INVESTMENT THEMES FOR THE NEXT DECADE

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This piece reviews the major secular investment trends that will influence the economy and markets in the coming years.

MAJOR INVESTMENT THEMES FOR THE NEXT DECADE

1. Recently demonstrated advancements in artificial intelligence (AI) highlight the transformative potential of technology advancements. There were already many secular trends in place for the Technology sector, including e-commerce and increased internet usage, cloud computing, big data and advanced analytics (led by AI), automation, advanced communication systems, and cybersecurity. As a result of the pandemic and recent AI advancements, these trends have accelerated, to the benefit of the Technology sector. We see these trends as sustainable and critical for enhancing productivity and economic growth in the coming years.
2. The Communication Services sector also benefits from secular technology trends, with firms well positioned for consumers spending more time online with advertising dollars following.
3. Health Care is another sector that remains well-positioned with secular trends due to aging demographics and technological advances.
4. Firms from many other sectors of the economy that were already leaders in successfully implementing advanced technology should see their competitive advantage enhanced in the coming years as they continue to lead in technology implementation.
5. Many Technology, Communication Services, and Health Care stocks are considered growth stocks, with these sectors making up a combined 52% of the S&P 500 stock market index (more on this below). Given the secular trends for these sectors, lack of exposure to them and their themes could be costly to portfolio performance.
6. The accelerating movement toward clean energy has implications for many sectors, especially Energy, Materials, Utilities, and Industrials, that are discussed below.
7. While clean energy represents a headwind for oil and gas firms, fossil fuels meet approximately 80% of today's energy demand, and oil and gas firms remain critical to the economy with traditional energy in demand for the foreseeable future.
8. Pandemic-induced supply chain disruptions coupled with geopolitical tensions with China are causing many firms to consider "onshoring" or bringing manufacturing back to the U.S. This is leading to a U.S. manufacturing renaissance that benefits many sectors of the U.S. economy. "Nearshoring" or moving manufacturing from China to nearby or friendly countries, is also an important investment theme.
9. The Financial sector (particularly banks) has been negatively impacted by interest rate hikes that produced higher long-term interest rates and an inverted yield curve (short-term interest rates higher than long-term rates). We expect interest rates to normalize as inflation falls toward the Federal Reserve's 2.0% target. This should provide a more favorable backdrop for financials in the coming years.
10. We continue to favor high-quality companies with strong balance sheets and the ability to grow cash flow and dividends that offer exposure to the above secular themes.
11. As always, we recommend investors stay invested in a well-diversified portfolio with periodic rebalancing—keeping in mind the above secular themes.

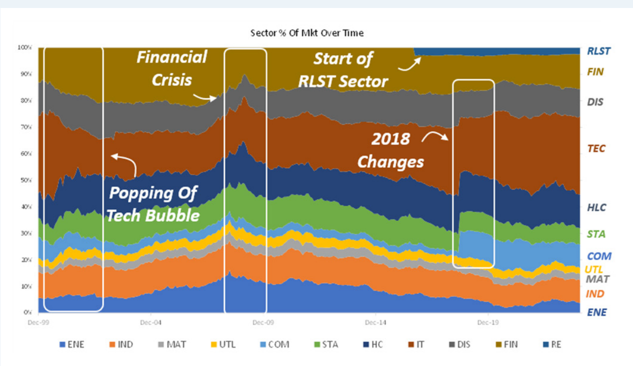
ECONOMIC SECTOR IMPACT OF MAJOR SECULAR THEMES

The S&P 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies (market capitalization of a firm is the number of its shares multiplied by the stock price). This index is further divided into 11 sectors designed to represent different parts of the economy.

Stock prices are forward-looking and a reflection of a firm's perceived future profits. A large market capitalization implies large future profits. Taking this one step further, the size and growth of a sector is a reflection of its perceived importance to future economic activity.

Consequently, a lot can be learned about the potential direction of the economy by sector analysis. Technology is by far the largest sector of the S&P 500 Index, and the products and services it provides have a major influence on firms within all other sectors. Leading firms from all industries are excellent at adopting and efficiently utilizing technology to optimize their business models.

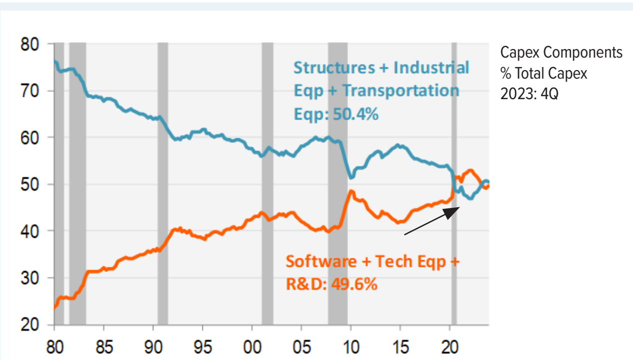
Chart 1: Sector Weights Shift as Perceived Importance to Economy Changes



Source: Janney Investment Strategy Group; Piper Sandler Companies

The following section reviews the major secular themes we see developing for each sector of the economy in the coming years and highlights the importance of technology to all parts of the future economy.

Chart 2: Growing Importance of Software and Technology for Business Investment



Source: Janney Investment Strategy Group; Piper Sandler Companies

Technology (30% of S&P 500 Index): The Technology sector has many secular drivers that provide potential for significant future growth.

While recently demonstrated AI breakthroughs are dominating headlines, other important secular drivers have been in place including:

- Greater connectivity (smartphones, unlimited data plans, and ever more sophisticated communications networks)
- Global acceleration of e-commerce
- Further gains in computing power (an important catalyst for machine learning and artificial intelligence)
- Growth of big data and the need for data analytics
- Cloud computing which entails allowing a third party to handle your computing needs
- Internet-of-things which is leading to ubiquitous smart devices
- Cybersecurity which remains critical due to ever increasing threats

Importantly, the cost and ease of implementing these advanced technology solutions continues to come down over time. The ability to apply technology solutions is growing rapidly because of:

- Advanced communication systems that allow for new applications
- Massive amounts of data being generated
- The ability to use computing power and advanced analytics (led by AI) to analyze the data

Cloud computing is enabling low-cost secure data storage, computing power, and analytical expertise for all sectors of the economy.

The pandemic accelerated these secular drivers. Many online activities, including work at home, remote learning, e-commerce, and increased internet usage, are seeing sustainable increases because of the pandemic—to the benefit of the Tech sector.

In contrast to the late 1990s tech bubble, many tech firms today have strong balance sheets and quality earnings. This healthy cash position supports future investments and dividends. The sector's large cash balances, low debt levels, and resilient secular drivers have resulted in the sector becoming higher quality and less cyclical.

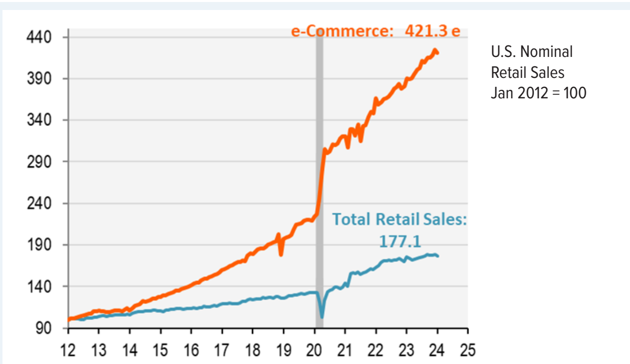
Business investment in the U.S., boosted by tax reform's lower corporate tax rate and immediate expensing of capital expenditures in 2017, is now receiving significant additional support through the CHIPS and Science Act and Inflation Reduction Act (which includes significant investment incentives for clean energy). The Tech sector is a major beneficiary of these onshoring drivers. The pandemic-related global supply chain disruptions and renewed tensions with China are additional catalysts for increased U.S. technology investment.

Software, IT Services, Internet Services, and Semiconductors are all benefiting from the secular trends mentioned above. Cybersecurity also represents a secular growth opportunity for software and technology, in general.

Health Care (13% of S&P 500): Aging demographics and the demand for more prescriptions and procedures as we age provide the major tailwind for the Health Care sector. However, industry-leading firms within health care are heavily dependent on advanced technology, now led by AI. Technology plays a critical role in drug and medical device development while insurers and service providers utilize big data and advanced analytics to optimize their business operations and control health care costs.

Communication Services (9% of S&P 500): There are many firms within this sector that are beneficiaries of the secular technology trends. The best-in-class firms within this sector engage a growing number of users, collect massive amounts of data from them, and analyze the data with state-of-the-art techniques—led by AI. Advertising and consumer dollars continue to flow toward these firms that are increasingly able to quantify their worth to businesses and consumers—at the expense of traditional media.

Chart 3: E-commerce Demonstrates Technology's Major Economic Impact



Source: Janny Investment Strategy Group; Piper Sandler Companies

Consumer Discretionary (11% of S&P 500): The shift to online retailing has been the major secular theme for this sector. Developing a first-class online presence is critical for success with some firms much better positioned than others. This transition involves utilizing many of the advanced technologies mentioned above and requires significant investment. Retailers that haven't been successful at making this transition continue to face a major headwind.

Housing never completely recovered after the 2008 financial crisis and now faces the headwind of high interest rates. We expect the coming years to show improvement, especially as interest rates ultimately normalize with lower inflationary pressures. We see opportunities for housing-related stocks with pent-up demand from millennials that are now in their home buying sweet spot.

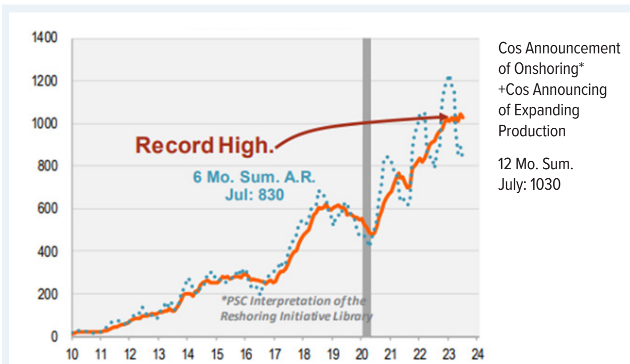
The transition to electric vehicles (EVs) is having a significant impact on the auto and auto components industry that will continue playing out in the coming years with most auto manufacturers committed to all EV fleets by the middle of the next decade.

Financials (13% of S&P 500): Financials face the near-term headwind from the inverted yield curve (short-term interest rates higher than long-term rates) which is pressuring banks' all-important net interest income (banks borrow at short-term interest rates and loan at long-term rates). However, valuation is relatively favorable and there are firms in the sector that utilize technology as a major driver of their competitive advantage. These well-positioned firms have significant scale that allows them to make the needed technology investments. They have access to massive data and the ability to analyze it with advanced analytics. The pandemic has accelerated the move to online from brick-and-mortar banking to the benefit of the technology leaders.

Well positioned firms in this space have diversified business models that include traditional banking, investment banking, and wealth management. These business models are proving their worth with diverse revenue streams helping offset the impact of high interest rates.

Industrials (9% of S&P 500): Best-in-class industrials are utilizing technology to automate factories, optimize supply chains, and gain other efficiencies. Railroads and logistics firms have established scale and barriers to entry that should maintain their future profitability. Defense firms remain critical for national security and are beneficiaries of heightened tensions with China, Russia, and Iran. Industrials are also beneficiaries of reshoring as a result of pandemic-induced supply chain disruptions and geopolitical tensions with China.

Chart 4: Onshoring and Nearshoring Are Important Secular Themes



Source: Janney Investment Strategy Group; Piper Sandler Companies (PSC)

Many industrial firms are involved in commodity extraction, transportation, and improving energy efficiency. They are directly involved in, and impacted by, the movement toward clean energy with many well positioned for the transition.

Consumer Staples (6% of S&P 500): Best-in-class staples firms have global brands that stand the test of time. These firms are defensive because the demand for their products is relatively immune to the business cycle—thus providing stable earnings that support growing dividends. They also have tremendous expertise utilizing technology to optimize sales and global supply chains while minimizing other costs. These factors should ensure the future success of the sector's blue chips.

Real Estate (2% of S&P 500): Technology and warehouse REITs are major beneficiaries of the secular technology trends including AI and cloud computing and the move away from brick-and-mortar retailing. Retailing REITs continue to face the headwind from the shift to online retailing which accelerated as a result of the pandemic. Commercial REITs remain under pressure from work-from-home and hybrid work arrangements that have become permanent features of the workplace.

Utilities (2% of S&P 500): Utilities are seeing a fundamental change to their business model because of clean energy requirements. Historically, utilities pass through to retail customers the cost of fossil fuel used to generate electricity (about 40-50% of a typical bill). With renewable energy, customers don't pay a fuel charge, but pay a cost that allows utilities to recapture their investment in renewable generation.

This investment is projected to be substantial in the coming years while investment in the electric grid is also projected to be massive due to substantially higher electricity usage. Consequently, higher investment is causing many utilities to see their long-term earnings growth rates increase, which should ultimately benefit the valuation they are given by investors.

Materials (2% of S&P 500): The last decade saw the Materials sector under secular pressure from China's economic slowdown and excess capacity. We expect a major shift in the future as years of underinvestment should ultimately lead to tighter supply for many commodities while the movement to clean energy sources requires significant commodity inputs.

Studies by the World Bank and the International Energy Agency (IEA) point to significant demand for base metals and other materials needed for the transition to clean energy. A typical electric car requires six times the mineral inputs of a conventional car, and an onshore wind plant requires nine times more mineral resources than a gas-fired power plant. Metal and mining firms are well positioned for higher demand that is set to last decades.

Meanwhile, firms within the sector that provide significant value-add to their final products and are successful at utilizing advanced technologies remain well positioned. These best-in-class firms have created competitive advantages that should remain sustainable in the future—despite the cyclical nature of this sector.

Energy (4% of S&P 500): This notoriously boom-or-bust sector continues to face many crosswinds. The success in developing shale oil and gas has impressively led to energy independence for the U.S. While this success led to excess global productive capacity, OPEC+ and shale producers have shown discipline in bringing on new supply, which has supported prices and profitability.

Meanwhile, growing concerns about climate change are causing a secular shift toward alternative energy and electric vehicles, with alternatives becoming cost-competitive with traditional oil and gas. Solar and wind energy producers should see significant growth in the coming years, with low-cost producers well positioned.

While traditional oil and gas firms are being pressured by major shareholders to show they can transition their business models to a low-carbon world, traditional energy sources will be in demand for the foreseeable future. Fossil fuels meet approximately 80% of today's energy demand, and oil and gas firms remain critical to the economy, providing a flexible source of power with diverse applications.

Major oil companies are developing carbon capture and sequestration systems and making their own investment into clean energy, which should help them make the transition to a low-carbon world.

Longer term, natural gas will continue to play a key role in energy production, considering it produces less carbon relative to other fossil fuels and can be used for base-load electricity generation.

Please refer to our Sector Strategy Spotlight reports for additional detail on all of the sector themes discussed.

Contact your Janney Financial Advisor for actionable investment ideas related to the themes in this report.

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