

McMURTRY INVESTMENT REPORT™

Investment Advice for Everyone

A tale of Two Markets

January 6, 2022

Equity Sectors %	TSX	S&P 500			
Financials	32.2	10.7			
Energy	13.1	2.7			
Industrials	12.0	7.8			
Materials	11.5	2.6			
Technology	10.7	29.2			
Communications	4.7	10.2			
Utilities	4.6	2.5			
Cons. Staples	3.7	5.9			
Cons. Disc.	3.6	12.5			
Reits	3.1	2.8			
Healthcare	0.8	13.3			

	TSX	S&P 500		
Cyclicals	72.4	36.3		
Growth	10.7	39.4		
Defensive	13.0	21.7		

As you can all see from the attached tables above, there is a large divergence between the Canadian and US equity markets. Even after the recent runup in prices, the US Energy sector represents only 2.7% of the S&P 500 index, much lower than the 13.1% weight of the TSX Composite. Last year it was no wonder that US money managers sharply underperformed the overall market benchmark with the Energy stocks providing the best performance during this time, with many managers choosing to have no exposure.

Domestically it is easier to outperform the overall market than is the case south of the border. If you are able to correctly over and underweight the Financials, Energy, Materials and Industrial sectors you will probably beat the domestic benchmark market returns. In the US it is much more difficult to beat the overall market with many more factors to consider.

For example, in the middle of a recession overweighting cyclical stocks is not going to lead to you outperforming the market. Alternatively in an inflationary environment with strong economic growth as we have today, overweighting cyclical sectors is a much easier decision to make.

I have not included REITs in the percentage of Cyclical in the above table as the group is more of a hybrid one. In addition, I have included both Technology and Communications stocks in the Growth percentage weights in the US. The Communication sector in the US includes Facebook and Google which are clearly Technology stocks. Domestically the Communications sector is dominated by telecom stocks which are not Growth stocks. Consequently, I have included Canadian Communications stocks in Defensive sectors.

How portfolio managers value both equity markets is also very different. Taking into consideration the much lower cyclicity of the US market, money managers use traditional valuation measures such as the PE multiple. Domestically resulting from the very large cyclical makeup, PE multiples do not provide much value for companies that go in and out of profitability in good and bad economic times. I use Enterprise Value to Forward EBITDA instead of the PE multiple for cyclical companies.

Recommendation

In a period of rising interest rates and inflation and strong economic growth, cyclical sectors should continue to do well relative to growth and defensive sectors. As I have mentioned previously, higher rates in 2022 will provide a significant headwind for the Technology and Communications sectors.

Currently rising rates should not pose an immediate problem in regards to economic growth. Please keep in mind that cyclical stocks tend to lag the rest of the market during an initial market rebound out of a recession. However, cyclicals also lag in terms of continuing to outperform the rest of the market at the end of an economic cycle. We are still not at the end of the economic cycle at this time.

The two cyclical groups that are currently showing the most strength so far this year are the Energy and Financial sectors.

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