BARCLAYS

Equity Research
31 October 2019

# Equity Compass

# The bottom is near

**Earnings surprises for the current earnings season are in line with historical norms. However, NTM consensus growth forecasts continue to decline from unreasonably high levels. However, the macro environment is stabilizing: our thematic baskets indicate that concerns about a recession and U.S.-China trade war are abating. There are increasing signs that economic and earnings growth is nearing a trough but we continue to think that the recovery will be quite shallow.**

**3Q earnings not as bad as some feared:** SPX EPS surprise is so far tracking at +4.4%, which is slightly below the post-crisis median (+5.2%). The earnings beat has been relatively consistent across sectors, with the exception of FANG stocks, which significantly missed expectations. 67% of the companies have beaten expectations, which is well below 2018 levels but slightly higher than the post-crisis median (64%).

**However, forward guidance is coming down.** NTM consensus growth continued to decline (from 3.5% to 2.7%) from elevated levels. This caused our NTM bottom-up model projection to fall from -1.5% to -2.0%, despite stability in Leading Economic Indicators. 2019 consensus earnings for U.S. stocks with high international dropped by the sharpest amount in six months. In contrast, our domestically focused top-down model NTM growth projection rose from 3.9% to 4.1% due to improving economic forecasts for inflation and industrial production, but still remains near post-crisis lows.

**Stocks with more international exposure and trade-war exposure outperformed this month as U.S. China trade war fears abated.** Companies with more non-U.S. exposure, whether through higher levels of international sales or exposure to the U.S.-China trade war, outperformed in October. However, the level of our trade war basket is still well below the highs in 1Q19, indicating investor caution on this front.

**Recession fears abate:** Our optimized early recession portfolio, which is Overweight defensives relative to cyclicals, had its worst month YTD. Our early recession portfolio now trails our optimized middle expansion portfolio YTD, showing a rotation from defensive stocks into cyclicals. This is also apparent from the dispersion of sector performance this month, with HARD+SEMI and INDU seeing positive returns, while UTIL+REAL and STAP declined.

**Fed put still in place.** The Fed cut rates in October by 25bps, the third cut this year. However, Fed Chairman Powell has stated that the stance of the policy was now “appropriate,” so additional cuts may be on hold in the near term. Our economists expect another cut in December even though futures markets are only assigning a 25% for this outcome. We still believe that the Fed put is firmly in place and will continue to keep the SPX PE (currently 18.4x) well above its fair value (16.5x).

MACRO STRATEGY

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# EARNINGS AND PRICE FORECASTS

**S&P 500 Official Price Target Forecast**

2019 EPS: $162 ✖ P/E Ratio: 18.5x = 2019 Price Target: 3000

**Model Tracking Projections ***

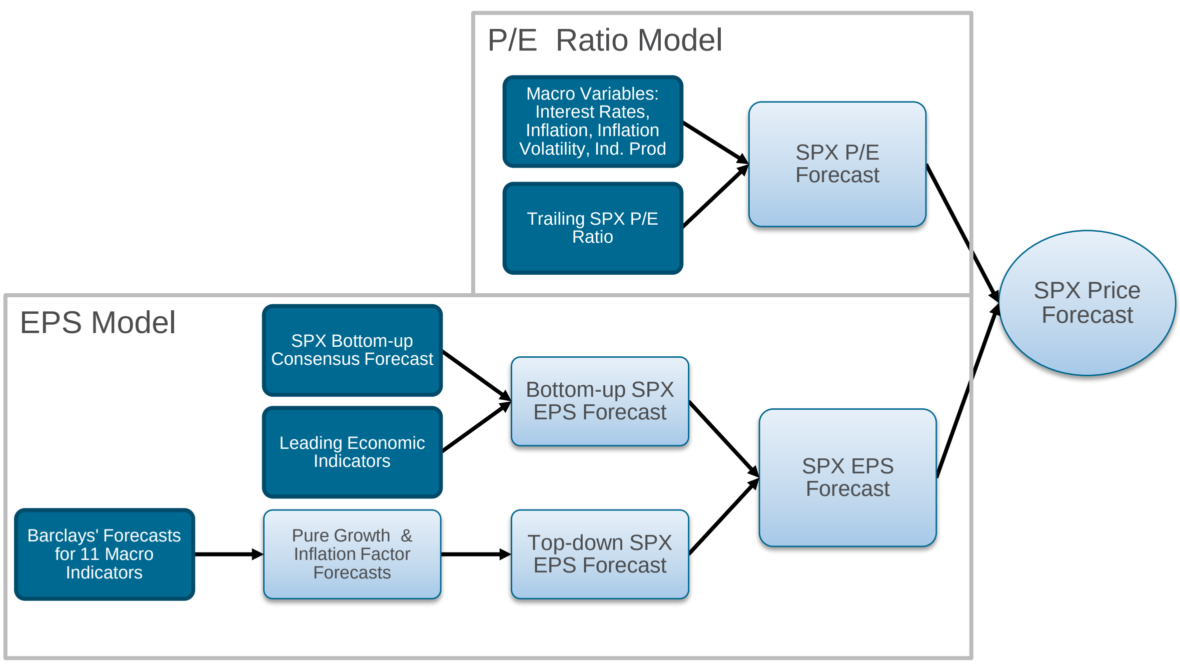
**S&P 500 P/E Model Projections**

| Current P/E | Fair Value P/E | Projected 2019 P/E |
|---|---|---|
| 18.4 | 16.5 | 18.3 |

| Actual | 2018Q3 | 2018Q4 | 2019Q1 | 2019Q2 | LTM | CY2018 | |
|---|---|---|---|---|---|---|---|
| | 42.8 | 41.4 | 38.9 | 41.5 | 164.6 | 163.3 | |
| **Forecast** | **2019Q3** | **2019Q4** | **2020Q1** | **2020Q2** | **NTM** | **CY2019** | **CY2020** |
| **Consensus EPS** | 41.5 | 42.1 | 41.2 | 44.5 | 169.2 | 164.0 | 179.1 |
| Top-Down EPS | 43.3 | 42.4 | 41.5 | 44.3 | 171.5 | 166.1 | 177.7 |
| Bottom-up EPS | 41.2 | 40.3 | 38.6 | 41.2 | 161.4 | 162.0 | 163.4 |
| Avg of TD & BU Models | 42.2 | 41.3 | 40.1 | 42.8 | 166.4 | 164.0 | 170.5 |
| Tariff Impact | -0.5% | -0.7% | -0.9% | -0.9% | -0.7% | -0.3% | -0.9% |
| **Final EPS** | **41.0** | **40.0** | **38.3** | **40.9** | **160.2** | **161.5** | **161.9** |
| **Forecast Growth** | **2019Q3** | **2019Q4** | **2020Q1** | **2020Q2** | **NTM** | **CY2019** | **CY2020** |
| Consensus EPS | -3.2% | 1.7% | 5.8% | 7.0% | 2.7% | 0.4% | 9.2% |
| Top-Down EPS | 1.1% | 2.4% | 6.6% | 6.7% | 4.2% | 1.7% | 7.0% |
| Bottom-up EPS | -3.8% | -2.5% | -0.7% | -0.7% | -2.0% | -0.8% | 0.9% |
| Final EPS | -4.3% | -3.2% | -1.6% | -1.6% | -2.7% | -1.1% | 0.3% |

Source: Barclays Research. Consensus estimates are from Refinitiv; data as of 28 October 2019.

* The Model Tracking Projections reflect the current output of our EPS and P/E models, which can deviate from our official price target forecasts. For more information regarding the Bottom-Up, Top-Down, and PE models please see *U.S. Equity Strategy: SPX 2900 – This is How We Get There*, 6/11/2018



## Current earnings season has good upside surprise, but limited growth

- The EPS surprise for the current SPX earnings season has been positive (+4.4%), but slightly below levels seen in 19Q1 and 19Q2. Overall, the level of surprise is slightly below the post-crisis median (+5.2%). EPS surprise has been relatively consistent across sectors, with the exception of FANG stocks, which significantly missed expectations. The percentage of companies beating expectations (67%) is slightly higher than the post-crisis median (64%), but is still well below levels seen in 2018.
- Even with the hefty upside surprise, the level of growth has been limited (-0.4%) with particularly weak YoY EPS growth seen in ENR+MATR, HARD+SEMI, and FANGs. In contrast, HLTH, SOFT, CONDx, and UTIL+REAL have seen growth of high single digits or above, driven by significant positive surprise.

FIGURE 1

**So far this quarter every sector is showing a strong EPS surprise, except for FANGs**

| Sector | 2019Q3 YoY | Surprise |
|---|---|---|
| FANG | -20.8% | -13.9% |
| COMMx | 7.6% | 1.8% |
| INDU | 3.7% | 1.9% |
| FINL | -0.5% | 3.4% |
| CONDx | 8.2% | 4.9% |
| CONS | 4.2% | 5.0% |
| ENR+MATR | -21.5% | 6.0% |
| SOFT | 7.6% | 6.8% |
| HLTH | 11.7% | 8.3% |
| HARD+SEMI | -25.4% | 11.8% |
| UTIL+RE | 14.8% | 20.6% |
| **SPX** | **-0.4%** | **4.4%** |

Source: Barclays Research, Refinitiv

Note: Earnings Surprise measured relative to consensus 1-day prior to report. Surprise is the % difference between total reported and consensus Net Income.

FIGURE 2

**Most sectors are seeing beats in excess of 60%, excluding ENR+MATR, FANGs, and COMMx**

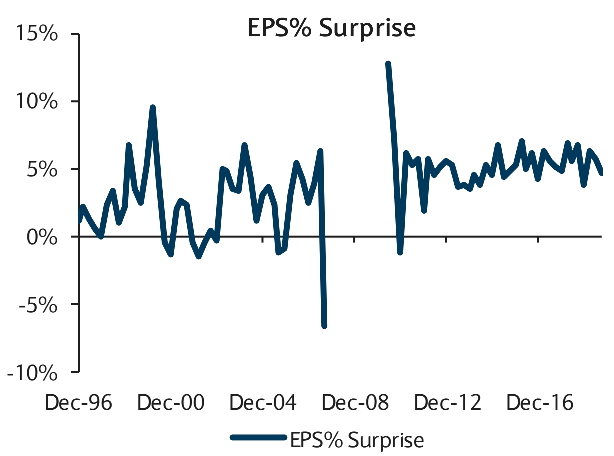
| Ticker | BEAT % | MISS % | MET % |
|---|---|---|---|
| UTIL+RE | 61% | 39% | 0% |
| SOFT | 71% | 7% | 21% |
| INDU | 69% | 18% | 13% |
| HLTH | 67% | 4% | 30% |
| ENR+MATR | 55% | 20% | 25% |
| CONDx | 74% | 17% | 9% |
| FINL | 69% | 18% | 14% |
| FANG | 25% | 75% | 0% |
| HARD+SEMI | 82% | 9% | 9% |
| CONS | 79% | 0% | 21% |
| COMMx | 38% | 13% | 50% |
| **SPX** | **67%** | **17%** | **17%** |

Source: Barclays Research, Refinitiv

Note: EPS surprise = actual EPS minus consensus normalized by price 1-day prior to report. A Beat/Miss = EPS surprise greater/less than 0.2%/-0.2%.

FIGURE 3

**The current SPX EPS Surprise of 4.4% is consistent with the post-crisis median**

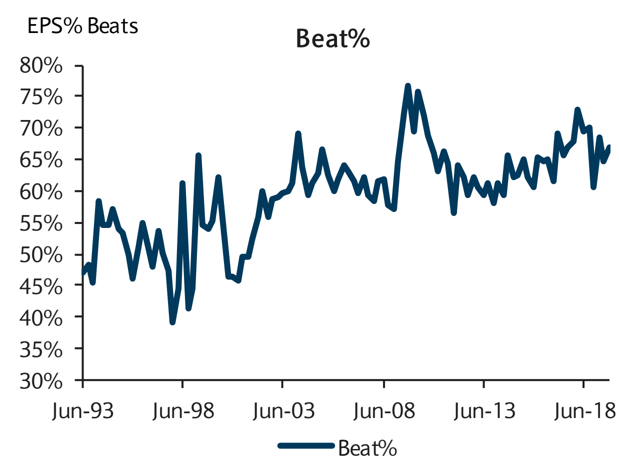



Source: Barclays Research, Refinitiv

Note: Quarters with EPS Surprise greater than +/-20% are excluded.

FIGURE 4

**The % of companies beating expectations is slightly higher than normal, but below levels seen in 2018**



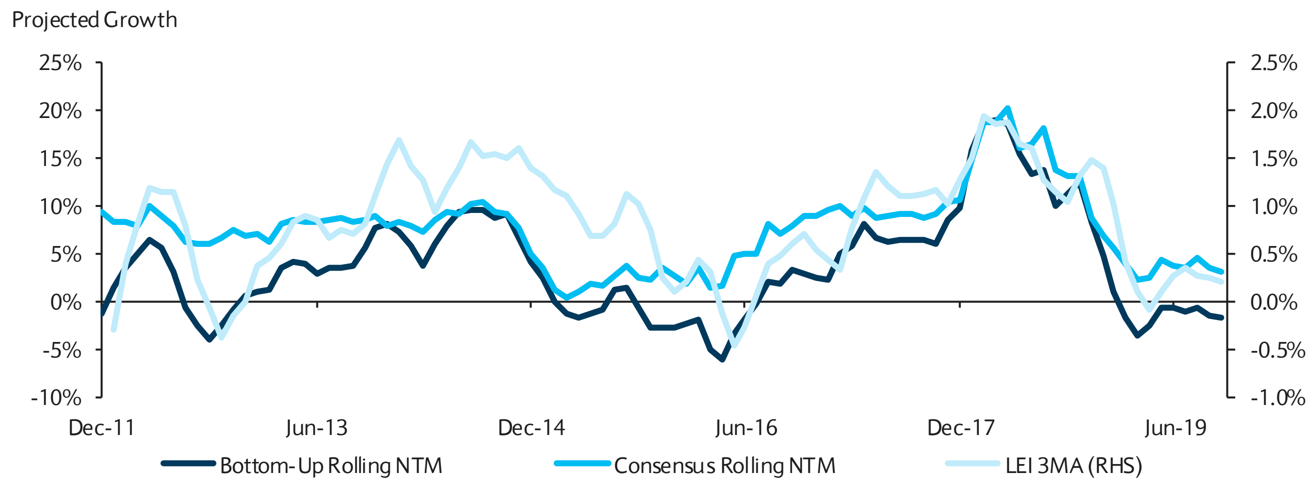

Source: Barclays Research, Refinitiv

## Bottom-up model projections decline due to weaker consensus and LEI

*Our bottom-up model forecasts S&P 500 earnings by starting with bottom-up sell-side analyst consensus forecasts and adjusts them for the current economic environment using the moving average of 3M returns of the Leading Economic Index (LEI 3MA)*

FIGURE 5

**S&P 500 consensus earnings projections fell last month, pushing our NTM bottom-up projections lower**




Source: Barclays Research, Refinitiv

Note: LEI 3MA, which is the 3M moving average of the LEI 3M Change, is lagged by one month to account for reporting lag

- Our bottom-up NTM S&P 500 EPS Growth projections declined in September (from -1.5% to -2.0%), its lowest point since April this year. The decline in our model projections was primarily driven by lower consensus projections (contribution of -0.4%), as the smoothed 3M LEI was relatively unchanged.
- Figure 6 shows a formal attribution of the components of our bottom-up model, on both an NTM basis and for a fixed calendar period (2019Q3–2020Q2). Our bottom-up model forecast for the 2019Q3–2020Q2 period fell by -0.4% over the last month, adding to declines seen over the last 6M (-1.5%). The recent declines have been primarily driven by a decline in consensus expectations, while the 6M change in our projections has been driven by both lower consensus expectations as well as the interaction between LEI and consensus expectations.

FIGURE 6

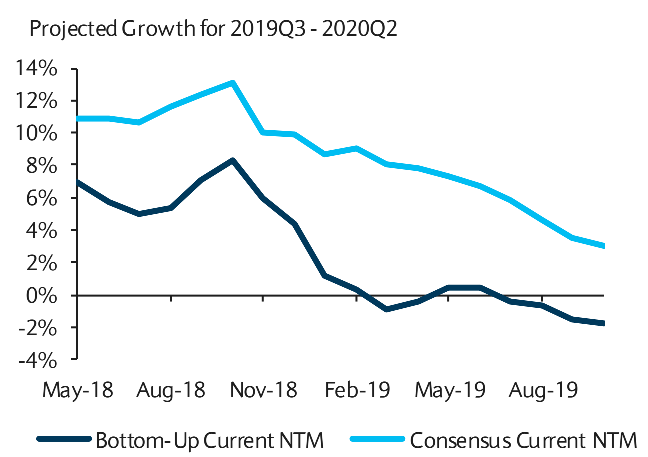
**Our NTM bottom-up projections for the current calendar period have fallen over the last 6M**

| Contribution to Bottom Up Model Projections | | | | | |
|---|---|---|---|---|---|
| | Actuals | 2019Q3 - 2020Q2 | | Rolling NTM | |
| | Current | 1M Chg | 6M Chg | 1M Chg | 6M Chg |
| Consensus | 2.7% | -0.4% | -0.8% | -0.4% | 0.1% |
| LEI 3MA | 0.2% | 0.0% | 0.3% | 0.0% | 0.5% |
| Interaction | NA | 0.0% | -1.1% | 0.0% | 0.0% |
| Total | NA | -0.4% | -1.5% | -0.4% | 0.5% |

Source: Barclays Research, Refinitiv

FIGURE 7

**The gap between consensus projections and our Bottom-Up model has narrowed over the last 6M due to a stabler LEI**




Source: Barclays Research, Refinitiv

## Current economic forecasts call for improving inflation and industrial production

*In this section we discuss the current economic forecasts that are used as inputs to our top-down EPS model, as well as their contribution to the top-down EPS model forecasts*

- The current forecasts from the Barclays economic research team (see *US Country Snapshot, 10/25/2019*) point to three trends in the next year: 1) improving inflation numbers into 1H20, 2) improving industrial production numbers through 2020, and 3) stability in private consumption and investment, as well as the unemployment rate.

FIGURE 8

**Current Barclays Economic Forecasts**

| Current Forecasts | 18Q3(A) | 18Q4(A) | 19Q1(A) | 19Q2(A) | 19Q3 | 19Q4 | 20Q1 | 20Q2 | 20Q3 | 20Q4 |
|---|---|---|---|---|---|---|---|---|---|---|
| Core PCE price index (% y/y) | 2.0 | 1.9 | 1.6 | 1.6 | 1.7 | 1.7 | 2.0 | 2.0 | 2.0 | 2.0 |
| CPI Inflation (% y/y) | 2.6 | 2.2 | 1.6 | 1.8 | 1.8 | 1.8 | 2.0 | 1.9 | 1.9 | 1.9 |
| PCE price index (% y/y) | 2.2 | 1.9 | 1.4 | 1.4 | 1.4 | 1.5 | 1.8 | 1.7 | 1.8 | 1.8 |
| GDP price index | 2.0 | 1.6 | 1.1 | 2.4 | 1.9 | 1.9 | 2.0 | 2.3 | 2.2 | 1.9 |
| Industrial Production (%y/y) | 4.9 | 4.0 | 2.9 | 1.0 | 0.0 | -0.5 | 0.0 | 1.0 | 1.0 | 1.5 |
| Private consumption | 3.5 | 1.4 | 1.1 | 4.6 | 2.5 | 1.5 | 2.0 | 2.0 | 2.0 | 2.0 |
| Gross private investment | 13.7 | 3.0 | 6.2 | -6.3 | 1.0 | 1.0 | 2.0 | 3.5 | 3.5 | 3.5 |
| Public consumption and invest. | 2.1 | -0.4 | 2.9 | 4.8 | 0.5 | 1.5 | 2.0 | 2.0 | 1.0 | 1.0 |
| Unemployment rate (%) | 3.8 | 3.8 | 3.9 | 3.6 | 3.6 | 3.5 | 3.5 | 3.4 | 3.4 | 3.4 |

Source: Barclays Research
Note: Forecasts are % Q/Q unless otherwise stated

- Overall, our top-down model is calling for a strong improvement in EPS growth from 19Q3 to 20Q1, driven by expectations of improving inflation. After 20Q1, expectations of improving industrial production push our top-down EPS forecast another ~1% higher by 20Q4.
- Poor inflation forecasts (core PCE, CPI, PCE, GDP Price Index) from Barclays economists are currently contributing -3.1% to our top-down forecast of 19Q3, but stronger forecasts for future quarters shift the contribution from inflation metrics to +1.8% by 20Q1. Similarly, the Barclays economics forecast of negative industrial production for 19Q4 is a -1.4% drag on our EPS projection, but by improving IP forecasts result in a weaker negative contribution by 20Q4 (-0.3%).

FIGURE 9

**Improving inflation and industrial production projections through 2020 from Barclays economists result in our top-down model forecasts increasing from 1.1% in 19Q3 to 7.3% by 20Q4**

| Contribution to EPS Growth | 19Q3 | 19Q4 | 20Q1 | 20Q2 | 20Q3 | 20Q4 |
|---|---|---|---|---|---|---|
| Core PCE price index (% y/y) | -0.5% | -0.2% | 0.8% | 0.9% | 0.6% | 0.6% |
| CPI Inflation (% y/y) | -0.6% | -0.3% | 0.3% | 0.1% | 0.2% | 0.1% |
| PCE price index (% y/y) | -0.8% | -0.4% | 0.5% | 0.4% | 0.5% | 0.4% |
| GDP price index | -1.2% | -0.7% | 0.2% | 0.5% | 0.7% | 0.5% |
| Industrial Production (%y/y) | -1.2% | -1.4% | -1.2% | -0.6% | -0.6% | -0.3% |
| Private consumption | -0.5% | -0.5% | -0.2% | -1.0% | -1.1% | -1.0% |
| Gross private investment | -0.7% | -0.9% | -1.1% | -0.5% | -0.3% | -0.1% |
| Public consumption and invest. | -0.2% | -0.4% | -0.3% | 0.0% | -0.1% | 0.0% |
| Unemployment rate (%) | 0.1% | 0.4% | 0.7% | 0.2% | 0.3% | 0.0% |
| Total Projected EPS Growth | 1.1% | 2.4% | 6.6% | 6.7% | 7.1% | 7.3% |

Source: Barclays Research, Refinitiv

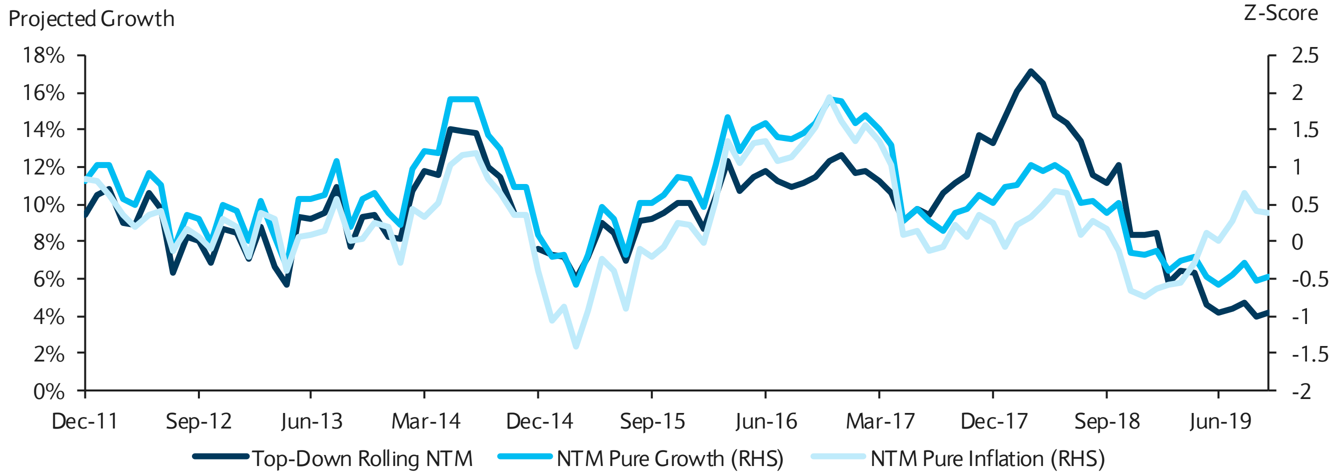
## Top-down model projections improve, but remain near post-crisis lows

*Our top-down model distils a combination of macro variables into factors that capture the growth in the U.S. economy (Pure Growth) and the US inflation adjusted for growth (Pure Inflation). We use the historical relationship between SPX EPS Growth and Pure Growth/Inflation as well as our current Barclays' economist forecasts to project forward SPX EPS growth.*

- Our top-down NTM EPS model forecast rose in October (from 3.9% to 4.1%), but still remains within striking distance of its post-crisis lows. Higher CPI and lower unemployment forecasts drove our NTM top-down model projections lower, even as private consumption and investment numbers fell slightly.

FIGURE 10

**Our NTM Top-Down model projection rose slightly this month, but remains near post-crisis lows**




Source: Barclays Research, Refinitiv

- The increase in our NTM top-down forecast was mainly driven by our NTM "Pure Growth" factor, which is a proxy for general U.S. economic growth. After falling near the 5yr low in September (Zscore of -0.52), the Pure Growth factor has rebounded slightly, but still remains near the lowest levels since the 2015/16 industrial recession.
- Our "Pure Inflation" factor, which can be thought of as inflation adjusted for growth, continued to fall this month (from 0.42 to 0.38) due to lower inflation projections for our in-house economist. This decrease in projected "Pure Inflation" added 0.1% to our top-down NTM projection, which is intuitive as inflation independent of growth is typically a drag on SPX earnings growth.
- Much like our bottom-up model, we also calculate EPS projections on both an NTM basis and for a fixed calendar period (2019Q3–2020Q2). Projections for the current calendar period moved in tandem with the current NTM, as the EPS contribution from an increases in our Pure Growth factor was complemented by the positive contribution from a lower Pure Inflation value, resulting in a 0.2% increase in the EPS forecast for the current fixed calendar period.
- Figure 12 shows although our top-down forecast for the current calendar NTM (4.1%) has been steadily declining YTD, it still remains above the consensus projection of 2.7% (and well above our bottom-up projection of -2.0%). This would indicate that while expectations of lower U.S. economic growth are a major risk factor, international economic growth remains a larger concern for SPX earnings growth.

FIGURE 11

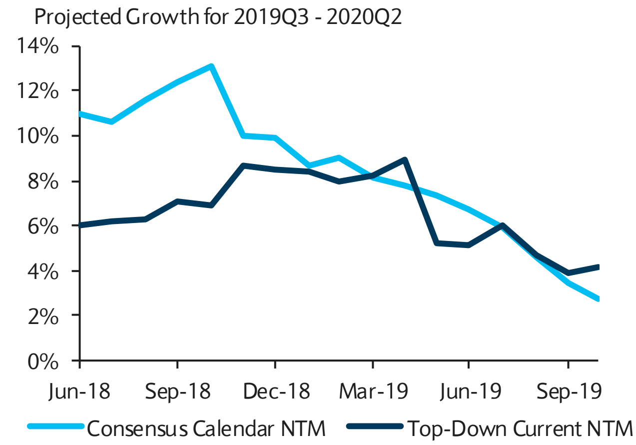
**Our NTM top-down projections rose in October due to stronger inflation and employment projections, but have fallen sharply over the last 6M**

| Contribution to Top Down Model Projections | | | | | |
|---|---|---|---|---|---|
| | Actuals | 2019Q3 - 2020Q2 | | Rolling NTM | |
| | Current | 1M Chg | 6M Chg | 1M Chg | 6M Chg |
| Pure Growth | -0.48 | 0.2% | -5.4% | 0.2% | -1.2% |
| Pure Inflation | 0.38 | 0.1% | 0.6% | 0.1% | -0.8% |
| Total | NA | 0.2% | -4.7% | 0.2% | -2.0% |

Source: Barclays Research, Refinitiv

FIGURE 12

**Our top-down projection for the current calendar NTM has seen steady declines YTD, it still remains above consensus expectations**



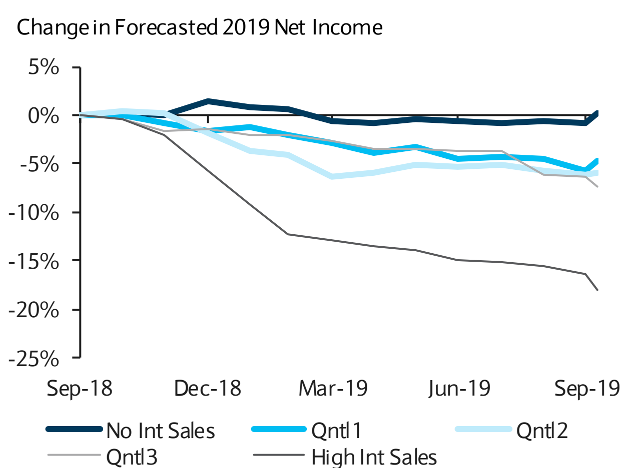

Source: Barclays Research, Refinitiv

## Stocks with high international exposure see strongest downward revisions since February

- Declining consensus expectations for 2019 continue to be primarily driven by concerns over a slowdown in non-U.S. economies.
- Companies with the highest levels of international sales (High Int Sales) have seen their 2019 Net Income expectations decline by 18.1% since 9/2018, compared to an 0.1% increase for stocks with no international exposure (No Int Sales). High Int Sales companies have been responsible for 55% of the decline in consensus since 9/2018.
- High Int Sales 2019 net income expectations fell sharply in October (-2.1%), the largest decline since February this year. Overall there was a strong correlation between international sales and downward 2019 EPS revisions, as second highest quartile (Qntl3) of international sales also saw strong downward revisions (-1.1%), while stocks with low international sales (No Int Sales) and low Int Sales (Qnt1) saw ~1% increase in projected 2019 earnings. We believe this points to an increase in optimism in the U.S. economy relative to the rest of the world.

FIGURE 13

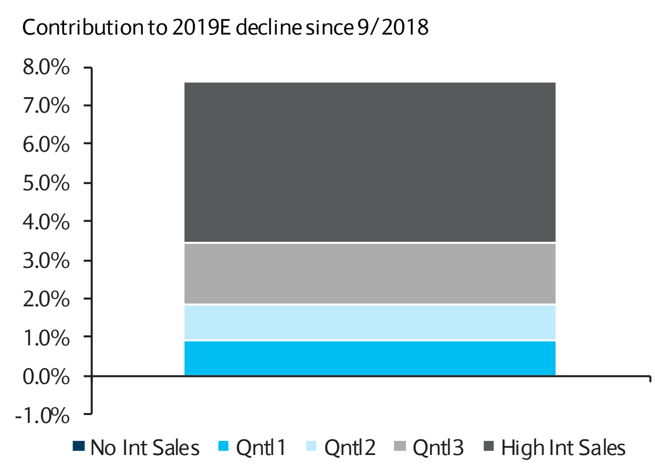
**Companies with high international sales continued to see declining earnings expectations in October …**




Source: Barclays Research, Refinitiv

FIGURE 14

**… while companies with little to no international sales exposure saw an increase in forecast 2019 earnings**



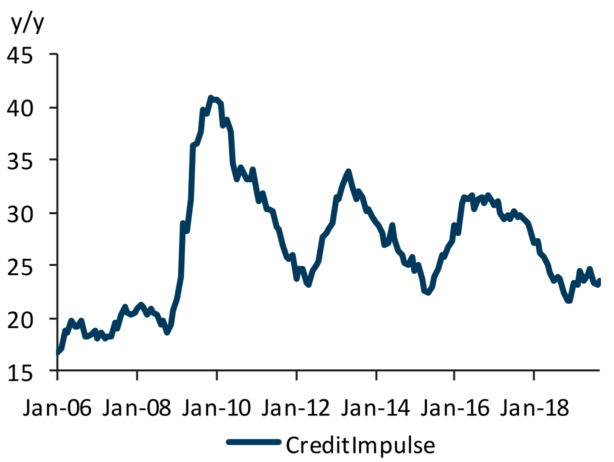

Source: Barclays Research, Refinitiv

## Chinese credit and economic growth see slight improvement, but remains weak

- The Chinese credit cycle has been the primary driver of the slowdown in non-US macro growth, especially EM growth and earnings growth for internationally focused U.S. companies. While the policies implemented by Chinese policymakers stabilized credit growth (Figure 15), credit impulse data and key economic indicators (Figure 16) have moderated over the last three months, indicating a soggier soft patch.
- Chinese equities earnings growth are more driven by trade than domestic factors. Imports/Exports remain weak (Figure 17), and escalation of U.S.-China trade war tensions could further weigh them down. Interestingly, imports have continued to decline YTD with exports almost flat as opposed to prior troughs due to China's policy measures being more domestically oriented and limiting the amount of pass-through to the rest of the world.
- A model based on growth in net exports, rail volume and bank loans does an excellent job at predicting NTM earnings growth for Chinese equities. However, the actual LTM EPS yoy growth has recently surprised to the downside at -3.6%, much lower than the model-predicted growth of 8.6% (Figure 18).

FIGURE 15

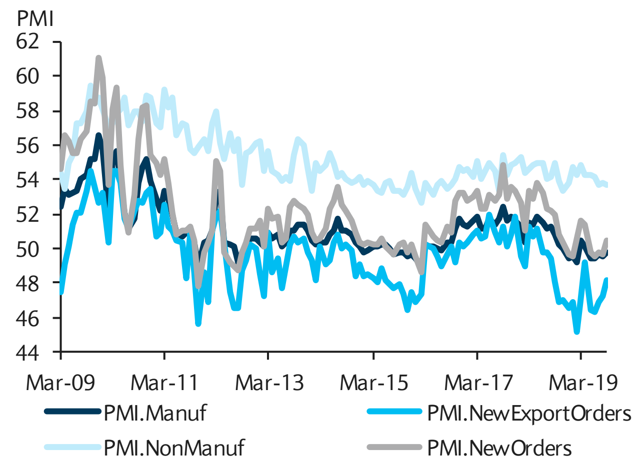
**A rebound in the China credit cycle is not definitive, due to the decline in credit impulse in recent months**




Source: Barclays Research, Bloomberg

FIGURE 16

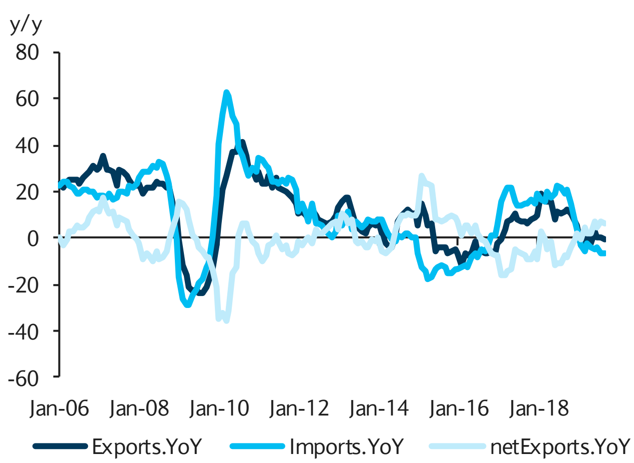
**NBS PMI also saw improvement last month, but remains weak**




Source: Barclays Research, Bloomberg

FIGURE 17

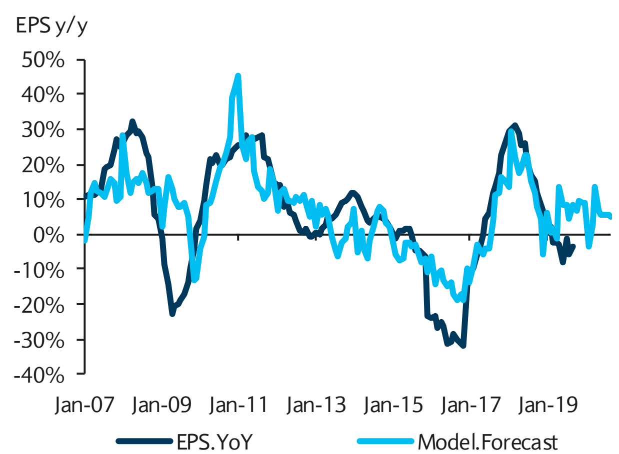
**While China imports/exports are already in negative territory, U.S.-China trade tensions could make things worse**




Source: Barclays Research, Bloomberg

FIGURE 18

**Model predicted earnings growth saw a moderate rebound in October**




Source: Barclays Research, Bloomberg

## High International Sales Basket

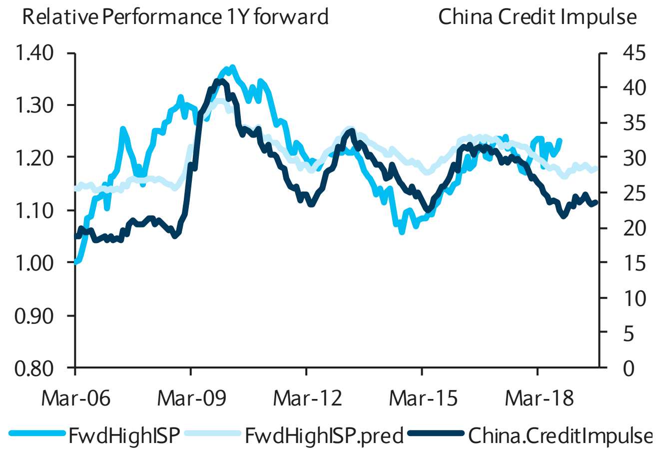
### Rationale

To quantify the non-U.S. economic impact on U.S. equities, we monitor the performance of equities with the high international sales exposure (high ISP). There is a strong correlation between the China Credit Impulse lagged by 1Yr and the performance of the high ISP basket, indicating that the China credit cycle is a strong predictor of the future performance of stocks with high international exposure.

Figure 19 shows the performance of high ISP basket relative to the SPX, the China credit impulse lagged by one year, as well as our regression predicted value of the high ISP basket based on the China credit impulse.

FIGURE 19

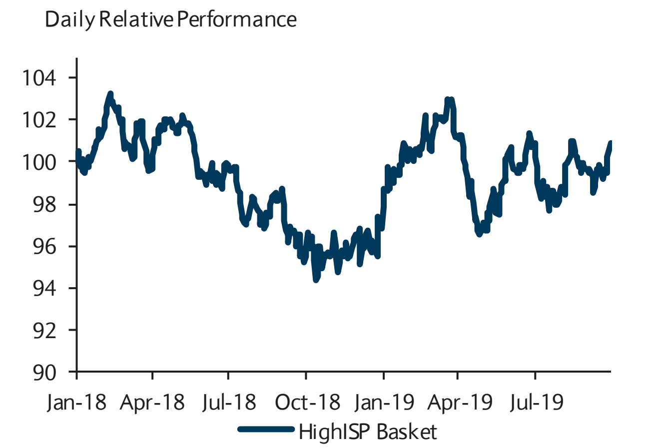
**Relative performance of stocks with high international sales tracks the China Credit Impulse with one year lag**




Source: Barclays Research, Bloomberg, Refinitiv

FIGURE 20

**The High ISP basket has increased relative to the market this month, mainly driven by gains in the last week**




Source: Barclays Research, Bloomberg, Refinitiv

### Brief Methodology

Each year at the end of March we separate all of the SPX companies with non-zero International Sales into quartiles based on International Sales Exposure (International Sales/Total Sales). The remaining companies with no International sales is our no ISP basket. The high ISP basket is the top quartile of this ranking. The high ISP basket is then equally weighted and rebalanced monthly. (See ***U.S. Equity Strategy: Binary risks,*** 7 January 2019, for more details of the methodology.)

### Commentary on Recent Performance

The high ISP basket slightly outperformed the SPX this month (+1.0%), most likely due to a continued increase in optimism surrounding a trade war resolution and an increase in expectations for global QE. The high ISP basket's performance has been very choppy YTD, oscillating between periods of trade war and global growth pessimism/optimism. However, higher ISP companies have outperformed the SPX YTD (+4.6%), indicating that trade war tensions and the fear of slowing global growth are not as prevalent as they were at the beginning of the year. Additionally, the high ISP basket performance continues to trend well above our model predicted performance, indicating the potential for further downside of ~5% relative to the SPX.

## MSCI US and EU domiciled baskets based on Geographical Sales Exposure

### Rationale

We construct a unique dataset of geographical sales exposure for stocks in the MSCI World index, which allows us take a nuanced view of geographical sales exposure. Using the dataset, we construct MSCI US and EU domiciled baskets of stocks that are most exposed to the U.S., EU and EM to benefit from the divergence between U.S. and non-U.S. economies.

FIGURE 21

**Geographical sales exposure of names in the MSCI World Index**

| | Geographical Sales Exposure | | | | | |
|---|---|---|---|---|---|---|
| Country of Domicile | % of Sales | US/Canada | Europe | Oceania | EM | Mixed |
| | US/Canada | 69.5% | 9.0% | 1.4% | 8.1% | 12.0% |
| | Europe | 21.0% | 25.0% | 1.4% | 22.3% | 30.4% |
| | Oceania | 15.8% | 3.8% | 59.3% | 13.6% | 7.5% |

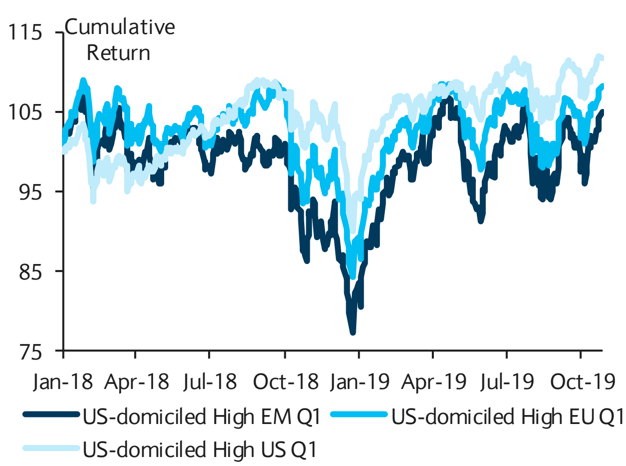
Source: Barclays Research, Bloomberg

### Methodology

While the companies report segment sales information, there is no standardized disclosure template, which makes it difficult to do a bottom-up aggregation of this data. As a result, we had to resort to a careful parsing algorithm overlaid with substantial manual overrides to standardize the geographical sales exposure across companies by bucketing them into the following regions: EM, U.S./Canada, Europe, Oceania, Foreign and Mixed. For each company, we then sum the sales of each region and normalize it with total sales of the company to get a percentage of sales exposure for that region. Finally, we use this dataset to create baskets for each domicile by ranking the companies by each geographical sales exposure and picking the top quartile for our baskets.

FIGURE 22

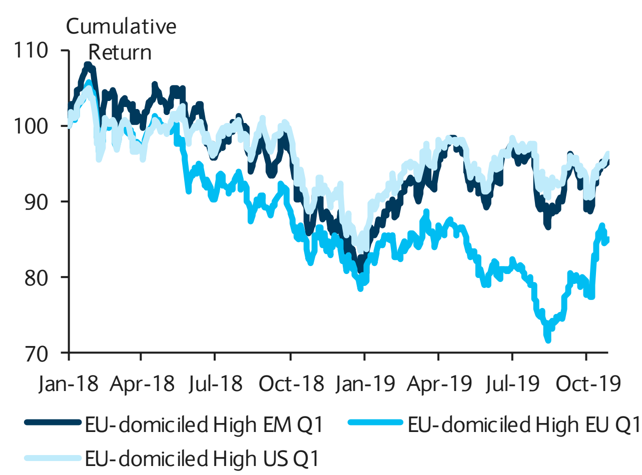
**US-domiciled stocks increased this month, but lagged EU-domiciled stocks**




Source: Barclays Research, Bloomberg

FIGURE 23

**EU-domiciled stocks with high EU exposure continued to see strong performance, but still lag YTD**




Source: Barclays Research, Bloomberg

### Commentary on Recent Performance

After strongly underperforming U.S. domiciled companies YTD, EU-domiciled companies rebounded strongly last month. EU-domiciled companies with high EU exposure had the strongest performance, followed by U.S.-domiciled High EM companies. In contrast US-domiciled High US companies had the weakest returns. The stronger performance of companies with higher non-U.S. exposure indicates that concerns over slowing international growth are dissipating, while concerns over a slower U.S. economy are inching higher.

## Trade war tensions abate

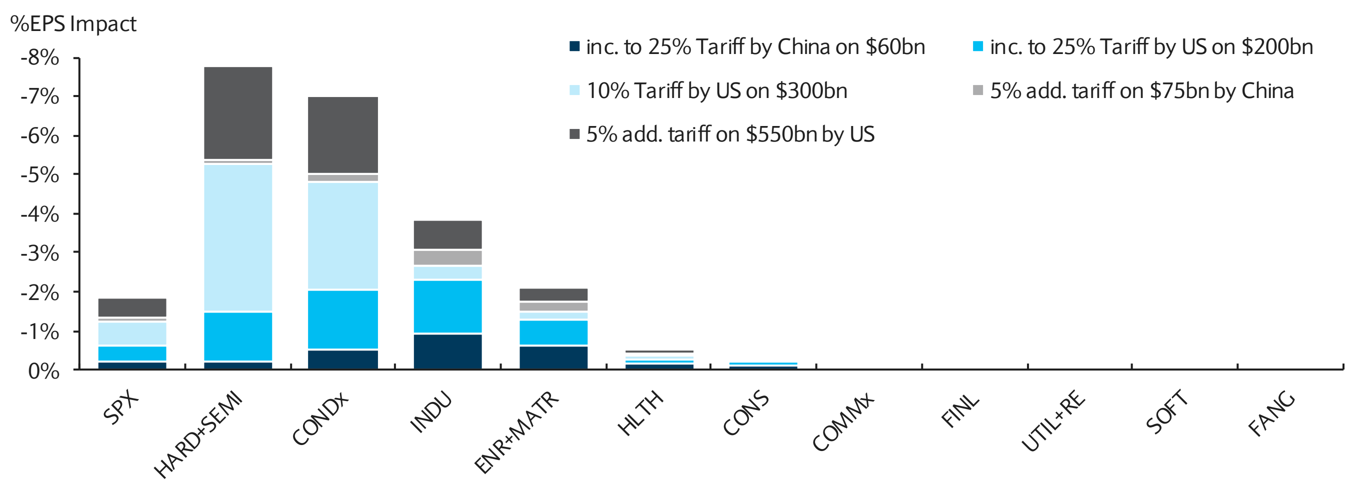
- **As the multi-front trade war continues to escalate, technology, national security and the race to control the next wave of the tech revolution have emerged as some of the key issues underpinning the trade war.** Two days of talks ended Oct. 11 with a meeting between U.S. President Trump and Vice Premier Liu He, China's chief negotiator, and the announcement that Beijing and Washington had reached a "phase one" agreement. As a result, the U.S. delayed its planned Oct. 15 tariff increase on $250 billion in Chinese goods and China committed to buying American agricultural goods. A presumed target date for a written agreement to be signed is in mid-November, when Trump and Chinese President Xi Jinping plan to meet.

- Markets, however, remain on edge as any number of issues could cause another escalation. The easing of restrictions on Huawei was not part of the “phase one” deal. Additionally, the partial deal doesn't cover most of the difficult structural issues such as China's industrial policies, intellectual property protections, and government subsidies to its economy or an enforcement mechanism. The current temporary licenses that Washington has issued for some of Huawei's U.S. partners expires on Nov. 18.

- Using our bottom-up framework (see *US-China trade war flares up again, 9 May 2019*), we estimate that the net impact on overall S&P 500 earnings is relatively modest at ~1.8% (Figure 24), although Consumer Discretionary, Information Technology, Industrials and Materials are the most affected.

FIGURE 24

**Hardware + Semis and Consumer Discretionary are most exposed to further trade war escalation**




Source: US Census Bureau, BEA,10-K filings of S&P 500 companies, Bloomberg, Barclays Research

FIGURE 25

**Concerns of trade war remain as any number of issues could cause another escalation**


Source: trends.google.com

# Tracking the U.S.-China trade war

## Rationale

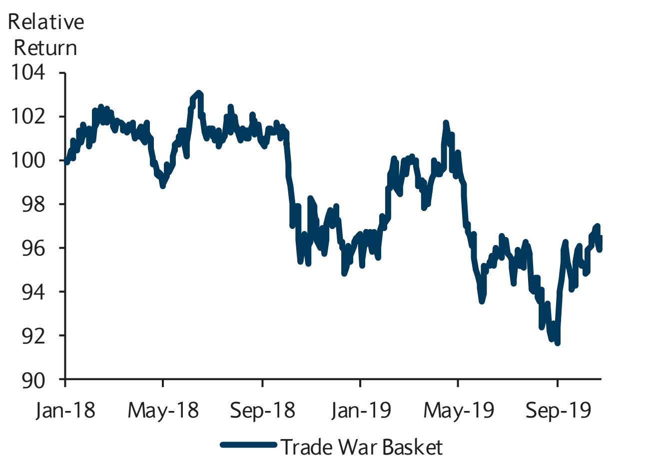
We construct a basket of stocks that are most exposed to the U.S.-China trade war, which we believe are likely to underperform if trade tensions escalate further.

## Methodology

Since companies do not uniformly report actual imports and exports, we estimate these metrics for each S&P 500 company by leveraging trade and input-output data from U.S. Census Bureau and Bureau of Economic Analysis (BEA) respectively for the entire U.S. economy. We use the 5-digit level NAICS classification, which gives a better estimate of these ratios for each company. Our construction methodology selects the 25 NAICS industries that are most exposed to US-China trade and then includes all names in those industries irrespective of their profitability margins. We are agnostic to profitability margins as U.S. companies have responded to tariffs by sharing the higher costs with their customers and suppliers or shifting their supply chain and production to other low cost countries instead of bearing the full impact on their margins.

FIGURE 26

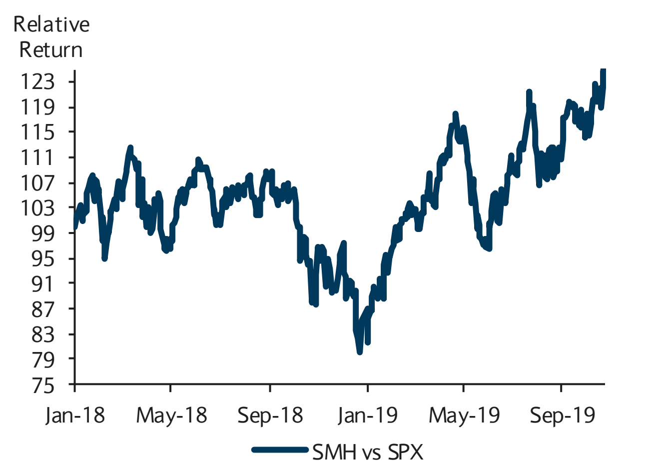
**Stocks exposed to US-China trade war saw a slight increase this month, but have rallied strongly since early September**




Source: Bloomberg, Barclays Research

FIGURE 27

**Semiconductor stocks are at YTD relative highs vs the SPX, indicating that the market does not believe that export restrictions to China will materialize**




Source: Bloomberg, Barclays Research

## Summary of Recent Performance

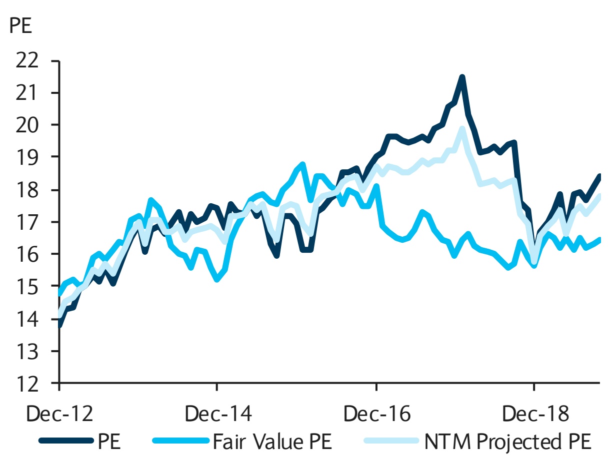
The U.S.-China trade war basket was in line with the market this month (+0.4%), as initial trade war tensions gave way to optimism over advances in a trade deal in the last week. The U.S.-China trade war basket has now outperformed the market by 5.3% since early September lows, which the U.S. announced additional tariffs of 5% and 10% were announced for $75bil in goods. While recent returns have been strong, the relative performance of the trade war basket is still well below highs seen in 18Q4, indicating that the market does not believe we are anywhere near a full resolution. In contrast, semiconductor names are at YTD relative highs vs the SPX, indicating that restrictions on exports to China for semiconductor companies are unlikely to materialize.

## P/E Model Update: Fed Put keeps valuations well above fair value

- The re-emergence of the Fed put has led to a continued premium between equity valuations and our estimate of fair value (18.4x vs. 16.5x), which has risen from levels at the beginning of the year (15.7x) and one year prior (16.4x). Our fair value PE represents the value the SPX PE dictated by the macro environment, namely CPI, CPI volatility, Industrial Production, and rates (see *U.S. Equity Strategy: SPX 2900 – This is How We Get There*, 6/11/18).
- The SPX fair value PE rose slightly this month, primarily due to a rebound in the 10Yr Yield (+0.1x), as well as a decline in industrial production (+0.17x) and inflation (+0.04x). In contrast, higher inflation volatility detracted from the fair value (-0.14x). Over the last year lower inflation and industrial production has supported the fair value PE, cancelling out the negative effects of lower yields and higher inflation volatility which has kept the overall fair value relatively range bound between 15.5x and 16.5x.
- Our current view is that in the near term, the Fed will continue to follow market expectations, with one additional rate cut in 2020. Although we believe that we are still entering an economic "soft patch" as opposed to a full recession (see *U.S. Equity Strategy: Melt-up scenario now the base case, 7/3/2019*), risks to the downside have increase. Thus, while our base case is that an economic soft patch and dovish fed will continue to keep SPX valuations above fair value, there is a non-trivial downside risk of a recession.

FIGURE 28

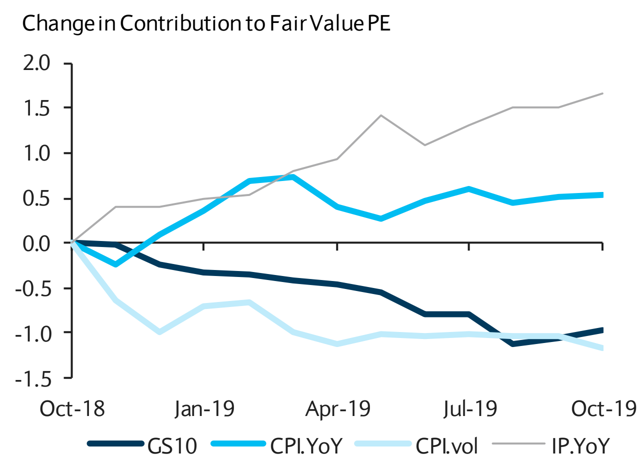
**Our fair value of SPX PE rose this month …**




Source: Barclays Research, Refinitiv

FIGURE 29

**… due to an increase in the 10Yr yield and decline in industrial production**



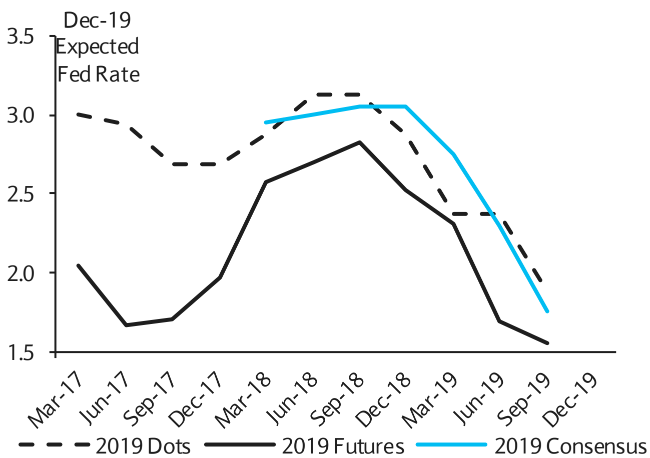

Source: Barclays Research, Refinitiv

# Fed Commentary Page

- After the cut in October, the third this year, Fed fund futures are now a low probability of a cut in 2019 but an additional 25-50bps by 2020 (as opposed to 50-75bps at the end of September). Currently, the futures market is pricing in a 25% likelihood of an additional cut by the end of the year.
- Fed Chair Powell stated that the stance of the policy was now "appropriate" for the economy and that inflation was nearing the 2% target for the Fed. However, any further escalation in the U.S.-China Trade War or slowing non-US growth could push the Fed back to a more dovish stance.

FIGURE 30

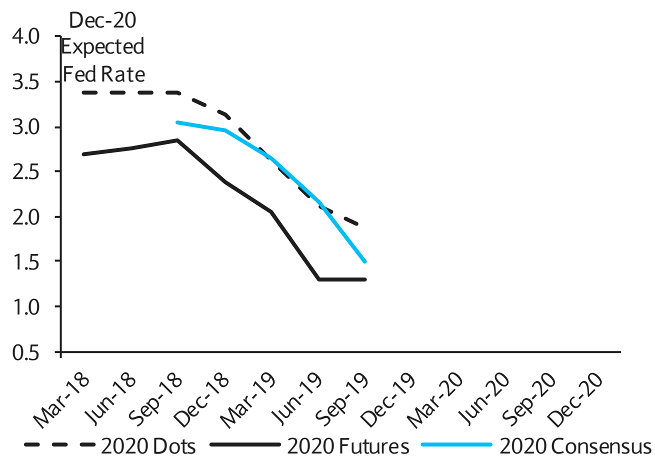
**While Fed dot plot and consensus call for no additional cuts in 2019, as do Fed Fund Futures**




Source: Barclays Research, Bloomberg

FIGURE 31

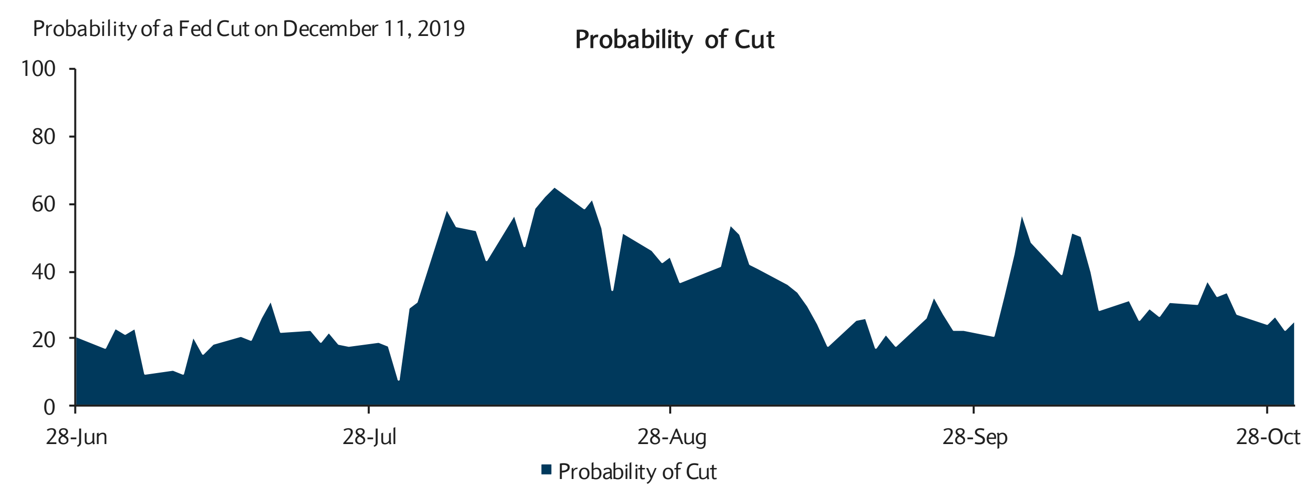
**While Fed dot plot calls for no additional cuts in 2020, consensus and Fed fund futures are projecting one two additional cuts in 2020**




Source: Barclays Research, Bloomberg

FIGURE 32

**There is ~25% probability of a cut in December**




Source: Barclays Research, Bloomberg

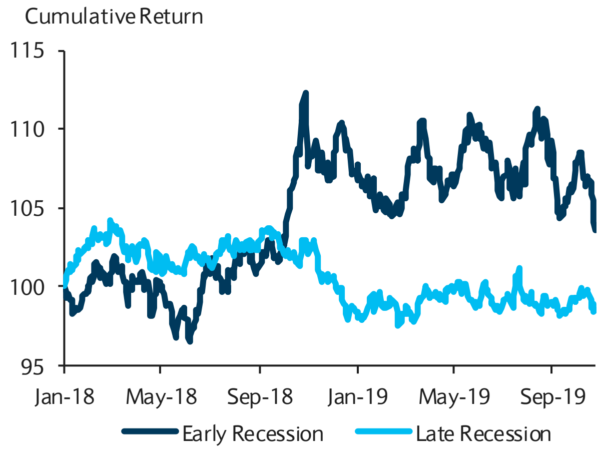
# Business Cycle Stages Optimized Baskets

## Rationale

We construct optimal sector baskets for each stage of the expansion (early, middle, late) and recession (early, late) best suited for each stage of the business cycle. Recent price performance of these baskets also gives some indication of market pricing of the stage of the business cycle.

FIGURE 33

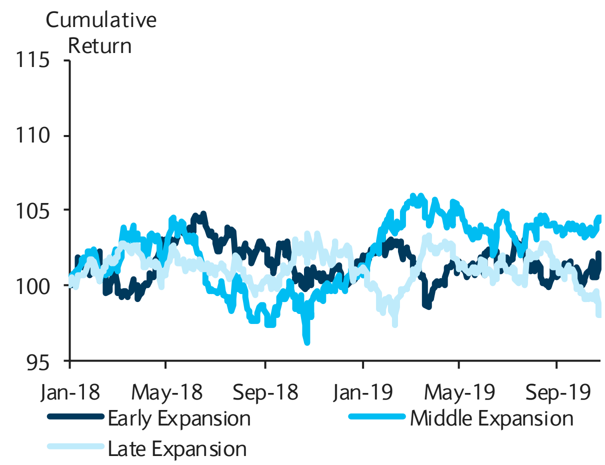
**The early recession basket fell sharply in October and is down ~4% YTD …**




Source: Barclays Research, Bloomberg

FIGURE 34

**… while the middle expansion portfolio was the best performing portfolio for the month and YTD, indicating a rotation out of defensives into cyclicals**




Source: Barclays Research, Bloomberg

## Brief Methodology

We use mean-variance optimization of 90 years of industry return data over 17 business cycles to determine long/short industry weights for each stage of the business cycle. These are then mapped to individual stocks within the S&P 500 to construct optimized baskets (see ***U.S. Equity Strategy: Optimal Sector Allocation Across the Business Cycle***, 11 June 2018, for more details of the methodology). In general, the early recession portfolio is long defensive industries and short cyclical industries. Figure 33 and Figure 34show the performance of the optimized portfolios for each cycle stage, with weights rebalanced daily.

## Commentary on Recent Performance

The early recession portfolio (-2.6%) and late expansion portfolio (-1.7%) underperformed significantly this month (-2.6%), while the early expansion (+1.0%) and middle expansion (+0.8%) optimized portfolios saw strong outperformance. This pattern indicates a rotation away from defensive industries (early recession, late expansion) into cyclical industries (early/middle expansion). Given the rise in optimism over a trade war deal, rising long-term yields, and the SPX reaching new all-time highs, it is no surprise that defensive stocks saw strong underperformance.

Additionally, the underperformance of the early recession portfolio leaves it as the second best performing portfolio since early 2018 after the middle expansion portfolio. The middle expansion portfolio is also the best performer YTD (+3.0%), indicating that risk aversion has significantly subsided since the beginning of the year. While concerns over the U.S-China trade war and slowing non-US growth persist, the market seems to be looking past these headwinds to continued improvements in the U.S. economy.

# Sector View Summary

We use a multi-pronged approach for our sector ratings, where we marry our quantitative framework for price appreciation, the allocations of our optimal business cycle stage baskets, downside risk exposure due further escalation of U.S.-China trade war, performance in previous soft patches accompanied by aggressive Fed easing and Industry specific factors including any industry cycles, secular trends like disruptive innovation, government policies, or other idiosyncratic factors affecting the sector. We use our bottom-up model for EPS projections because the top-down model does not capture the effects of the slow-down in non-US economies and this is the dominant factor affecting U.S. companies currently through their international sales.

FIGURE 35

**Current Sector NTM tracking forecasts based for Quantitative Model**

| Model Tracking Projections for Next 12 Months (2019Q3 - 2020Q2)* | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| NTM EPS Growth | | | | | | | P/E Ratio | | Return |
| Sector Mnemonic | Consensus Bottom-Up | Barclays Bottom-Up | Top-Down Model | Bottom-Up Model | Tariff Impact | Final Fcast | Current | Final Fcast | Final Fcast |
| HLTH | 4.9% | 5.3% | 10.1% | 7.5% | -0.3% | 7.3% | 16.0 | 15.8 | 6.3% |
| SOFT | 8.6% | 8.2% | 9.7% | 9.1% | 0.0% | 9.1% | 26.5 | 25.1 | 3.2% |
| FINL | 5.0% | 4.8% | -20.1% | -2.6% | 0.0% | -2.6% | 13.3 | 13.9 | 2.2% |
| COMMx | 1.4% | 2.3% | 2.8% | -1.9% | 0.0% | -1.9% | 14.5 | 14.9 | 0.7% |
| CONS | 3.3% | 3.1% | 8.2% | 3.1% | -0.2% | 2.9% | 20.4 | 19.8 | -0.2% |
| SPX Wgt Sum | 3.1% | 2.8% | 3.4% | 1.2% | -0.9% | 0.3% | 18.4 | 18.1 | -1.0% |
| INDU | 8.0% | 6.6% | 4.5% | 4.3% | -1.9% | 2.4% | 18.1 | 17.5 | -1.1% |
| CONDx | 5.5% | 5.9% | 0.9% | -0.5% | -3.5% | -4.0% | 17.9 | 17.7 | -4.9% |
| UTIL+RE | 0.3% | 0.7% | 0.0% | -1.3% | 0.0% | -1.3% | 27.3 | 25.6 | -7.5% |
| ENR+MATR | -7.9% | -5.1% | 2.3% | -13.3% | -1.0% | -14.4% | 16.5 | 17.3 | -10.6% |
| HARD+SEMI | -1.7% | -2.7% | 3.7% | -1.7% | -3.9% | -5.6% | 17.6 | 16.6 | -10.7% |

Source: Barclays Research, Refinitiv, Bloomberg

FIGURE 36

**Sector Allocation: A multi-pronged approach (as of 9/12/2019)**

| Sector Recommendations | | | | | | | |
|---|---|---|---|---|---|---|---|
| Sector | Sector Mnemonic | Price Upside Model | Optimized Cycle Allocation | Soft Patch Allocation | Trade War | Industry Specific Factor | Final Allocation |
| Software | SOFT | — | — | ▲ | | ▲ | OW |
| FANG (Internet) | FANG | ▲ | | | | ▼ | OW |
| Healthcare | HLTH | ▲ | ▲ | ▲ | | ▼ | OW |
| Industrials | INDU | — | ▼ | ▲ | ▼ | | MW |
| Consumer Staples | CONS | — | ▲ | ▼ | | | MW |
| Consumer Discretionary ex. FANG | CONDx | ▼ | ▼ | ▼ | ▼ | ▲ | MW |
| Communication Services ex. FANG | COMMx | — | — | — | | | MW |
| Financials | FINL | ▲ | ▼ | ▼ | | ▼ | UW |
| Energy + Materials | ENRS+MATR | ▼ | ▲ | ▲ | ▼ | | UW |
| Hardware + Semiconductors | HARD+SEMI | ▼ | ▲ | — | ▼ | | UW |
| Utilities + Real Estate | UTIL+RE | ▼ | — | — | | | UW |

Source: Barclays Research. OW = Overweight; MW = Market Weight; UW = Underweight.

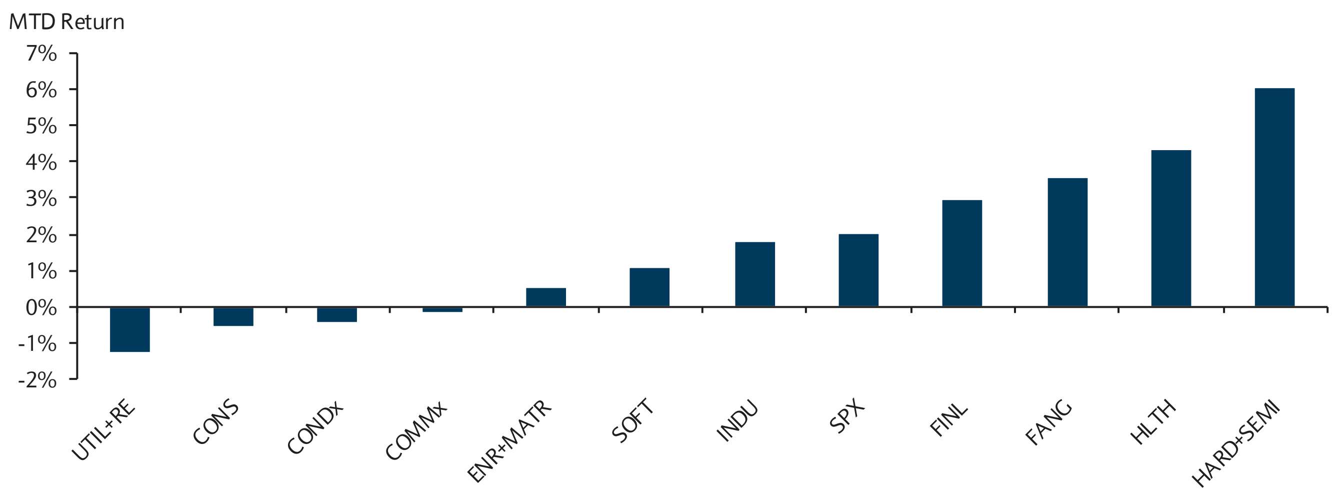
Note: Price Upside Model takes into consideration the output of our sector price projection model as well as manual overrides to PE/EPS forecasts due to industry specific catalysts

## Detailed Sector Views

- The price performance was more dispersed across sectors in October compared to the previous month as Hardware & Semis, Healthcare, FANG outperformed and Utilities, Consumer Staples, Consumer Discretionary ex FANG, Communication Services ex FANG, and Energy & Materials underperformed the broader market.
- Hardware & Semis and Healthcare outperformed on a strong earnings season. Positive momentum on new Apple iPhone 11 demand in international markets as a result of a price cut to last year's best-selling iPhone XR and strong earnings by INTC and NVDA buoyed the Hardware & Semis sector. Healthcare stocks rebounded after the selloff last month as a result of strong earnings from biopharma (BIIB, PFE) and health care services (UNH, ANTM) companies.
- FANG rebounded as concerns of increased regulatory overhang on the group eased this month after escalating last month (as a result of Senator Warren's rise in national polling data in September). We view the bar to prove consumer harm to be quite high under current U.S. antitrust law, and believe that new Congress legislation will be needed to challenge the business practices and organizational structure of big tech.
- Utilities & Real Estate and Consumer Staples underperformed as valuations receded from the highs of 28.1x and 20.7x, respectively, with 10-year Treasury yields appreciating 20 bps; however, they are still much higher than 2016 levels, when 10-year Treasury yields were lower than they are now.
- Consumer Discretionary ex FANG underperformed, mostly driven by lacklustre earnings from restaurants (MCD, CMG) this month.
- Communication Services ex FANG underperformed on concerns of increased competition for content with the impending launch of OTT services including Disney+, HBO Max and Apple TV+. The media and telecom companies are trying to adapt to the internet's disruption of cable TV and media by moving toward vertical integration to offer content-based bundles and announcing streaming OTT services at attractive price points.
- Energy & Materials underperformed as weak manufacturing data from ISM at the end of last month led to concerns that a slowdown in global industrial activity could lead to a weak demand outlook for the sector.

FIGURE 37

**High dispersion between MTD returns across sectors**




Source: Barclays Research, Bloomberg

FIGURE 38

**Software earnings growth has been fueled by IT spending on cloud-based services and growth in electronic payments**

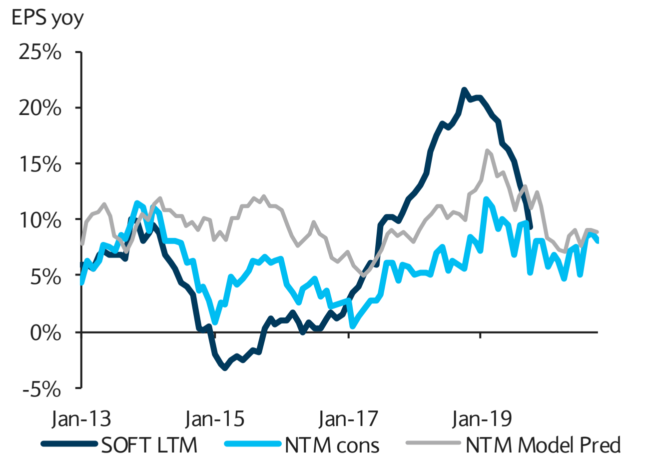



FIGURE 39

**Software trades at high valuations as the product mix moves toward cloud-based SaaS offerings**

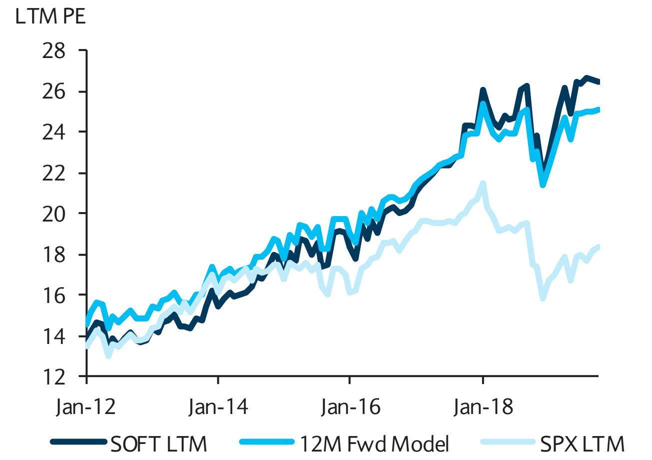



FIGURE 40

**FANG earnings growth appears to have stabilized in the last quarter although consensus expectations are conservative**

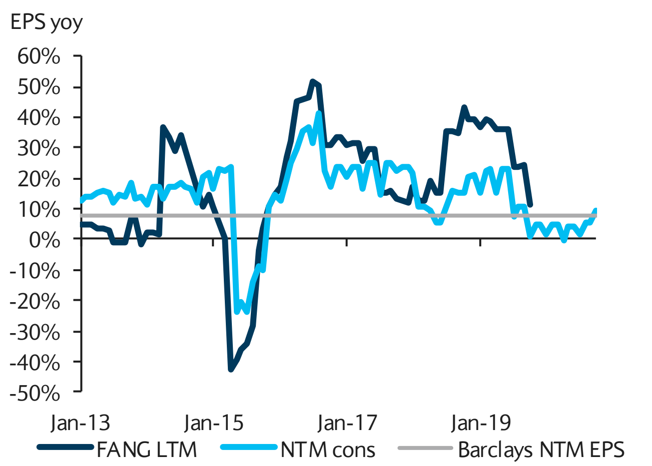



FIGURE 41

**FANG valuations already appear to be pricing a slowdown in consumer internet and the regulatory overhang on the group**

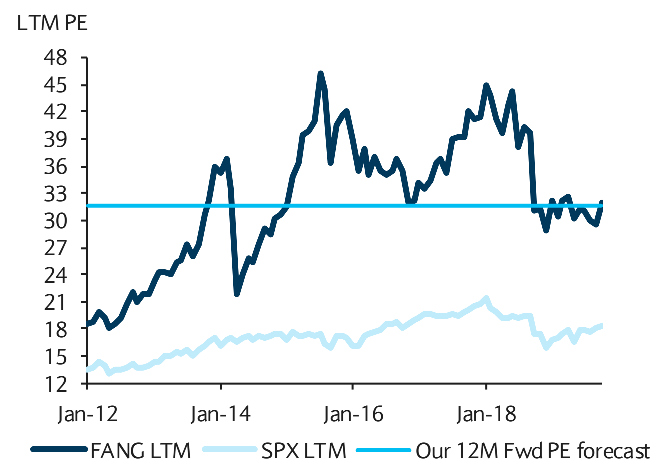



FIGURE 42

**Healthcare earnings growth is expected to weaken as patent cliff could lead to higher competition from generics**

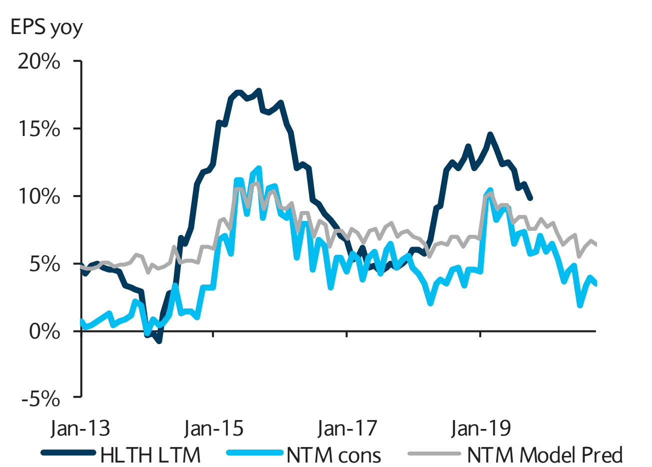



FIGURE 43

**As a result, Healthcare valuations have declined with expectations of lower growth for large-cap biopharma**

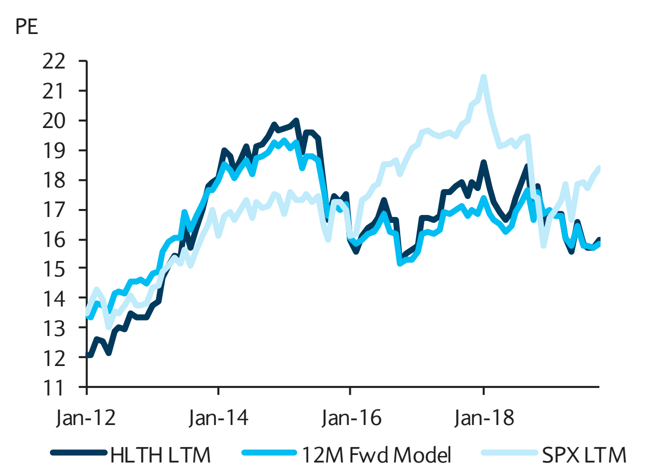


FIGURE 44

**Media and telecom companies are facing dim prospects but have tried to adapt to the evolving media landscape**

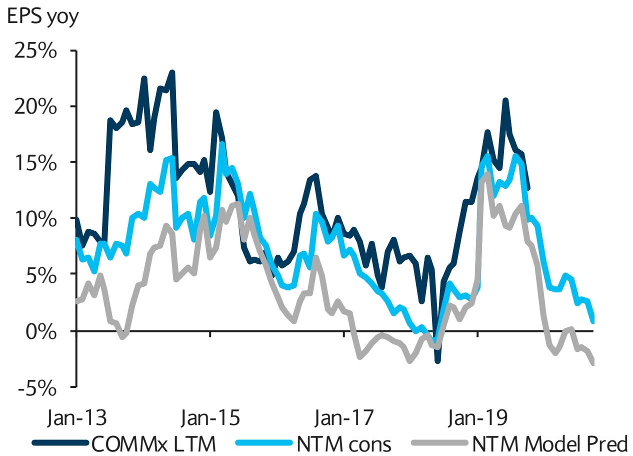



FIGURE 45

**Valuations appear to have bottomed after declining 7x in last 6 years as internet companies disrupted media and telecom**

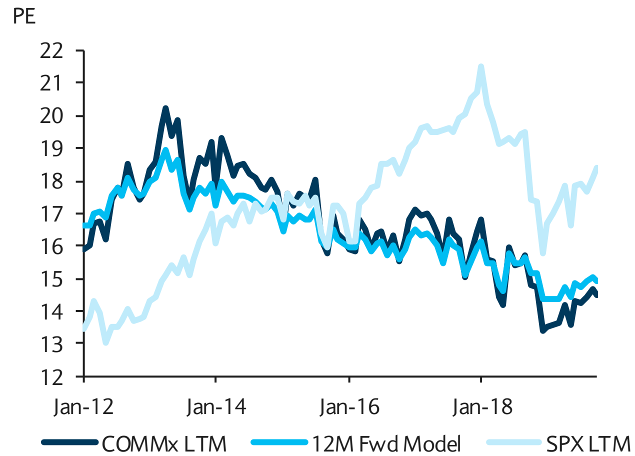



FIGURE 46

**Resilient consumer economy leads to resilient earnings growth for consumer staples**


FIGURE 47

**Low bond yields and a resilient consumer already appear to be priced in high valuations of consumer staples**

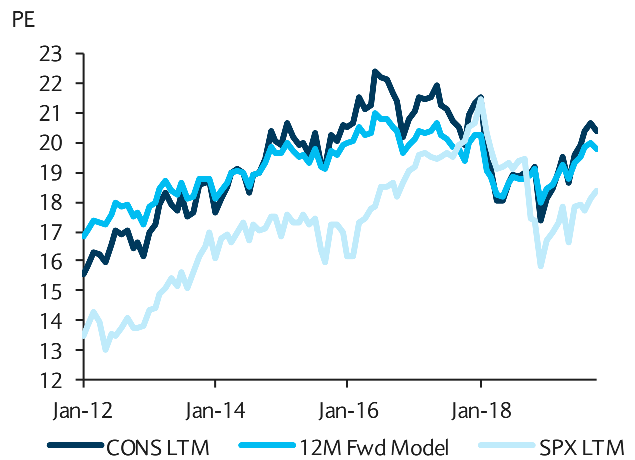



FIGURE 48

**Resilient consumer economy leads to resilient earnings growth for consumer discretionary**

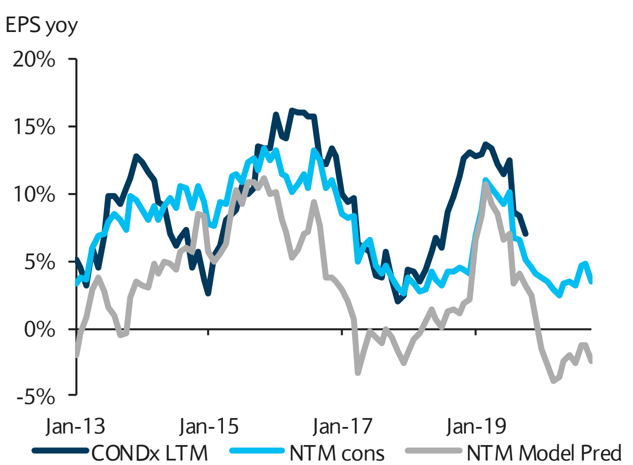



FIGURE 49

**A resilient consumer economy already appear to be priced in high valuations of consumer discretionary**

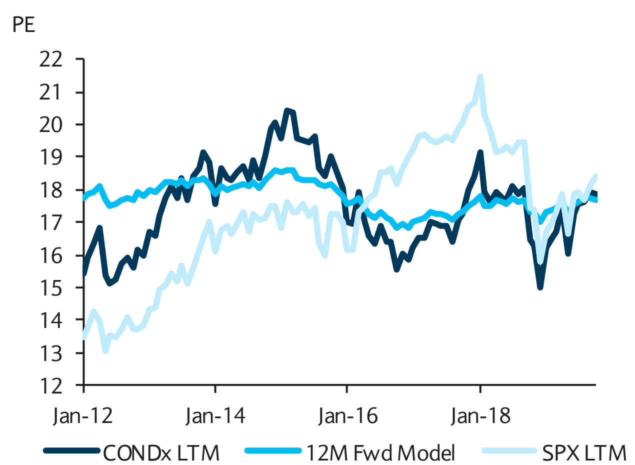


FIGURE 50

**Consensus forecasts a rebound in industrials' earnings growth but we are more cautious**

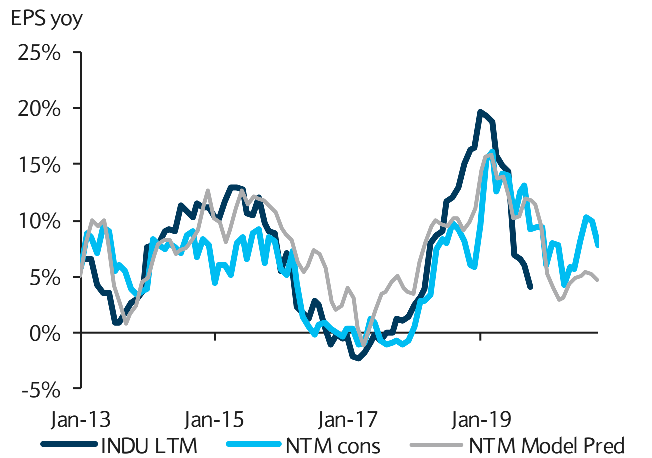



FIGURE 51

**While industrials valuations are in line with SPX, our model forecasts lower valuations due to industrial softness**

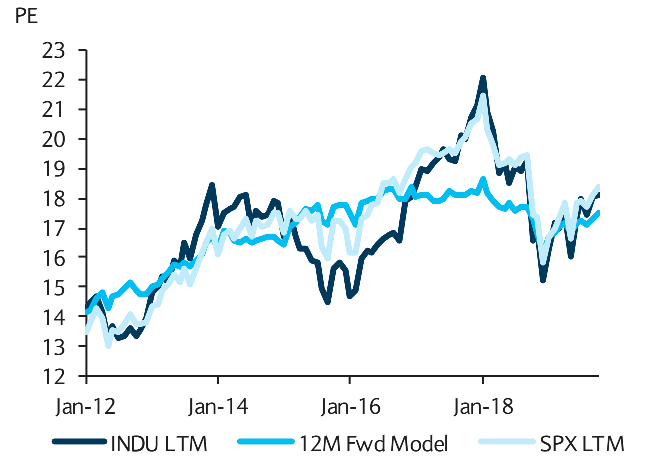



FIGURE 52

**Our forecast is optimistic for Hardware+Semis as we expect current semiconductor down-cycle to be shallow**

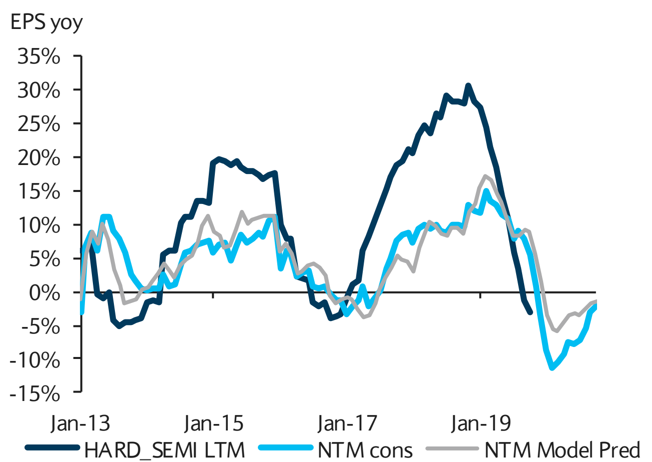



FIGURE 53

**While Hardware+Semis valuations are cheap, their discount to SPX valuations is trading at historical average**

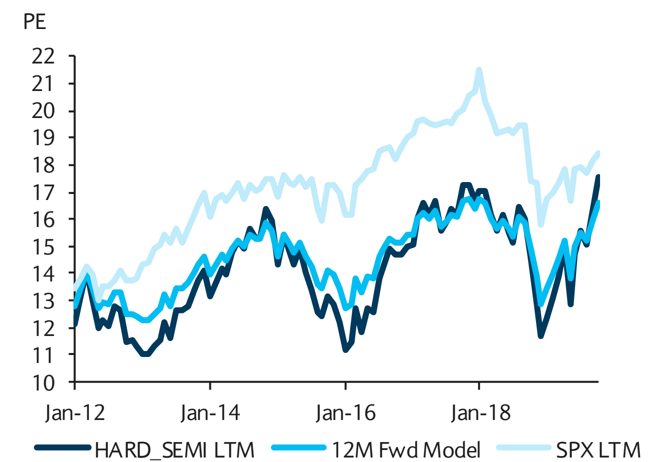



FIGURE 54

**Our model forecasts for Utilities+Real Estate are more conservative than consensus expectations**

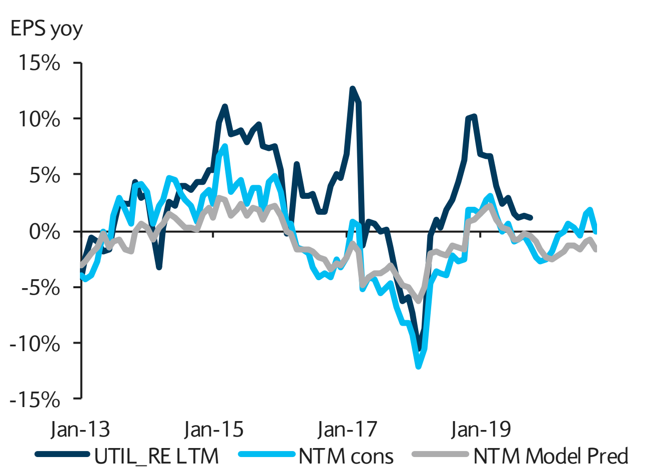



FIGURE 55

**Our model forecasts a mean reversion in valuations of Utilities+Real Estate as they approach all-time highs**

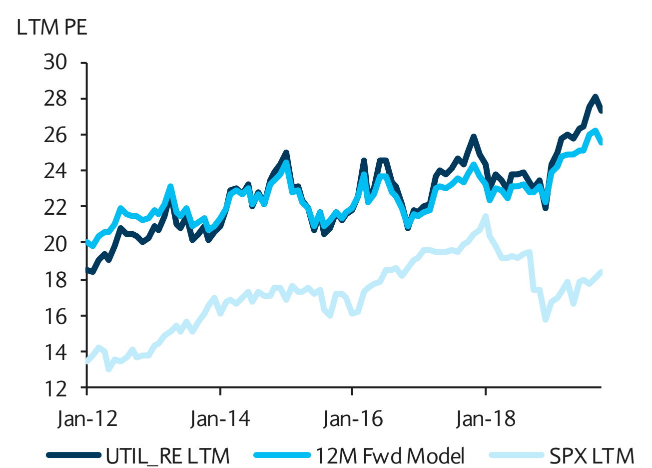


FIGURE 56

**While consensus earnings expectations call for a slowdown in Financials earnings growth, our model is more conservative given the weak macro environment**

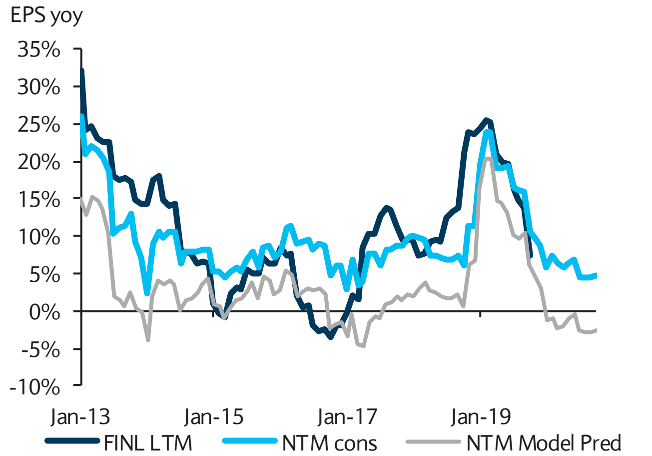



FIGURE 57

**While our model forecast calls for a mean reversion in valuations of Financials, we adjust it to current valuations given the low rate environment**

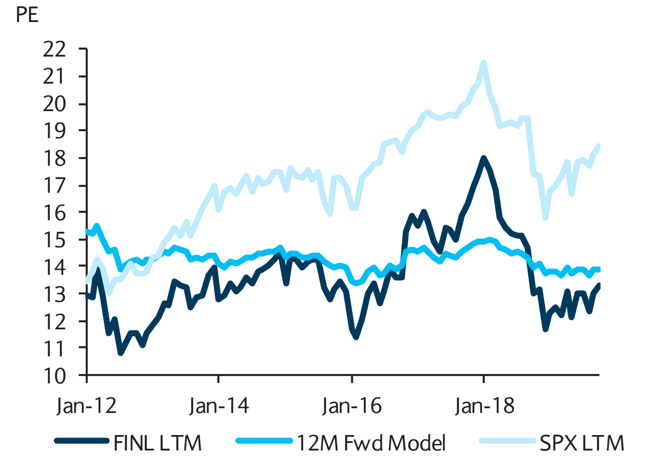



FIGURE 58

**Consensus expectations for Energy+Materials call for no earnings growth due to low demand environment and negative outlook for oil prices and chemical commodities**

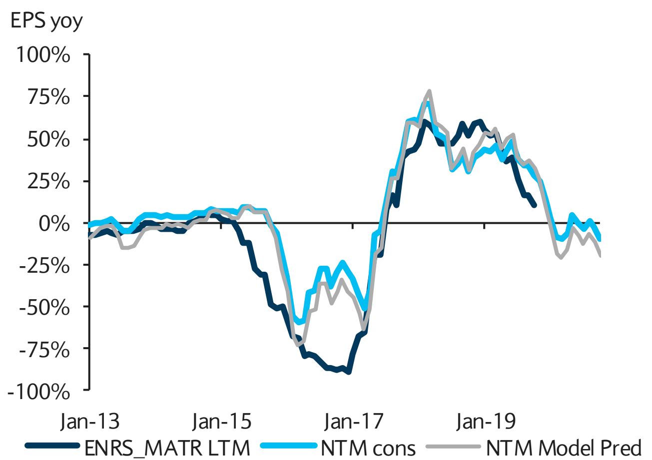
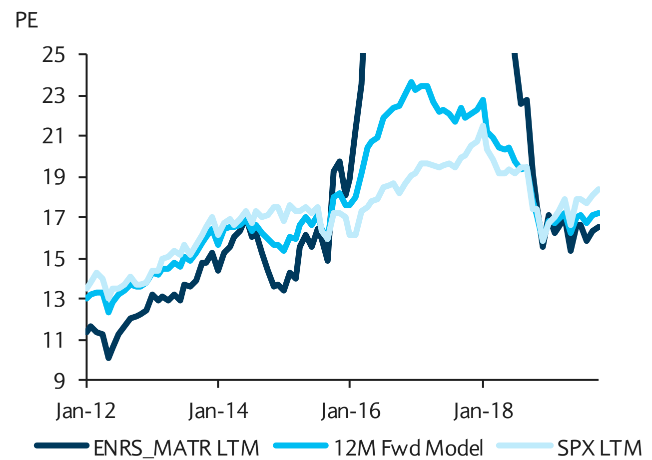



FIGURE 59

**Energy+Materials valuations have normalized compared to 2015-18 as supply glut and global economic weakness keeps a lid on oil prices**




Source for Figures 38-59: Refinitiv, Barclays Research

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