Level Set: 4 Things We Are Thinking About

We Remain Cautious on the First Half of the Year

We don't want to say that earnings season is over, as after all, NVDA, the most important stock in the market, reports this coming week. However, we have enough data points year-to-date to comment on what we have learned, what's been confirmed, and what's new. We continue to focus on an increasingly volatile environment, weakness in Consumer Discretionary, and opportunities for outperformance in Healthcare and Industrials.

Firstly, we wrote in our year-ahead outlook published in early January the following:

"New policies not bullish?: We think investors have too benign of an interpretation of potential new policies and their impact on US earnings. Outside of Healthcare, where investors have determined RFK, Jr. will wreak havoc on earnings, we have not seen stocks sell-off on the specter of tariffs, the stronger dollar, or other potentially volatility-introducing policies articulated by the Trump team. It could be challenging for CEOs to optimize US / non-US hiring, and they may see a fall-off in demand as they attempt to raise pricing."

This past week, we think we are starting to see some more broad-based concern about a volatile backdrop. The S&P500 closed this week below where it did two weeks ago, following a 2.1% two-day sell-off. We would take risk cautiously in the coming weeks until we have more certainty, and we reiterate our conclusion from the outlook:

"We can no longer romanticize we are contrarian bulls, like we were able to do in our year-ahead outlooks in 2023 and in 2024. The consensus sell-side strategist is embedding low double-digit returns for 2025. Many of the "word salad" prognosticators who were cautious the last two years now like US equities and small caps. That's worrisome. Given the market run, we think it is likely the market will correct in the first half of 2025. Our judgment is that the risks are skewed toward the downside for the S&P500 in the first half of the year."

We view Friday's extreme daily change in the US Citigroup Economic Surprise Index, which was the lowest in a long time, perhaps a visible negative sign that policy uncertainties are starting to have a negative impact.

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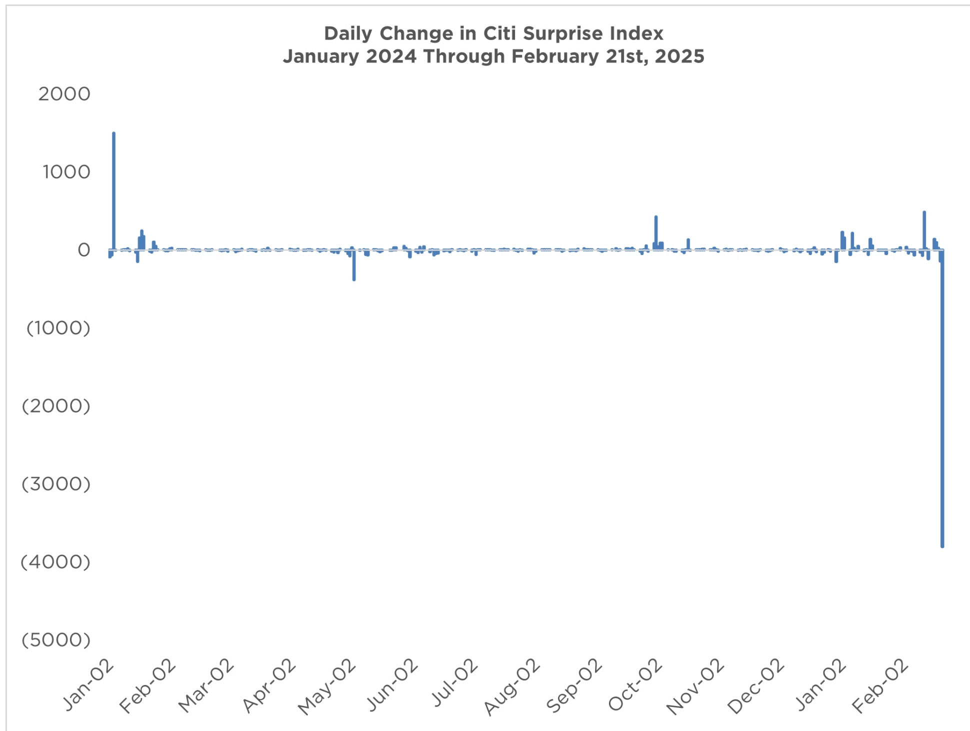
The Lowest Citi Group Surprise Day



Source: Bloomberg, Trivariate Research, LP

We Recommend an Underweight in Consumer Discretionary

Secondly, we have been recommending that investors underweight Consumer Discretionary. Retail Sales showed modest downside surprise last week and Walmart (Ticker: WMT), a company that has revenue of over 2% of the US GDP, lowered its full-year 2025 revenue guidance during its earnings report earlier this week. Those are both substantial data points in our judgment.

Consumer Discretionary has been the worst performing sector year-to-date (see chart below) but stock selection has been crucial. There has been substantial return dispersion in the Consumer Discretionary Sector already this year, and typically volatility is a sign of subsequent uncertainty. Several stocks are up meaningfully year-to-date, including Tapestry (Ticker: TPR), Starbucks (Ticker: SBUX), Hasbro (Ticker: HAS), and Ralph Lauren (Ticker: RL)--all of which are up more than 20% this year. However, the underperformers have been thematically in several areas, including in select Apparel stocks like Deckers (Ticker: DECK), down 28%, and Ulta Beauty (Ticker: ULTA), down 17%; in Tesla (Ticker: TSLA), down 16%; in Homebuilding stocks like Lennar (Ticker: LEN), DR Horton (Ticker: DHI) and NVR (Ticker: NVR), which have all been weak; and well-known stocks like Chipotle Mexican Grill (Ticker: CMG) and Las Vegas Sands (Ticker: LVS), both down more than 14% already this year.

We would maintain caution on the Consumer. Pushback from clients revolves around the challenge of betting against the US consumer, an investment stance that has not be prudent over the last 25 years. Our view is that the interest rate cycle is correlated to Consumer Discretionary performance, and to the extent that the perception about incremental dovish is now over, and we are transitioning to late in the accommodative cycle, that is bearish for the US consumer stocks. Moreover, sector selection is more about “change” than “level,” and while the aggregate consumer data on jobs, wages, and credit card delinquency metrics, to name a few well-followed trends, may still look robust in absolute terms, they are generally deteriorating. Government sector layoffs, potential deportations, and a slowing economy likely cause some changes to consumer behavior that are not all in the prices.

Year-to-Date Performance by Sector Through February 21st, 2025	
Sector	**Performance**
Consumer Staples	6.2%
Healthcare	6.2%
Utilities	5.6%
Energy	5.2%
Financials	4.8%
Communication Services	4.8%
Materials	4.6%
Real Estate	3.7%
S&P500	2.2%
Industrials	2.2%
Technology	(0.3%)
Consumer Discretionary	(3.4%)

Source: Trivariate Research, LP

We Recommend an Overweight in Healthcare

On the contrary, our biggest overweight recommendation is in Healthcare. Healthcare has outperformed so far this year, with 17 S&P500 Healthcare stocks up more than 10% year-to-date, and only five down more than 10%. The earnings momentum is starting to improve, with Healthcare having the biggest positive changes to EPS over the last few weeks of any sector in the market. Ultimately, we think the fears of a material change to the outlook for Healthcare earnings are overblown, and continued strong relative earnings revisions will catalyze a positive re-rating.

S&P500 Last 12 Month Earnigs Per Share Changes By Sector As of February 21st, 2024			
Sector	**3-month**	**1-month**	**1Week**
Health Care	8.7%	7.4%	6.2%
Industrials	4.3%	2.4%	3.7%
Communication Services	5.5%	2.6%	3.0%
Energy	(3.7%)	(0.4%)	2.0%
Consumer Discretionary	2.0%	0.5%	0.8%
Real Estate	(0.8%)	(1.2%)	0.8%
Financials	5.1%	2.6%	0.5%
Information Technology	5.3%	1.7%	0.2%
Utilities	2.9%	0.6%	0.0%
Materials	(1.0%)	(0.1%)	(0.0%)
Consumer Staples	(0.4%)	(0.6%)	(0.7%)
S&P 500	4.2%	2.2%	1.7%

Source: Trivariate Research, LP

We Recommend an Overweight in Industrials

Additional points of interest in our judgment are forming in the Industrials complex. In aggregate this past week, we saw some significant data that we think broadly supports our thesis to be overweight the stocks. While industrials have lagged the market year-to-date, recent earnings momentum has been better than average (see above). Moreover, the laggards have been the previous darlings perceived as Electrification or AI beneficiaries. Quanta Services (Ticker: PWR) is down 14.8% year-to-date, AXON (Ticker: AXON) is down 13.8%, Generac Holdings (Ticker: GNRC) is down 11%, and Electrification poster-child Eaton (Ticker: ETN) is down 10.4%. Underneath the surface there has been some rotation.

Industrial production had a modest upside surprise last week, on the back of an above 50.0 ISM Manufacturing survey result earlier this month. As a reminder, Trivariate's Proprietary Industrial Activity gauge indicated signals were positive at year-end, something we featured in our year-ahead outlook. We are starting to see some stocks that are down in absolute terms in the last year - against a backdrop of a strongly performing S&P500, now have positive returns in the last week while the overall

market was down. This includes Lincoln Electric Holdings (Ticker: LECO), Huntington Ingalls Industries (Ticker: HII), Nextracker Inc. (Ticker NXT), AGCO (Ticker: AGO), Dayforce (Ticker: DAY), Robert Half (Ticker RHI), and United Parcel Services (UPS), among others. We view this rotation within industrials as likely to be a harbinger of stronger broad-based performance of Machinery, Transportation, and perhaps even Building Products, which seem safer than Homebuilders at present.

CONCLUSION: We are cautious on the US equity market for the first half of the year. We like Healthcare and Industrials, and we are cautious on the Consumer Discretionary Sector. In our recent meetings, three topics come up the most:

1. Our work on Beta — and how skewing beta below 1.0 at the portfolio level is crucial (see here).
2. Our work on Healthcare — what the bull case is — and why we are optimistic.
3. Our downgrade of the Mag 7 in our Level Set two weeks ago (see here).

Let us know if you would like to connect to discuss any of these topics in greater detail.

Important Disclosures

Analyst Certification

The analysts, Adam Parker, Maxwell Arnold, Chang Ge, Colin Cooney and Ryan McGovern, responsible for the preparation of this research report certifies that: all the views expressed in this research report accurately reflect the research analyst's personal views.

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