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NED DAVIS RESEARCH

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Mega-cap divergences led to model shift

The quickest recovery to all-time highs following a 15%+ S&P 500 drawdown led to rapid improvement in many of our equity indicators and models. The sector model was no exception, quickly shifting its preference from defensive sectors back to cyclicals in the weeks after the bottom.

The overarching message from the sector model was little changed following its July update. Based on average composite scores, **the model continues to lean cyclical over defensive and favor Growth over Value**.

Despite the overall message remaining intact, the model made several recommendation changes, which we outlined in last week's Monthly Sector Update. The model's adjustments reflect the leadership rotation that has occurred under the surface amid the continuing cyclical-led advance.

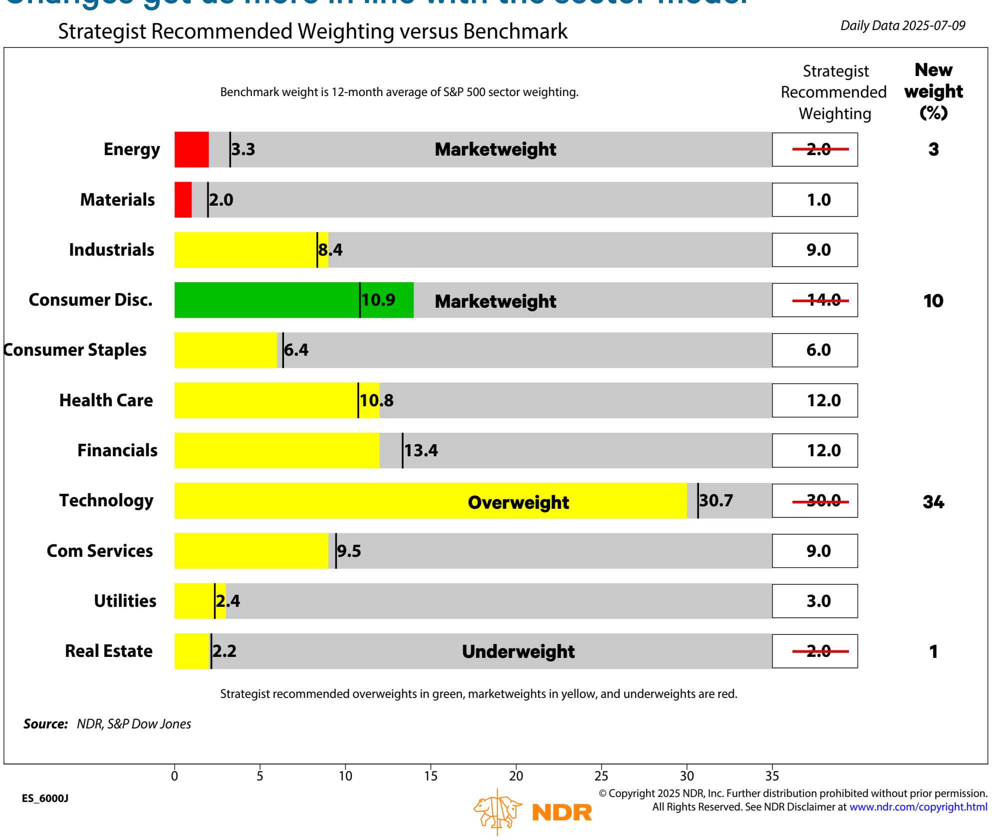
To get more aligned, we are **removing 4% from Consumer Discretionary and 1% from Real Estate, downgrading the sectors to marketweight and underweight, respectively**. The downgrades come amid deteriorating composite scores from both sectors in recent weeks.

Current Recommendations

Sector	Position	Recommended	Benchmark
Technology	Overweight	34%	30.1%
Communication Services	Marketweight	9%	9.2%
Consumer Discretionary	Marketweight	10%	10.6%
Consumer Staples	Marketweight	6%	6.5%
Energy	Marketweight	3%	3.7%
Financials	Marketweight	12%	12.6%
Health Care	Marketweight	12%	12.1%
Industrials	Marketweight	9%	8.5%
Utilities	Marketweight	3%	2.3%
Materials	Underweight	1%	2.3%
Real Estate	Underweight	1%	2.3%

● Overweight ● Marketweight ● Underweight

Changes get us more in line with the sector model



In contrast, following model improvement, we are adding 4% to Technology and upgrading the sector to overweight. We are also **adding 1% to Energy to close out our underweight on the sector**. The table at left summarizes the changes.

Tech to overweight

Technology has seen the most sector model composite improvement since the April low, and the model upgraded the sector to overweight at last week's update.

The Tech sector is made up of five industries, but just three – Semiconductors, Software, and Hardware – make up more than 90% of the sector's market cap. All five industries trailed the S&P 500 from the February high through the April low.

Since then, all have outperformed, with the **exception of Hardware**. Importantly, Semiconductors and Software have been particularly strong, up 65% and 42% from the low, respectively. Hardware's 25% gain is roughly in line with the S&P 500's return since the bottom.

Of course, the three big industries are driven by Nvidia, Microsoft, and Apple. The three companies together make up **over 60%** of the S&P 500 Technology sector's market cap.

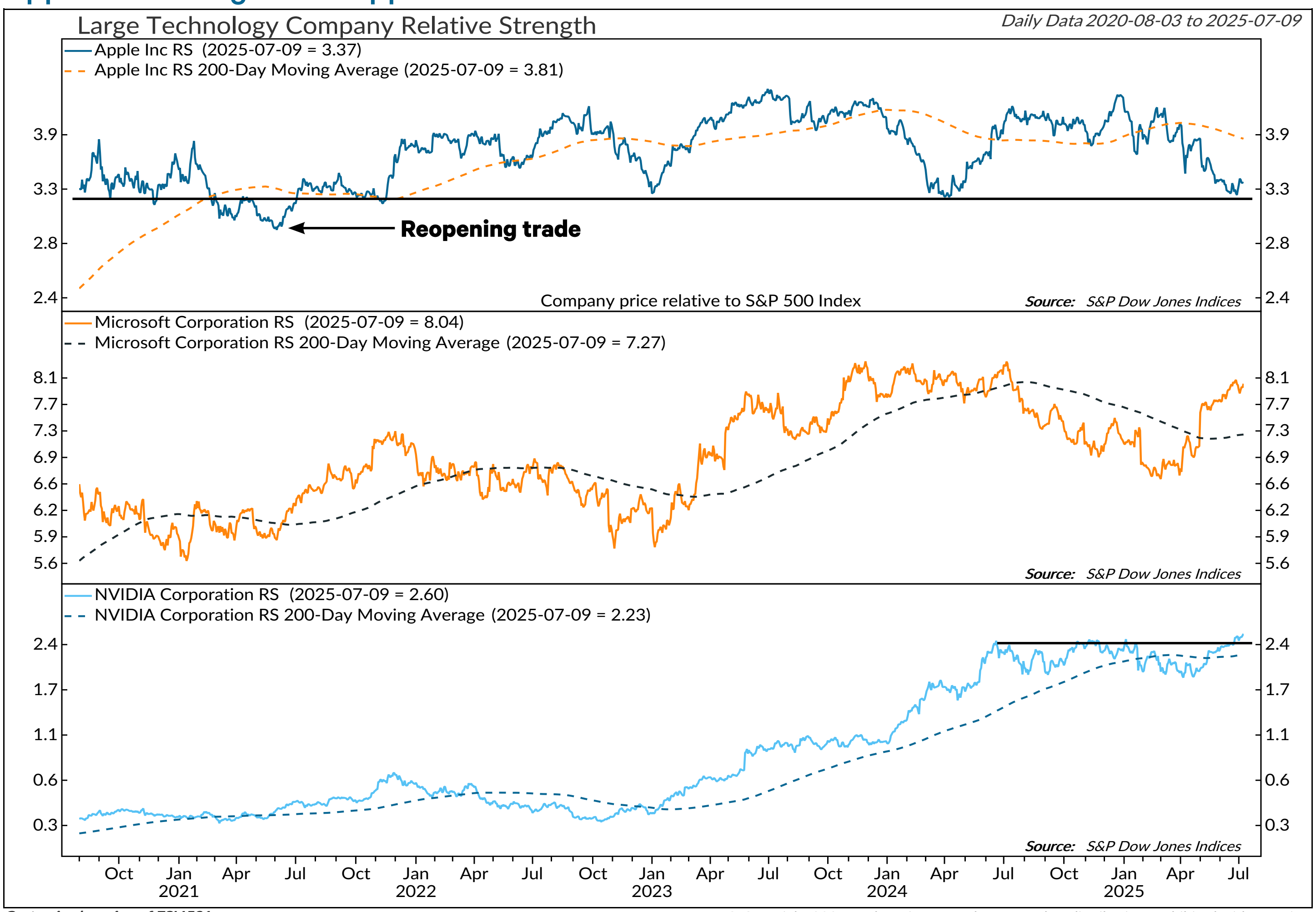
The chart below shows both Nvidia and Microsoft have outperformed since the April low. Nvidia has taken out its January relative strength high (bottom clip), while Microsoft remains below its July 2024 high (middle clip). In contrast, Apple has remained in a relative downtrend (top clip). However, it now trades near the bottom of its five-year trading range, a level only breached during the reopening trade in 2021. **A bounce from these levels would turn the Apple headwind into a tailwind for Technology.** But even if Apple is only a market performer from here, it would be an improvement compared to the first half of the year.

Back to optimism

The series of breadth thrust signals that have triggered since the market bottom has tipped the scale in favor of cyclical sector leadership. However, the **quick recovery in sentiment from the low represents a risk**.

First, Technology's forward P/E ratio has jumped from its April low of 22 back to 30. While we discount valuations given their poor correlation with future returns in the short-term, especially for Technology, the move higher represents a longer-term risk for the sector. Additionally, most of our **sentiment gauges are back to extreme optimism**, including the Daily Trading Composite and Crowd Sentiment Poll. Extreme optimism has been more bullish for defensive leadership, historically.

Apple fell to long-term support



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The chart below shows **Technology has struggled when Nasdaq sentiment is elevated, as is the case currently**.

Discretionary to marketweight

Like Technology, Consumer Discretionary is largely driven by its mega-caps of Amazon and Tesla, which make up more than half of the sector's market cap. While Amazon has steadily moved higher to erase most of its losses since its February high, Tesla's recovery has stalled, with the stock down 19% since May 28.

In total, **five of the sector's six internal (price-based) indicators are now bearish, and the sector's overall composite score has plummeted, no longer meriting an overweight**.

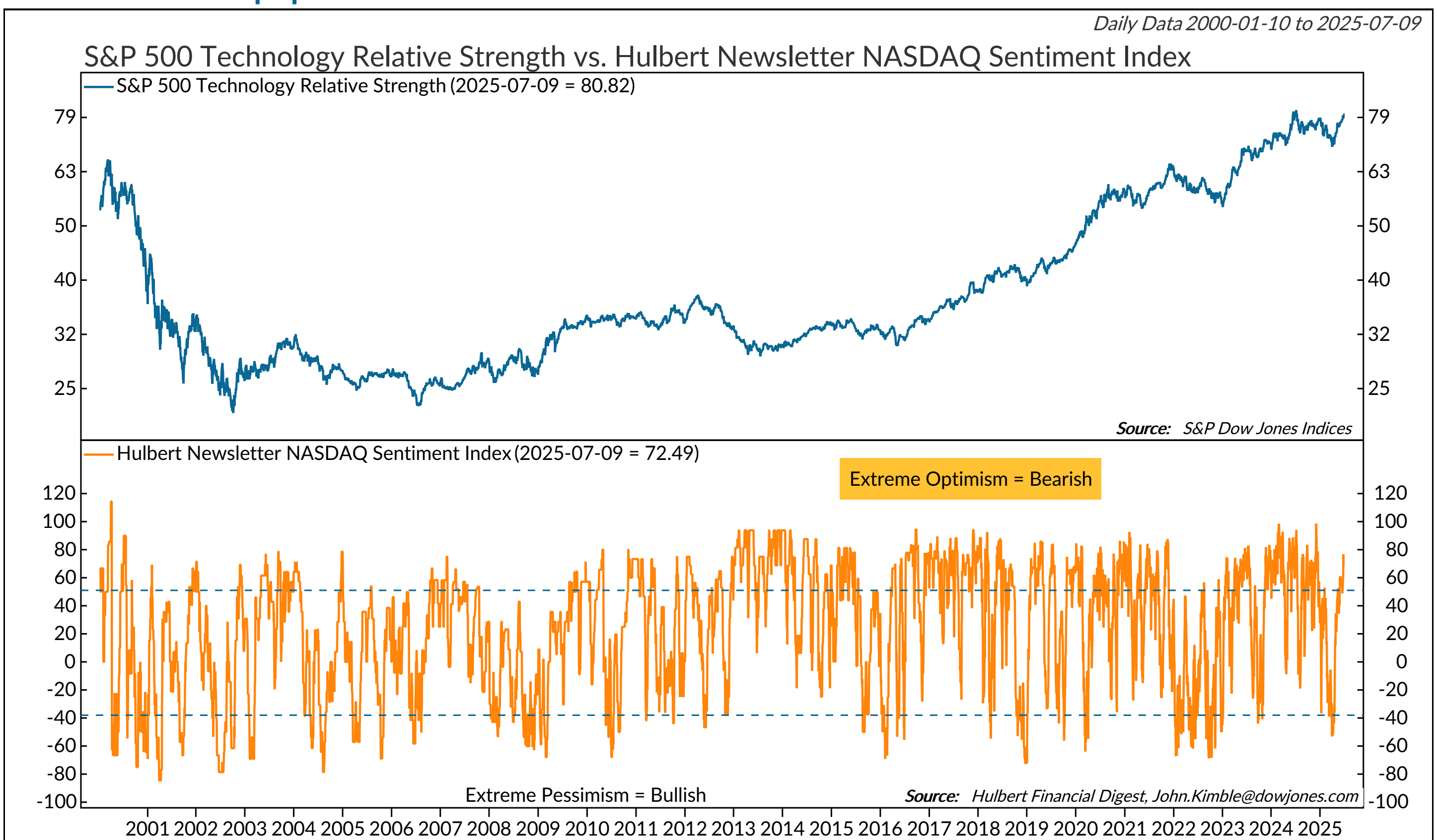
Real Estate to underweight

Just two of the seven external indicators are bullish, suggesting a challenging macro environment for Real Estate. The message is consistent with our macro team's Growth and Inflation Regime Report, which shows that the sector has struggled in weak growth/neutral inflation backdrops, as is the case currently.

Energy to marketweight

The weight of the evidence for Energy continues to lean bearish but has improved in recent weeks and further model improvement looks likely. The sector's Volume Supply/ Demand indicator and the well-established long-term relative downtrend are bearish offsets. **We could redowngrade if the sector breaks down to a new relative low.**

Extreme Nasdaq optimism could be a headwind for Tech



Source: Hulbert Financial Digest
To subscribe to daily data updates
Contact john.kimble@dowjones.com

S&P 500 Technology RS Performance
Full History: 2000-01-10 to 2025-07-09

NASDAQ Sentiment is	% Gain/ Annum	% of Time
Above 51.0	-3.68	34.71
-38.0 - 51.0	0.85	53.92
Below -38.0	23.27	11.37

Buy/Hold = 1.54% Gain/Annum

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Recommendations

NDR's sector team uses a quantitative sector model as the primary guide to deriving our recommendations. The model is designed to identify sectors and industries with the strongest fundamental (macro, economic, valuation, profitability) and technical price trends. Our team uses the model as the framework for our tactical shifts around longer-term fundamental themes. As a discipline, our recommendations are put on a "short leash" if they rank opposite the model's top and bottom quintiles, unless industry-specific influences can be shown to dominate.

Some sectors receive "over-," "market-," or "under-" weight recommendations, which means that the research firm recommends that more, the same, or less of the sector should be held in your portfolio than is held in the market.

Definitions

S&P 500 Index. A capitalization-weighted stock index of 500 of the largest and best known common stocks. The S&P 500 is one of the most quoted indexes, and is the often used as a benchmark for the stock market.
Alpha. The remaining portion of excess return after compensating for market risk.
Price-to-Earnings (P/E) Ratio. The price of a stock divided by its earnings. Also known as Price Multiple.
Price/Earnings to Growth (PEG) Ratio. A stock's price-to-earnings ratio divided by the growth rate of its earnings for a specified time period. The price/earnings to growth (PEG) ratio is used to determine a stock's value while taking the company's earnings growth into account, and is considered to provide a more complete picture than the P/E ratio.
Return on Equity (ROE). The amount of net income returned as a percentage of shareholder equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.
Basis Point. One hundredth of a percent. Used when describing change in yield. There are 100 basis points in 1%.
Price-to-Dividend. The price of a stock divided by the amount of dividends per share paid by the company each year. It is a measure of the return on investment for a stock.

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See the signals.™

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