The Equity Strategist: Our pivot to the service sector, a safe harbour

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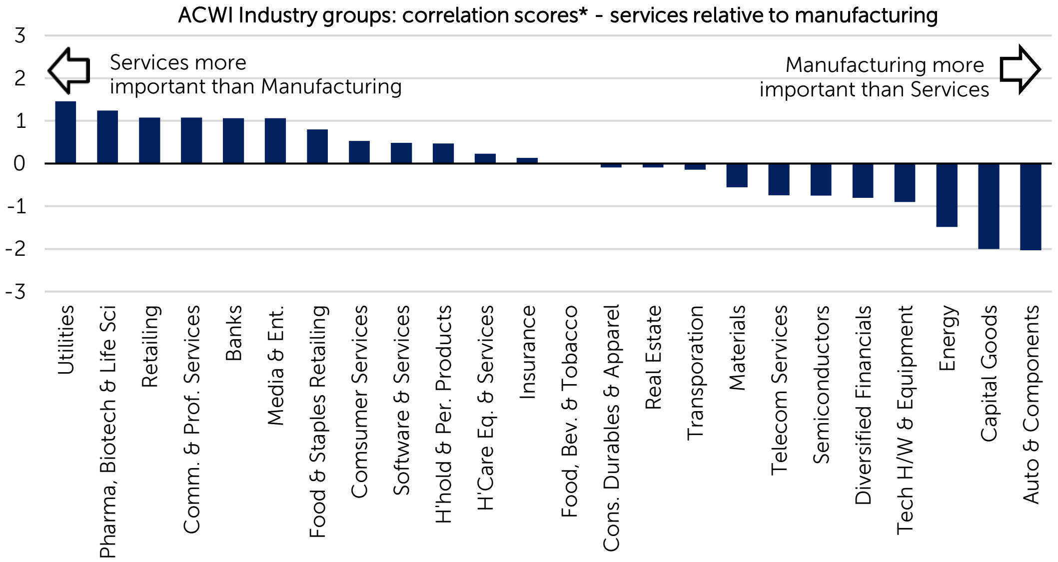
- **Purchasing Managers' Index (PMI) data point to continued outperformance of the service sector relative to the manufacturing sector; this divergence should be a strong macro theme for equities looking ahead**
- **Utilities, pharma & biotech, retailers, consumer/commercial services, banks, media & entertainment and household & personal products are more correlated to the services PMI than to the manufacturing PMI**
- **Autos, capital goods, energy, tech hardware & equipment, diversified financials, semiconductors, telecoms and materials are more tied to the manufacturing cycle**

The service sector strength (compared to the manufacturing sector) has been one of the most defining aspects of the global economy for almost a year now. We expect this outperformance of the service sector to continue and that to be a dominant investment theme in the near future. However, even if the manufacturing sector will inevitably strongly rebound in the next cyclical upturn, we believe that over longer time period, the service sector will continue to outperform.

In this note, using simple correlation analysis, we highlight investment opportunities in equities to play this divergence. Results of the analysis support our current sector positioning (see exhibit 11). In this report we also discuss the cyclical and structural case for the service sector. Industry groups like utilities, pharma & biotech, retailers, consumer/commercial services, banks, media & entertainment and household & personal products are expected to benefit from the relative strength of the service sector (compared to manufacturing). Autos, capital goods, energy, tech hardware & equipment, diversified financials, semiconductors, telecoms and materials are less likely to see an uplift from strengthening service sector (see exhibit 1).

We look at correlations of 24 industry groups (in the MSCI ACWI index) to Global services PMI and to Global Manufacturing PMI – using monthly data of the last three years. Relative correlation is calculated as the difference between 'the correlation of equity prices to the Global Services PMI' and 'the correlation of equity prices to Global Manufacturing PMI'. Exhibit 1 presents relative correlation data for all 24 industry groups as a Z-score – to highlight the dispersion. Columns to the left hand side show industries that benefit more from the strength of the service sector over manufacturing and the columns to the right hand side show industries that benefit less from the service sector outgrowing manufacturing.

Exhibit 1: Global industry groups and their correlations to service and manufacturing sectors

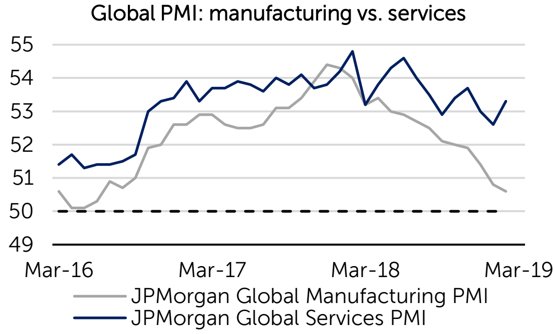


Source: MSCI, JPMorgan, Markit, Bloomberg, ADCB Asset Management | Notes: *Z-score is calculated for the relative correlation – to highlight the spread/dispersion. Relative correlation is calculated as the difference between 'the correlation of equity prices to Services PMI' and 'the correlation of equity prices to Manufacturing PMI'. Correlations are calculated using monthly data of the past three years.

Cyclical underpin remains

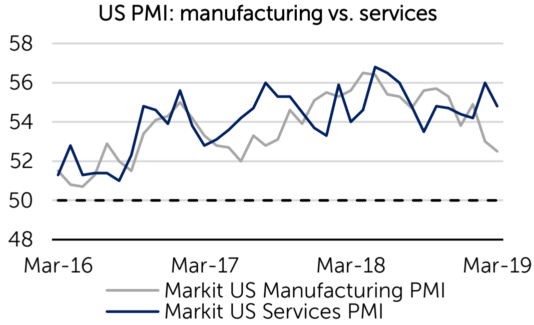
Business confidence in the service sector continued to outpace the business confidence in manufacturing sector over the past twelve months (see exhibit 2). This is not the case only for the US (see exhibit 3) but also for Europe, Japan and emerging markets (see exhibits 4-7). In fact in many cases, the strength in the service sector is compensating for the weakness in the manufacturing segment.

Exhibit 2: Globally, the service sector PMI outperforms manufacturing PMI...



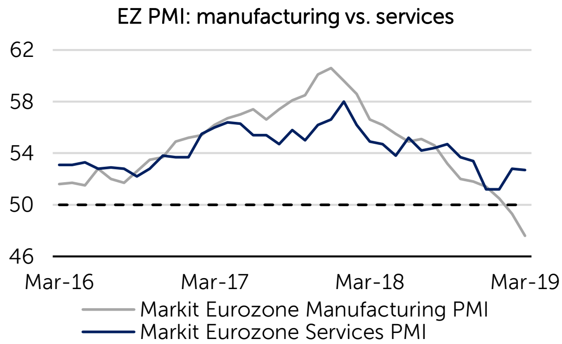
Source: JPMorgan, Bloomberg, ADCB Asset Management

Exhibit 3: ... this divergence has picked up in the US ...



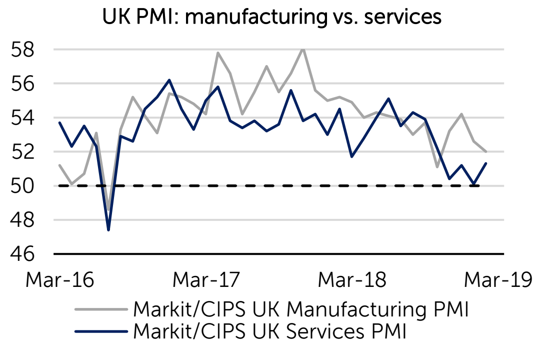
Source: Markit, Bloomberg, ADCB Asset Management

Exhibit 4: ... continues in the Eurozone ...



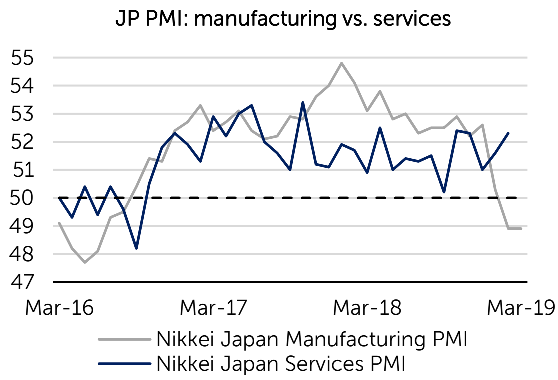
Source: Markit, Bloomberg, ADCB Asset Management

Exhibit 5: ... modest in the UK due to Brexit ...



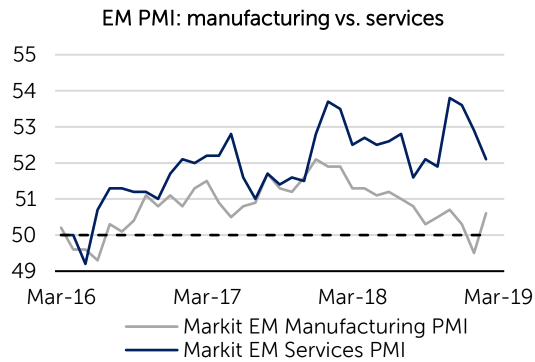
Source: Markit, CIPS, Bloomberg, ADCB Asset Management

Exhibit 6: ... but in Japan, its more pronounced ...



Source: Nikkei, Bloomberg, ADCB Asset Management

Exhibit 7: ... as is the case in emerging markets



Source: Markit, Bloomberg, ADCB Asset Management

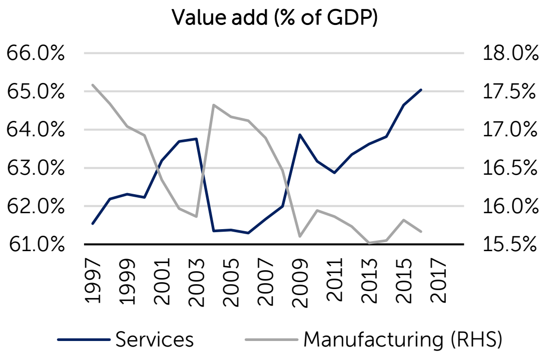
Especially in the US (where the share of the service sector in the economy is the largest across the world), the service sector strength was rather indomitable. It is worth noting that the payroll data suggest continued additions to personnel in the sectors of 'professional and business services', 'financial activities' and 'education and health services'. This is in deep contrast to 'construction', 'mining and logging' sectors where there was sizable retrenchment. The ISM Non-manufacturing index (NMI) for February showed a broad-based expansion across services segments – led by education services, transportation and warehousing, utilities, real estate, finance & insurance and healthcare.

ISM NMI sub-indices also point to further strength. For instance, the index for new orders, increasing for the 115th consecutive month jumped to 65.2 in February from the January reading of 62.7. Business expectations continue to be encouraging too. The business activity index for February came in at 64.7 – suggesting an uptick in business activity for the 115th consecutive month as well.

Structural trends are positive too

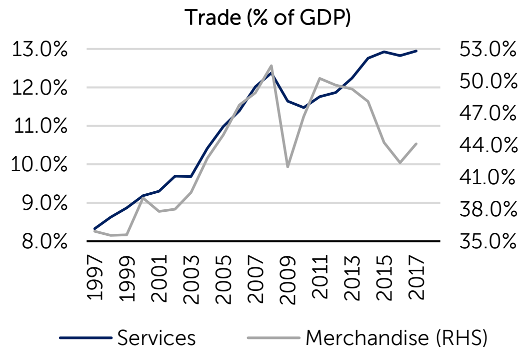
The service sector also presents a structural opportunity. With continuously rising contribution to world GDP, the service sector is expected to garner more importance (see exhibit 8). Further, as most services tend to be domestically focussed, the sector is likely to remain immune to trade disruptions. However, it is worth noting that trade in services has been rather stable compared with a fall in merchandise trade during the last three years (see exhibit 9).

Exhibit 8: Service outgrowing manufacturing



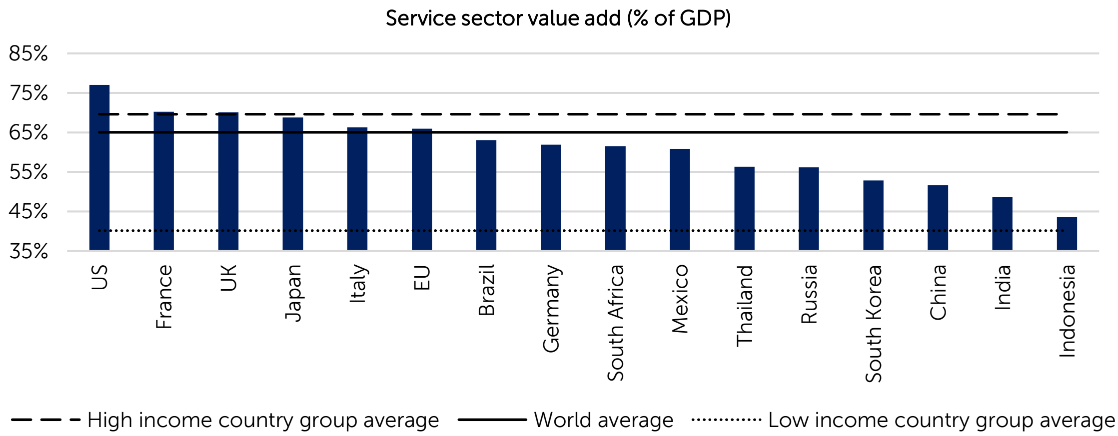
Source: World Bank national accounts data, OECD National Accounts data files and ADCB Asset Management

Exhibit 9: Service trade: low but rising



Source: World Bank national accounts data, OECD National Accounts data files and ADCB Asset Management

Exhibit 10: Developed markets are more 'service-oriented' than emerging markets



Source: World Bank national accounts data, OECD National Accounts data files and ADCB Asset Management

In most developed markets, the service sector is quite dominant with a high contribution to overall value add (see exhibit 10). However, emerging markets are catching up. Very broadly aging global population means more demand for services like healthcare etc. Even the rise of millennials and their increased preference for "experience" (generated by a product along with an associated service) is supportive of a services-pivot. Especially as economies embrace digitalisation, the movement from manufacturing-led growth to services-led growth becomes easier. For instance, with the rise of car sharing services like ZipCar and Car2Go and alternative cab services like Uber and Lyft, car ownership has transformed itself from a product into "mobility" as a service. There are also examples where services are helping certain product categories. Internet of things (IoT) and cloud services have improved the value for smart products. Further, having a service as a part of the offering opens more business opportunities and ways to please and retain customers. Corporates are adjusting their strategies accordingly (see box below).

From selling products to providing services – case study of corporates

Here we discuss a couple of cases where corporations have changed their focus from product/manufacturing to services. In the past we have seen the likes of GE, IBM, and Xerox (to name a few) move from being product-oriented enterprises to increasingly services-led. In the case of GE, the new business model "Power by the Hour" increased the focus on services and helped turn its aviation business more profitable. Xerox too moved its business agenda from selling printers to providing printing services. IBM's transformation from being a product based company to a solutions company was phenomenal. In fact using services, IBM was able to deliver a whole product to customers. However, the most recent evidence comes from Apple which we discuss in detail below.

Apple: a world beyond iPhone is in App store

Earlier this year, Apple issued a market warning that it is expecting a multibillion-dollar revenue shortfall for the quarter ending December 2018 (see "Letter from Tim Cook to Apple investors", Apple Press Release, 2 January 2019). In his letter to investors, Tim Cook (CEO of Apple) attributed this weakness to four key factors – early sales of iPhone XS and iPhone XS Max in the previous quarter, strength in USD, supply constraints and weakness in emerging markets. The latter, according to Mr. Cook had a significantly greater impact on sales. Whilst Apple did acknowledge lower than anticipated iPhone revenue from Greater China, it also indicated a new record for services revenue. This, we believe is the next chapter of the Apple story.

In fact, on the following day, Apple's press release (see "Customers Spent $1.22B During the 2018 Holiday and Kicked off 2019 With a New Single-Day Record on New Year's Day", Apple Press Release, 3 January 2019) indicated that App Store customers worldwide set new spending records over the holidays, wrapping up a record-breaking year. App Store helped drive services revenue to an all-time record in the holiday quarter. Apple services set new all-time records in multiple categories, including the App Store, Apple Music, Cloud Services, Apple Pay and the App Store's search ad business.

Over the last three months, Apple launched a range of initiatives that should help the company move to be more services-oriented. For example expansion of Apple Pay (at various merchants in the US), extending Apple Music (to American Airlines), announcement of Apple Card (a new kind of credit card), introduction of Apple Arcade (a game subscription service), launch of Apple News+ (a new subscription that brings together over 300 popular magazines, newspapers and digital publishers) and unveiling of Apple TV+ (featuring exclusive shows, movies and documentaries) are all indicative of the rising importance of services within the company. All this does indicate an ongoing effort of Apple to embrace services to lead their business.

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Our equity strategy in two minutes

Exhibit 11: Equity strategy summary

	Underweight (UW)	Neutral (N)	Overweight (OW)	Comments
Regions				
US			■	Prefer consumption and services themes
Canada		■		Stick with the benchmark
Europe ex UK	■			Focus on defensive quality
UK		■		Stick with the benchmark
Japan		■		Prefer a cyclical tilt
Asia Pacific ex Japan	■			Structurally OW India
EM LatAm	■			Tactically OW Brazil
EM EMEA	■			Tactically OW South Africa
GCC		■		Prefer KSA; regional banks
Global sectors				
Comm. Services			■	Prefer US exposure over rest of the world
Consumer Discr.		■		Prefer Consumer Services to Auto & Components
Consumer Staples			■	Prefer Household & personal products
Energy			■	Companies with positive cash flow to outperform
Financials		■		Prefer Banks with diversified business models
Health Care			■	Prefer Pharma, biotech & life sciences
Industrials		■		Prefer Commercial & Professional Services
IT	■			UW Tech H/W and Semiconductor sub-sectors
Materials	■			UW Materials hedged with OW Brazil and SA
Real Estate		■		Prefer US exposure over Europe
Utilities		■		Stick with the benchmark
Factors/styles/sizes				
Large cap			■	Strong balance sheet, earnings visibility
Mid cap		■		Likely to be market-performers
Small cap	■			US small cap strained by leverage
Growth			■	Prefer non-cyclical growth
Value		■		Growth at a reasonable price (GARP)
Dividend yield			■	Prefer quality dividends
Quality			■	Quality in the environment of low risk-tolerance
Momentum		■		Watch momentum for leadership change
Legend	*New*	*Old*	*No change*	

Source: ADCB Asset Management

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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