce high yield (HY) to an Underweight 2% (from the previous 5%, which is also Neutral), rather than go all the way to zero. Though the cycle may still favour HY, spreads are tight, and we expect benchmark government yields to rise. The question is then which assets to boost. Counter to what we expected when we started this process, we have chosen to add to the equities allocation. We find that the rise in equity prices over recent months has been more than justified by the rise in earnings and dividends. Hence, valuations relative to fixed income assets have actually improved, in our opinion, and we are choosing to rotate from one cyclical asset (HY) to another (equities). The allocation to equities is consequently raised from 51% to 54%, versus a Neutral 45%.

Real estate remains our favourite cyclical asset category. It may suffer a loss of demand for office and retail space as a result of Covid-19 but we find the yields to be attractive (a lot of bad news is in the price, in our opinion) and expect growth to resume as economies recover. Among other cyclical assets, we remain Underweight commodities, with a small 1% position entirely dedicated to the agriculture sub-group which we find to be good value. Within the bond segment, we continue to have a zero allocation to investment grade and are sticking to an Underweight allocation to government bonds, within which EM is the only region that is Overweight. Cash remains our defensive asset of choice, and we think gold will struggle if treasury yields and the dollar rise, so we maintain a zero allocation.

From a regional perspective, we have switched the emphasis within Europe (from Eurozone to UK) and our preferred regions across all assets are now the UK and EM.

Figure 3 – Market forecasts

	Current (30/09/21)	Forecast 12-month
Central Bank Rates		
US	0.25	0.25
Eurozone	-0.50	-0.50
China	4.35	4.35
Japan	-0.10	-0.10
UK	0.10	0.10
10y Bond Yields		
US	1.53	2.20
Eurozone	-0.19	0.15
China	2.87	3.40
Japan	0.07	0.15
UK	1.02	1.10
Exchange Rates/US$		
EUR/USD	1.16	1.15
USD/CNY	6.45	6.60
USD/JPY	111.29	112.00
GBP/USD	1.35	1.35
USD/CHF	0.93	0.95
Equity Indices		
S&P 500	4308	4500
Euro Stoxx 50	4048	4400
FTSE A50	15486	16500
Nikkei 225	29453	31000
FTSE 100	7086	7800
Commodities (US$)		
Brent/barrel	78	70
Gold/ounce	1761	1600
Copper/tonne	8945	10000

Notes: There is no guarantee that these views will come to pass. See Appendices for definitions, methodology and disclaimers. See The Big Picture for a full explanation.
Source: Refinitiv Datastream and Invesco Global Market Strategy Office

Changes to sector allocations

Global equity markets swung between optimism and pessimism and made little headway during the third quarter of 2021. Financials and energy led the way, but the narrative switched from reflation (and demand-pull inflation) to concerns about cost-push inflation as supply chain bottlenecks persisted. Further, demand soared not just for oil, but also for natural gas, while wages are rising in some sectors. These pressures seem to be easing, and inflation rates may normalise in the next 12 months, albeit at a higher price level. After a period of increased volatility, we believe that global equities may enter calmer waters, although we expect returns to be more muted than in the past 12 months. Tapering announcements did not cause as much upheaval as in 2013, neither by the ECB, nor by the US Federal Reserve. We think that we are part-way through the transition phase into a more settled period of growth and do not expect the economic cycle to end prematurely in the next year. We rotate into more cyclical sectors, while incrementally shifting the balance from early- to late-cyclicals. We also believe that factor leadership will narrow and change and therefore maintain exposure to both value and growth.

Oil and gas prices have dominated the headlines recently and we believe that oil prices will remain near current levels for the next 12 months. While we missed the rally year-to-date, we expect demand to provide enough support for the **energy** sector, which we upgrade to **Neutral**. In our view, the sector is a late-cyclical and valuations are close to fair value on our multiple regression model and its implied dividend growth is close to that of the market. Supply has not responded to higher prices, yet, and it may take time to do so, considering the underinvestment in the last few years partly because of the political pressure to focus on renewable energy sources.

We are more enthusiastic about **basic resources**, whose valuations we think look attractive: it has the largest discount versus the relative dividend yield implied by our multiple regression model and its implied perpetual dividend growth is negative. We also expect positive returns from industrial metals in the next 12 months and expect the sector to be crucial in providing key ingredients to both infrastructure investments and the “green transition”. Recent underperformance may be overdone and therefore we upgrade to **Overweight**.

Industrial goods & services will provide the tools for infrastructure and green projects in our view, and therefore we upgrade the sector to **Overweight**. Although its valuations may not look the most attractive, we believe that it provides a diversified exposure including aerospace & defence, payment systems, vehicle manufacturers and logistics providers. Margin pressures remain a significant risk through the commodity price channel, but we think that healthy demand will compensate for that, not to mention that the sector is also a supplier to the mining industry. The increasing militarisation in the US-China relationship could boost defence equipment manufacturers, while infrastructure investment and the green transition could be a source of healthy demand for manufacturers. We expect logistics providers to have strong demand in the next 12 months even if supply chain bottlenecks ease and transportation rates fall, while aerospace manufacturers may be boosted by increasing airline traffic and demand for new aircraft.

We also reshuffle our allocations in consumer discretionary and downgrade **media** to **Underweight**. It is one of the most expensive sectors based on both our multiple regression model and implied dividend growth. Although we valued its defensive qualities during the recent market turbulence partly driven by worries about the Delta-variant of Covid-19, we think subscriber growth to streaming services may have been pulled forward and we fear more churn in subscriptions. We are more positive on the more consumer-facing sectors, such as retailers and travel & leisure, which were somewhat left behind in the “reflation trade”. Easing supply chain disruptions will boost retailers and we expect the gradual return of both leisure and business tourism to allow travel & leisure to catch up with the market. **Retailers** may look a touch overvalued on our models, but that may be due to the dominance of online retailers. Nevertheless, we think continued economic growth will support the sector and therefore we upgrade to

Overweight. **Travel & leisure** looks closer to fair value, but we are concerned that travelling will remain more expensive than pre-pandemic and worries about Covid-19 may linger, hence our more cautious upgrade to **Neutral**.

This tilt towards cyclical sectors would not be complete in our view without a reduction in our allocation to defensives across the board. We still prefer defensive growth as a hedge in case economic growth and inflation undershoots expectations, but downgrade both **food, beverage & tobacco** and **healthcare** to **Neutral**.

We also downgrade **telecommunications** and **utilities** to **Underweight**, because we think they will struggle to keep up with the more cyclical sectors in the market. We are especially worried about utilities if margins are squeezed further by high input prices and investment costs, while regulators keep consumer charges under control.

Finally, we upgrade **financial services** to **Overweight** as we expect markets to move into a more settled phase, while broad economic growth may provide them with more customers seeking investment products. Although its valuations are higher than that of banks and insurance, we prefer not to be too exposed to changes in the yield curve and sluggish loan demand in banks, or natural disasters and increasing healthcare costs in insurance.

The best and worst of the rest

Chemicals was one of the sectors we deemed to have been well-positioned for resilience during the pandemic, but we think it may struggle to outperform in the recovery, thus we maintain our **Neutral** allocation. It looks close to fair value on our multiple regression model and its implied dividend growth is also in line with the market. One of its main input costs has risen with oil prices trading above $80 per barrel and we think environmental concerns are resuming as consumers emerge from "survival mode" reducing the demand for plastic products.

It seems that we missed the boat on **automobiles & parts** (excuse the mixed metaphor) and we feel it is prudent to remain **Underweight**. In our view, its gravity-defying rally has gone too far and the whole sector has mainly been pulled along by its dominant leader. We doubt the sector will achieve its currently implied 4.1% perpetual real dividend growth, although it may continue to outperform for a while as long as central bank support continues and investors accord the sector technology-like valuations.

We also maintain an **Overweight** allocation to **consumer products & services**. We expect the sector to benefit from its diversity in constituents that have the potential to outperform even if growth slows and COVID-19 cases rise globally once more. Although its valuations remain rich, especially relative to that suggested by our multiple regression model, we believe this premium is warranted if it gives exposure to both stay-at-home and recovery stocks.

We remain concerned about the profitability of **banks** and therefore stick with our **Underweight** allocation. Loan growth has remained sluggish, especially in the US, which may be partly driven by consumers reducing savings rates to increase spending, rather than taking on more debt. Even though we expect treasury yields to climb, we believe that we may have seen the majority of yield curve steepening. Profits are still driven by loan loss reserve releases in the US and UK, while only those with significant investment banking businesses can reap the rewards of high M&A and capital raising volumes. The sector has also been one of the best performers in 2021 and may struggle to maintain that early-cycle pace.

We also keep our **Underweight** in **insurance**, which we expect to struggle with natural disasters throughout the Northern Hemisphere winter and could struggle to generate adequate returns if our forecasts for financial markets play out in the next 12 months. Although its valuations seem attractive, we are concerned that that will not be enough for sustained outperformance in a mid-cycle environment.

We retain our **Overweight** to **real estate**, a sector that has weathered this downturn relatively well so far. That could be a sign of complacency, but depressed valuations – dividend yields have priced in sub-1% real perpetual growth – suggest good long-term potential for the sector. The main risk is that the economy will dip into recession if lockdowns remain in place longer than currently expected and companies in the sector lose more tenants or are forced to offer further rent holidays.

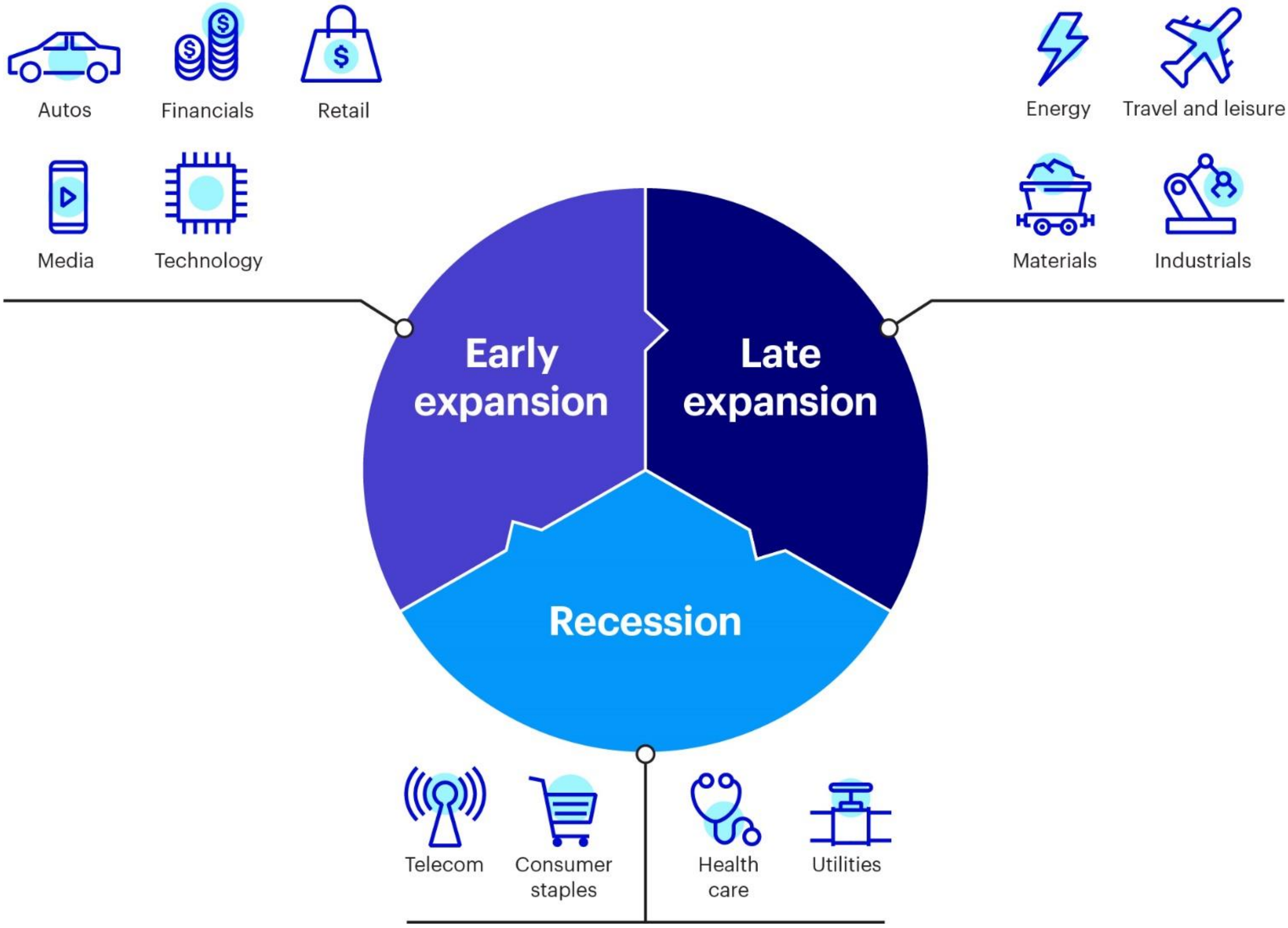
We maintain our **Overweight** allocation to **technology**, which we think will continue to benefit from the structural trends accelerated and amplified by the COVID-19 crisis. Valuations look rich on implied perpetual dividend growth, but they are nowhere near the extremes of the tech bubble. We suspect the changing composition of the sector played a part in reducing its volatility and cyclicality, thus making it an unexpected defensive.

Figure 4 – Model allocations for Global sectors

	Neutral	Invesco		Preferred Region
Energy	**6.3%**	**Neutral**	↑	**US**
Basic Materials	**4.3%**	**Overweight**	↑	**Europe**
Basic Resources	2.3%	Overweight	↑	Europe
Chemicals	1.9%	Neutral		US
Industrials	**12.9%**	**Overweight**	↑	**US**
Construction & Materials	1.6%	Neutral		EM
Industrial Goods & Services	11.3%	Overweight	↑	US
Consumer Discretionary	**15.6%**	**Neutral**	↑	**US**
Automobiles & Parts	2.8%	Underweight		Japan
Media	1.3%	Underweight	↓	Europe
Retailers	5.6%	Overweight	↑	US
Travel & Leisure	2.1%	Neutral	↑	US
Consumer Products & Services	3.9%	Overweight		Japan
Consumer Staples	**6.0%**	**Neutral**	↓	**Europe**
Food, Beverage & Tobacco	3.9%	Neutral	↓	US
Personal Care, Drug & Grocery Stores	2.1%	Neutral		Europe
Healthcare	**10.0%**	**Neutral**	↓	**US**
Financials	**14.9%**	**Underweight**		**Japan**
Banks	7.5%	Underweight		Japan
Financial Services	4.8%	Overweight	↑	Japan
Insurance	2.6%	Underweight		US
Real Estate	**3.4%**	**Overweight**		**Japan**
Technology	**19.8%**	**Overweight**		**US**
Telecommunications	**3.8%**	**Underweight**	↓	**Japan**
Utilities	**3.0%**	**Underweight**	↓	**Europe**

Notes: Arrows indicate latest changes in allocations versus the previous edition. See appendices for methodology and disclaimers.
Source: Refinitiv Datastream and Invesco

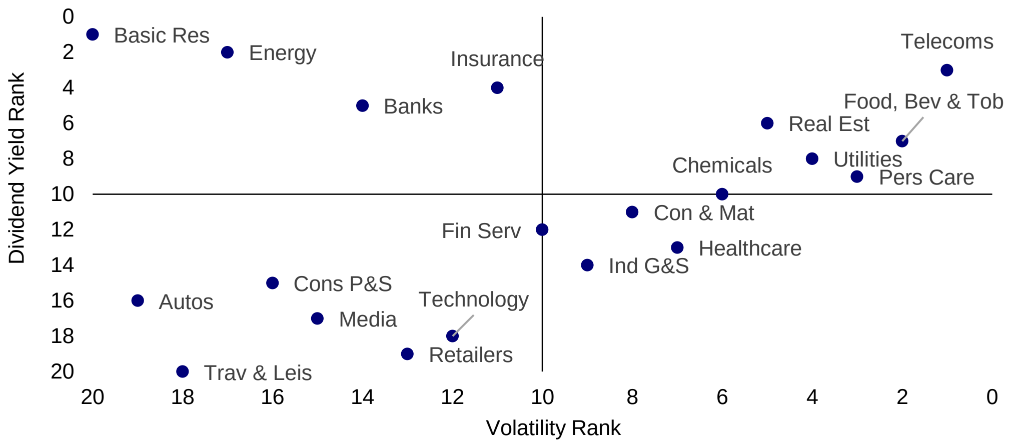
Figure 5 – Economic cycle and main sector allocation decisions



Note: The chart shows our opinion about which sectors tend to perform best at which stage of the economic cycle, based on our analysis of previous cycles.
Source: Invesco

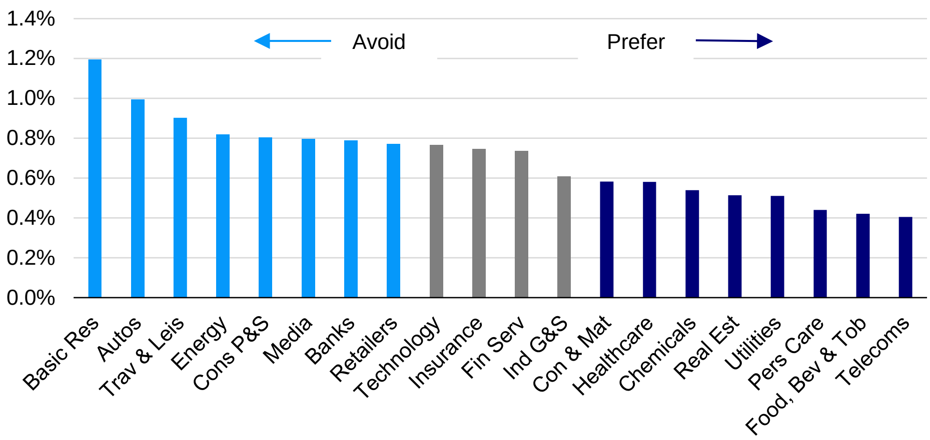
Systematic strategy – Global

Figure 6 – Global sectors ranked by volatility and dividend yield



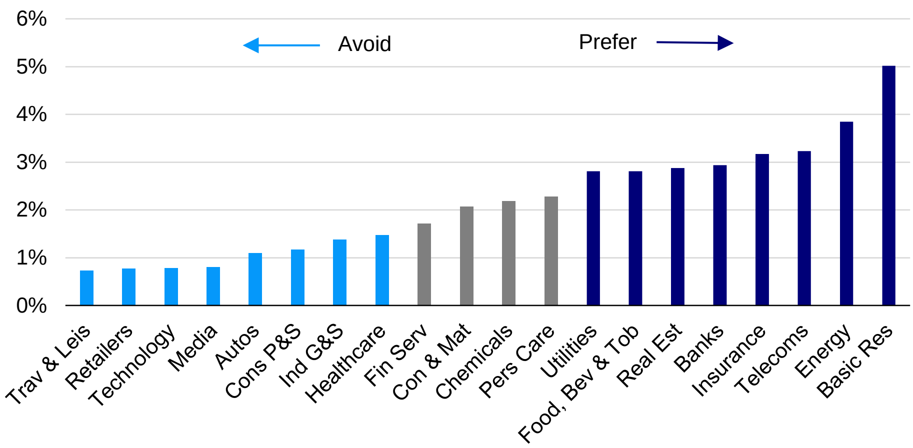
- A purely systematic approach would favour sectors in the top right corner: telecoms, food, beverage & tobacco and utilities
- The approach would avoid sectors in the bottom left, such as autos, media, or travel & leisure

Figure 7 – Global sector volatility of daily returns (using standard deviation in the past 3 months)



- The daily returns of basic resources, autos and travel & leisure were the most volatile in the past 3 months
- Telecoms, food, beverage & tobacco, personal care and utilities were the least volatile

Figure 8 – Global sector dividend yield (12-month trailing)

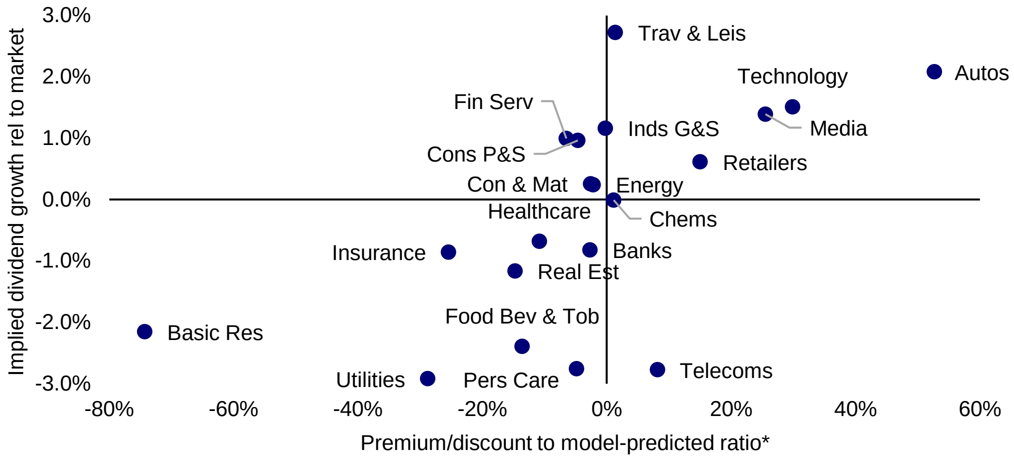


- Basic resources, energy and telecoms look the cheapest based on their dividend yield
- The lowest yielding sectors include travel & leisure, retailers and technology

Notes: In Figure 6, we rank sectors on the vertical axis by their current 12-month trailing dividend yields. On the horizontal axis, the sectors are ranked by the 3-month standard deviation of their daily returns. See appendices for methodology and disclaimers. Any reference to a ranking, a rating or an award provides no guarantee for future performance results and is not constant over time.
Source: Refinitiv Datastream and Invesco

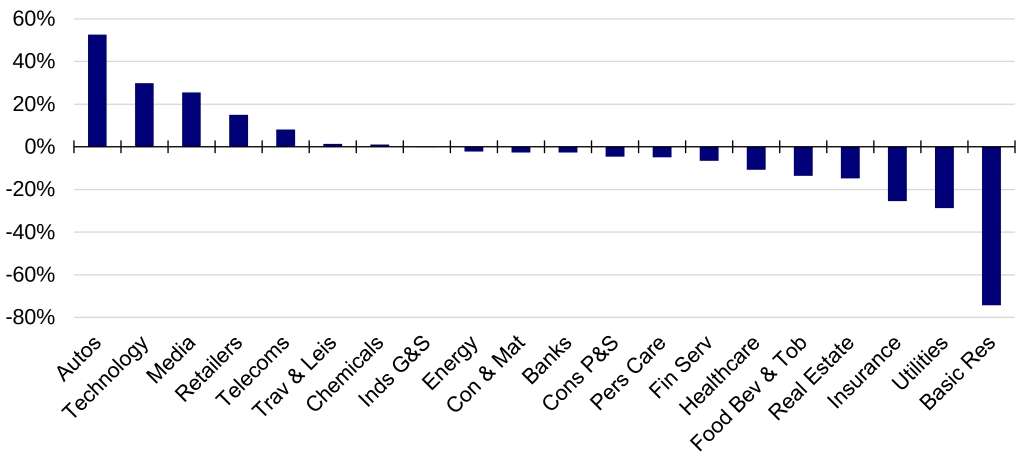
Valuations – Global

Figure 9 – Global sectors valuation matrix



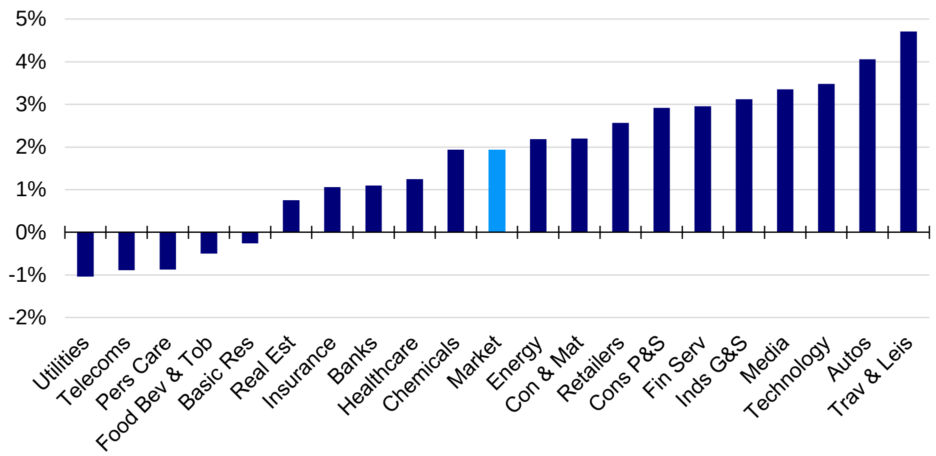
- Sectors in the top right corner look overvalued on both measures, while those in the bottom left appear undervalued
- This approach would avoid, for example, autos, technology and media
- Basic resources, utilities and insurance look better value

Figure 10 – Premium/discount to model-predicted ratio*



- Autos, technology and media look the most overvalued versus our model
- Basic resources, utilities and insurance seem the most undervalued versus our model-predicted ratios

Figure 11 – Global implied perpetual real dividend growth

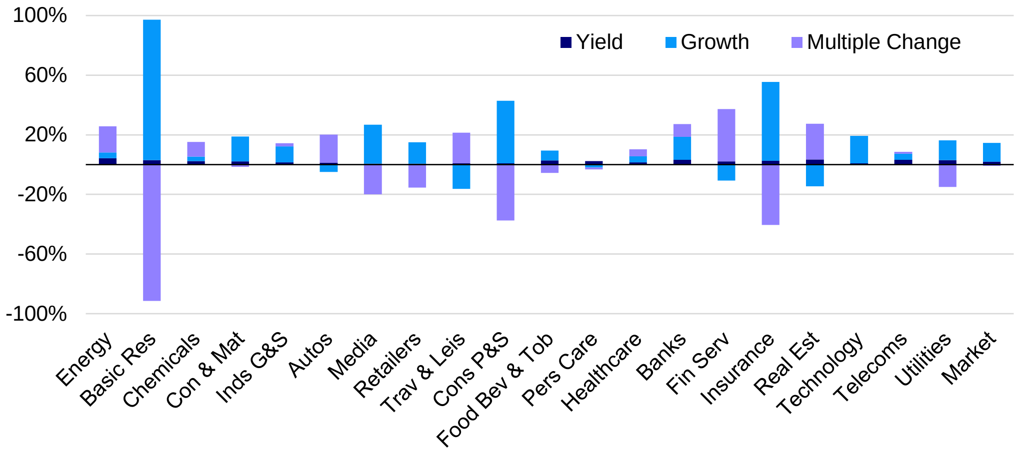


- Shows the future real growth required to justify current prices
- Travel & leisure and autos appear priced for over 4% real growth in dividends (expensive)
- Five sectors appear priced for negative growth (cheap)

Notes: *% above/below using dividend yield. See appendices for methodology and disclaimers. Source: Refinitiv Datastream and Invesco

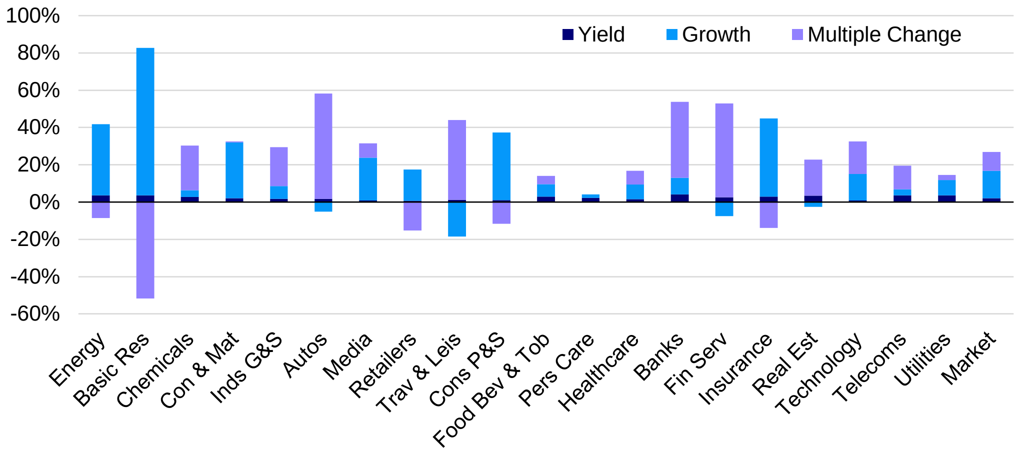
Decomposed returns – Global

Figure 12 – Global year-to-date total returns decomposed (annualised)



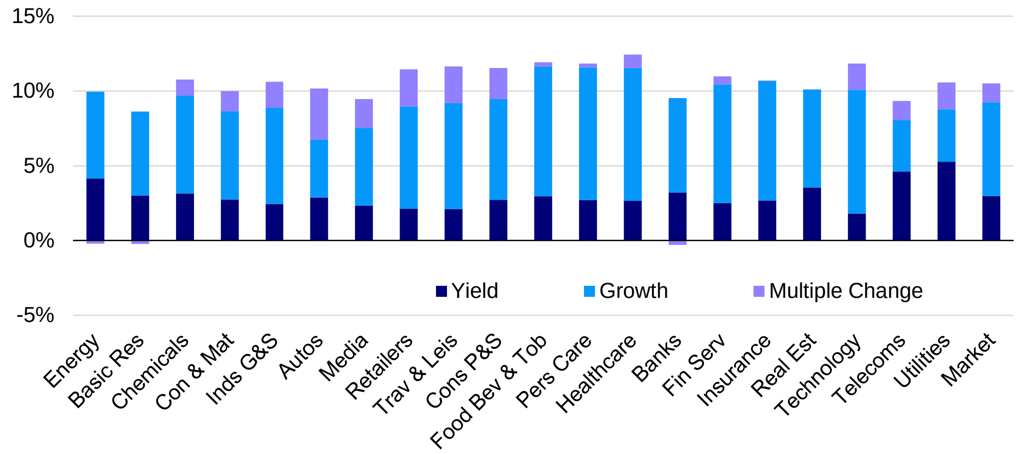
- Basic resources, consumer products & services and insurance have grown their dividend by over 30% in 2021
- Financial services, real estate and travel & leisure, had the biggest rise in sentiment (multiple expansion)

Figure 13 – Global rolling 12-month total returns decomposed



- Only five sectors de-rated (multiple contraction): energy, basic resources, retailers, consumer products & services and insurance
- Only banks had a yield above 4%

Figure 14 – Global overall total returns decomposed (annualised, since 1973)



- Growth and yield drive long-term returns
- Growth is the most important, except for telecoms and utilities
- Four sectors suffered from a multiple-related performance drag: energy, basic resources, banks and real estate

Notes: See appendices for methodology and disclaimers. Past performance is not a guarantee of future results. Source: Refinitiv Datastream and Invesco

Appendices

Appendix 1: Coefficients for variables used in multiple regression model

Figure 15 – Regression coefficients of Global defensive sectors

	Food, Bev & Tobacco	Personal Care	Health Care	Telecoms	Utilities	Market
Real Oil					0.47	
Real Copper		0.00	0.00	0.02	-0.01	
Consumer Confidence	0.00		0.00	0.00	0.00	-0.01
Manufacturing Confidence		0.01	0.01	0.01	-0.01	0.01
IP		0.61	1.03		3.26	-5.20
10y Yield				-6.11	14.34	-13.46
CPI	3.52		-3.96		-9.28	5.83
Net Debt/EBITDA		0.03	-0.05	0.07	0.21	
ROE	-1.48	-0.99	1.29	0.74	-2.74	

Notes: IP = industrial production. CPI = consumer price index. EBITDA = earnings before interest, taxes, depreciation and amortization. ROE = return on equity. Bev = beverage. Only showing coefficients that have a statistically significant relationship with valuations at the 0.05 level. We use the dividend yield relative to market as our dependent variable. See the Methodology in Appendix 6 for more details. Source: Refinitiv Datastream and Invesco

Figure 16 – Regression coefficients of Global resource-related and industrial sectors

	Energy	Basic Resources	Chemicals	Construction & Materials	Industrial G&S	Market
Real Oil	-1.44	-0.89				
Real Copper	0.01			-0.01	0.00	
Consumer Confidence	0.01	0.01	0.01	0.00	0.00	-0.01
Manufacturing Confidence		-0.02	-0.01	-0.01	0.00	0.01
IP	-2.07		-0.88	1.04	0.29	-5.20
10y Yield	-2.62	-3.88			0.90	-13.46
CPI	15.46	21.73	8.23	11.31	-1.22	5.83
Net Debt/EBITDA	-0.20	-0.13	0.07	0.22	0.02	
ROE	-4.22	-2.48	-1.50		0.63	

Notes: IP = industrial production. CPI = consumer price index. EBITDA = earnings before interest, taxes, depreciation and amortization. ROE = return on equity. G&S = goods & services. Only showing coefficients that have a statistically significant relationship with valuations at the 0.05 level. We use the dividend yield relative to market as our dependent variable. See the Methodology in Appendix 6 for more details. Source: Refinitiv Datastream and Invesco

Figure 17 – Regression coefficients of Global consumer discretionary and technology sectors

	Autos & Parts	Media	Retail	Travel & Leisure	Cons P&S	Tech	Market
Real Oil	0.78		0.29	0.27	0.98	0.31	
Real Copper	-0.01	0.00	0.00		-0.01		
Consumer Confidence	0.01	0.00	0.00	0.00	0.00	0.00	-0.01
Manufacturing Confidence			0.00		0.00	0.02	0.01
IP	-3.27	-0.52	0.65	-0.52	0.79	-2.07	-5.20
10y Yield		6.07	4.12	-2.37	8.96	-2.69	-13.46
CPI	7.79	-2.93	-4.73		-6.85		5.83
Net Debt/EBITDA	-0.06	-0.01	0.10	0.00	-0.21	0.09	
ROE		0.85	-1.81	0.61	-1.59	0.72	

Notes: IP = industrial production. CPI = consumer price index. EBITDA = earnings before interest, taxes, depreciation and amortization. ROE = return on equity. Cons = consumer. P&S = products & services. Only showing coefficients that have a statistically significant relationship with valuations at the 0.05 level. We use the dividend yield relative to market as our dependent variable. See the Methodology in Appendix 6 for more details. Source: Refinitiv Datastream and Invesco

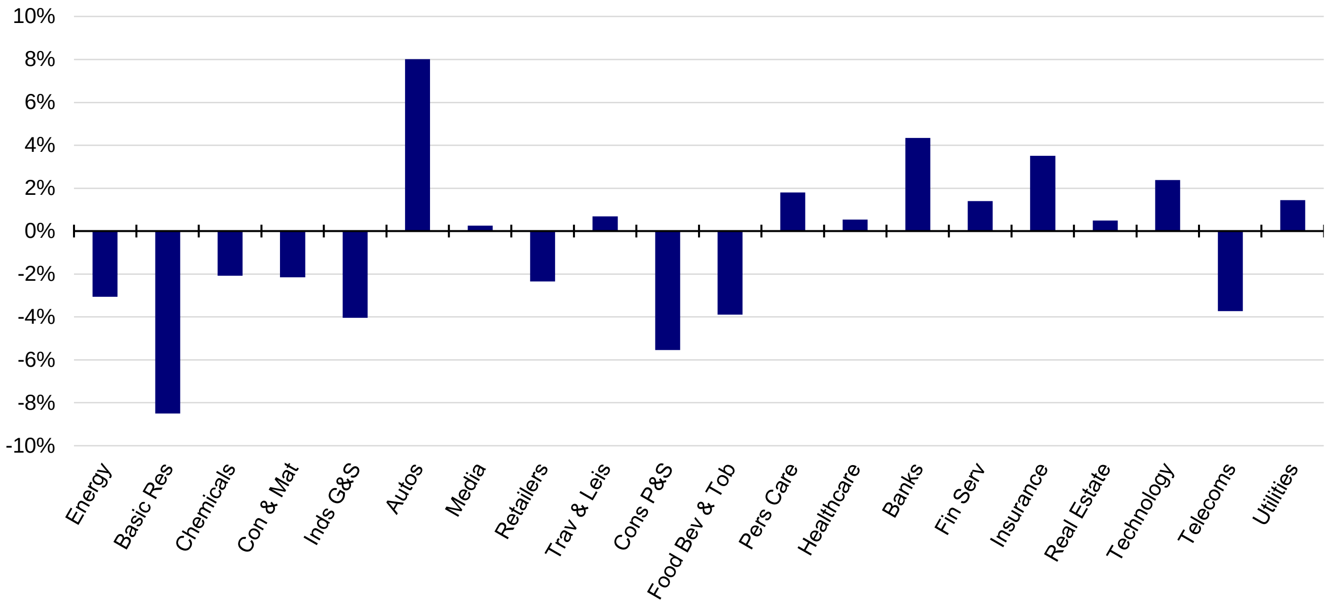
Figure 18 – Regression coefficients of Global financial sectors

	Banks	Financial Services	Insurance	Real Estate	Market
Real Oil	0.40	-0.32	-0.40	0.55	
Real Copper	-0.01	0.00	0.01	-0.02	
Consumer Confidence	0.01	0.00	0.00	0.01	-0.01
Manufacturing Confidence	-0.01	-0.02		-0.03	0.01
IP	-2.11	1.65	0.65	3.45	-5.20
10y Yield	-10.55		-6.20	3.12	-13.46
CPI	7.32		8.34		5.83
ROE	3.68	0.59	-1.27	-3.78	

Notes: IP = industrial production. CPI = consumer price index. EBITDA = earnings before interest, taxes, depreciation and amortization. ROE = return on equity. Only showing coefficients that have a statistically significant relationship with valuations at the 0.05 level. We use the dividend yield relative to market as our dependent variable. See the Methodology in Appendix 6 for more details. Source: Refinitiv Datastream and Invesco

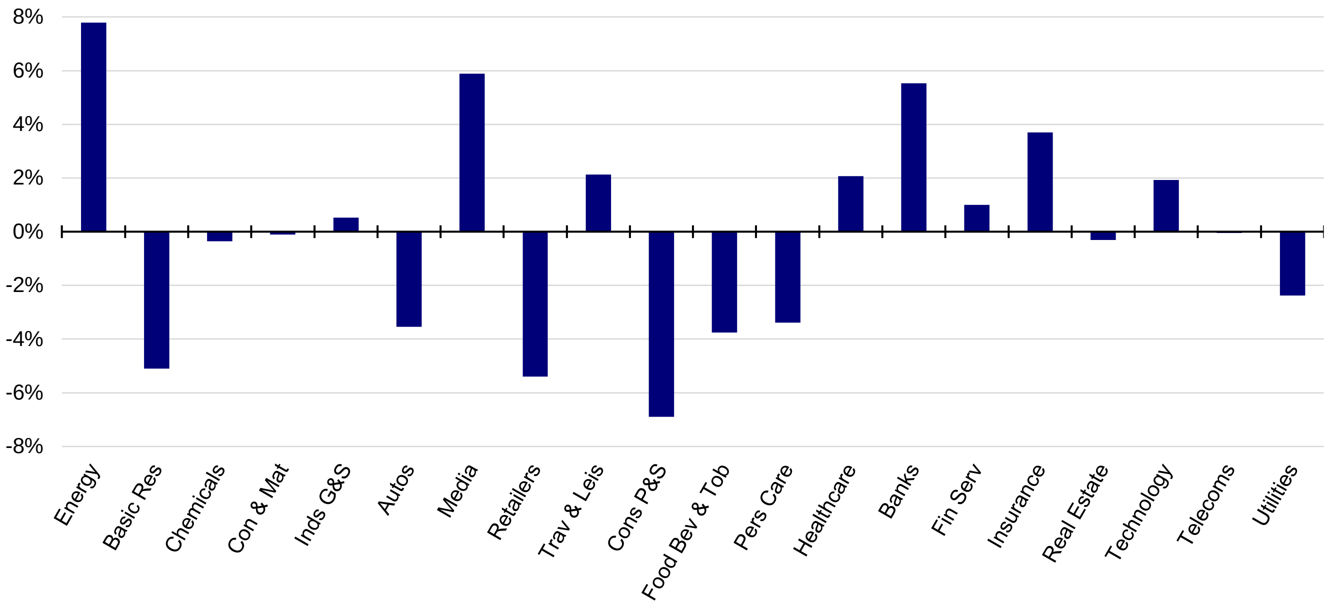
Appendix 2: Sector returns by region

Figure 19 – 3m US sector returns relative to market



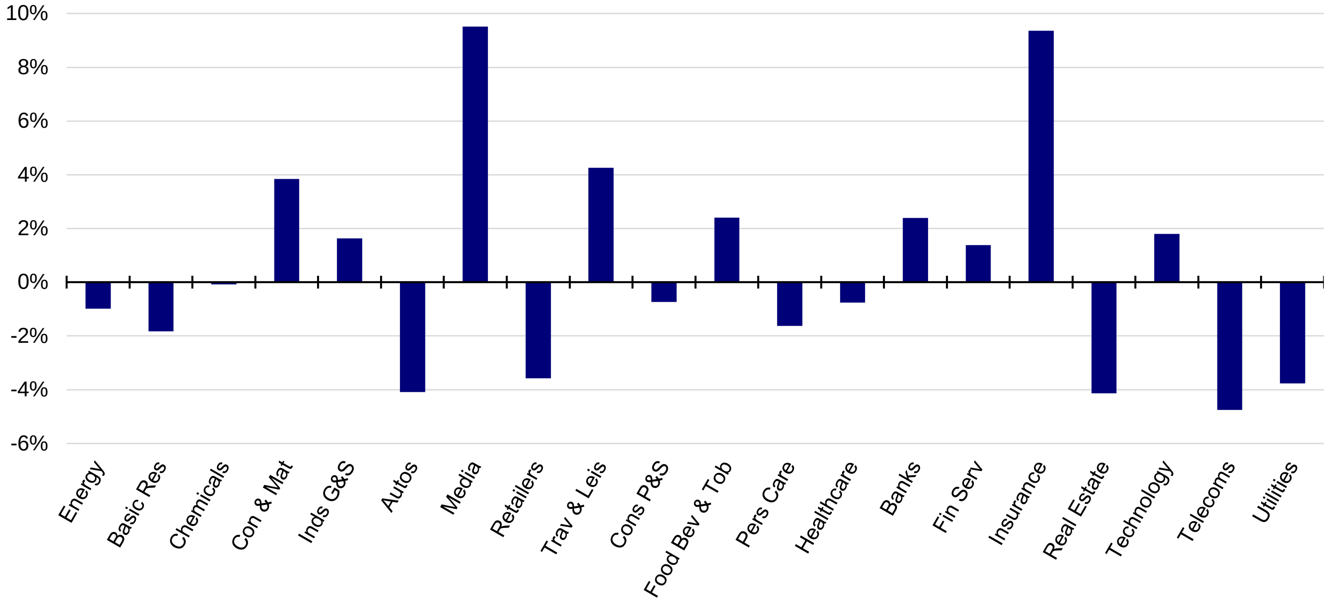
Notes: See appendices for methodology and disclaimers. Returns shown between 30th June 2021 and 30th September 2021. **Past performance is not a guarantee of future results.** Source: Refinitiv Datastream and Invesco

Figure 20 – 3m European sector returns relative to market



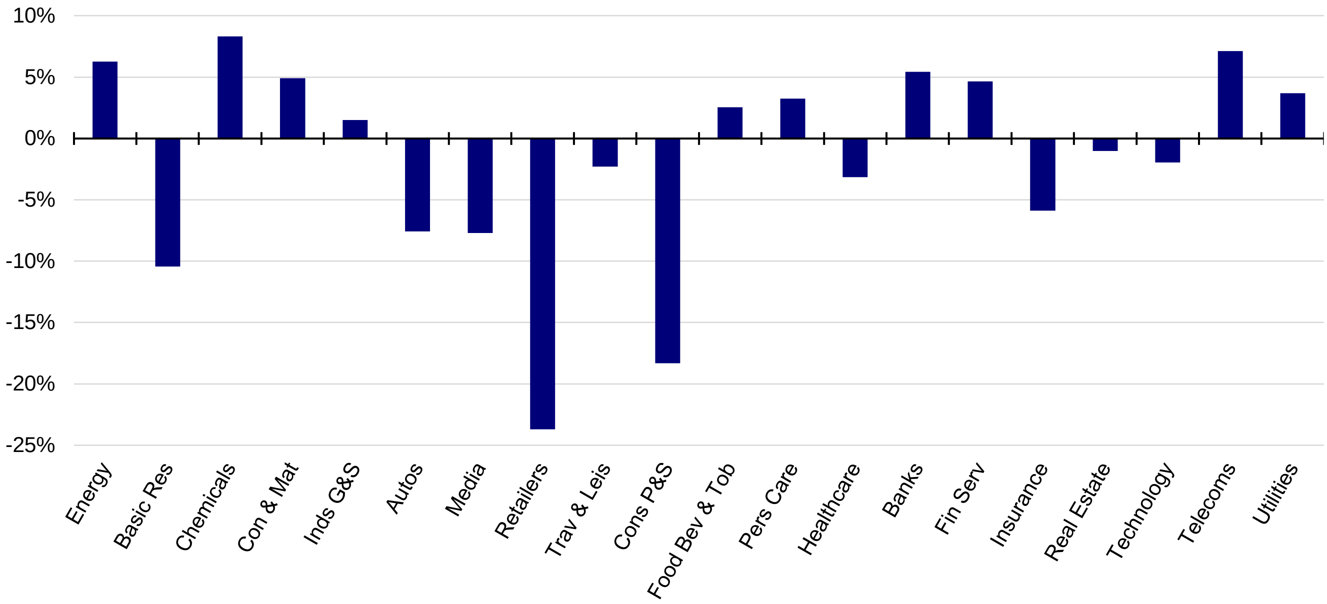
Notes: See appendices for methodology and disclaimers. Returns shown between 30th June 2021 and 30th September 2021. **Past performance is not a guarantee of future results.** Source: Refinitiv Datastream and Invesco

Figure 21 – 3m Japanese sector returns relative to market



Notes: See appendices for methodology and disclaimers. Returns shown between 30th June 2021 and 30th September 2021. **Past performance is not a guarantee of future results.** Source: Refinitiv Datastream and Invesco

Figure 22 – 3m Emerging Market sector returns relative to market



Notes: See appendices for methodology and disclaimers. Returns shown between 30th June 2021 and 30th September 2021. **Past performance is not a guarantee of future results.** Source: Refinitiv Datastream and Invesco

Appendix 3: Valuations tables

Figure 23 – Global absolute valuations

	Price/Earnings			Dividend Yield			Price/Book Value			Price/Cash Flow		
	Now	Avg	Now vs Avg*	Now	Avg	Now vs Avg*	Now	Avg	Now vs Avg*	Now	Avg	Now vs Avg*
Energy	**20.1**	**14.6**	**0.8**	**3.9**	**3.9**	**0.0**	**1.9**	**1.7**	**0.4**	**11.5**	**6.2**	**2.7**
Basic Materials	**12.2**	**16.9**	**-1.0**	**3.7**	**2.7**	**1.3**	**1.8**	**1.8**	**-0.1**	**9.3**	**7.3**	**1.2**
Basic Resources	9.3	17.1	-1.3	5.0	2.8	2.5	1.4	1.7	-0.6	7.4	7.3	0.0
Chemicals	19.9	17.2	0.5	2.2	2.9	-0.8	2.5	2.0	1.2	13.2	7.6	3.3
Industrials	**23.2**	**18.2**	**1.0**	**1.5**	**2.3**	**-1.1**	**3.2**	**2.1**	**2.4**	**15.8**	**9.2**	**3.3**
Construction & Mat.	18.7	16.7	0.5	2.1	2.5	-0.7	2.2	1.8	0.9	11.8	9.0	1.0
Industrial G&S	24.1	18.7	1.1	1.4	2.2	-1.2	3.4	2.2	2.6	16.6	9.3	3.6
Consumer Disc.	**25.8**	**18.7**	**1.3**	**0.9**	**2.3**	**-1.6**	**4.0**	**2.1**	**3.4**	**16.9**	**8.5**	**4.4**
Automobiles & Parts	14.2	15.1	-0.1	1.1	2.6	-1.3	1.9	1.5	1.3	9.8	5.5	3.7
Media	34.8	21.7	1.7	0.8	2.1	-1.6	4.0	2.4	2.1	14.9	9.5	1.4
Retailers	29.8	21.1	1.4	0.8	1.9	-1.4	6.8	3.2	3.1	19.7	12.7	2.3
Travel & Leisure	62.7	23.0	3.6	0.7	1.9	-1.4	4.7	2.4	3.4	30.3	9.3	5.5
Consumer Prod & Serv	25.8	19.2	1.4	1.2	2.4	-1.9	4.6	2.2	3.5	19.1	10.8	3.2
Consumer Staples	**22.4**	**16.7**	**1.1**	**2.6**	**2.5**	**0.1**	**3.6**	**2.9**	**0.9**	**13.7**	**10.8**	**1.1**
Food, Bev & Tobacco	21.4	18.3	0.6	2.8	2.7	0.2	3.3	2.8	0.8	14.3	11.0	1.2
Personal Care	24.7	20.4	0.7	2.3	2.4	-0.1	4.3	3.2	1.1	12.7	10.4	0.8
Healthcare	**30.3**	**20.0**	**1.8**	**1.5**	**2.4**	**-1.1**	**5.0**	**3.4**	**1.4**	**18.9**	**12.8**	**1.6**
Financials	**11.6**	**15.7**	**-0.9**	**2.6**	**2.7**	**-0.2**	**1.2**	**1.5**	**-0.7**	**6.8**	**5.6**	**0.8**
Banks	11.1	14.5	-0.7	2.9	3.0	0.0	1.0	1.4	-0.8	6.8	6.3	0.3
Financial Services	12.6	18.4	-1.0	1.7	2.3	-0.9	1.3	1.5	-0.4	13.3	9.0	1.5
Insurance	11.1	16.0	-1.0	3.2	2.4	1.0	1.5	1.7	-0.4	3.6	3.7	-0.1
Real Estate	16.9	19.3	-0.4	2.9	3.2	-0.4	1.5	1.4	0.3	18.2	13.0	1.4
Technology	**29.8**	**24.2**	**0.5**	**0.8**	**1.6**	**-0.9**	**6.9**	**3.0**	**3.5**	**24.0**	**11.4**	**2.9**
Telecommunications	**14.9**	**17.5**	**-0.3**	**3.2**	**4.3**	**-0.5**	**2.2**	**2.6**	**-0.4**	**5.8**	**6.3**	**-0.2**
Utilities	**18.2**	**14.4**	**1.0**	**3.4**	**4.9**	**-0.8**	**1.9**	**1.6**	**0.7**	**7.5**	**5.6**	**1.4**
Market	**20.0**	**17.2**	**0.6**	**1.9**	**2.7**	**-0.9**	**2.6**	**2.0**	**1.2**	**12.5**	**7.6**	**2.6**

Notes: *in standard deviations from historical average. Mat. = materials. G&S = goods & services. Disc. = discretionary. Prod & Serv = products & services. Bev = beverage. Data starts on 1st January 1973 for price/earnings and dividend yield and 1st January 1980 for price/book and price/cash flow. See appendices for methodology and disclaimers. Source: Refinitiv Datastream and Invesco

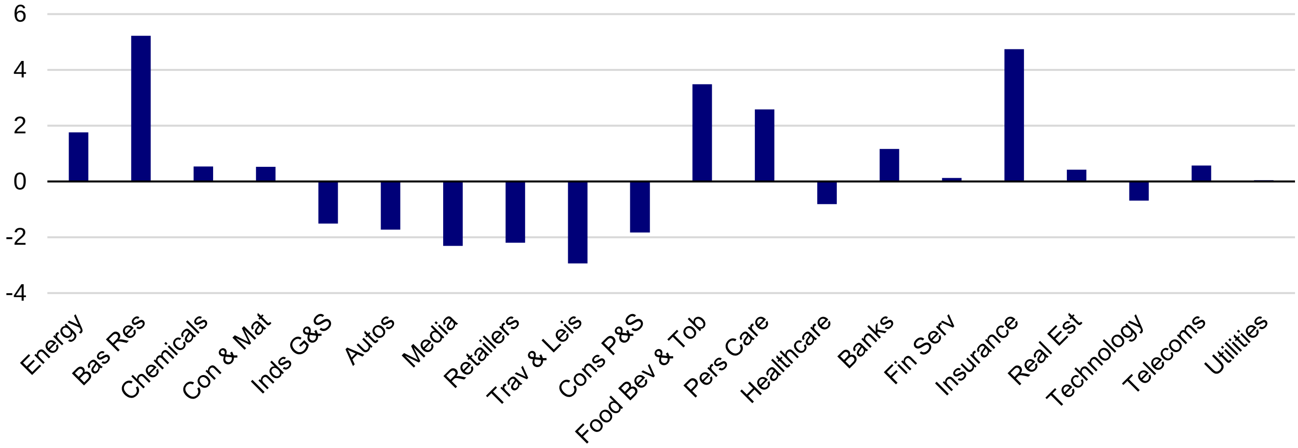
Figure 24 – Global cyclically-adjusted valuations

	Price/Earnings			Dividend Yield			Price/Book Value			Price/Cash Flow		
	Now	Avg	Now vs Avg*	Now	Avg	Now vs Avg*	Now	Avg	Now vs Avg*	Now	Avg	Now vs Avg*
Energy	**11.9**	**18.8**	**-0.9**	**4.5**	**2.8**	**1.7**	**1.1**	**2.5**	**-1.3**	**5.3**	**8.6**	**-1.1**
Basic Materials	**23.0**	**23.2**	**0.0**	**2.0**	**1.9**	**0.3**	**2.1**	**2.4**	**-0.5**	**10.2**	**9.7**	**0.2**
Basic Resources	20.4	21.5	-0.1	2.3	2.1	0.2	1.7	2.3	-0.6	8.6	9.3	-0.2
Chemicals	25.5	24.5	0.2	1.8	1.9	-0.1	2.7	2.7	-0.1	12.4	10.6	1.0
Industrials	**29.9**	**26.6**	**0.6**	**1.3**	**1.5**	**-0.5**	**3.5**	**3.0**	**0.9**	**16.6**	**12.9**	**1.5**
Construction & Mat.	25.1	24.0	0.1	1.6	1.9	-0.4	2.3	2.4	0.0	12.8	11.6	0.3
Industrial G&S	30.8	27.3	0.6	1.3	1.4	-0.6	3.8	3.0	1.5	17.3	12.7	2.1
Consumer Disc.	**32.0**	**27.1**	**1.0**	**1.1**	**1.4**	**-1.0**	**4.1**	**3.0**	**2.5**	**16.2**	**11.7**	**2.4**
Automobiles & Parts	20.0	19.0	0.2	1.3	1.7	-0.8	2.1	2.0	0.4	9.6	6.7	2.1
Media	34.3	30.2	0.5	1.0	1.4	-1.1	4.2	3.3	0.7	16.9	13.1	1.0
Retailers	43.1	32.0	1.8	0.9	1.1	-1.0	7.6	4.7	3.0	24.2	18.9	1.3
Travel & Leisure	26.9	34.4	-0.8	1.3	1.1	0.5	4.0	3.5	0.5	13.5	13.1	0.1
Consumer Prod & Serv	35.2	28.6	1.4	1.2	1.6	-1.2	4.9	3.1	3.4	20.7	15.4	2.5
Consumer Staples	**22.2**	**22.6**	**-0.1**	**2.0**	**1.6**	**0.9**	**4.0**	**3.9**	**0.1**	**15.9**	**14.6**	**0.6**
Food, Bev & Tobacco	26.2	28.3	-0.4	2.1	1.6	1.2	3.8	4.2	-0.9	16.2	16.4	-0.1
Personal Care	29.1	31.7	-0.4	1.8	1.4	0.9	4.4	4.9	-0.6	15.3	16.3	-0.4
Healthcare	**40.4**	**31.4**	**1.5**	**1.1**	**1.4**	**-0.9**	**5.9**	**5.2**	**0.7**	**23.4**	**19.8**	**1.2**
Financials	**17.1**	**23.7**	**-0.6**	**2.3**	**2.0**	**0.4**	**1.4**	**2.0**	**-1.0**	**7.1**	**7.2**	**-0.1**
Banks	13.3	21.1	-0.8	3.0	2.3	0.7	1.2	1.8	-1.1	6.1	7.9	-0.8
Financial Services	26.4	29.6	-0.2	1.3	1.5	-0.4	1.7	2.0	-0.5	14.9	11.9	1.2
Insurance	18.6	24.1	-0.6	2.0	1.6	0.6	1.8	2.4	-0.8	4.9	4.8	0.1
Real Estate	17.2	26.8	-0.7	2.9	2.5	0.4	1.6	1.7	-0.3	1.8	14.6	-1.9
Technology	**57.2**	**38.7**	**0.8**	**0.5**	**0.9**	**-0.8**	**9.3**	**4.6**	**2.0**	**32.7**	**18.3**	**1.6**
Telecommunications	**17.9**	**23.2**	**-0.5**	**3.7**	**3.0**	**0.6**	**2.4**	**3.3**	**-0.8**	**6.1**	**8.0**	**-0.6**
Utilities	**19.5**	**18.5**	**0.2**	**3.2**	**3.5**	**-0.3**	**1.7**	**2.0**	**-0.6**	**7.1**	**6.9**	**0.2**
Market	**26.0**	**24.8**	**0.2**	**1.6**	**1.8**	**-0.3**	**2.8**	**2.8**	**0.0**	**10.7**	**10.4**	**0.2**

Notes: *in standard deviations from historical average. Mat. = materials. G&S = goods & services. Disc. = discretionary. Prod & Serv = products & services. Bev = beverage. Data starts on 1st January 1983 for price/earnings and dividend yield and 1st January 1990 for price/book and price/cash flow. See appendices for methodology and disclaimers. Source: Refinitiv Datastream and Invesco

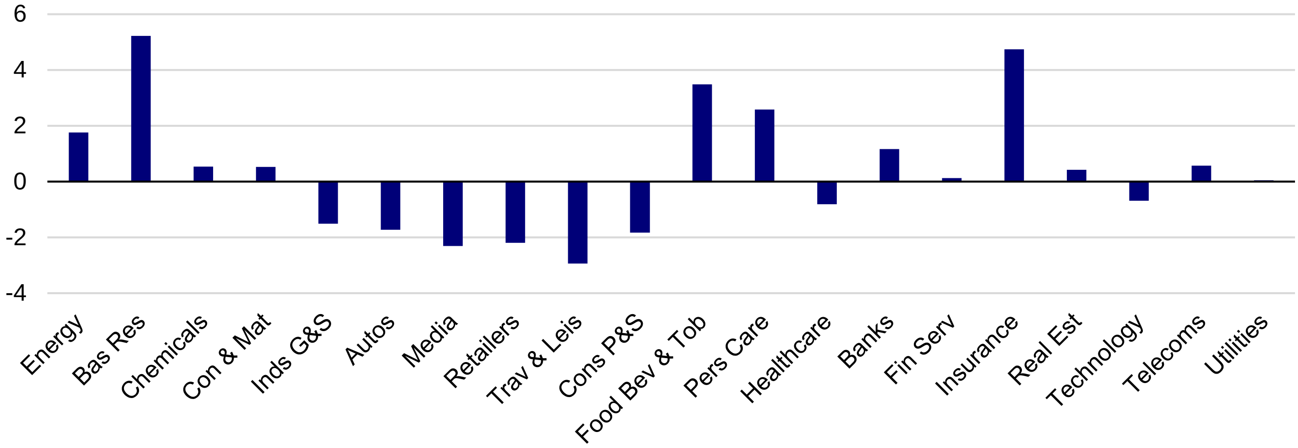
Appendix 4: Sector valuations by region

Figure 25 – Global dividend yields relative to market (z-score)



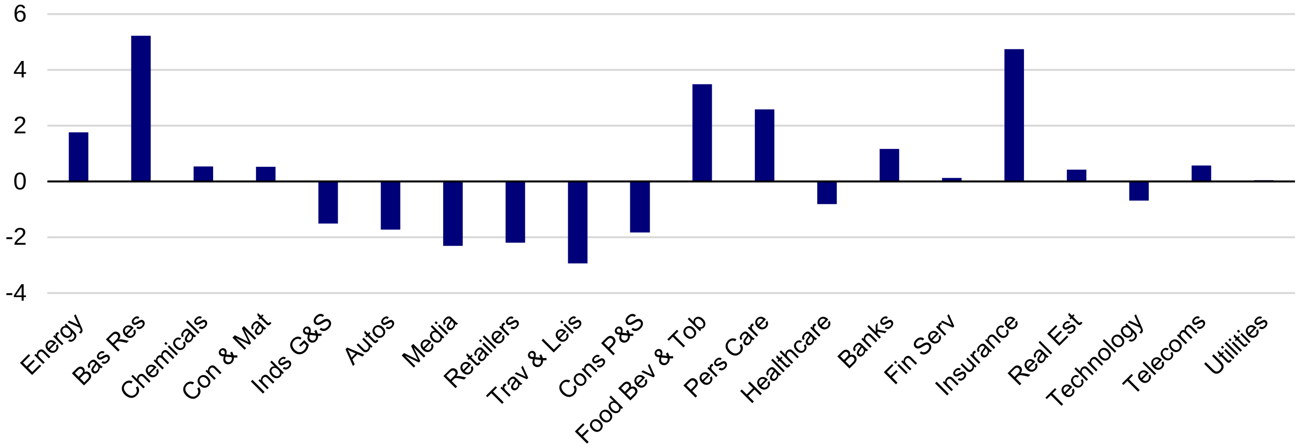
Notes: See appendices for methodology and disclaimers. Source: Refinitiv Datastream and Invesco

Figure 26 – US dividend yields relative to local benchmark (z-score)



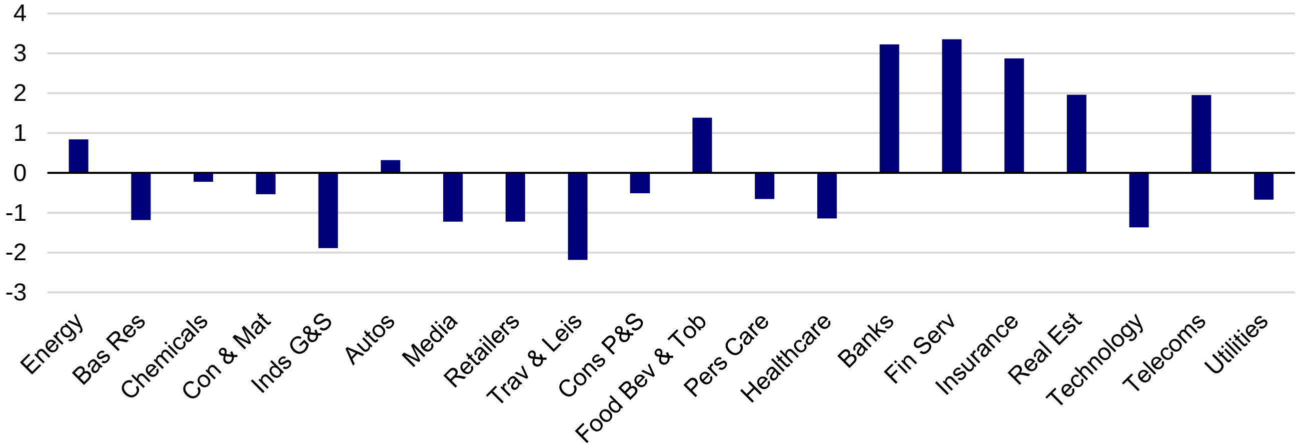
Notes: See appendices for methodology and disclaimers. The local benchmark is the Datastream US Total Market Index. Source: Refinitiv Datastream and Invesco

Figure 27 – Europe dividend yields relative to local benchmark (z-score)



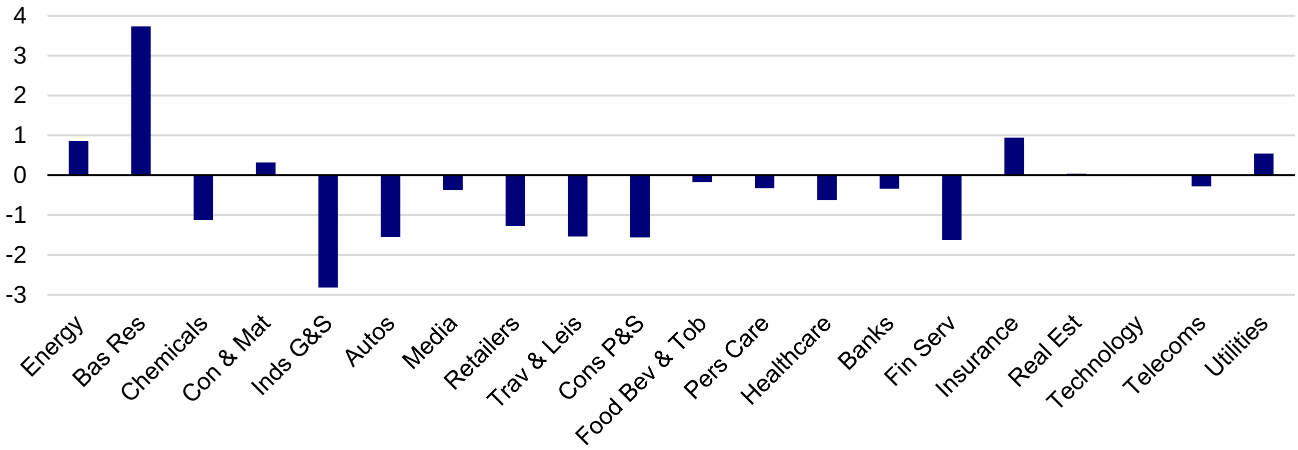
Notes: See appendices for methodology and disclaimers. The local benchmark is the Datastream Europe Ex-Emerging Total Market Index. Source: Refinitiv Datastream and Invesco

Figure 28 – Japan dividend yields relative to local benchmark (z-score)



Notes: See appendices for methodology and disclaimers. The local benchmark is the Datastream Japan Total Market Index. Source: Refinitiv Datastream and Invesco

Figure 29 – Emerging markets dividend yields relative to local benchmark (z-score)



Notes: See appendices for methodology and disclaimers. The local benchmark is the Datastream Emerging Markets Total Market Index. Source: Refinitiv Datastream and Invesco

Appendix 4: Performance tables

Figure 30 – Global equity sector total returns relative to market

Data as at 30/09/2021	Global				
	3m	**YTD**	**12m**	**5y***	**10y***
Energy	**4.3**	**8.1**	**5.8**	**-9.4**	**-8.9**
Basic Materials	**-4.2**	**-2.6**	**3.0**	**-0.4**	**-3.8**
Basic Resources	-8.6	-5.3	3.5	-0.4	-7.0
Chemicals	1.7	0.9	2.5	-0.7	-1.2
Industrials	**-0.6**	**0.6**	**2.2**	**0.2**	**0.9**
Construction & Materials	1.3	2.5	4.6	-2.9	-1.9
Industrial Goods & Services	-0.9	0.3	1.8	0.8	1.3
Consumer Discretionary	**-3.5**	**-6.1**	**-5.7**	**0.2**	**1.2**
Automobiles & Parts	0.7	0.9	20.3	2.5	1.0
Media	2.7	-4.7	3.3	-0.6	2.4
Retailers	-5.8	-9.7	-19.7	1.8	1.9
Travel & Leisure	-0.5	-6.1	-1.6	-4.1	-1.4
Consumer Products & Services	-6.3	-5.8	-1.2	0.4	1.3
Consumer Staples	**-1.7**	**-8.0**	**-13.2**	**-5.7**	**-2.3**
Food, Beverage & Tobacco	-2.3	-6.7	-10.3	-6.7	-3.0
Personal Care, Drug & Grocery Stores	-0.6	-10.1	-18.3	-5.2	-1.7
Healthcare	**0.5**	**-2.4**	**-8.1**	**0.6**	**3.1**
Financials	**3.5**	**8.0**	**15.6**	**-1.2**	**-0.9**
Banks	4.5	10.4	22.4	-2.8	-3.1
Financial Services	2.6	8.5	14.3	3.5	3.1
Insurance	2.5	1.1	3.5	-1.8	0.4
Real Estate	**-1.7**	**-0.9**	**-5.6**	**-5.2**	**-2.1**
Technology	**0.9**	**3.8**	**4.2**	**12.6**	**8.7**
Telecommunications	**-0.4**	**-3.5**	**-5.9**	**-6.4**	**-4.4**
Utilities	**1.1**	**-8.3**	**-9.9**	**-3.7**	**-4.2**

Notes: *showing annualised returns. Returns shown are for Datastream sector indices versus the total market index. **Past performance is no guarantee of future results.** Source: Refinitiv Datastream and Invesco

Appendix 5: Methodology

Multiple regression analysis

We have run a multiple regression analysis to examine how macroeconomic factors influence sector valuations. We have used the dividend yield relative to market as the dependent variable and have run the regressions with the following independent variables:

Monthly series since 31/01/1991:

- **1-year change in:** industrial production, consumer price index
- **The level of:** real oil price (US CPI adjusted), real copper price (US CPI adjusted), consumer confidence index, manufacturing confidence index, 10-year benchmark government bond yield, net debt/EBITDA (only for non-financial sectors), return on equity

We calculate a global measure of industrial production growth, consumer price index growth, consumer confidence, manufacturing confidence and government bond yields using data from four regions or countries representing 65% of global Gross Domestic Product: United States, Europe, Japan and China. The global measures are weighted averages using Datastream global index market capitalisations as weights.

This analysis shows us which independent variables have a statistically significant relationship with sector valuation ratios. In addition, the regression coefficients tell us how much each independent variable influences those ratios. Finally, we use those coefficients to calculate what the valuation ratios should be, based on the model, and compare them to currently observed valuations. In theory, this allows us to determine whether a sector is undervalued or overvalued based on the macroeconomic factors we have used.

Sector classification

We use the Industry Classification Benchmark (ICB).

Leverage and profitability ratios

We calculate Net Debt/EBITDA from sector and market level aggregates supplied by Refinitiv Datastream. They define Net Debt as Total Debt minus Cash, where Cash represents Cash & Due from Banks for Banks, Cash for Insurance companies and Cash & Short Term Investments for all other industries. We tend to exclude Financials from Net Debt/EBITDA comparisons for it is difficult to distinguish debt they sell as a product and debt they incur during the operation of the business. In addition, Refinitiv Datastream define EBITDA – Earnings before Interest, Taxes and Depreciation – as the earnings of a company before interest expense, income taxes and depreciation. It is calculated by taking the pre-tax income and adding back interest expense on debt and depreciation, depletion and amortisation and subtracting interest capitalised.

Decomposed returns

We break down total returns into 3 components to examine what has driven sector performance year-to-date, in the last 12 months and for the whole history of the index. “Yield” shows the income investors received from dividends paid during the period concerned. “Growth” shows the rate of dividend growth, calculated using the percentage change in dividend per share (DPS) values for the sector indices. DPS is calculated as dividend yield times the price index. “Multiple Change” refers to the change in dividend yield between the two periods indicated, plus the change in dividend yield times dividend growth. We use it to measure investor expectations and sentiment regarding the sectors.

Implied perpetual growth models

A valuation cross-check is sought by calculating the perpetual real growth in dividends required to justify current prices. This then allows an evaluation of whether those implied growth rates are realistic.

We use a simple perpetual growth model to calculate implied growth. If Price = Dividend/(Discount Factor - Growth), then Growth = Discount Factor – Dividend Yield. The Discount Factor is equal to Risk Free Rate + (Beta x Market Risk Premium). Everything is expressed in real terms to eliminate the distorting influence of inflation, the output being growth in real terms. The important ingredients are derived as follows:

- The risk-free rate is an equity market capitalisation weighted average of US, UK, Eurozone, Japanese and Chinese 10-year real yields.
- Sector betas are calculated using five years of weekly price movements relative to the global market index.
- The risk premium is derived from US equity and treasury market returns since 1871.
- The dividend yield for each sector is the 12-month trailing yield calculated by Datastream.

Sector allocations

We start by considering where the equity markets are in their respective economic cycles, which determines whether cyclical or defensive sectors are more likely to outperform. Our preferred measure of cyclical sensitivity is beta. Sector betas are calculated using five years of weekly price movements relative to the local market index.

Next, we refine our decisions by looking at how sector yields relative to the market relate to the ratio calculated by our multiple regression model and how much dividend growth is implied in current trailing 12-month dividend yields relative to market.

Finally, we rank sectors by their recent volatility, using the standard deviation of daily returns for the three months before our cut-off date. After that we rank sectors by their 12-month trailing dividend yield. Based on our thematic report about sector strategies, Sector strategies: Control your volatility, combining these approaches provided the best cost-adjusted and risk-adjusted returns in the US, and was among the best in cost-adjusted returns in Europe.

An investment decision is the result of balancing a range of factors and the weightings applied to those factors can vary across time and sectors. “Overweight” suggests that we prefer to hold more of the given sector than suggested by the market capitalisation-weighted “neutral” position. “Underweight” suggests we prefer to hold less of the given sector than suggested by the market capitalisation-weighted “neutral” position. “Neutral” suggests a holding in line with the market capitalisation-weighted benchmark.

Preferred regions

We measure sector valuations relative to their respective local benchmarks in the United States, Europe, Japan and Emerging Markets. We calculate a z-score comparing the latest relative dividend yield to its historical average, which gives us a standardised way to measure how far valuations are from those averages in each region. Our normal preference would be for the cheapest region based on this measure, but we also take into account thematic and other fundamental considerations.

Appendix 6: Abbreviations

Changes in allocations on the front page: OW = Overweight, N = Neutral, UW = Underweight

Sector name abbreviations:

Autos = Automobiles & parts
Basic Res = Basic Resources
Chem = Chemicals
Con & Mat = Construction & Materials
Cons P&S = Consumer Products & Services
Fin Serv = Financial Services
Food, Bev & Tob = Food, Beverage & Tobacco
Ind G&S = Industrial Goods & Services
Pers Care = Personal Care, Drug & Grocery Stores
Pers & Hh Gds = Personal & Household Goods
Real Est = Real Estate
Tech = Technology
Telecoms = Telecommunications
Trav & Leis = Travel & Leisure

Appendix 7: Definitions of data and benchmarks

Sources: we source data from Refinitiv Datastream unless otherwise indicated.

Government bonds (figure 3): Current values use Refinitiv Datastream benchmark 10-year yields for the US, Eurozone, Japan and the UK and the Thomson Reuters China benchmark 10-year yield for China.

Value sectors: stocks or sectors that have low price/book value or price/earnings multiples or high dividend yields. Some of these stocks or sectors may generally trade at a discount compared to the market if investors expect their earnings or dividends to grow at a slower pace than the market. Examples of such sectors are utilities, telecommunications, banks and oil & gas.

Growth sectors: stocks or sectors that have high price/book or price/earnings multiples or low dividend yields, because investors expect them to have high earnings or dividend growth. Examples of these sectors are technology, healthcare and food & beverage.

Defensive sectors: stocks or sectors that have business models that investors consider to be relatively stable throughout the business cycle. We refer to the following sectors as defensive: food & beverage, personal & household goods, healthcare, telecommunications and utilities.

Cyclical sectors: stocks or sectors that have business models that investors consider to be sensitive to the economic cycle. We refer to the following sectors as cyclical: oil & gas, basic resources, chemicals, construction & materials, industrial goods & services, automobiles & parts, media, retail, travel & leisure, banks, financial services, insurance, real estate and technology.

Growth factor: a subset of the S&P 500 in the US and the Stoxx 600 index in Europe and includes stocks in the top third based on both their 5-year sales per share trend and their internal growth rate (the product of the 5-year average return on equity and the retention ratio).

Low volatility factor: a subset of the S&P 500 in the US and the Stoxx 600 index in Europe and includes stocks in the bottom quintile based on the standard deviation of their daily returns in the previous three months.

Price momentum factor: a subset of the S&P 500 in the US and the Stoxx 600 index in Europe and includes stocks in the top quintile based on their performance in the previous 12 months.

Quality factor: a subset of the S&P 500 in the US and the Stoxx 600 index in Europe and includes stocks in the top third based on both their return on invested capital and their EBIT to EV ratio (earnings before interest and taxes to enterprise value).

Size factor: a subset of the S&P 500 in the US and the Stoxx 600 index in Europe and includes stocks in the bottom quintile based on their market value in US dollars for the US and euros for Europe.

Value factor: a subset of the S&P 500 in the US and the Stoxx 600 index in Europe and includes stocks in the bottom quintile based on their price to book value ratios.

Data as of 30th September 2021 unless stated otherwise. This publication is updated quarterly.

Important information

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