Market Commentary Blog

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Defensive Sectors and Elevated Inflation

S&P 500 Defensive Sectors vs. S&P 500 Index: Total Returns

(Years In Which Trailing 12-Month CPI ≥ 3.0%)

Year	CPI Rate	S&P 500	S&P 500 Health Care	S&P 500 Consumer Staples	S&P 500 Utilities
2024 (10/15)	2.4% (9/30)	23.26%	13.51%	18.44%	30.38%
2023	3.1%	26.26%	2.06%	0.52%	-7.08%
2022	6.5%	-18.13%	-1.95%	-0.62%	1.56%
2021	7.0%	28.71%	26.13%	18.63%	17.67%
2011	3.0%	2.11%	12.73%	13.99%	19.91%
2007	4.1%	5.49%	7.15%	14.18%	19.38%
2005	3.4%	4.91%	6.46%	3.58%	16.84%
2004	3.3%	10.88%	1.68%	8.16%	24.28%
2000	3.4%	-9.10%	37.05%	16.78%	57.19%
1996	3.3%	22.96%	21.04%	25.90%	5.68%
1991	3.1%	30.47%	53.69%	41.66%	23.89%
1990	6.1%	-3.10%	17.29%	15.32%	-0.63%

Source: Bloomberg. **Past Performance is no guarantee of future results.**

View from the Observation Deck

Given their non-cyclical nature, defensive sectors may offer better performance than their counterparts during periods of heightened volatility. For today's post (and the previous posts in this series), we set out to determine if that outperformance also exists during periods of high inflation. To construct the table above, we started in 1990 and selected calendar years where inflation, as measured by the Consumer Price Index (CPI), increased by 3.0% or more on a trailing 12-month basis. We chose 3.0% as our baseline because the rate of change in the CPI averaged 3.0% from 1926-2023, according to data from the Bureau of Labor Statistics. We then selected three defensive sectors (Health Care, Consumer Staples, and Utilities) and compared their total returns to those of the S&P 500 Index over those periods.

- **While the CPI remains above the Federal Reserve's target rate of 2.0%, it has fallen below the target level of 3.0% we use for this post. Despite this, the S&P 500 Utilities Index has been the top performer year-to-date, outpacing the broader S&P 500 Index by 7.12 percentage points through 10/15/24.**

One reason for Utilities' continued outperformance in 2024 is the rise in global usage of Artificial Intelligence (AI). The International Energy Agency reported that the global electricity consumed by data centers, which typically house the servers that host AI graphics processing units, is forecast to surge from an estimated 460 terra-watt hours in 2022 to more than 1,000 terra-watt hours in 2026. For comparison, this demand is roughly equivalent to the electricity consumption of Japan. We have posted on this subject recently (click here to view "The Only Constant is Change"), but it warrants repeating that U.S. data centers are projected to use 8% of total power by 2030, up from just 3% in 2022.

- **Of the eleven time frames in the table where inflation increased by 3.0% or more on a trailing 12-month basis, there were only two (2021 and 2023) where the S&P 500 Index outperformed each of the Health Care, Consumer Staples, and Utilities sectors.**
- **From 12/29/89 – 10/15/24 (period captured in the table above), the average annualized total returns posted by the four equity indices presented were as follows (best to worst): 11.66% (S&P 500 Health Care); 10.64% (S&P 500 Consumer Staples); 10.61% (S&P 500 Index); and 8.51% (S&P 500 Utilities), according to data from Bloomberg.**

Takeaway

Despite recent disinflation, the S&P 500 Utilities Index continues to lead the broader S&P 500 Index by a significant margin YTD. We think improving earnings estimates, surging demand for electricity resulting from increased AI adoption, and recent economic volatility may account for the sector's outperformance. On 10/11/24 data from Bloomberg revealed that earnings for S&P 500 Utilities companies are estimated to increase by 14.6% and 9.1% in 2024 and 2025, respectively. For comparison, those same estimates stood at 8.5% and 7.4%, respectively, on 12/29/23. While forecasts vary for the effect of AI on global electricity consumption, the impact is not likely to be subtle. We think the increase in earnings estimates reflect these expectations. Additionally, recent economic data and geopolitical strife may have prompted investors to utilize defensive sectors as a safe haven. In early October, concerns that the Federal Reserve had cut rates too deeply mounted when non-farm payrolls surpassed all expectations, increasing by 254,000 in September. Notably, the news came on the heels of an August report from the Bureau of Labor Statistics which revised payrolls downward by 818,000 over the 12-month period ended March 2024. From our perspective, investor interest in defensive sectors may remain strong in light of geopolitical strife, economic volatility, and the potential for a resurgence in the pace of rising prices.