Spotting Trends
Sector and Industry

September 2024

Sector Opportunities for Q4 2024

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- **REITs** Capture positive tailwinds of lower rates and attractive valuations with REITs.
- **Homebuilders** Balanced exposure to homebuilders and housing-related segments may help investors capture the broad recovery of housing activity.
- **Banks** Lower rates, potentially higher loan growth, and less-than-expected regulations support the further expansion of bank valuations.

Following jolts of equity volatility driven by the unwinding of the global carry trade and weak US job reports, the S&P 500 Index finished the quarter with its 43rd all-time high on the back of the Federal Reserve's 50 basis point (bps) rate cut and China's aggressive monetary and fiscal stimulus.[1] Looking under the hood, market breadth has improved with rate-sensitive defensives (Utilities and Real Estate) and cyclical value sectors (Financials, Industrials, and Materials) outperforming.

While US election uncertainty and Middle East geopolitical tensions pose downside risks to equities, the Fed's dovish pivot and still solid US economy strengthen the case for a soft landing, supporting cyclical value and rate-sensitive exposures, specifically REITs, Homebuilders, and Banks.

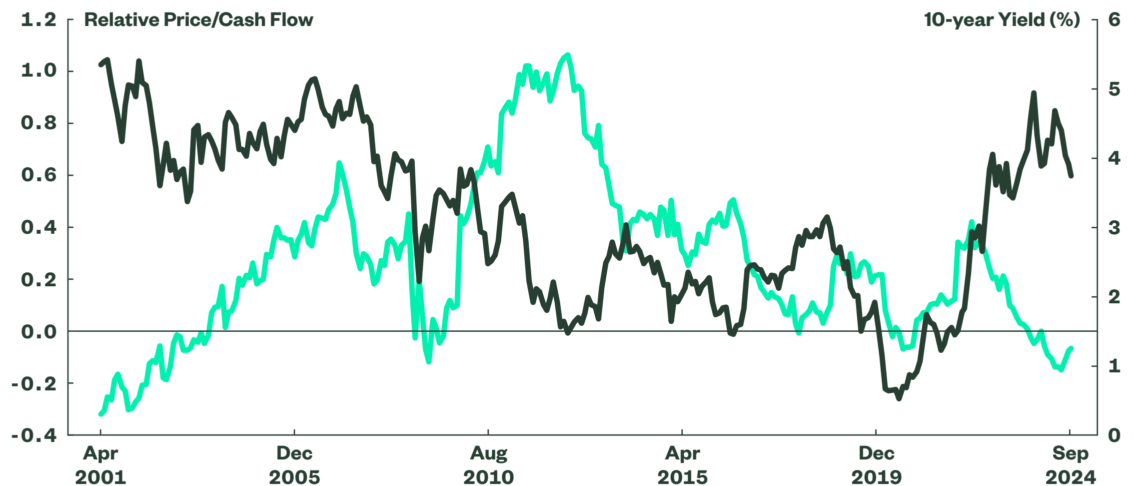
REITs: Beneficiary of Lower Rates with Attractive Valuations

Public REITs have underperformed equities by nearly 30% since the beginning of the Fed hiking cycle in 2022.[2] High interest rates have pushed REITs' relative valuations to 20-year lows, with price-to-cash-flow trading at a 6% discount compared to the 33% premium of their 20-year average. With the Fed beginning the easing cycle with a 50 bps cut in September and at least 150 bps cuts expected by the end of next year,[3] REITs may play catch-up with broad equities given their attractive valuations, solid industry fundamentals, and the macroeconomic backdrop.

REIT relative valuations to the broad equity have only been near or greater than the current level during two periods in the past two decades: the peak of Global Financial Crisis (GFC) in 2009 and the COVID Pandemic in 2020 (Figure 1). Following those periods of depressed valuations, REITs outperformed broad equities in the subsequent one and two years driven by valuation recovery.[4] Given the strong negative correlation between long-term yields and REIT valuations (-0.5), declining yields could be the catalyst for the valuation rebound.[5]

Figure 1
Lower Yields Support REIT Valuations

10-year Yield
Price/Cash Flow Relative to the S&P 500



Source: FactSet, as of September 23, 2024.

Despite high financing costs, REITs have shown resilient net operating income growth supported by healthy occupancy rates. With the exception of office REITs, the average occupancy rates of US public retail, industrial, and apartment REITs have been all above 95%, thanks to resilient economy and consumers.[6] In fact, increases in net operating income outpaced CPI inflation for nine of the past 12 quarters by an average of 2.6%.[7]

REITs also have maintained healthy balance sheets since the GFC, providing the financial strength necessary to navigate the current high interest rate environment. And the industry's focus on fixed, long-term debt years before the pandemic means less impact from high interest rates. The interest coverage ratio sits at its highest pre-pandemic level, while debt to total asset value is near the lowest for the same period.[8]

To capture positive tailwinds of lower rates and attractive valuations, consider the SPDR® Dow Jones® REIT ETF (RWR).

Homebuilders: Potential Broad Recovery in the Housing Sector

Homebuilding-related stocks have rallied 20% over the past three months as mortgage rates fell from more than 7% to 6.2% on the back of increased rate cut expectations. While the recent rally has expanded the industry price multiples, lower mortgage rates and potentially improving housing activity may provide the industry's next leg up.

Over the four rate-cut cycles since 1990, mortgage rates have followed the same direction as the federal fund rates, declining between 1% and 2% depending on the number of rate cuts. And lower mortgage rates increase housing affordability, boding well for housing activity and homebuilders' profitability.

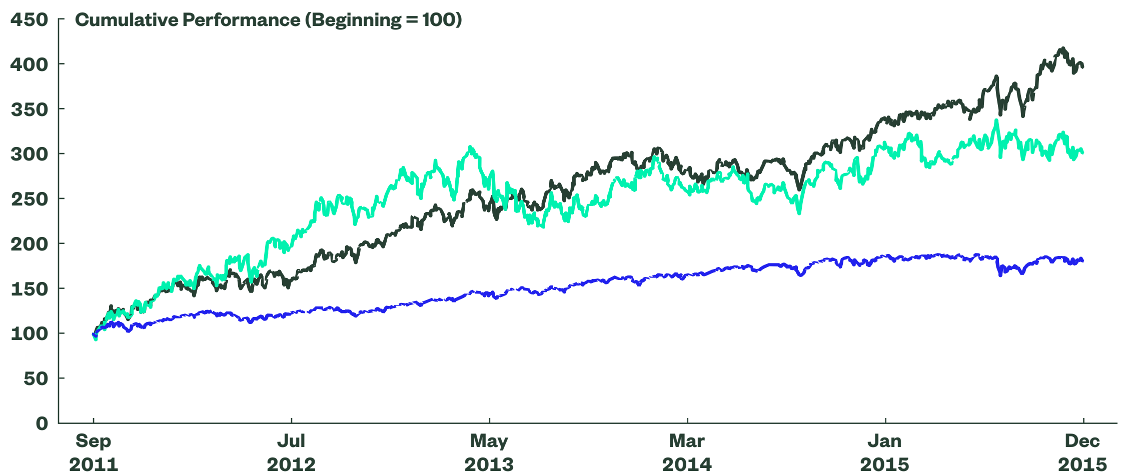
Since the market started pricing in more rate cuts for this year over the summer, 30-year fixed mortgage rates have declined to their lowest level in two years.[9] The three-month moving average for new home sales is at its highest level since March 2022, while homebuilder sentiment improved in August,[10] breaking four consecutive monthly declines. On the other hand, existing home inventory remains well below its pre-pandemic average as the mortgage rate lock-in effects are still holding back existing home sales.

Increasing housing affordability and still positive real-wage growth also give builders more pricing power as fewer builders cut prices or offer sales incentives evidenced in the latest NAHB homebuilder survey. Lower fed fund rates will also reduce the cost of homebuilder and developer loans, further boosting builders' profit margins.

As housing continues to recover, the decline in home improvement spending is poised to stabilize and resume an upward trend next year. Housing price appreciation and healthy wage growth give homeowners confidence to spend more on home improvements, especially if they have a low mortgage rate.

Therefore, building product stocks may lead the homebuilding industry rally in the coming quarters. During the housing recovery after the GFC, while both homebuilder and building product stocks outperformed the broad market substantially, the leadership changed later during the recovery thanks to rising home improvement spending (Figure 2).

Figure 2
Performance of Housing-related Industries Post-GFC



Source: Bloomberg Finance, L.P., for the period between September 30, 2011, and December 31, 2015. **Past performance is not a reliable indicator of future performance.**

With a balanced exposure to homebuilders and housing-related segments like building products and home improvement retail, the SPDR S&P Homebuilders ETF (XHB) may help investors capture the broad recovery of housing activity.

Banks: Improved Earnings Outlook With Attractive Valuations

Bank stocks historically have exhibited strong positive sensitivity to yield curve movements according to our research on sectors' macroeconomic sensitivity.[11] Indeed, US banks outperformed the S&P 500 by more than 10% in Q2 as 10- and 2-year yield spreads turned positive for the first time in over two years.[12] With more rate cuts expected by the end of 2025, deposit costs will likely decline with the fed funds rate, while banks' asset yields may fall at a slower pace, supporting their net interest margin.

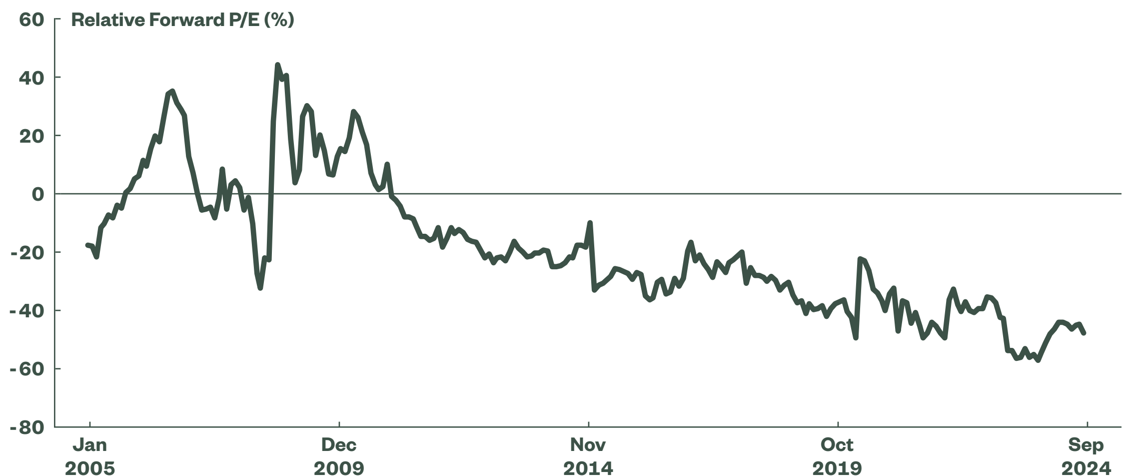
Commercial and industrial loan growth also turned positive in Q2 after seven consecutive months of decline.[13] The Q2 Senior Loan Officer Survey points to easing loan standards and increasing demand across all types of loans. As interest rates continue declining and the Fed takes a preemptive approach to support economic growth, loan growth may rebound further from the cycle trough, boosting banks' net income growth.

Banks' asset quality remains strong, despite increased charge-offs. While banks' provisions for credit losses continue to increase due to loan growth, deterioration in office real estate, and credit card charge-offs, the level of noncurrent loans remains stable, well below pre-pandemic levels.[14] The higher-than-average reserve-to-loan ratio indicates banks have taken a cautious approach to navigating economic uncertainties by strengthening their balance sheet.

Regulatory headwinds also could subside in the coming quarters. The recently revealed modified proposal for the Basel Endgame — a set of US banking regulations that aims to boost capital requirements for banks to manage risks — cuts extra capital needed by the largest banks by roughly half compared to the original proposal. It also excluded banks with assets between $100 and $250 billion from the endgame changes, other than the requirement to recognize unrealized gains and losses of their securities in regulatory capital.[15]

Although bank price-to-earnings relative valuations have improved since the Silicon Valley Bank selloff last year, they are still below the trough level of the GFC and 11% lower than the post-GFC average (Figure 3).

Figure 3
Banks Are Trading at a Record Discount to the Broad Market



Source: FactSet, as of September 27, 2024. Banks are represented by the S&P Composite 1500 Bank Industry Index. Valuations are relative to the S&P Composite 1500 Index.

Tailwinds from lower rates, higher loan growth, and less-than-expected regulations support the further expansion of bank valuations. Consider the SPDR® S&P® Bank ETF (KBE) to pursue benefits from the potential turnaround of the bank industry.

Endnotes

1 Bloomberg Finance, L.P., as of 09/30/2024.

2 Bloomberg Finance, L.P., as of 09/23/2024. S&P 500 and Dow Jones US Select REITs Indices are used to represent broad equities and REITs, respectively.

3 CME FedWatch, as of 09/23/2024.

4 FactSet, as of 09/30/2024.

5 FactSet, for 20-year period ending on August 31, 2024. REITs' valuations are measured by price to fund from operation. Long-term yields are represented by 10-year treasury yields.

6 Nareit, T-Tracker, Q2 2024.

7 Nareit, T-Tracker, Q2 2024.

8 Nareit, T-Tracker, Q2 2024.

9 Bloomberg Finance, L.P., as of 09/26/2024.

10 NAHB, as of 09/26/2024.

11 State Street Global Advisors, How Macroeconomic Variables Impact Sector Performance, September 2023.

12 Bloomberg Finance, L.P., as of 09/26/2024.

13 Board of Governors of the Federal Reserve System, retrieved from FRED, Federal Reserve Bank of St. Louis, as of 09/30/2024.

14 FDIC, Quarterly Banking Profile for Q2 2024, 09/25/2024.

15 The Next Steps on Capital, Vice Chair for Supervision Michael S. Barr's speech at the Brookings Institution.

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* Pensions & Investments Research Center, as of December 31, 2023.
† This figure is presented as of June 30, 2024 and includes ETF AUM of $1,393.92 billion USD of which approximately $69.35 billion USD is in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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Glossary

Earnings Per Share (EPS) A profitability measure that is calculated by dividing a company's net income by the number of shares outstanding.

Global Financial Crisis (GFC) It refers to the economic upheaval of 2007-2009 that is generally considered the largest downturn since the Great Depression of the 1930s. This crisis was triggered largely by the subprime mortgage crisis that led to the collapse of systemically vital US investment banks such as Bear Stearns and Lehman Brothers. An aggravating factor was the speculative spike in energy that lifted oil prices to almost $150 a barrel in the summer of 2008, and which surely contributed to the economic slowdown.

Real Estate Investment Trust (REIT) Companies that own and operate commercial properties, such as office buildings and apartment complexes.

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While the shares of ETFs are tradable on secondary markets, they may not readily trade in all market conditions and may trade at significant discounts in periods of market stress.

Because of their narrow focus, sector investing tends to be more volatile than investments that diversify across many sectors and companies.

Investing in REITs involves certain distinct risks in addition to those risks associated with investing in the real estate industry in general. Equity REITs may be affected by changes in the value of the underlying property owned by the REITs, while mortgage REITs may be affected by the quality of credit extended. REITs are subject to heavy cash flow dependency, default by borrowers and self-liquidation. REITs, especially mortgage REITs, are also subject to interest rate risk (i.e., as interest rates rise, the value of the REIT may decline).

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When the Fund focuses its investments in a particular industry or sector, financial, economic, business, and other developments affecting issuers in that industry, market, or economic sector will have a greater effect on the Fund than if it had not done so.

Passively managed funds invest by sampling the Index, holding a range of securities that, in the aggregate, approximates the full Index in terms of key risk factors and other characteristics. This may cause the fund to experience tracking errors relative to performance of the Index.

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