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Sector Views: GICS Change Adds Growth to Financials

The S&P 500 Financials sector just experienced a dose of growth. The traditional value-oriented sector has new entries from the growthier Information Technology sector, specifically in FinTech. The shakeup is the result of changes to the Global Industry Classification Standard (GICS), which is a system for categorizing public companies by sectors and industries. Changes were implemented after the close of business on Friday, March 17, 2023, with 14 S&P 500 stocks reclassified at the sector level.[1] For investors, new additions to the Financials sector could result in a higher growth exposure than originally intended.

In this report, we will outline specific GICS sector changes impacting Financials and Information Technology along with insight on how to position in the current market environment.

Key Takeaways:

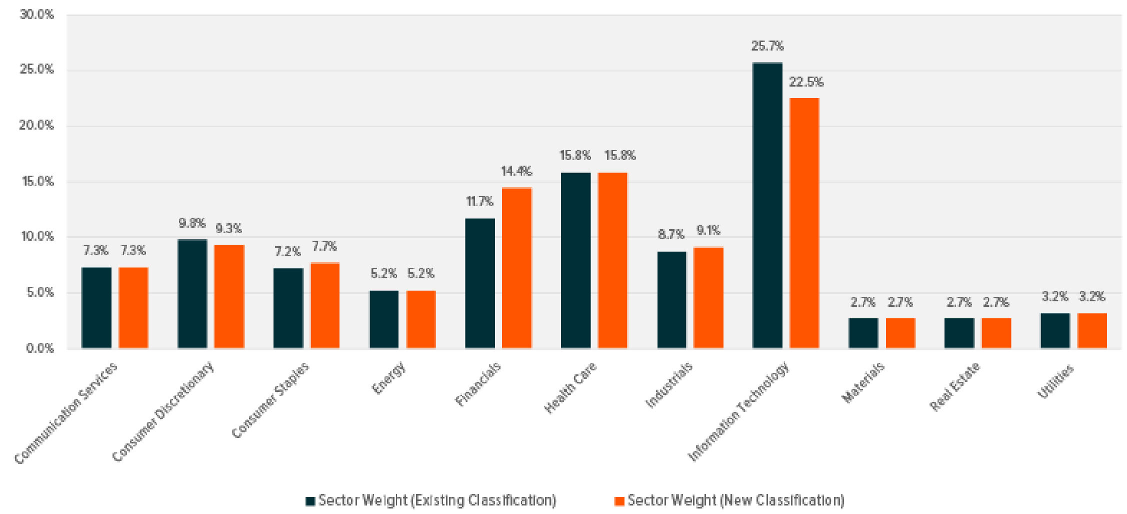
- GICS changes reflect FinTech's disruption on the Financials sector.
- Financials' growth allocation could rise, albeit with minimal impact on macro sensitivities.
- Bank stocks face headwinds as the U.S. economy transitions from late cycle to recession.

Summary of GICS Changes

After the GICS change, Financials will account for roughly 14% of the S&P 500 Index versus its current 11% weight. Information Technology will lose 11 stocks, resulting in the largest reduction in market capitalization among the 11 GICS sectors.[2]

GICS STRUCTURE CHANGES TO AFFECT S&P 500 SECTOR WEIGHTS

Source: S&P Dow Jones Indices data as of March 9, 2023



Reclassification Within FinTech and Impacts on the Financials Sector

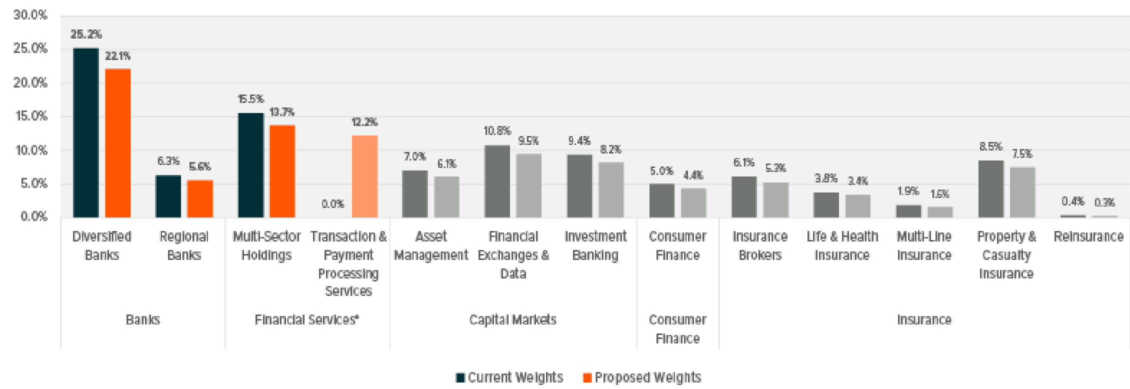
Mobile payments and payment processing companies have been the center of a digital revolution in banking, disrupting the traditional banking industry as society has become increasingly cashless. Up until now, some of these FinTech companies have been classified as Data Processing & Outsourced Services within the Information Technology sector. As part of the GICS sector changes, this portion of the FinTech theme will be reclassified to Transaction & Payment Processing Services, a proposed new sub-industry within the Financials sector.

Focusing on the S&P 500 Index, the GICS sector reshuffle will involve eight companies moving from Information Technology to Financials. These firms account for roughly 10% of their present home in the Information Technology sector. Following the GICS changes, the eight payment companies will account for roughly 12% of the Financials sector, based on Bloomberg data as of March 16, 2023. The remaining three firms currently classified as Data Processing & Outsourcing Services will be moved to Industrials under a new sub-industry of Human Resources & Employment Services.

The chart below shows current industry and sub-industry group weights for the Financials sector versus proposed weights by GICS. The new sub-industry, Transaction & Payment Processing Services, is also included.

IMPACT OF GICS RECLASSIFICATION ON FINANCIALS INDEX WEIGHTS

Source: Bloomberg data as of March 16, 2023



*Reflects new GICS change. Financial Services previously classified as Diversified Financial Services

The banking industry will see the largest reduction in weight because of the GICS reclassification. This could be a positive for the Financials sector given recent liquidity concerns, particularly among regional banks. New developments have exposed the consequences of a deeply inverted yield curve. Greater economic risk and persistent inflation caused the Federal Reserve to aggressively raise interest rates, which drove short-term Treasury yields higher than long-term yields. The yield curve inversion could result in lower incomes from bank loans that are issued at longer maturities.

Short-term liabilities such as savings and checking accounts can be withdrawn at any time. This means that banks may have to compete to attract depositors with higher rates, or they will have to charge higher interest on their loans (not a competitive option) to keep margins positive. Here are some key points to consider when positioning within the banking industry.

- Banks have tightened lending standards and increased their loan loss provisions, possibly reflecting economic uncertainty.[3]
- We expect regional banks to remain challenged since they rely heavily on income from interest on loans, while large banks are more diversified with more sources of non-interest income.[4]
- Yield curve inversions typically signal recessions and could weigh on bank margins although a steepening of the yield curve can occur just before or during recessions.

Currently, the market is expecting the Fed to pause or slow the pace of rate hikes because of banking system stress. The shift in expectations triggered a steepening of the yield curve after sustained inversion, causing the largest drop in the 2-year Treasury yield since the 1980s, and falling below the Fed Funds rate.[5]

As existing industry weights decline, investors could see greater exposure to a portion of FinTech within Transaction & Payment Processing Services. The new sub-industry will include credit card companies, digital wallet providers, and other payment technology firms. The new GICS change could also result in a greater allocation to growth stocks. Therefore, the Financials sector could experience higher forward earnings growth, according to analysis by State Street.[6] However, this is unlikely to change the sector's overall sensitivity to the macroeconomic cycle, with payment companies remaining sensitive to consumer spending and payment volumes. Over time, a recovery in spending activity and digital payment infrastructure demand could bode well for certain stocks within the sub-industry.

Positioning in the Current Environment

As the U.S. approaches the end of the rate hike cycle, investors could eventually find opportunities within sectors that benefit from recovery dynamics, including Financials, Consumer Discretionary, and Real Estate. But for now, defensive positioning could mitigate downside risk.

Our sector views table below provides more detail on sector positioning.

CURRENT VIEWS ON U.S. SECTORS

	Positive Factors	Negative Factors	Overall View
Communication Services	Reasonably positive trends in subscription services, including streaming, benefit the sector. The development of augmented reality and the Metaverse may provide positive benefits in the long run.	The privacy overhang from major hardware providers could impact revenues for interactive media companies. Slower advertising spending remains a drag on social media earnings.	**Underweight**

Consumer Discretionary	Consumers increased their use of online ordering and deliveries over the past two years. Greater savings and a tight job market could encourage spending.	Wage pressure combined with higher input costs in materials are a risk to margins, especially if companies are unable to increase sales prices. And a deeper economic contraction could weigh on consumer spending.	**Underweight**
Consumer Staples	Demand for consumer staples could remain steady, especially in the event of a deeper economic contraction.	Inflation is likely to negatively impact margins for companies that cannot pass through rising materials costs to the end consumer. In our pricing power analysis, Consumer Staples generally scored poorly.	**Overweight**
Energy	Escalated tensions with Russia and greater natural gas demand from Europe could keep energy prices elevated globally. OPEC+ production cuts and a delayed supply response in terms of drilling could keep energy markets tight and prices high. Large, diversified oil and gas companies ramped up buybacks along with record profits and healthy balance sheets.	A global economic contraction could weigh on demand.	**Market Weight**
Financials	Solid household and corporate balance sheets help support robust consumer spending.	A deeper economic contraction could slow lending growth and increase credit risk. A flattening or inversion of the yield curve will likely hurt margins.	**Underweight**
Health Care	Aging demographics around the world combined with the growing middle class in emerging	Drug pricing pressure remains a risk factor. Senate proposals to grant Medicare powers to	**Overweight**

	markets benefit health care demand. Health Care is a defensive sector that typically outperforms during severe economic downturns.	negotiate prices on certain drugs could limit price increases on medicines.[7]	
Industrials	Reshoring and a shift toward automation infrastructure spending will likely be a long-term benefit for Robotics & AI. An increase in U.S. public construction spending from fiscal packages could boost demand for tools and machinery for the foreseeable future.	Elevated leverage, increasingly expensive valuations, and rising earnings volatility may detract from performance. Rising labor costs could pressure margins, particularly in the transport industry.	**Market Weight**
Information Technology	The sector displays quality factors and positive free cash flow growth. The increased adoption of cloud computing, cybersecurity, and cleantech are likely to remain in a post-COVID-19 world as societies adapt to these key disruptive technologies. Beneficiary of secular themes related to onshoring, automation & CapEx.	Increased regulatory scrutiny is a risk, and there is bipartisan support for increased regulation in this space.	**Market Weight**
Materials	Increased focus on electric vehicle adoption, alternative energy sources, and energy storage may benefit disruptive materials such as lithium, copper, and battery producers. The sector benefits from rising inflation, leading to higher prices for raw materials.	A deeper economic contraction could be a big headwind. Increased regulations, especially those focused on preventing climate change, is a potential negative.	**Underweight**
Real Estate	The sector can offer inflation-protected yield.	A fast rise in interest rates could increase the cost of financing, and a deeper	**Market Weight**

		economic contraction could raise the risk of costs not being passed along to tenants.	
Utilities	A preferred defensive sector in recessionary environments due to the inelasticity of goods and services. Adoption of renewables could help transform the sector over the long run.	The potential for increased climate-related regulations over time may detract from this sector's appeal. Companies may not be able to pass through higher inflation-related costs due to government regulations.	**Market Weight**

Footnotes

[1] State Street Global Advisors, 2023 GICS Changes: Companies Impacted and What You Need to Know, January 23, 2023
[2] Bloomberg data as of March 15, 2023; ETF Strategy, GICS Changes Set to Impact S&P 500 and Sector ETFs, March 9, 2023
[3] Based on data from the Federal Reserve Bank of St. Louis, as of March 13, 2023
[4] Federal Reserve Bank of Kansas City, Do Net Interest Margins for Small and Large Banks Vary Differently with Interest Rates? February 10, 2022
[5] Financial Times, Drop in Two-Year Treasury Yields Among the Biggest Since 1980, March 13, 2023
[6] Financial Times, Drop in Two-Year Treasury Yields Among the Biggest Since 1980, March 13, 2023
[7] CNBC, 'Once-in-a-generation' Prescription Drug Pricing Reform Could be Coming, July 29, 2022

Definitions

Capital Expenditures (CapEx): Funds used by a company to acquire, update, and maintain physical assets such as buildings, technology, and equipment; often used to undertake new investments/projects.

S&P 500 Total Return Index: The index includes 500 leading U.S. companies and captures approximately 80% coverage of available market capitalization.