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The Equity Breakdown: Parsing the Key Debate in Five Sectors

The nearly $50 trillion U.S. equity market is a complex mélange of sectors, each with its own competitive dynamics and evolving storylines. While there are countless debates within each sector, some conversations—in our view—matter more than most.

In this paper, five of our seasoned research analysts break down their views on what they consider to be the key debate in each of their sectors, including technology, healthcare services, industrials, consumer goods and utilities.

Taken together, we believe this collection offers a more meaningfully nuanced view of the broader equity market, as well as actionable guidance for investors contemplating shifts in their portfolios to enhance long-term, risk-adjusted returns.

Executive Summary

This paper examines key debates in five crucial equity sectors:

- **Technology: *Is AI a threat to Google?*** Competition lurks, yet we argue that the reigning search champ can dodge disruption by Generative AI.
- **Consumer Goods: *Will the surprisingly resilient U.S. housing market stay strong?*** While homes and mortgages remain expensive, we think a chronic housing supply shortage and other factors could continue to support prices.
- **Industrials: *Has electric-vehicle (EV) growth hit a speed limit?*** Bears point to high prices and a dearth of charging stations, yet we think market sentiment has overly soured relative to the industry's underlying fundamentals.
- **Healthcare Services: *Are rising costs a blip—or something else?*** Many managed care organizations (MCOs) underestimated care costs in recent quarters, but we think underwriters will likely do a better job of pricing their coverage in 2025.
- **Utilities: *Can the sector capitalize on the looming power crunch?*** We believe mounting U.S. power demand presents an attractive and unequivocal mega-theme for long-term investors.

For each sector, our analysts sketch the current industry backdrop, present the bull and bear sides of the key debate, and ultimately defend their stance.

Technology: Is AI a Threat to Google?

The Backdrop

History is littered with technology titans that got left behind, seemingly in a flash: Kodak, AOL, Netscape, Sun Microsystems, Blackberry, MySpace, Nokia…the list goes on and on. In this sector, no leader can rest on its laurels—even one as mighty as Alphabet's Google.

While Google still commands a vast majority (92%[1]) of the online search market, rapid advancements in generative AI now pose a potentially significant threat to the company's growth trajectory and Alphabet's valuation. As the AI revolution continues to capture the market's collective imagination, many investors are wondering: Can Google stay technologically relevant and dodge disruption?

Alphabet isn't exactly quick to assuage the market's fears—management routinely gives paltry guidance on earnings and other key metrics, in our view—but one thing is certain: In tech, you rarely get a second chance.

The Bear Case

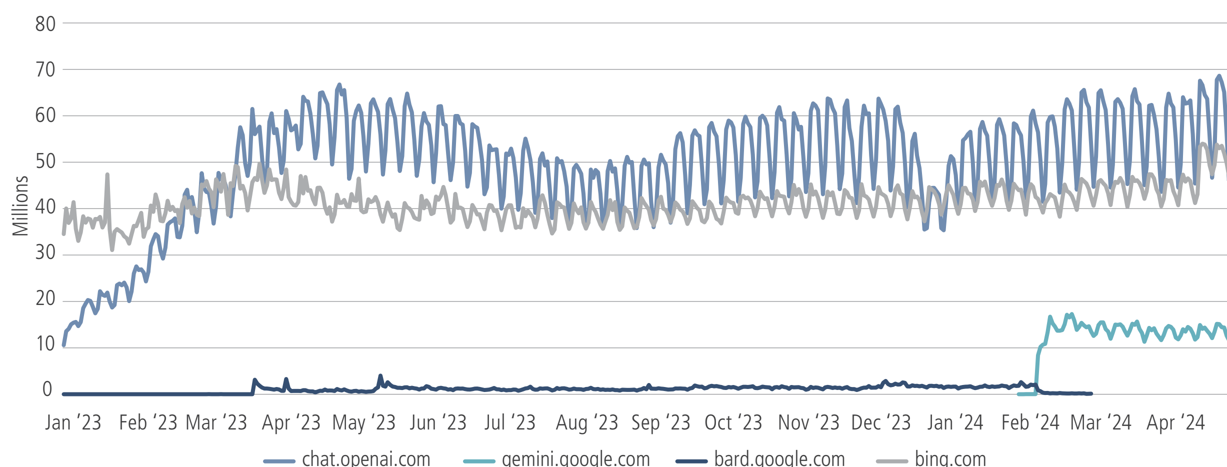
Some argue that Google has been woefully late to the AI-driven search party, where guests of honor now include OpenAI (the Microsoft-backed creator of ChapGPT), Microsoft's Bing (infused with OpenAI technology) and even hot startups like Perplexity, now attempting to raise a reported $250 million in additional funding at a $2.5 billion valuation.[2]

As shown in figure 1, ChatGPT and Bing have managed to attract sizable audiences to their generative AI platforms, while Google Bard (an AI chatbot) has struggled to gain traction. (In February 2024, Google changed the Bard moniker to "Gemini" to reflect that users are interacting directly with the underlying AI model bearing the same name.)

[1] Source: Statcounter, BofA Global Research. Data as of April 30, 2024.
[2] Source: Perplexity is raising $250M+ at a $2.5B-$3B valuation for its AI search platform, sources say, TechCrunch, April 23, 2024.

FIGURE 1: GENERATIVE AI PLATFORMS COULD THREATEN GOOGLE'S DOMINANCE IN SEARCH

Daily Generative AI Traffic



Source: Similarweb, BofA Global Research. Data as of April 30, 2024. Note: Does not include Google search traffic.

Bears fret that steeper competition could curb Google's growth: If millions of users switch to ChapGPT to handle their search needs, Google's traffic—and the rich advertising revenue it brings—may suffer. And while all AI models, including Gemini, have exhibited bouts of "hallucination," we believe Google will likely draw the most scrutiny given its dominant position in search.

The Bull Case

While AI's disruptive potential and management's tight lips have sown doubt on Wall Street, we believe Google can maintain its formidable competitive moat.

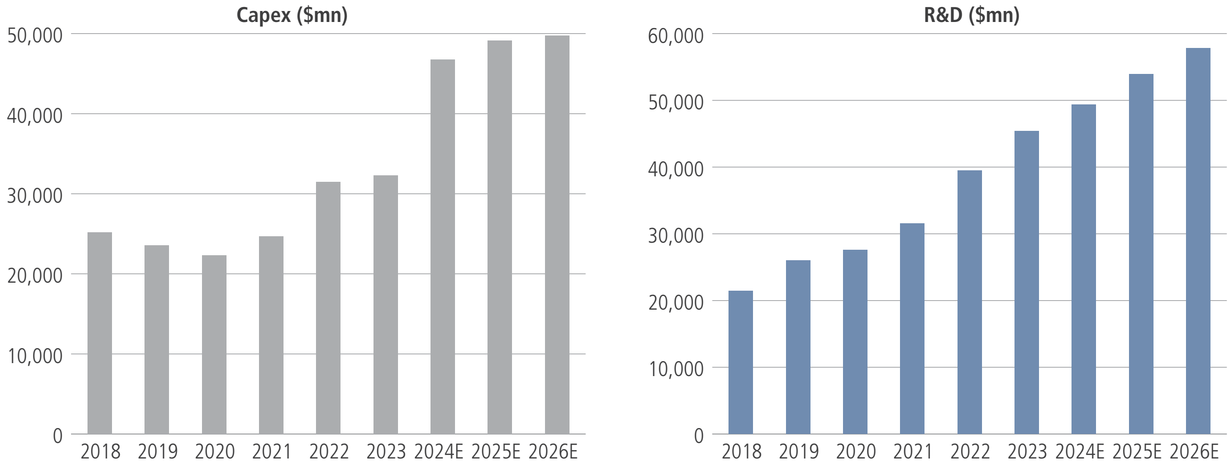
Indeed, we think that GenAI could be less a threat and more of a *tailwind* for Google by turbocharging a familiar virtuous cycle: As Google embeds GenAI in its offerings, it increases overall "utility" by yielding more valuable search results, enhancing potential returns for advertisers and ultimately driving its own incremental revenue.

One might, for example, ask Gemini to plan a two-week trip to France, including stops in Nice, Alsace and Paris. In mere seconds, Gemini can assemble a full itinerary, complete with recommendations for flights, hotels and restaurants—no travel agent required. And because this is a very specific search, likely made by someone who intends to act on the results, French hotels and restaurants might be willing to pay more to place their ads alongside Gemini's results. (Subscriptions are also part of the potential revenue mix: Power searchers can currently access Gemini's Advanced service for $19.99 per month.)

Furthermore, we think GenAI could help Google drive incremental growth by giving users new ways to extract value from the platform, in addition to search. Small business owners with meager marketing budgets might use Gemini's video- and image-generation capabilities to help create their company logos or YouTube campaigns.

Surviving the AI battle will require consistent execution, in our view, as well significant incremental investment in research and technical infrastructure (including powerful chips and data centers). Google appears sufficiently committed: As shown in figure 2, consensus estimates project the company's R&D and capex budgets will rise 27% and 54%, respectively, by 2026.

FIGURE 2: GOOGLE IS BOOSTING R&D AND CAPEX TO WARD OFF AI CHALLENGERS



Source: Company reports, FactSet.

While these investments could pressure earnings in the near term, we believe they will drive significant revenue growth and profit over the medium to long term. Disruptors may lurk, but Google, in our view, will prove up to the challenge.

Consumer Goods: Will the surprisingly resilient housing market stay strong?

The Backdrop

The housing market has been on an improbable ride.

Four years ago, the Covid-19 pandemic jumpstarted a seismic shift. Locked-down urban dwellers able to work from home sought more living space while professional investment firms scooped up thousands of houses to flip or rent. All of this activity stoked demand in lower-cost locales and drove housing prices higher: In June 2022, the median price of a single-family home in the U.S. hit a record $413,800, up from $281,000 in March 2020 at the start of the pandemic.[3]

Then something peculiar happened. Since the Federal Reserve started ratcheting interest rates to tame surging inflation, the average rate on a 30-year fixed-rate mortgage has risen to 7.33% as of mid-April 2024, up from less than 3%, on average, in 2021.[4] Meanwhile, home values have barely cooled: In March 2024, the median home price was $393,000, barely off its pandemic peak.

Such resilience in the face of rising borrowing costs and relatively rich home values has taken many market watchers by surprise. With the Fed seemingly more reluctant to cut rates than markets had expected, investors are now wondering: *Have housing prices finally hit a ceiling?*

The Bear Case

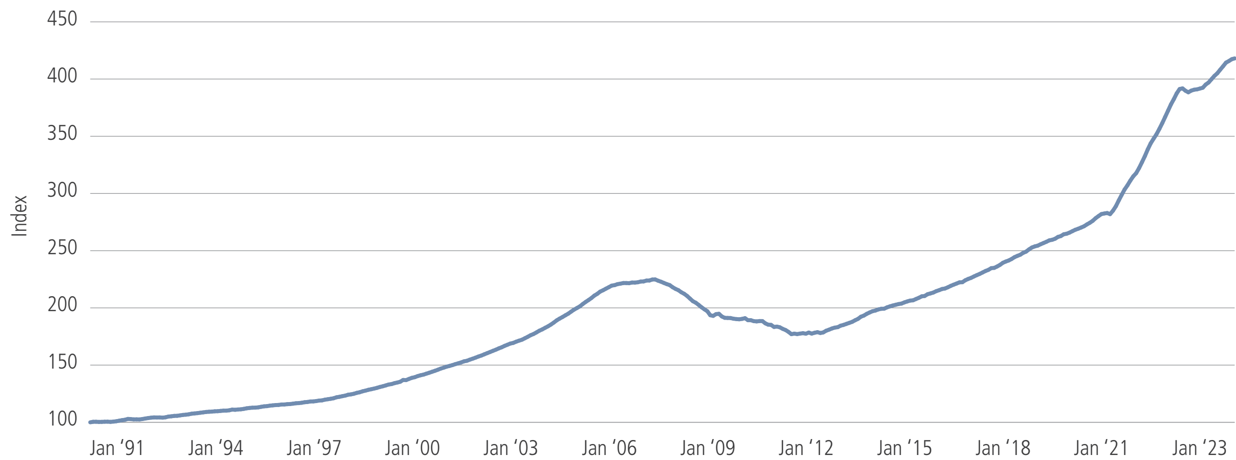
By some measures, the housing market would appear to have entered frothy territory.

After the dust settled following the Great Financial Crisis (GFC) in 2008, home prices marked a steady ascent between 2012 and 2020 before accelerating through the pandemic (see figure 3).

[3] Source: "Existing-home sales dip, but prices keep rising", Bankrate, April 18, 2024.
[4] Source: "Mortgage rate history: 1970s to 2024", Bankrate, April 8, 2024.

FIGURE 3: MEDIAN HOME PRICES HAVE HIT HISTORIC PEAKS

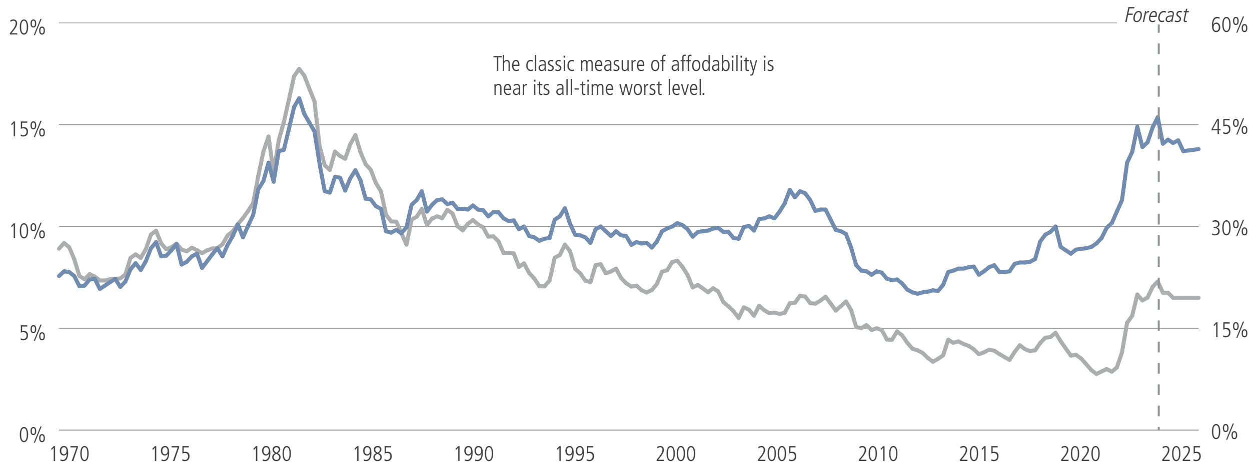
FHFA Home Price Index



Source: Federal Housing Finance Agency, data as of February 2024.

As home prices rocketed, affordability sank. As shown in figure 4, median homeowners now spend nearly half of every dollar of income on their mortgage payments—a level of unaffordability not seen since mortgage rates spiked to 17% in the early 1980s.

FIGURE 4: HOMES ARE NEARLY AS UNAFFORDABLE AS THEY'VE EVER BEEN



Source: Freddie Mac, NAR, Evercore ISI Research. Data as of March 2024.

To recap: Interest rates have risen (and now might stay higher for longer), home prices are near record highs, and homeowners are stretching to pay their mortgages. Against that potentially challenging backdrop, it's understandable that market-watchers are questioning the durability of the housing market.

The Bull Case

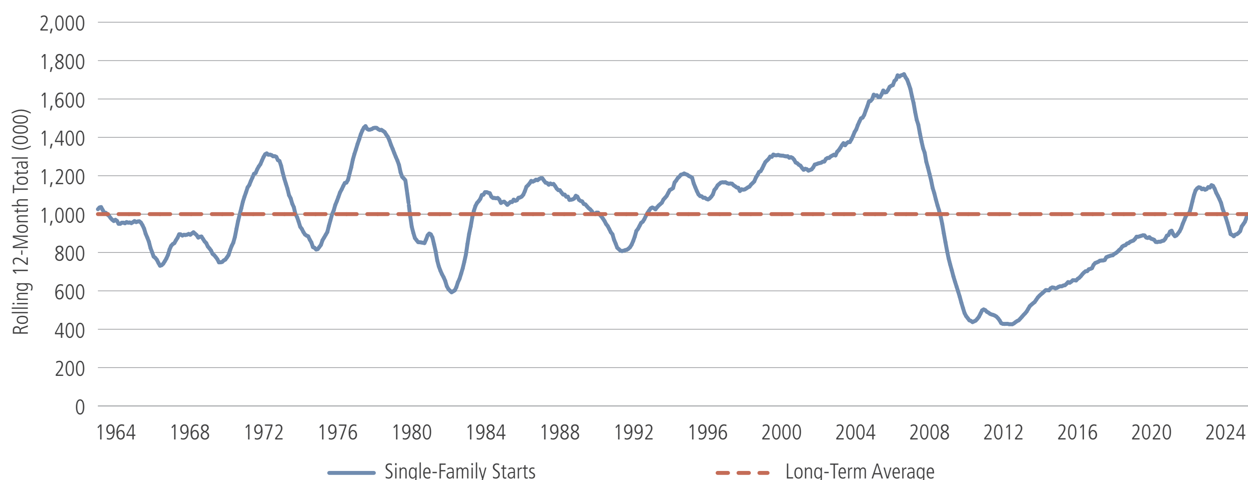
While we acknowledge the bears' concerns, we maintain a more buoyant view on the U.S. housing market based on a few key factors.

Lack of Supply

We believe a foundational pillar of the market's strength in recent years has been the chronic lack of housing supply. We trace this structural deficit to several factors—the most important, in our view, being the decade-plus of below-trend housing starts coming out of the GFC, the longest period of below-trend housing construction since the Census Bureau began reporting this data (see figure 5).

FIGURE 5: WEAK POST-GFC HOUSING CONSTRUCTION HAD LED TO A CHRONIC LACK OF SUPPLY

U.S Single-Family Housing Starts



Source: U.S. Census Bureau and Neuberger Berman.

Even before the pandemic hit, vacancy rates and existing inventories had already declined to record lows. Those trends—combined with rate-quashing measures by the Fed in 2020 – 2021—drove the most rapid home price inflation since the 1970's.

So why hasn't this led to a cyclical bust?

In our view, when homebuilders tried to increase production in 2021, their pandemic-snarled supply chains could not keep up. Homebuilder conference calls were rife with complaints about all manner of shortages, from windows to appliances. Although supply chains have mostly healed over the last two years, housing starts still face another hurdle: a dearth of developed land.

Private developers who fled the 2008 – 2009 housing bust have been slow to return, leaving homebuilders to fill the void using their own balance sheets to acquire and develop residential lots. Some homebuilders that have tried partnering with developers have come up against a lack of available capital, expertise or both; meanwhile, county and municipal government offices that laid off real estate inspection staff during the GFC have been slow to scale up, often delaying project zoning and permitting.

Yet another factor, in our view, may help keep home prices elevated: subdued resale activity. Many existing homeowners with 30-year mortgage loans at rates below 4% (the average rate on outstanding mortgages was 3.78% in 1Q24[5]) may have little incentive to sell and take out a new mortgage at rates north of 7%.

Add it all up and it looks to us like the housing supply crunch may need considerable time to subside, potentially keeping a sturdy floor under home prices.

[5] Source: Freddie Mac.

Affordability Solutions
As intractable as the housing-affordability problem might appear (and despite a recent rebound in mortgage rates), we find that most homebuilders continued to report solid traffic and order growth through the first quarter of 2024.

A key to their success, we believe, has been the use of sales incentives, particularly mortgage rate "buydowns" whereby the builder pays an upfront fee to reduce the rate on the buyer's mortgage.

Builders are also aiming to increase affordability by building denser communities (reducing the real estate cost per unit) and smaller homes. (The average square footage of new single-family homes is down 13% from peak levels.[6]) So while it is true that housing inflation has outpaced income growth over the last several years, we believe builders are taking meaningful action to keep their homes within customers' reach.

Buyers Are Still in Good Financial Shape
We remain pleasantly surprised by the financial health of today's homebuyers. Mortgage application data from homebuilders and other sources reveal a pattern of steady or rising credit scores, stable loan-to-value ratios and higher household incomes.

Furthermore, the much-discussed Millennial age cohort—which broadly delayed major life events like marriage, children and homeownership—is now older and wealthier than previous generations of first-time homebuyers. Finally, we believe that almost anyone who bought a house at least three years ago has seen their home equity increase, potentially giving them more financial firepower when they decide to trade up.

Industrials: Has electric vehicle growth hit a speed limit?

The Backdrop
Aggressive adoption of electric vehicles (EVs) has been one of most consequential developments in the automotive industry in decades. Global automakers now roll out approximately 90 million vehicles per year,[7] and battery-powered electric vehicles (BEVs) account for 12% of global auto sales, up from just 1% in 2017.[8]

Yet there are signs that EVs could be hitting a speed limit: Over the last 15 months, higher interest rates and subsidy phaseouts have dampened EV demand; increased competition has prompted price cuts by Tesla and others; some automakers have trimmed their production forecasts; and investor sentiment is as low as we've seen.

The big question: Will EV growth remain lackluster or reaccelerate?

The Bear Case
Doubters point to three main reasons EVs could face an increasingly uphill climb:

- **Affordability.** The costly and complex transition to manufacturing EVs may continue to limit operational scale and keep EV prices high relative to internal combustion engine (ICE) vehicles. Meanwhile, recent price concessions on EVs could make potential buyers wonder whether the vehicles will retain their value.
- **Infrastructure.** After sticker shock, the limited network of EV-charging stations may continue to give buyers pause. In the U.S., there are approximately 15 EVs per public charger; in Europe, 11.[9] Charging times also remain a point of frustration: Using a DC fast-charger, it can take anywhere from 20 to 60 minutes to charge an empty EV battery to 80% of its capacity,[10] versus a few minutes to fill a traditional car tank.

[6] Source: U.S. Census Bureau.
[7] Source: S&P Global.
[8] Source: S&P Global, Neuberger Berman estimates.
[9] Source: IEA.
[10] Source: "Charger Types and Speeds", U.S. Department of Transportation.

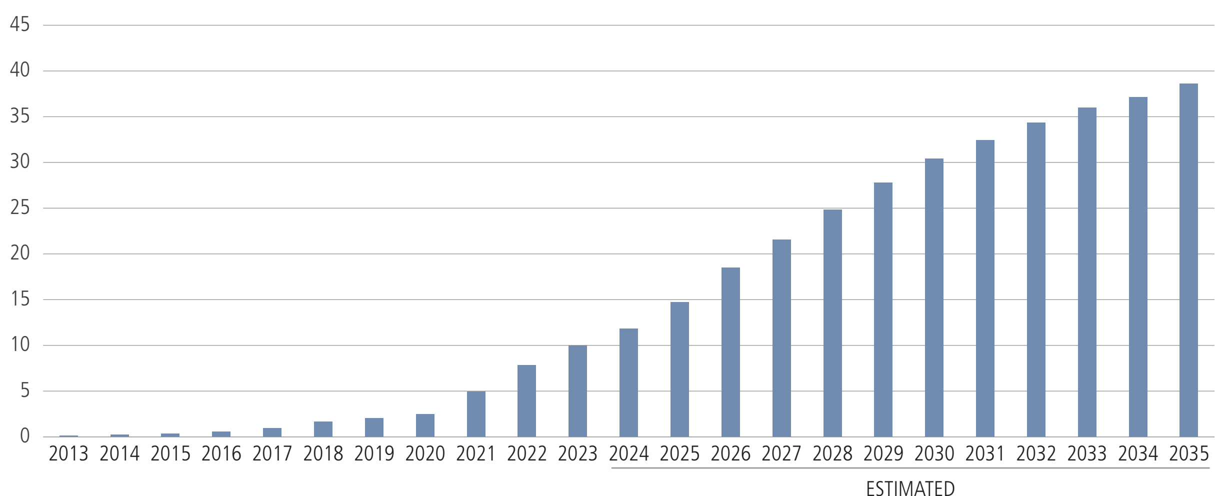
- **Policy.** While government subsidies have helped drive global EV growth thus far, that generous support could fade. In Europe, key countries like Germany phased out their EV subsidies in 2023, and the outcome of Parliamentary elections this summer could lead to a softening of CO_2 targets. In the U.S., a new Republican administration might choose to relax EPA emission standards and tighten eligibility requirements for subsidies embedded in the Inflation Reduction Act (IRA).

The Bull Case

We believe near-term sentiment has overly soured relative to the EV industry's underlying fundamentals and expect a reacceleration in EV volume growth over the next two years.

As shown in figure 6, we estimate that global EV volumes could rise 15 – 20% in 2024 and *accelerate* to 25% growth in 2025 followed by a similar rate of growth in 2026. The market's current pessimism could present an attractive opportunity if EV demand proves stronger than many anticipate.

FIGURE 6: UNDERLYING INDUSTRY FUNDAMENTALS COULD CONTINUE TO DRIVE GLOBAL EV DEMAND



Source: Neuberger Berman data and estimates.

Addressing the bear case point-by-point, we find:

Affordability

China is currently the only market where EVs are priced similar to ICE vehicles, but we believe that EVs could reach parity in other geographies within the next few years.

In our view, several factors could help automakers improve their operational and financial performance, including greater fixed cost leverage (from higher production volumes); the introduction of lower-cost lithium iron phosphate battery cells; falling battery raw material costs; and new manufacturing techniques, such as Tesla's "unboxed" approach, which involves performing assembly operations in parallel to reduce final-assembly time.

We believe these improvements could help EV makers reduce prices and unlock a broader customer base. (In late April, Tesla announced plans to launch lower-cost models by the second half of 2024 or the first half of 2025.) Meanwhile, we find that traditional OEMs are gaining scale and forming partnerships to reduce costs. For example, VW and Xpeng entered into an agreement[11] to jointly develop EVs in China, which could reduce development time and operational redundancies while increasing leverage with suppliers.

Finally, we believe EV leaders, such as BYD in China, will continue to apply pressure on their global competitors to create more advanced yet affordable models, potentially accelerating the overall EV transition.

[11] "Ready for next EV push: Volkswagen enters into agreement with Xpeng for fast joint development of two smart e-cars", Volkswagen Group, February 29, 2024.

Infrastructure
While customer satisfaction with public charging stations remains subdued,[12] the industry continues to make progress on various fronts. First, after rising each year since 2020, the number of EVs per charger is expected to decline in the U.S., and level off in Europe, through 2025.[13] Second, Tesla has been opening up its public-charging network to other automakers in North America, where it now operates an estimated 12,000 charging ports across the U.S. and Canada.

Additionally, we think that improvements in battery technology—such as silicon anodes, which have greater energy density than traditional graphite anodes—could meaningfully reduce battery production costs (by reducing the size of the battery) while also improving EV-charging speeds.

Policy
Amidst the global shift toward decarbonization, we think lawmakers in the U.S. and Europe will continue to back regulations to lower emissions standards and, in turn, drive EV demand. For example, increasingly restrictive CO_2 emission standards in Europe will effectively require automakers to sell more EVs over time. Meanwhile, China continues to drive its own EV transition through a variety of incentives, from offering tax breaks to restricting transit permits for new ICE vehicles. Finally, we believe China's support of the EV ecosystem—by expanding charging availability and building out the country's battery supply chain—will continue to expand access to affordable EVs.

Taken together, these factors suggest to us that—despite the market's current pessimism—EV demand has the potential for durable growth ahead.

Health Care Services: Are rising costs a blip—or something else?

The Backdrop
We believe this sector's near-term performance hangs, in great part, on the direction of health care costs, which have been accelerating in the wake of the COVID pandemic's retreat.

While the health services sector spans a hodgepodge of names with various business models, managed care organizations (MCOs) accounted for approximately 77.5% of the benchmark's total market capitalization as of the first quarter of 2024.[14] Managed care health plans aim to control costs in three ways: 1) by deploying clinical programs to optimize the health of their beneficiaries; 2) by steering beneficiaries to the most economical care providers; and 3) by reducing the scope of their provider networks in exchange for volume discounts on care.

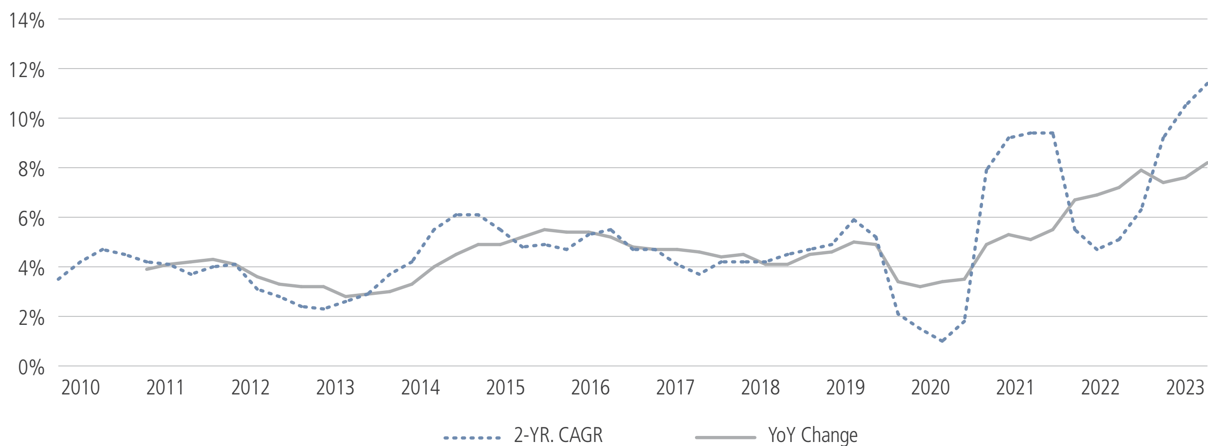
The challenge for all health care underwriters, including MCOs: The premiums they charge—and thus the revenue they collect—are a function of the *projected* cost of care. If care costs rise faster than forecasted, MCO profits can get squeezed, along with their valuations.

The Bear Case
The market's concern about rising costs is understandable: In 2023, MCOs with significant exposure to Medicare Advantage (MA) plans appeared to have underestimated year-over-year growth coming out of the COVID pandemic—a time when hospitals were strapped for labor and many elderly patients were too afraid to seek on-site care. (MA plans are privately run versions of Medicare in specific geographies.)

[12] "Public Charging Issues May Short-Circuit EV Growth, J.D. Power Finds", JD Power, August 16, 2023.
[13] Source: IEA.
[14] Source: Neuberger Berman.

When medical consumption rebounded (see figure 7), spiking costs caught underwriters off guard—particularly in MA plans—and triggered downward earnings revisions by several companies in the sector.

FIGURE 7: HEALTH COSTS HAVE SPIKED FASTER THAN MANAGED CARE ORGANIZATIONS' FORECASTS



Source: Census Bureau, Neuberger Berman.

We believe the risk moving forward is that health costs could accelerate further in 2024—like we've seen recently from CVS Health—and/or that MCOs once again fail to appropriately underwrite their book of business in 2025.

Broadly speaking, we find that management teams are saying all the right things heading into the 2025 pricing cycle, yet doubt remains whether their actions will match their words.

The Bull Case

While we acknowledge the rise in health care costs (and that Baby Boomers are starting to weigh more significantly on the health system), we believe MCOs can still thrive in an inflationary environment. Once insurance premiums better reflect the growth in medical costs, we expect margins across the sector will stabilize and earnings will return to historical growth rates.

In 2023, and somewhat in 2024, underwriters got taken by surprise. Looking ahead to 2025, we think underwriters will likely do a better job of pricing their products for the following reasons: first, the element of surprise appears to be gone; second, healthcare providers have capacity constraints that will likely limit any future growth of medical costs; and third, markets have a tendency to discipline poor pricing (see the swift reaction to CVS Health's poor first-quarter earnings announcement).

The Election Factor

We believe the relative performance of the health services sector—perhaps more than most—could also turn on the outcome of November's presidential election.

As November draws near, sector volatility tends to spike and stocks move in tandem with projected outcomes from various betting markets. For example, when Senator Elizabeth Warren (D-MA) ran for president during the 2019 – 2020 cycle, investors worried that her support for Medicare for All legislation might dent earnings across the sector; as her prospects faded, MCO stocks rallied. We expect a similar uptick in volatility during this election cycle given the candidates' clashing positions on key policy issues.

- **If Trump wins:** On the whole, we see a Trump victory being a tailwind for health care services stocks. First, Trump's predilection for lower corporate tax rates would theoretically buoy this mainly U.S.-centric sector. Second, there is a perception that a Trump administration might support MA over government-run Medicare by increasing reimbursement rates for MA plans. Such a shift, in our view, could be a tailwind for companies with significant MA exposure, such as Humana and United Healthcare.

- **If Biden wins:** On the flip side, we believe a Biden reelection could give a boost to specific players with sizable exposure to large government programs, including Medicaid and the public exchanges offering subsidized individual health care plans. By that logic, we think sector beneficiaries could include Centene, Molina Healthcare and Oscar Health.

For now, oddsmakers still see the election as a toss-up, and the market doesn't appear to be pricing in a particular outcome. As the battle wears on, however, we believe the election could have a gradually increasing impact on the sector's volatility and performance.

Utilities: Can the sector capitalize on the looming power crunch?

The Backdrop

The U.S. economy runs on electrons, and demand is gradually outstripping supply. This mismatch presents a mix of opportunities and challenges for regulated utilities and independent power producers (IPPs).

Demand for power is poised to rise thanks to advancements in artificial intelligence (AI)—data centers that process large language AI models draw a *shocking* amount of electricity—as well as ongoing structural shifts toward onshore manufacturing and electric vehicles (EVs).

Meanwhile, around-the-clock power capacity has been shrinking: Coal plants are increasingly being retired; nuclear generation remains prohibitively expensive; and intermittent renewable sources (wind and solar) can't yet fully pick up all the slack.

Though electrons may be in high demand, utility stocks haven't been until recently. The big question now: Can this relatively "boring" low-beta sector capitalize on the oncoming power crunch?

The Bear Case

Meeting increased power demand will require significant capital investment to build plants, expand the grid, store capacity and stabilize the system to accommodate more renewables. Utilities often rely on debt to finance large infrastructure projects, which makes this sector especially sensitive to shifts in interest rates.

Should the Federal Reserve persevere in keeping rates higher for longer to tame still-stubborn inflation, higher interest expenses could put pressure on power company profits in the near term. And while utilities often offer attractive dividend yields, higher rates could also increase the appeal of fixed-income investments (such as corporate bonds) relative to utility stocks.

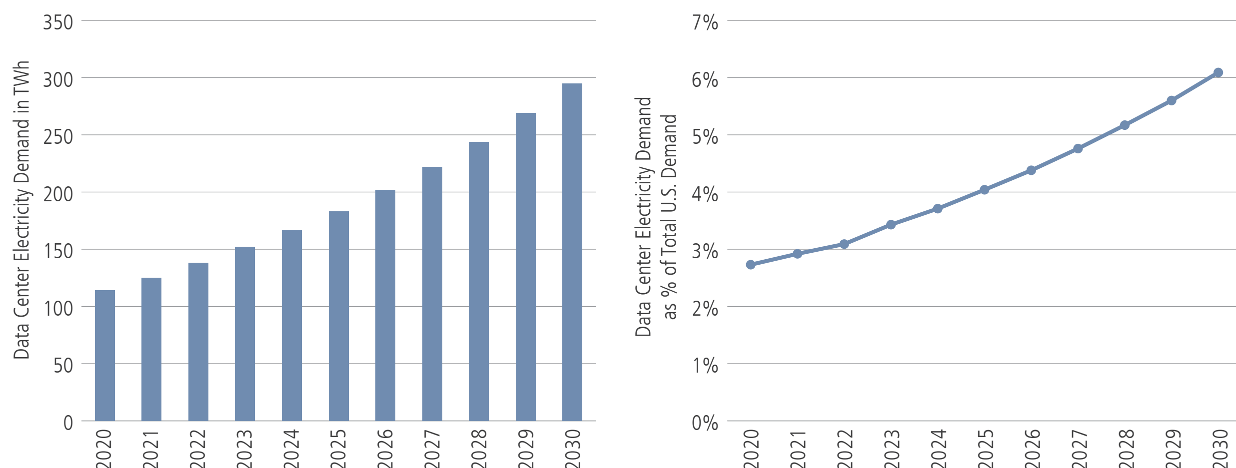
Bears also note that equity markets can remain enamored of "growthier" sectors, such as technology and communications services, for longer than many might expect. Thus far in 2024, many AI-flavored stocks still boast rich multiples—even as warnings about AI's appetite for power continue to swell.

The Bull Case

We believe mounting U.S. power demand presents an attractive and unequivocal mega-theme for long-term investors in utilities.

First, power hungry data centers at the heart of the AI revolution are poised to boost the earnings of power and utility companies. As shown on the left side of figure 8, data center electricity demand is estimated to grow 10% per year between 2020 and 2030. By the end of the decade, McKinsey projects that U.S. data centers may consume upwards of 35 gigawatts of power—the equivalent of *35 large nuclear plants*. Meanwhile, data centers could account for as much as 7.5% of total U.S. power consumption, up from just 2.5% today (see the right side of figure 8).

FIGURE 8: DATA CENTERS WILL INCREASINGLY TAX THE POWER GRID



Source: EIA, McKinsey.

But this story isn't just about selling more electrons—it's also about selling them at potentially higher prices. Adding capacity and fortifying the grid will take time: Until the infrastructure to supply more power can be built, we think sudden demand spikes could send power prices higher, driving higher profits for unregulated independent power producers (IPPs).

In addition to driving demand, we believe AI has the potential to make power companies more efficient. Smart grids (enhanced by AI) could optimize power distribution by reducing waste and improving reliability; likewise, a more algorithmic approach to grid maintenance could help utilities avoid power failures before they occur, reducing costs and downtime. We think these enhancements could help utilities manage the surge in power consumption while converting those gains into higher profits.

Supplying power to a rapidly electrifying economy would seem a good place to be, and utilities are just starting to receive credit. In our view, however, we are still at the early stage of this mega-theme: As of late April, the S&P 500 index was up nearly 23% over the previous year, while the utilities sector was essentially flat.

Despite the sector's recent rebound, we believe its underlying fundamentals and still modest relative valuations could present an attractive opportunity for long-term investors.

Conclusion

We believe parsing key debates at the sector level is crucial to generating alpha within equity portfolios. Naturally, sector storylines evolve and today's controversies become tomorrow's reflections. We believe identifying those shifts, putting them in context and grappling with their potential implications requires skill, experience and tenacity.

That's why we maintain our fundamental belief that deep, sector-specific analysis has the potential to produce superior risk-adjusted returns for long-term investors.

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