Spotting Trends
Sector and Industry

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Sector Opportunities for Q1 2025

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- **Utilities** Capture the secular tailwind on higher power demand with Utilities.
- **Telecom** AI-driven demand for high-speed and reliable communication systems herald renewed investor interest in telecom.
- **Regional Banks** Lower rates, potential fiscal expansion, and anticipated bank de-regulations support multiple expansion for regional banks.

After back-to-back years of over 20% gains led by big Tech, S&P 500 valuations have become stretched, trading 21.7x next-12-month earnings.[1] That's close to their post-COVID peak. Meanwhile, corporate profits are forecast to accelerate in 2025 thanks to resilient economic growth, the Federal Reserve's (Fed) easing cycle, the Trump administration's pro-growth policy agenda, and continued AI development.

With a changing economic and policy landscape, return paths across sectors and industries will likely become more divergent than usual, improving market breadth and creating greater opportunities for sector selection.

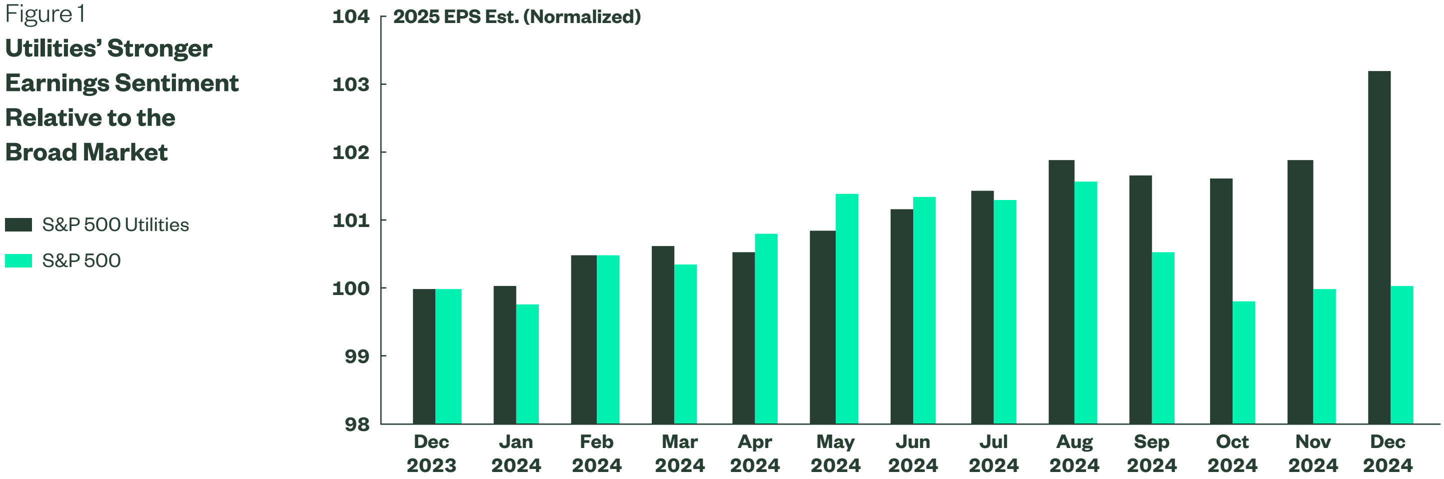
Against this backdrop, we've identified relative value opportunities in **Utilities and Telecom** resulting from the AI Capex boom and **Regional Banks** as a cyclical value exposure that will likely benefit from regulatory tailwinds.

Utilities: Booming Data Center Power Demand

After outperforming the broad market for most of the second half of 2024, the Utilities sector sold off in December amid surging Treasury yields and lagged the broad market.[2] While concerns about a higher-for-longer interest rate environment have weighed on Utilities' valuations, the sector's earnings sentiment remains strong. The booming data center power demand, together with the broad electrification of our society and manufacturing reshoring, likely will lift the sector's growth trajectory in the next few years, supporting higher relative valuations going forward.

Since we highlighted this sector opportunity in Q3 2024, Utilities' earnings results have provided greater visibility into data center-driven demand increases for 2025. Companies raised earnings growth guidance on the back of strong load growth and capital expenditure (capex) projections. Their 2025 EPS revisions have been positive — increasing 2% since June compared to a 1.3% decline for the broad market (Figure 1), following right behind Tech and Communication Services.[3] If the 8.4% earnings growth estimate is achieved this year, it will be Utilities' third straight year of above historical average growth, underscoring the ongoing secular demand increase in the US power market.

Figure 1
Utilities' Stronger Earnings Sentiment Relative to the Broad Market



Source: FactSet, as of December 18, 2024.

Nationwide, electricity demand is forecast to increase 15.8% over the next five years with an annual peak demand growth of 3%, led by substantial increases in data centers.[4] While 3% growth may seem small, it's the highest growth rate since the 1980s and six times the electricity consumption growth between 2001 and 2024.[5] Strong demand may lead to higher capex, increasing Utilities' rate base and supporting revenue growth.

A continued disinflation trend in Utilities, stabilized natural gas prices, and special tariffs for data center customers to avoid costs spreading to existing customers may ease utility regulators' concerns about power affordability. And that could potentially lead to higher authorized revenue increases and return on equity.

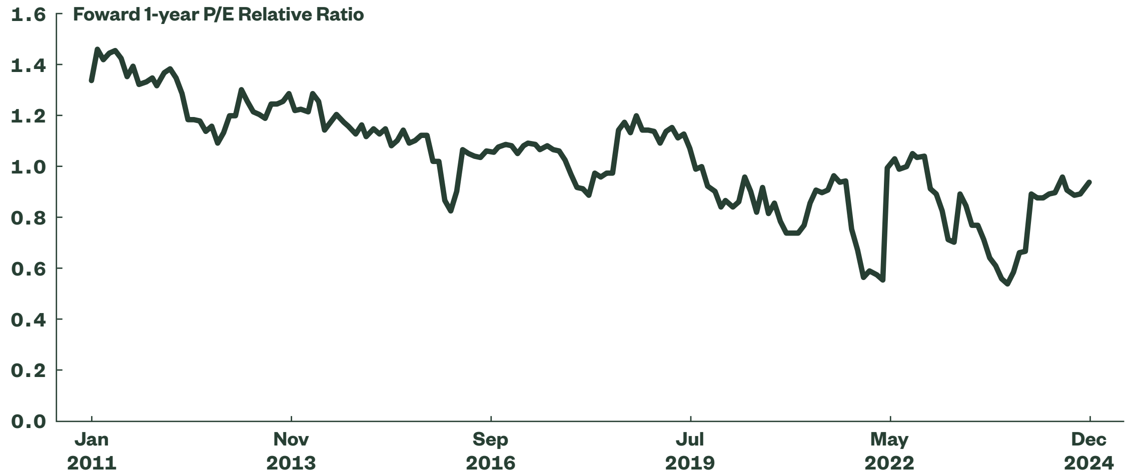
The Trump administration's potential to rollback EPA rules that limit greenhouse gas emissions by gas power plants and fast approvals of natural gas and LNG project permits will help ease Utilities' input costs and improve customer affordability. And while there's a risk of potential changes to the Inflation Reduction Act, the Production Tax Credits (PTCs) related to renewable energy that have funded the capex for utility companies' renewable power projects probably will not be completely removed, given that many Republican states are major beneficiaries of PTCs.

Although investors recently have focused on Utilities' vulnerability to high interest rates, the sector's secular tailwind on higher power demand remains underappreciated, given its near 15-year low relative valuations.[6] Consider the Utilities Select Sector SPDR Fund (XLU) to position for increasing power demand.

Telecom: An Underappreciated AI Infrastructure Opportunity

AI-driven demand for high-speed and reliable communication systems has renewed investors' interest in the Telecom industry. The industry staged a significant rebound in the second half of 2024, outperforming Tech by more than 30% — the best six-month relative performance since 2011.[7] Despite its outperformance, the industry's relative valuations are still trading in the bottom tercile of the past 15 years, indicating an underappreciated AI infrastructure opportunity (Figure 2).

Figure 2
The Telecom Industry's Attractive Relative Valuations



Source: FactSet, as of December 17, 2024. Using the S&P Telecom Select Industry Index to represent the telecom industry. Valuations are relative to the S&P Composite 1500 Index.

The Telecom industry comprises providers of communication equipment and telecommunication services, both of which play critical roles in AI infrastructure. AI relies on large-scale, high-speed advanced communication systems to transfer massive amounts of data and enable real-time process for AI training and inference. The system requires more complex and high-bandwidth networks for data transmission and low-latency communication among servers and end-users as the AI industry shifts to AI inference applications. Communication equipment like high-performance routers and switches and fiber-optic networks ensure that data flows seamlessly and quickly between servers and end users.

As hyperscales accelerate their datacenter buildout and the AI inference applications rise, networking equipment and enterprise fiber services likely will become key drivers of revenue growth for the Telecom industry. The overall generative AI network equipment spending is expected to grow at a compound annual rate of 34% by 2028, driven by the exponential increase in AI workload.[8] In particular, the Ethernet network switch market is forecast to grow at a five-year compound annual rate of 70% by 2028 because its low-latency and high throughput connectivity are needed for running dense clusters of GPU servers.[9] High margins of the latest generation and highest speed switches, together with operating software solutions, may boost providers' profitability. Lumen Partners' $12 billion AI fiber connectivity deals with hyperscalers in 2024 revealed significant business wireline revenue opportunities for other major fiber providers, like AT&T and Verizon, as more capacity is needed.

Meanwhile, AI and other emerging technologies are boosting the industry operation efficiency. New approaches to RAN (Radio Access Network) enable operators to mix equipment from multiple vendors, reducing network deployment costs and accelerating the deployment of new network services. The industry is also using AI to manage network traffic, proactively address maintenance needs, optimize network performance, and detect security threats.

To position for the inflection point of the Telecom industry driven by AI and other emerging technologies, consider the SPDR® S&P® Telecom ETF (XTL).

Regional Banks: Cyclical Value Exposure With Regulatory Tailwinds

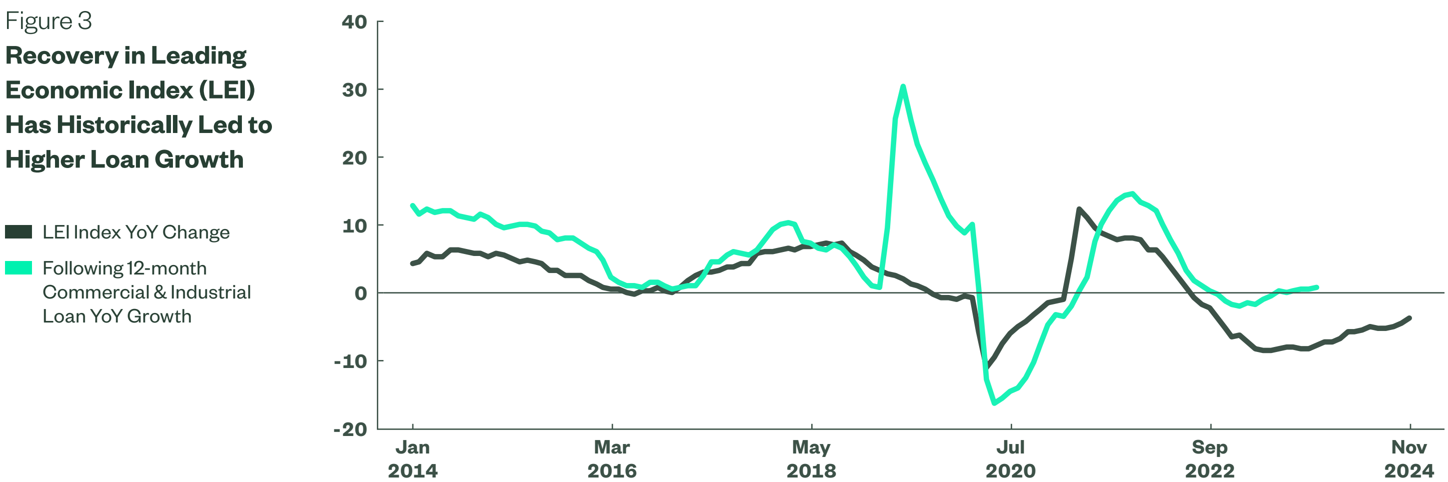
The regional bank industry gave back most of its post-election gains following the hawkish takeaways of the December FOMC meeting. But history from the most recent soft landing between 1995 and 1997 indicates that an extended period of rate normalization and banking de-regulation without a recession is supportive for bank profitability, potentially leading to strong performance of bank stocks.

Between February 1994 and February 1995, the Fed aggressively raised interest rates seven times, bringing the federal funds rate to 6%. It then made a series of mid-cycle adjustments, cutting rates three times to 5.25% in February 1996 and maintaining them at the same level for 13 months before another rate hike in March 1997 and 18 months of unchanged rate policy. Over this period, a steepened yield curve, easing bank regulation, and strong loan demand drove bank stocks' outperformance over the broad market by 48% on a cumulative basis until the LTCM Crisis started brewing in July 1998.[10]

History doesn't repeat itself, but it often rhymes. Despite the downside risk to growth and inflation≈uncertainty driven by potential trade conflicts in 2025, multiple tailwinds are in play for the rebound in regional bank valuations. With the Fed still signaling more rate cuts in 2025, long- and short-term yield spreads may remain positive, supporting further net interest margin (NIM) expansion.

A US-first policy agenda and potential corporate and individual tax cuts also should support domestic investment and consumer spending, boding well for loan growth. Indeed, small business sentiment and consumer confidence have improved following the US election. The Leading Economic Index rose for the first time since February 2022, with the year-over-year change posting the smallest loss in more than two years (Figure 3). The potential for higher loan growth and improving NIM may end the industry's two years of negative operating leverage (revenue growth outpacing expense growth), bolstering the industry's 2025 EPS growth outlook.

Figure 3
Recovery in Leading Economic Index (LEI) Has Historically Led to Higher Loan Growth



Source: Bloomberg Finance, L.P., Federal Reserve Bank of St. Louis, FRED as of November 30, 2024.

Additionally, President-Elect Trump's deregulation agenda may ease federal agencies' supervision and relax capital requirements, paving the way for more share buybacks and the return of capital to shareholders. And more industry-friendly leadership at key supervisory federal agencies may shorten banks' M&A approval process and lower the barriers for bank consolidation, accelerating M&A activities in the regional bank industry.

Post-FOMC price actions in December have created even more attractive entry points for investors to position for the positive industry outlook. Regional banks are trading around their long-term median based on price-to-book and forward one-year price-to-earnings ratios, while their relative valuations are around the bottom decile of the past 20 years.[11]

Tailwinds from lower rates and potential fiscal expansion and bank de-regulations support regional banks' multiple expansion. Consider the SPDR® S&P® Regional Banking ETF (KRE) to pursue the potential benefits from domestic-focused cyclical regional bank exposure.

Endnotes

1 FactSet, as of December 31, 2024.

2 Bloomberg Finance, L.P., as of December 18, 2024.

3 FactSet, as of December 18, 2024.

4 GridStrategies, Strategic Industries Surging: Driving US Power Demand, December 2024.

5 GridStrategies, Strategic Industries Surging: Driving US Power Demand, December 2024.

6 FactSet, as of December 19, 2024, based on S&P 500 Utilities next-12-month forward P/E relative to the S&P 500 Index over the past 15 years.

7 FactSet, as of December 31, 2024.

8 Morningstar, Generative AI for Networking, as of November 4, 2024.

9 IDC: AI workloads driving high-speed Ethernet switch adoption, September 13, 2024.

10 Bloomberg Finance, L.P., for the period between June 30, 1995, and July 31, 1998. Bank stocks are represented by KBW Bank Index.

11 FactSet, as of December 20, 2024. Based on a 2 0-year period. Relative valuations are relative to the S&P Composite 1500 Index.

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* Pensions & Investments Research Center, as of December 31, 2023.
†This figure is presented as of September 30, 2024 and includes ETF AUM of $1,515.67 billion USD of which approximately $82.59 billion USD 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.

Forward P/E The price of a security per share at a given time divided by its projected earnings per share over the coming year. A forward P/E ratio is a way to help determine a security's stock valuation — that is, the fair value of a stock in a perfect market. It is also a measure of expected, but not realized, growth.

Leading Economic Index (LEI) A composite of 10 economic components that are analyzed monthly to help foresee changes in the overall economy. The LEI components are: average weekly hours of manufacturing workers; average initial jobless claims; new manufacturer orders for goods and materials; speed of delivery of new goods to vendors; new orders of capital goods not related to defense; new residential building permits; changes to the S&P 500® Index; changes in inflation-adjusted money supply; the difference between long and short interest rates; and consumer sentiment. The data series is compiled by the Conference Board, a private, non-profit business research group.

LTCM Crisis The hedge fund Long-Term Capital Management almost collapsed in late 1998. Since many banks and pension funds had invested in LTCM, its problems threatened to push most of them to near bankruptcy, setting off a global financial crisis. The crisis was averted when 14 banks bailed out LTCM.

Net Interest Margin The difference between the revenue that is generated from a bank's assets and the expenses associated with paying out its liabilities.

Production Tax Credits The PTC is a ten-year, inflation adjusted US federal income tax credit for each kilowatt hour (kWh) of electricity generated by certain types of renewable or zero carbon emission projects.

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Non-diversified funds that focus on a relatively small number of securities tend to be more volatile than diversified funds and the market as a whole.

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