State of the Market

Be more *contrarian*...

fundstrat

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For Reg AC certification and other important disclosures, see slide 103.

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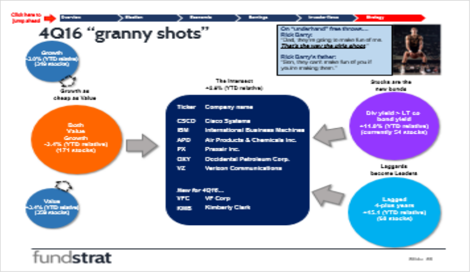
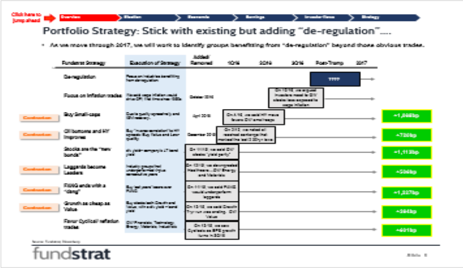
Our views in 9 charts....

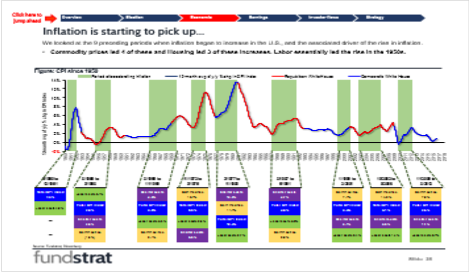
Granny shots



Anybody but current president…

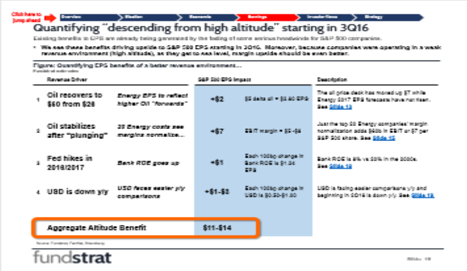


Inflation picking up…

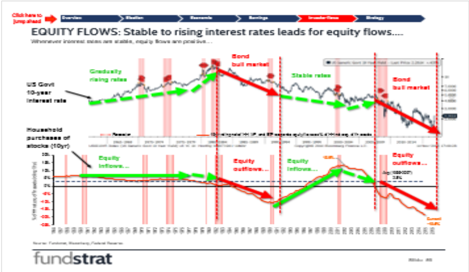


Higher CPI means sales growth…

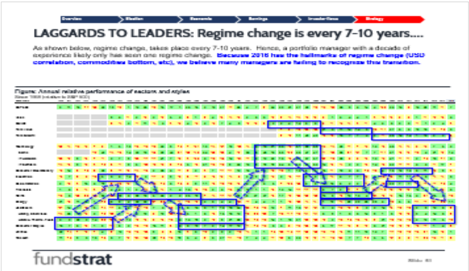
Energy sector $9-plus EPS swing…



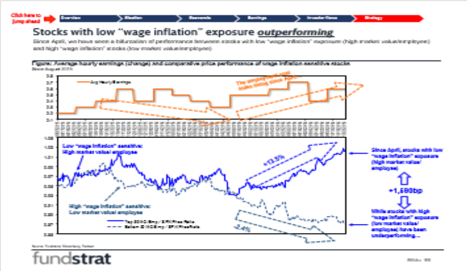
Higher rates mean equity inflows...



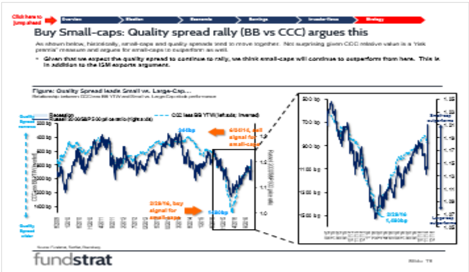
Buy laggards… forget Healthcare



Buy high MC/employee stocks…



Buy small-caps on HY rally…



Key Principles

		fundstrat Takeaway
1. Credit _lead_ equities	Stocks "junior" piece of capital structure	• High-yield remains supportive. • US spreads attractive vs RoW
2. Regimes supercede business cycles	Regimes drive multi-year, multi-decade cycles which need to be overlayed to biz cycle dynamics	• Market underpricing inflation • Global growth shifting to DM • Housing more than Trade
3. Investors too reliant on "last cycle" factors	Today's Portfolio Manager has a median tenure of 7 years—meaning he has only seen one cycle.	• US not China • Value not Growth • Laggards not leaders
4. Consensus lags (not leads)	Consensus tools and indicators are already discounted by markets and computers.	• Stocks new bonds • Looks like 1990 • Smallcap over Large
5. "Signal" from Noise	We look for 1, 2, 3-sigma signals to identify quantifiable investment opportunities.	• Quality spread—buy smallcaps • Stocks momentum into YE • Investors underlevered—OW Value

Overview: Investors finally recognizing regime change

For much of 2016, investor overwhelmingly indifferent to our view that S&P 500 would achieve double-digit gains in 2016 and many dismissed it as "ridiculous" and "blind to risks"—yet, the S&P 500 is up 8% YTD (all-time high to boot). Now consensus is competing to have the most optimistic take on why Trump is causing markets to march higher. In reality, investors are chasing a market that has been signaling (all-year) that it was poised to move higher—the significant outperformance of the high-yield market signaled back in July the likelihood the S&P 500 would be up at least double-digits (**Slide 54**): HY is expected to be up 17% this year and stocks never posted less than a 10% return in those instances:

- **Notably, the two longest bull markets in history 1953-1974 (Slide 21) and 1982-1999 (Slide 22) were preceded by a Republican "revolution"—Eisenhower (1952) brought infrastructure spend. Reagan (1980) saw tax cuts and de-regulation.**

- **Trump looks to be both an "inflation" and "de-regulation" president—In our view, Trump is likely a bit of both Eisenhower and Reagan. Why? The secret to real estate wealth is essentially inflation as Ambrose/Eicholtz showed in "House Prices and Fundamentals, 355 years" in studying 7 centuries of real estate transaction in Amsterdam (click here for MIT study).**

- **Higher inflation and interest rates will encourage business and consumer behavior towards longer-term spending and investments. Just like 1950s and 1990s, a move towards reflation unleashes investment spend, and US housing has 2mm-plus pent-up demand. We estimate the GDP lift over a decade is a cumulative $3.5T-$4T of growth (Slide 29).**

- **Higher rates to trigger titanic shift into equities. The last decade saw $2T rotated out of equities, the largest in history (as share of HH savings flows) and we believe the inflows will average at least $400b per year for next decade (Slide 50).**

- **Higher interest rates positively transforms the economics of active equity investing. Higher rates dramatically improves attractiveness of equity investing as cost and fee structures take subordination to absolute return generation.**

STRATEGY: Investors need to focus on laggards (+2900bp and counting, Slide 69) small-caps (+1,000bp, Slide 75) value (+400bp, Slide 72)—strategies we have argued all year.

What Could Go Wrong?

There are many issues potentially becoming so significant that the economy and markets succumb to the risks**:**

- **Is the market too optimistic about a Trump bull market?** The best analogs are 1952 and 1980—both saw a major political party shift to Republicans. In 1952, it resulted in a major fiscal policy initiative (national highway infrastructure) and in 1980 it was a major de-regulation effort. Both set the stage for a 17-year bull market, but it also started with a major stock market correction.

- **Fed tightening while other Central banks remain loose—are central banks losing credibility? Policy uncertainty:** A broader issue for markets is the inability to track policy risk which has grown in frequency in past few years. We think central banks maintain a lot of credibility and it is most evident in the low level of rates. If investors have lost faith in central banks, currencies should be losing value and, therefore, interest rates would be rising.

- **China:** China is navigating an extremely challenging balance of slowing credit growth/expansion while transitioning growth from an investment-oriented to consumption oriented model. The structural changes over the past decade have resulted in China and its EM neighbors increasingly operating as an ecosystem, with the US less affected by "shocks" in China.

- **Commodity producers:** Commodity producers are seeing increasing financial stress, stemming from falling volumes and prices, currency weakening and diminished confidence by capital markets.

- **Market could be surprised by inflation later in 2016.** We think USD is more affected by inflation than policy rates and more than "flight to safety". **We believe markets are underpricing inflation risk, similar to 2000-2002 and 2006-2009 (USD fell 30%-ish both times). This is positive for Cyclicals.**

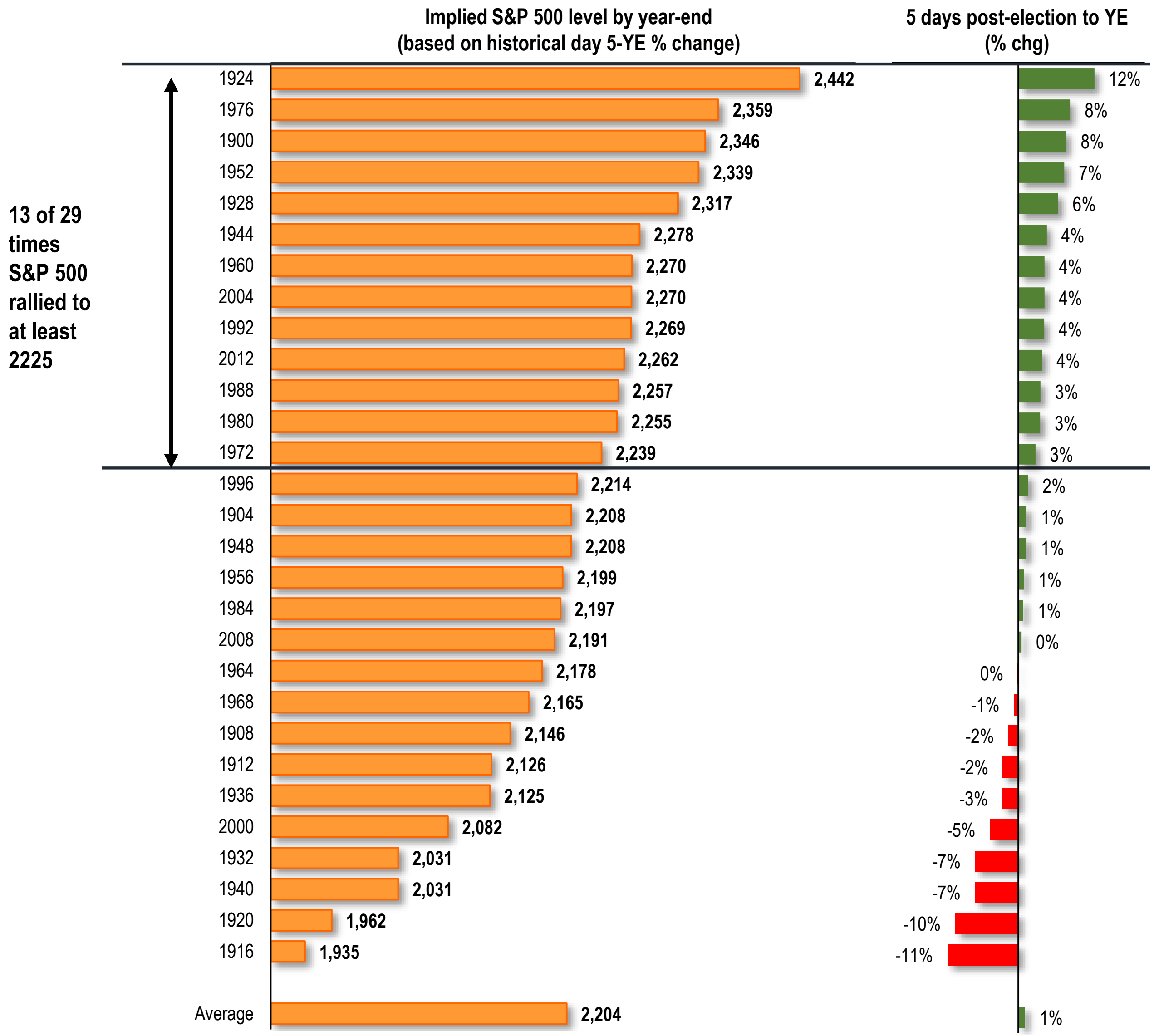
- **Credit cycle:** Default expectations have risen in 2016, stemming concerns about falling commodity prices and reduced market liquidity. Investors have pulled nearly $80 billion from high-yield mutual funds over the past 18 months.

YE 2225 achievable

We have plotted the return of equity markets following Presidential elections.

- **On the right, we highlight the historical gains post Presidential election (day +5 to YE).**
- **2225 is achievable as it implies an overall 3% move of that size (or more) happened 13 of 29 post-election years.**
- **The bigger message, in our view, is that the S&P 500 is on track to deliver around 10%-plus total return in 2016.**

Figure: Price Performance of Equities following Presidential elections
Since 1900



Source: Fundstrat, Bloomberg

Portfolio Strategy: Stick with existing but adding “de-regulation”....

- **As we move through 2017, we will work to identify groups benefitting from “de-regulation” beyond those obvious trades.**

	Fundstrat Strategy	Execution of Strategy	Added/ Removed	1Q16	2Q16	3Q16	Post-Trump	2017	
	De-regulation	Focus on industries benefitting from de-regulation:					????		
	Focus on Inflation trades	We said wage inflation would drive CPI, first time since 1950s	October 2016			On 10/16, we argued investors need to OW stocks less exposed to wage inflation			
Contrarian	Buy Small-caps	Due to quality spread-rally and ISM recovery.	April 2016		On 4/16, we said HY move favors OW small-caps				+1,068bp
Contrarian	Oil bottoms and HY improves	Buy “inverse correlation” to HY spreads: **Buy Value and Low-quality**	December 2015	On 2/12, we noted oil reached contango that marked the last 2 30-yr lows					+720bp
	Stocks are the “new bonds”	div yield> company’s LT bond yield	On 11/15, we said OW stocks “yield parity”						+1,113bp
Contrarian	Laggards become Leaders	Industry groups that underperformed 4-plus consecutive years	On 12/15, we downgraded Healthcare…OW Energy and Materials						+506bp
Contrarian	FANG ends with a “dang”	Buy last years’ losers over FANG	On 11/15, we said FANG would underperform laggards						+1,227bp
Contrarian	Growth as cheap as Value	Buy stocks both Growth and Value, with a div yield > bond yield	On 12/15, we said Growth 7-yr run was ending. OW Value						+264bp
	Favor Cyclical/ reflation trades	OW Financials, Technology, Energy, Materials, Industrials	On 12/15, we saw Cyclicals as EPS growth turns in 3Q16						+601bp

Source: Fundstrat, Bloomberg

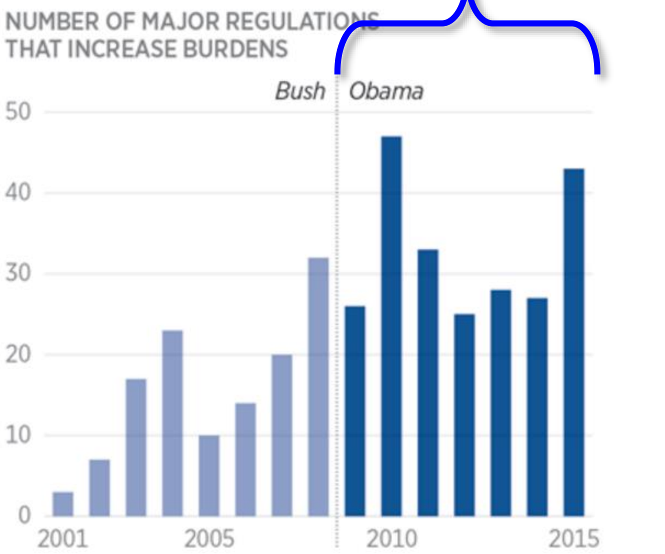
Regulatory burdens have increased in past 8 years…

To gain some perspective about the potential impact of a Reagan-type reduction in regulations, consider the sizeable increases in regulatory burdens seen for individuals and businesses as shown below.

- **Since 2009, there has been a substantial rise in rules and major rules totaling more than 20,600 and at an estimated cost of $108 billion.**

Figure: Rapid increase in regulatory burdens in past 8 years
From Heritage.org

Notable increase in major regulations in past 8 years…



SOURCES: U.S. Government Accountability Office, GAO Federal Rules D
April 21, 2016), and Heritage Foundation calculations based on data prov

Since 2009, there have been >20,600 new rules

	Since 2009	Since 2001
Total number of new rules	20,642	47,661
Total number of new major rules	566	1,062
Increasing burdens	229	355
Decreasing burdens	26	58
IN BILLIONS OF 2015 DOLLARS		
Cost of major increases in burden	$112.0	$182.9
Savings from major decreases in burden	$3.4	$5.9
Net increase in burden*	$107.7	$176.0

With a net cost of $108 billion… or 0.5% of GDP

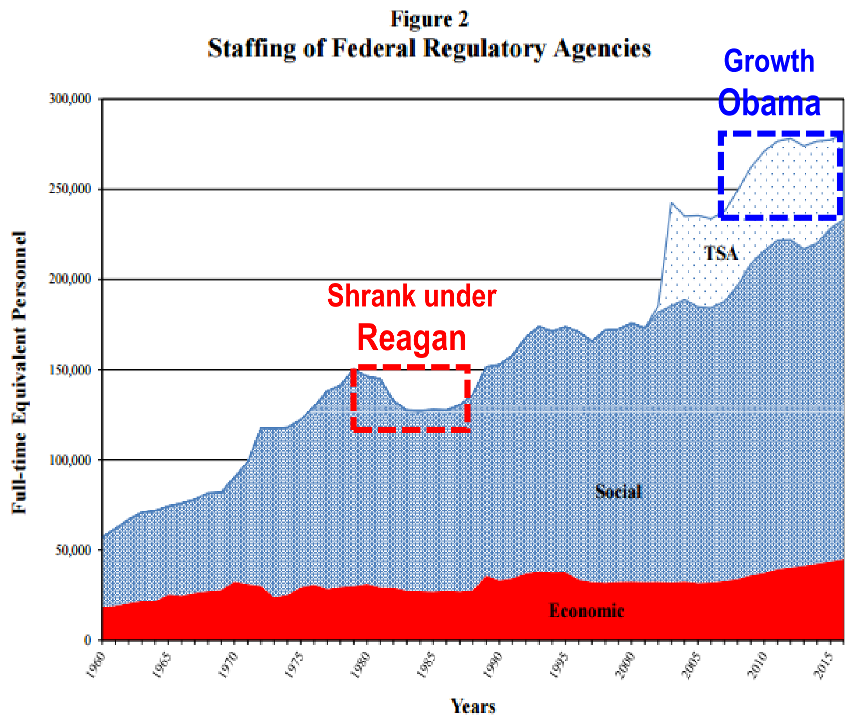
Source: Fundstrat, http://www.heritage.org/research/reports/2016/05/red-tape-rising-2016-obama-regs-top-100-billion-annually

Staffing at regulatory agencies now exceeds 275,000

Staffing at Federal Regulatory agencies has risen from 225,000 in 2008 to more than 275,000 in 8 years—this is a 22% rise and one of the most rapid increases in staffing ever.

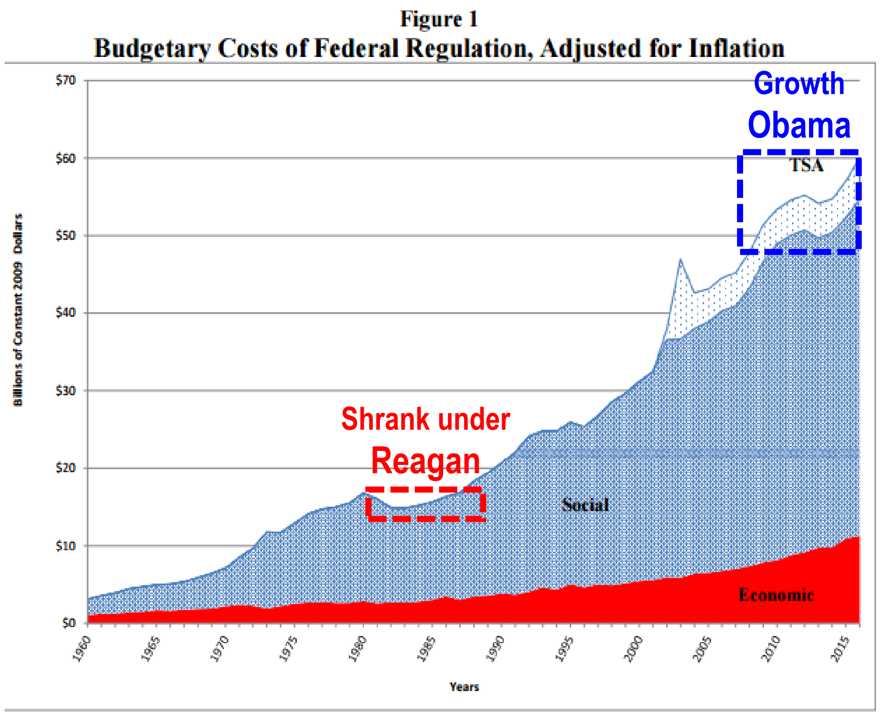
- **As shown below, during Reagan's de-regulation 8 years, staffing fell by about 17%. Thus, there remains substantial potential to reduce regulation.**

Figure: Staffing at Federal Regulatory Agencies
Since 1960



Source: Weidenbaum Center, Washington University and the George Washington University Regulatory Studies Center. Derived from the *Budget of the United States Government* and related documents, various fiscal years.

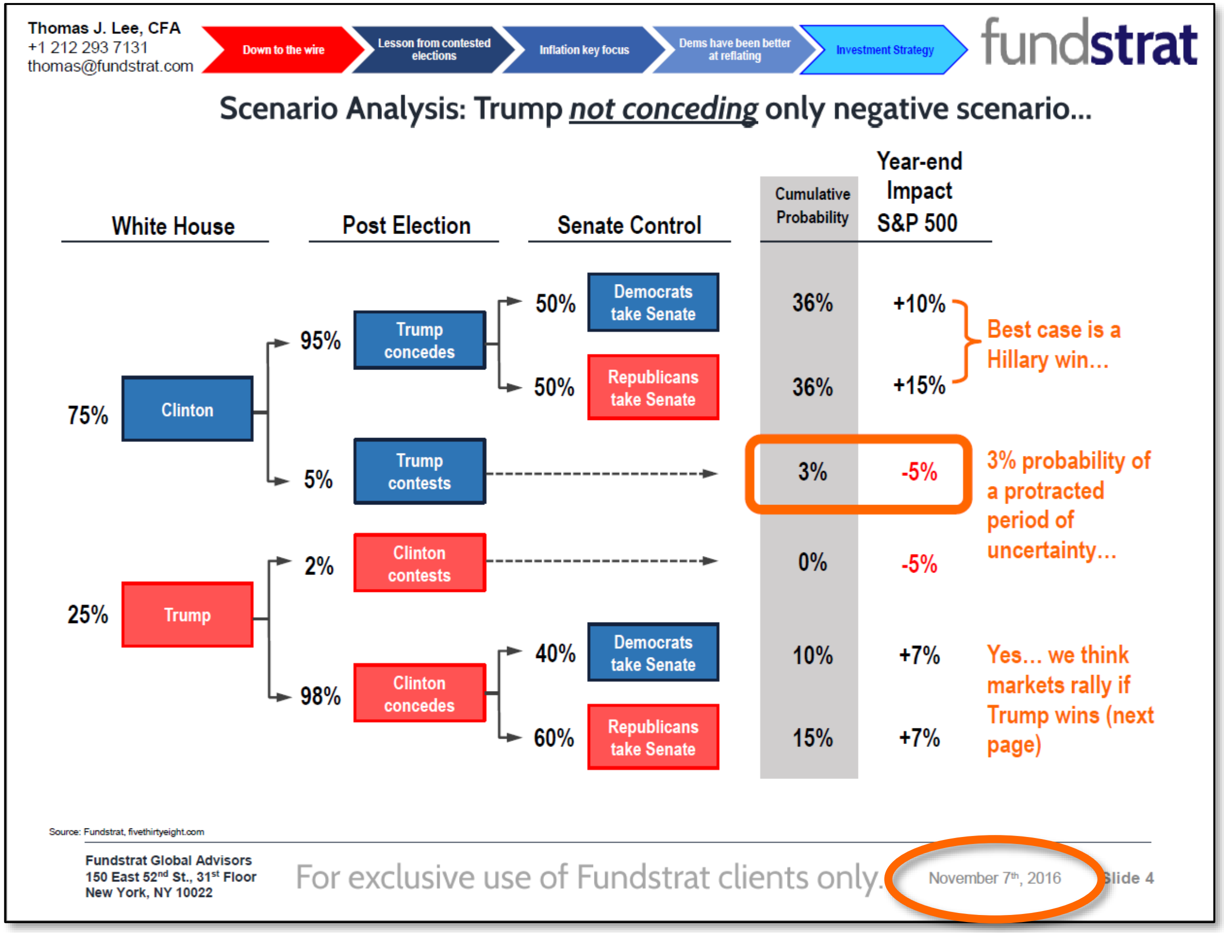
Figure: Budgetary Cost of Federal Regulation
Since 1960, inflation adjusted



Source: Weidenbaum Center, Washington University and the George Washington University Regulatory Studies Center. Derived from the *Budget of the United States Government* and related documents, various fiscal years.

Source: Fundstrat, https://regulatorystudies.columbian.gwu.edu/sites/regulatorystudies.columbian.gwu.edu/files/downloads/2016_Regulators_Budget.pdf

We expected Trump win to trigger 7% rally… anybody but Obama….



As noted in our November 7, 2016 "Policy Manual" report, we saw Trump win as triggering a 7% rally.

- **That implies 2225 by YE**

Source: Fundstrat, Bloomberg

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Why would markets rally on a Trump victory?

Figure: 8 reasons that Trump victory could lead to equity market rally

1.	**Markets discounted this…**	Markets have already fallen 4% as we approach election day and for equities to fall further, one needs to argue that Trump would trigger a recession.
2.	**Likely RRR Trifecta…**	Trump victory likely also means Republican control of Senate and House.
3.	**100+ business leaders endorsed…**	Trump has the support of some notable business leaders including Peter Thiel, Carl Icahn, Sheldon Adelson, John Paulson, Peter Coors.
4.	**Economy more than leader…**	As we discuss in this report, developing trends in the US economy tend to sustain regardless of the party elected.
5.	**Unpopular Presidents had good markets….**	Unpopular president does not equal bad equities. History shows there are bad economies that drive bad stock markets, but bad presidents rarely create bad stock markets. • LBJ was notoriously unpopular but equity markets did well. • Obama was unpopular with investors during 2010-2013, yet, equity markets still performed very well.
6.	**Obamacare repealed…**	Obamacare likely repealed and is enormously unpopular. This can be repealed under the reconciliation process.
7.	**Trump's plan has merits….**	Trump's economic plan includes potential for tax cuts and higher infrastructure spending.
8.	**Investors want DC changed…**	Investors would start focusing on the potential of Trump to reform Washington.

Source: Fundstrat

As noted in our November 7, 2016 "Policy Manual" report, we saw Trump as being an "inflationary" President

- **We saw likely RRR if he won**
- **We also argued investors would eventually focus on de-regulation, repealing Obamacare and infrastructure…**

Source: Fundstrat, Bloomberg

POST-ELECTION: What was working keeps working…

Figure: Comparative performance by various periods
2016

	Sell-off	Rally	Sell-off	Rally	Sell-off	Pre-election YTD	Rally	
Between	11/2/15 to 2/11/16	2/11/16 to 6/8/16	6/8/16 to 6/24/16	6/24/16 to 8/18/16	8/18/16 to 11/8/16	**12/31/15 to 11/8/16**	11/8/16 to 11/17/16	Year to Date
S&P 500	(13.1%)	15.9%	(3.9%)	7.3%	(2.2%)	4.7%	2.2%	7.0%
BofA US High Yield	(9.8%)	15.4%	(0.9%)	5.2%	1.0%	15.3%	(0.9%)	14.3%
BofA US BB return	(7.0%)	12.0%	(0.8%)	4.5%	0.5%	12.4%	(1.3%)	11.0%
BofA US CCC return	(18.1%)	30.6%	(0.7%)	6.7%	3.4%	29.6%	(0.2%)	29.3%
Dollar Index	(1.4%)	(2.1%)	2.0%	(1.4%)	3.9%	(0.8%)	3.1%	2.3%
US 10-yr Total Return	(7.0%)	12.0%	(0.8%)	4.5%	0.5%	12.4%	(1.3%)	11.0%
Relative to S&P 500								
S&P 500 Pure Growth	(4.7%)	3.4%	(0.6%)	0.6%	(0.4%)	**(2.4%)**	(0.9%)	**(3.3%)**
S&P 500 Pure Value	(5.8%)	8.5%	(2.1%)	0.1%	0.5%	**1.9%**	4.3%	**6.5%**
Russell 2000	(6.5%)	8.8%	(1.3%)	2.4%	(1.2%)	**0.5%**	7.3%	**8.3%**
Russell 2000 Growth	(9.0%)	9.7%	(2.1%)	2.7%	(2.5%)	**(4.3%)**	6.5%	**2.2%**
Russell 2000 Value	(4.1%)	7.9%	(0.6%)	2.0%	0.1%	**5.5%**	8.1%	**14.6%**
Long Momentum	(3.7%)	1.6%	1.3%	(2.0%)	(1.4%)	**(4.6%)**	(0.1%)	**(4.8%)**
DJ Contrarian Index	(5.8%)	7.1%	(2.8%)	2.9%	(0.0%)	**3.3%**	8.3%	**12.4%**
S&P 500 Low Volatility	8.3%	(2.5%)	3.5%	(3.6%)	(1.8%)	**2.7%**	(2.7%)	**(0.1%)**
Sector Indices								
Technology	(1.0%)	(0.7%)	(1.2%)	4.9%	4.4%	**6.1%**	(2.4%)	**3.6%**
Consumer Discretionary	(2.7%)	(0.0%)	0.0%	(0.6%)	(1.0%)	**(3.9%)**	1.0%	**(3.0%)**
Industrials	1.9%	0.6%	(0.4%)	0.6%	0.7%	**3.8%**	2.8%	**7.0%**
Basic Materials	(1.6%)	8.3%	(0.8%)	(1.5%)	(1.0%)	**3.6%**	0.0%	**3.7%**
Energy	(8.0%)	10.6%	0.7%	(2.4%)	(0.1%)	**9.2%**	(0.6%)	**8.6%**
Financials	(6.5%)	4.1%	(2.4%)	1.2%	4.7%	**(1.6%)**	8.5%	**7.1%**
Real Estate	(1.1%)	2.7%	4.2%	(3.3%)	(6.4%)	**(6.0%)**	(5.7%)	**(11.8%)**
Health Care	0.2%	(1.7%)	(0.3%)	(0.2%)	(6.0%)	**(9.9%)**	0.8%	**(9.4%)**
Consumer Staples	11.3%	(7.1%)	2.8%	(3.9%)	(1.8%)	**(0.4%)**	(6.2%)	**(6.9%)**
Utilities	17.1%	(6.3%)	4.9%	(6.9%)	(0.9%)	**8.6%**	(8.1%)	**(0.4%)**
Telecom Services	18.4%	(8.3%)	8.1%	(8.7%)	(8.0%)	**(0.2%)**	(1.4%)	**(1.7%)**

Source: Fundstrat, Bloomberg

Why we are bullish on equity markets

	Factor	*Description*	Impact on Equities
1.	Global economic growth is accelerating	*As the global shock from weak oil fades, growth is improving*	Adds to sales growth
2.	New President	*Corporate tax reform* *De-regulation* *Encourage banking sector to expand*	US economic growth accelerates
3.	Pent-up demand in U.S.	*Investment spending and housing starts are at historic lows, even as US population has gained…*	US economic growth accelerates
4.	Inflation and interest rates rising	*Trigger a rotation back into equities and higher interest rates associated with higher PE*	Boost P/E ratio
5.	Sentiment is still terrible	*Investors are focused on deflation and haunted by the financial crisis*	Boost P/E ratio
6.	Stocks are cyclicals	*Bull markets last 17 years—by some measures, current bull market started in 2013…*	Boost P/E ratio

Source: Fundstrat, Bloomberg

Being down 8 consecutive days *associated with "structural lows"*

We have identified 25 precedent periods where the S&P 500 sold off 8 consecutive days.

- **The last time equities sold off 8 consecutive days was through October 10, 2008. Then, the S&P 500 lost 22% over 8 days versus 2.8% today. Then, the S&P 500 fell to 839.**
- **Notably, the S&P 500 in October 2008 reached its "internal low" on that date—from there, many sectors began to outperform. *Consumer Discretionary, Retail, Technology and other groups began to lead from there.***
- **In fact, looking over the last 85 years, being down 8 consecutive days have only been significantly bearish 5 times (of 25) with significant further losses over the next 6 months—those years are '31, '66, '69, '77 and '08.**

Figure: 25 prior instances of down 8 consecutive day
Since 1929

	#	Date of 8th down day	Streak Length (Days)	Forward Return (S&P 500) 1D	1W	3M	6M
	1	5/20/1931	8	1.0%	(3.6%)	2.0%	(22.0%)
Structural low	2	4/11/1932	10	(0.2%)	0.8%	(26.7%)	21.7%
	3	2/6/1933	8	0.9%	(2.5%)	36.6%	61.7%
	4	5/31/1938	8	3.2%	4.6%	36.1%	34.1%
	5	5/16/1956	8	1.2%	(2.2%)	5.5%	1.0%
Structural low	6	2/11/1957	9	(0.4%)	2.1%	8.9%	10.2%
	7	5/25/1962	9	(6.7%)	(3.7%)	0.5%	2.3%
	8	7/19/1963	9	(0.7%)	0.3%	5.9%	12.0%
	9	2/21/1966	10	(0.4%)	(2.0%)	(7.5%)	(12.7%)
	10	5/3/1966	12	(0.5%)	(3.1%)	(7.0%)	(10.7%)
	11	1/24/1968	8	0.1%	(1.0%)	3.7%	3.9%
	12	7/25/1968	8	0.4%	(1.3%)	6.1%	3.5%
	13	11/20/1969	11	(0.6%)	(1.2%)	(7.9%)	(22.5%)
	14	7/30/1971	8	0.4%	(1.4%)	(0.9%)	7.5%
	15	10/22/1971	11	(0.4%)	(1.3%)	8.8%	14.3%
	16	8/19/1974	8	0.5%	(3.2%)	(1.6%)	8.6%
Structural low	17	10/2/1974	9	(1.7%)	7.0%	6.0%	30.4%
	18	7/25/1975	10	(0.7%)	(1.5%)	1.4%	10.0%
	19	3/28/1977	8	0.7%	(0.8%)	1.6%	(4.0%)
	20	2/21/1978	9	(0.0%)	(0.6%)	12.6%	20.0%
	21	12/10/1980	9	(0.7%)	3.6%	1.7%	2.9%
Structural low	22	8/12/1982	8	1.4%	6.6%	37.1%	43.5%
	23	9/10/1991	8	0.1%	0.2%	(1.9%)	5.2%
	24	6/19/1996	8	0.0%	0.4%	3.3%	10.1%
Structural low	25	10/10/2008	8	11.6%	4.6%	1.2%	(4.7%)
		Average		**0.3%**	**0.0%**	**5.0%**	**9.0%**
		Median		**0.0%**	**(1.0%)**	**2.0%**	**7.5%**
		Win Ratio		**52.0%**	**40.0%**	**72.0%**	**76.0%**

Source: Fundstrat, Bloomberg

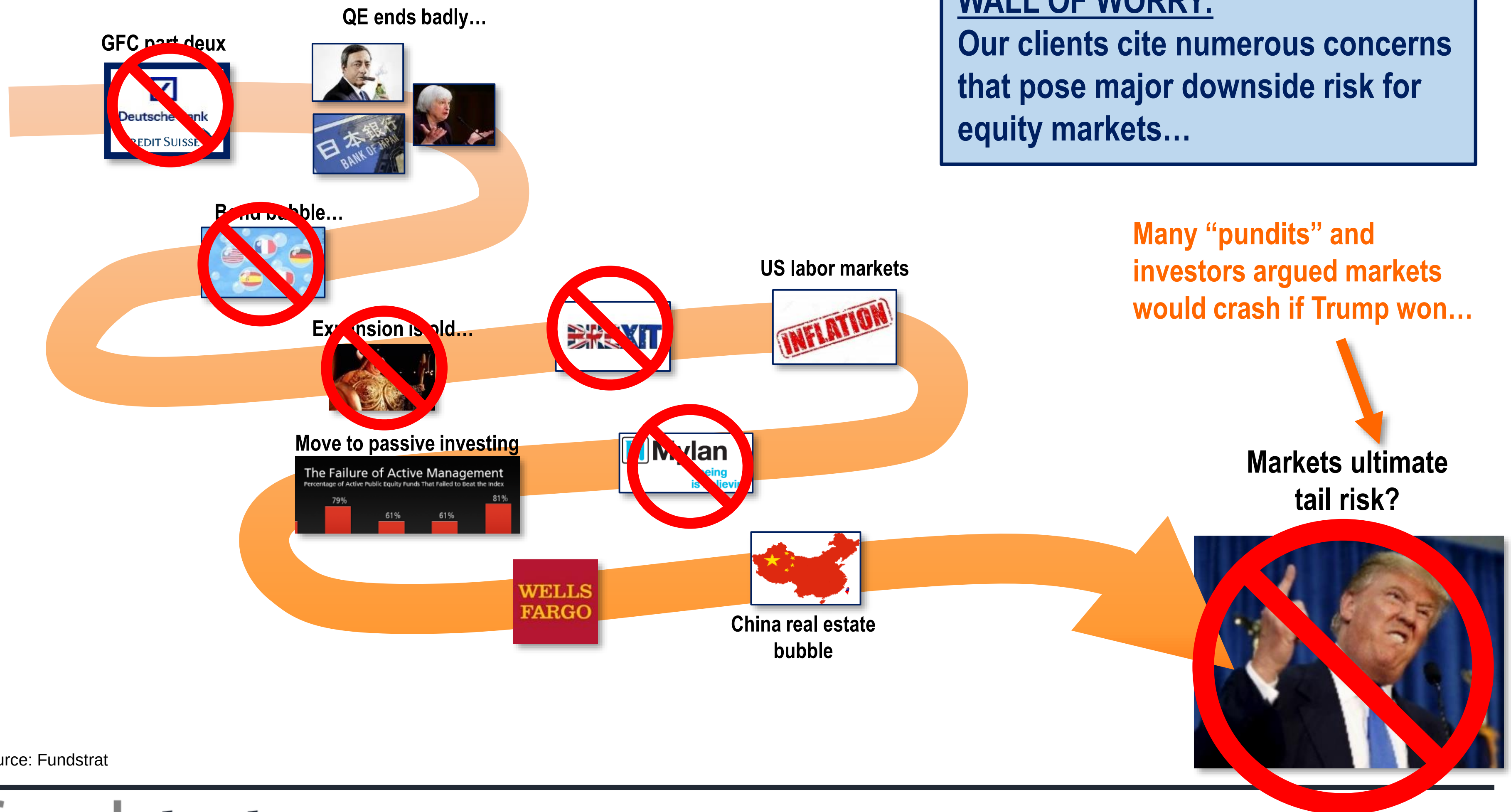
FOLLY OF BEARS? Black swan happened… but we lived

As we noted last week, retail investor sentiment is as bad today as it was during Brexit and when oil was $26—both times, the global economy was facing a potential recession…

- **Our clients continue to cite multiple headline risks and reasons why they are under-invested.**

Figure: The path of destruction of global asset markets…

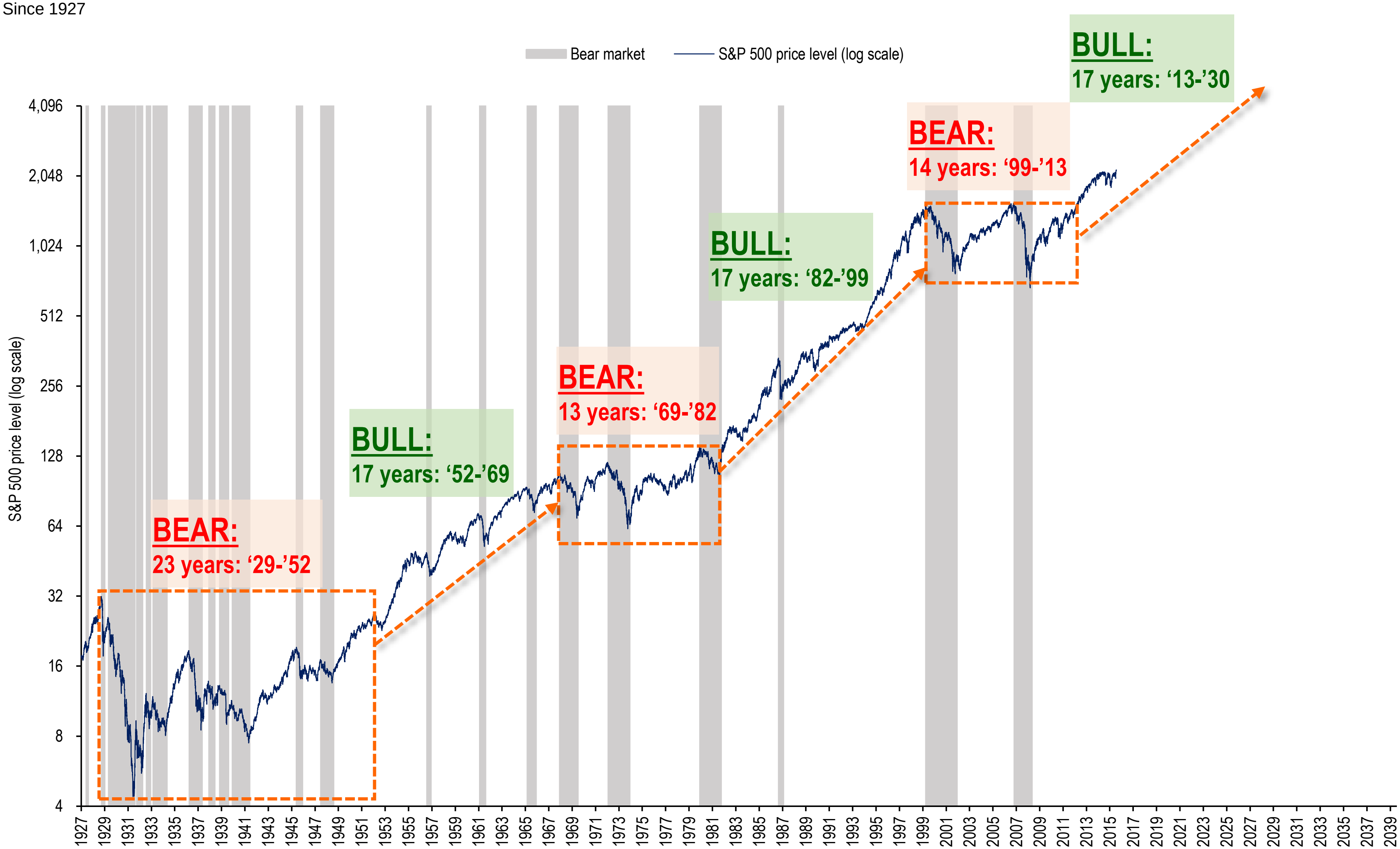
WALL OF WORRY:
Our clients cite numerous concerns that pose major downside risk for equity markets…



Source: Fundstrat

LONG CYCLES: Bull markets have lasted 17 years since 1927…

Figure: The bull market ends in 2030?
Since 1927

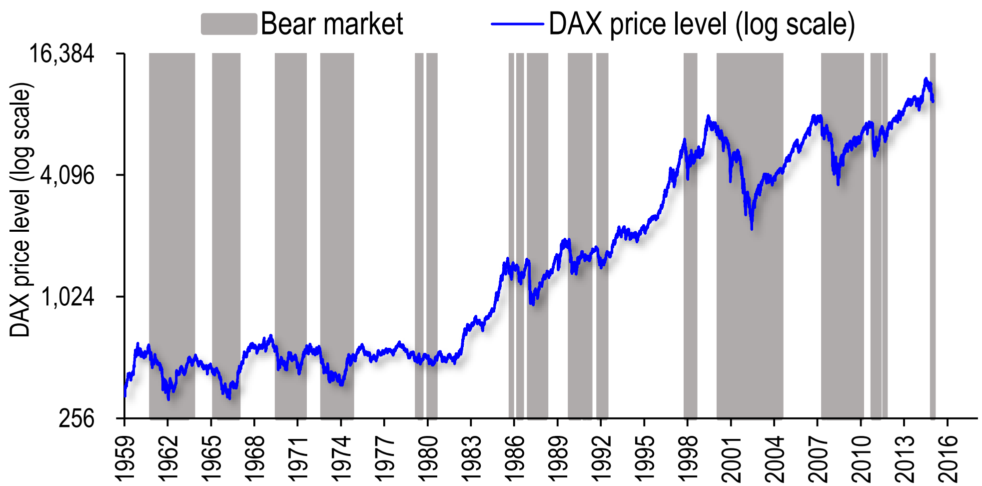


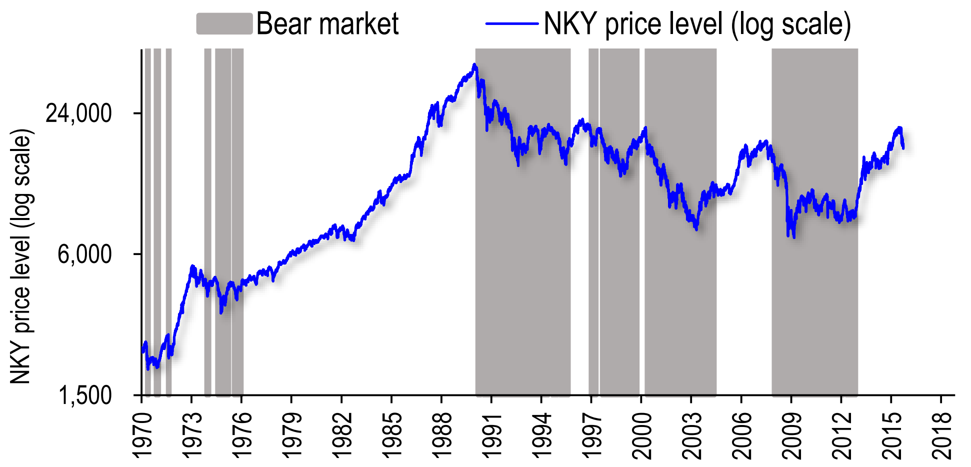
Source: Fundstrat, Bloomberg

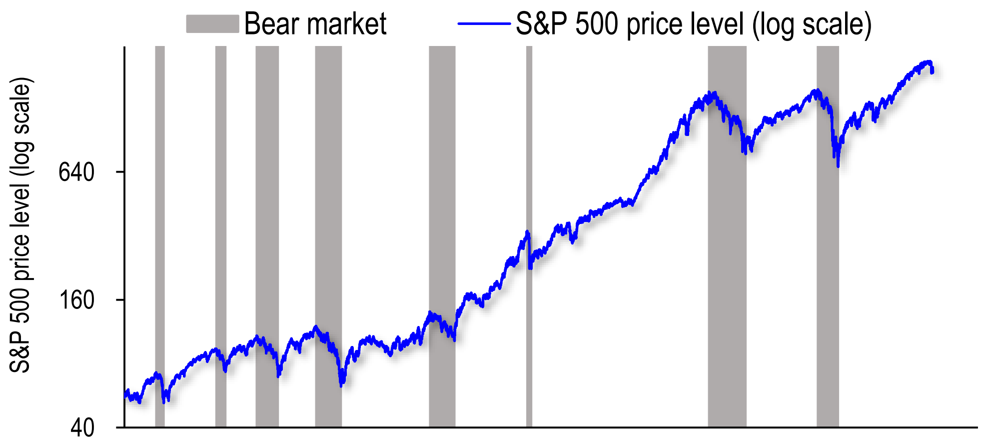
IGNORES RoW: US equity markets tend to *ignore* global markets....

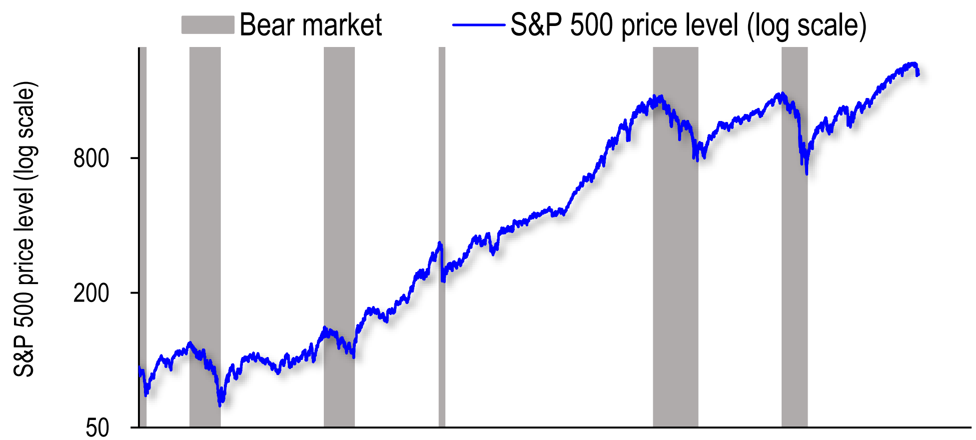
Germany has 3X more bear markets than US…

Japan has 2X more bear markets than US…





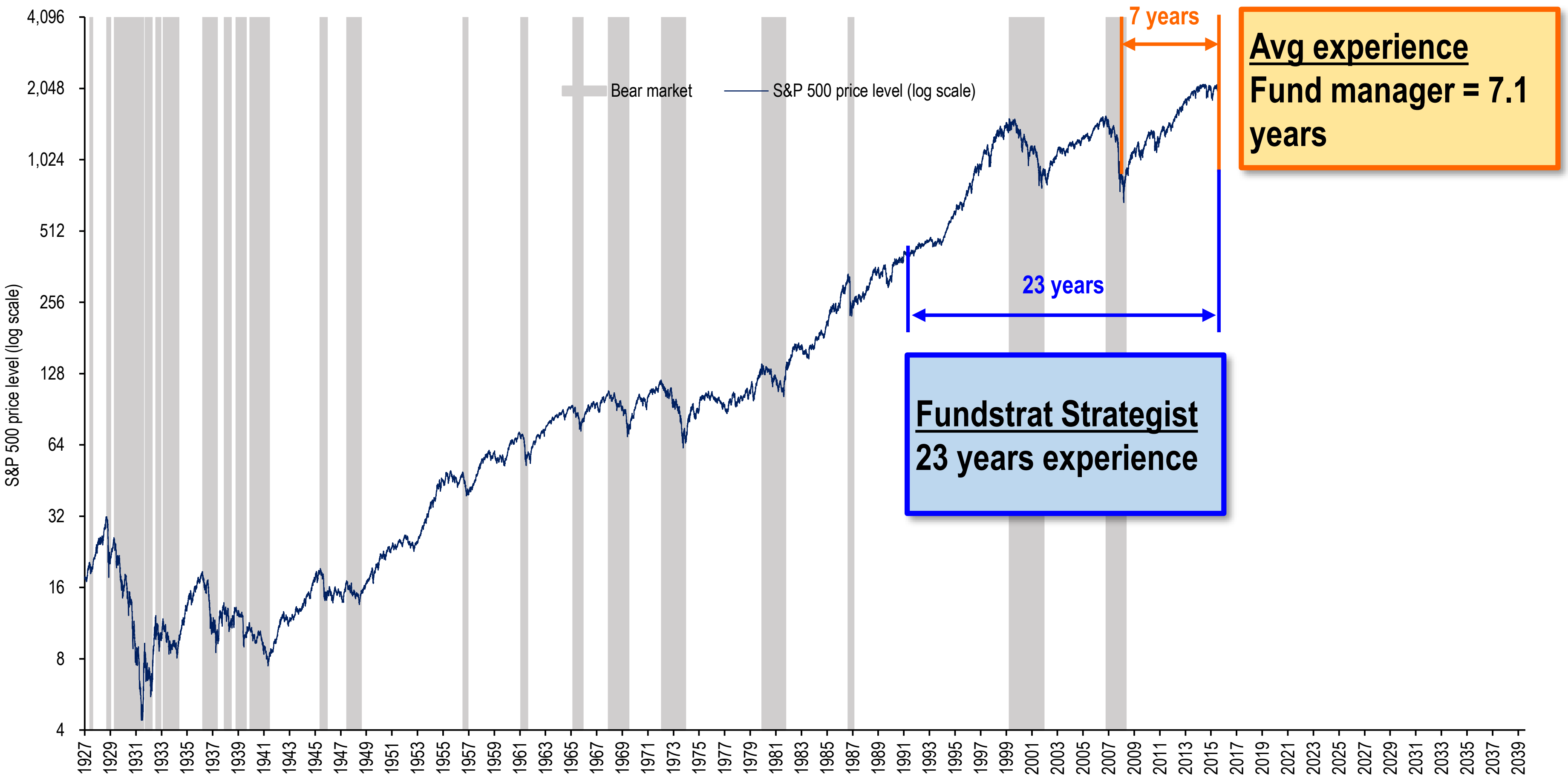




Source: Fundstrat, Bloomberg

INVESTORS LACK PERSPECTIVE: Investment managers avg 7 yrs experience...

Figure: The bull market ends in 2030?
Since 1927



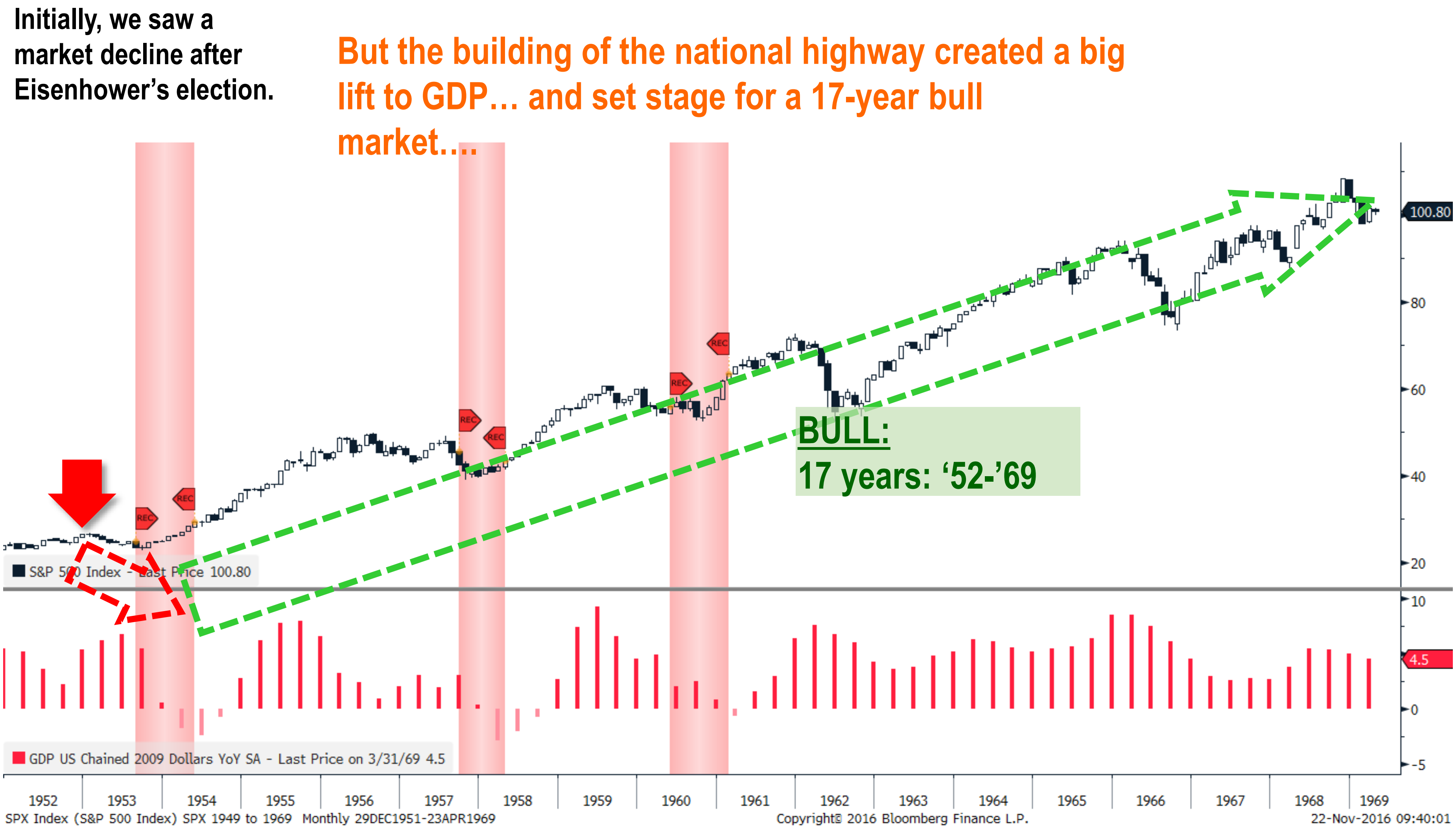
Source: Fundstrat, Bloomberg

POLICY: Anybody but current president is reason markets rally…

Obama	Issue	Clinton	Trump
Negative, CEO confidence lower	**CEO and corporate confidence**	Positive, centrist	Positive, pro-business agenda
Negative, Dodd-Frank, punish banks	**Banks**	Neutral	Positive, repeal Dodd-Frank
Negative, Increase in regulations	**Regulation**	Positive, reduce red-tape	Positive, limit govt regulation
Negative, raised taxes No reform	**Taxes**	Tax cuts	Tax cuts
Easy money	**Monetary policy**	Easy money	Fire Fed
Obamacare	**Healthcare**	Improve Obamacare	Repeal Obamacare
Encouraged	**Global Trade**	Rethink TPP	More restrictive
Mixed	**Geo-political**	Tougher on terrorists	Tougher on terrorists
Contractionary	**Government spending**	Expansionary	Expansionary

1952… Eisenhower wins and Republicans sweep…

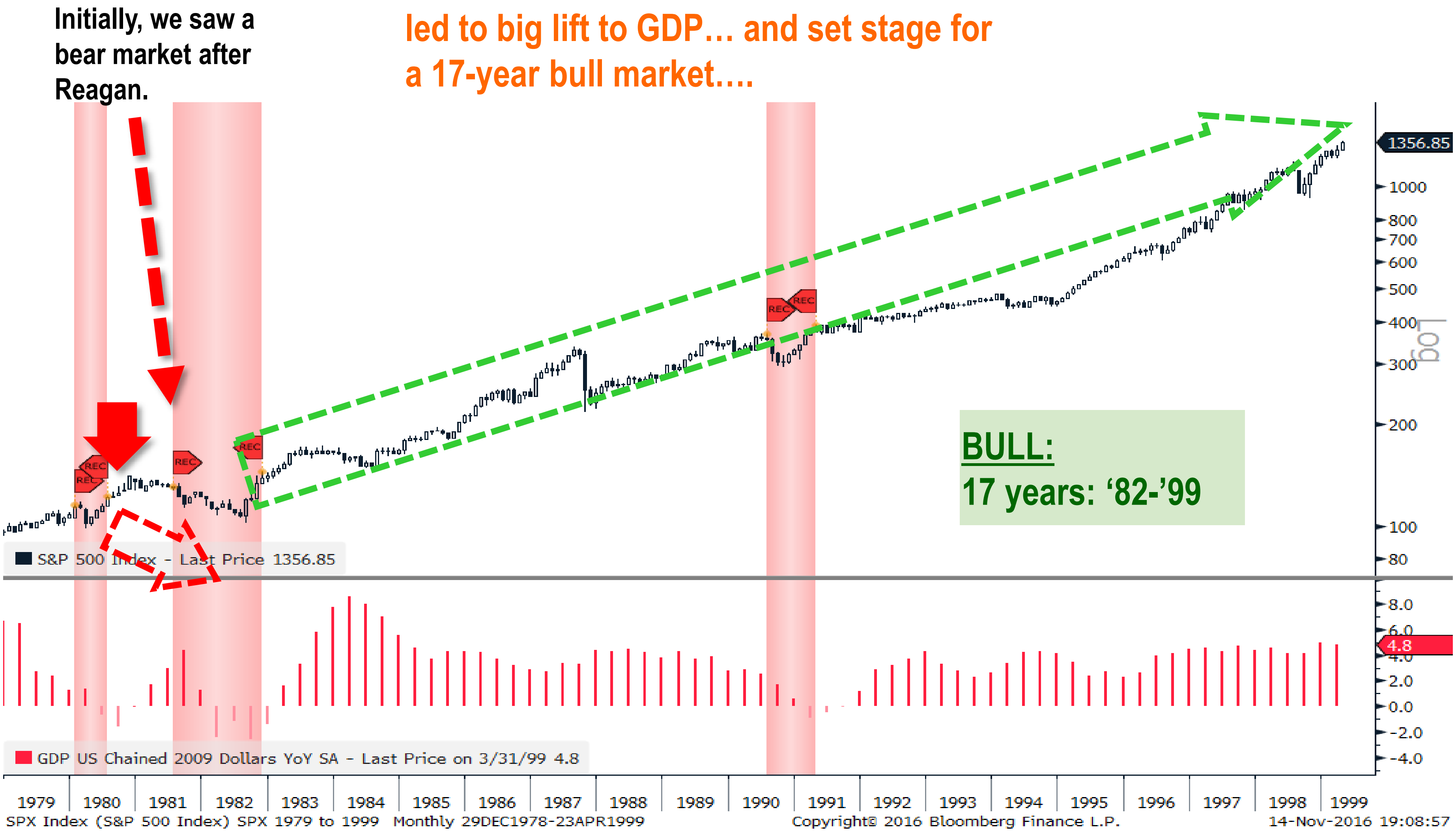
Figure: S&P 500



Source: Fundstrat, Bloomberg

1980 Reagan wins and Republicans take control of Senate…

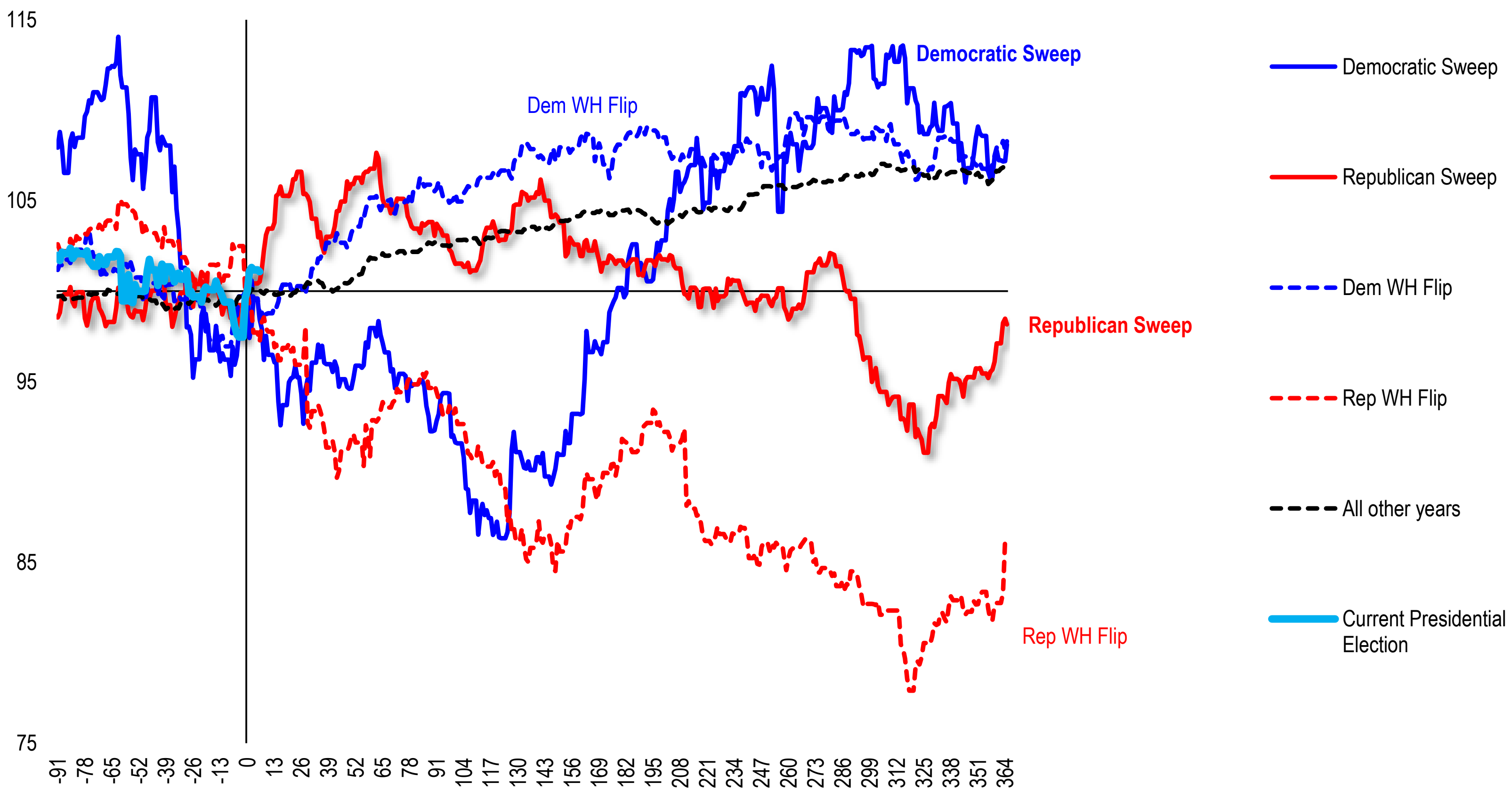
Figure: S&P 500



Source: Fundstrat, Bloomberg

POWER SHIFTS: Markets favor shifts to Democratic power

Figure: Price Performance of Equities following Party Shift
Since 1900



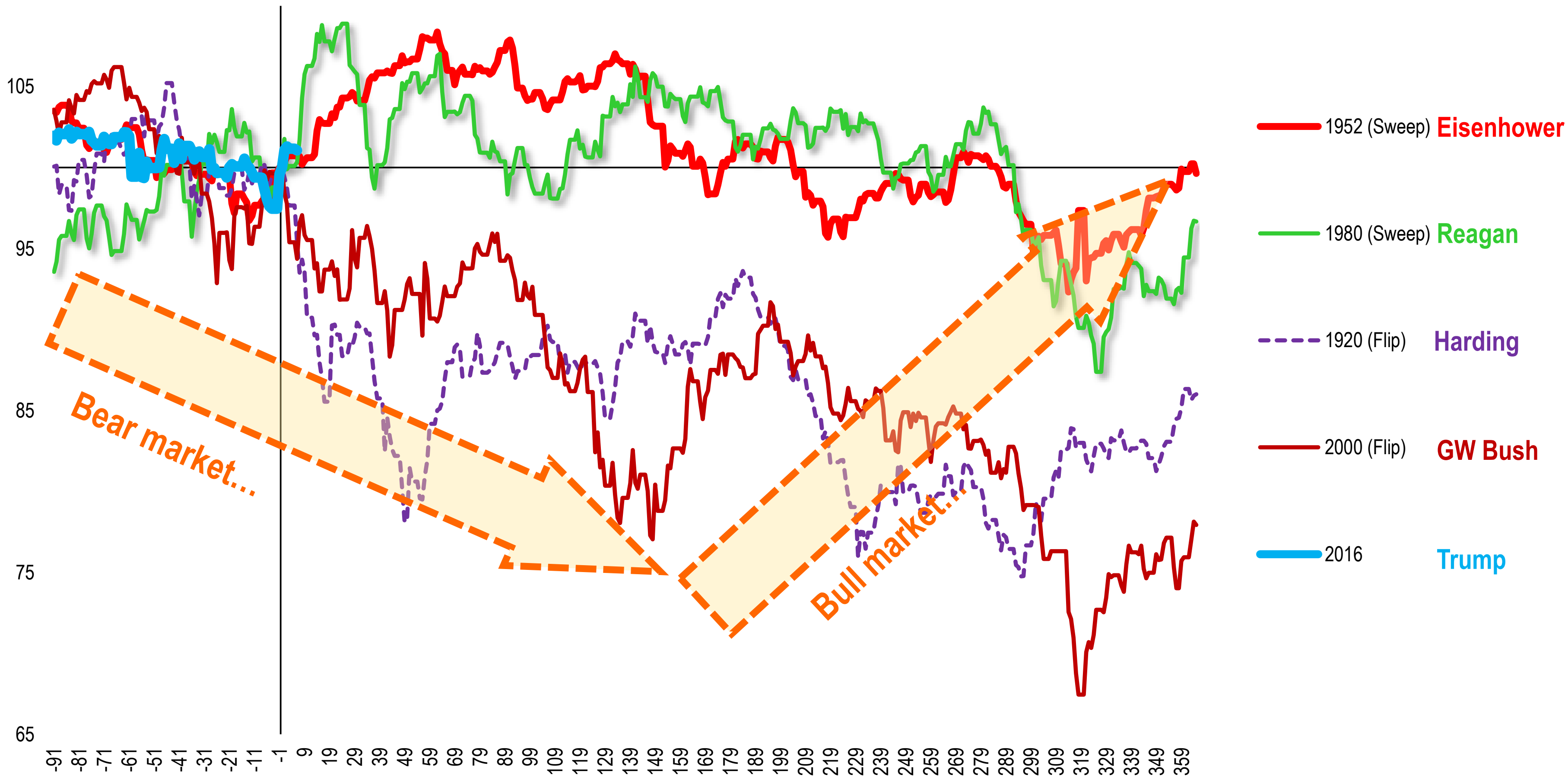
Source: Fundstrat, Bloomberg

Click here to jump ahead

Overview | Election | Economic | Earnings | Investor flows | Strategy

REPUBLICAN SWEEPS: First a "pullback" before a rally....

Figure: Price Performance of Equities following *Republican Party* Power shift
Since 1900



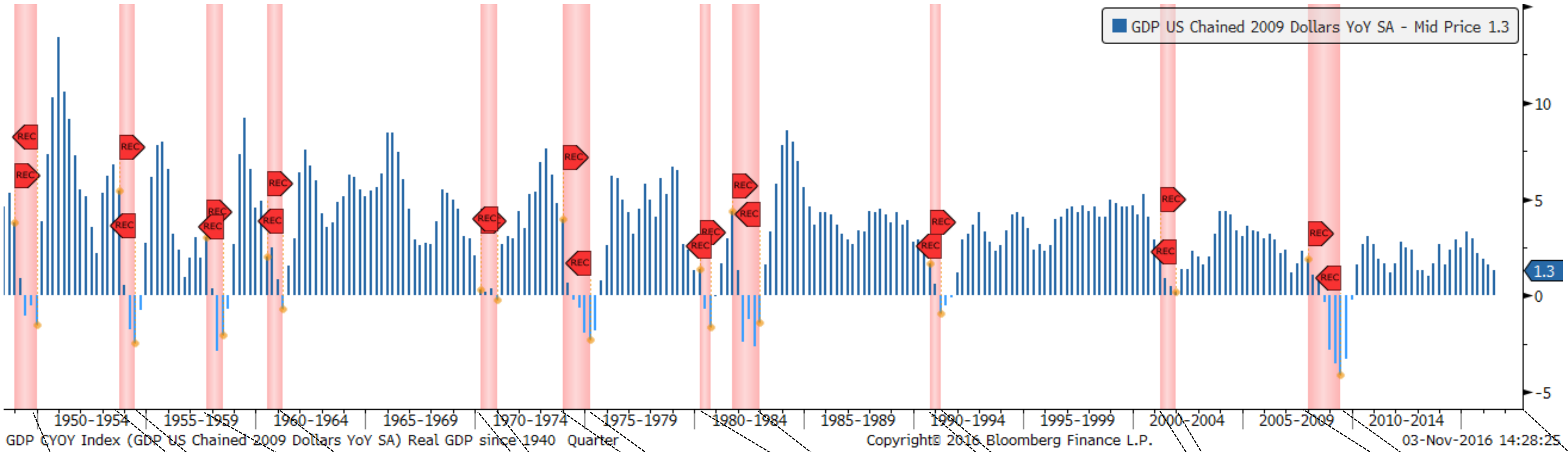
Source: Fundstrat, Bloomberg

How does this expansion compare?

As shown below, this is one of the weakest expansions since WWII with real GDP growth averaging 2.1% annually.

- **Two primary differences are the weaker consumer spending (PCE) from weak income growth and lower government spending. Government spending actually was a drag since 2009.**

Figure: Real GDP growth since 1950
Bloomberg



	10/49-6/53	6/54-6/57	3/61-9/69	12/70-12/73	6/75-12/79	12/82-6/90	6/91-12/00	12/01-9/05	9/05-9/07	9/09-now
GDP	7.0	3.8	5.1	4.5	4.5	4.3	3.8	3.1	2.4	2.1
Consumer	2.6	2.7	2.8	2.9	2.5	2.7	2.6	2.3	1.7	1.6
Investment	1.6	1.1	1.3	1.7	1.8	1.0	1.4	0.8	0.1	0.8
Net exports	-0.5	0.2	-0.1	0.2	-0.1	-0.2	-0.4	-0.5	0.2	-0.2
Government	3.3	-0.1	1.0	-0.2	0.4	0.8	0.2	0.4	0.3	-0.2
Housing	0.3	0.2	0.2	0.6	0.4	0.3	0.2	0.4	-0.8	0.2
Capex	0.4	0.3	0.5	0.6	0.6	0.3	0.6	0.3	0.4	0.4

Source: Fundstrat, AAII

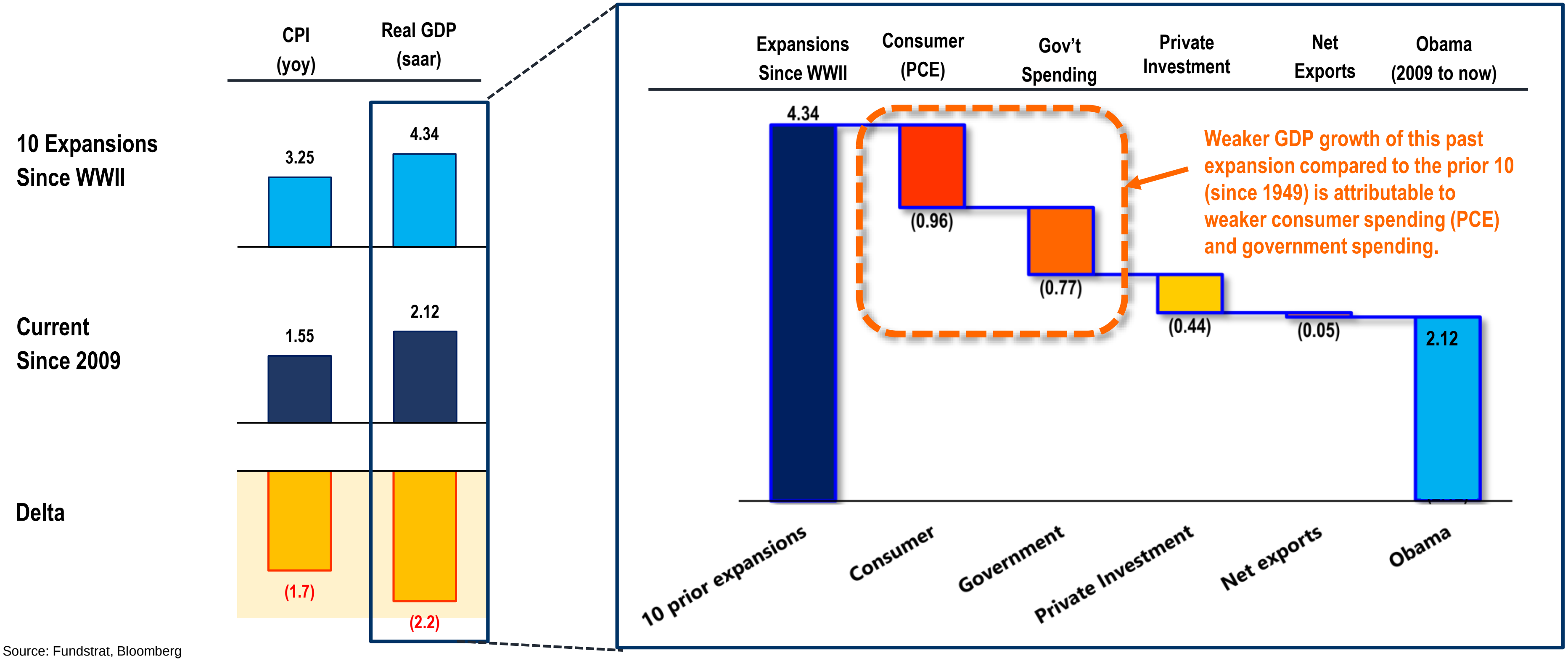
fundstrat

Real GDP since 2009 trails due to Gov't and PCE

We have plotted a waterfall chart comparing the GDP performance of the US economy since 2009 versus the prior 10 expansions (since 1949).

- **As shown below, the primary differences between the GDP growth of 2.12% and 4.34% are attributable primarily to weaker consumer spending and government spending.**
- **Weaker consumer spending reflects weaker wage gains (which are improving). And weaker government contribution is attributable to fiscal contraction. There is growing acknowledgement that fiscal contraction has slowed global growth. Hence, the potential for stronger GDP growth is there.**

Figure: WATERFALL: Comparing Real GDP since 2009 versus the past 10 expansions
Since 1949

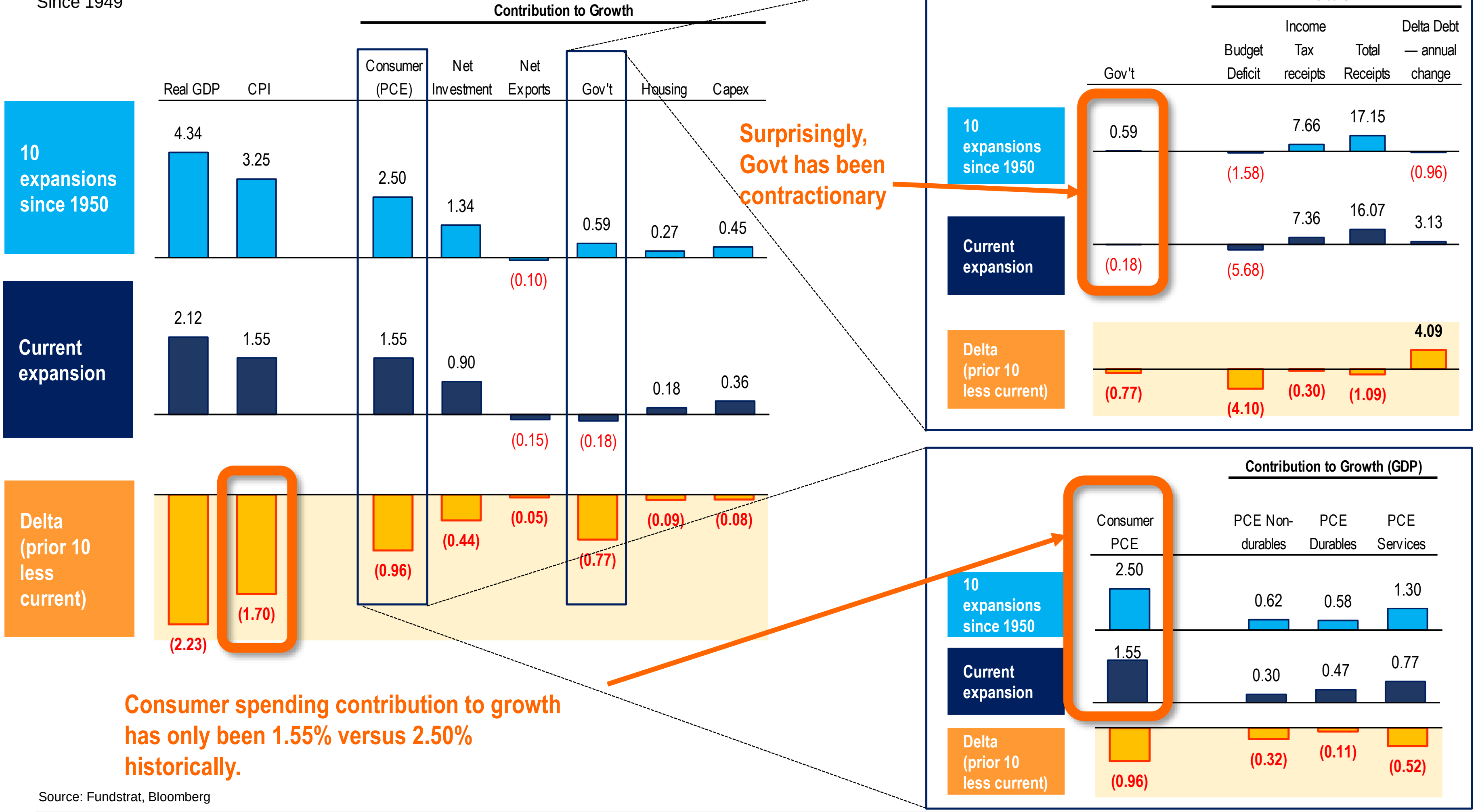


Source: Fundstrat, Bloomberg

Gov't spending has contracted on average since 2009…

Decoding this further, as highlighted below, government spending, while contractionary, has still resulted in massive budget deficits and increases in debt outstanding (as % GDP). It is not an issue of tax receipts, but rather as noted previously, the lack of inflation. Weak consumer spending is fairly broad-based and is a result of weak income growth.

Figure: Components of Government and Consumer spending
Since 1949



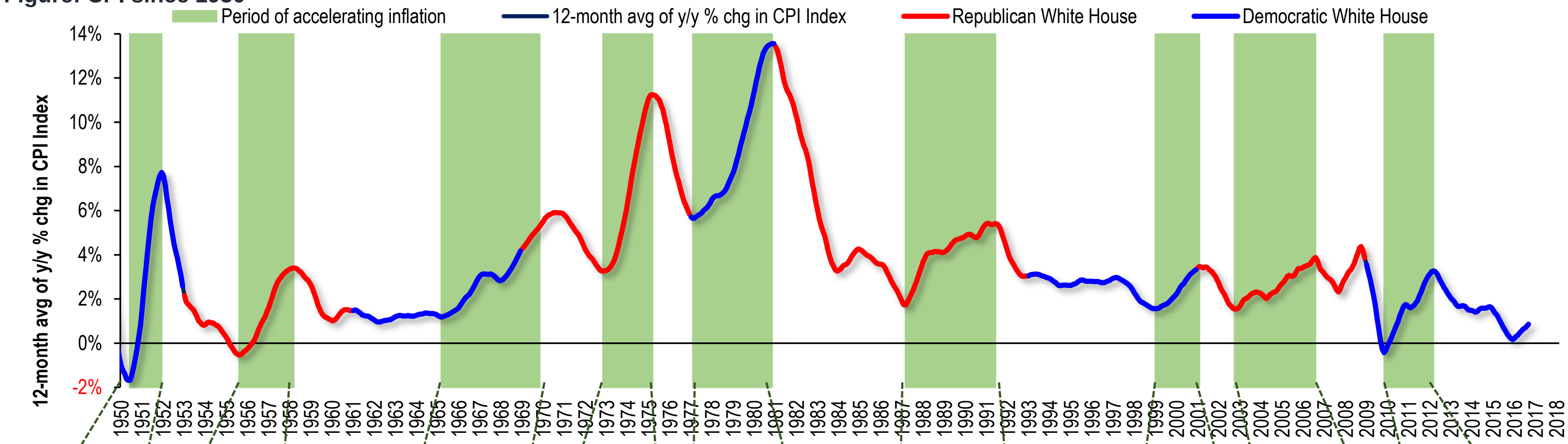
Source: Fundstrat, Bloomberg

Inflation is starting to pick up…

We looked at the 9 preceding periods when inflation began to increase in the U.S., and the associated driver of the rise in inflation.

- **Commodity prices led 4 of these and Housing led 3 of these increases. Labor essentially led the rise in the 1950s.**

Figure: CPI since 1950



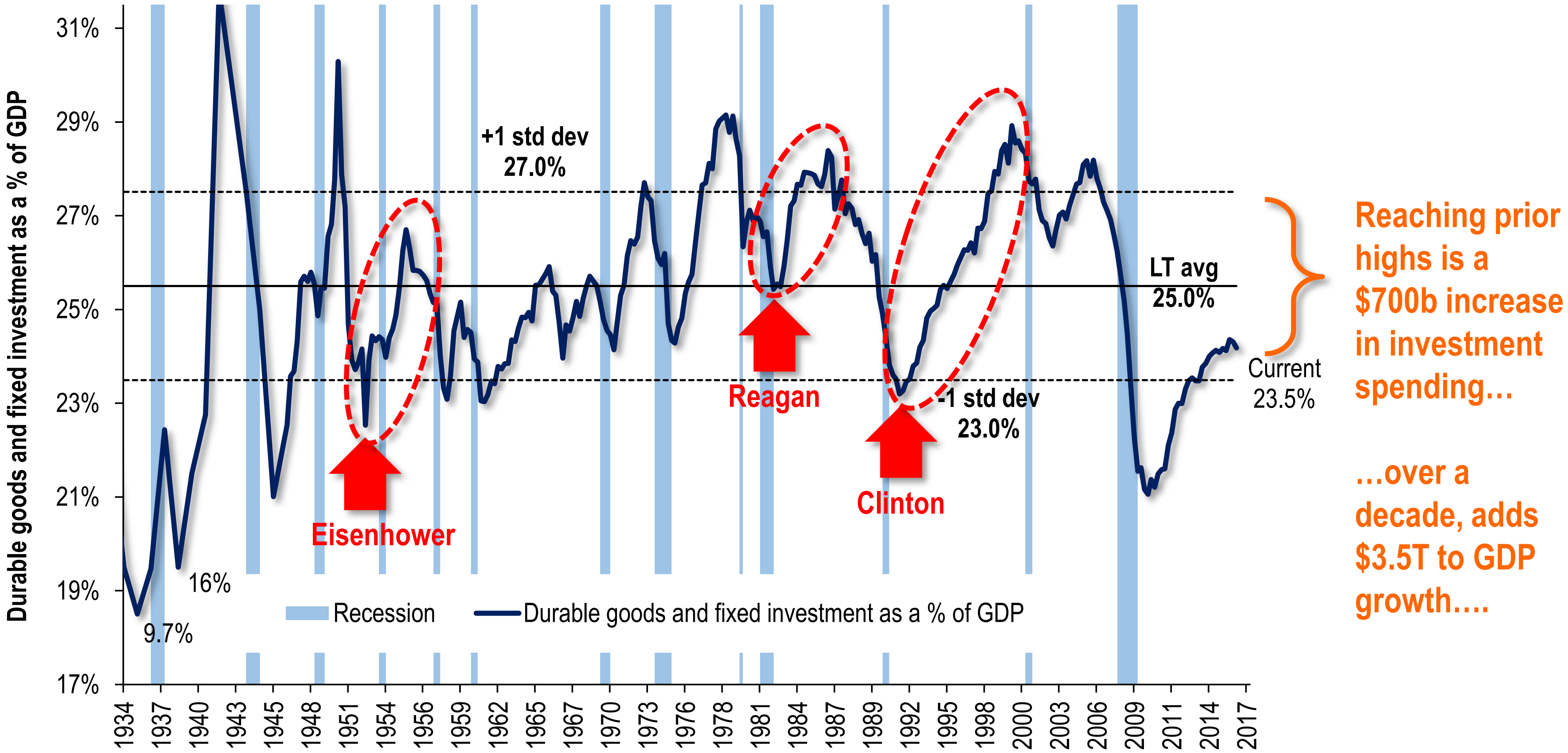
6/1950 to 12/1951	8/1955 to 3/1958	3/1965 to 11/1969	11/1972 to 3/1975	2/1977 to 11/1980	3/1987 to 6/1991	1/1999 to 2/2001	10/2002 to 8/2006	11/2009 to 3/2012
Total CPI Index 7.3%	Labor costs 5.1%	Shelter costs 4.8%	Commodities 19.7%	Shelter costs 13.0%	Shelter costs 4.7%	Commodities 7.7%	Commodities 14.8%	Commodities 7.8%
Labor costs 4.9%	Total CPI Index 2.8%	Total CPI Index 3.9%	Total CPI Index 9.6%	Commodities 11.7%	Total CPI Index 4.6%	Total CPI Index 3.3%	Total CPI Index 3.1%	Total CPI Index 2.5%
–	Shelter costs 2.6%	Labor costs 3.6%	Labor costs 9.5%	Total CPI Index 10.2%	Labor costs 3.0%	Shelter costs 3.1%	Shelter costs 2.8%	Shelter costs 1.1%
–	Commodities (1.5%)	Commodities 0.1%	Shelter costs 8.8%	Labor costs 8.7%	Commodities 0.0%	Labor costs 2.4%	Labor costs 1.4%	Labor costs 0.7%

Source: Fundstrat, Bloomberg

Investment spending is at "recession" levels still....

Normalizing this spending level would mean $3.5T in additional GDP growth over the next decade…

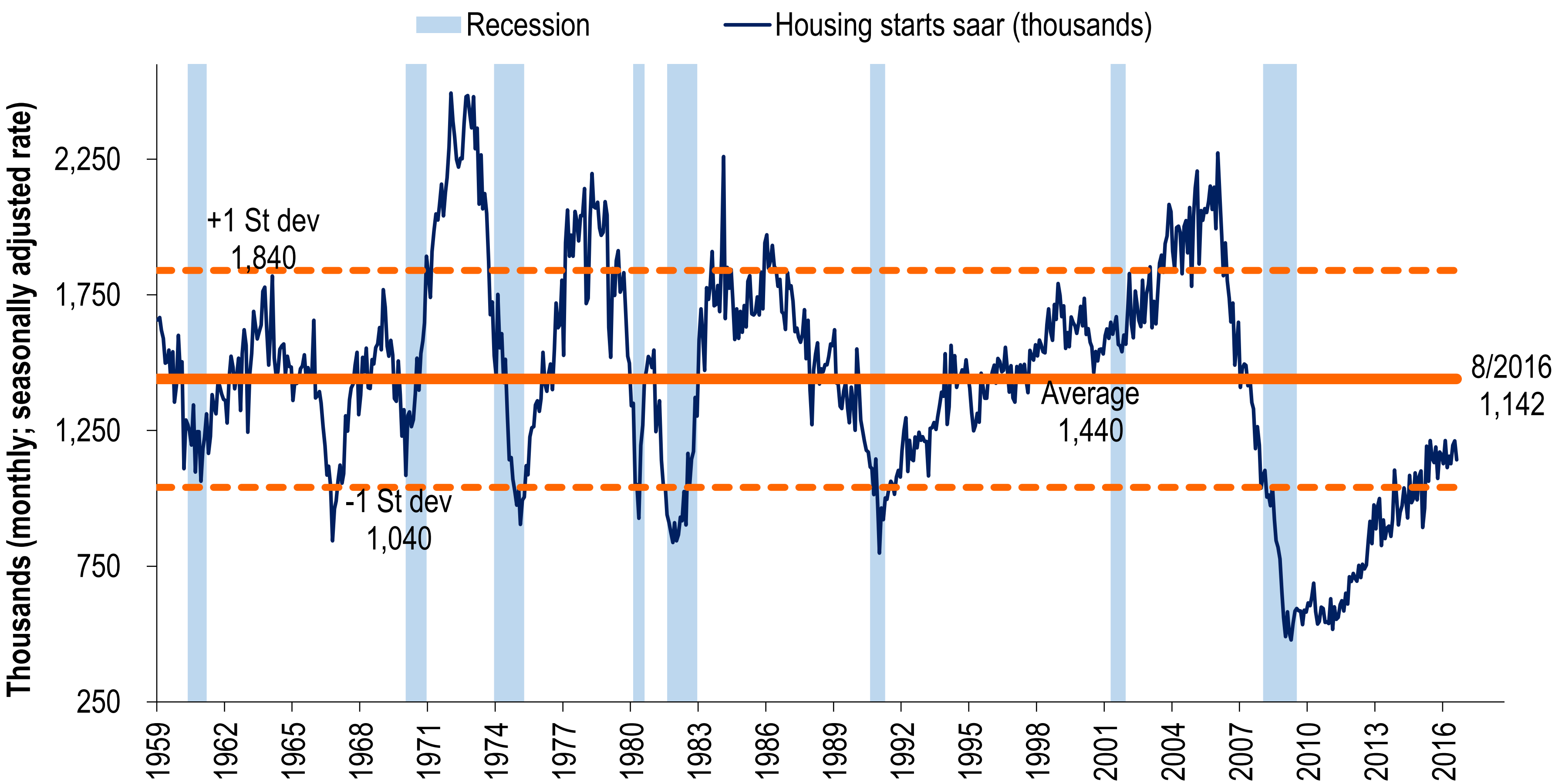
Figure: Investment spend as % GDP
Since 1934



Source: Fundstrat, Bloomberg

HOUSING: We need to build 1.5-2.0mm homes…

Figure: Housing Starts since 1959
Since 1959

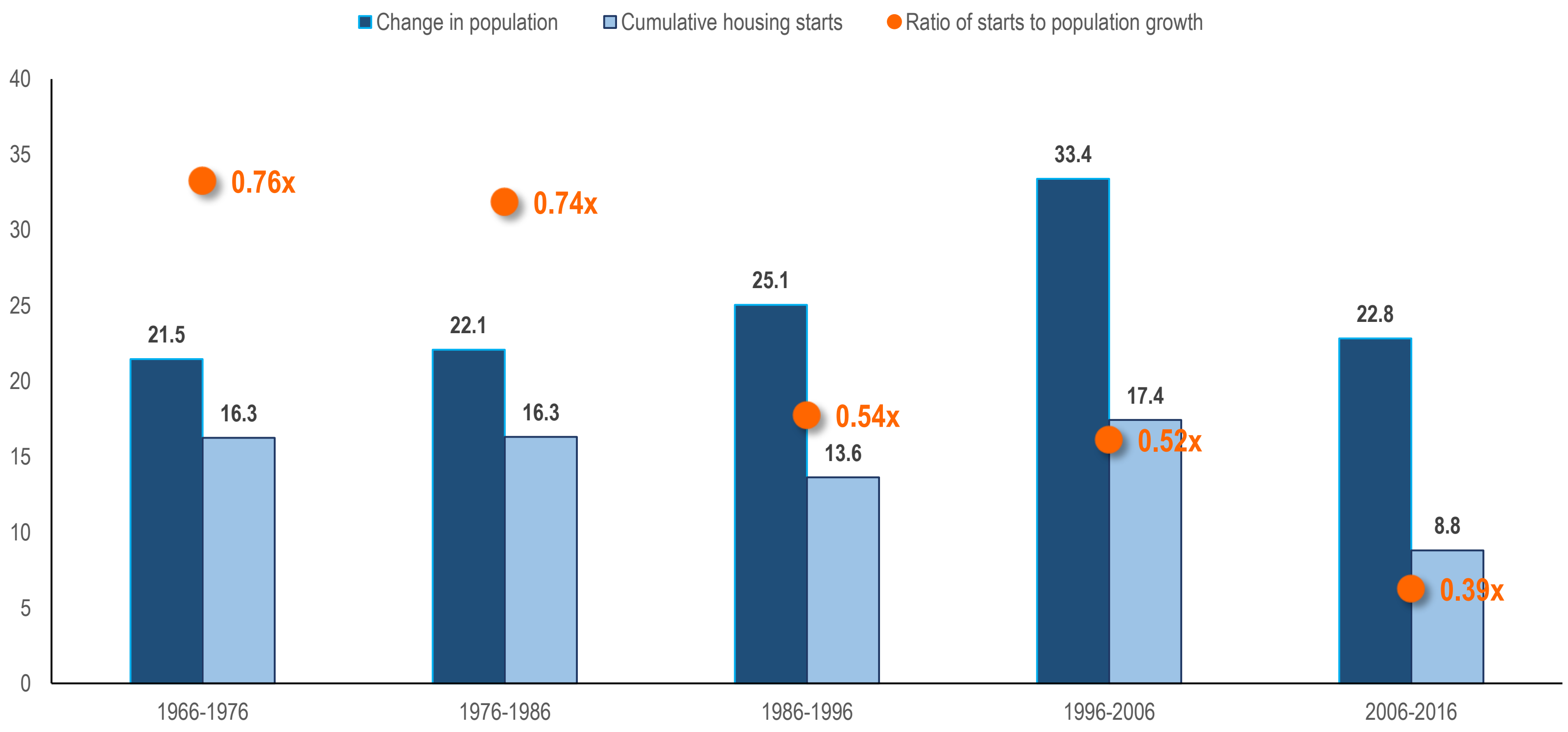


Source: Fundstrat, Bloomberg, BEA.
Note: we are including government fixed investment during the WWII period to account for the reclassification of private property as public property.

U.S. housing market still undersupplied…

Since 2006, the U.S. population has increased by 23 million. Historically, we would have built around 11mm homes over the past 10 years to accommodate this growth. Instead, we built around 8.8mm homes.

Figure: Changes in housing starts and population growth
From 1966



Source: Fundstrat, Bloomberg

Different drivers in each business cycle…

Taking a broader step back, there are some reasons to believe 2016 is the start of a regime change:

- **As shown below, the drivers here are changes in global growth drivers as well as currency, inflation trends and eventually equity flows.**

	1982-1990	1990-1999	2000-2006	2007-2015	2016-future…
Global growth driver	Japan	US and DM Technology boom	China and Commodity producers Housing	China	US and G7
Saving Flow	To: Japan From: G7	To: Asia From: Japan/G7	To: Commodity producers From: G7	To: US & Chinese consumers From: Commodity producers	To: G7 and EM From: US & China consumers
USD trend	Weakening	Rising	Weakening	Rising	Weakening
Inflation	Falling	Flat	Rising	Falling	Rising
Equity flows	Negative	Positive	Flat	Negative	Positive

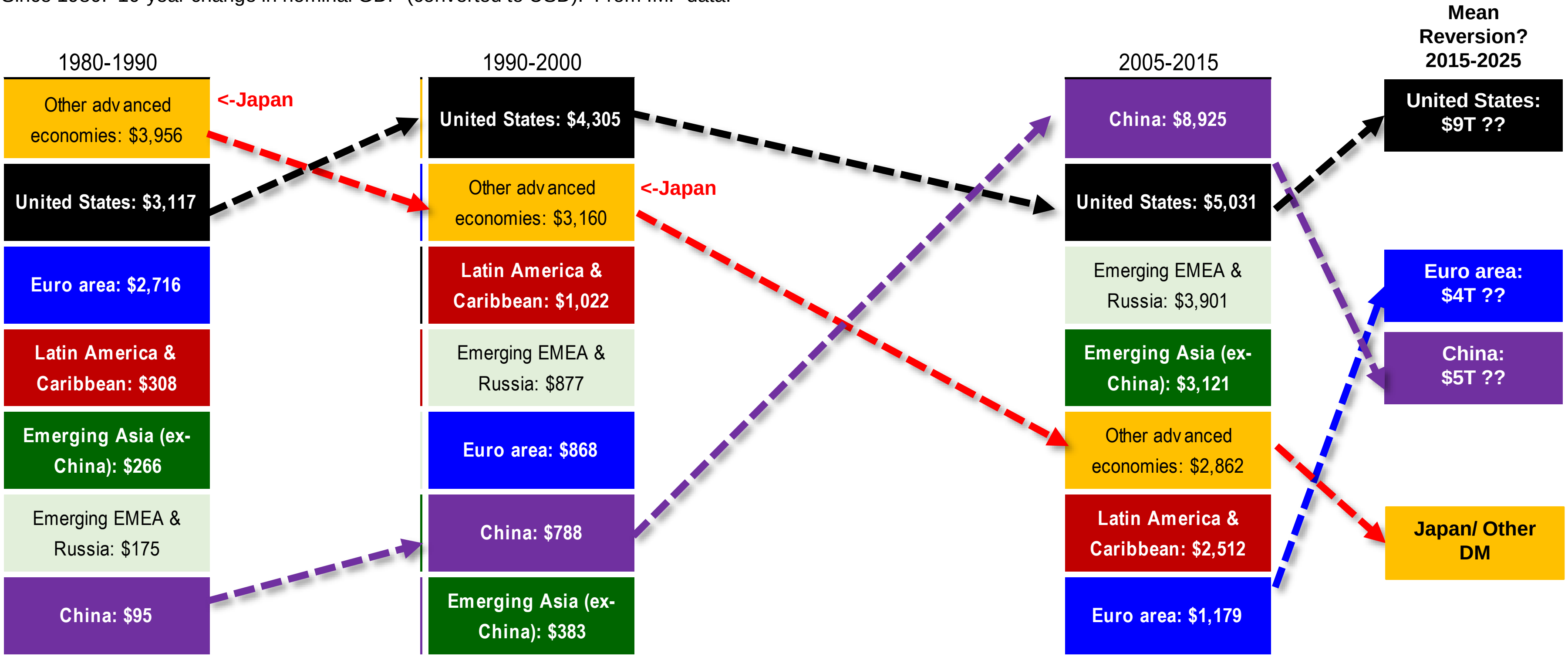
CHINA: Will U.S. be driver of global growth in next decade?

We have listed the key contributors to global growth for each decade below (5 year intervals), based on data provided by the IMF. And a few things really stand out. Foremost, one can see the ascendancy of China over the 35 years, as its contribution to global growth surged to nearly $9T in the past 10 years (and well above the U.S.). But as we think about the next decade, one can make the case that U.S. and even Europe become important contributors to global growth:

- For Europe, we can see the pathway, driven by completion of existing reforms, completion of the painful de-leveraging and new regulation and even the positives of the influx of refugees (growing the population);
- For the U.S., the incremental drivers are a recovery in: (i) U.S. housing, (ii) corporate capital spending, (iii) new administration; (iv) millennials and (v) eventual innovation from Energy production.

Figure: Which regions dominated growth in each 10-year period?

Since 1980. 10-year change in nominal GDP (converted to USD). From IMF data.

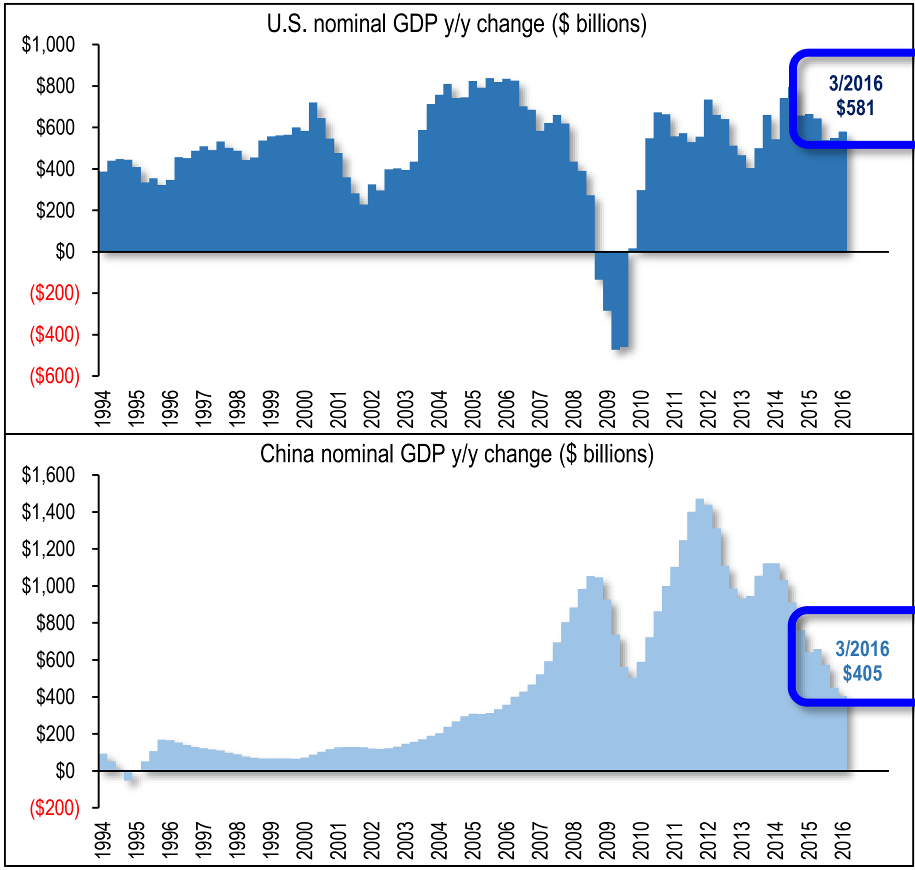


Source: Fundstrat, FactSet, Bloomberg, IMF.

CHINA: US is outgrowing China for the first time in a decade

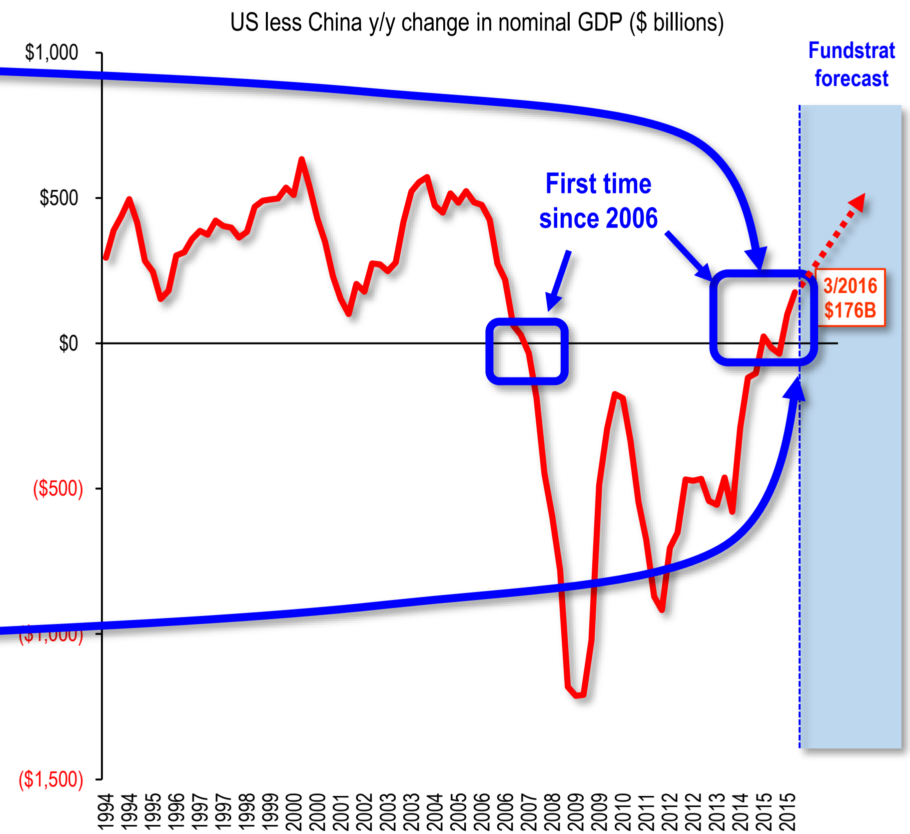
- We see U.S. growth remaining fairly healthy, supported by a rise in housing investment, consumer durables purchases, non-residential and even business investment spend (yes, even with oil depressed). **Over the next decade, the US could potentially add more GDP dollars than China.**

Figure: U.S. and China GDP growth Y/Y
$ billions



Source: Fundstrat, Bloomberg.

Figure: Spread between US GDP and China GDP growth y/y
$ billions



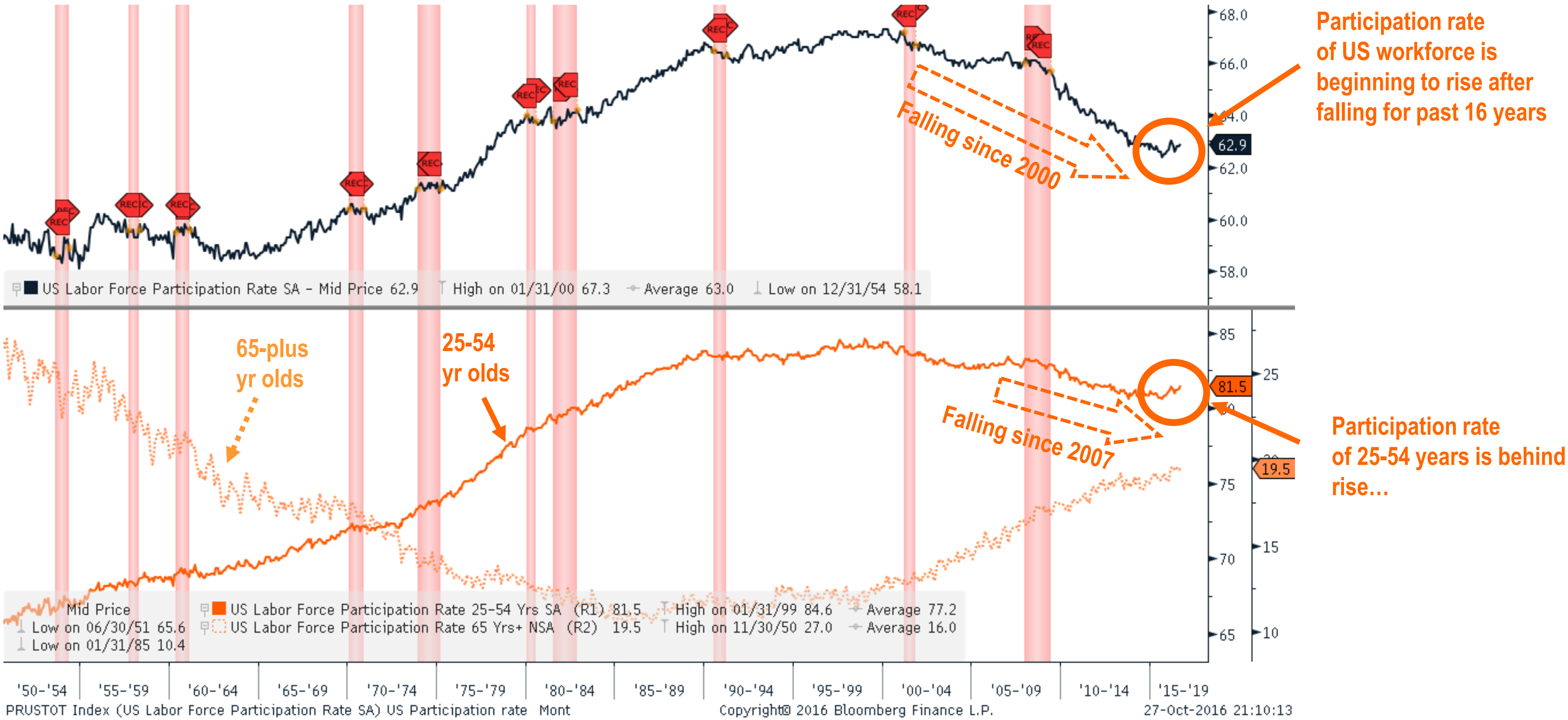
Source: Fundstrat, Bloomberg.

offset somewhat by Labor Force Participation rates increase…

One of the challenges for the labor market has been the declining labor force participation rates. As shown below, in 2016, labor force participation rates have begun to increase.

- **An uptick in participation rates brings more workers into the labor market and helps offset the wage pressures from a tightening labor market.**

Figure: Labor participation rates
Since 1950



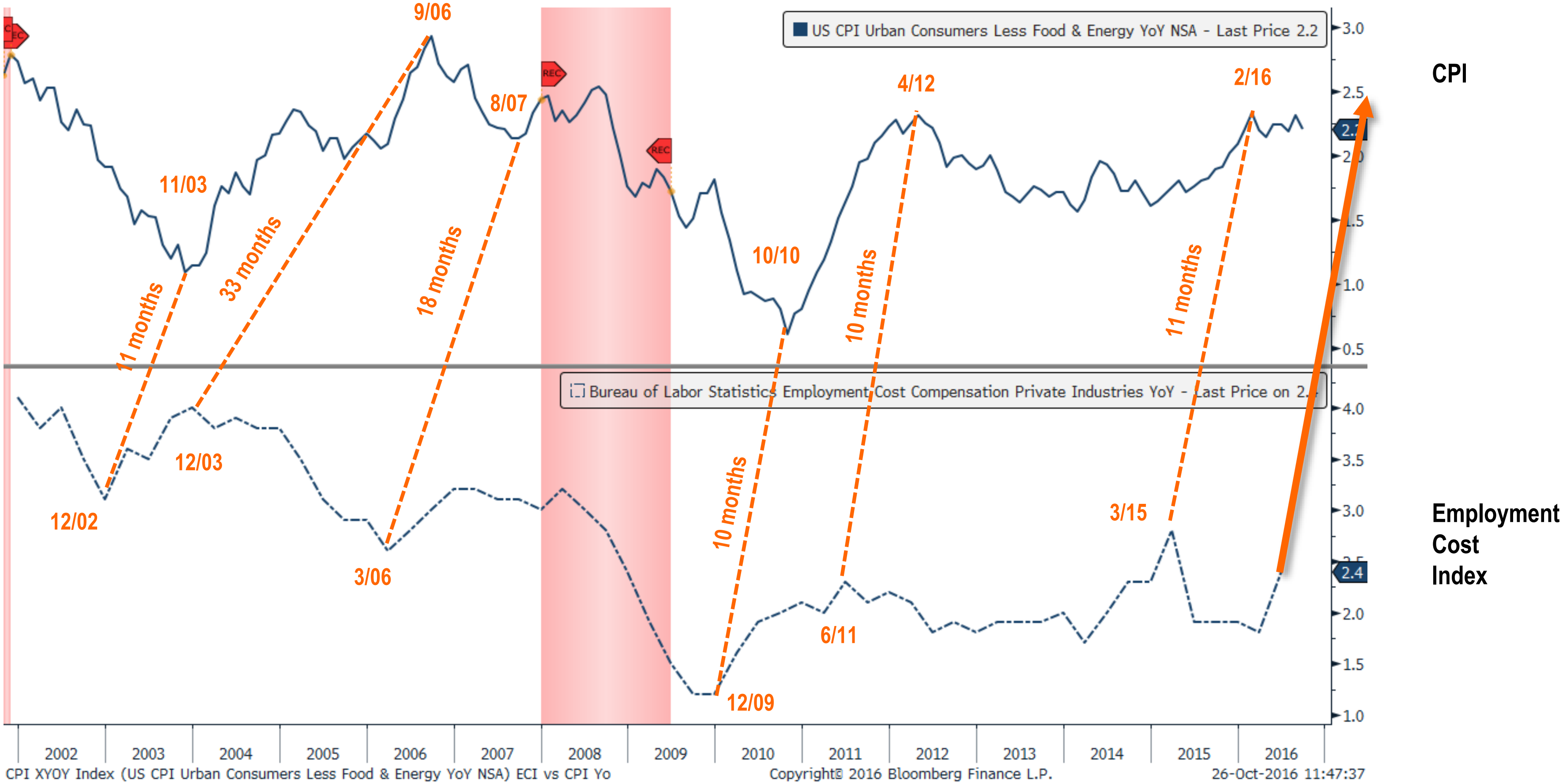
Source: Fundstrat, Bloomberg, Factset

As for CPI, Employment cost index leads CPI by 11 months…

We have plotted CPI and employment cost index below. And as shown, employment cost index tends to inflect 11 months before CPI. In other words, we expect US inflation to tick up in the next few months.

- **This suggests investors should incorporate more inflation sensitivity into their portfolio holdings.**

Figure: Employment Cost Index leads CPI by 11 months…
Employment cost index vs CPI



Source: Fundstrat, Bloomberg

Stronger USD due to Fed and growth, but inflation pickup could weaken USD…

We have highlighted the theoretical factors impacting currency below (based on PPP/interest differentials).

- **As shown, higher inflation (as discussed before) would add downside pressure to USD, particularly if the Fed is "behind the inflation curve".**

Figure: Currency exchange rates is ultimately based on interest rate differentials.
Fundstrat estimates

	Interest rate differential	Market-based measure	Impact on exchange rate
A	Risk-free rate	Differential Central bank policy rate	Higher policy rate, stronger currency
B	Real Term premium	Differential real GDP growth expectations	Higher GDP growth, Stronger currency
C	Inflation	Differential inflation expectations	Higher inflation, Weaker currency
A+B+C	Interest rate differential	Expected exchange rate between currencies	

Investors expect USD to strengthen from Fed high (A) and from stronger US growth (B)

But if inflation strengthens, as evidenced by ECI and labor indicators, then this *could weaken USD*

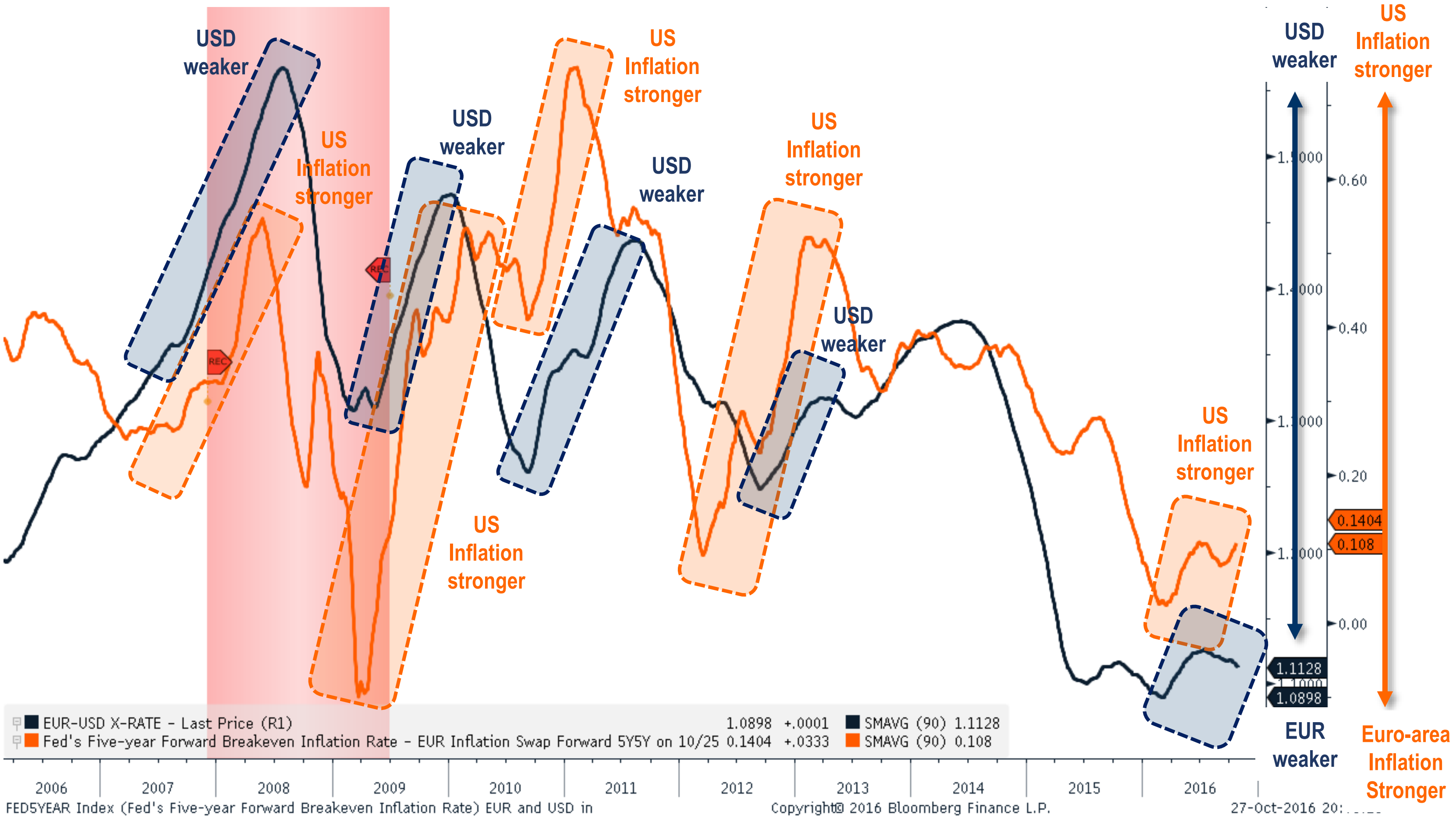
Source: Fundstrat,.

History shows when US relative inflation rises, USD weakens...

We plotted comparative inflation of the US vs Euro-zone (using inflation breakevens) and the USD/EUR exchange rate.

- **As shown below, whenever US inflation expectations rise (vs Eurozone), the USD tends to weaken (dark blue line). Given the tightening US labor market and likely lead on CPI, we believe this would add downside pressure to USD.**

Figure: USD/EUR versus 5-year inflation breakevens (US less EUR)
Since 2006



Source: Fundstrat, Bloomberg, Factset

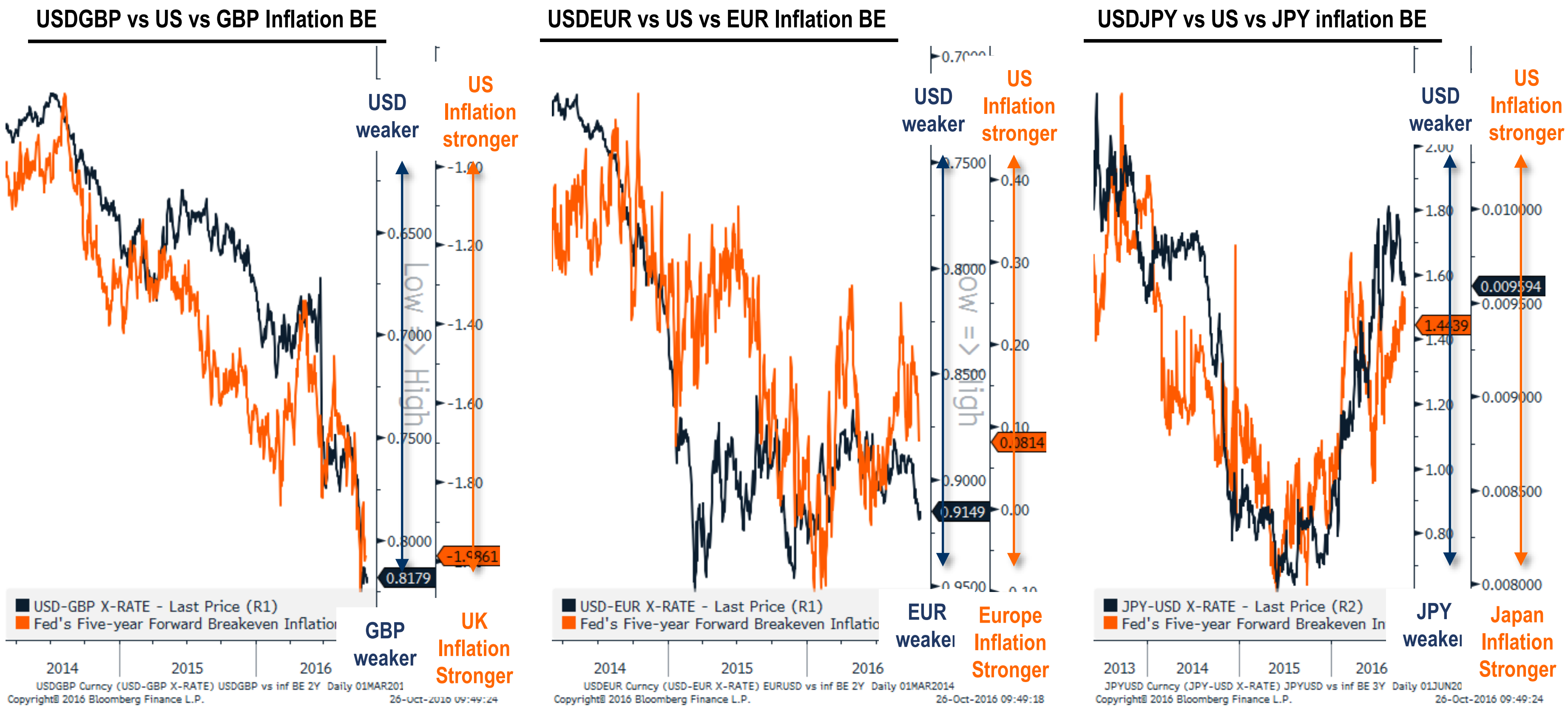
In past month, higher UK/Eurozone inflation strengthened USD…

The rise in inflation expectations in UK and Eurozone recently (vs US) explains in part, the strengthening of the USD. We have plotted the comparative changes in inflation breakevens (orange) and exchange rate (blue line).

- **As shown, as UK and Eurozone inflation expectations rose faster (orange line falls), USD strengthens (blue line falls). As discussed previously, we believe US inflation expectations should ultimately rise faster than Eurozone and hence, we see downside to USD.**

Figure: USD against GBP/EUR/JPY currencies and comparative inflation breakevens

Since 2013. Orange line is 5-year US inflation breakevens (FED5YEAR Index) less respective country inflation BE



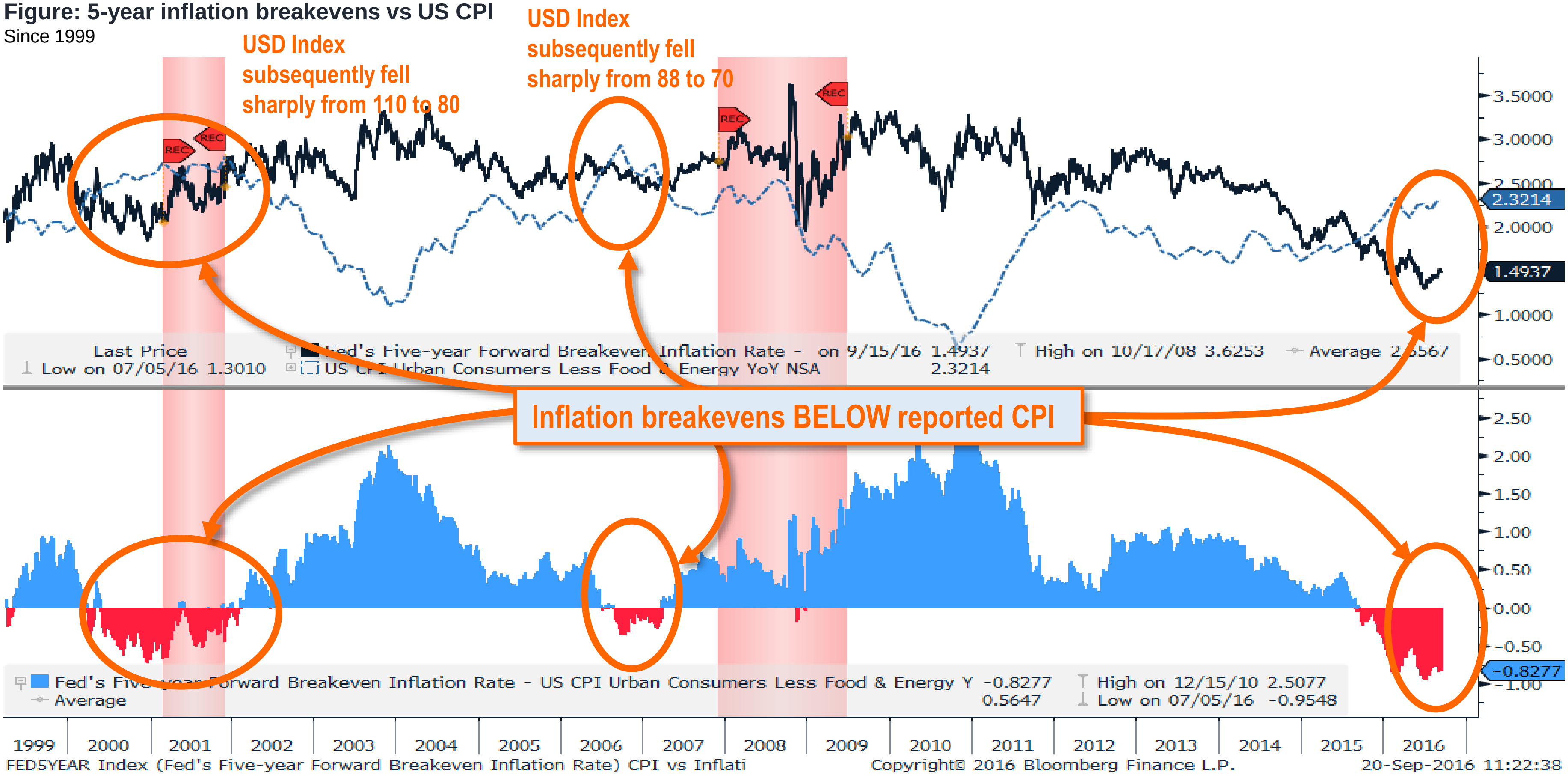
Source: Fundstrat, Bloomberg.

Lower US inflation transitory as markets "selling" inflation premia… downside to USD.

Financial markets seem to be pricing in the opposite. If we use Fed 5-year breakevens (5-yr US vs 5-yr US TIPS), we see that inflationary expectations have fallen steadily over the past few months. And in fact, are now below US CPI.

- **This was seen in 2000 and in 2006—and we know markets were "surprised" with inflation back then. Both in 2000 and 2006, the USD subsequently weakened.**
- **In other words, we believe USD could see further weakness as markets start to discount higher inflation. Again, the precedents as shown below were 2000 and 2006 and both saw USD subsequent USD weakness.**

Figure: 5-year inflation breakevens vs US CPI
Since 1999



Source: Fundstrat, Bloomberg.

Democratic WH: Higher inflation *lower* debt as % GDP

It may not be intuitive that higher government spending under Democratic administrations can lead to lower Federal debt. The connection, as highlighted below, is the higher overall inflation rate under Democratic presidents. As shown on the bottom left, those periods of Democratic administrations saw higher CPI and falling debt.

- **In fact, as shown on the right grid, Budget deficits are pretty similar (between Rep and Dems) but it is the inflation component that differs. Higher inflation is higher nominal income for Govt and thus, reduces debt.**

Figure: Scatter: CPI overall (x-axis) versus Change in Federal Debt annually
Since 1949

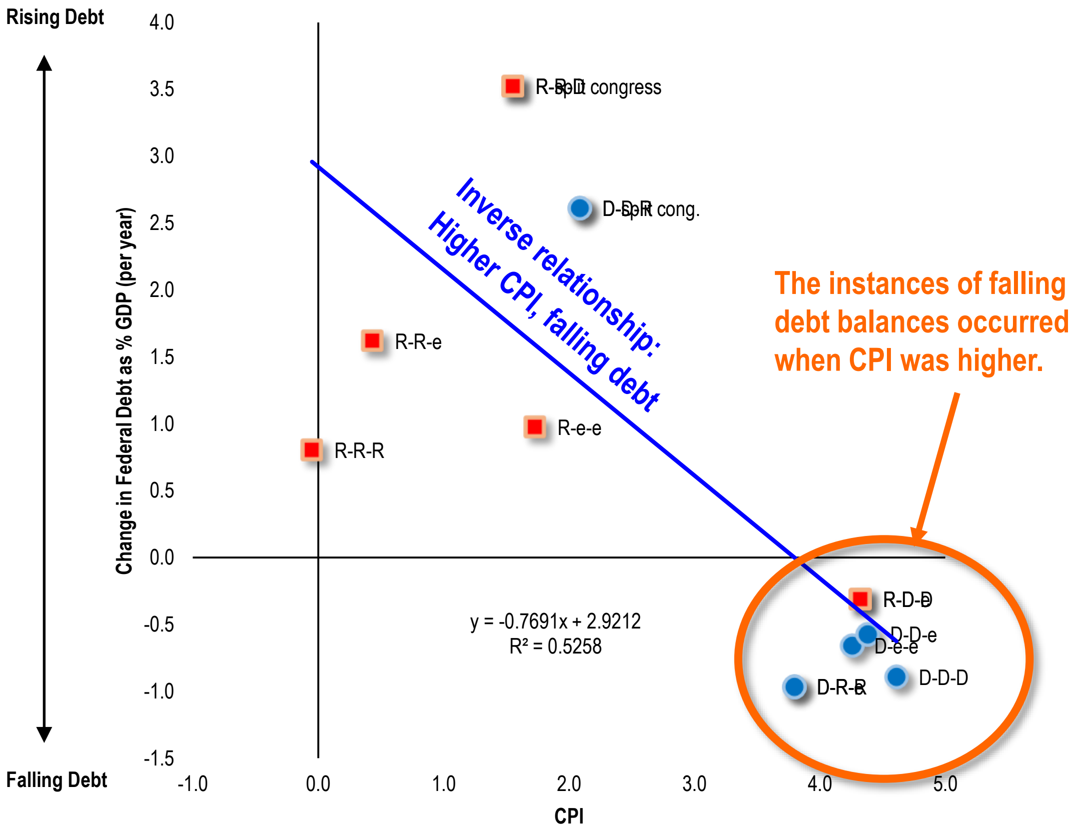


Figure: Budget Deficits and CPI under different Party regimes
Since 1949

Budget Deficit (% GDP)

Senate	House of Representatives	White House: Democratic	White House: Republican
		(1.74)	(2.02)
Democratic	Democratic	(1.66)	(1.77)
Democratic	Republican	(5.68)	--
Republican	Democratic	--	(3.51)
Republican	Republican	(0.72)	(1.56)

CPI Overall YoY (includes Food and Energy)

Senate	House of Representatives	White House: Democratic	White House: Republican
		4.26	1.73
Democratic	Democratic	4.61	4.33
Democratic	Republican	2.09	--
Republican	Democratic	--	1.56
Republican	Republican	3.80	(0.05)

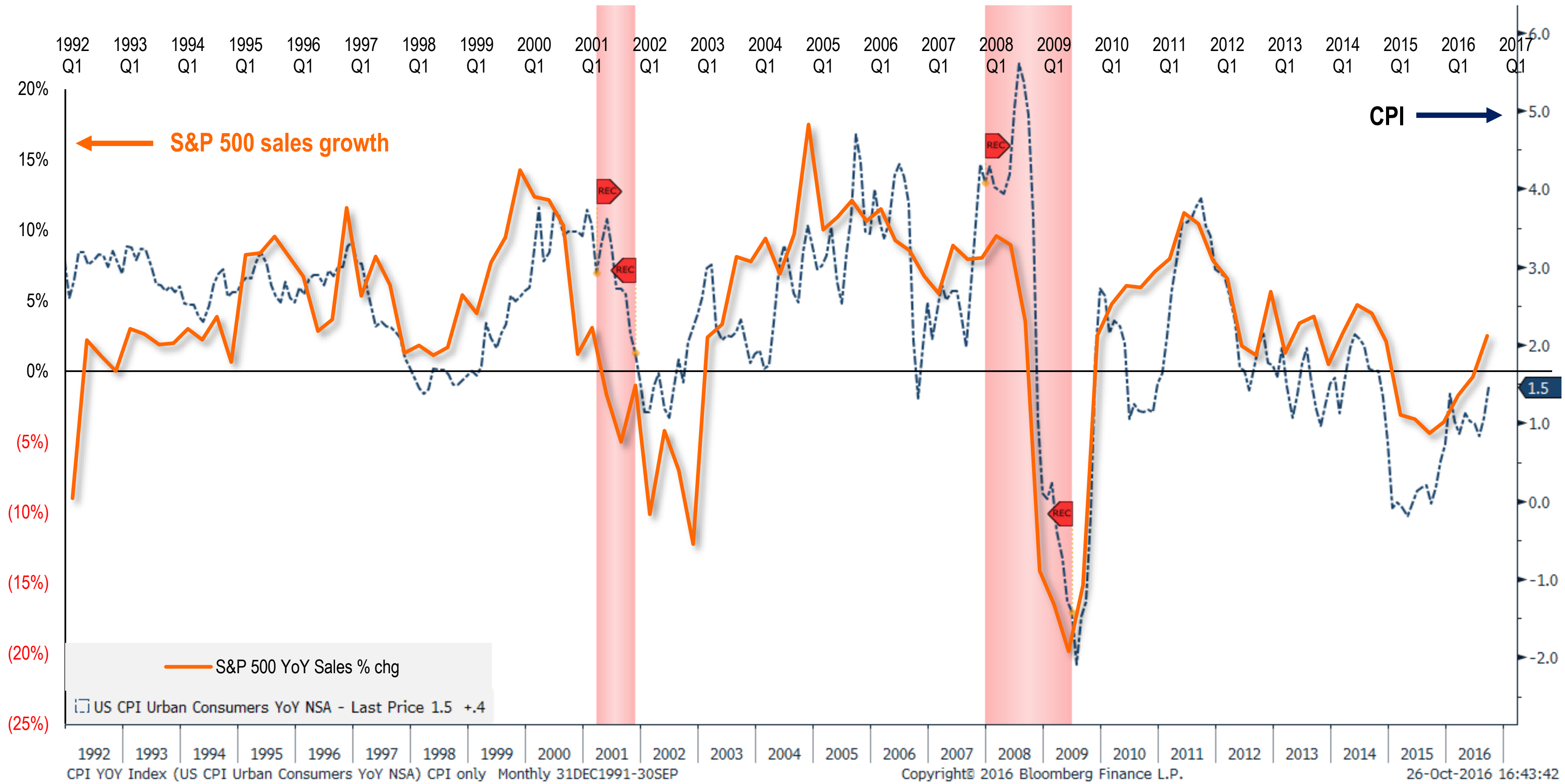
Source: Fundstrat, Bloomberg

Higher inflation points to *higher* S&P revenue growth…

We have compared CPI and S&P 500 revenue growth below. And as shown, S&P 500 revenue growth tracks changes in CPI fairly closely.

- **In other words, we believe the recent upturn in S&P 500 sales growth has "legs" as inflation begins to strengthen in the US.**

Figure: CPI and S&P 500 sales growth
CPI Urban Consumer ex-Energy & Food and S&P 500 sales per share growth y/y

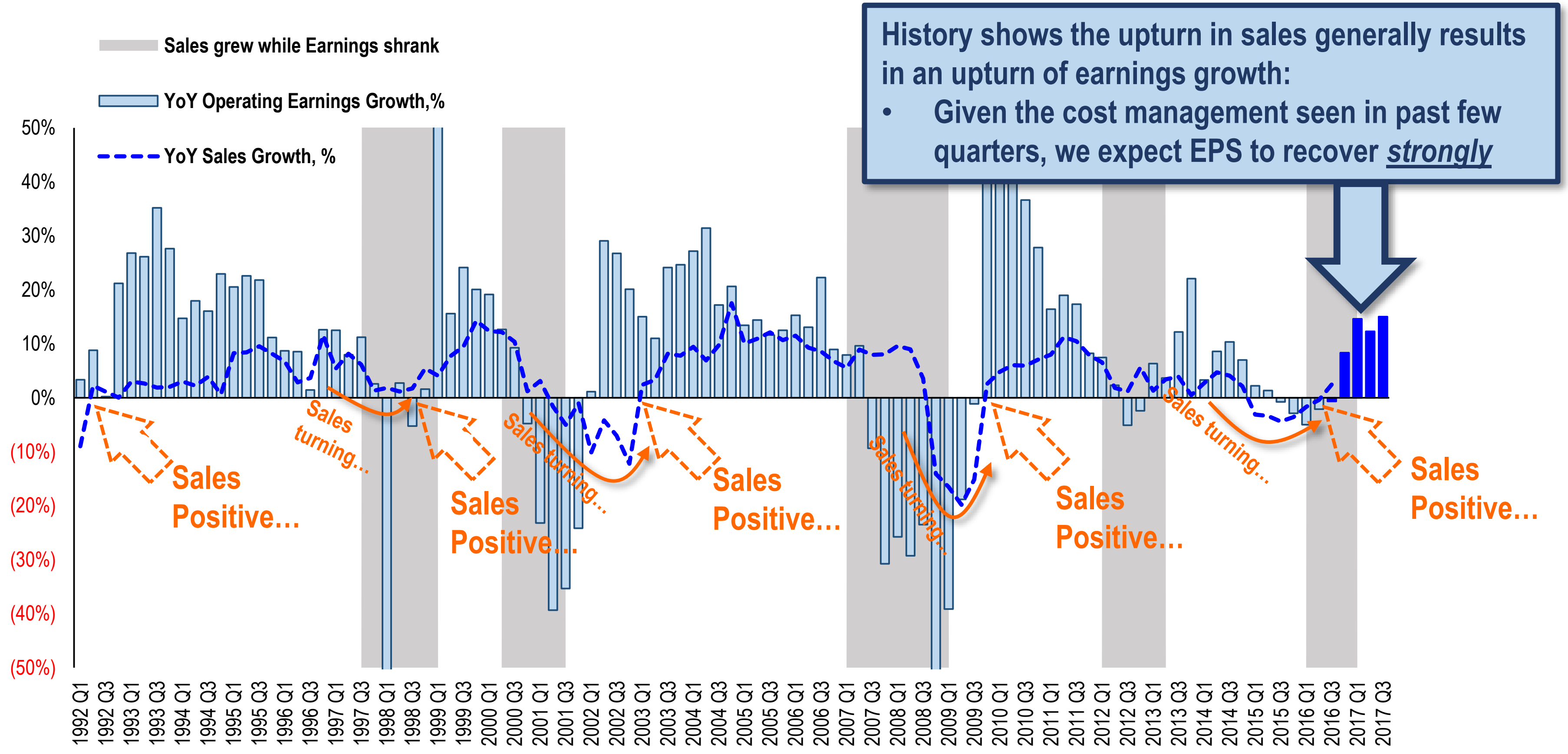


4 of 4 times, sales *inflecting*, *leads* EPS acceleration…

Another positive development in 3Q16 results is that sales growth is turning positive, and EPS returned to growth during 3Q16 earnings season.

- **As shown below, in the past 20 years, an upturn in sales growth yoy only signals positive developments in EPS growth. S&P 500 EPS growth has been down for 6 quarters now and we believe we are now at the turning point.**
- **We expect earnings to gradually accelerate back towards mid- to high-single-digit EPS growth by mid 2017…**

Figure: Past upturns in sales are associated with upturns in EPS growth….



Source: Fundstrat, Thomson Reuters.

US Energy sector bottoming…

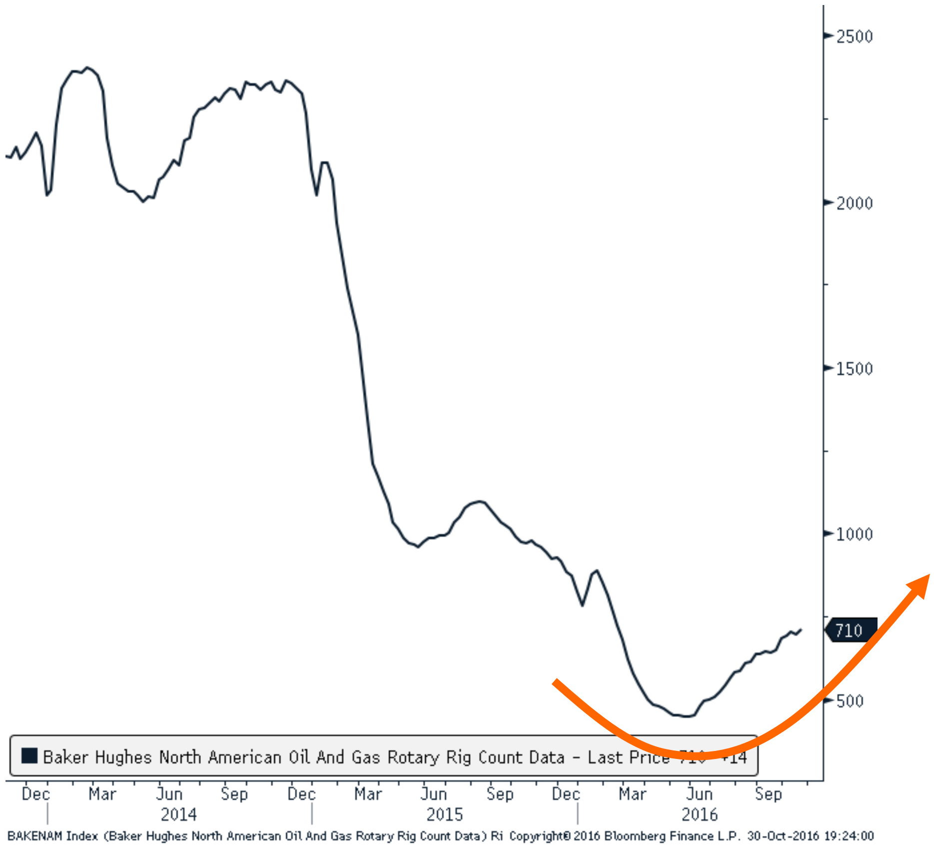
The Energy sector, which has been a significant drag on global growth (40% of global GDP, on a PPP-basis is a commodity producer).

- **As shown below, the recovery in oil prices and the resulting lift in rig count are a positive boost to global growth.**
- **About 1/3 of Industrial sector revenues are derived from resource-related activities (Resource activities also account for about 25% of US private investment) and therefore a recovery in this area is positive for earnings growth for Cyclicals.**

Figure: Oil prices bottomed in February 2016
WTI crude prices

Source: Fundstrat, FactSet, Bloomberg

Figure: North America rig count bottomed in June 2016
Baker Hughes Oil & Gas Rig count



Source: Fundstrat, Bloomberg, Factset

Quantifying "descending from high altitude" starting in 3Q16

Existing benefits to EPS are already being generated by the fading of some serious headwinds for S&P 500 companies.

- **We see these benefits driving upside to S&P 500 EPS starting in 3Q16. Moreover, because companies were operating in a weak revenue environment (high altitude), as they get to sea level, margin upside should be even better.**

Figure: Quantifying EPS benefits of a better revenue environment…
Fundstrat estimates

	Revenue Driver		S&P 500 EPS Impact		Description
1	Oil recovers to $50 from $26	*Energy EPS to reflect higher Oil "forwards"*	+$2	$5 delta oil = $2.60 EPS	The oil price deck has moved up $7 while Energy 2017 EPS forecasts have not risen. See Slide 13
2	Oil stabilizes after "plunging"	*20 Energy costs see margins normalize…*	+$7	EBIT margin = $5 -$8	Just the top 20 Energy companies' margin normalization adds $60b in EBIT or $7 per S&P 500 share. See Slide 15
3	Fed hikes in 2016/2017	*Bank ROE goes up*	+$1	Each 100bp change in Bank ROE is $1.24 EPS	Bank ROE is 8% vs 20% in the 2000s. See Slide 18
4	USD is down y/y	*USD faces easier y/y comparisons*	+$1-$3	Each 100bp change in USD is $0.50-$1.00	USD is facing easier comparisons y/y and beginning in 2Q16 is down y/y. See Slide 19
	Aggregate Altitude Benefit		**$11-$14**		

Source: Fundstrat, FactSet, Bloomberg.

S&P 500 EBIT margins

Figure: Deciles of S&P 500 EBIT margins
Since 1999

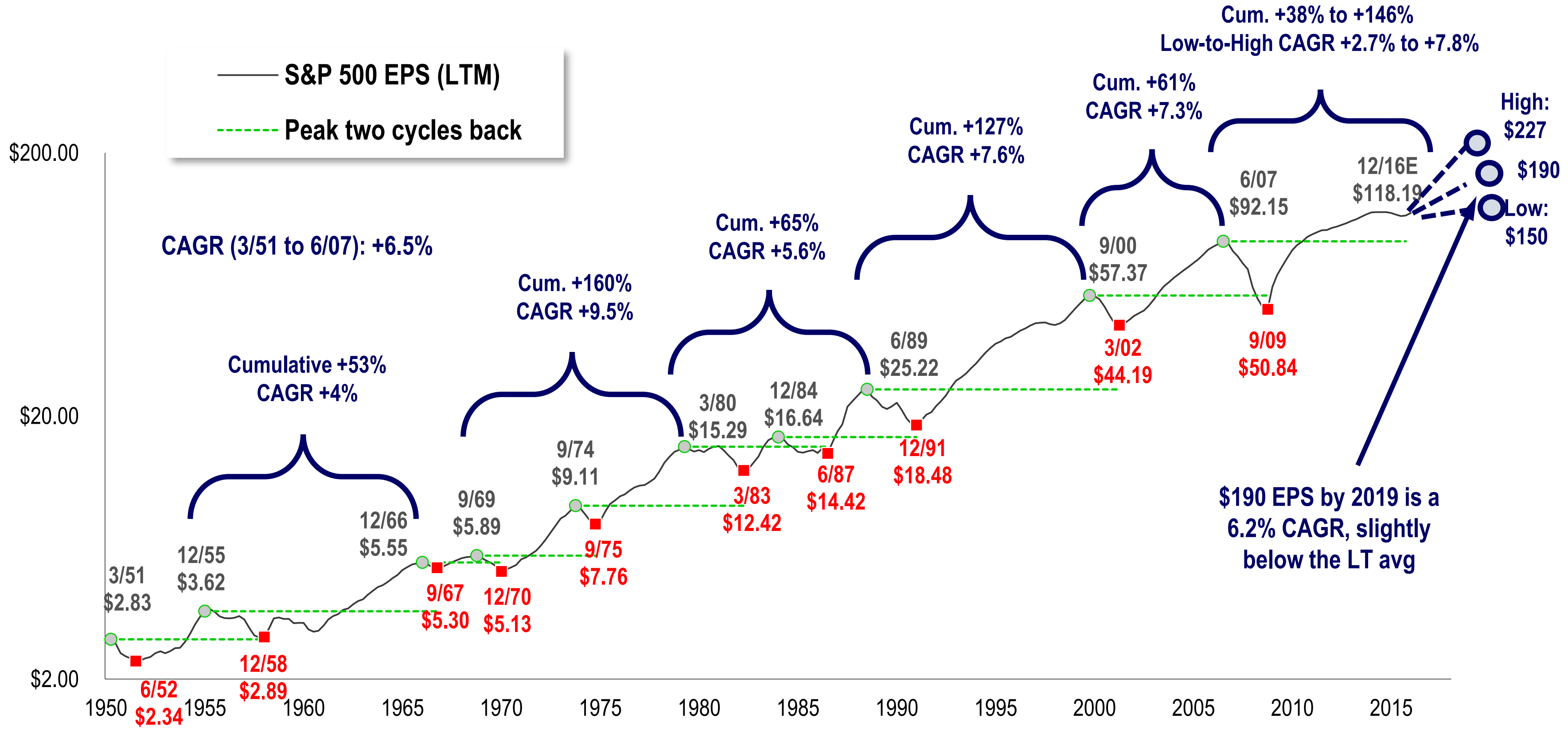
% contribution to S&P 500 Sales		% contribution to S&P 500 EBIT		Market cap weight		
Sales ($B)	% share	Total EBIT	% share	Market cap	% share	
$8,251	100%	$1,182	100%	$19,044	100%	S&P 500
$1,234	15%	$278	24%	$4,090	21%	Technology
$1,209	15%	$168	14%	$2,004	11%	Industrials
$1,650	20%	$190	16%	$2,480	13%	Consumer Discretionary
$324	4%	$45	4%	$548	3%	Basic Materials
$896	11%	$32	3%	$1,383	7%	Energy
$1,378	17%	$48	4%	$2,731	14%	Financials sector (NET MARGIN)
$1,559	19%	$150	13%	$2,729	14%	Healthcare
$1,593	19%	$150	13%	$2,035	11%	Consumer Staples
$310	4%	$60	5%	$462	2%	Telecom Services
$311	4%	$60	5%	$582	3%	Utilities

Source: Fundstrat, Factset, Bloomberg

History says S&P 500 EPS peaks ~$150-$220, CAGR of 7.5%

- Since 1950 S&P 500 EPS has compounded at 6.5% annually and about that level “peak-to-peak” in the intermediate cycles. That is about the rate of nominal GDP growth during that time.
- **This suggests a potential peak EPS of $195 this cycle compared to the currently estimated $118 of earnings for 2016.**

Figure: S&P 500 EPS historically compounds at 6.5% annually, implying $190 in EPS by 2019…
EPS cycles since 1950



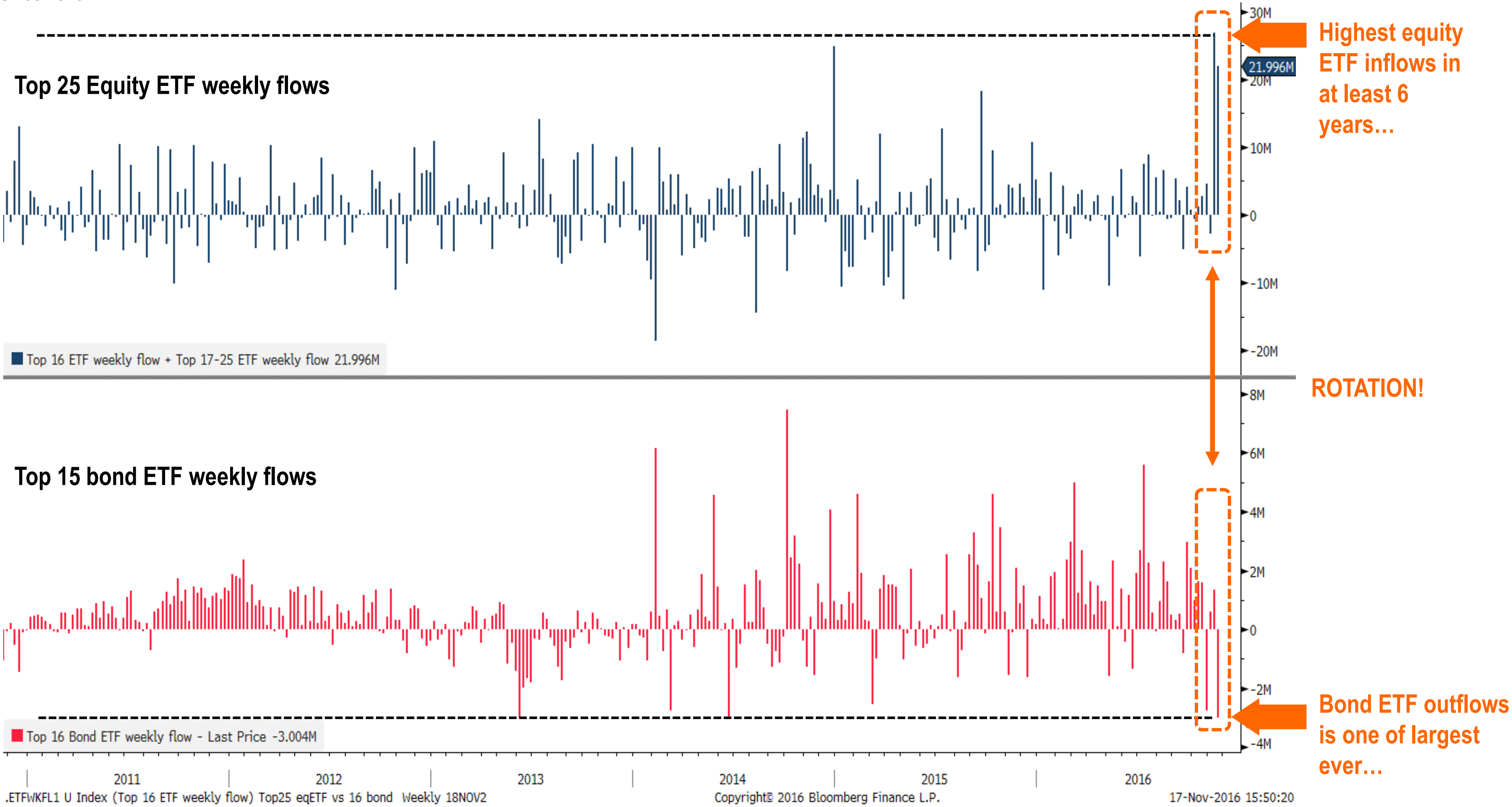
Source: Fundstrat, Thomson Reuters.

Investors are scrambling into equity ETFs

As shown below, equity ETFs have seen two weeks of some of the largest flows in more than 6 years .

- **And it is taking place while we have seen a large rotation out of bond ETFs.**

Figure: Comparative weekly ETF flows: Equity vs Bonds
Since 2010

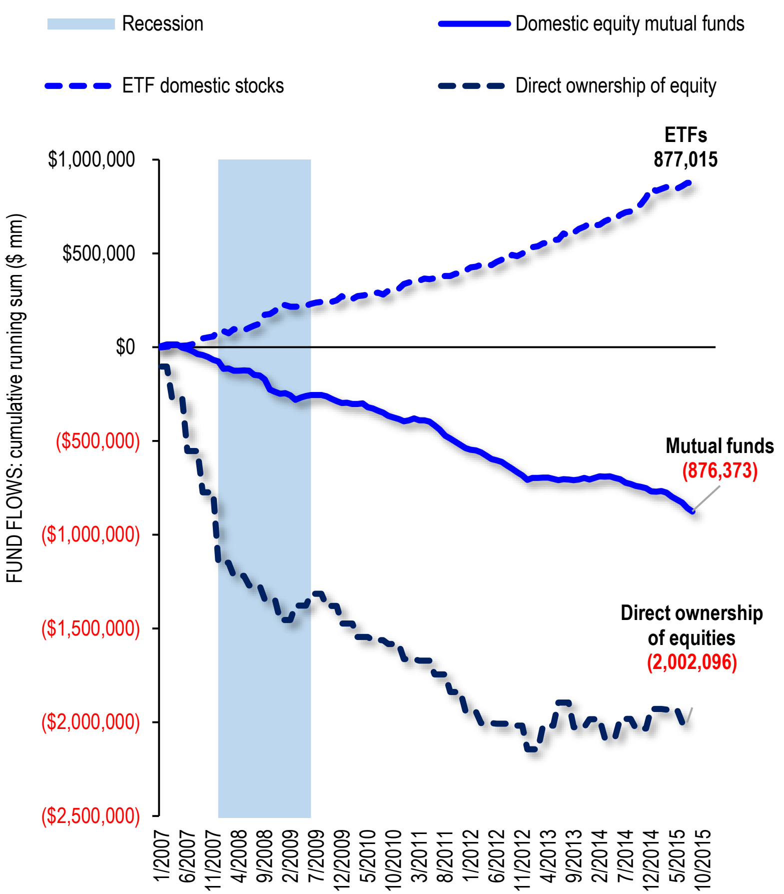


Source: Fundstrat, Bloomberg

HISTORIC LIQUIDATION: Households have *only bought bonds* since 2007…

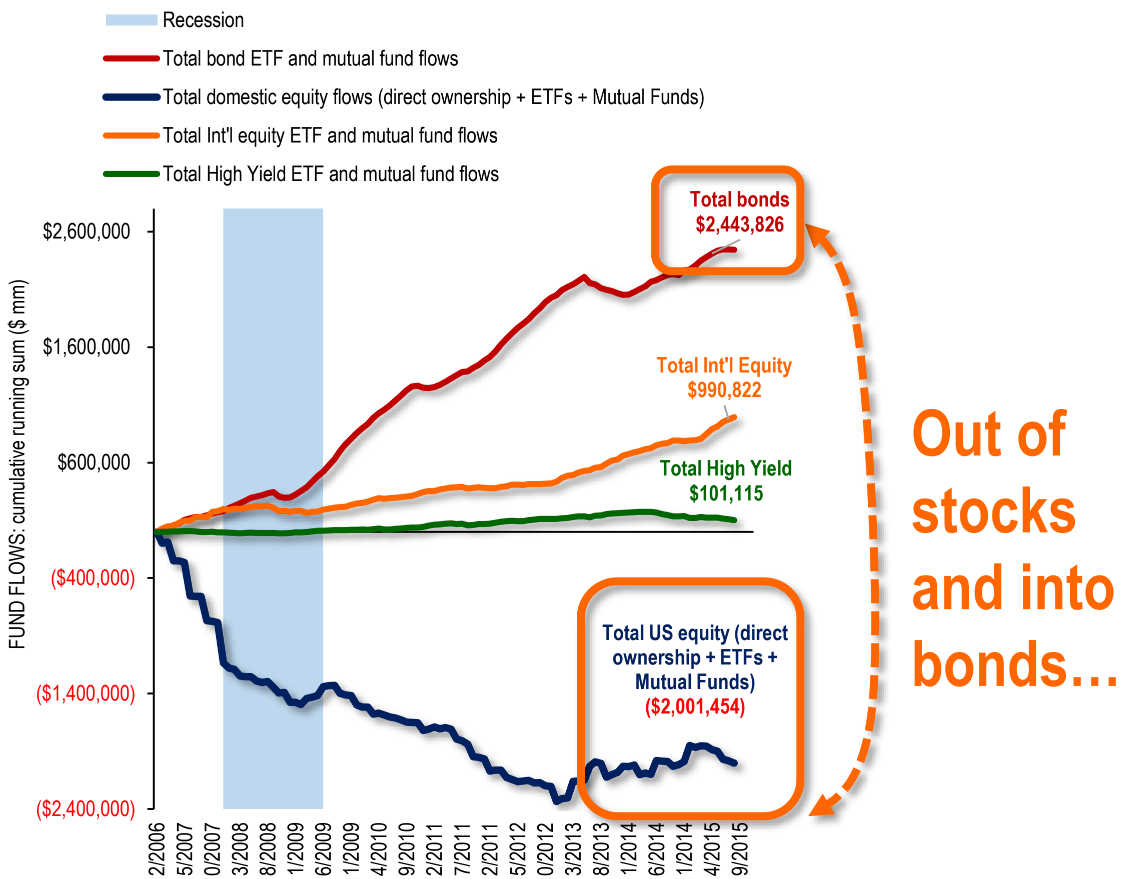
- The largest decline has been direct ownership of stocks (down $2T) and this reflects the buyback programs of US corporates. Essentially, they have been buying equity holdings from households (institutional ownership of stocks is essentially the same). The only area of purchases has been domestic equity ETFs. **Instead of equities, households have diverted $2.4T into bonds, $1T into international equities and $100b into high-yield.**

Figure: Households liquidated equities holdings since '07
Cumulative U.S. equity flows since 2007 ($ mm)



Source: Fundstrat, ICI, Bloomberg. Federal Reserve Flow of Funds.

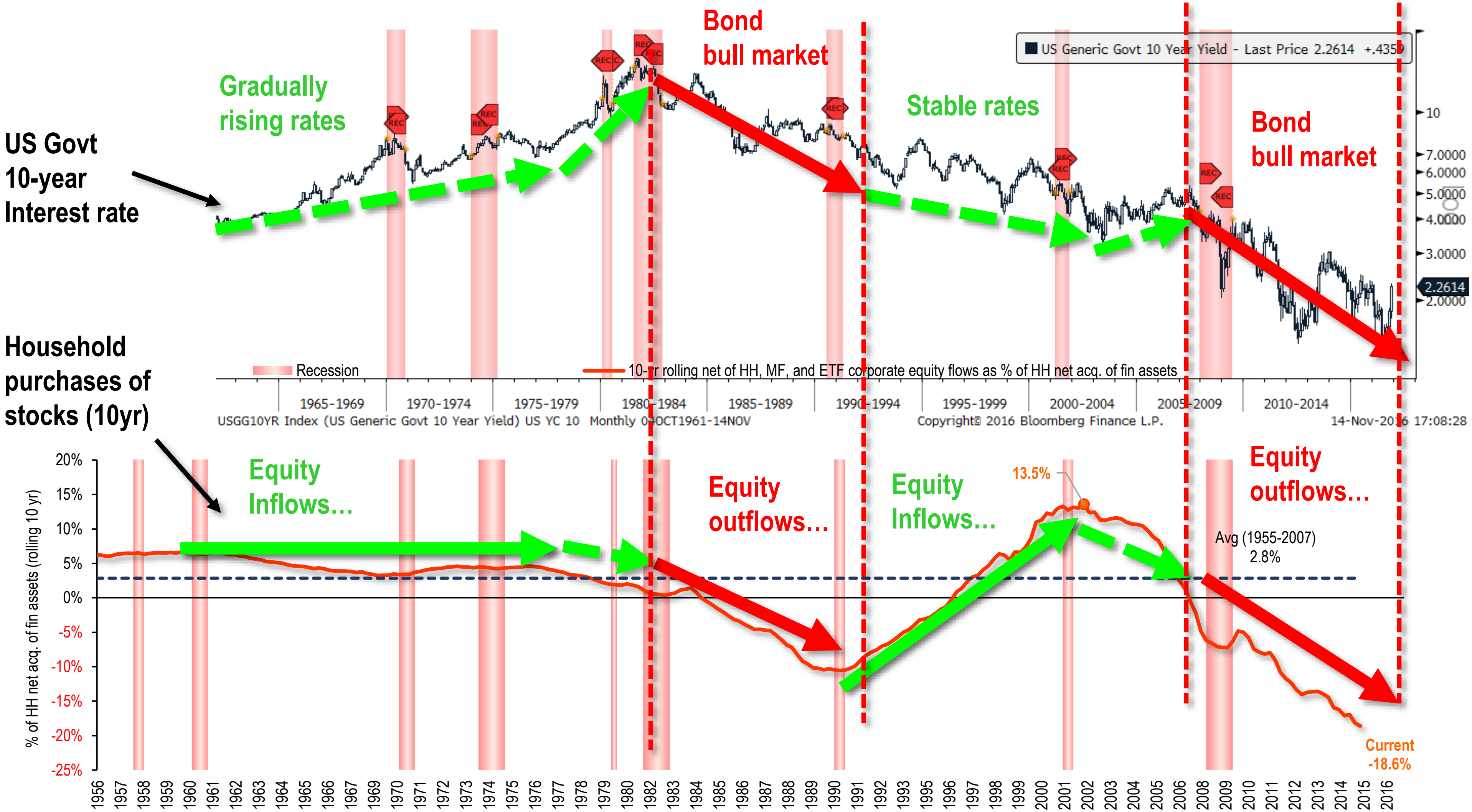
Figure: $2T in U.S. equity *OUTFLOWS* since 2007
Domestic / Int'l equity, bond, and high yield ETF and mutual fund flows since 2007 ($ mm)



Source: Fundstrat, ICI, Bloomberg.

EQUITY FLOWS: Stable to rising interest rates leads for equity flows....

Whenever interest rates are stable, equity flows are positive…



Source: Fundstrat, Bloomberg, Federal Reserve.

Equity markets tend to do well when inflation is low and rising…

We have plotted the comparative performance of stocks during various inflation scenarios and changes in inflation rate.

- **As shown, stocks tend to do fairly well when inflation levels are low and begin to modestly increase.**

Figure: Equity returns and PE and EPS growth under different inflation scenarios
Since 1950

S&P 500 1-year returns…

Change in inflation rate

Inflation rate		Decelerating Δ <=0	Picking Up Δ 0.1 to 1.1	Accelerating Δ >=1.2
High Inflation	>=3.8	9.9%	10.5%	7.7%
Moderate Inflation	1.8 to 3.7	9.9%	9.5%	5.0%
Low Inflation	0.6 to 1.7	11.9%	12.3%	17.3%
Disinflation	<=0.5	14.2%	2.1%	--

Positive…

S&P 500 win-ratio (1-yr returns)

Change in inflation rate

Inflation rate		Decelerating Δ <=0	Picking Up Δ 0.1 to 1.1	Accelerating Δ >=1.2
High Inflation	>=3.8	73%	74%	60%
Moderate Inflation	1.8 to 3.7	79%	72%	63%
Low Inflation	0.6 to 1.7	72%	76%	89%
Disinflation	<=0.5	75%	57%	--

Positive…

Change in PE ratio…

Change in inflation rate

Inflation rate		Decelerating Δ <=0	Picking Up Δ 0.1 to 1.1	Accelerating Δ >=1.2
High Inflation	>=3.8	0.8 X	0.0 X	(0.7)X
Moderate Inflation	1.8 to 3.7	0.1 X	(0.4)X	(0.6)X
Low Inflation	0.6 to 1.7	--	0.2 X	0.8 X
Disinflation	<=0.5	0.6 X	0.3 X	--

Positive…

EPS change yoy

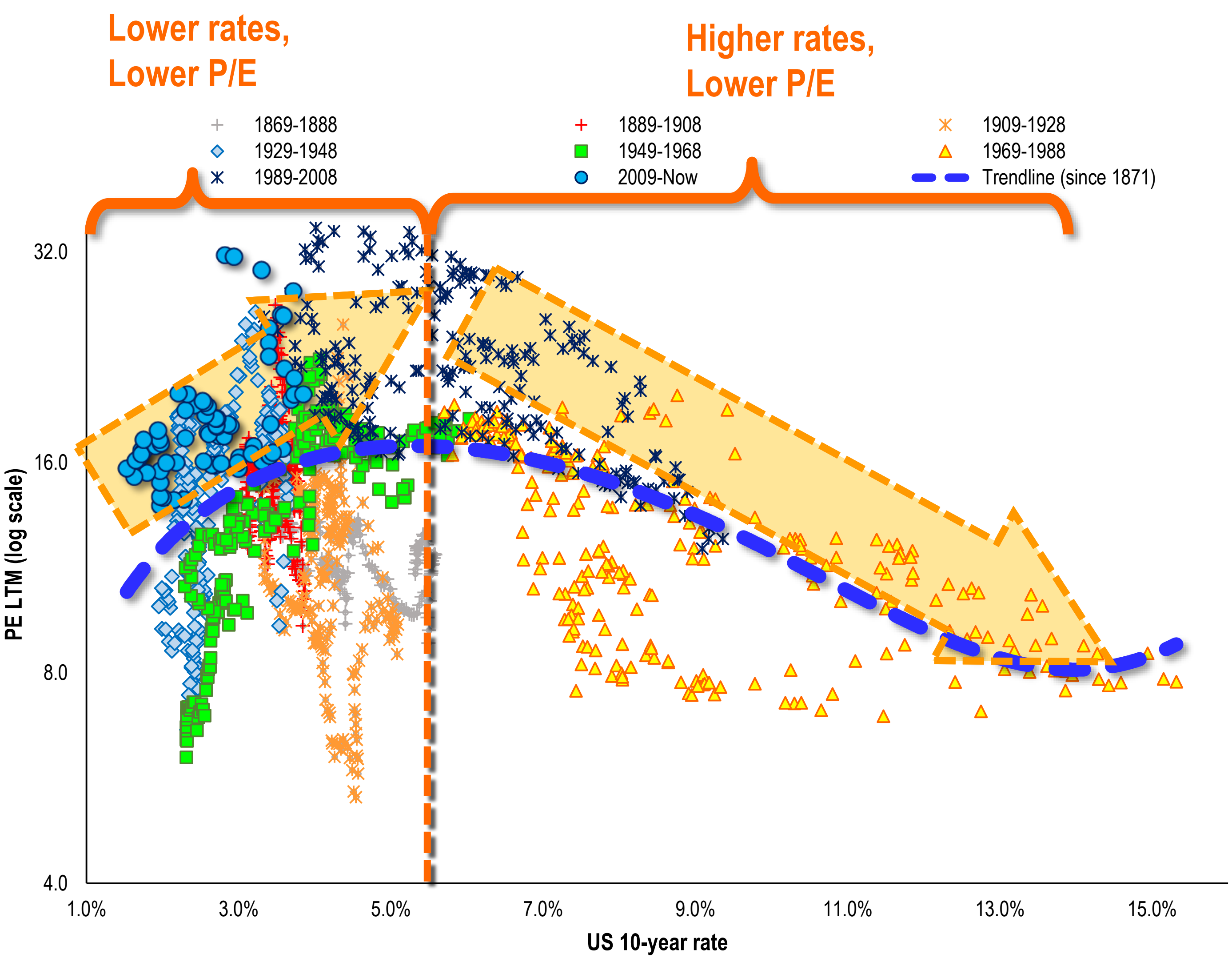
Change in inflation rate

Inflation rate		Decelerating Δ <=0	Picking Up Δ 0.1 to 1.1	Accelerating Δ >=1.2
High Inflation	>=3.8	1.6%	5.1%	5.3%
Moderate Inflation	1.8 to 3.7	10.4%	12.3%	5.8%
Low Inflation	0.6 to 1.7	--	10.2%	15.9%
Deflation	<=0.5	19.5%	(3.9%)	--

Positive…

Source: Fundstrat, Bloomberg

US: History shows rising US interest rates do not lead to P/E compression



Source: Fundstrat, Bloomberg

As we move from extraordinarily low interest rates, we expect P/E to actually expand…

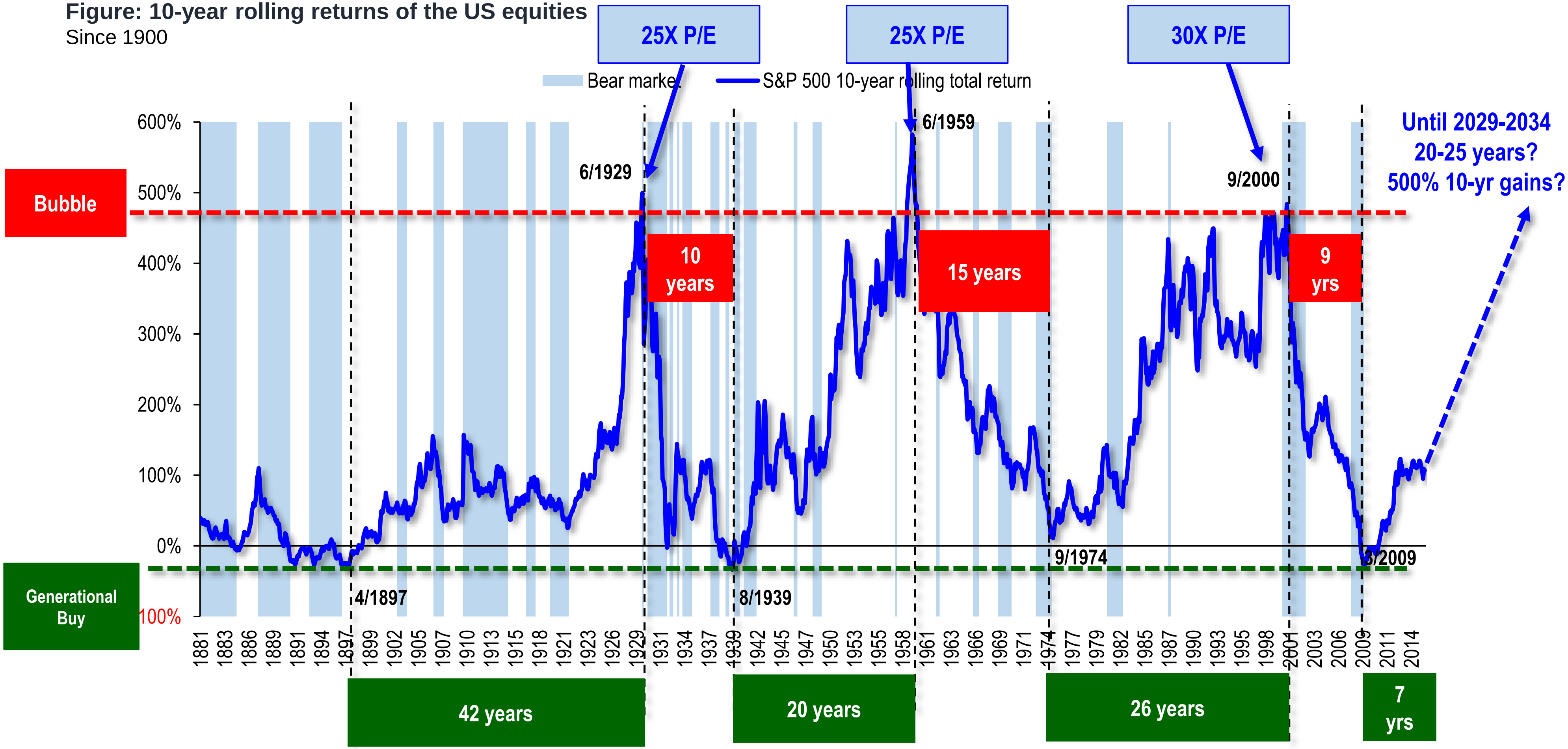
This has happened in the 20s, 40s, 50s, 60s and in almost every decade…

Secular bull cycles last 20-42 years... we are 7 years into this one

As shown below, long-term bull markets have lasted 20-42 years and generate cumulative returns of 500% or more…

- ***The current bull market has risen for 7 years and 10-year rolling returns are around 100%...***

Figure: 10-year rolling returns of the US equities
Since 1900



Source: Fundstrat, Bloomberg.

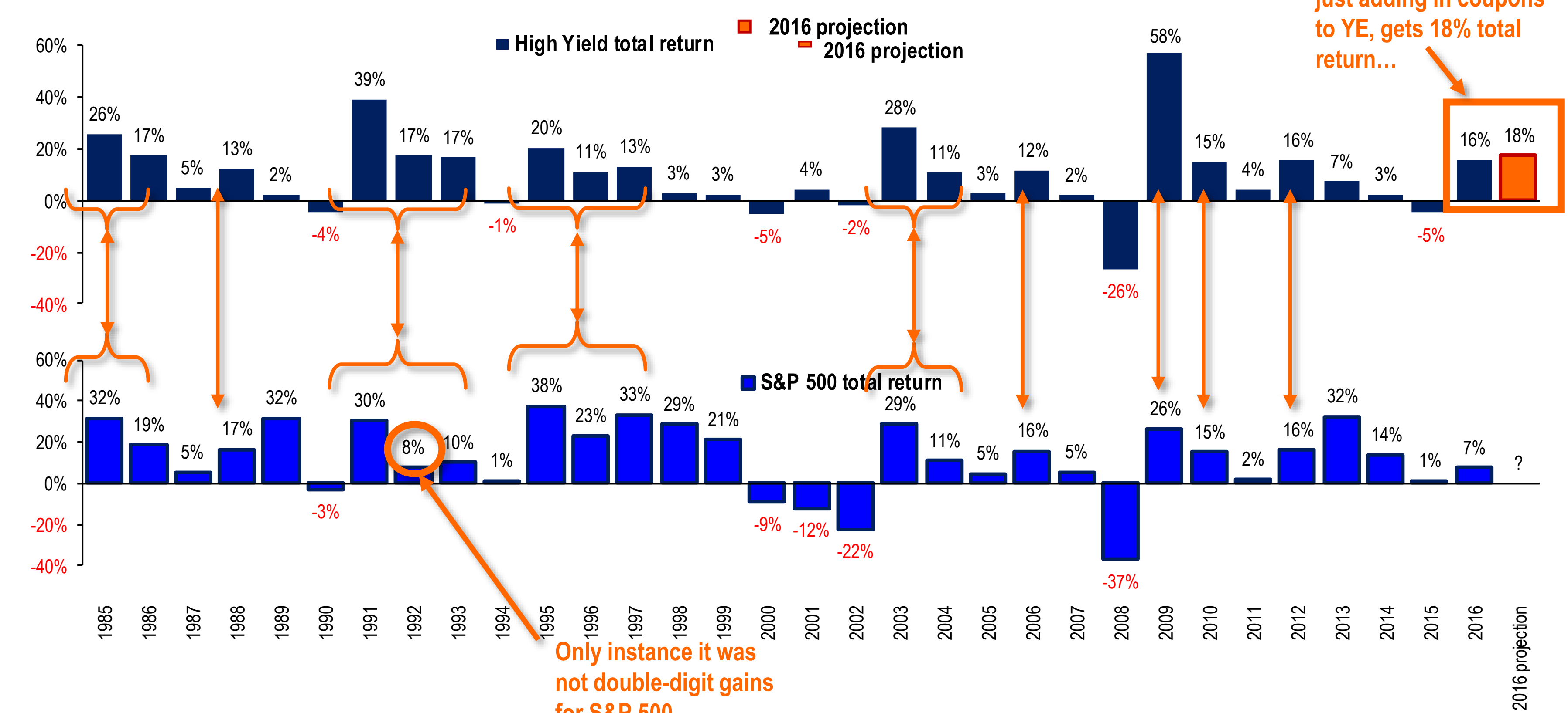
Click here to jump ahead
Overview | Election | Economic | Earnings | Investor flows | Strategy

HIGH-YIELD: HY double-digits ~ equities average 22% gains…

Equity and high-yield generally move in tandem. As shown below, HY is set to gain 13% total return in 2016 (8% from coupon). And would represent the first double-digit year since 2012 for HY bonds.

- **Since 1985, there have been 15 years where HY has returned double-digits and equities gained at least 10% in 14 of the 15 years (8% in 1992). The average equity gain is 22% whenever high-yield returns are double-digit.**
- **In other words, history says there is a sizable catch-up trade coming in equities in the next 7 months.**

Figure: 14 of 15 times High Yield saw double-digit gains, Equities also posted double-digit gains…
Annual total return of High Yield and S&P 500



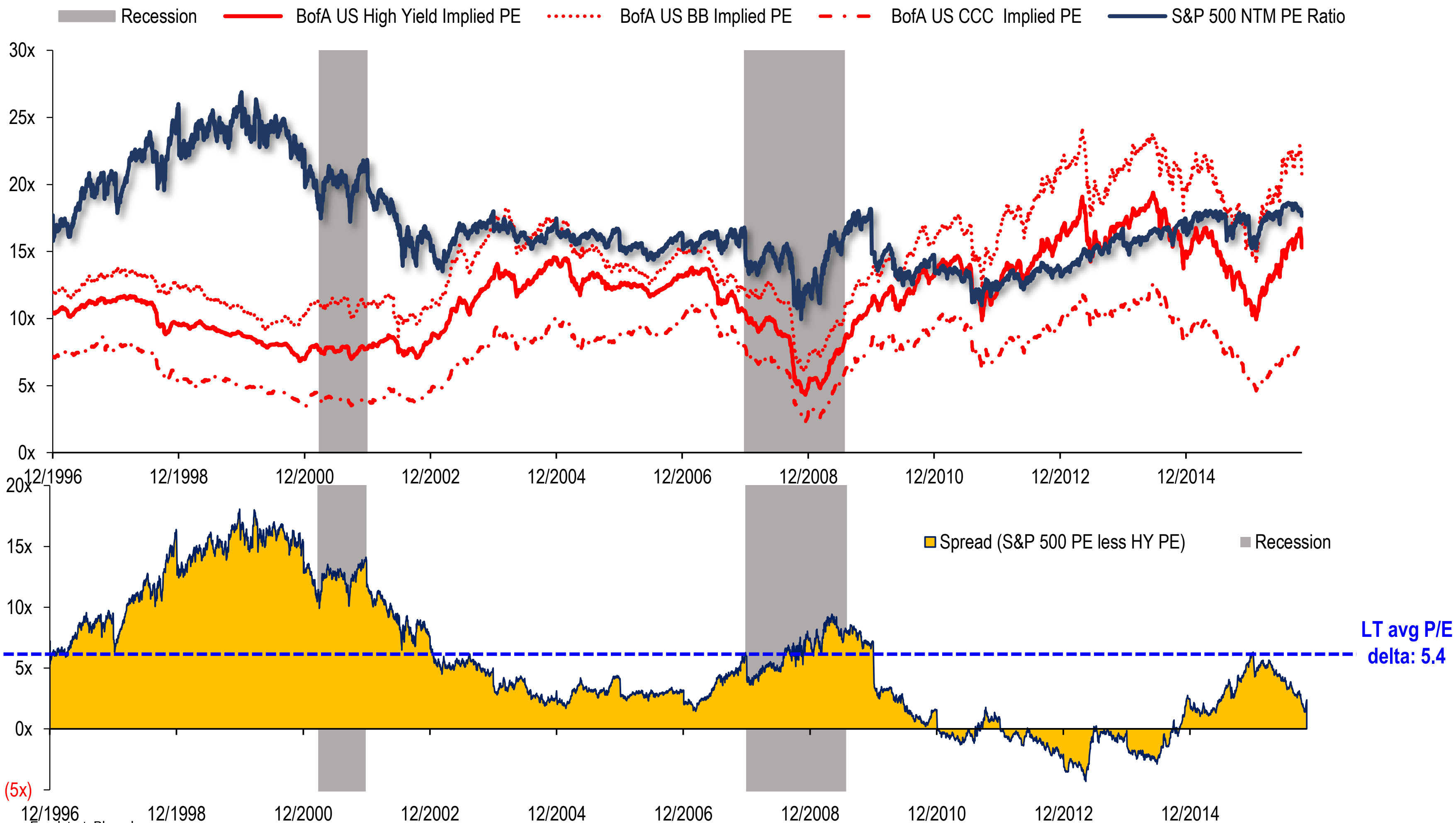
Source: Fundstrat, Bloomberg, St. Louis Federal Reserve.

High-yield bonds implied P/E is above long-term average

As shown below, while HY bonds have seen their valuations weaken recently (higher yield, means lower implied PE)

- **As shown below, the spread of S&P 500 PE vs HY PE is still below the long-term average.**

Figure: Comparative valuation of HY vs S&P 500 (P/E versus inverse HY YTW)
Since 1996. BofA HY data



Source: Fundstrat, Bloomberg

Fundstrat Recommended Strategies

	Strategies	*Rationale*	Sectors and Styles
1.	**Long Value**	*Value outperforms when inflation strengthens and GDP growth accelerates*	Financials "Old" Technology stocks Lower-margin stocks ETFs: IVE, IWN
2.	**Long Small-caps**	*Rally in high-yield market points to further gains for small-caps. Small-caps are leveraged to faster GDP growth and has more positive net impacts from higher inflation*	ETFs: IWM, IWN
3.	**Long Cyclical stocks**	*We believe US growth is accelerating and hence favor being long cyclical stocks*	Technology Energy Materials Discretionary Industrials
4.	**Avoid Defensives stocks**	*Many defensive stocks are expensive as investors bought these simply for yield…*	Healthcare Staples Utilities

Source: Fundstrat, Bloomberg

Portfolio Strategy: Summary of Performance

Our Portfolio Strategy recommendations are below. We have 5 current strategies we are recommending.

- **The stocks are discussed in the following section. Our highest conviction remains "stocks are the new bonds".**

Figure: Fundstrat Portfolio Strategy Recommendations for 4Q16

4Q16 Fundstrat Recommendations

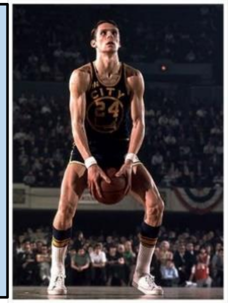
	Fundstrat Strategy	Execution of Strategy	Added/ Removed	Relative performance (vs S&P 500) 1Q16	2Q16	3Q16	4Q16 QTD
	USD outright weakens	"inverse correlation" to USD: **Buy Energy, Materials, Telecoms**	December 2015	+630bp	-190bp	(deleted 7/16)	
	Oil bottoms and HY improves	Buy "inverse correlation" to HY spreads: **Buy Value and Low-quality**	December 2015	-60bp	-110bp	(deleted 7/16)	
Current Strategies	Stocks are the "new bonds"	div yield> company's LT bond yield	November 2015	+890bp	+320bp	+10bp	-119bp
Current Strategies	Laggards become Leaders	Industry groups that underperformed 4-plus consecutive years	December 2015	+230bp	+570bp	-114bp	-46bp
Current Strategies	FANG ends with a "dang"	Buy last years' losers over FANG	December 2015	+540bp	+410bp	+255bp	-85bp
Current Strategies	Buy Small-caps	Due to quality spread-rally and ISM recovery.	April 2016		+150bp	+555bp	+513bp
Current Strategies	Growth as cheap as Value	Buy stocks both Growth and Value, with a div yield > bond yield	July 2016			-65bp	-276bp

Source: Fundstrat, Bloomberg.

4Q16 "granny shots"

On "underhand" free throws…
Rick Barry:
"Dad, they're going to make fun of me. ***That's the way the girls shoot***."

Rick Barry's father:
"Son, they can't make fun of you if you're making them."



Growth
-3.0% (YTD relative)
(319 stocks)

Growth as cheap as Value

Both
Value
Growth
-3.4% (YTD relative)
(171 stocks)

Value
+3.4% (YTD relative)
(359 stocks)

The Intersect
+2.6% (YTD relative)

Ticker	Company name
CSCO	Cisco Systems
IBM	International Business Machines
APD	Air Products & Chemicals Inc.
PX	Praxair Inc.
OXY	Occidental Petroleum Corp.
VZ	Verizon Communications
New for 4Q16…	
VFC	VF Corp
KMB	Kimberly Clark

Stocks are the new bonds

Div yield > LT co bond yield
+11.0% (YTD relative)
(currently 54 stocks)

Laggards become Leaders

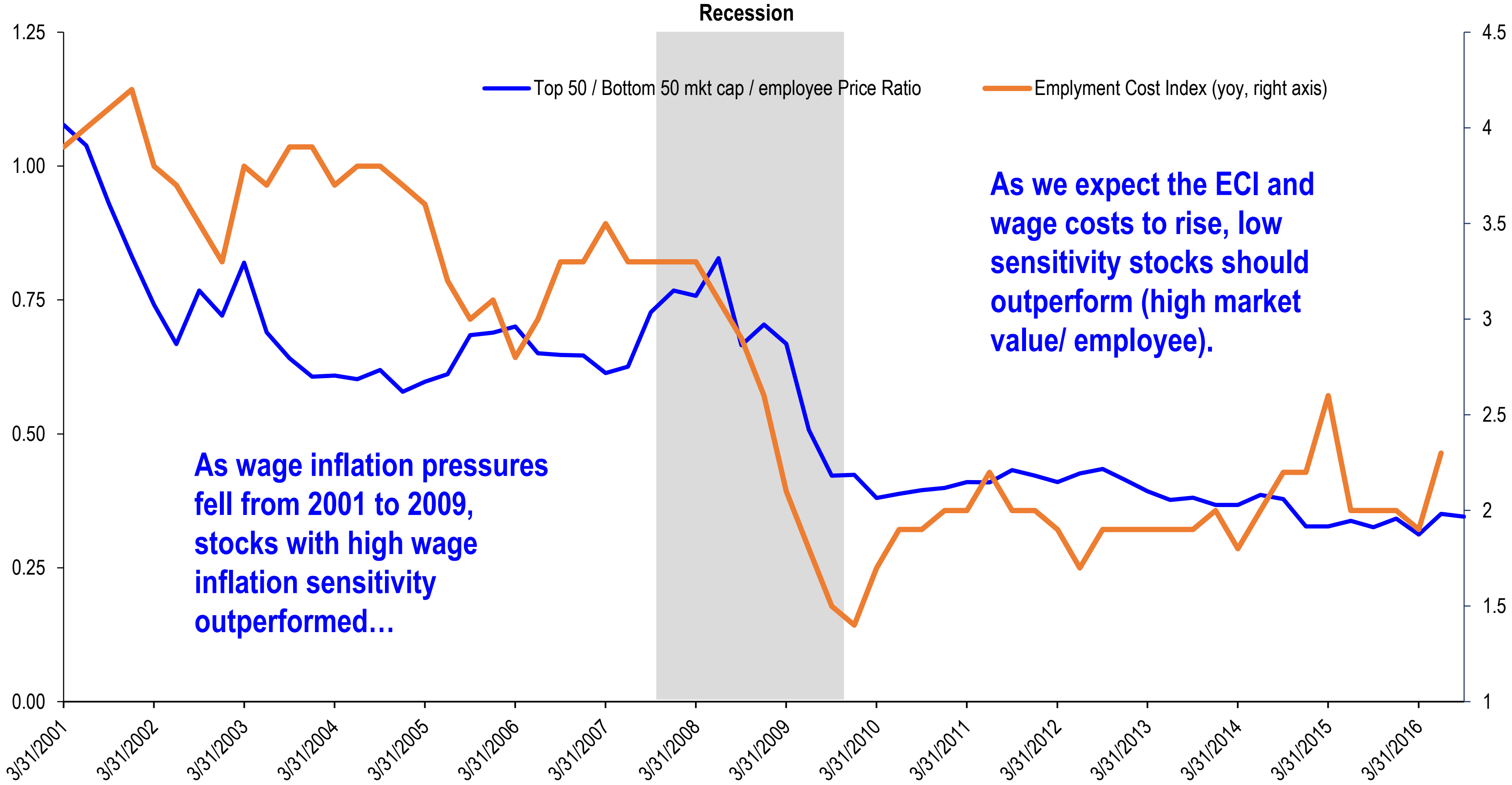
Lagged
4-plus years
+15.1 (YTD relative)
(68 stocks)

Last 16 years, these stocks track labor costs closely…

We have plotted the employment cost index and the relative price performance of wage sensitive stocks.

- **As shown below, as employment cost rises, low wage sensitivity stocks outperform high wage sensitivity stocks.**

Figure: Employment Cost Index explains moves in relative performance of high market cap / employee vs. low market cap / employee stocks
Since 2001. Index of Top 50 and Bottom 50 is rebalanced every quarter.

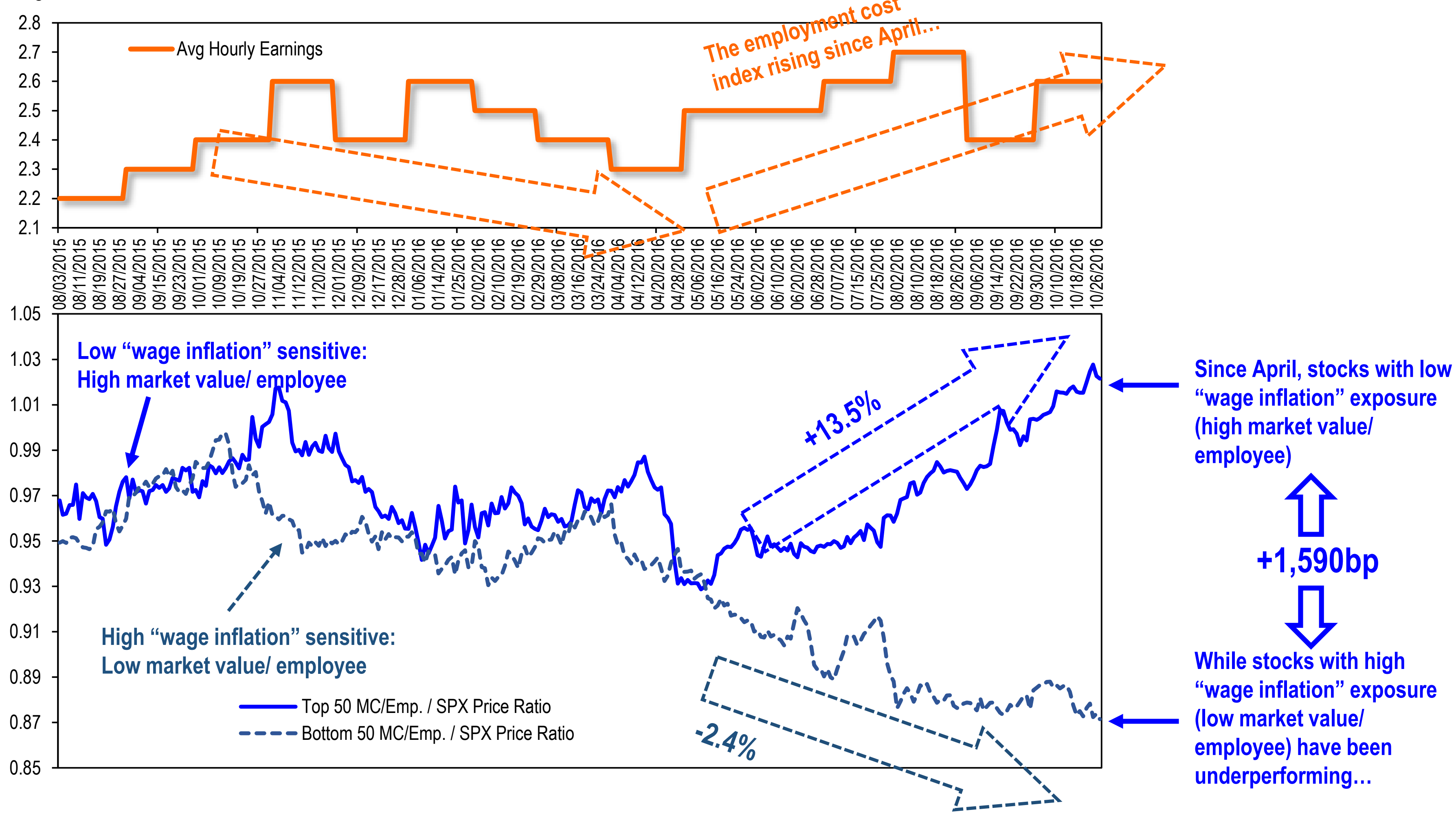


Source: Fundstrat, Bloomberg, Factset

Stocks with low “wage inflation” exposure *outperforming*

Since April, we have seen a bifurcation of performance between stocks with low “wage inflation” exposure (high market value/employee) and high “wage inflation” stocks (low market value/employee)

Figure: Average hourly earnings (change) and comparative price performance of wage inflation sensitive stocks
Since August 2015



Source: Fundstrat, Bloomberg, Factset

Top and Bottom "wage inflation" sensitive stocks…

We have listed the stocks least and most sensitive to wage inflation. The metric to identify these stocks is market value per employee.

- **The stock with the highest market value/ employee is Facebook ($30mm per employee). At the other end of the spectrum is Darden with $50,000 of market value per employee.**

Figure: Top / Bottom 25 stocks by market cap per employee in S&P 500

Low "wage inflation" sensitive: High market value/ employee

Ticker	Name	GICS 4 Industry	Market Cap	Market Value / Employee ('000s)	Relative Perf, YTD
SPX	S&P 500 Index		$19,167,404	$792.1	4.4%
FB	Facebook Inc-A	Internet Software & Services	$372,383	$29,342.3	19.6%
MNST	Monster Beverage Corp	Soft Drinks	$27,282	$26,538.6	(8.2%)
COG	Cabot Oil & Gas Corp	Oil & Gas Exploration & Produ	$10,070	$21,940.0	18.0%
EOG	Eog Resources Inc	Oil & Gas Exploration & Produ	$50,516	$18,302.9	25.2%
V	Visa Inc-Class A Shares	Data Processing & Outsourced	$193,398	$17,114.8	1.3%
CXO	Concho Resources Inc	Oil & Gas Exploration & Produ	$18,816	$16,785.3	39.6%
NFLX	Netflix Inc	Internet & Direct Marketing Re	$54,274	$15,506.8	6.2%
MO	Altria Group Inc	Tobacco	$125,656	$14,279.1	6.3%
RAI	Reynolds American Inc	Tobacco	$77,363	$13,814.9	13.2%
XEC	Cimarex Energy Co	Oil & Gas Exploration & Produ	$12,643	$13,667.8	44.6%
CME	Cme Group Inc	Financial Exchanges & Data	$33,926	$13,409.6	6.1%
GILD	Gilead Sciences Inc	Biotechnology	$100,070	$12,508.7	(29.4%)
RRC	Range Resources Corp	Oil & Gas Exploration & Produ	$8,811	$11,842.4	40.5%
CELG	Celgene Corp	Biotechnology	$81,179	$11,645.3	(16.9%)
ALXN	Alexion Pharmaceuticals Inc	Biotechnology	$29,459	$10,075.1	(35.5%)
MA	Mastercard Inc - A	Data Processing & Outsourced	$113,726	$10,064.3	2.0%
VRTX	Vertex Pharmaceuticals Inc	Biotechnology	$18,792	$9,636.7	(44.1%)
GOOG	Alphabet Inc-Cl C	Internet Software & Services	$553,647	$8,956.7	0.4%
REGN	Regeneron Pharmaceuticals	Biotechnology	$38,469	$8,946.4	(37.1%)
BIIB	Biogen Inc	Biotechnology	$63,290	$8,610.9	(9.4%)
AVGO	Broadcom Ltd	Semiconductors	$68,436	$8,345.9	14.3%
PXD	Pioneer Natural Resources Co	Oil & Gas Exploration & Produ	$30,982	$8,301.8	41.3%
VRSN	Verisign Inc	Internet Software & Services	$8,445	$8,288.0	(11.9%)
ISRG	Intuitive Surgical Inc	Health Care Equipment	$25,698	$8,003.2	17.1%
NFX	Newfield Exploration Co	Oil & Gas Exploration & Produ	$8,327	$7,495.5	24.4%

Source: Fundstrat, Bloomberg, Factset

High "wage inflation" sensitive: Low market value/ employee

Ticker	Name	GICS 4 Industry	Market Cap	Market Value / Employee ('000s)	Relative Perf, YTD
SPX	S&P 500 Index		$19,167,404	$792.1	4.4%
DRI	Darden Restaurants Inc	Restaurants	$7,572	$50.5	(7.7%)
XRX	Xerox Corp	Data Processing & Outsourced	$9,697	$67.5	(14.3%)
KR	Kroger Co	Food Retail	$29,288	$68.0	(30.2%)
M	Macy'S Inc	Department Stores	$10,889	$69.0	(3.4%)
GPS	Gap Inc/The	Apparel Retail	$10,607	$75.2	3.4%
HPQ	Hp Inc	Technology Hardware, Storage	$23,935	$83.4	13.8%
WMT	Wal-Mart Stores Inc	Hypermarkets & Super Center	$216,002	$93.9	9.6%
JEC	Jacobs Engineering Group Inc	Construction & Engineering	$6,154	$96.2	16.5%
BBY	Best Buy Co Inc	Computer & Electronics Retail	$12,209	$97.7	23.7%
BBBY	Bed Bath & Beyond Inc	Homefurnishing Retail	$6,103	$98.4	(21.2%)
SPLS	Staples Inc	Specialty Stores	$4,735	$111.3	(27.5%)
R	Ryder System Inc	Trucking	$3,699	$111.8	17.4%
TGT	Target Corp	General Merchandise Stores	$38,872	$114.0	(11.2%)
WHR	Whirlpool Corp	Household Appliances	$11,093	$114.4	(3.8%)
OI	Owens-Illinois Inc	Metal & Glass Containers	$3,156	$116.9	7.4%
GT	Goodyear Tire & Rubber Co	Tires & Rubber	$8,157	$123.6	(9.2%)
JWN	Nordstrom Inc	Department Stores	$9,106	$125.6	1.0%
DLPH	Delphi Automotive Plc	Auto Parts & Equipment	$17,580	$126.5	(29.2%)
HBI	Hanesbrands Inc	Apparel, Accessories & Luxur	$8,992	$137.7	(23.5%)
CTSH	Cognizant Tech Solutions-A	IT Consulting & Other Service	$31,136	$140.4	(18.9%)
WFM	Whole Foods Market Inc	Food Retail	$9,019	$146.2	(19.9%)
UHS	Universal Health Services-B	Health Care Facilities	$11,914	$159.7	(2.0%)
DG	Dollar General Corp	General Merchandise Stores	$19,004	$167.6	(10.5%)
HCA	Hca Holdings Inc	Health Care Facilities	$30,030	$172.6	12.9%
PWR	Quanta Services Inc	Construction & Engineering	$4,259	$173.8	34.9%

Technology and Energy tend to be least sensitive…
…Consumer Discretionary most sensitive…

- The least sensitive (highest market value per employee) are companies like Internet ($9mm per employee), E&Ps ($7mm), etc.
- The most sensitive are Food retail and other types of retailers.

Figure: Top and Bottom Wage sensitives by Industries

Rank	Industry	# of Companies	Market Cap, $M	Number of Employees	Market Value / Employee ('000s)	Relative Perf, YTD
	S&P 500	500	$19,234,742	24,198,536	$794.9	4.7%
1	Internet Software & Services	6	$1,028,065	103608	$9,923	9.8%
2	Biotechnology	8	$551,930	77395	$7,131	(22.0%)
3	Oil & Gas Exploration & Produc	18	$344,763	60957	$5,656	24.0%
4	Oil & Gas Storage & Transporta	4	$110,442	26232	$4,210	54.3%
5	Integrated Oil & Gas	3	$610,318	146100	$4,177	6.8%
6	Distillers & Vintners	2	$51,916	13400	$3,874	(0.4%)
7	Tobacco	3	$353,161	94600	$3,733	8.5%
8	Home Entertainment Software	2	$58,057	15800	$3,674	13.6%
9	Financial Exchanges & Data	5	$128,425	42303	$3,036	5.7%
10	Application Software	5	$161,452	60535	$2,667	5.2%
11	Commodity Chemicals	1	$33,432	13000	$2,572	(12.1%)
12	Brewers	1	$22,673	9100	$2,491	7.7%
13	Systems Software	5	$673,088	281062	$2,395	9.0%
14	Pharmaceuticals	11	$1,013,300	459881	$2,203	(20.9%)
15	Semiconductor Equipment	3	$58,646	27680	$2,119	23.5%
16	Semiconductors	13	$554,293	267701	$2,071	18.8%
17	Specialized Consumer Services	1	$4,969	2400	$2,070	(36.6%)
18	Internet & Direct Marketing Re	5	$544,869	271538	$2,007	(0.2%)
19	Water Utilities	1	$12,893	6700	$1,924	16.6%
20	Household Products	5	$363,718	198300	$1,834	(2.5%)
21	Construction Materials	2	$26,104	14486	$1,802	19.0%
22	Multi-Utilities	11	$201,144	115336	$1,744	9.4%
23	Investment Banking & Brokerage	4	$191,164	111739	$1,711	(4.6%)
24	Electric Utilities	14	$382,214	232645	$1,643	7.3%
25	Communications Equipment	5	$195,321	121936	$1,602	5.9%

Rank	Industry	# of Companies	Market Cap, $M	Number of Employees	Market Value / Employee ('000s)	Relative Perf, YTD
119	Food Retail	2	$38,421	492700	$78	(25.1%)
118	Computer & Electronics Retail	1	$12,431	125000	$99	25.2%
117	Homefurnishing Retail	1	$6,170	62000	$100	(20.8%)
116	Department Stores	3	$28,201	262400	$107	(4.3%)
115	Household Appliances	1	$11,214	97000	$116	(3.3%)
114	Hypermarkets & Super Centers	2	$281,209	2426000	$116	(1.1%)
113	Tires & Rubber	1	$8,167	66000	$124	(10.3%)
112	General Merchandise Stores	3	$76,294	509700	$150	(9.3%)
111	Construction & Engineering	3	$17,563	115695	$152	18.8%
110	Health Care Facilities	2	$42,265	248600	$170	6.1%
109	Aluminum	1	$12,268	60000	$204	(10.3%)
108	Office Services & Supplies	1	$3,278	14800	$221	(19.2%)
107	Advertising	2	$27,622	122300	$226	(4.3%)
106	Automobile Manufacturers	2	$94,598	414000	$228	(16.5%)
105	Trucking	2	$12,802	54662	$234	11.1%
104	Apparel Retail	6	$117,772	479304	$246	4.8%
103	IT Consulting & Other Services	5	$259,849	1012757	$257	(5.3%)
102	Restaurants	5	$223,898	867330	$258	(9.7%)
101	Hotels, Resorts & Cruise Lines	4	$81,907	311700	$263	(20.1%)
100	Air Freight & Logistics	4	$160,336	587556	$273	7.6%
99	Airlines	5	$101,969	350243	$291	(15.1%)
98	Auto Parts & Equipment	3	$66,261	226000	$293	(9.0%)
97	Human Resource & Employment S	1	$4,772	16100	$296	(26.9%)
96	Publishing	1	$7,172	24000	$299	(15.0%)
95	Electronic Manufacturing Servi	1	$22,115	72000	$307	(8.4%)

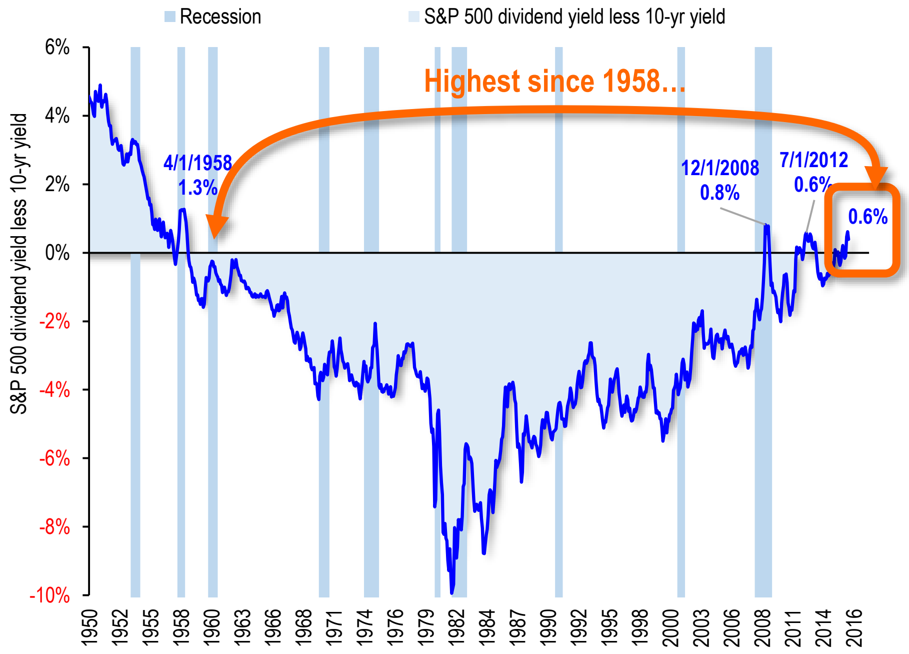
Source: Fundstrat, Bloomberg, Factset

"Stocks are the new bonds"– aka yield parity

Our favorite strategy remains "stocks are the new bonds"—taking advantage of an idiosyncratic relationship. That is, a company's dividend yield exceeds the same company's long-term debt yield. Given the same credit profile, there is no reason for this to exist.

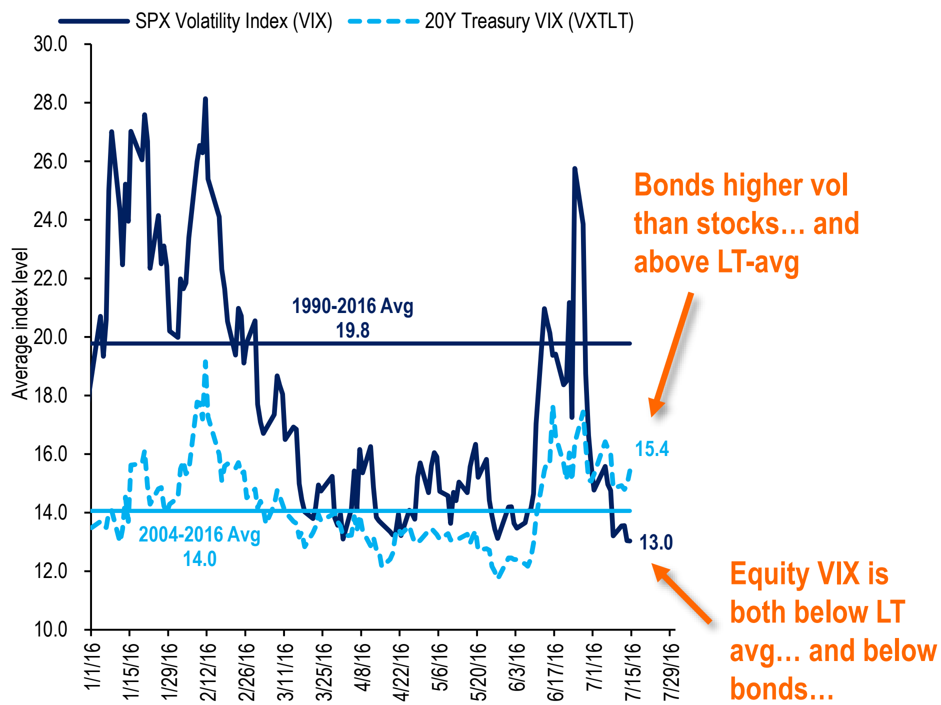
- **Logically, the dividend yield should always be lower than the bond yield of the same issuer—particularly as dividend yields generally grow. The global search for carry is further amplifying the differences as interest rates are falling and as a consequence, the dividend yield of the S&P 500 exceeds the 10-year yield by the largest margin since the 1950s (outside of the Financial crisis).**
- **More interestingly, volatility of bonds now EXCEEDS that of equities. As shown on the bottom right, the VIX of bonds is 20% higher than equity VIX and the opposite of LT averages (Equity VIX LT = 20, Bonds = 14)**

Figure: Dividend yield less 10-year yield nearing 50-year high…
S&P 500 dividend yield less 10-year yield since 1950



Source: Fundstrat, FactSet, Bloomberg.

Figure: Bonds now have greater volatility vs Stocks…
Based on the VIX index for equities and CBOE VIX for TLT



Source: Fundstrat, FactSet, Bloomberg.

Stay OW "Stocks are the new bonds"–New List

We have updated our "Stocks are the new bonds" portfolio (stocks with div yield > their own LT bond yield and credit rating of A- or better). 12 stocks were deleted, due to equity appreciation, changes in dividend policy, or changes in bond yield.

- **And 23 stocks have been added (column 2), which we have added to the portfolio.**

Figure: Changes to Fundstrat's "Stocks are the new bonds" portfolio since April 8th, 2016
We have added 23 stocks, and removed 12 stocks

1 — Original list on 7/1/2016

Ticker	Company Name	Ticker	Company Name
RL	Ralph Lauren Corp	AVB	Avalonbay Communities Inc
TGT	Target Corp	BBT	Bb&T Corp
BA	Boeing Co/The	BLK	Blackrock Inc
CAT	Caterpillar Inc	IVZ	Invesco Ltd
EMR	Emerson Electric Co	JPM	Jpmorgan Chase & Co
MMM	3M Co	MET	Metlife Inc
PCAR	Paccar Inc	PSA	Public Storage
UPS	United Parcel Service-Cl B	SPG	Simon Property Group Inc
CSCC	Cisco Systems Inc	KO	Coca-Cola Co/The
IBM	Intl Business Machines Corp	PEP	Pepsico Inc
INTC	Intel Corp	PG	Procter & Gamble Co/The
MSFT	Microsoft Corp	PM	Philip Morris International
QCOI	Qualcomm Inc	LLY	Eli Lilly & Co
TXN	Texas Instruments Inc	MRK	Merck & Co. Inc.
XLNX	Xilinx Inc	PFE	Pfizer Inc
APD	Air Products & Chemicals Inc	CNP	Centerpoint Energy Inc
PX	Praxair Inc	DUK	Duke Energy Corp
CVX	Chevron Corp	PPL	Ppl Corp
OXY	Occidental Petroleum Corp	SO	Southern Co/The
SLB	Schlumberger Ltd	T	At&T Inc
XOM	Exxon Mobil Corp	VZ	Verizon Communications Inc
AMP	Ameriprise Financial Inc		

+ 2 — ***Additions*** (stocks incrementally meeting criteria)

Ticker	Company Name
VFC	Vf Corp
DOV	Dover Corp
GE	General Electric Co
HON	Honeywell International Inc
ITW	Illinois Tool Works
UTX	United Technologies Corp
ADP	Automatic Data Processing
NUE	Nucor Corp
BEN	Franklin Resources Inc
EQR	Equity Residential
CLX	Clorox Company
HSY	Hershey Co/The
KMB	Kimberly-Clark Corp
MO	Altria Group Inc
WMT	Wal-Mart Stores Inc
ABBV	Abbvie Inc
BMY	Bristol-Myers Squibb Co
DHR	Danaher Corp
BMY	Bristol-Myers Squibb Co
ES	Eversource Energy
NEE	Nextera Energy Inc
WEC	Wec Energy Group Inc
XEL	Xcel Energy Inc

23 New names…

− 3 — ***Subtractions*** (div yield lower than bond yield)

Ticker	Company Name	Rel. Perf since 6/30/16
RL	Ralph Lauren Corp	10.2%
CAT	Caterpillar Inc	14.8%
EMR	Emerson Electric Co	(0.6%)
PCAR	Paccar Inc	12.3%
UPS	United Parcel Service-Cl B	(1.7%)
MSFT	Microsoft Corp	9.9%
XLNX	Xilinx Inc	12.9%
SLB	Schlumberger Ltd	0.0%
JPM	Jpmorgan Chase & Co	6.3%
MET	Metlife Inc	15.4%
PFE	Pfizer Inc	(7.4%)
CNP	Centerpoint Energy Inc	(10.0%)
Average		5.2%

Deletions outperformed by over 2000bp annualized…

= 4 — New list of "Stocks are the New Bonds" as of 10/6/16

Ticker	Company Name	Ticker	Company Name
TGT	Target Corp	SO	Southern Co/The
BA	Boeing Co/The	T	At&T Inc
MMM	3M Co	VZ	Verizon Communications Inc
CSCO	Cisco Systems Inc		
IBM	Intl Business Machines Corp		***New additions***
INTC	Intel Corp	VFC	Vf Corp
QCOM	Qualcomm Inc	DOV	Dover Corp
TXN	Texas Instruments Inc	GE	General Electric Co
APD	Air Products & Chemicals Inc	HON	Honeywell International Inc
PX	Praxair Inc	ITW	Illinois Tool Works
CVX	Chevron Corp	UTX	United Technologies Corp
OXY	Occidental Petroleum Corp	ADP	Automatic Data Processing
XOM	Exxon Mobil Corp	NUE	Nucor Corp
AMP	Ameriprise Financial Inc	BEN	Franklin Resources Inc
AVB	Avalonbay Communities Inc	EQR	Equity Residential
BBT	Bb&T Corp	CLX	Clorox Company
BLK	Blackrock Inc	HSY	Hershey Co/The
IVZ	Invesco Ltd	KMB	Kimberly-Clark Corp
PSA	Public Storage	MO	Altria Group Inc
SPG	Simon Property Group Inc	WMT	Wal-Mart Stores Inc
KO	Coca-Cola Co/The	ABBV	Abbvie Inc
PEP	Pepsico Inc	BMY	Bristol-Myers Squibb Co
PG	Procter & Gamble Co/The	DHR	Danaher Corp
PM	Philip Morris International	BMY	Bristol-Myers Squibb Co
LLY	Eli Lilly & Co	ES	Eversource Energy
MRK	Merck & Co. Inc.	NEE	Nextera Energy Inc
DUK	Duke Energy Corp	WEC	Wec Energy Group Inc
PPL	Ppl Corp	XEL	Xcel Energy Inc

Source: Fundstrat, Bloomberg, FactSet.

STRATEGY: Stocks are the New Bonds

Stocks are the New Bonds Screening Criteria

a. US Listed stocks with Market Cap >$10B
b. S&P Issuer Credit Rating of A- or better
c. Regular Dividend Yield > Issuer's own weighted average Bond Yield

Deletions…

Ticker	Company Name	Rel. Perf since 6/30/16
RL	Ralph Lauren Corp	10.2%
CAT	Caterpillar Inc	14.8%
EMR	Emerson Electric Co	(0.6%)
PCAR	Paccar Inc	12.3%
UPS	United Parcel Service-Cl B	(1.7%)
MSFT	Microsoft Corp	9.9%
XLNX	Xilinx Inc	12.9%
SLB	Schlumberger Ltd	0.0%
JPM	Jpmorgan Chase & Co	6.3%
MET	Metlife Inc	15.4%
PFE	Pfizer Inc	(7.4%)
CNP	Centerpoint Energy Inc	(10.0%)
Average		5.2%

Outperformed by over 2000 bp annualized

		Ticker	Company name	Current Price	Mkt cap ($ mm)	3m avg daily liquidity ($ mm)	YTD perf (relative to S&P 500)	Dividend Payout Ratio	Dividend Yield	Special Dvd + Buyback Yield	CASH RETURN Yield	Adj CASH RETURN Yield	Adj Wgt Avg Bond Yield	Dvd Yld less Bond Yield	Adj CASH RETURN less Bond Yield	2017E P/E	Issuer Rating
									a	b	c = a + b	d = a + 0.25*b	e	f = a - e	g = d - e		
Discretionary	1	TGT	Target Corp	$68.31	$39,267	$383.5	-11.6%	46.3%	3.5%	11.3%	14.8%	6.3%	3.0%	51	334	12.7x	A
	2	VFC	Vf Corp	$54.68	$22,678	$157.9	-17.9%	42.6%	2.7%	3.7%	6.4%	3.6%	1.8%	92	184	15.3x	A
Industrials	3	BA	Boeing Co/The	$134.61	$83,973	$427.3	-12.7%	49.7%	3.2%	9.2%	12.5%	5.5%	3.0%	28	259	14.1x	A
	4	DOV	Dover Corp	$73.70	$11,439	$87.4	14.4%	42.0%	2.4%	0.9%	3.3%	2.6%	2.4%	1	23	18.7x	A-
	5	GE	General Electric Co	$29.27	$262,295	$982.3	-11.8%	108.6%	3.1%	14.2%	17.4%	6.7%	2.5%	66	422	17.0x	AA-
	6	HON	Honeywell International Inc	$115.61	$87,965	$308.5	6.5%	32.9%	2.1%	3.4%	5.5%	2.9%	1.3%	78	165	15.9x	A
	7	ITW	Illinois Tool Works	$119.56	$42,439	$159.1	23.3%	40.0%	2.2%	2.8%	4.9%	2.9%	1.7%	48	116	19.5x	A+
	8	MMM	3M Co	$171.64	$103,739	$304.8	8.2%	52.8%	2.6%	4.4%	7.0%	3.7%	2.5%	11	121	19.4x	AA-
	9	UTX	United Technologies Corp	$102.06	$85,417	$332.9	0.5%	39.1%	2.6%	0.0%	2.6%	2.6%	2.2%	43	43	14.9x	A-
Technology	10	ADP	Automatic Data Processing	$87.56	$39,785	$148.7	-2.4%	63.5%	2.4%	3.0%	5.4%	3.2%	2.3%	12	87	24.3x	AA
	11	CSCO	Cisco Systems Inc	$31.48	$157,852	$676.8	10.2%	45.9%	3.3%	2.5%	5.8%	3.9%	2.8%	45	108	13.0x	AA-
	12	IBM	Intl Business Machines Corp	$156.88	$149,953	$514.6	8.3%	32.9%	3.6%	2.7%	6.3%	4.2%	2.5%	109	176	11.1x	AA-
	13	INTC	Intel Corp	$38.07	$180,109	$787.5	4.8%	39.8%	2.7%	2.3%	5.0%	3.3%	2.6%	13	71	13.5x	A+
	14	QCOM	Qualcomm Inc	$67.78	$99,884	$568.1	30.0%	55.6%	3.1%	7.2%	10.3%	4.9%	2.5%	61	240	14.3x	A+
	15	TXN	Texas Instruments Inc	$70.97	$71,198	$351.4	23.8%	49.0%	2.1%	3.6%	5.8%	3.0%	1.4%	73	163	21.2x	A+
Materials	16	APD	Air Products & Chemicals Inc	$137.03	$29,674	$205.5	8.2%	48.2%	2.5%	0.0%	2.5%	2.5%	1.0%	149	149	16.7x	A
	17	NUE	Nucor Corp	$47.98	$15,275	$144.2	13.3%	92.9%	3.1%	0.0%	3.1%	3.1%	2.9%	22	22	15.1x	A-
	18	PX	Praxair Inc	$120.85	$34,470	$146.7	12.3%	49.5%	2.5%	0.9%	3.4%	2.7%	1.9%	59	82	20.0x	A
Energy	19	CVX	Chevron Corp	$102.28	$192,944	$662.7	8.0%	129.2%	4.2%	0.0%	4.2%	4.2%	2.5%	171	171	21.9x	AA-
	20	OXY	Occidental Petroleum Corp	$73.54	$56,179	$294.3	3.1%	--	4.1%	1.1%	5.2%	4.4%	2.7%	147	174	57.3x	A
	21	XOM	Exxon Mobil Corp	$87.24	$361,754	$976.9	6.2%	74.9%	3.4%	0.5%	4.0%	3.6%	2.6%	82	96	19.8x	AA+
Financials	22	AMP	Ameriprise Financial Inc	$102.81	$16,596	$84.0	-9.1%	30.3%	2.9%	11.1%	14.0%	5.7%	2.4%	53	330	9.8x	A
	23	BBT	Bb&T Corp	$38.89	$31,676	$150.8	-2.8%	38.0%	3.1%	0.1%	3.2%	3.1%	1.7%	142	145	12.7x	A-
	24	BEN	Franklin Resources Inc	$36.17	$20,838	$96.4	-7.5%	33.7%	2.0%	7.5%	9.5%	3.9%	2.0%	4	192	13.2x	A+
	25	BLK	Blackrock Inc	$356.80	$58,576	$194.5	-0.9%	45.1%	2.6%	2.4%	4.9%	3.2%	2.5%	9	68	15.9x	AA-
	26	IVZ	Invesco Ltd	$31.81	$13,039	$106.8	-10.7%	46.9%	3.5%	5.8%	9.3%	5.0%	2.0%	150	295	11.9x	A
Real Estate	27	AVB	Avalonbay Communities Inc	$167.10	$22,944	$136.3	-14.8%	95.6%	3.2%	0.0%	3.3%	3.2%	2.7%	55	56	34.6x	A-
	28	EQR	Equity Residential	$61.43	$22,456	$166.4	-17.3%	92.4%	3.3%	13.2%	16.5%	6.6%	2.6%	70	400	43.9x	A-
	29	PSA	Public Storage	$211.18	$36,619	$195.9	-20.5%	106.6%	3.4%	0.0%	3.4%	3.4%	1.1%	228	228	28.4x	A
	30	SPG	Simon Property Group Inc	$196.48	$61,740	$266.4	-4.7%	96.4%	3.4%	0.0%	3.3%	3.4%	2.1%	127	127	29.0x	A
Staples	31	CLX	Clorox Company	$123.04	$15,943	$114.2	-8.8%	61.5%	2.6%	1.6%	4.2%	3.0%	2.0%	55	95	22.5x	A-
	32	HSY	Hershey Co/The	$95.11	$20,276	$157.0	0.8%	53.9%	2.6%	3.5%	6.1%	3.5%	2.2%	39	128	20.8x	A
	33	KMB	Kimberly-Clark Corp	$123.23	$44,318	$206.9	-8.9%	126.4%	3.0%	1.8%	4.8%	3.4%	2.1%	91	136	18.9x	A
	34	KO	Coca-Cola Co/The	$41.71	$180,022	$492.2	-8.6%	63.7%	3.4%	2.5%	5.8%	4.0%	2.5%	88	149	20.8x	AA-
	35	MO	Altria Group Inc	$61.75	$120,651	$352.5	0.3%	81.1%	4.0%	0.4%	4.3%	4.1%	3.1%	83	93	18.5x	A-
	36	PEP	Pepsico Inc	$106.40	$152,597	$429.4	0.8%	59.3%	2.8%	2.5%	5.3%	3.5%	1.9%	94	157	20.5x	A
	37	PG	Procter & Gamble Co/The	$89.48	$238,857	$1,708.2	7.0%	71.1%	3.0%	3.5%	6.5%	3.9%	2.5%	52	140	23.0x	AA-
	38	PM	Philip Morris International	$95.64	$148,369	$417.1	3.1%	91.7%	4.3%	0.0%	4.4%	4.4%	2.3%	203	203	19.3x	A
	39	WMT	Wal-Mart Stores Inc	$69.40	$214,657	$593.4	7.5%	44.5%	2.9%	3.6%	6.5%	3.8%	2.2%	67	158	15.6x	AA
Healthcare	40	ABBV	Abbvie Inc	$62.83	$102,321	$439.7	0.3%	50.5%	3.6%	6.3%	9.9%	5.2%	2.8%	83	241	11.1x	A-
	41	BMY	Bristol-Myers Squibb Co	$55.05	$91,981	$713.4	-25.7%	158.7%	2.8%	0.4%	3.2%	2.9%	2.0%	73	82	18.3x	A+
	42	DHR	Danaher Corp	$78.32	$54,083	$257.6	5.5%	13.6%	0.6%	0.0%	0.6%	0.6%	0.5%	10	10	20.0x	A *-
	43	BMY	Bristol-Myers Squibb Co	$55.05	$91,981	$713.4	-25.7%	158.7%	2.8%	0.4%	3.2%	2.9%	2.0%	73	82	18.3x	A+
	44	LLY	Eli Lilly & Co	$81.47	$89,930	$276.7	-9.0%	88.7%	2.5%	0.7%	3.2%	2.7%	2.5%	2	20	20.0x	AA-
	45	MRK	Merck & Co. Inc.	$62.35	$172,411	$592.7	12.0%	115.2%	3.0%	2.3%	5.3%	3.5%	1.9%	104	162	16.2x	AA
Telecoms	46	T	At&T Inc	$39.12	$240,666	$834.7	8.0%	78.2%	4.9%	0.2%	5.1%	5.0%	3.3%	161	166	13.0x	BBB+
	47	VZ	Verizon Communications Inc	$50.26	$204,875	$671.8	3.0%	52.1%	4.6%	0.0%	4.6%	4.6%	3.4%	122	123	12.4x	BBB+
Utilities	48	DUK	Duke Energy Corp	$77.35	$53,289	$245.9	3.0%	73.5%	4.4%	0.0%	4.4%	4.4%	2.7%	168	168	16.4x	A-
	49	ES	Eversource Energy	$52.65	$16,701	$89.3	-2.6%	59.0%	3.4%	1.1%	4.4%	3.6%	3.0%	36	63	16.7x	A
	50	NEE	Nextera Energy Inc	$118.18	$54,596	$251.2	8.0%	54.6%	2.9%	0.0%	3.0%	2.9%	2.8%	16	16	18.1x	A-
	51	PPL	Ppl Corp	$32.60	$22,102	$163.3	-10.1%	67.9%	4.7%	0.0%	4.7%	4.7%	3.0%	166	166	15.0x	A-
	52	SO	Southern Co/The	$49.43	$48,381	$297.8	0.2%	74.5%	4.5%	0.0%	4.5%	4.5%	3.4%	113	113	16.6x	A-
	53	WEC	Wec Energy Group Inc	$57.25	$18,069	$107.9	5.8%	61.5%	3.5%	0.0%	3.5%	3.5%	2.8%	62	63	18.5x	A-
	54	XEL	Xcel Energy Inc	$39.51	$20,069	$133.5	4.3%	66.0%	3.4%	0.0%	3.4%	3.4%	2.7%	70	71	17.1x	A-
		Average			**$89,443**	**$375.5**	**0.1%**	**67%**	**3%**	**3%**	**6%**	**4%**	**2%**	**78**	**145**	**18.9x**	
		Median			**$57,378**	**$285.5**	**0.8%**	**59%**	**3%**	**1%**	**5%**	**4%**	**2%**	**70**	**138**	**17.6x**	
		% of stocks positive					**59%**										

Source: Fundstrat, Bloomberg, Factset,

fundstrat

LEADERS AND LAGGARDS: History says Resources rebound…

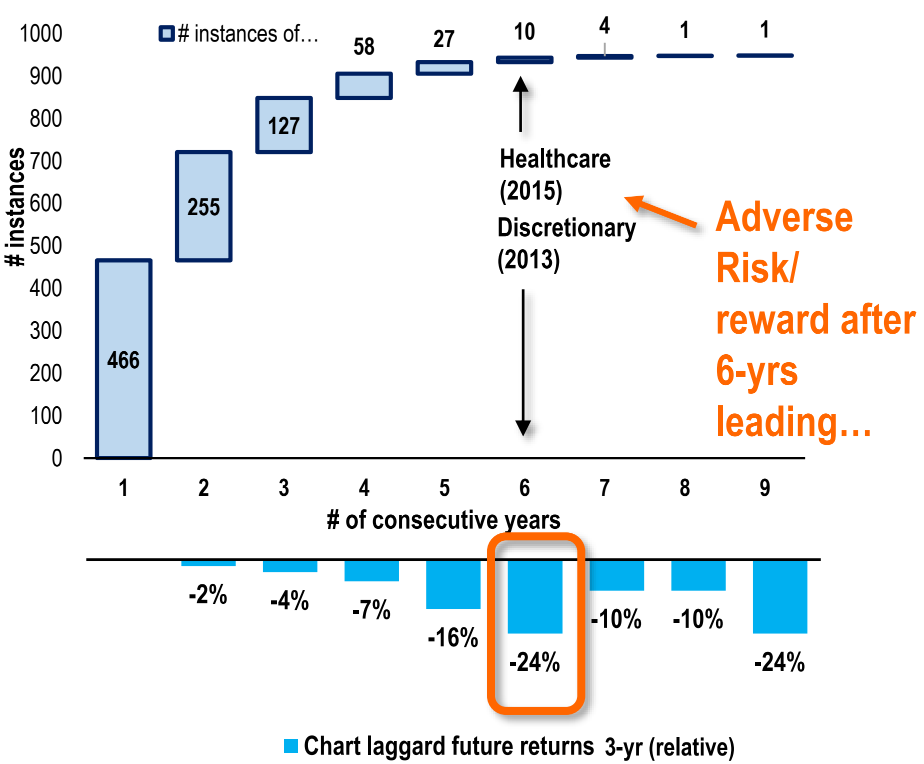
From our 2016 Outlook (dated 12/17/15):

History shows that when a group has been a leader or a laggard for more than 3 consecutive years, that is when investors need to start paying attention:

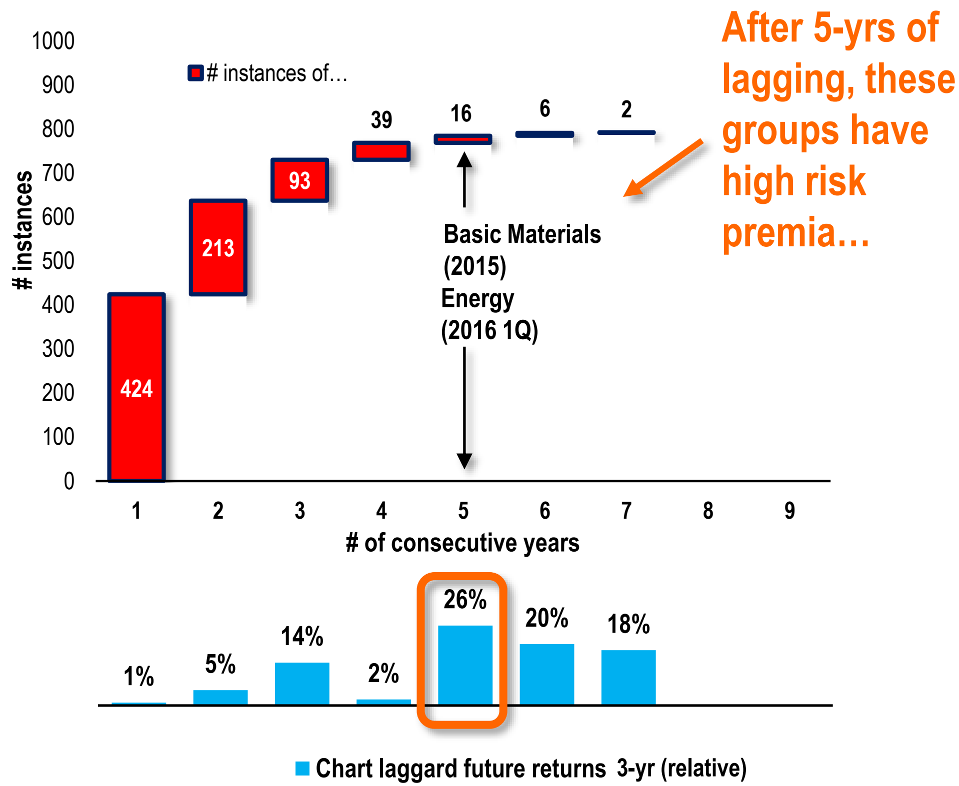
- The group to watch for a downturn: Healthcare (63% chance of underperforming in 2016)
- The groups to watch for "new leadership": **Basic Materials** and **Energy** in 2016

Figure: Comparative likelihood of Laggards "staying laggards" and Leaders "staying leaders"
Since 1927

Consecutive years a group "leads" (the S&P 500)



Consecutive years a group "lags" (the S&P 500)



LAGGARDS TO LEADERS: Regime change is every 7-10 years….

As shown below, regime change, takes place every 7-10 years. Hence, a portfolio manager with a decade of experience likely only has seen one regime change. **Because 2016 has the hallmarks of regime change (USD correlation, commodities bottom, etc), we believe many managers are failing to recognize this transition.**

Figure: Annual relative performance of sectors and styles

Since 1970 (relative to S&P 500)

Sector name	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
S&P 500	0	11	16	-17	-30	32	19	-12	1	12	26	-10	15	17	1	26	15	2	12	27	-7	26	4
Value							9	3	-1	2	-8	2	-2	5	2	-3	1	-2	4	-6	-4	-8	2
Growth							-9	-4	2	-1	11	-4	3	-4	-3	4	-3	2	-3	7	4	9	-2
Pure Value																							
Pure Growth																							
Technology	-32	-4	-13	-3	-7	0	1	5	10	-15	-13	-19	32	9	-13	-7	-31	10	-14	-37	10	-20	-4
Semis					-12	42	-14	-15	14	32	16	-45	39	44	-31	-32	-40	34	-30	-25	4	-2	58
IT Hardware	-20	-2	9	-6	-7	-1	2	7	9	-20	-17	-17	41	7	-9	-4	-33	3	-10	-46	14	-24	-7
IT Software	-14	-6	9	-8	-4	-12	-5	-1	9	5	-29	-9	-9	-9	-16	5	-6	31	-16	-18	9	23	13
Consumer Discretionary	-8	14	-3	-19	-9	29	-5	-7	-9	-14	-16	2	26	3	-7	-2	2	-4	7	-11	-11	12	13
Industrials	-6	7	-3	0	-10	5	6	3	14	-2	3	-17	0	9	-8	-5	-7	0	-6	-3	-4	0	2
Basic Materials	2	-8	-4	15	3	19	-3	-16	-3	7	-11	-13	-13	8	-16	0	9	11	-6	-10	-10	-5	3
Financials	1	6	-6	-4	-4	-15	4	4	1	2	-14	12	-4	1	4	16	-5	-16	2	3	-15	18	15
REITs	-10	6	-30	-39	-33	92	-26	10	3	60	16	5	23	2	2	25	10	-7	-4	-17	-41	19	8
Energy	21	-9	11	22	1	-12	8	6	4	23	33	-27	-38	1	-1	-16	-2	2	6	4	4	-24	-7
Healthcare	-27	14	1	-2	5	-14	-17	3	4	-10	-10	7	3	-10	1	8	13	6	1	13	18	24	-23
HC Eq. & Services	-14	28	15	-3	2	-12	-29	7	-1	4	10	0	10	-28	-18	5	1	8	-5	15	18	12	-18
HC Bio, Pharma, Tools	3	2	20	2	14	-32	-22	-3	12	-2	-5	0	-6	-10	3	13	19	2	-2	9	21	26	-23
Consumer Staples	16	7	8	-9	1	0	-10	6	2	-16	-19	15	11	-5	6	6	10	7	2	14	17	12	-1
Utilities	22	-14	-1	-9	-1	4	-2	12	-13	-16	-25	9	0	-5	15	-4	8	-12	2	0	2	-10	-4
Telecom	11	-13	9	8	16	-15	6	7	-2	-24	-33	30	-16	-10	19	5	4	-2	6	27	-11	-18	7

Sector name	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
S&P 500	7	-2	34	20	31	27	20	-10	-13	-23	26	9	3	14	4	-38	23	13	0	13	30	11	-1	7
Value	8	-2	-2	-2	-4	-14	-9	14	0	1	3	4	1	4	-4	-3	-6	0	-3	1	-1	-2	-5	4
Growth	-8	2	2	2	4	14	8	-12	0	-1	-3	-4	-1	-4	4	3	6	0	3	-1	1	2	4	-4
Pure Value				-7	0	-19	-25	19	21	3	11	14	8	4	-10	-11	27	8	-3	10	16	-1	-10	7
Pure Growth				-2	-2	11	40	2	-5	-9	15	7	4	-7	2	-1	26	14	0	1	13	2	2	-4
Technology	13	21	5	23	-3	51	59	-31	-13	-14	20	-7	-3	-6	12	-5	36	-4	1	0	-3	7	5	2
Semis	46	18	1	56	-22	38	47	-14	-1	-26	66	-31	7	-22	7	-11	31	-5	-1	-18	4	21	-2	14
IT Hardware	12	22	4	18	-6	51	57	-25	-22	-18	28	0	-5	1	12	-3	41	-1	0	2	-13	16	-11	3
IT Software	19	19	6	34	8	53	62	-42	14	-6	-4	2	-5	-6	14	-5	32	-7	3	3	3	-1	17	-1
Consumer Discretionary	6	-8	-16	-10	1	13	5	-11	15	-1	10	3	-10	4	-18	4	15	13	4	8	11	-3	9	-4
Industrials	9	-3	2	2	-6	-17	0	15	6	-4	3	7	-3	-3	6	-3	-6	11	-3	-1	8	-4	-4	8
Basic Materials	3	5	-17	-7	-25	-35	3	-8	14	16	8	2	-1	2	16	-9	22	7	-12	-1	-7	-7	-10	4
Financials	1	-5	16	12	14	-17	-17	34	3	7	2	-1	1	3	-24	-18	-9	-2	-18	13	4	2	-3	8
REITs	27	-5	-16	17	-2	-50	-32	31	15	8	-6	13	4	23	-24	-6	-3	15	8	3	-31	15	2	-10
Energy	4	1	-8	1	-9	-29	-4	23	1	10	-4	20	26	9	29	3	-12	5	3	-11	-7	-21	-23	11
Healthcare	-18	12	20	-1	11	16	-31	46	0	3	-13	-9	2	-8	2	14	-6	-12	10	2	9	12	6	-9
HC Eq. & Services	-20	7	11	-10	-17	-10	-41	66	8	9	1	8	14	-14	9	1	8	-9	6	0	4	14	8	-3
HC Bio, Pharma, Tools	-18	14	23	1	18	21	-29	41	-2	2	-18	-16	-5	-4	-2	21	-12	-13	13	2	12	11	5	-12
Consumer Staples	-13	8	2	3	0	-13	-36	25	5	17	-17	-3	-2	-2	8	21	-12	-2	11	-6	-7	1	4	-6
Utilities	1	-16	-9	-20	-13	-17	-32	62	-19	-10	-5	11	10	3	12	7	-17	-12	15	-16	-21	13	-8	1
Telecom	4	-7	3	-22	6	23	-2	-30	-1	-13	-23	7	-12	19	5	5	-21	0	1	-1	-23	-13	-1	-3

WHAT MAKES 2016 UNIQUE? Leaders became Laggards (vice versa)

2016 has proven to be a challenging year for clients (an understatement) and one of the reasons for this is that leadership changed abruptly (groups leading or lagging for 5-7 years):

- Long-time leaders like Healthcare and Consumer Discretionary have turned into laggards in 2016. And Growth underperformed in 2016. The two sectors and this style are popular both with hedge-fund and long only managers. Hence, creating turmoil. **Similarly, groups which were "easy to short (underweight)" have become leaders—with sizable gains.**

Figure: Leaders become Laggards and vice versa…
Annual performance (relative to S&P 500) since 2008

LEADERS

Group name	Consec. # yrs of outperform (as of 2015 YE)	2007	2008	2009	2010	2011	2012	2013	2014	2015	YTD 2016
Healthcare sector	5					10%	2%	9%	12%	6%	-4%
Biotechnology	5					22%	24%	45%	21%	6%	-13%
Healthcare Distributors	9	0%	1%	20%	5%	8%	2%	32%	14%	6%	-14%
Consumer Discretionary	1		4%	15%	13%	4%	8%	11%	-3%	9%	-0%
Apparel Retail	7			46%	19%	22%	16%	5%	5%	2%	-6%
Pure Growth	7			26%	14%	0%	1%	13%	2%	2%	-2%

LEADER 5 years

LEADER 7 years

LEADER 7 years

We downgraded Healthcare on 12/17/15

We downgraded Discretionary on 11/13/15

LAGGARDS

Group name	Consec. # yrs of underperform (as of 2015 YE)	2007	2008	2009	2010	2011	2012	2013	2014	2015	YTD 2016
Energy sector	4						-11%	-7%	-21%	-23%	8%
Oil and Gas Exploration	6				-4%	-7%	-11%	-4%	-23%	-35%	12%
Coal/Consumable Fuels	5					-47%	-41%	-39%	-47%	-79%	88%
Materials	5					-12%	-1%	-7%	-7%	-10%	5%
Metals and Mining	5					-37%	-20%	-15%	-49%	-70%	71%
Gold	5					-2%	-36%	-80%	-29%	-4%	87%
Steel	6				-1%	-25%	-28%	-19%	-23%	-18%	17%
Heavy Machinery	5					-12%	-7%	-20%	-12%	-31%	13%
Communications Equip.	6				-16%	-5%	-2%	-13%	-1%	-13%	-2%
Value	9	-4%	-3%	-6%	-0%	-3%	1%	-1%	-2%	-5%	2%

Commodity Bust 6 years

Commodity Bust 5 years

Industrial Recession 5 years

Value LAGGED 9 years…

Source: Fundstrat, FactSet, Bloomberg.

Laggards become leaders… 16 of 16 laggards beat in 2016

In our 2016 outlook, we emphasized how this year was likely to shape up to be a "laggards become leaders" year. As shown below 16 of 16 groups which lagged at least 4 consecutive years are outperforming in 2016.

- **As shown below, the laggards are outperforming the S&P 500 by 2,800bp in 2016—but the most notable aspect is that this outperformance has only clawed back about 1/4 of the cumulative underperformance.**

Figure: PAST LAGGARDS (4-plus consecutive years)

16 industry groups that underperformed the S&P 500 at least 4 years in a row

		a		b	c = (b / a)
Group name	Consecutive yrs of under-performance	Cumulative under-performance	2015 relative return	**YTD 2016 relative return**	2016 return as % of cumulative
Oil & Gas Drilling	6	-145%	-31%	**-6%**	4%
Steel	6	-126%	-18%	**13%**	10%
Oil & Gas Exploration & Production	6	-110%	-35%	**21%**	19%
Communications Equipment	6	-69%	-13%	**7%**	10%
Coal & Consumable Fuels	5	-155%	-79%	**145%**	93%
Diversified Metals & Mining	5	-150%	-70%	**42%**	28%
Gold	5	-133%	-4%	**87%**	65%
Construction & Farm Machinery & Heav	5	-92%	-31%	**26%**	28%
Oil & Gas Equipment & Services	5	-82%	-20%	**15%**	18%
Integrated Oil & Gas	4	-74%	-16%	**7%**	10%
Apparel, Accessories & Luxury Goods	4	-69%	-24%	**-6%**	8%
Trading Companies & Distributors	4	-69%	-20%	**-1%**	2%
IT Consulting & Other Services	4	-62%	-3%	**3%**	4%
Integrated Telecommunications Services	4	-53%	-1%	**7%**	13%
Household Products	4	-31%	-7%	**4%**	12%
Industrial Gases	4	-40%	-12%	**8%**	20%
Average		-91%	-24%	**23%**	22%
% outperforming				**81%**	

The outperformance of laggards has only recovered 1/4 of the cumulative underperformance…

Source: Fundstrat, FactSet, Bloomberg.

Figure: PAST LEADERS (4-plus consecutive years)

14 industry groups that outperformed the S&P 500 at least 4 years in a row

		a		b	c = (b / a)
Group name	Consecutive yrs of out-performance	Cumulative out-performance	2015 relative return	**YTD 2016 relative return**	2016 return as % of cumulative
Health Care Distributors	9	146%	6%	**-20%**	14%
Apparel Retail	7	335%	2%	**0%**	0%
Distillers & Vintners	6	252%	33%	**7%**	3%
Housewares & Specialties	6	230%	16%	**12%**	5%
Home Improvement Retail	6	223%	22%	**-9%**	4%
Cable & Satellite	6	139%	4%	**11%**	8%
Biotechnology	5	247%	6%	**-18%**	7%
Data Processing & Outsourced Services	5	134%	11%	**0%**	0%
Drug Retail	5	92%	6%	**-14%**	15%
Building Products	4	150%	25%	**5%**	4%
Application Software	4	75%	21%	**2%**	2%
Real Estate Services	4	65%	2%	**-26%**	41%
Property & Casualty Insurance	4	34%	8%	**1%**	4%
Electronic Manufacturing Services	4	26%	3%	**-8%**	32%
Average		153%	12%	**-4%**	10%
% outperforming				**57%**	

The underperformance of past leaders has only ceded 11% of cumulative outperformance…

Source: Fundstrat, FactSet, Bloomberg.

Laggards become Leaders

We identified 26 laggards stock ideas using the following criteria:

i. The stock is a member of one of the 16 “Laggard” industries we identified.

ii. The stock is in both the S&P 500 Growth and Value Index

Figure: 15 “Laggards become Leaders” stock ideas
Priced as of 10/6/2016

		Company information						Analyst Ratings					Fundamentals & Valuation			
		Ticker	Company name	Current Price	Mkt cap ($ mm)	3m avg daily liquidity ($ mm)	YTD perf (relative to S&P 500)	FC Mean (5=Buy 1=Sell) [1]	Mean implied upside [2]	Dividend Yield	Issuer Rating	Short interest % of float	2017E sales growth [3]	2017E EPS growth [3]	P/E ('17E)	ROE
Discretionary	1	KORS	Michael Kors Holdings Ltd	$47.37	$8,006	$128.3	12.5%	3.43	16%	0.0%	—	12.1%	2%	5%	9.8x	43%
	2	VFC	Vf Corp	$54.77	$22,713	$157.9	-17.8%	4.00	20%	2.7%	A	3.8%	7%	12%	15.3x	26%
Industrials	3	FAST	Fastenal Co	$42.50	$12,281	$105.0	-1.6%	3.00	5%	2.8%	—	8.0%	5%	6%	22.9x	28%
	4	GWW	Ww Grainger Inc	$227.58	$13,751	$116.0	6.6%	2.91	-3%	2.1%	AA-	16.0%	4%	8%	18.2x	28%
	5	URI	United Rentals Inc	$83.50	$7,194	$142.5	9.4%	3.36	-7%	0.0%	BB-	9.5%	0%	3%	9.9x	40%
Technology	6	CSCO	Cisco Systems Inc	$31.51	$157,977	$676.8	10.3%	4.08	5%	3.4%	AA-	1.0%	1%	3%	13.0x	17%
	7	CSRA	Csra Inc	$26.78	$4,382	$31.7	-16.5%	4.43	25%	--	BB+	1.9%	3%	6%	12.9x	9%
	8	FFIV	F5 Networks Inc	$124.92	$8,270	$79.7	23.1%	3.33	-0%	0.0%	—	6.4%	7%	11%	15.8x	29%
	9	HRS	Harris Corp	$91.90	$11,357	$60.6	0.0%	4.75	10%	2.3%	BBB-	2.7%	-3%	1%	15.9x	22%
	10	IBM	Intl Business Machines Corp	$157.12	$150,182	$514.6	8.4%	3.25	2%	3.4%	AA-	2.7%	-0%	4%	11.1x	94%
	11	MSI	Motorola Solutions Inc	$74.44	$12,411	$90.3	3.0%	3.22	0%	2.2%	BBB-	2.5%	2%	9%	14.9x	—
	12	TDC	Teradata Corp	$30.41	$3,965	$49.2	9.4%	2.62	-3%	0.0%	—	15.6%	-1%	-1%	12.4x	26%
Materials	13	APD	Air Products & Chemicals Inc	$136.94	$29,654	$205.5	8.1%	3.82	7%	2.4%	A	1.1%	6%	9%	16.7x	22%
	14	PX	Praxair Inc	$120.80	$34,456	$146.7	12.2%	3.68	5%	2.5%	A	0.9%	6%	10%	20.0x	31%
Energy	15	APA	Apache Corp	$64.50	$24,496	$219.2	39.4%	3.27	-5%	1.5%	BBB	5.9%	30%	236%	52.6x	-3%
	16	APC	Anadarko Petroleum Corp	$64.15	$35,515	$309.1	26.3%	4.31	9%	0.6%	BBB	1.7%	37%	99%	nm	-11%
	17	COG	Cabot Oil & Gas Corp	$25.50	$11,861	$131.7	38.4%	4.08	15%	0.3%	—	3.3%	49%	391%	54.1x	-4%
	18	CXO	Concho Resources Inc	$141.14	$19,871	$185.3	46.3%	4.42	5%	0.0%	BB+	5.0%	48%	-163%	nm	1%
	19	DVN	Devon Energy Corp	$43.55	$22,808	$259.9	30.4%	4.32	9%	1.0%	BBB	2.5%	15%	590%	33.4x	8%
	20	EOG	Eog Resources Inc	$97.41	$53,655	$271.1	31.9%	3.84	3%	0.7%	BBB+	1.7%	37%	127%	nm	-6%
	21	NFX	Newfield Exploration Co	$42.94	$8,530	$119.5	26.2%	4.54	22%	0.0%	BB+	3.8%	25%	62%	33.3x	6%
	22	OXY	Occidental Petroleum Corp	$73.76	$56,348	$294.3	3.4%	3.62	8%	4.1%	A	1.9%	30%	290%	57.5x	-2%
	23	XEC	Cimarex Energy Co	$139.74	$13,273	$105.0	50.6%	4.09	3%	0.3%	BBB-	2.7%	43%	466%	41.2x	-2%
Staples	24	CL	Colgate-Palmolive Co	$73.41	$65,445	$213.6	4.5%	3.40	5%	2.1%	AA-	0.9%	5%	9%	23.8x	—
	25	KMB	Kimberly-Clark Corp	$123.54	$44,429	$206.9	-8.7%	3.53	11%	3.0%	A	1.3%	4%	7%	19.0x	619%
Telecoms	26	VZ	Verizon Communications Inc	$50.30	$205,038	$671.8	3.1%	3.56	9%	4.5%	BBB+	0.9%	1%	4%	12.4x	105%
		Average			$39,918	$211.3	13.8%	3.73	7%	2%		4.5%	14%	85%	23.3x	47%
		Median			$21,292	$152.3	9.4%	3.65	5%	2%		2.7%	5%	9%	16.7x	22%
		% of stocks positive					85%		81%				88%	92%		75%

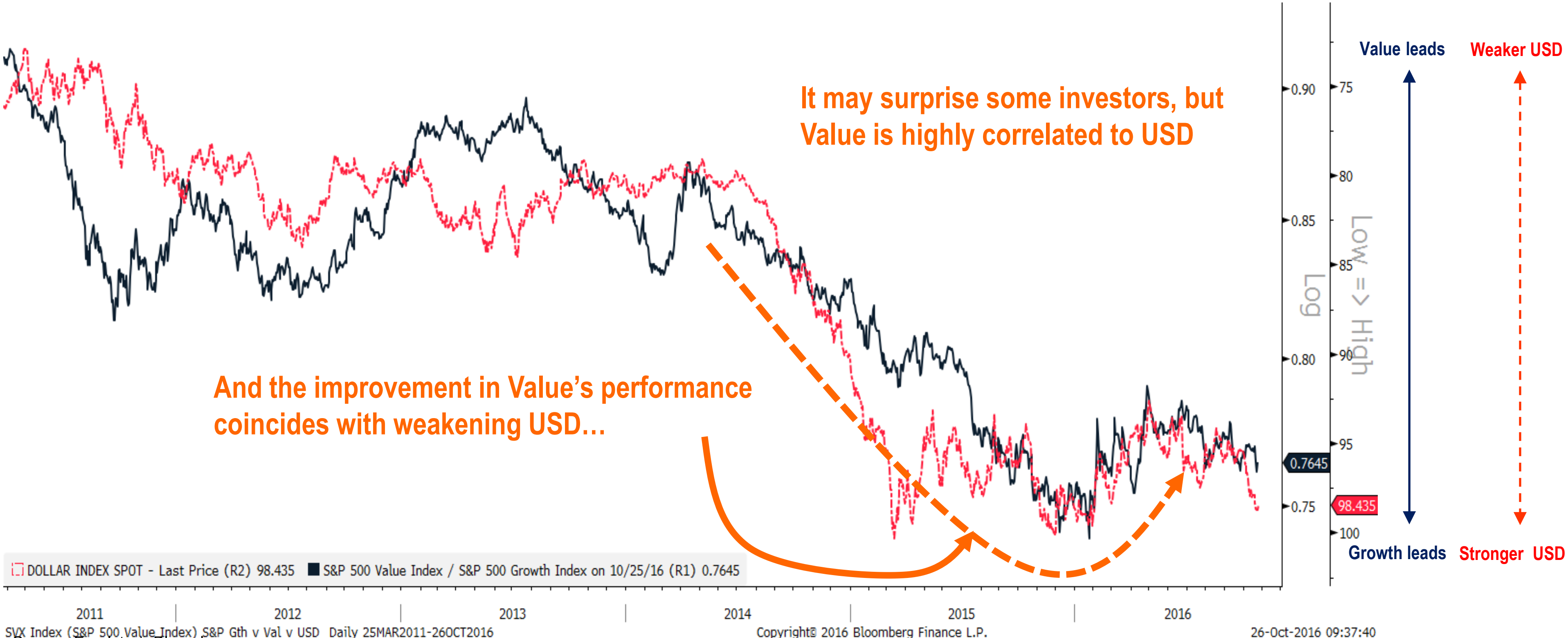
Source: Fundstrat, FactSet, Bloomberg.

Overweight *Value* if the USD is weakening…

Value has been highly correlated to USD and the relationship is highlighted on the chart below. There are a few reasons why we believe this relationship exists:

- **A modest factor is that Value has a higher OW in Energy (700bp more than Growth) and Industrials (200bp) but this OW in Energy does not explain the difference.**
- **Rather, we think the driver is that Value (sector neutral) has lower valuations and therefore is more positively levered to implied higher inflation—that is, weaker USD tends to lead to higher import costs—this would de-rate higher multiple stocks. And thus, the incremental boost on EPS is better levered in Value stocks.**

Figure: Value (relative to S&P 500) is highly correlated to performance of the US Dollar
Since 2011



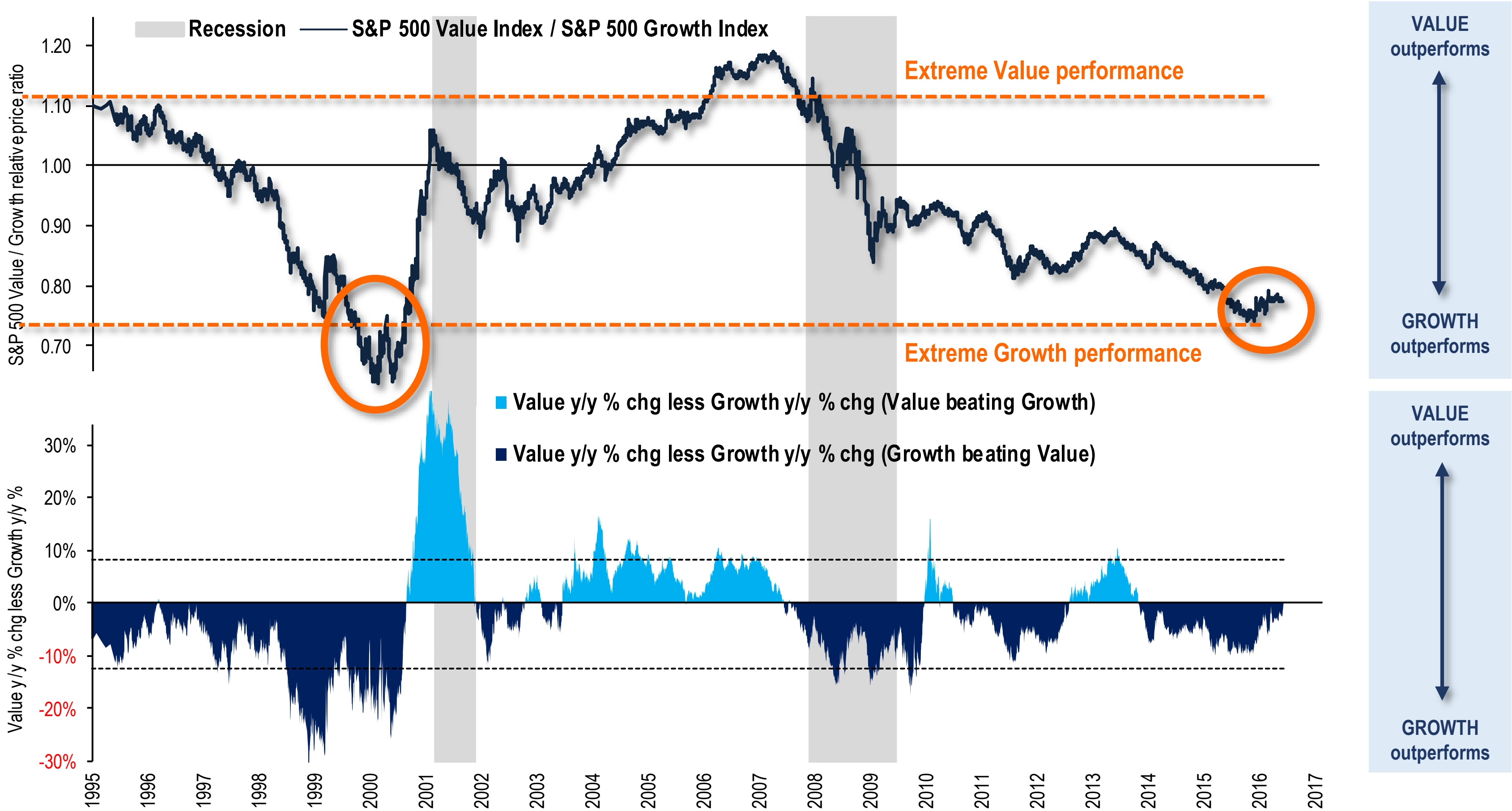
Source: Fundstrat, Bloomberg.

STRATEGY: VALUE over GROWTH, Growth *stretched* to 20-year highs…

Taking a step back, the massive outperformance of Growth over Value has taken us to 20-year extremes as shown below:

- As shown, we are now back to a price ratio last seen in the late-1990s, right before **Value** began its decade-long outperformance. **Another reason to be bullish on Value.**

Figure: S&P 500 Value vs. Growth price ratio
Since 1995



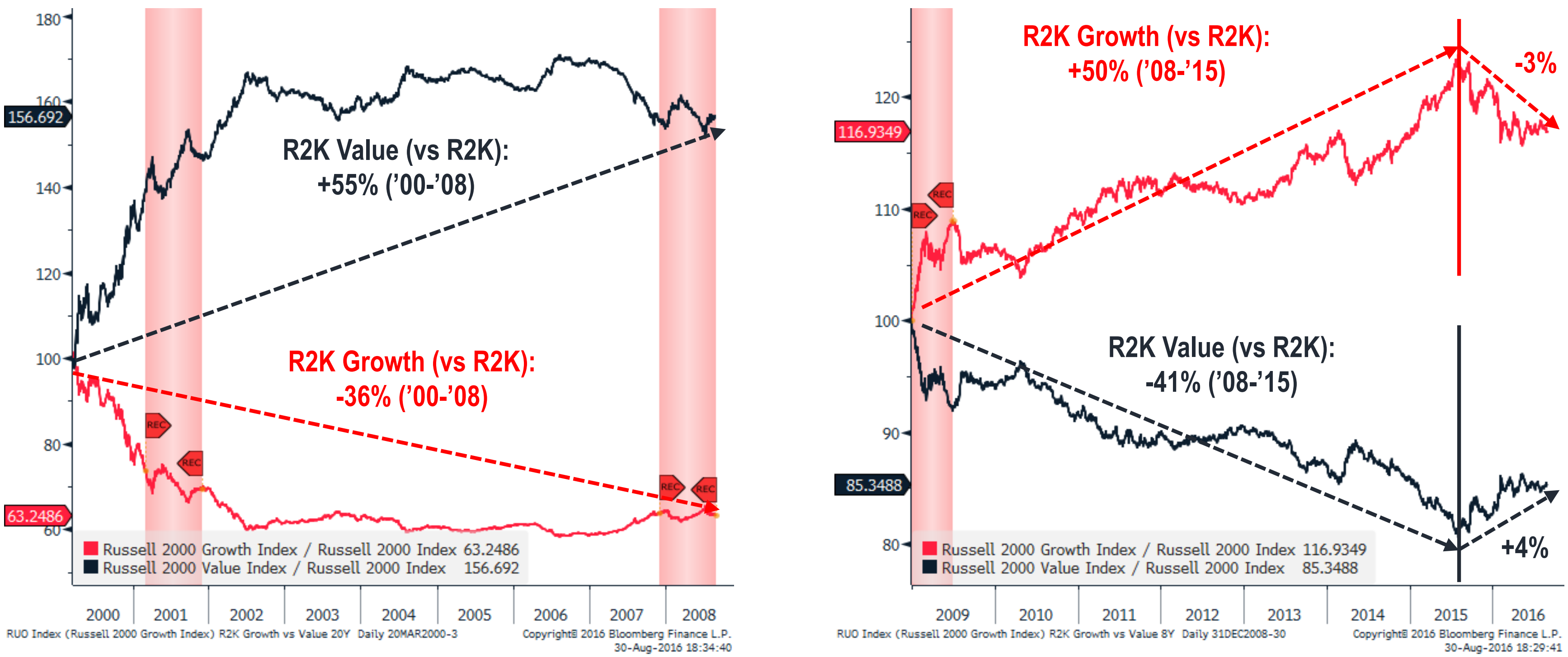
Source: Fundstrat, Bloomberg.

Is this an 8-year cycle turning to small-cap value?

We have highlighted the comparative performance between small-cap value and growth (Russell 2000, RUJ and RUO, respectively). And as shown, one could argue the performance differential follows 7-8 year cycles:

- **From 2000-2008, Value dramatically outperformed (+55% versus -36%) but since 2008, we have seen this invert—Growth outperformed by 50% (vs -41% for Value).**

Figure: Relative Performance of Russell 2000 Growth and Value (vs Russell 2000)
Since 2000



Source: Fundstrat, FactSet, Bloomberg

FANG still ends with a DANG–buy last year's bottom 10

Last year, we wrote about how the top contributors of market performance rarely follow through in the following year and that bottom 10 tend to reverse (see "FANG ends with a DANG" dated 12/10/15). This has played out in 2016 and we see this continuing into YE.

- **Take a look at those 2015 bottom 10 stocks, we see a case to remain long these names—they are a combination of Energy (we like), Technology (catch-up) and/or stock are new bonds/dividend payers. As a consequence, we see the case to remain focused on outperformance of the bottom 10 into YE.**

Figure: "Top 10 of 2015" Returns in 2016

Top 10 stocks from 2015 based on excess point contribution to S&P 500

	Ticker	Company name	Relative returns 2015	Relative returns 2016 YTD
1	AMZN	Amazon.Com Inc	118.5%	6.8%
2	GOOGL	Alphabet Inc-Cl A	47.3%	-8.1%
3	MSFT	Microsoft Corp	20.2%	1.5%
4	FB	Facebook Inc-A	34.9%	7.1%
5	GE	General Electric Co	24.0%	-7.4%
6	HD	Home Depot Inc	26.7%	-8.6%
7	AAPL	Apple Inc	-3.9%	-2.8%
8	SBUX	Starbucks Corp	47.1%	-12.1%
9	NFLX	Netflix Inc	135.1%	-4.5%
10	V	Visa Inc-Class A Shares	19.0%	-5.3%
	Average		**46.9%**	-3.3%
	Win ratio		**90%**	**30%**

F
A
N
G

Ouch...

Source: Fundstrat, FactSet, Bloomberg.

Figure: "Bottom 10 of 2015" Returns in 2016

Bottom 10 stocks from 2015 based on excess point contribution to S&P 500

	Ticker	Company name	Relative returns 2015	Relative returns 2016 YTD
1	WMT	Wal-Mart Stores Inc	-27.9%	7.5%
2	XOM	Exxon Mobil Corp	-15.0%	3.5%
3	KMI	Kinder Morgan Inc	-64.0%	39.9%
4	BRK/B	Berkshire Hathaway Inc-Cl E	-11.3%	12.3%
5	CVX	Chevron Corp	-19.1%	15.4%
6	QCOM	Qualcomm Inc	-32.0%	28.4%
7	ORCL	Oracle Corp	-18.0%	1.8%
8	UNP	Union Pacific Corp	-33.6%	21.5%
9	PG	Procter & Gamble Co/The	-12.1%	-3.5%
10	COP	ConocoPhillips	-31.7%	-8.9%
	Average		**-26.5%**	**11.8%**
	Win ratio		**0%**	**80%**

Wow....

Source: Fundstrat, FactSet, Bloomberg.

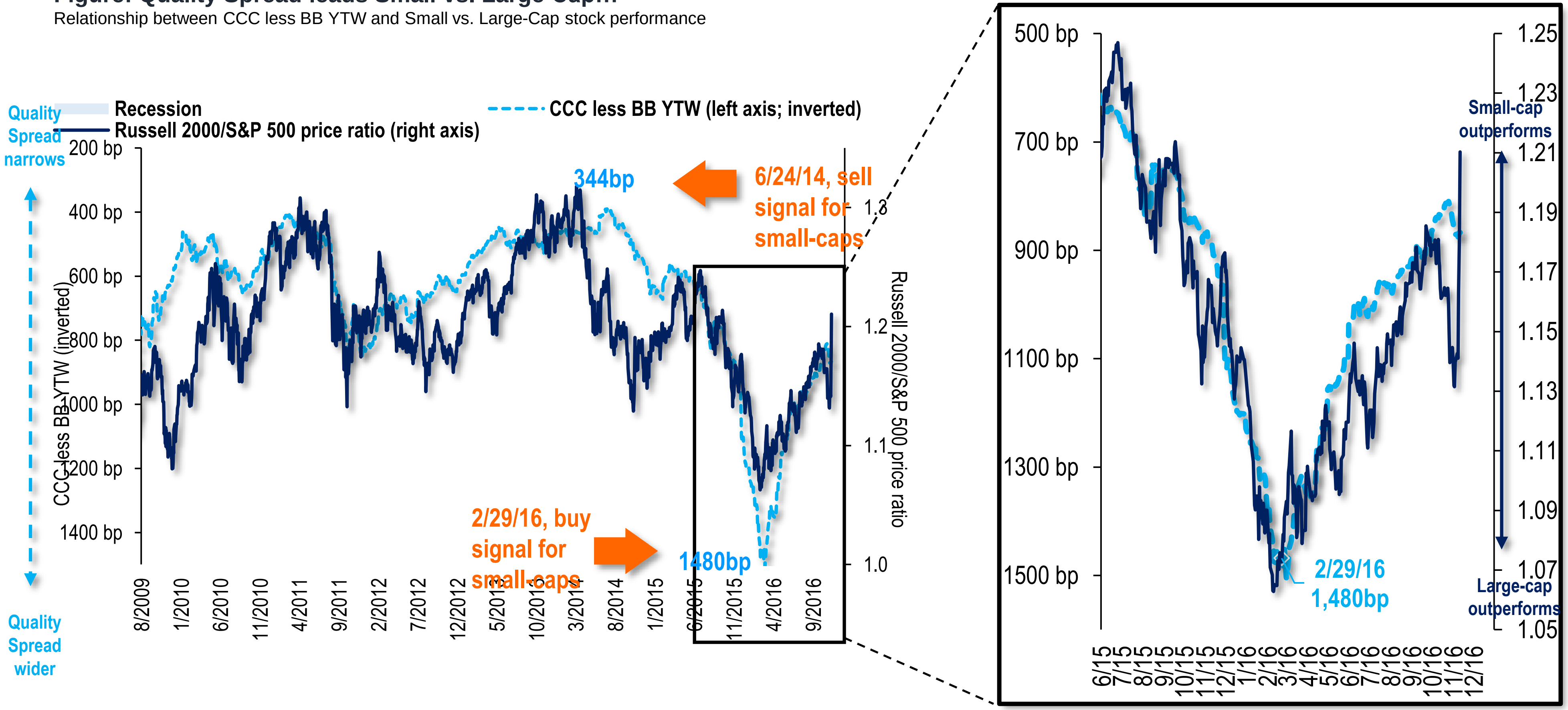
Buy Small-caps: Quality spread rally (BB vs CCC) argues this

As shown below, historically, small-caps and quality spreads tend to move together. Not surprising given CCC relative value is a "risk premia" measure and argues for small-caps to outperform as well.

- **Given that we expect the quality spread to continue to rally, we think small-caps will continue to outperform from here. This is in addition to the ISM exports argument.**

Figure: Quality Spread leads Small vs. Large-Cap…

Relationship between CCC less BB YTW and Small vs. Large-Cap stock performance



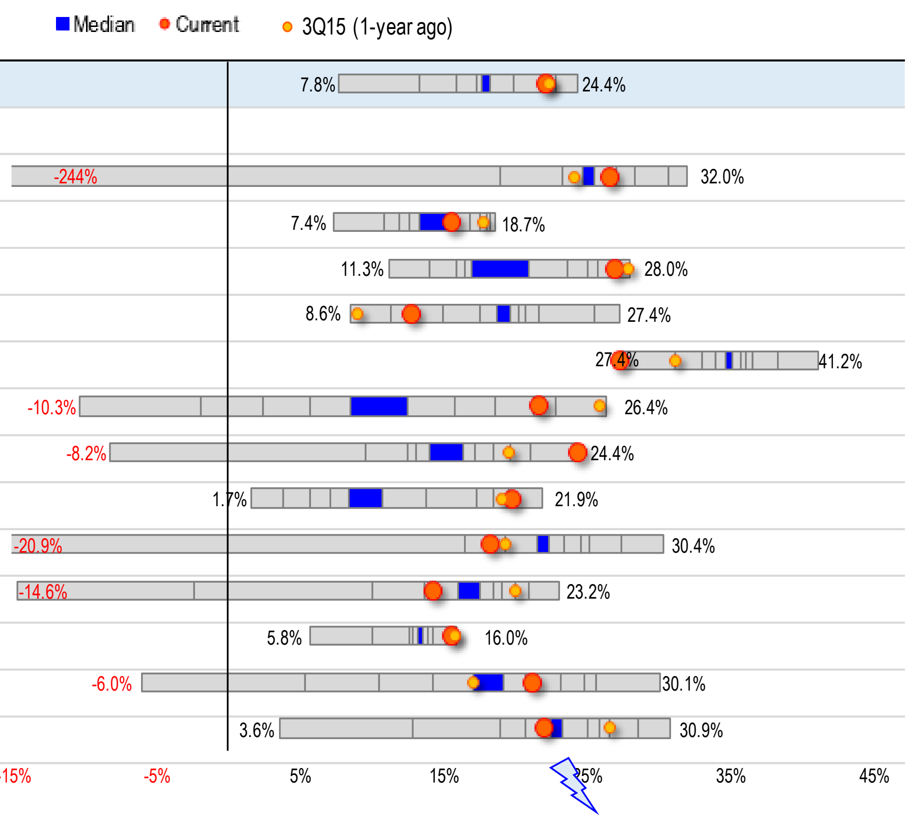
Source: Fundstrat, FactSet, Bloomberg.

Technology sector EBIT margins

Figure: Deciles of Technology sector EBIT margins
Since 1999

% contribution to sector Sales		% contribution to sector EBIT		Market cap weight		
Total Sales ($ mm)	% of total sector Sales	Total EBIT ($ mm)	% of total sector EBIT	Mkt cap ($ mm)	% weight in sector	
$1,218,477	100%	$270,651	100%	$4,089,534	100%	Technology
$201,679	17%	$53,791	20%	$866,474	21%	Internet Software & Services
$134,468	11%	$21,063	8%	$268,461	7%	IT Consulting & Other Services
$98,689	8%	$26,609	10%	$473,980	12%	Data Processing & Outsourced Services
$23,139	2%	$2,961	1%	$164,602	4%	Application Software
$132,229	11%	$36,207	13%	$679,094	17%	Systems Software
$9,858	1%	$2,143	1%	$53,710	1%	Home Entertainment Software
$69,299	6%	$16,924	6%	$196,653	5%	Communications Equipment
$361,096	30%	$71,557	26%	$691,403	17%	Technology Hardware, Storage & Peripherals
$1,602	0%	$293	0%	$4,815	0%	Electronic Equipment & Instruments
$14,789	1%	$2,118	1%	$43,638	1%	Electronic Components
$11,890	1%	$1,862	1%	$23,868	1%	Electronic Manufacturing Services
$18,771	2%	$3,996	1%	$62,475	2%	Semiconductor Equipment
$140,968	12%	$31,128	12%	$560,361	14%	Semiconductors

Deciles of LTM EBIT margin (quarterly frequency; since 1999)



Source: Fundstrat, Factset, Bloomberg

INDUSTRIALS: Conglomerates and Machinery key to upside

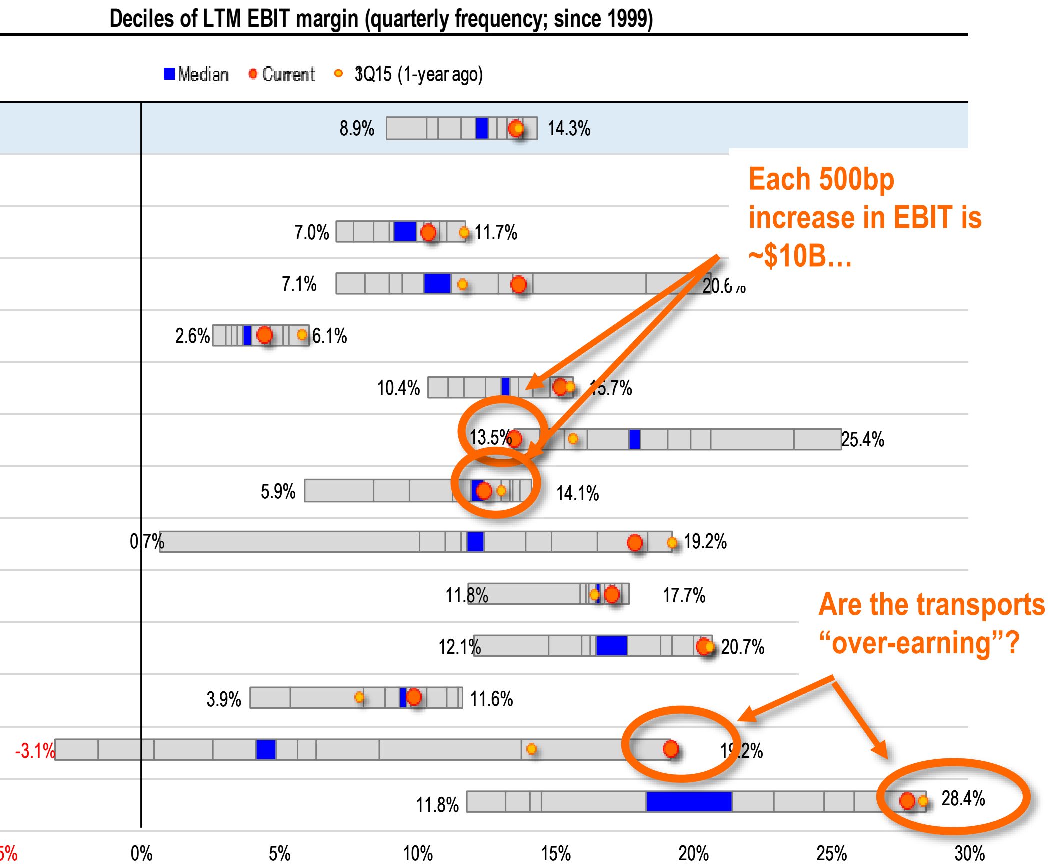
We all know about the industrial recession that has been underway for several years.

- **And as a consequence, margins are underperforming in Conglomerates and Machinery stocks. We believe these groups benefit from a recovery in commodity prices (end market customers) and by a weakening USD. As shown below, each 500bp improvement in EBIT (from depressed levels) is $20b in total, or $1.33 per S&P 500 share.**

Figure: : Deciles of Industrials sector EBIT margins

Since 1999

% contribution to sector Sales		% contribution to sector EBIT		Market cap weight		
Total Sales ($ mm)	% of total sector Sales	Total EBIT ($ mm)	% of total sector EBIT	Total market cap ($ mm)	% weight in sector	
$1,210,201	100%	$164,165	100%	$2,004,384	100%	Industrials
$313,847	26%	$32,629	20%	$448,328	22%	Aerospace & Defense
$23,981	2%	$3,272	2%	$67,869	3%	Building Products
$36,823	3%	$1,647	1%	$18,950	1%	Construction & Engineering
$53,722	4%	$8,139	5%	$103,595	5%	Electrical Equipment
$195,309	16%	$26,374	16%	$480,894	24%	Industrial Conglomerates
$185,406	15%	$23,032	14%	$292,139	15%	Machinery
$19,804	2%	$3,545	2%	$33,878	2%	Trading Companies & Distributors
$34,207	3%	$5,823	4%	$69,737	3%	Commercial Services & Supplies
$18,192	2%	$3,706	2%	$54,380	3%	Professional Services
$128,500	11%	$12,676	8%	$147,127	7%	Air Freight & Logistics
$143,507	12%	$27,529	17%	$120,416	6%	Airlines
$56,904	5%	$15,794	10%	$167,070	8%	Road & Rail



Source: Fundstrat, Bloomberg, FactSet

Consumer Discretionary sector EBIT margins

Focus on the “low margin” players like AMZN and margin growers like household durables.

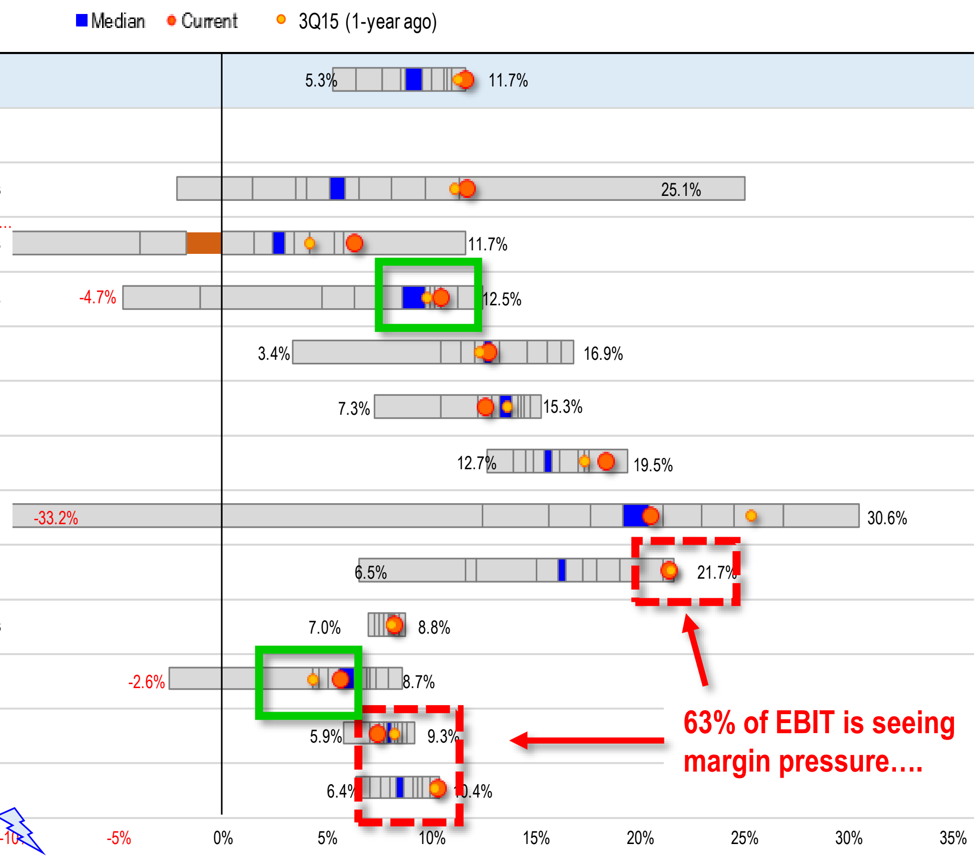
- **63% of the EBIT margins are in sectors facing enormous margin pressures.**

Figure: Deciles of Consumer Discretionary sector EBIT margins

Since 1999

% contribution to sector Sales		% contribution to sector EBIT		Market cap weight		
Total Sales ($ mm)	% of total sector Sales	Total EBIT ($ mm)	% of total sector EBIT	Market cap ($ mm)	% weight in sector	
$1,709,144	100%	$199,406	100%	$2,480,312	100%	Consumer Discretionary
$40,190	2%	$4,713	2%	$33,946	1%	Auto Components
$319,808	19%	$20,272	10%	$107,541	4%	Automobiles
$79,903	5%	$8,393	4%	$99,392	4%	Household Durables
$10,269	1%	$1,312	1%	$21,606	1%	Leisure Products
$84,029	5%	$10,627	5%	$147,379	6%	Textiles, Apparel & Luxury Goods
$118,561	7%	$21,863	11%	$316,720	13%	Hotels, Restaurants & Leisure
$3,026	0%	$622	0%	$5,046	0%	Diversified Consumer Services
$315,150	18%	$67,487	34%	$612,955	25%	Media
$23,174	1%	$1,912	1%	$24,117	1%	Distributors
$147,272	9%	$8,331	4%	$507,579	20%	Internet & Catalog Retail
$172,778	10%	$12,934	6%	$117,900	5%	Multiline Retail
$394,984	23%	$40,939	21%	$486,131	20%	Specialty Retail

Deciles of LTM EBIT margin (quarterly frequency; since 1999)



Source: Fundstrat, Factset, Bloomberg

ENERGY EPS UPSIDE: Integrateds and E&Ps may add $70b in EBIT in 2017

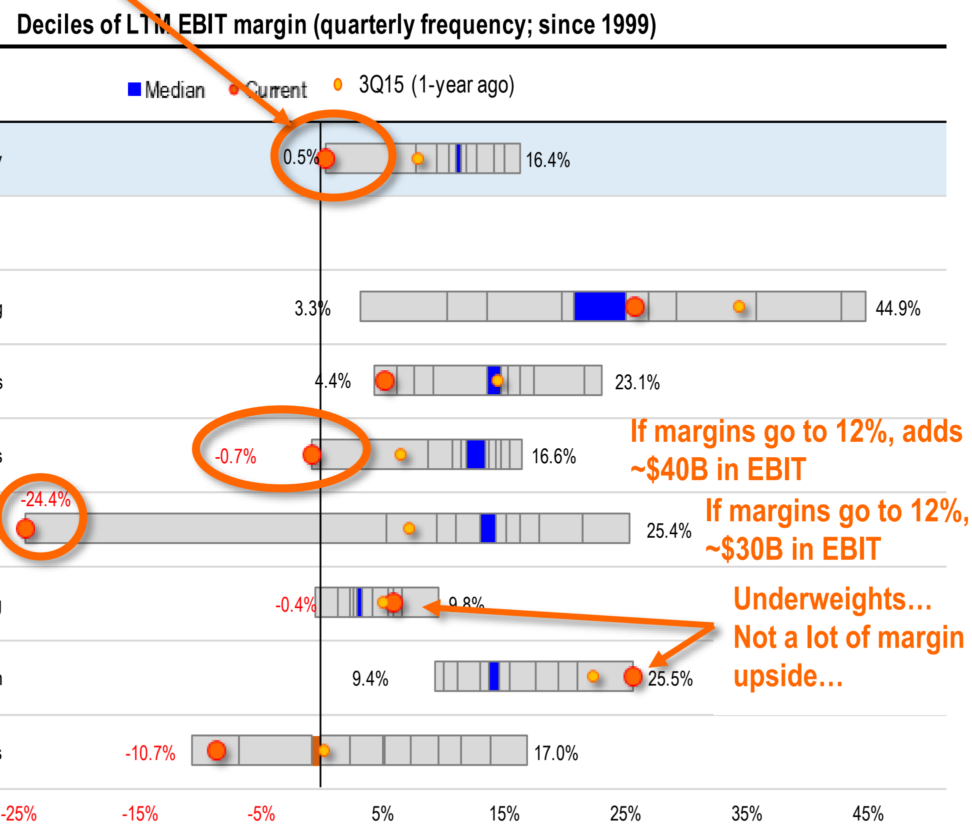
We see upside in Energy EBIT margins over the next few years, as oil prices recover. As we said in the past (and everyone knows), Energy companies only make money when oil prices are higher than they are now.

- **We believe Integrateds and E&Ps could add $70B in EBIT in next 12 months ($5 per S&P 500 share). In other words, major leverage on EPS from higher oil.**

Figure: Deciles of Energy Sector EBIT margins
Since 1999

Upside to Energy EBIT margins over new few years…

% of total sector Sales		% of total sector EBIT		Market cap weight		
Total Sales ($ mm)	% of total sector Sales	Total EBIT ($ mm)	% of total sector EBIT	Total mkt cap ($ mm)	% weight in sector	
$770,788	100%	$3,283	100%	$1,382,629	100%	Energy
$7,602	1%	$1,967	60%	$11,284	1%	Oil & Gas Drilling
$76,195	10%	$3,976	121%	$200,561	15%	Oil & Gas Equipment & Services
$327,727	43%	($2,404)	-73%	$609,348	44%	Integrated Oil & Gas
$92,406	12%	($22,525)	-686%	$345,996	25%	Oil & Gas Exploration & Production
$231,551	30%	$13,916	424%	$105,940	8%	Oil & Gas Refining & Marketing
$33,201	4%	$8,535	260%	$109,501	8%	Oil & Gas Storage & Transportation
$2,106	0%	($181)	-6%	n/a	n/a	Coal & Consumable Fuels



Source: Fundstrat, Bloomberg, FactSet

Healthcare sector EBIT margins

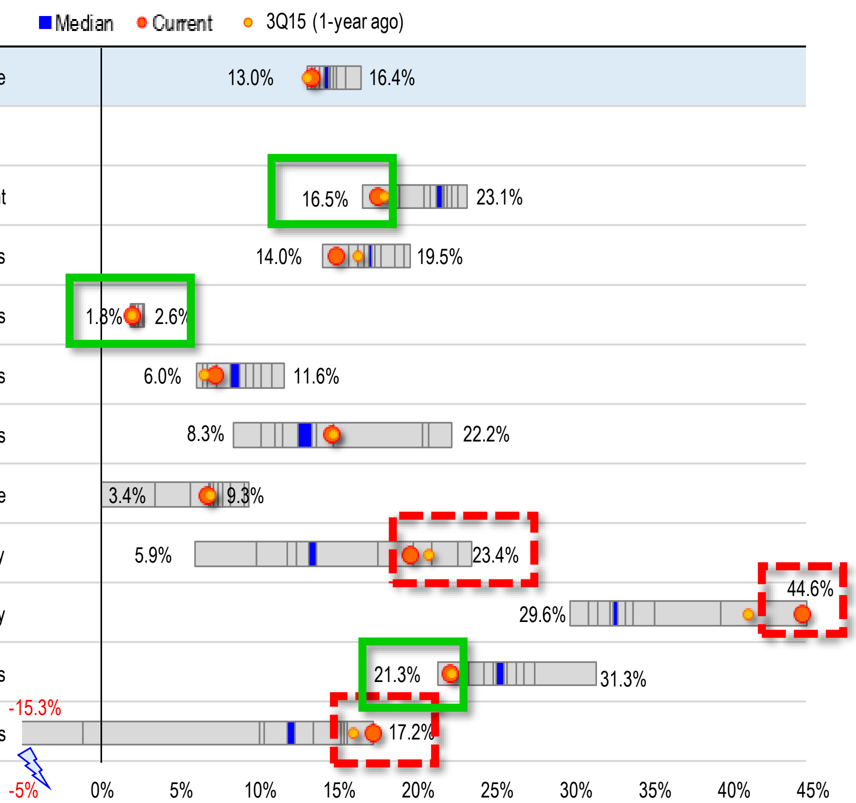
The group's most attractive, in our view, are those with lower EBIT margins.

- **This suggest we should favor groups like Pharma, HC equipment and distributors.**

Figure: Deciles of Healthcare sector EBIT margins
Since 1999

% contribution to sector Sales		% contribution to sector EBIT		Market cap weight		
Total Sales ($ mm)	% of total sector Sales	Total EBIT ($ mm)	% of total sector EBIT	Market cap ($ mm)	% weight in sector	
$1,635,351	100%	$189,162	100%	$2,728,781	100%	Healthcare
$140,224	9%	$24,451	13%	$484,075	18%	Health Care Equipment
$5,018	0%	$743	0%	$22,573	1%	Health Care Supplies
$476,074	29%	$8,899	5%	$90,127	3%	Health Care Distributors
$132,685	8%	$9,456	5%	$84,359	3%	Health Care Services
$50,108	3%	$7,285	4%	$39,083	1%	Health Care Facilities
$443,388	27%	$30,249	16%	$299,991	11%	Managed Health Care
$4,657	0%	$909	0%	$16,836	1%	Health Care Technology
$108,229	7%	$47,979	25%	$565,667	21%	Biotechnology
$244,115	15%	$53,888	28%	$1,004,912	37%	Pharmaceuticals
$30,853	2%	$5,303	3%	$121,159	4%	Life Sciences Tools & Services

Deciles of LTM EBIT margin (quarterly frequency; since 1999)



Source: Fundstrat, Factset, Bloomberg

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