Sector-Specific Risk Is Up for Equity Investors

The technology sector's dramatic 2023 rebound opens up opportunity in other areas of the equity market.

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In 2023, equity market sector dynamics saw a return to the pre-2022 trend, in many ways. Technology is the prime example. After a deep decline in 2022, the Morningstar US Technology Index[1] and the Morningstar Global Technology Index were the year's top performers in their respective universes, on the back of investor enthusiasm for artificial intelligence. Technology has now surpassed its 2021 share of the market, representing 29% of the Morningstar US Market Index–its highest level since early 2000. And this does not even include stocks like Alphabet and Meta Platforms, which were reclassified from technology to other sectors.

Meanwhile, 2023's laggards were some of the best-performing sectors of 2022. Energy, by far the highest-flying section of the equity market in 2022, came back to earth in 2023. The defensive sectors—utilities, healthcare, and consumer defensive—that held up relatively well in the down market of 2022 posted lackluster returns in 2023.

If the lesson of the past couple of years is that sector leadership is changeable, what does the future hold? A bottom-up, valuation-based approach can be employed, albeit as a long-term signal. Aggregating Morningstar Equity Research's company-level price/fair value estimates to the sector index level reveals risks and opportunities in the U.S. market. Digging into company-level valuations is also useful, as overvalued sectors may still hold undervalued stocks, and vice versa.

Key Takeaways

- Technology stocks like Nvidia rode an AI wave in 2023, recovering from a brutal 2022. The technology sector has surpassed its 2021 market share and now represents its highest percentage of the Morningstar US Market Index since 2000. Investors holding a U.S. market portfolio now have outsize exposure to a single sector relative to historical averages.
- The energy sector also reverted to its long-term trend in 2023, underperforming the market as oil prices fell. Energy stocks represent just 4.2% of the Morningstar US Market Index's weight, down from 15.0% in 2008.
- Defensiveness was out of favor in 2023, undermining sectors like healthcare, utilities, and consumer defensive, all of which held up relatively well in 2022.
- When Morningstar equity analysts' price/fair value estimates are aggregated to the sector level, technology appears to be overvalued after its runup. The same goes for industrials and consumer cyclicals.

1 For a full discussion of index methodology, see "Construction Rules for the Morningstar Global Sector Indexes."

- The communication-services, real estate, energy, healthcare, and financial-services sectors all appear to be undervalued based on company-level estimates.

Equity Sector Trends Resumed

Equity market sector dynamics in 2023 saw a return to the pre-2022 trend in many respects, as displayed in Exhibit 1. The Morningstar US Technology Index, by far the best-performing of Morningstar's 11 sector indexes over the past decade, resumed its leadership role in 2023 after a deep decline in the down year of 2022. The technology index outpaced the Morningstar US Market Index's 26.4% gain in 2023 and 11.6% average annual gain for the trailing 10 years. The consumer cyclical sector, another star before 2022, also shone in 2023. On the negative side, the Morningstar US Energy Index returned to its lagging ways in 2023 after a stellar 2022. All the defensive sectors, which held up relatively well in 2022, underperformed in 2023.

Exhibit 1 Sector Performance in 2023 Returned to the Pre-2022 Trend

US Equity Sector Indexes	2023 Return %	2022 Return %	10-Year Return %
Cyclical			
Basic Materials	15.0	-11.4	8.8
Consumer Cyclical	39.5	-35.5	12.3
Financial Services	16.1	-12.3	10.3
Real Estate	11.8	-25.5	7.3
Sensitive			
Communication Services	54.5	-40.9	9.6
Energy	-0.6	65.5	2.8
Industrials	20.9	-8.1	10.4
Technology	59.1	-31.5	19.8
Defensive			
Consumer Defensive	2.4	-2.6	8.9
Healthcare	2.2	-5.2	11.0
Utilities	-7.0	1.7	8.7

Source: Morningstar Direct. Year-to-date 2023 and 10-year average annual return data through Nov. 30, 2023. Morningstar US Sector Indexes' gross return in U.S. dollars.

Technology thrived in the years leading up to 2022. Many of the dreams conceived during the 1990s' dot-com bubble were fulfilled in the 2010s. E-commerce, mobile computing, and the cloud took off. These trends were only accelerated by pandemic lockdowns.

Then, in 2022, when central banks began responding to persistent inflation by tightening borrowing costs, equity markets sold off sharply. The technology sector bore the brunt of the downturn. This was alternatively blamed on higher interest rates devaluing the shares of companies with longer-dated earnings and the highest flyers having the furthest to fall.

Starting in the fourth quarter of 2022, however, technology stocks rebounded. In November 2022, ChatGPT was introduced, and artificial intelligence captured investors' imagination. Perceived beneficiaries of this transformative new technology became 2023's market leaders. Strong earnings bolstered the narrative.

As a result of its impressive 2023 returns, technology now represents 29.0% of the Morningstar US Market Index, dwarfing the next-largest sector, healthcare at 12.4% (healthcare stocks consumed nearly 20% of the index before the 2008 financial crisis). As displayed in Exhibit 2, technology has now surpassed the 27% share it claimed in 2021 and stands at its largest percentage of the market since the first quarter of 2000, before the dot-com bubble burst. Investors holding a broad U.S. equity portfolio are heavily exposed to a single sector.

Exhibit 2 Technology's Share of the U.S. Equity Market (29%) Is Approaching Dot-Com Bubble Levels

Source: Morningstar Direct. Data as of Dec. 29, 2023.

Technology sector index constituents tell the story of the rise. Apple and Microsoft are the two largest public companies in the world. Nvidia, maker of graphical processing units, is the fourth, having crossed the $1 trillion market capitalization threshold in 2023. It is no coincidence that the most valuable non-U.S. company is now Taiwan Semiconductor, and the third most valuable company in Europe is ASML, which provides lithography for semiconductor foundries.

Semiconductor manufacturers have been likened to suppliers of picks and shovels to the AI gold rush. Unlike the 1990s, this isn't mere speculation. Nvidia and others have exceeded earnings estimates. Meanwhile, other long-running trends, such as cloud computing and e-commerce, have lifted other sectors beyond technology.

Consumer cyclical and communication services were also top-performing sectors in 2023 and over the 10-year period. The Morningstar Consumer Cyclicals Index is dominated by Amazon.com and Tesla, and the communication services index by Meta and Alphabet. Each of these companies enjoys strong earnings growth and profitability and was helped by a robust economy in 2023. They are all members of the "Magnificent Seven" group of market leaders.

Energy stands out in the opposite direction as a sector with poor long-term returns that enjoyed a strong 2022 but came back to earth in 2023. Russia's invasion of Ukraine and pandemic-related supply/demand imbalances sent the price of oil through the roof in 2022, lifting margins for many companies in the sector. These effects moderated in 2023. The sector is threatened by renewables and other factors. It's hard to believe that energy stocks consumed 15% of the Morningstar US Market Index's weight in 2008.

All the sectors classified as "defensive" in Morningstar's taxonomy experienced an abrupt change in sentiment between 2022 and 2023. Consumer defensive, healthcare, and utilities stocks posted solid 10-year returns, held up relatively well in 2022, but struggled in 2023. Defensiveness was a benefit in 2022 amid concerns over inflation and the economy, but it was a detractor in 2023, a year in which growth was surprisingly robust. Macro factors played a role in each sector's 2023 woes—inflation in the case of consumer defensives, policy changes for healthcare, and interest rates for utilities. Within healthcare, the popularity of obesity drugs made Novo Nordisk the largest company in Europe in 2023 and helped Eli Lilly become the largest U.S. healthcare stock by market capitalization.

Meanwhile, industrials, financial services, and basic materials look solid from the perspective of 10-year, 2022, and 2023 returns. They are diverse sectors. Industrials includes such industries as transportation, construction, and waste management. Financial services spans banks, insurers, credit card companies, and asset managers. Basic materials includes specialty chemicals, agricultural inputs, and building materials businesses. All three sectors are exposed to macro factors but also benefit from long-term secular growth trends. Industrials and basic materials are involved in the clean energy transition, while digital payments and other innovations are growth drivers for financials.

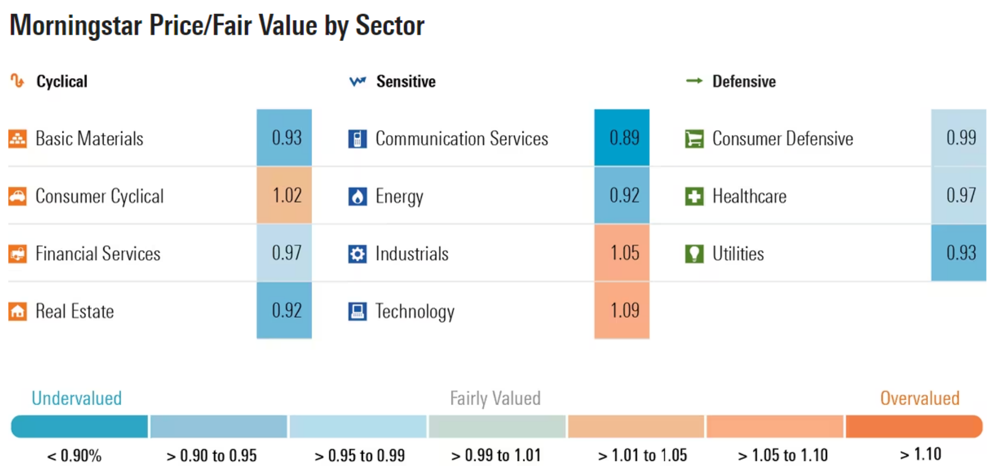
Real estate has persistently lagged because of short-term and long-term factors. Higher borrowing costs undermine demand. Commercial real estate is coping with a new normal after the height of the pandemic.

Sector Trends Are Changeable and Valuation Matters

What about the future? History shows that sector leadership waxes and wanes. Some investors favor sector-rotation strategies that allocate based on the business cycle or other macroeconomic factors.

A bottom-up, valuation-based approach can also be employed, albeit as a long-term signal. Morningstar Equity Research's company-level price/fair value estimates aggregated to the Morningstar US Sector Index level can provide a directional view of the U.S. equity market sector valuation, with the caveat that analysts cover most but not all of the index's weight. As displayed in Exhibit 3, the technology sector appears to be overvalued in aggregate. The same goes for industrials and consumer cyclical. Communication services, real estate, energy, basic materials, utilities, healthcare, and financial services appear undervalued in aggregate. Within each sector, valuation dispersion exists.

Exhibit 3 Morningstar Sector Returns in 2023 Have in Many Ways Returned to the Pre-2022 Trend



Source: Morningstar's "2024 Market Outlook: What a 'Return to Normal' Means for Stocks." Data as of Dec. 21, 2023.

Technology is the most overvalued sector, which is unsurprising given its 2023 run. Stocks like Apple, Nvidia, Palantir, AMD, Palo Alto Networks, and Microsoft are all trading at premiums to Morningstar analysts' estimates of fair value. On the flip side, tech stocks like Snowflake, Cognizant, and Teradyne are attractively valued.

The industrials sector also appears overvalued, thanks to stocks like Southwest Airlines, Caterpillar, and Illinois Tool Works. Undervalued industrials stocks include Emerson Electric, RTX, and Equifax.

Consumer cyclical is slightly overvalued in aggregate, thanks in large part to Tesla and Home Depot. Etsy, Polaris, and Nike are among the stocks in the sector considered undervalued.

Communication services is undervalued in aggregate, thanks to stocks like Disney, Verizon, and Comcast. Alphabet is considered undervalued as well, while Meta is trading at a premium to intrinsic value.

Energy is undervalued with Exxon and Chevron, the two largest stocks in the sector, as well as Equitrans Midstream trading at discounts.

Healthcare is seen as undervalued, with names like Pfizer, Illumina, and Zimmer Biomet all trading at discounts. Eli Lilly is trading at a premium to fair value in Morningstar Equity Research's view.

Utilities is undervalued in aggregate thanks to names like Entergy, NiSource, and WEC Energy Group.

Financial services is undervalued in aggregate, boosted by banks like Wells Fargo and U.S. Bancorp, as well as stocks like Charles Schwab.

The basic-materials sector looks undervalued thanks to names like Corteva, International Flavors & Fragrances, and Albemarle, a lithium miner.

Real estate is in undervalued territory thanks to names like Ventas, Welltower, and Equity Residential.

Consumer defensive is essentially trading at fair value in aggregate, with names like Costco, Target, and Procter & Gamble considered overvalued, while Campbell Soup, Kenvue, and Constellation Brands are trading at a discount.

Sector Matters

As seen in Exhibit 1, the performance of equity sectors can vary dramatically. Short-term sector behavior is driven by a range of variables, some macro and some micro. Sentiment can drive performance as much as fundamentals.

Over the long term, however, valuation matters. A sector may be benefiting from structural growth trends, but if that growth is fully reflected in asset prices, results will disappoint. Conversely, a sector facing fundamental challenges can hold upside if companies beat their low expectations. Often, stock performance can be unfairly influenced by sector association. Bad companies can ride a sector wave, while good businesses are dismissed for belonging to an unfashionable sector.

As with much in investing, sector leadership is cyclical. Sentiment waxes and wanes; macro conditions change; innovation disrupts; and business fundamentals shift. While future sector dynamics are uncertain, what's likely is that they will diverge from the past.

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