fundstrat

Fundstrat Global Advisors
150 East 52nd St, 31st floor
New York, NY 10022

STATE OF THE MARKET

To YE, t is all about the performance chase and sentiment....

Fall 2016

Equity Research

Thomas J. Lee, CFA AC
Head of Research
thomas@fundstrat.com
twitter: @fundstrat

L. Thomas Block
Washington Policy Strategist
tom.block@fundstrat.com
twitter: @TomBlock_FS

George Gianarikas
Event-Driven Strategy
george.gianarikas@fundstrat.com
twitter: @gianarikas

Sam Doctor
Quantamental Strategist
sam.doctor@fundstrat.com
twitter: @fundstratSMID

Sales

John Bai
Head of Sales
john@fundstrat.com

Bill Vasilakos
bill.vasilakos@fundstrat.com

Tzu-Wen Chen
tzuwen.chen@fundstrat.com

Jamie O'Connor
jamie.oconnor@fundstrat.com

Ted Tabasso
ted.tabasso@fundstrat.com

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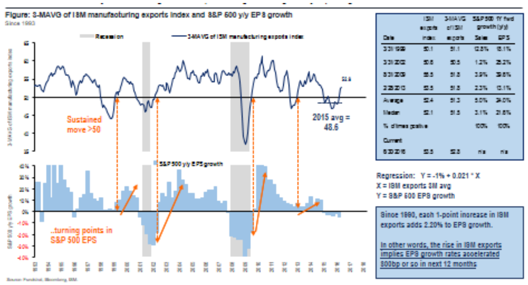
Executive Summary

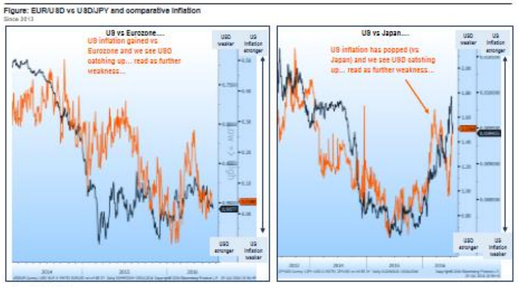
Tactical	Portfolio Strategy	Sectors and styles
Credit	Stocks are new bonds	Regime Shift
FX / Commodities	Laggards become leaders	Cyclicals
Economy	Growth as cheap as value	Energy
Earnings Outlook	FANG ends with a D@#G!	Financials
Market outlook	Buy small-caps	Defensives

9 Charts *you must* see...

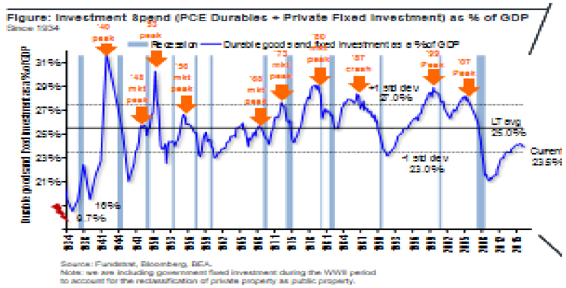
ISM exports say EPS upside….



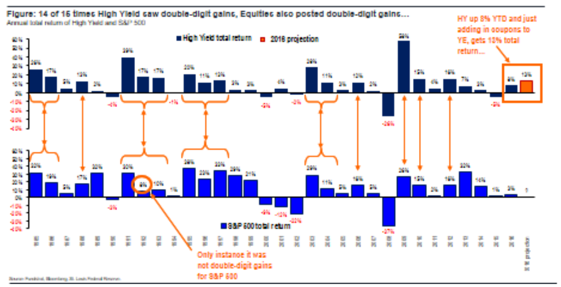
USD driven by inflation….



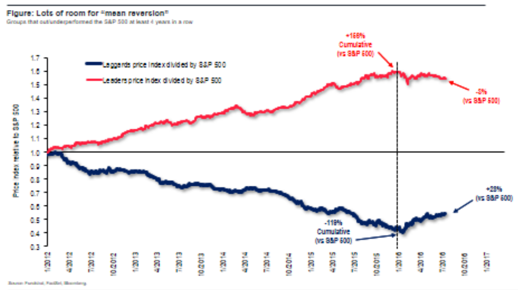
US investment cycle just starting…



High-yield says S&P 500 up 10%-plus

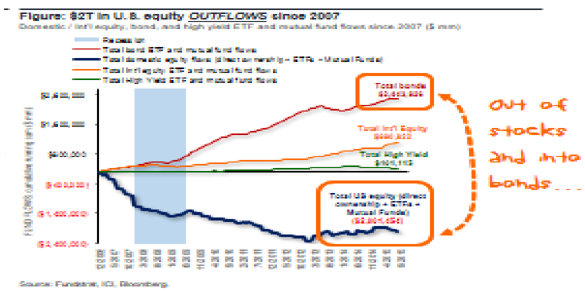


Laggards have a long way to go up…

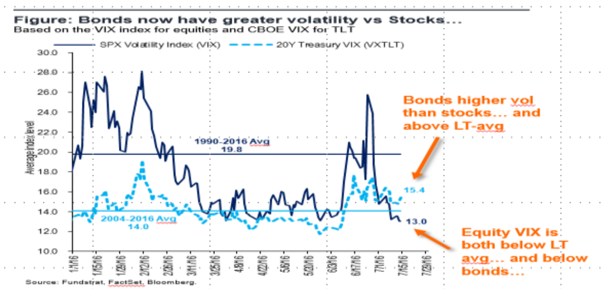


Value made a 20-year inflection…

Investors about mean revert…



Bonds now more volatile than stocks…



CCC says buy small-caps…

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

Arguments supporting higher prices in 2016 and into YE…

1.	**"Search for carry" looks like 1990...**	Similar to early 1990s. Then, search for carry led to reflation of stock market.
2.	**Credit conditions are favorable**	High-yield bond markets leads stocks and HY on track to be up 13%-plus in 2016, history says equities up at least 10%
3.	**USD is now a tailwind and building case for reflation**	Inflation expectations fell to multi-decade lows in US, but weaker dollar setting stage for higher inflation
4.	**Less about "global trade" but rather, pent-up demand in US housing and infrastructure**	Housing starts are on way to recover towards 2.0mm, boosting overall investment spending in US.
5.	**Newton's Law of Motion**	Stocks from Sep to YE follow direction YTD. When up 5%-20% YTD, markets see gains into YE 90% of time.

What Could Go Wrong?

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

- **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 fall 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.

- **Is this 2012 again?** Equity markets fared poorly after the 2012 elections and given the dynamics around the current US election, one wonders if 2016 is a replay. A couple of differences: (i) in 2012, Obama was widely disliked and his re-election was seen as a negative—Clinton, is better liked by the market; (ii) fiscal cliff faced markets after the election, hence, stocks looking forward weakened; (iii) in 2012, the S&P 500 was already up 16% YTD and thus, weaker into YE still left a 13% gain.

3Q16 Recommendations: Focus on "laggards become leaders"

In our 2016 Outlook (12/17/15), we noted "when a group has been a laggard for more than 3 consecutive years, that is when investors need to start paying attention." We believe this is the most practical investment strategy into 3Q16.

- **With a focus shifting towards global stabilization/recovery, the lagging groups should gain traction.**

Figure: Fundstrat Portfolio Strategy Recommendations for 3Q16

3Q16 Fundstrat Recommendations

Fundstrat Theme	Execution of Strategy	List of Stock Tickers
1. **Laggards become Leaders**	Buy stocks from industry groups that underperformed for more than 3 consecutive years	CSCO, IBM, RL, PCAR, CAT, APD, PX, HP, SLB, CVX, OXY, XOM, PG, T, VZ
2. **Stocks are the "new bonds"**	Cyclicals:	IBM, CSCO, QCOM, TXN, INTC, XLNX, MSFT, TGT, RL, EMR, CAT, BA, UPS, MMM, PCAR, PX, APD
	Near-Cyclicals (Energy/Financials):	BBT, BLK, JPM, AMP, PSA, IVZ, AVB, SPG, MET, CVX, XOM, OXY, SLB
	Defensives:	PFE, MRK, LLY, PM, KO, PG, PEP, PPL, DUK, CNP, T, VZ
Added 7/15/2016 3. **Growth as cheap as Value**	Buy stocks that are in both Growth and Value indices, with a div yield > bond yield (margin of safety)	CSCO, IBM, INTC, TXN, XLNX, MMM, UPS, APD, PX, AMP, BLK, SPG, OXY, LLY, PFE, KO, PEP, PM
4. **FANG ends with a "dang"**	Buy last years' losers over FANG	***Long:*** WMT, XOM, KMI, BRK/B, CVX, QCOM, ORCL, UNP, PG, AAPL ***Avoid:*** FB, AMZN, NFLX, GOOG, HD, V, SBUX, NKE
5. **Buy Small-caps **Small-cap value**	Favor Small-caps due to quality spread-rally and due to ISM exports recovery.	Russell 2000 over S&P 500 (IWM over SPY). IWN, IWS, IJJ EM stocks over DM stocks

Source: Fundstrat, Bloomberg.

Portfolio Strategy: Recommending 5 strategies

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 3Q16

3Q16 Fundstrat Recommendations

	Fundstrat Strategy	Execution of Strategy	Added/ Removed	Relative performance (vs S&P 500) 1Q16	2Q16	3Q16 (QTD)	4Q16
	USD outright weakens	"inverse correlation" to USD: **Buy Energy, Materials, Telecoms**	December 2015	+630bp	-190bp	(d[illegible]d 7/[illegible])	
	Oil bottoms and HY improves	Buy "inverse correlation" to HY spreads: **Buy Value and Low-quality**	December 2015	-60bp	-110bp	(d[illegible]d 7/[illegible])	
Current Strategies	Stocks are the "new bonds"	div yield> company's LT bond yield	November 2015	+890bp	+320bp	+10bp	
Current Strategies	Laggards become Leaders	Industry groups that underperformed 4-plus consecutive years	December 2015	+230bp	+570bp	-114bp	
Current Strategies	FANG ends with a "dang"	Buy last years' losers over FANG	December 2015	+540bp	+410bp	+255bp	
Current Strategies	Buy Small-caps	Due to quality spread-rally and ISM recovery.	April 2016		+150bp	+555bp	
Current Strategies	Growth as cheap as Value	Buy stocks both Growth and Value, with a div yield > bond yield	July 2016			-26bp	

"search for carry" stocks slipped last week…

Outperformance accelerated

Source: Fundstrat, Bloomberg.

We like "granny shots"

Growth
-1% (YTD)
(317 stocks)

Growth as cheap as Value

Both
Value
Growth
+2.1% (YTD)
(172 stocks)

Value
+1% (YTD)
(361 stocks)

The Intersect
+6.7% (YTD)

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

Stocks are the new bonds

Div yield > LT co bond yield
+11.5% (YTD)
(currently 43 stocks)

Laggards become Leaders

Lagged
4-plus years
+10.3% (YTD)
(68 stocks)

Newton's law of motion at play in equity markets…

We have highlighted the comparative performance of markets from mid-Sept to YE, based on distribution of returns YTD.

- **The S&P 500 is up 5% YTD (thru 9/15). Since 1940, this has happened 30 times (between +5% to +20% YTD) and the average gain is 5% to YE. The win-ratio is an astounding 90%.**
- **By contrast, if stocks are down YTD thru mid-Sept, gains are non-existent.**

Figure: Performance of S&P 500
Since 1940

S&P 500 YTD is up 5%

	Performance thru 9/15…	S&P 500: Start of Year… (Jan 1 to Sep 15) #	% total	% change	S&P 500: Sep 15 to YE (Sep 15 to YE) % change	Win-ratio
Up	Up >20%	9	4%	24.7%	3.1%	78%
	Up >5% but <20%	30	12%	12.2%	5.2%	90%
	Up >5%	39	16%	15.1%	4.7%	87%
	Up	53	21%	11.7%	4.5%	81%
	Total Instances	**76**	**70%**	**4.8%**	**3.2%**	**75%**
	Down	23	9%	(11.1%)	0.2%	61%
	Down <-5%	16	6%	(14.8%)	1.1%	63%
Down	Down <-20%	2	1%	(27.8%)	2.0%	50%

Win ratio is an *astounding 90%* from 9/15 to YE

9/15 to YE
Election vs Non-Election Year
(YTD between >5% but <20%)

	#	% chg	win ratio
Election Yr	9	4.2%	89%
Non-election Yr	21	5.3%	91%

Even an election year, still 8 of 9 times gained to YE

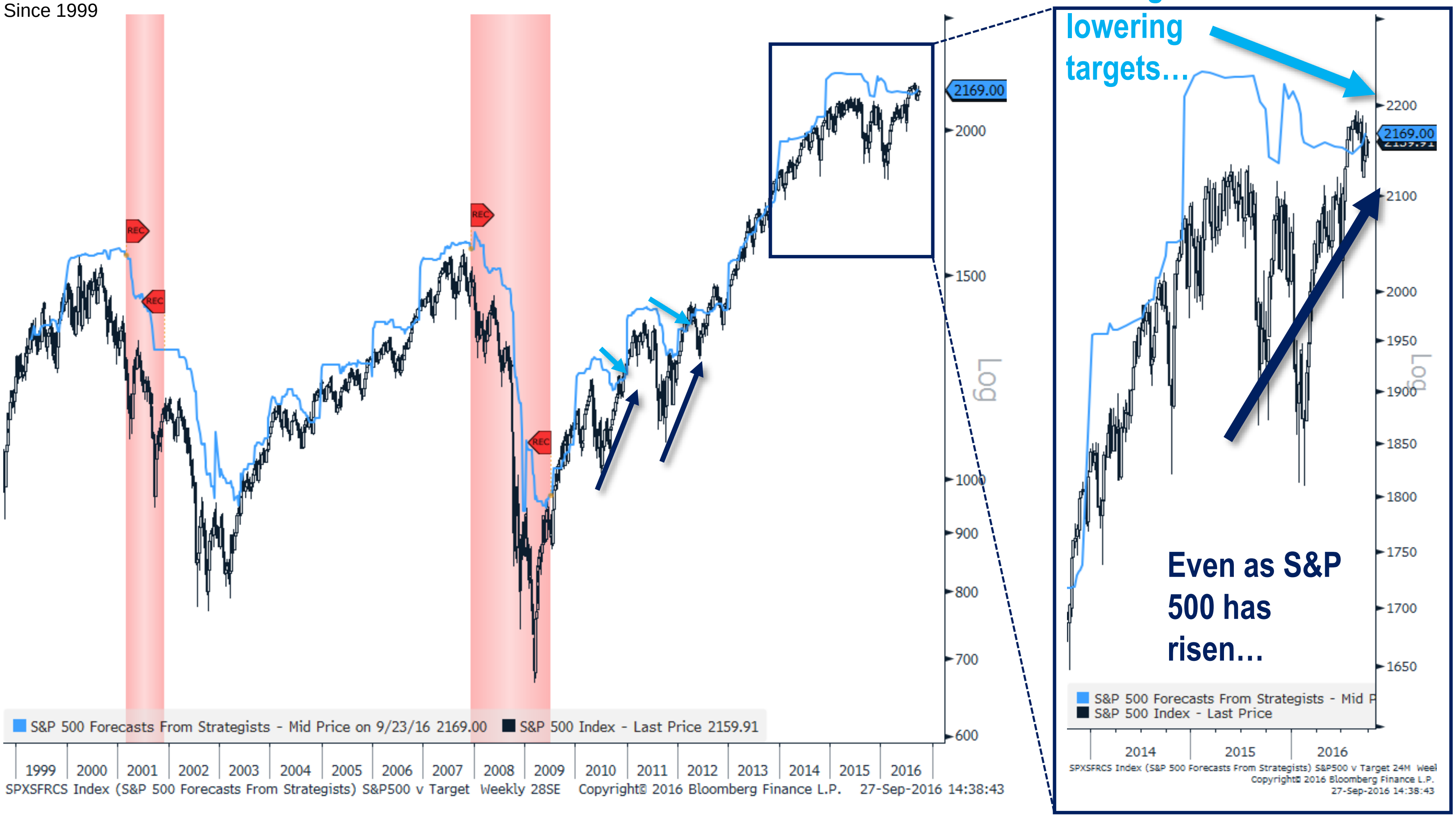
Source: Fundstrat, FactSet, Bloomberg

Strategists as ***bearish*** as they were at start of 2014…

Sell-side strategist consensus (SPXSFRCS Index GP <<GO>>) are as bearish on the market as they have been at the start of 2014. The easiest way to measure is comparing the upside of the target vs the market level. Currently, the Street is looking for ZERO upside.

- **This is the lowest upside since the start of 2014 and ranks as one of the lowest quintile readings ever (next page).**

Figure: Who is right? Strategists cutting S&P 500 Target while S&P 500 has risen…
Since 1999



Source: Fundstrat, FactSet, Bloomberg

When Strategists bear, it is the ultimate ***Buy*** signal…

We have compared the forward returns of the S&P 500 based on various levels of Strategist consensus target prices. .

- As shown below, Strategists tend to be an **extremely reliable contrarian indicator**. Whenever they are bullish on markets, measured by higher implied upside (13%-plus), equity markets rarely advance.
- **Similarly, whenever strategists see little upside in markets, the S&P 500 tends to do extraordinarily well.**
- **Currently, Strategists see zero upside in markets and historically, equity markets gain 95% over the next 12 months, with an average gain of 11%--and gain 92% over the next 6 months.**

Figure: Sell-side Strategist consensus is the ULTIMATE CONTRARIAN Indicator
Since 1999

We are HERE: Street looking for basically no upside for stocks…

Strategist Bearish

	Implied upside of Strategists target price			S&P 500 return (%)		S&P 500 win-ratio	
	Low	-	High	6M	12M	6M	12M
Decile 1	-7.0	-	-1.1	5.0%	9.9%	87%	88%
Decile 2	-1.1	-	1.2	6.3%	11.1%	92%	95%
Decile 3	1.2	-	2.8	6.3%	9.7%	86%	91%
Decile 4	2.8	-	4.2	4.0%	5.3%	72%	82%
Decile 5	4.2	-	5.6	3.3%	5.2%	67%	77%
Decile 6	5.6	-	7.0	1.1%	3.7%	57%	67%
Decile 7	7.0	-	9.2	0.3%	0.5%	59%	59%
Decile 8	9.2	-	13.4	-1.6%	-3.3%	53%	43%
Decile 9	13.4	-	18.3	-3.9%	-6.7%	37%	35%
Decile 10	18.3	-	54.7	1.3%	5.8%	47%	54%

Strategist Bullish

When Strategists BEARISH, Equity markets gain *90%-95%* of the time…

When Strategists BULLISH, Equity markets gain less than *50%* of the time…

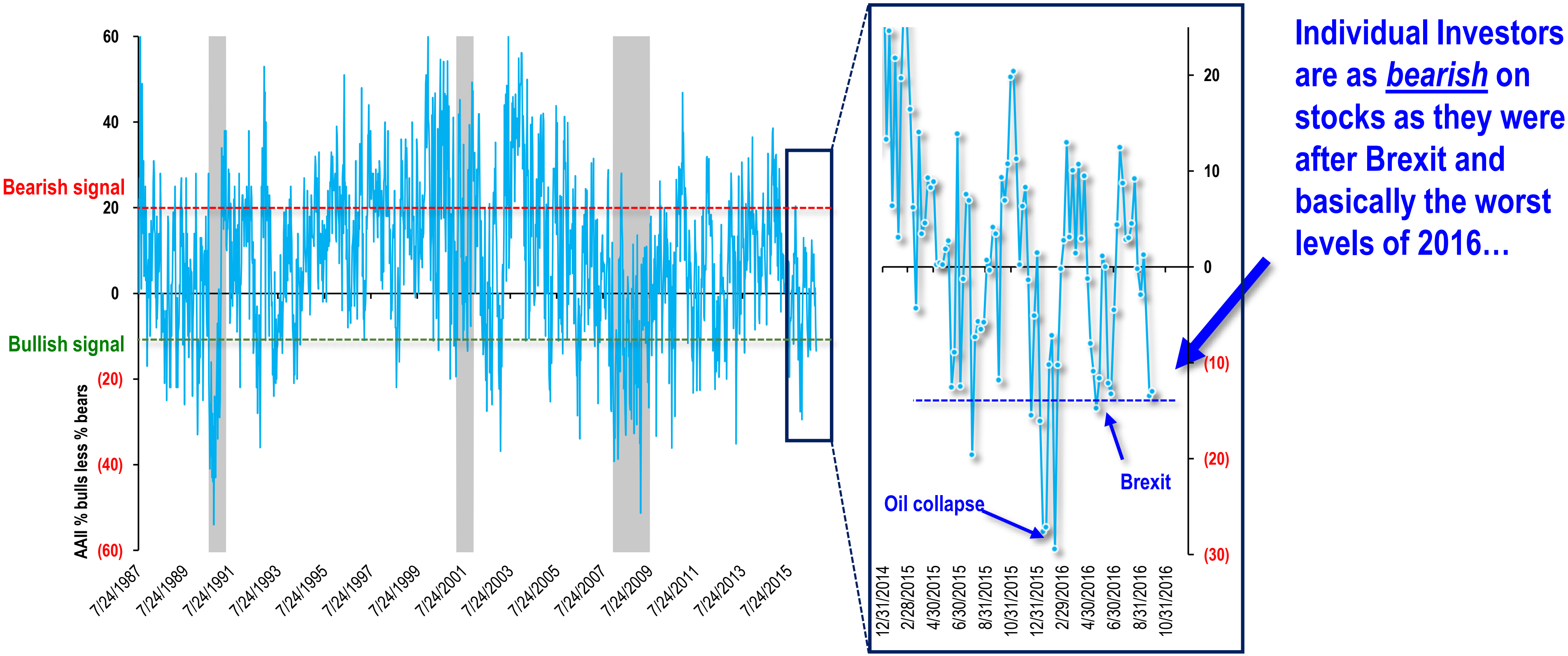
Source: Fundstrat, FactSet, Bloomberg

Retail sentiment is ***extremely*** negative two straight weeks

As many of our clients know, we like the AAII (American Association of Individual Investors) weekly survey and we pay a lot of attention to the spread between bulls and bears (% bulls less % bears).

- **As shown below, we have seen 2 consecutive weeks where the net % is below -13%.**
- **This is the worst readings since Brexit (June) and the oil collapse (earlier this year). In other words, investors' bearishness is reaching levels seen during the height of prior negativity.**

Figure: AAII % Bulls less % Bears
Since 1987



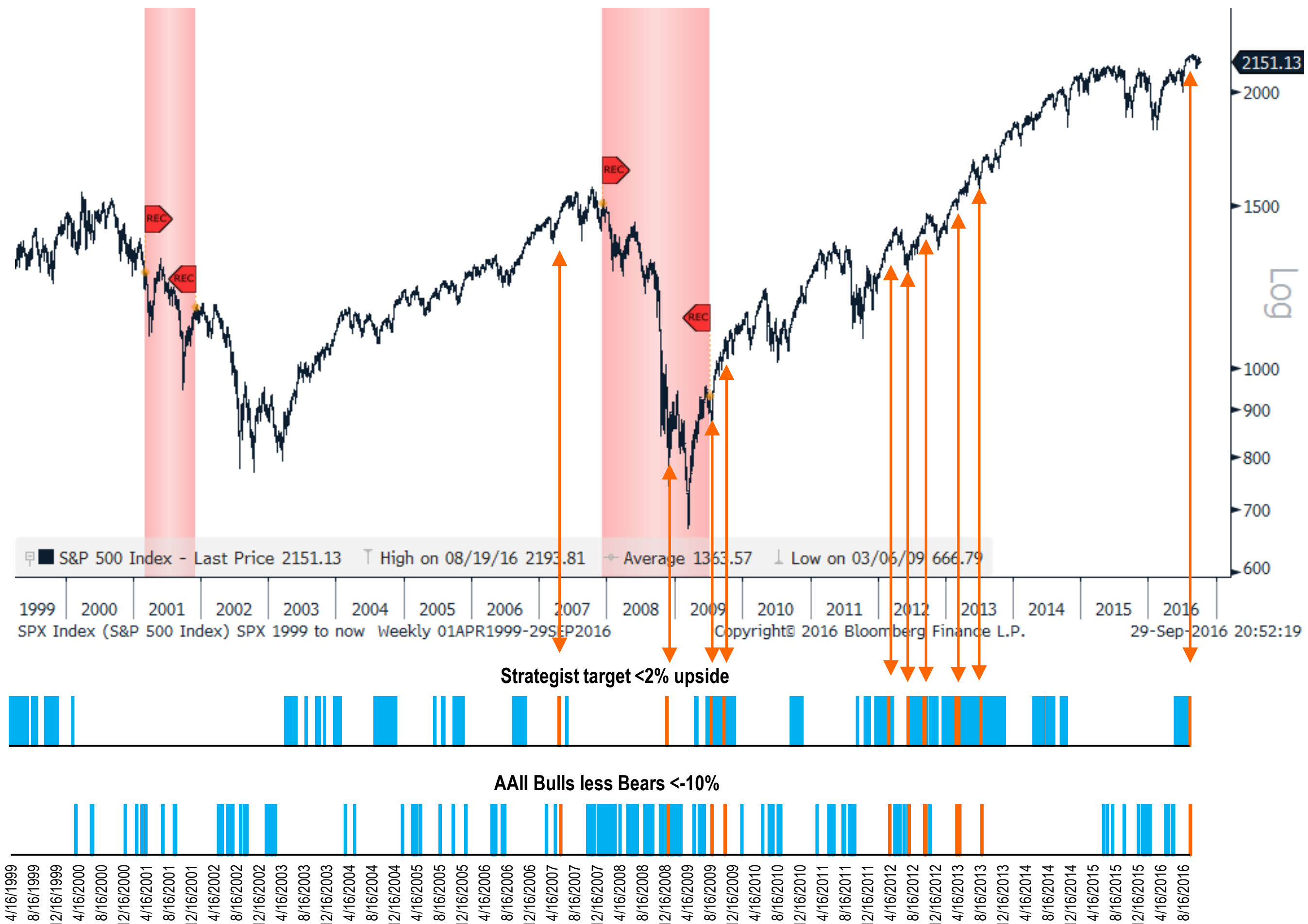
Source: Fundstrat, FactSet, Bloomberg

When Strategists and Retail are this bearish, avg gain = 18%

To put some additional perspective on how bearish consensus is, take a look below where we marked instances where both Strategists and Retail were both cautious.

- **As shown below, there are 12 instances where both were seen and as shown below, is extremely bullish.**

Figure: Only 12 instances when strategists AND retail investors were this bearish at once
Since 1999



	S&P 500 Forward Performance		
	3M	6M	12M
6/1/2007	(4.1%)	(3.6%)	(8.8%)
1/2/2009	(9.6%)	(3.8%)	19.7%
8/28/2009	6.1%	7.3%	3.5%
11/6/2009	(0.3%)	3.9%	14.6%
4/13/2012	(1.0%)	4.3%	16.0%
7/27/2012	1.9%	8.4%	22.1%
10/19/2012	3.7%	8.5%	21.7%
10/26/2012	6.4%	12.1%	24.6%
4/12/2013	5.7%	7.2%	14.3%
4/26/2013	6.9%	11.2%	17.8%
8/23/2013	8.5%	10.4%	19.5%
Median	**3.7%**	**7.3%**	**17.8%**
Win Ratio	**63.6%**	**81.8%**	**90.9%**
9/23/2016			

High probability of strong forward gains from here

Source: Fundstrat, FactSet, Bloomberg

Technology and Cyclicals stand out when AAII sentiment weak

We have looked at the subsequent performance of 21 sectors/ styles below.

- **What stands out is subsequent strong performance in Technology. The relative return is shown below.**

Figure: Comparative performance of S&P 500 at various readings of AAII Net Bulls (% bulls less % bears)
Since 1987

Sept/ Oct AAII readings only…

	Range of AAII Net Bull less Bears			# instances	S&P 500 6-month performance	
	Low	-	High	instances	% chg	win-ratio
Decile 1	-54.0	-	-14.8	34	6.6%	76%
Decile 2	-14.8	-	-7.0	33	9.4%	87%
Decile 3	-7.0	-	-1.0	24	5.4%	74%
Decile 4	-1.0	-	3.6	26	4.7%	84%
Decile 5	3.6	-	8.5	29	6.7%	72%
Decile 6	8.5	-	13.0	27	6.7%	93%
Decile 7	13.0	-	17.4	23	3.9%	83%
Decile 8	17.4	-	23.0	29	5.4%	83%
Decile 9	23.0	-	31.0	23	5.1%	78%
Decile 10	31.0	-	62.9	18	1.2%	67%

Data: AAII Net Bull less Bears — Latest data value: -13.11
BBG code: .aaiinetb f index — Current decile: 2
Total # data points: 266

		% return			win-ratio (%)		
		1M	3M	6M	1M	3M	6M
S&P 500	**Total Return**	**2.7%**	**5.4%**	**9.4%**	**63%**	**87%**	**87%**
Relative to S&P 500							
Growth or	S&P 500 Growth	0.3%	0.3%	0.5%	71%	48%	52%
Value	S&P 500 Value	(0.3%)	(0.4%)	(0.5%)	29%	52%	52%
Small vs	Russell 2000	(0.5%)	0.6%	1.1%	47%	53%	63%
Large	Russell 2000 Growth	0.1%	2.6%	4.2%	50%	72%	83%
	Russell 2000 Value	(1.4%)	0.9%	2.7%	39%	61%	78%
Relative to S&P 500			Wow			Wow	
Cyclicals	Information Technology	2.8%	6.3%	6.6%	81%	71%	76%
	Semiconductors & Semiconductor Equip	3.5%	9.7%	10.0%	67%	67%	71%
	Technology Hardware & Equipment	2.3%	5.6%	7.8%	62%	62%	86%
	Software & Services	3.3%	5.7%	5.8%	76%	76%	67%
	Consumer Discretionary	(0.0%)	0.8%	3.6%	62%	52%	67%
	Industrials	0.2%	1.1%	1.1%	62%	52%	67%
	Materials	(0.4%)	0.0%	(0.5%)	57%	67%	43%
Near	Financials	0.9%	0.1%	1.7%	57%	48%	71%
Cyclicals	ite 500 / Equity Real Estate Investment T	(2.9%)	(1.7%)	(1.0%)	50%	63%	56%
	Energy	(1.3%)	(3.0%)	(3.2%)	33%	33%	24%
Defensives	Health Care	(1.1%)	(1.8%)	(1.9%)	24%	19%	29%
	Health Care Equipment & Services	(2.5%)	(3.1%)	(4.2%)	19%	29%	33%
	Pharmaceuticals Biotechnology & Life Sc	(0.6%)	(1.2%)	(1.2%)	38%	38%	29%
	Consumer Staples	(1.8%)	(3.2%)	(5.2%)	29%	29%	24%
	Utilities	(4.2%)	(7.0%)	(10.8%)	19%	14%	14%
	Telecommunications Services	0.4%	0.1%	(2.2%)	48%	33%	43%

Technology is a standout to own whenever investor sentiment is this negative…

3M Rel Return:
Semis: 970bp
IT Hard.: 560bp
Software: 570bp

Source: Fundstrat, FactSet, Bloomberg

Staples and Utes not over-valued... other sectors cheaper

The fact that US risky assets (bonds and stocks) have better yields, in our view, is a multi-year relative value tailwind for stocks. And it also means that if this were true, we should expect US yield-oriented stocks to have higher multiples.

- **As shown below, this is indeed the case—Utilities and Staples (both stable groups) have seen their PE soar to 18X-20X today.**
- **We do not necessarily think this is over-valued—rather, it is arguably the "right multiple" to pay for equities. And instead, the rest of the market will gradually re-rate on a relative value basis.**

Figure: Valuation and performance of sectors and styles

As of 5/27/2016

	Name		BBG ticker	YTD performance: Absolute	YTD performance: Relative	P/E multiple: '16E (Y+1)	P/E multiple: '17E (Y+2)	P/E multiple: Z-Score (Y+2)	Div yield	Rel to 10-yr yield
Broad Market Indices	S&P 500		SPX	5.8%	**0.0%**	18.4x	16.2x	0.44	2.1%	55 bp
	Russell 2000		RTY	6.4%	**0.6%**	26.5x	21.2x	0.75	1.6%	2 bp
	Value		SVX	8.1%	**2.3%**	17.0x	15.0x	1.01	2.6%	104 bp
	Growth		SGX	4.8%	**-1.0%**	20.2x	17.9x	1.05	1.6%	5 bp
	Dow Jones Industrial Avg		INDU	5.9%	**0.1%**	17.5x	15.3x	0.25	2.5%	95 bp
	Dow Transports		TRAN	5.3%	**-0.4%**	13.8x	13.0x	-0.59	1.5%	-10 bp
Cyclicals	Technology	OW	S5INFT	4.5%	**-1.3%**	17.6x	15.7x	-0.11	1.6%	5 bp
	Discretionary	N	S5COND	4.3%	**-1.5%**	18.6x	16.6x	0.11	1.6%	4 bp
	Industrials	OW	S5INDU	8.4%	**2.6%**	17.5x	16.0x	0.28	2.2%	67 bp
	Materials	OW	S5MATR	10.8%	**5.0%**	18.5x	16.2x	0.82	2.1%	56 bp
Near Cyclicals	Financials	OW	S5FINL	-1.2%	**-7.0%**	14.7x	13.3x	0.60	2.3%	75 bp
	Energy	OW	S5ENRS	11.8%	**6.0%**	93.2x	28.8x	3.49	3.1%	152 bp
Defensives	Healthcare	N	S5HLTH	3.4%	**-2.4%**	16.7x	15.1x	-0.48	1.6%	3 bp
	Staples	UW	S5CONS	9.1%	**3.3%**	22.0x	20.1x	2.25	2.5%	93 bp
	Utilities	UW	S5UTIL	21.2%	**15.4%**	19.0x	18.4x	2.08	3.2%	165 bp
	Telecom	OW	S5TELS	21.6%	**15.8%**	15.0x	14.4x	-0.77	4.3%	272 bp

Essentially first time div yield is premium to 10-year yield since 1950s…

These multiples are PINNED due to the "search for carry"…

And these groups still have attractive yields…

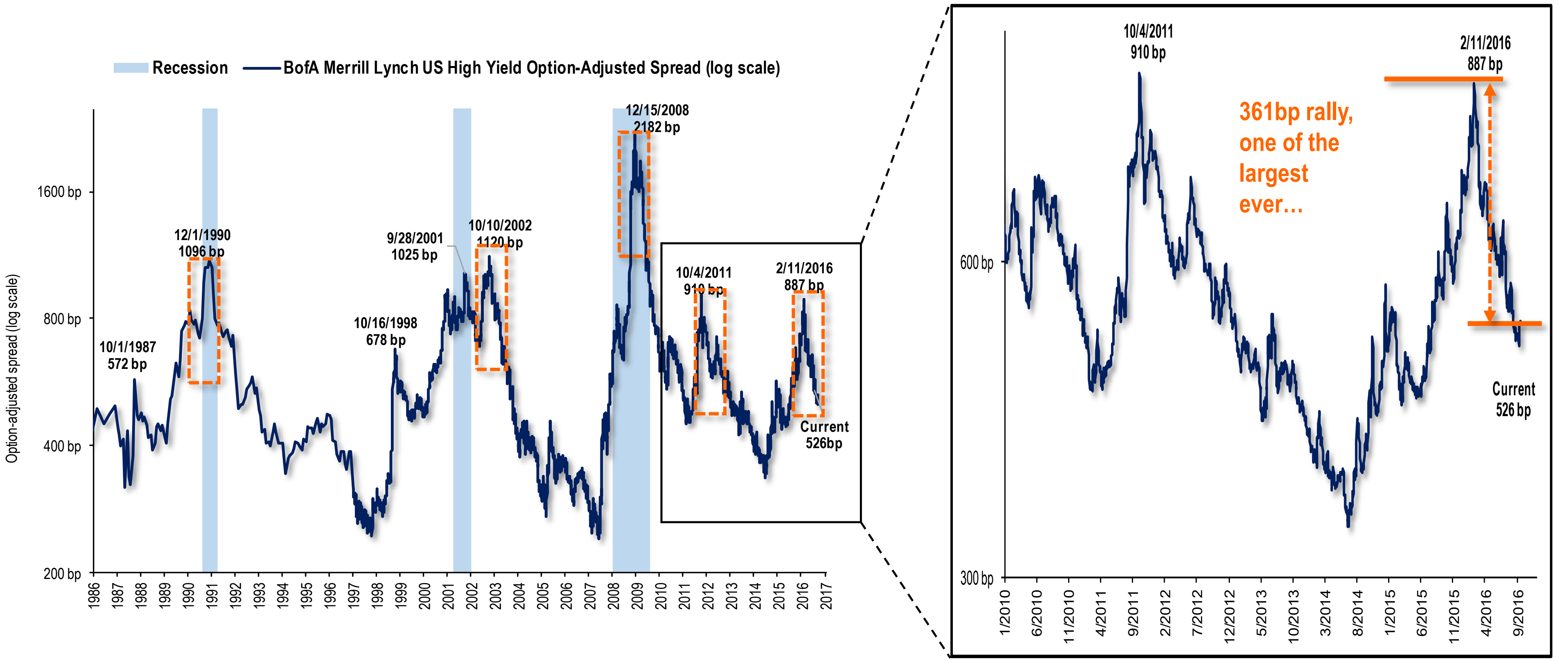
Source: Fundstrat, Bloomberg.

High-yield rally of 445bp is one of the largest ever

The HY market remains a critical support for a constructive view on equities. Equities are the junior piece of the capital structure and as shown below, only 5 other rallies in HY saw a similar magnitude of spread rally. In each of those precedent instances, the rally had much further to go.

- **In other words, the move in HY is signaling further gains for equities.**

Figure: High-yield rally since 2/11/2016 is one of the largest ever
High Yield OAS (option-adjusted spread) since 1986



Source: Fundstrat, Bloomberg, St. Louis Federal Reserve, Bank of America Merrill Lynch.

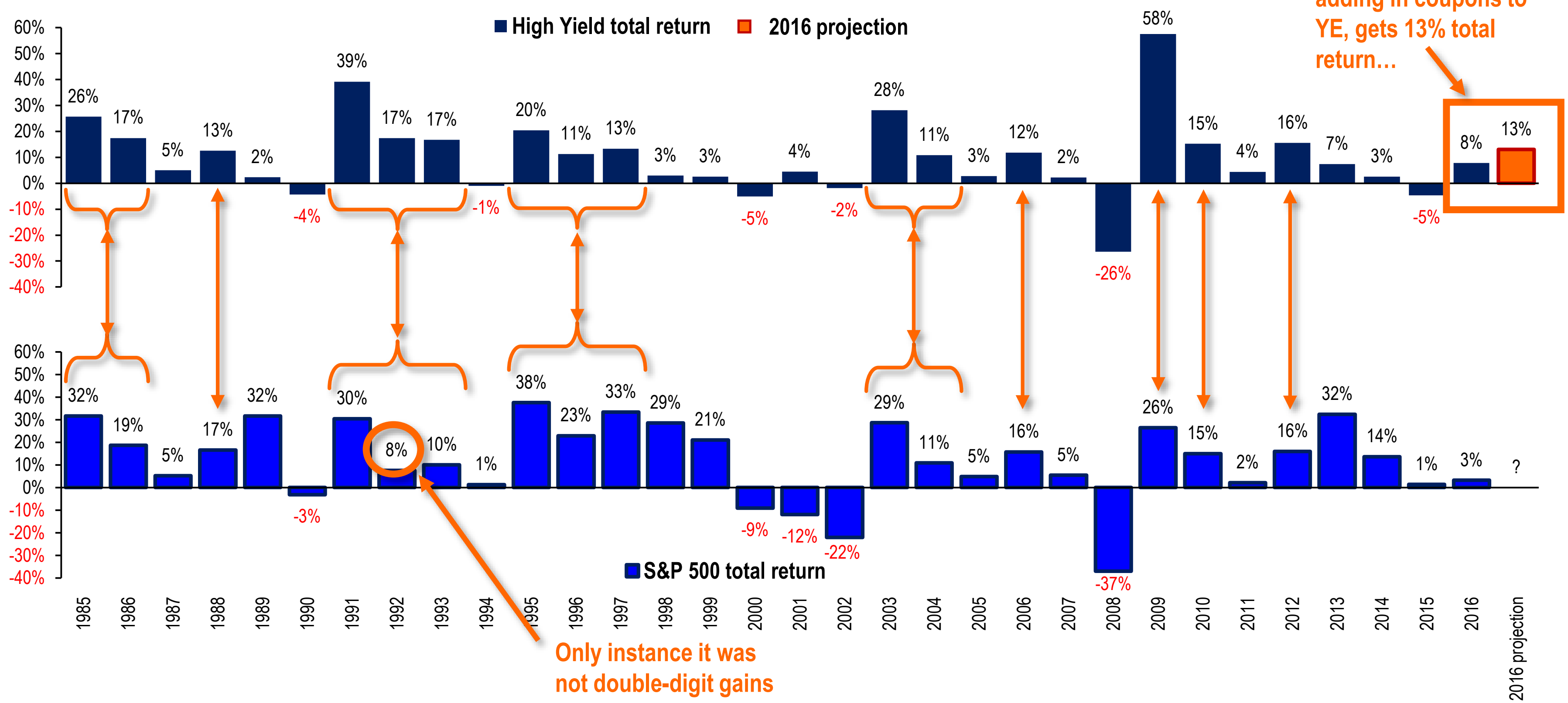
HIGH-YIELD: HY double-digits ~ equities average 22% gains…

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.

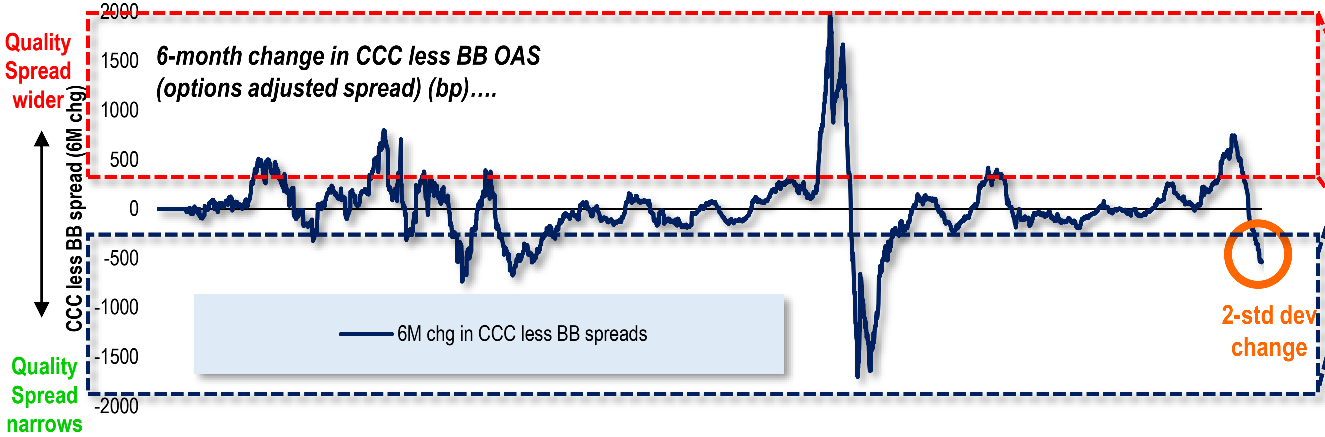
Credit conditions easing, particularly "quality spreads"

The rally in credit (especially high-yield) has driven an easing of financial conditions. Quality spreads, CCC less BB spreads, are staging an even greater rally. As shown below, this is the 3rd rally in the last 20 years.

- **Even more notable is the 2-std change in this spread (6-month change), which typically occurs earlier in the quality spread rally. As shown, this is *arguably a confirmation of a credit rally move.***

Figure: Quality spread (CCC less BB OAS) and change in spread

Since 1996



	Range of 6M chg in CCC less BB spreads			S&P 500 return (%)		S&P 500 win-ratio	
	Low	-	High	1M	3M	1M	3M
Decile 1	-1,705.0	-	-286.9	1.4%	4.7%	72%	82%
Decile 2	-286.9	-	-143.0	0.0%	-0.5%	55%	51%
Decile 3	-143.0	-	-99.0	1.0%	2.0%	68%	62%
Decile 4	-99.0	-	-48.0	0.3%	1.3%	54%	63%
Decile 5	-48.0	-	5.0	1.0%	3.1%	68%	78%
Decile 6	5.0	-	60.0	0.8%	1.0%	65%	58%
Decile 7	60.0	-	114.0	0.6%	1.3%	60%	64%
Decile 8	114.0	-	199.8	-0.8%	-2.3%	46%	49%
Decile 9	199.8	-	333.9	-0.1%	0.7%	57%	60%
Decile 10	333.9	-	2,328.0	1.1%	3.2%	59%	62%

Source: Fundstrat, FactSet, Bloomberg

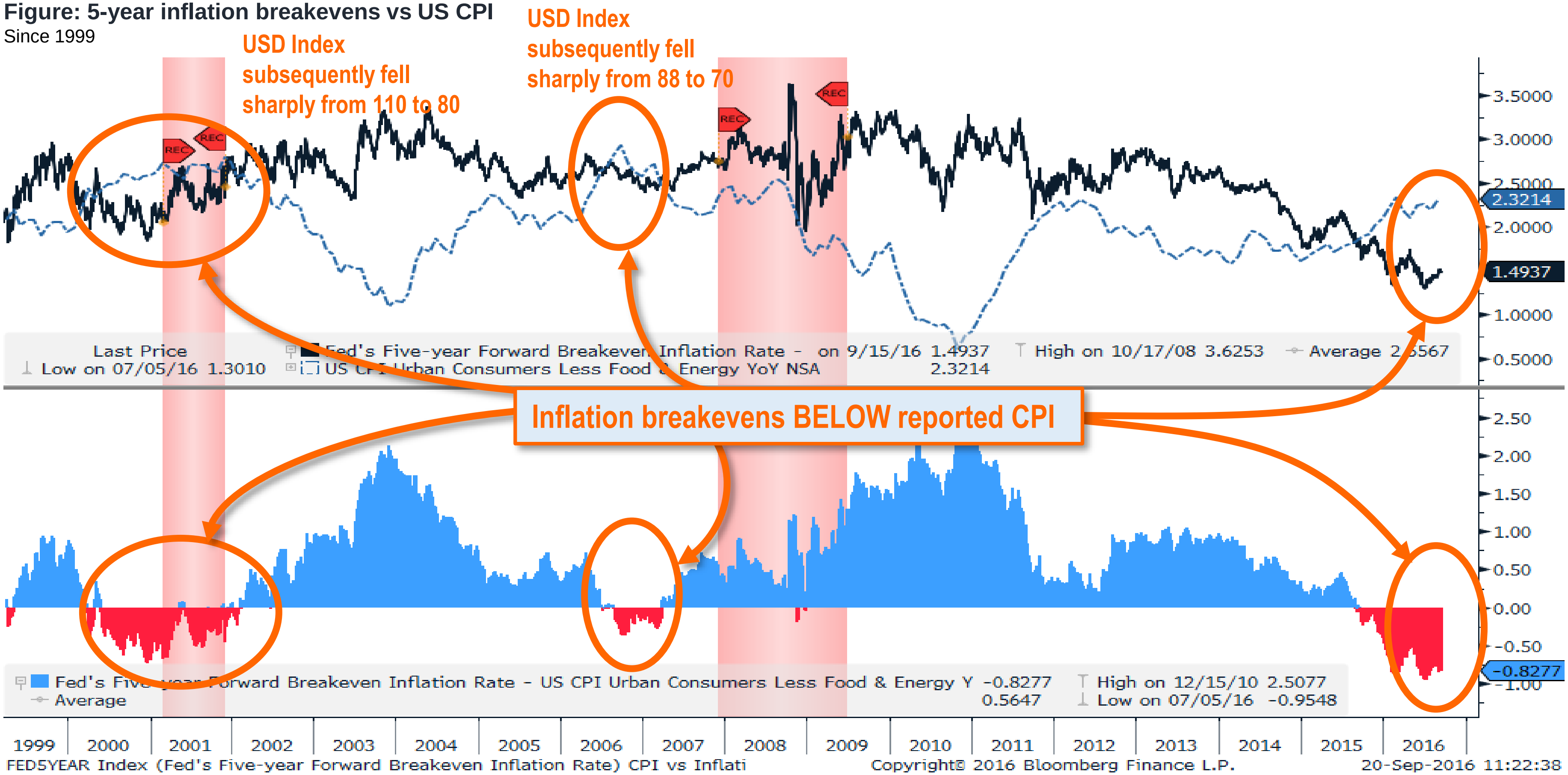
Lower US inflation transitory as markets "selling" inflation premia… downside to USD.

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

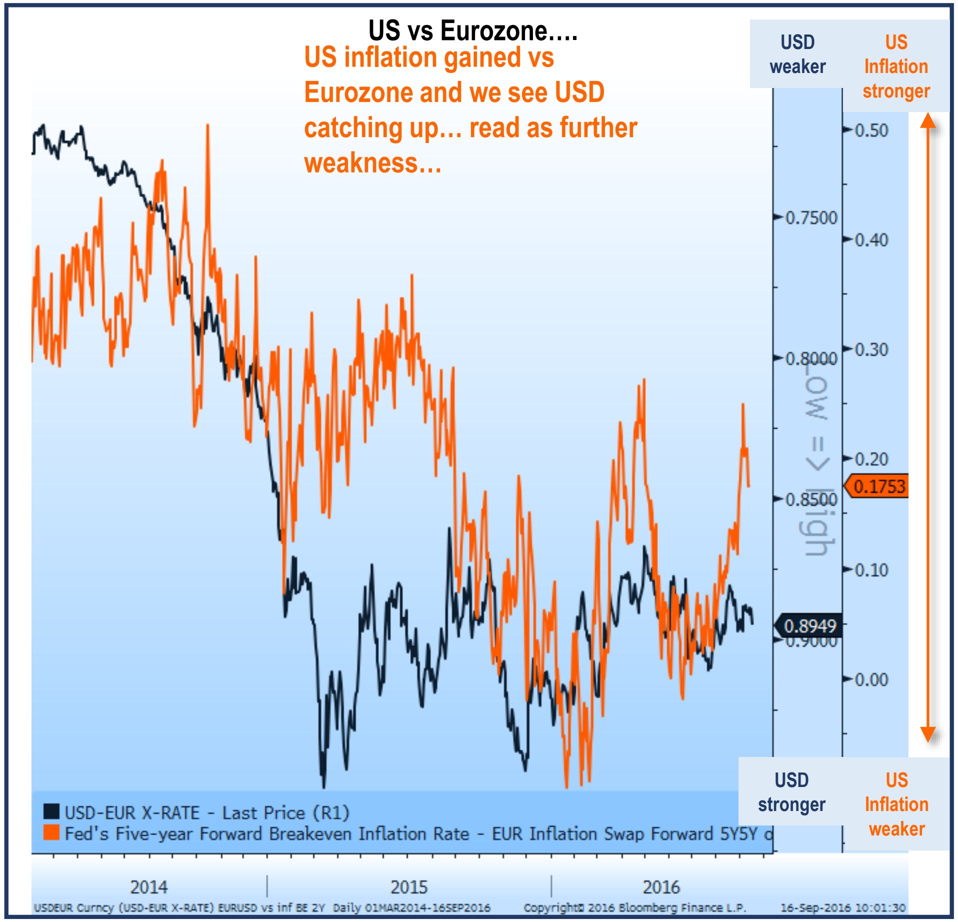


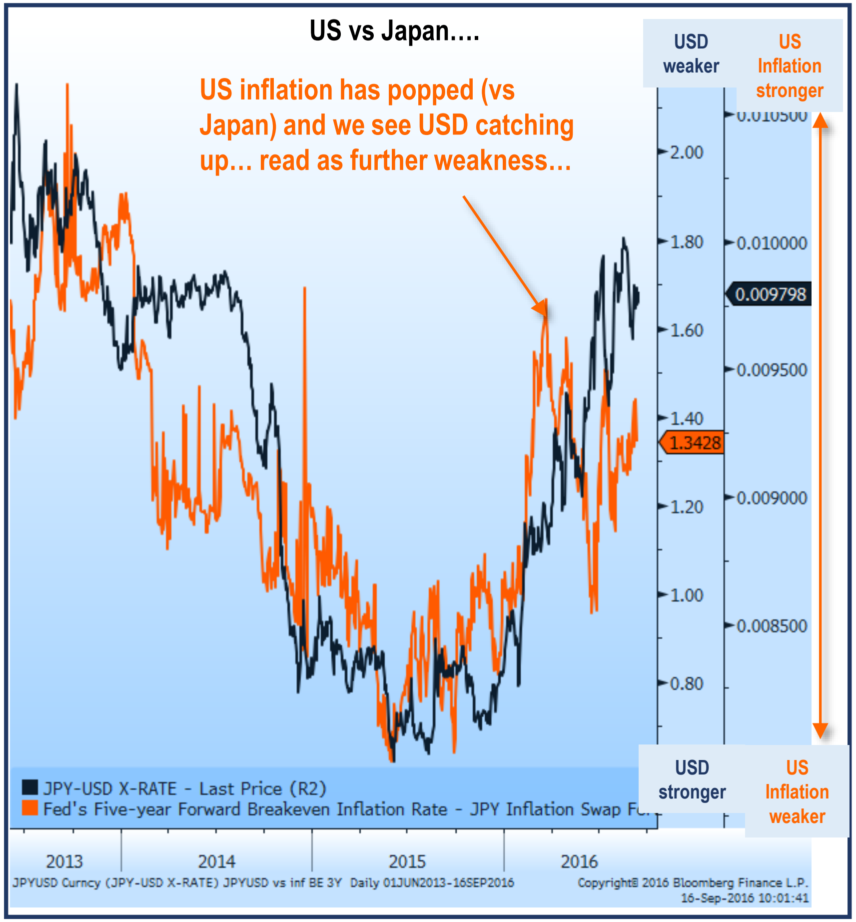
Source: Fundstrat, Bloomberg.

USD: *Relative inflation* argues USD should further weaken vs EUR and vs JPY

As shown below, US relative inflation (vs Eurozone and vs Japan) has been rising and as shown, has explained the weakening of the USD against EUR and JPY. In other words, as we argued for some time, policy rates (while logical) and relative real GDP growth (logical) explain some currency movement, but ***ultimately, relative inflation is an incremental driver. And with US inflation picking up, it should weaken the USD.***

Figure: EUR/USD vs USD/JPY and comparative inflation
Since 2013





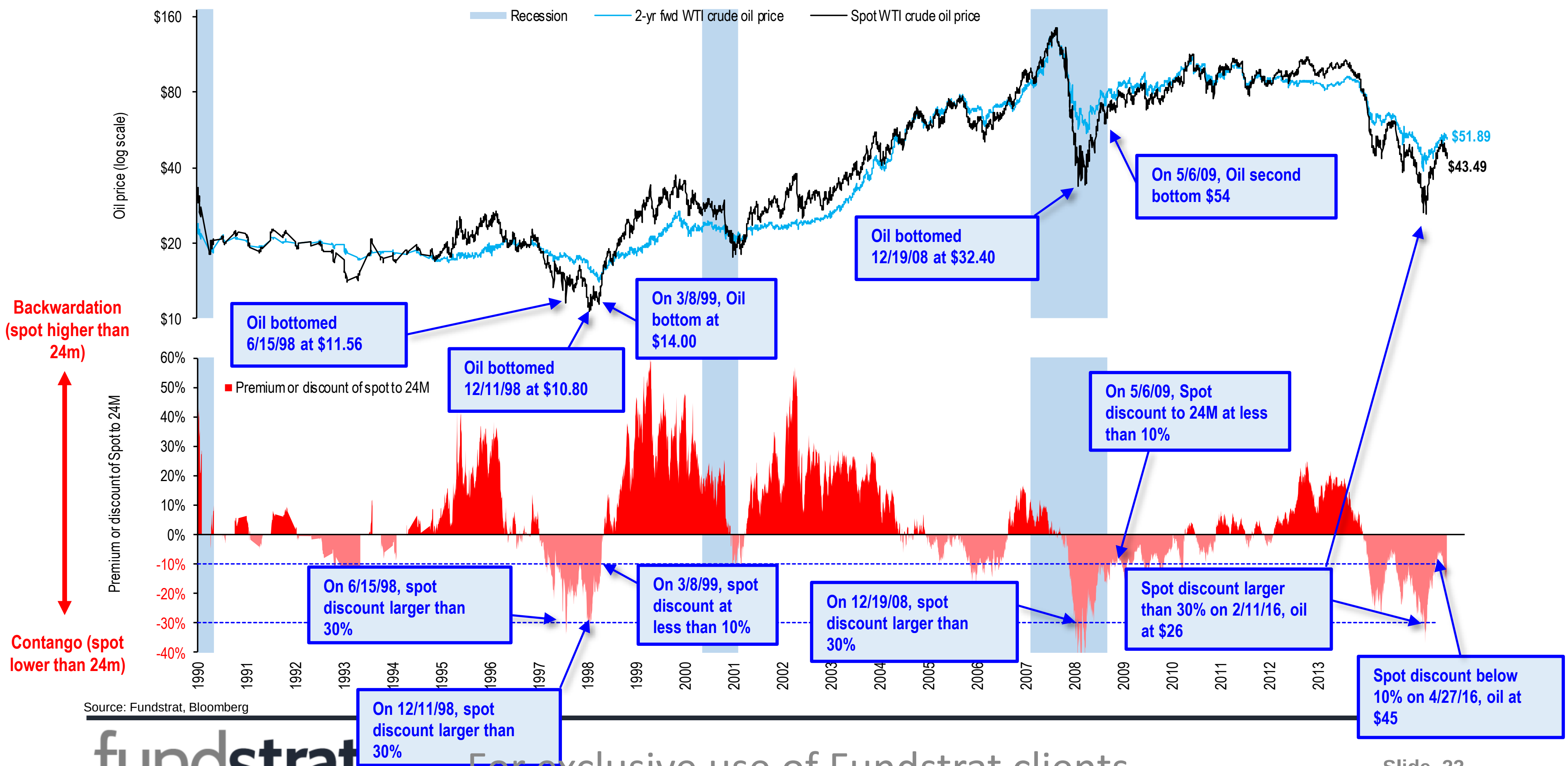
Source: Fundstrat, Bloomberg.

Oil: Past *MAX* contango… suggesting "within zip code" of oil bottom

We recently wrote about the extreme contango seen in oil markets (we looked at spot vs 24m) and how the sizable discount of spot to 24m (contango) was seen at major lows for oil. Contango results from such excess supply that current oil is priced well below future oil:

- **Interestingly, in 12/19/08, oil was similar at extreme contango (30% discount of spot to future) and that happened to be the ultimately low for oil in 2008 (it stayed low for 2 more months). In other words, as imbalanced as the oil market remains, we believe price is closer to a bottom than more investors appreciate.**

Figure: WTI price and the discount of "spot" vs "24 months forward" WTI
Since 1990

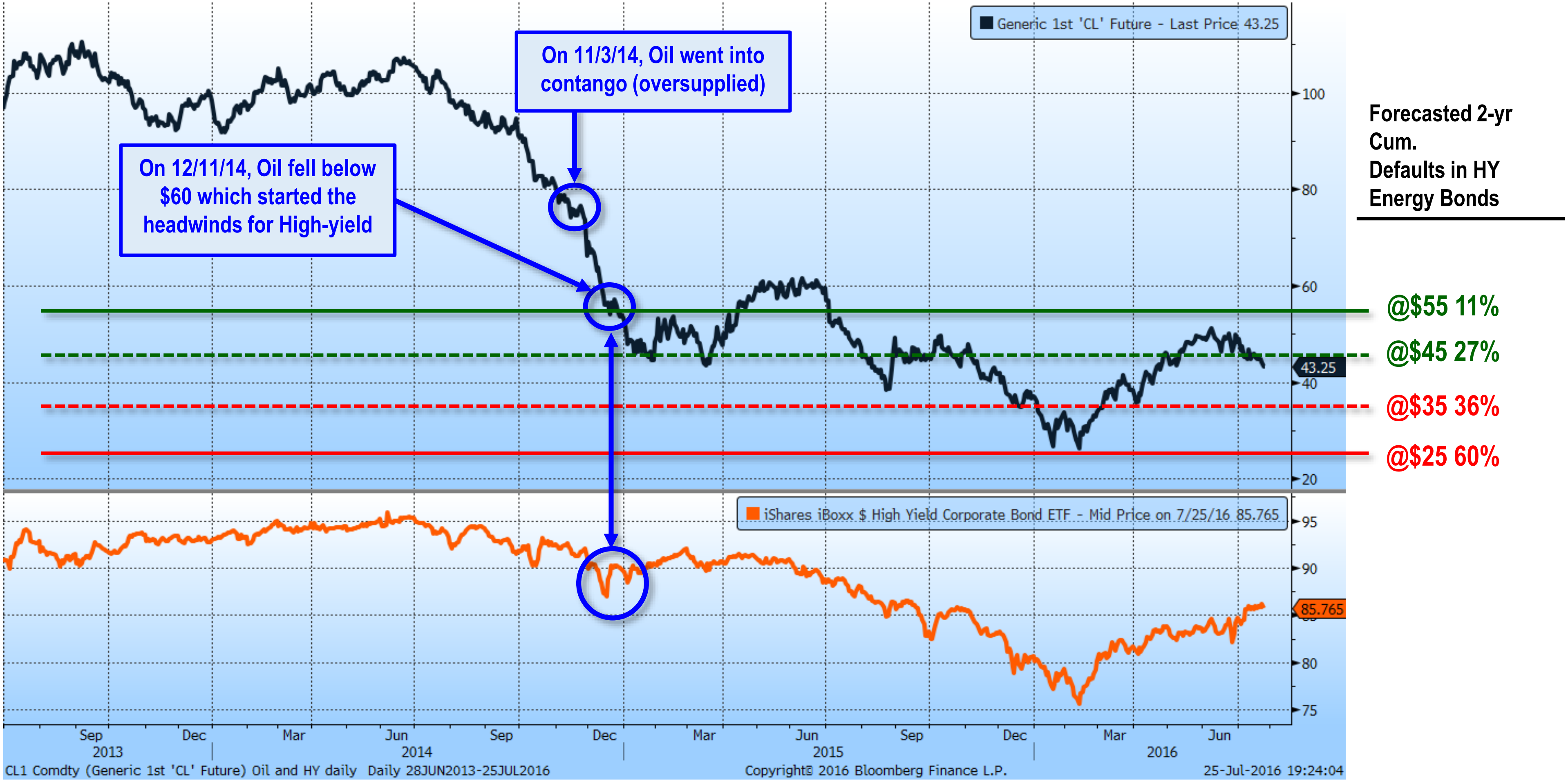


Source: Fundstrat, Bloomberg

Past bottoms in oil have seen big moves in the price over the next 9-12 months, implying that the rebound from $26 to $40 could hold, and potentially be the first leg of a steeper rally. Granted, this would need to be supported by an improvement in supply dynamics as well as continued demand visibility.

- **The impact on the HY market is substantial. As shown below, HY are sensitive to oil and at current levels, but if oil can rally to $45, we will see a substantially reduced Energy default rate compared to when oil was at its low in February of $26.**

Figure: WTI crude and price performance of iBoxx HY ETF (ticker: HYG)
Since 2013



Source: Fundstrat, Bloomberg

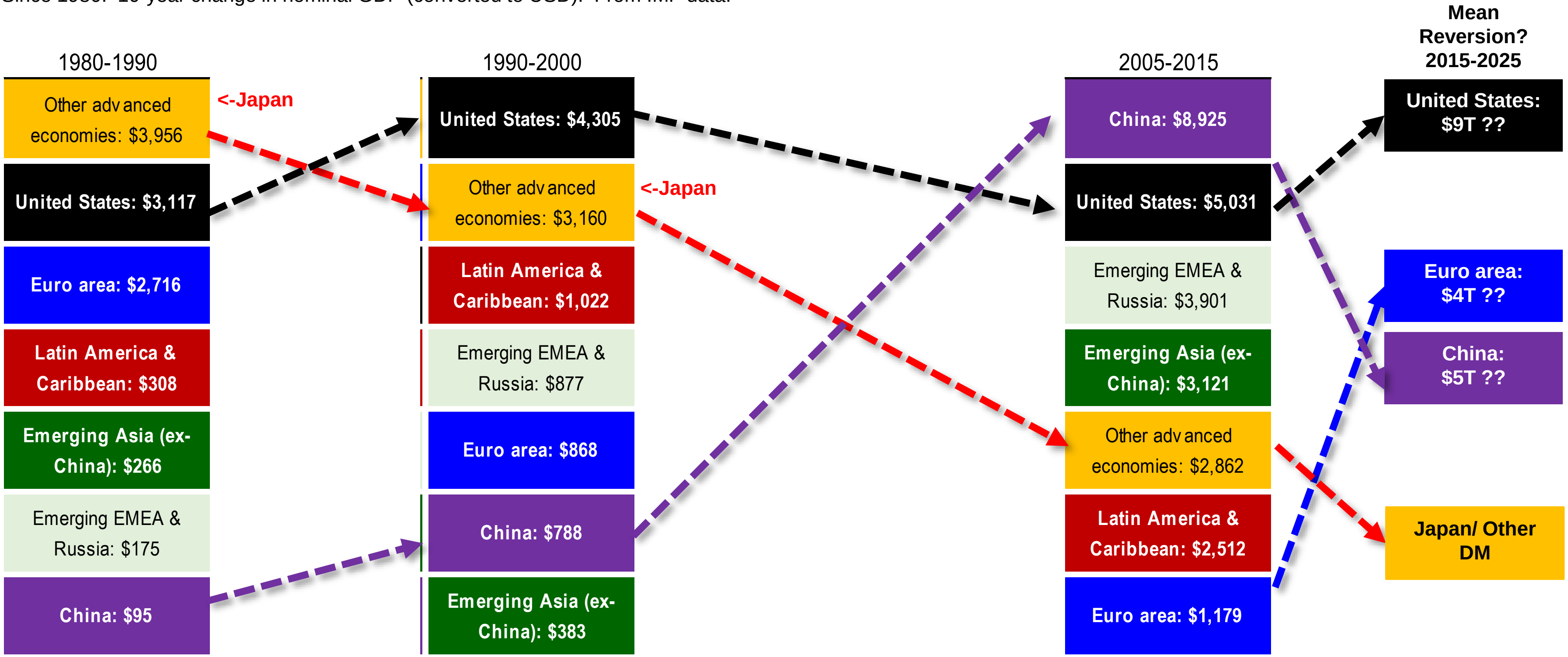
CHINA: Will U.S. be driver of global growth in next decade?

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.

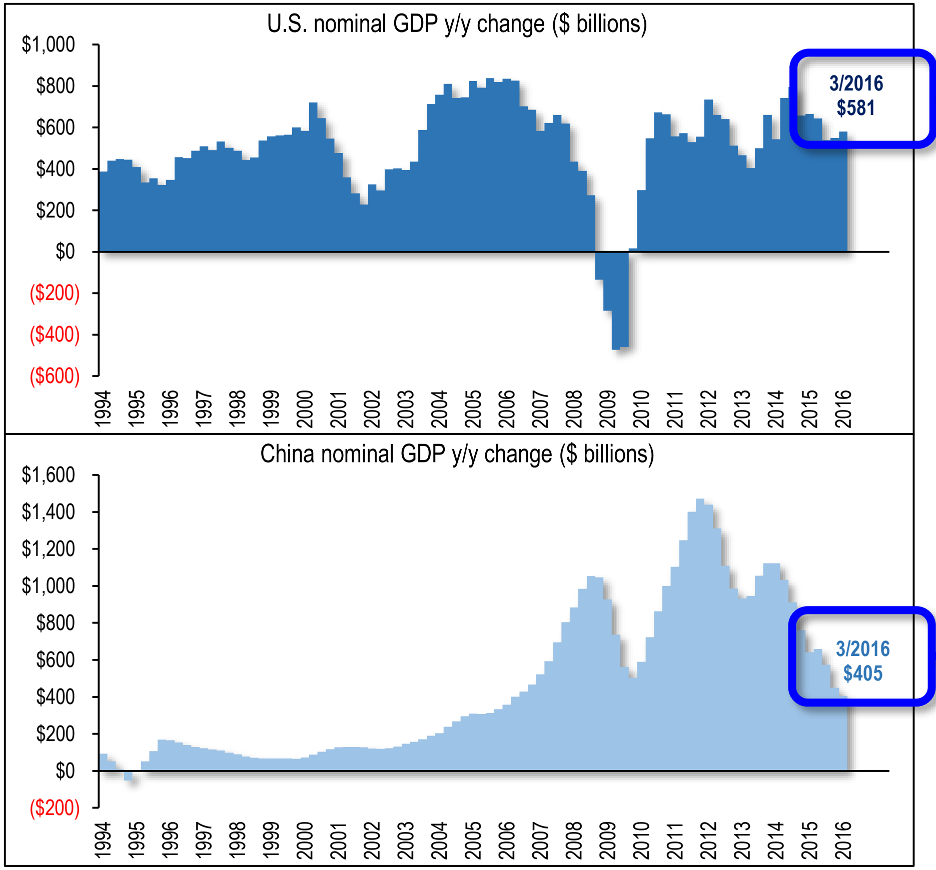


Source: Fundstrat, FactSet, Bloomberg, IMF.

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

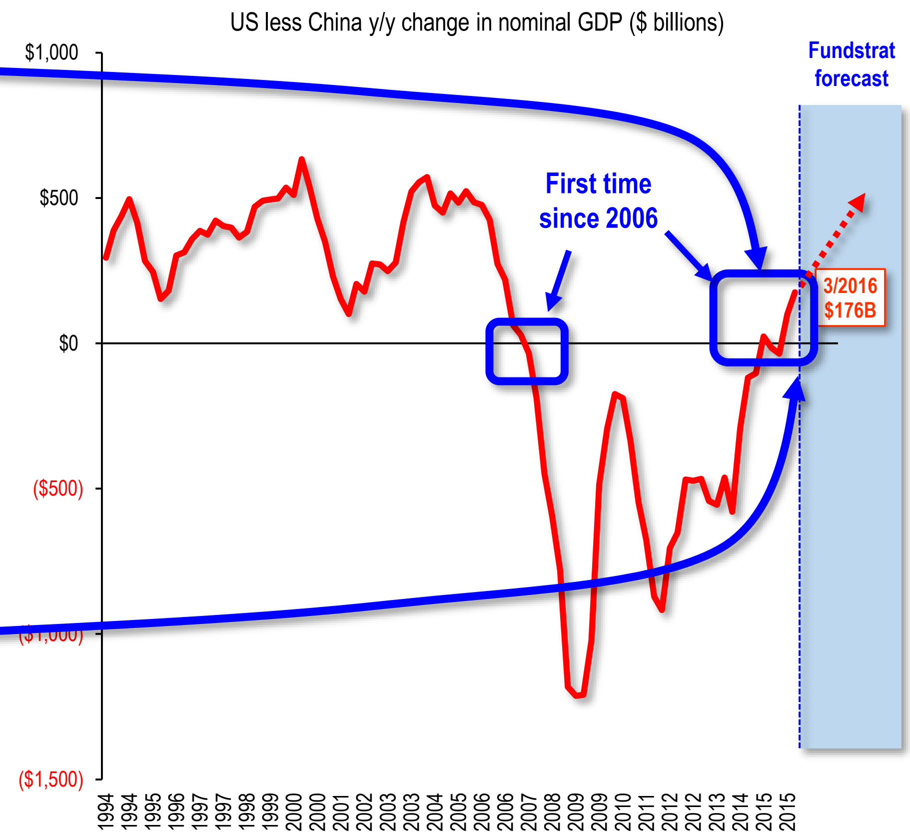
- We see U.S. growth remaining fairly healthy, supported by a rise in housing investment, consumer durables purchases, non-residential and even business investment spend (yes, even with oil depressed). **Over the next decade, the US could potentially add more GDP dollars than China.**

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



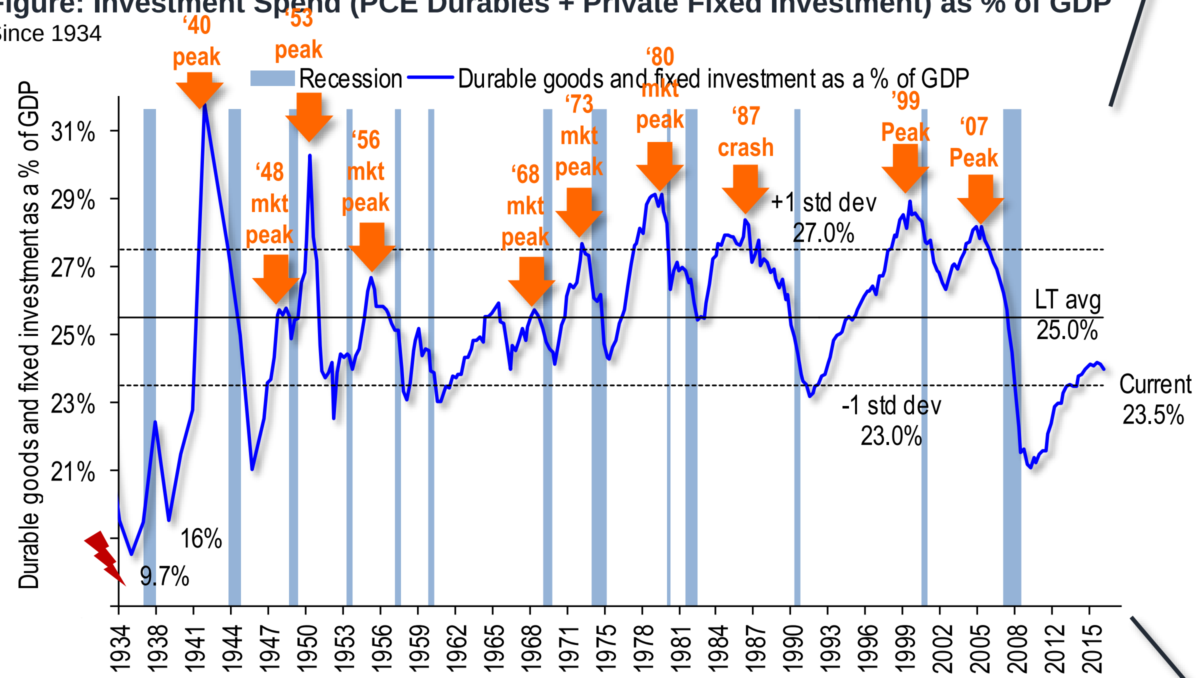
Source: Fundstrat, Bloomberg.

US GDP (cont'd): Investment spending >27% of GDP marks bull market tops…

Below is a chart showing U.S. investment spending (components on the right) since 1934.

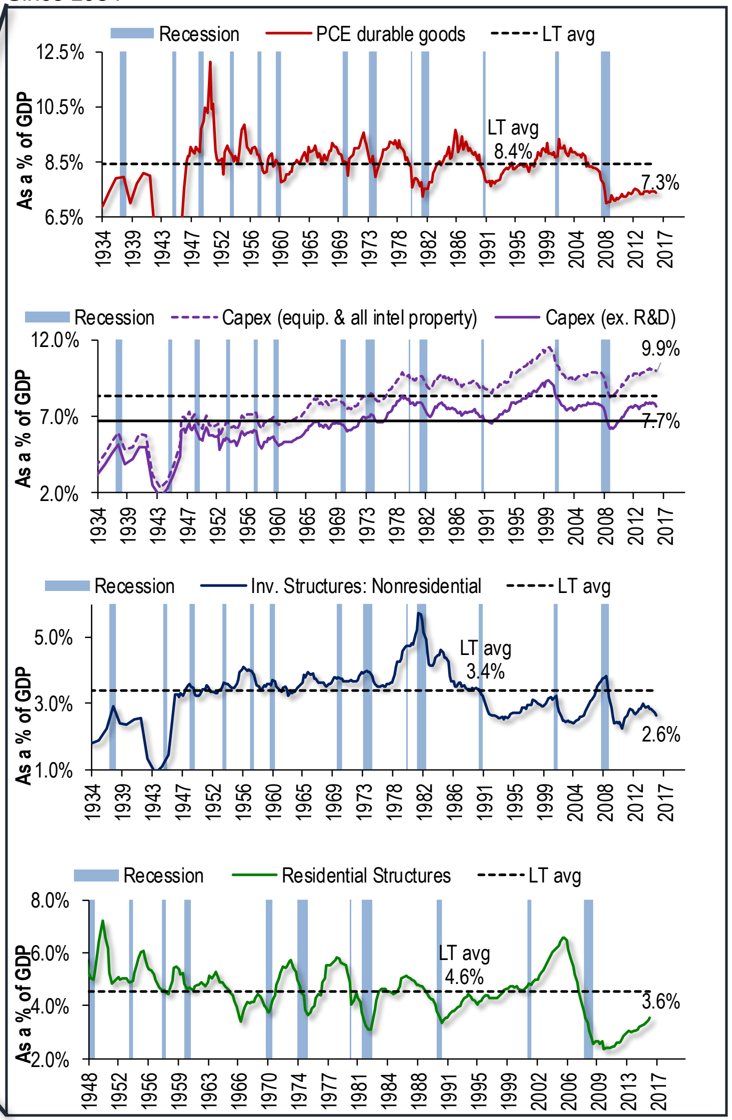
- As shown below, there has not been a bull market top seen without investment spending being at significantly higher levels than the current 23% today. Each 100bp increase in this figure is about $180b in GDP terms of investment spending increase.
- Some will argue this is due to capex being permanently lower, but as the charts on the right show, capex is only about one-third of this figure. And consumer purchases of durables and construction represent the other two-thirds.
- In other words, the absence of a current credit cycle (which drives investment spending), implies the bull market has not arguably reached maturity.

Figure: Investment Spend (PCE Durables + Private Fixed Investment) as % of GDP
Since 1934



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.

Figure: Components of Investment Spend
Since 1934



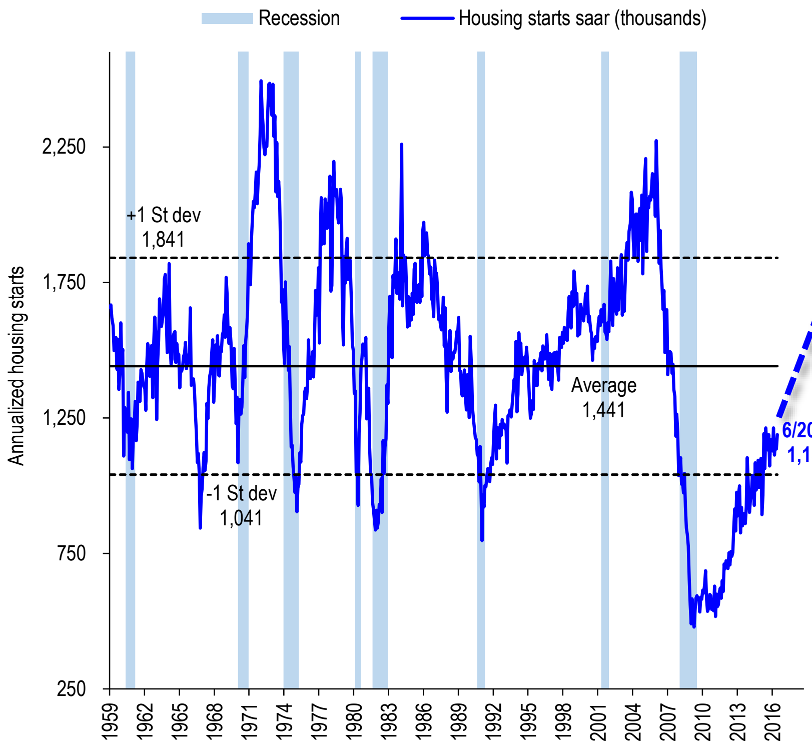
Source: Fundstrat, Bloomberg, BEA.

U.S. housing market still undersupplied...

Foremost, we believe there remains a lot of pent-up demand, especially in US housing. As shown below, US housing starts at 1.189 million per year remains at recession levels and below the 1.45mm long-term average.

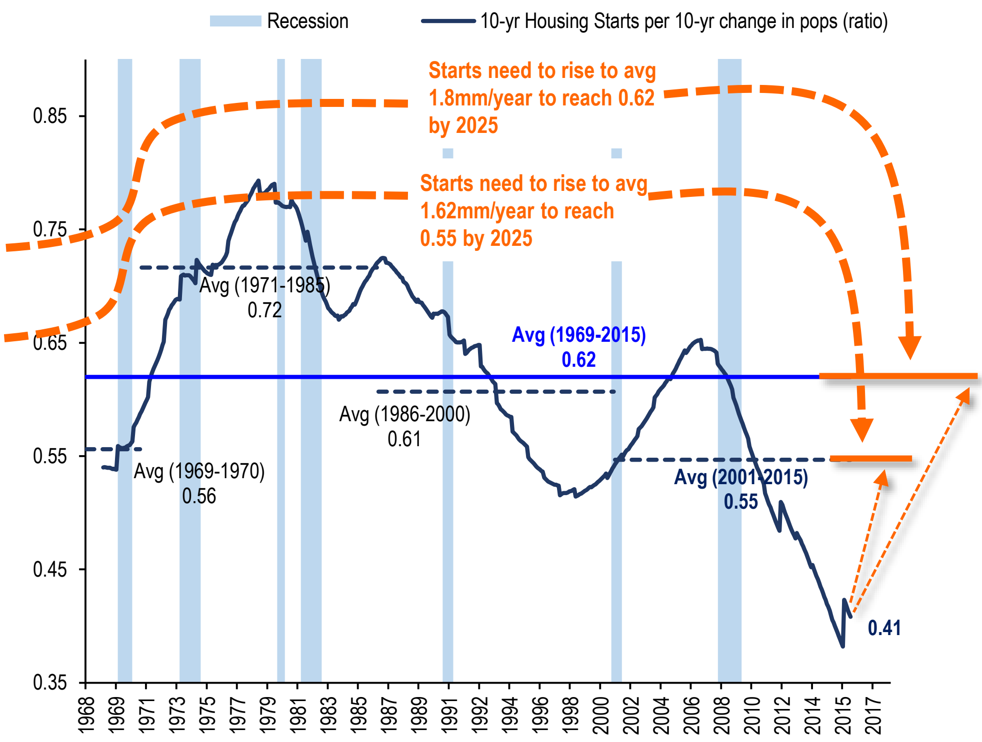
- But a better way to think about this is to look at housing starts for a change in population. On the bottom right, we calculated the number of housing starts compared to the change in US population over a 10-year period. The long term ratio is 0.62, meaning we need to built 62 homes for every 100 increase in population.
- **Recently, this ratio was 38, the lowest ever in 50 years. For this to recover to the long-term average of 62, we need to average 1.8mm starts per year for the next 10 years.**

Figure: U.S. housing starts are still at a recession levels.
Annualized housing starts since 1959



Source: Fundstrat, Bloomberg, Datastream.

Figure: We have built fewest homes ever for increase in population
Ratio of 10-yr sum of housing starts per 10-yr change in population



Source: Fundstrat, Bloomberg, Datastream.

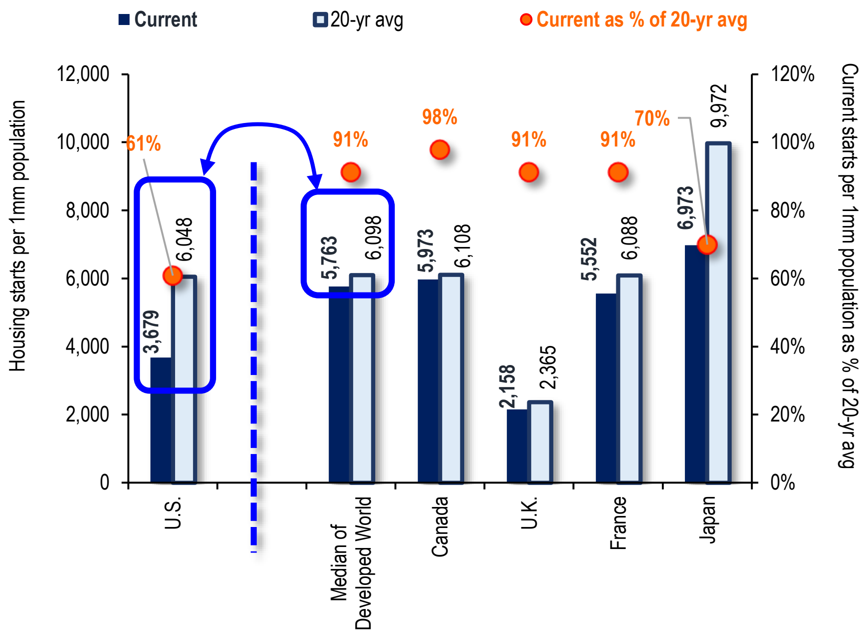
If US starts matched developed nations, starts closer to 1.8mm

The U.S. is undersupplying housing compared to the rest of the world adjusting for population. Below, we show housing starts per 1mm people and the median of developed nations is around 5,763 starts per 1mm people.

- At the high side is Japan which is currently building around 7,000 homes per 1 million residents but most countries are building homes at about 90% of the long-term average for that nation.
- **Currently, the U.S. is building 3,679 which is 36% less than other developed nations. In fact, if we built homes at this adjusted rate, US starts would be closer to 1.8mm per year.**
- As shown below, the long-term averages of the US are pretty similar to the rest of the world, at about 6,000 homes built per million residents annually.

Figure: U.S. housing starts lag RoW…

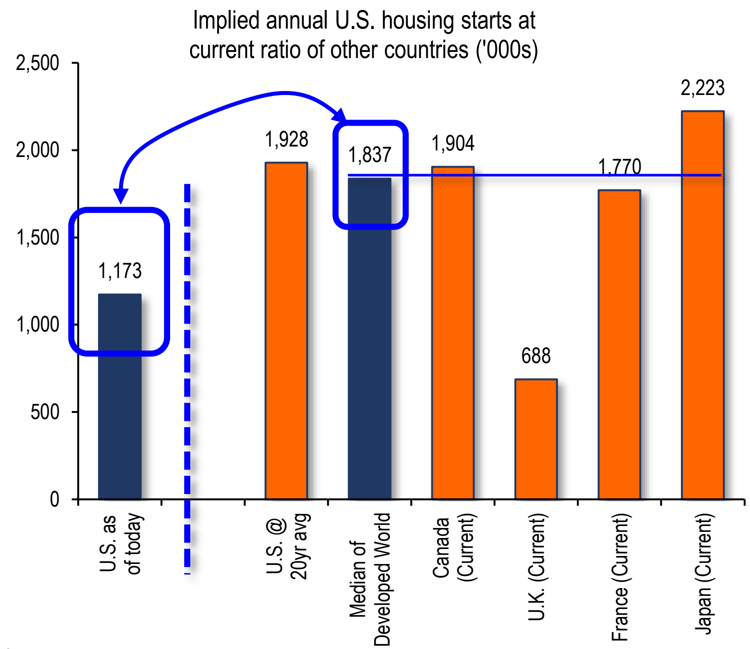
Housing starts per 1mm population vs 20-yr avg



Source: Fundstrat, Bloomberg, Datastream.

Figure: U.S. should be at closer to 1.8mm annual starts

Implied U.S. housing starts @ 20-yr avgs



Source: Fundstrat, Bloomberg, Datastream.

Consumer Revival as blemishes from ***Financial Crisis*** "discharged"

From FICO's Ethan Dornheim: "..it takes seven years for most derogatory information to come off consumer credit files… this credit indicator to decline substantively…between 2014 and 2016"

From FICO

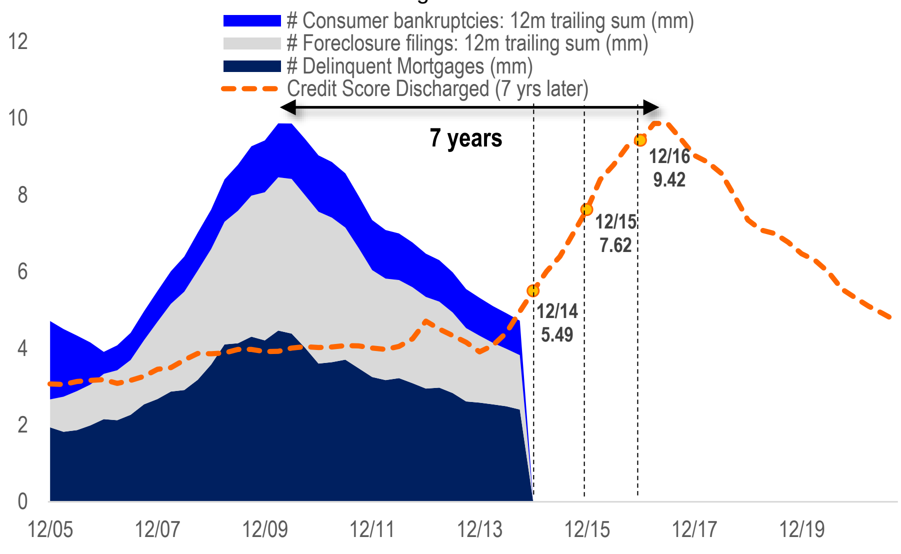
An assertion that these credit blemishes drop in 2015 and beyond…

Blemishes from late payments all the way down to bankruptcies and judgments remain on a consumer's credit history for 7 years. As shown below, if we advance this wave of distress/foreclosures/bankruptcies forward 7 years, we see the first of these "discharges" in 2014.

- The first wave of these will see their 7th year by the end of 2014 (5.5mm households) and within the next two years, the bulk of the financial crisis will be cleansed/discharged from consumer balance sheets.
- Interestingly, the "caution" stemming from the crisis (and resulting avoidance of leverage) has resulted in another 7.6mm Americans with super credit—***In other words, there is a tale of two Americas.***

Figure: Wave of consumer balance sheet resets coming…

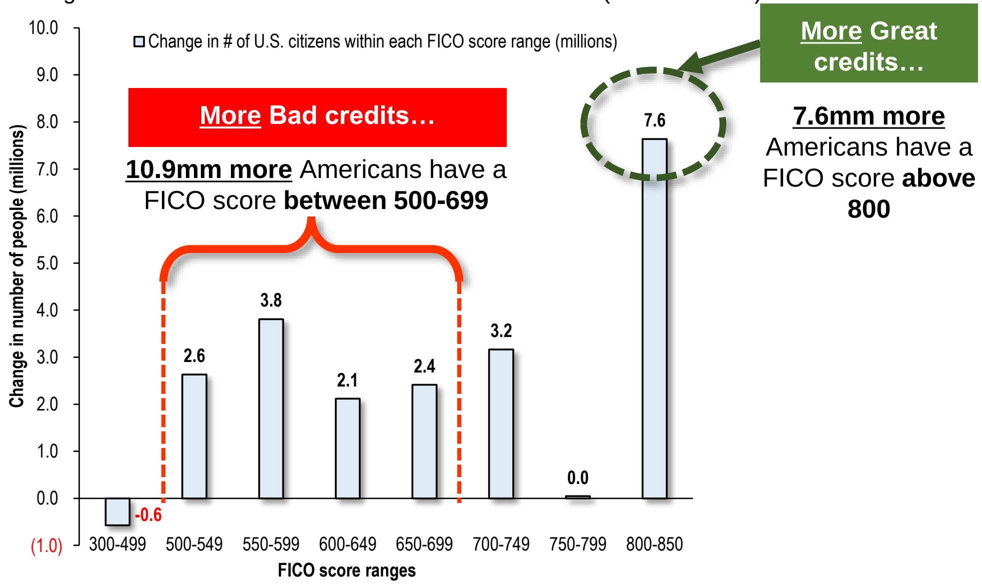
Schedule of consumer bad credit discharges



Source: Fundstrat, Bloomberg, Mortgage Bankers Association, Realty Trac Inc, American Bankruptcy Institute.
Note: For # of foreclosures, pre-2005 periods use the 2005 annual number as a proxy.

Figure: Tale of two FICOs: surge in "super credits" and "sub-700"

Change in # of Americans at each tranche of FICO scores (2014 vs. 2005)

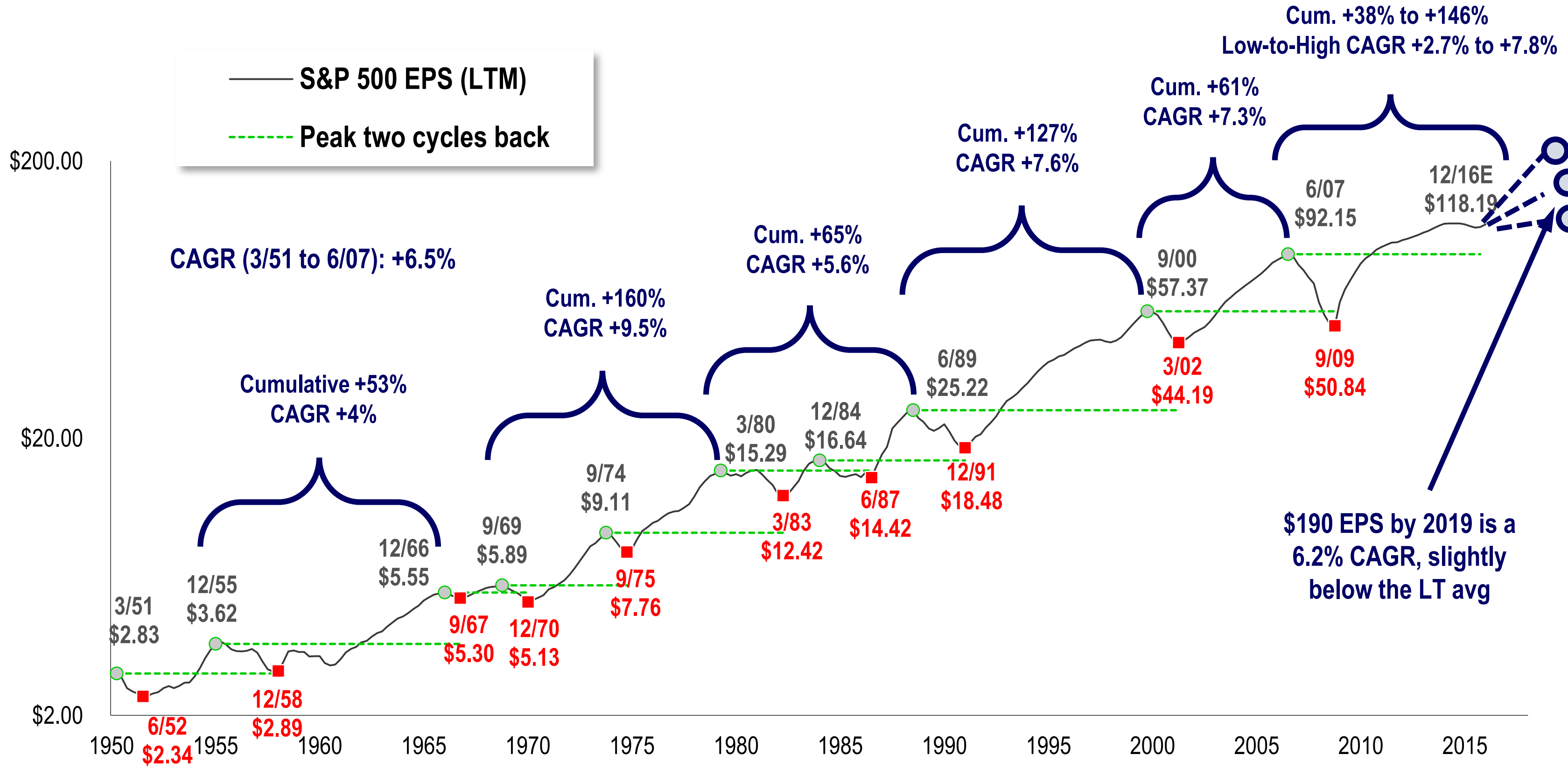


Source: Fundstrat, Fair Isaac Corporation.

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.
- Note how 3 of 5 EPS cycles compounded at 7.5% or so – applying similar results yields potential peak EPS of $195 this cycle compared to the currently estimated $118 of earnings for 2014.

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



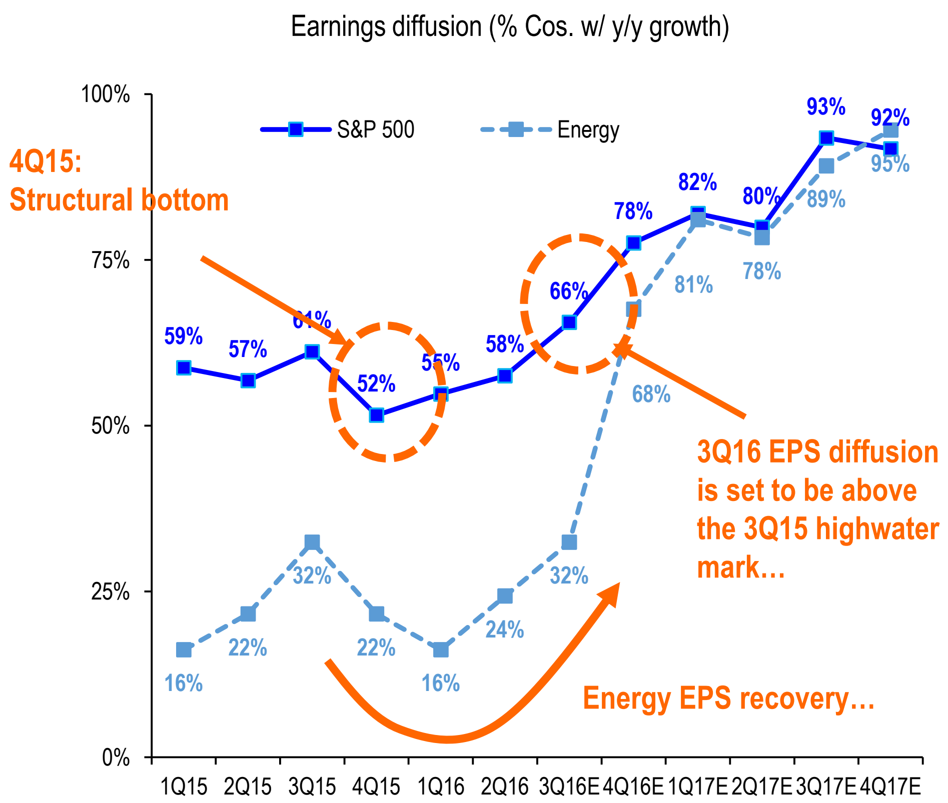
Source: Fundstrat, Thomson Reuters.

Diffusion of S&P 500 EPS turning higher, *leading indicator*

The percentage of S&P 500 companies report higher EPS is turning up. As shown below, this ratio has been steadily increasing since falling to a cycle low of 52% in 4Q15.

- **This figure has increased in each of the last two quarters to 55%/58% (1Q16/2Q16) and set to rise to 66% in 3Q16.**
- **This improvement is driven by Energy and as discussed on the next page, by Healthcare and Technology as well.**

Figure: Earnings expectations for S&P 500 picking up on easy Energy sector comps
% of companies reporting y/y growth in quarterly EPS



(% improving)	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16E	4Q16E
S&P 500	59%	57%	61%	52%	55%	58%	66%	78%
S&P ex-Energy	61%	59%	62%	53%	57%	59%	68%	78%
Consumer Discretionary	57%	60%	67%	54%	74%	70%	62%	75%
Information Technology	60%	52%	58%	49%	52%	61%	82%	87%
Industrials	72%	60%	63%	51%	52%	55%	57%	69%
Materials	59%	67%	56%	41%	52%	41%	63%	81%
Energy	16%	22%	32%	22%	16%	24%	32%	68%
Financials	59%	58%	53%	58%	48%	45%	59%	72%
Real Estate	71%	75%	71%	50%	54%	57%	64%	61%
Consumer Staples	58%	50%	58%	64%	50%	58%	64%	81%
Health Care	66%	61%	75%	53%	78%	75%	85%	93%
Telecommunication Services	0%	40%	60%	80%	60%	60%	100%	60%
Utilities	50%	57%	57%	50%	25%	50%	64%	79%

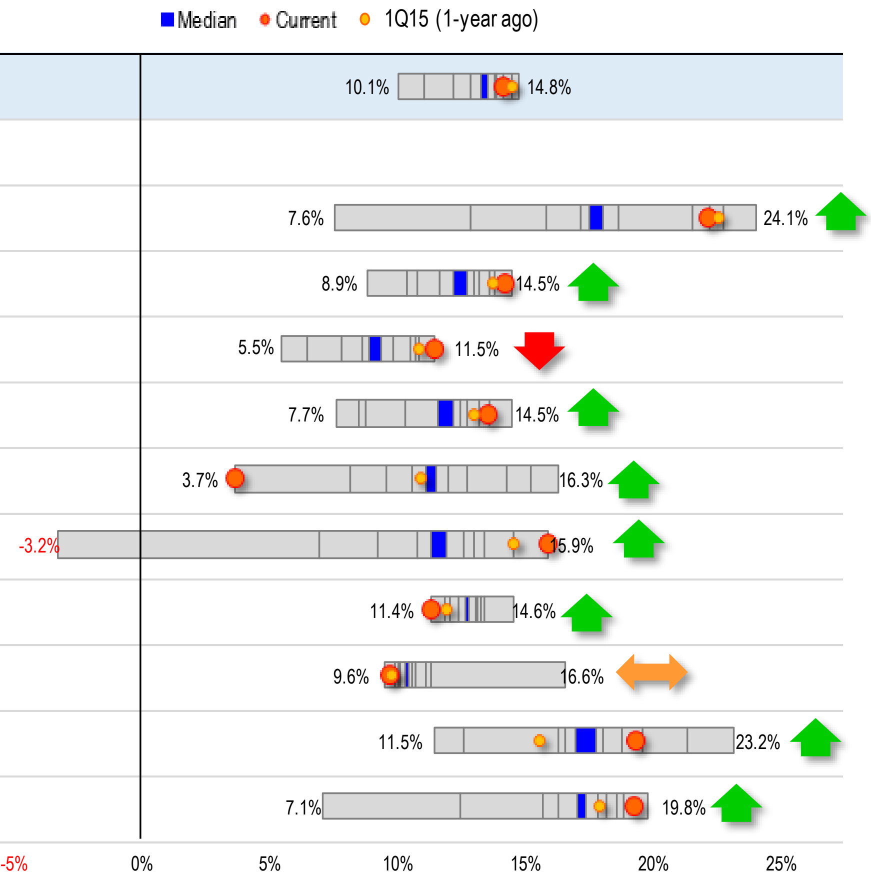
Source: Fundstrat, FactSet, Bloomberg

S&P 500 EBIT margins

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

% contribution to total S&P 500 Sales		% contribution to total S&P 500 EBIT		Market cap weight		
Total Sales ($ mm)	% of total S&P 500 Sales	Total EBIT ($ mm)	% of total S&P 500 EBIT	Market cap ($ mm)	% weight in S&P 500	
$8,407,843	100%	$1,510,114	100%	$18,478,932	100%	S&P 500
$1,264,613	15%	$280,789	19%	$3,704,773	20%	Technology
$1,216,919	14%	$173,533	11%	$1,839,720	10%	Industrials
$1,705,421	20%	$195,678	13%	$2,356,977	13%	Consumer Discretionary
$348,058	4%	$47,279	3%	$535,098	3%	Basic Materials
$900,162	11%	$33,071	2%	$1,309,219	7%	Energy
$1,431,928	17%	$328,435	22%	$2,908,998	16%	Financials sector (NET MARGIN)
$1,540,742	18%	$175,010	12%	$2,655,765	14%	Healthcare
$1,595,508	19%	$155,335	10%	$2,094,241	11%	Consumer Staples
$310,126	4%	$60,162	4%	$475,246	3%	Telecom
$314,828	4%	$60,822	4%	$598,895	3%	Utilities

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



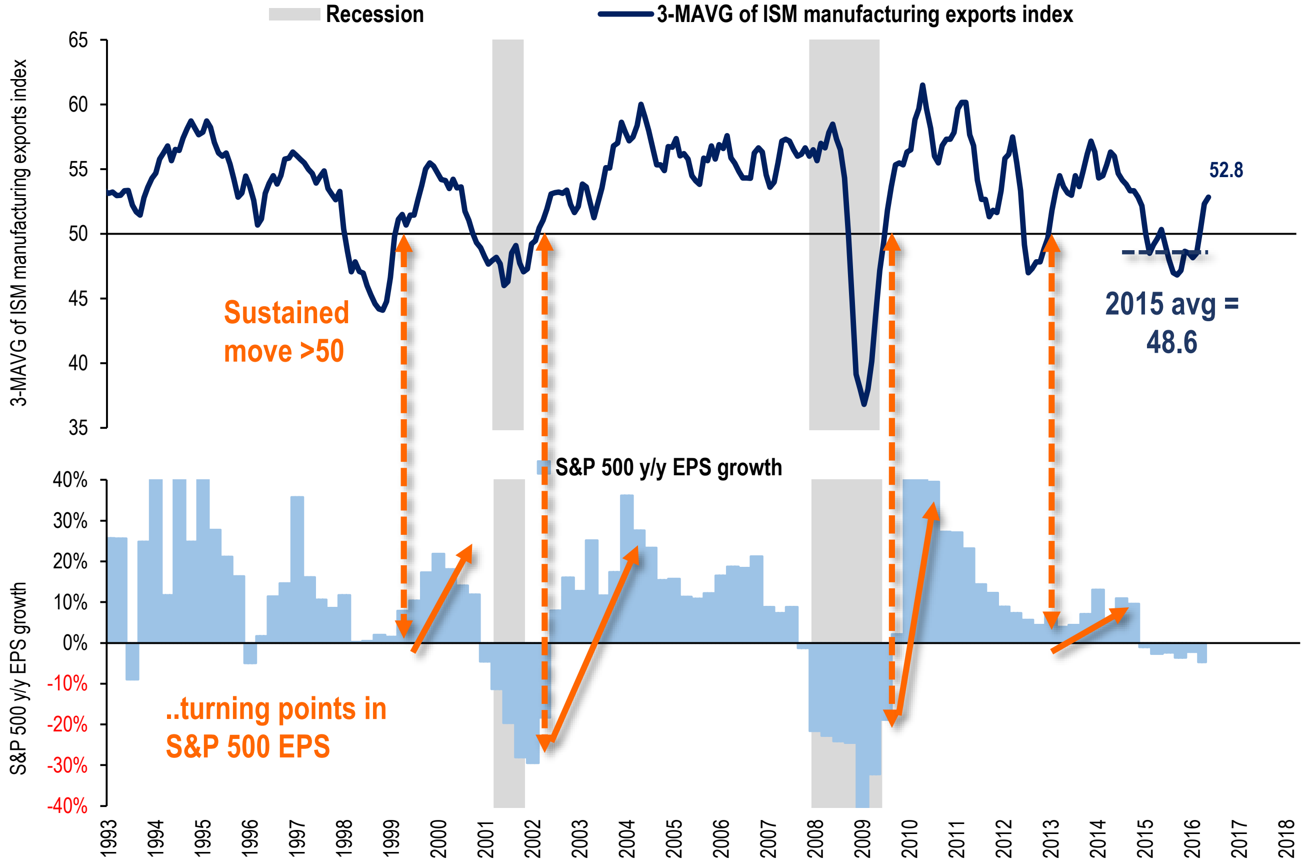
Source: Fundstrat, Factset, Bloomberg

US ISM Exports 4 points > 2015, implies 800bp EPS acceleration

The June ISM Exports posted a 53.5, an improvement over the last few months and boosting the 3-month moving average to 52.8. This is now 4 months above 50 after spending most of 2015 below 50.

- **As shown on bottom right table, each 1 point increase in ISM Exports adds 2.2% to S&P 500 EPS growth. The recent ISM reading of 52.8 is 4.2 points above the 2015 average (see below). As shown below, history suggests S&P 500 EPS growth should rise by 800bp relative to 2015 growth rates.**
- **We believe this recovery reflects abating of oil shock, weakening USD and generally improving conditions.**

Figure: 3-MAVG of ISM manufacturing exports index and S&P 500 y/y EPS growth
Since 1993



Source: Fundstrat, Bloomberg, ISM.

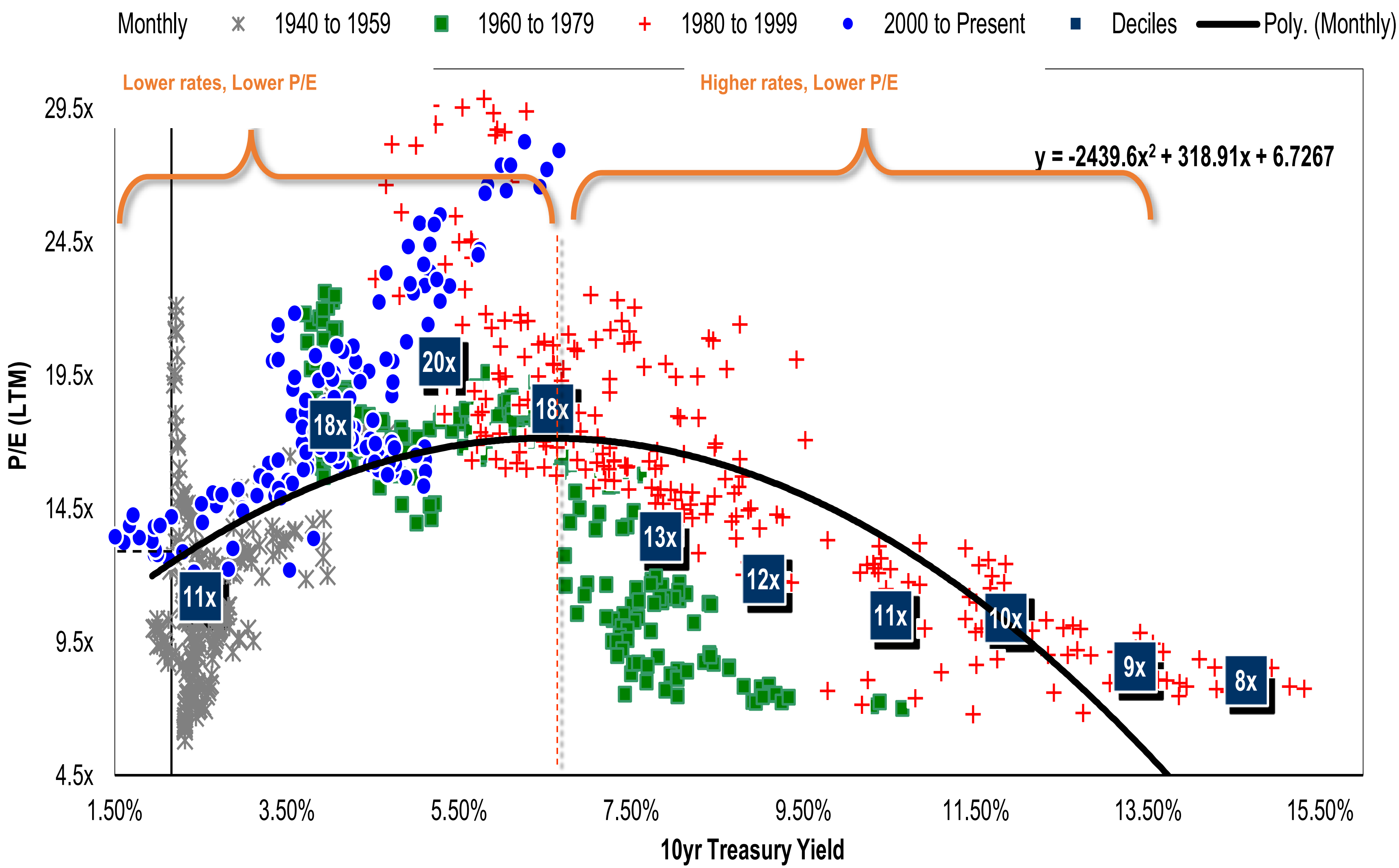
Date	ISM exports index	3-MAVG of ISM exports	S&P 500 1Y fwd growth (y/y) Sales	EPS
3/31/1999	50.1	51.1	12.8%	18.1%
3/31/2002	50.6	50.5	1.2%	25.2%
8/31/2009	55.5	51.8	3.9%	39.6%
2/28/2013	53.5	51.8	2.3%	13.1%
Average	52.4	51.3	5.0%	24.0%
Median	52.1	51.5	3.1%	21.6%
% of times positive			100%	100%
Current				
6/30/2016	53.5	52.8	n/a	n/a

Regression: Y = -1% + 0.021 * X
X = ISM exports 3M avg
Y = S&P 500 EPS growth

Since 1990, each 1-point increase in ISM exports adds 2.20% to EPS growth.

In other words, the rise in ISM exports implies EPS growth rates accelerated 800bp or so in next 12 months

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

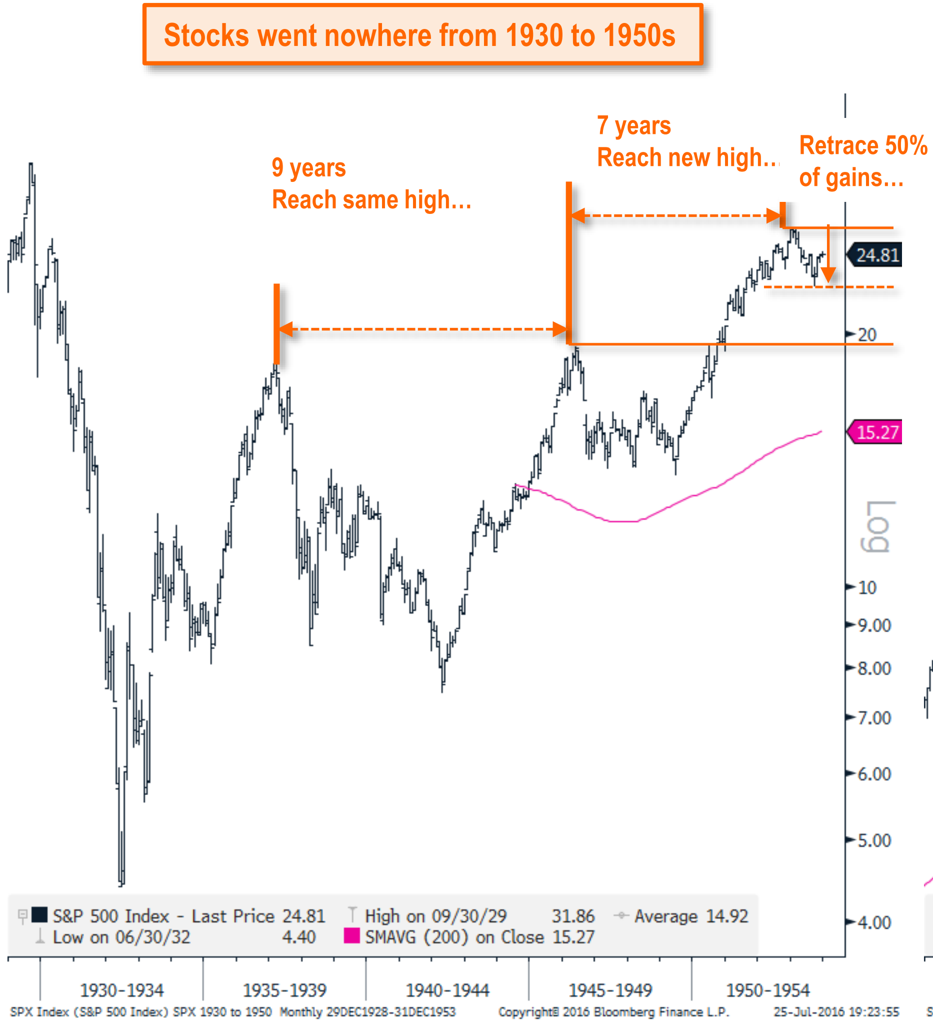


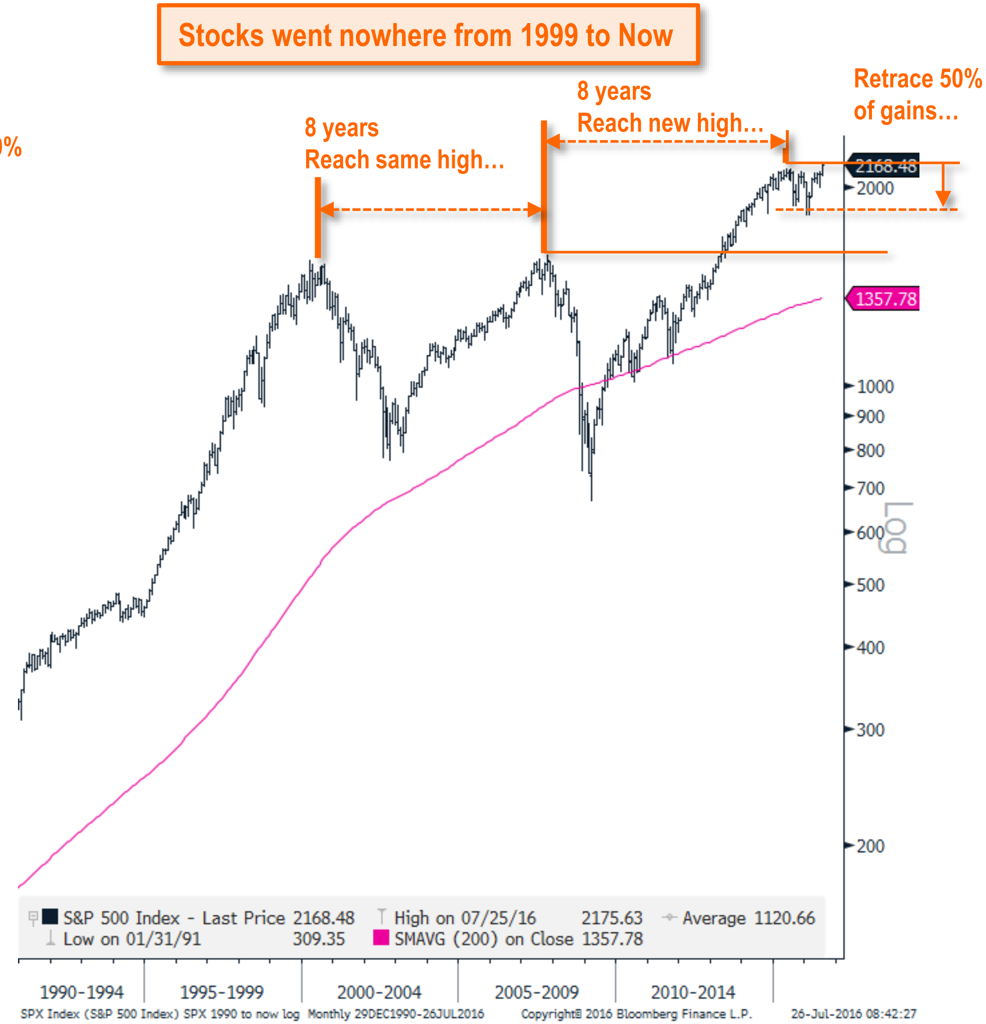
Source: Fundstrat, Bloomberg

This is similar to the S&P 500 in the 1950s

Does the phrase "stocks have gone nowhere for 20 years" sound familiar? We saw this in 1930 to 1950s and looks very similar to the 1999 to 2016 period…

Figure: S&P 500 Monthly



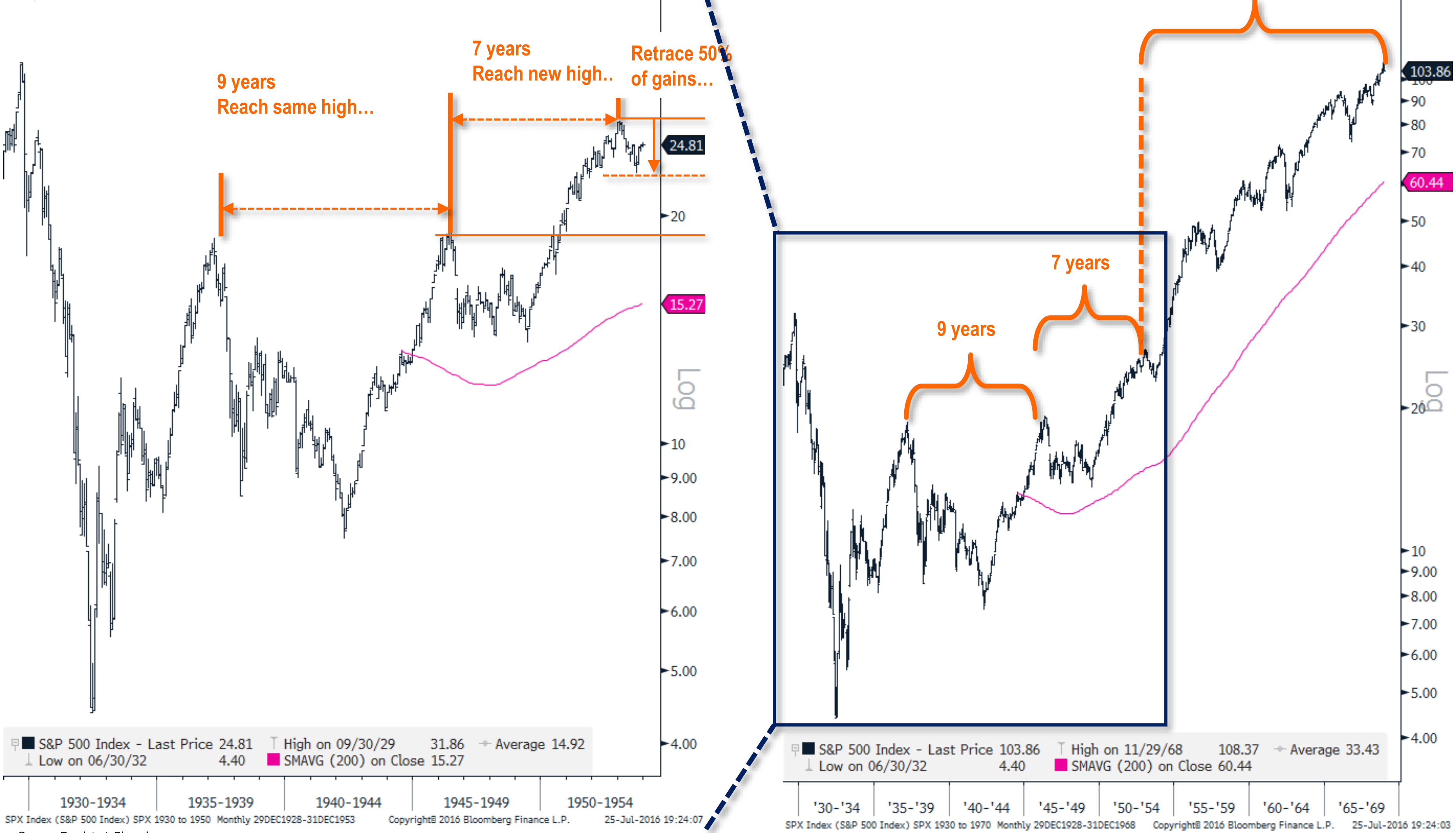


Source: Fundstrat, Bloomberg.

Stocks broke to the upside in the 1950s...

As shown, the "stocks went nowhere for 20 years" was resolved with a 17-year breakout of equities. As shown, stocks subsequently quadrupled between 1952 and 1969.

Figure: S&P 500 Monthly



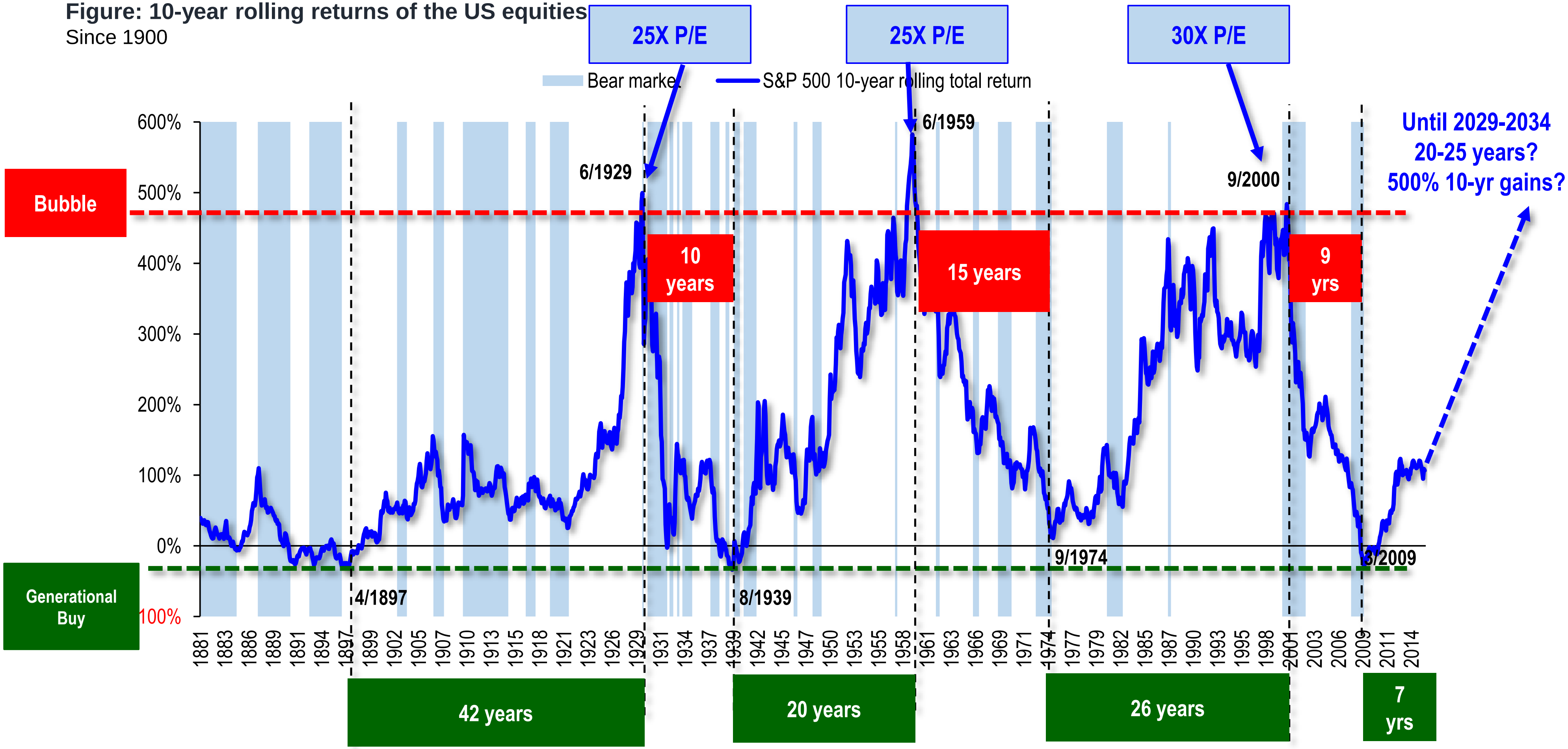
Source: Fundstrat, Bloomberg.

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.

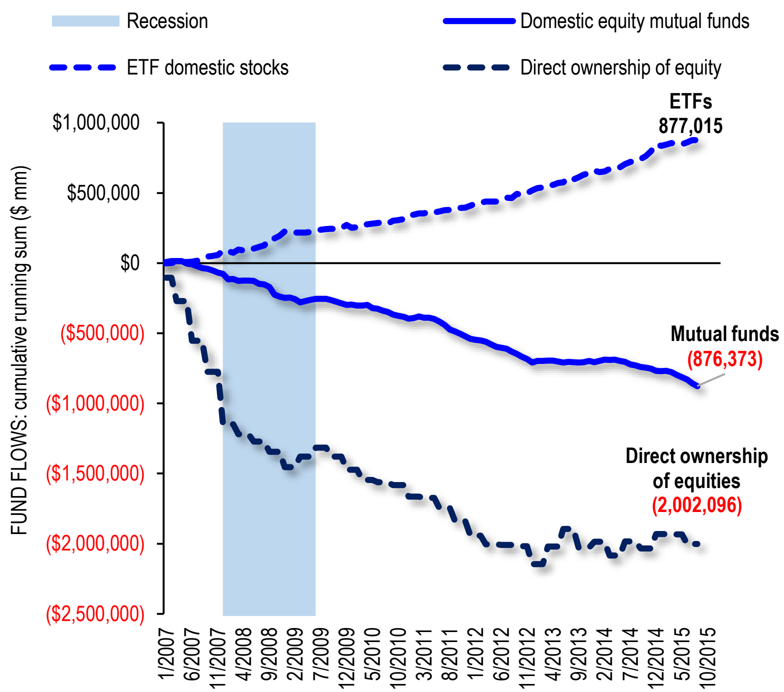
RATIONALE #1: Households have *only bought bonds* since 2007…

Households have not been buying equities generally since 2007. This is evident on the chart on the left below. As shown, there has been a substantial liquidation of equity ownership, most notably in direct ownership of stocks.

- 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

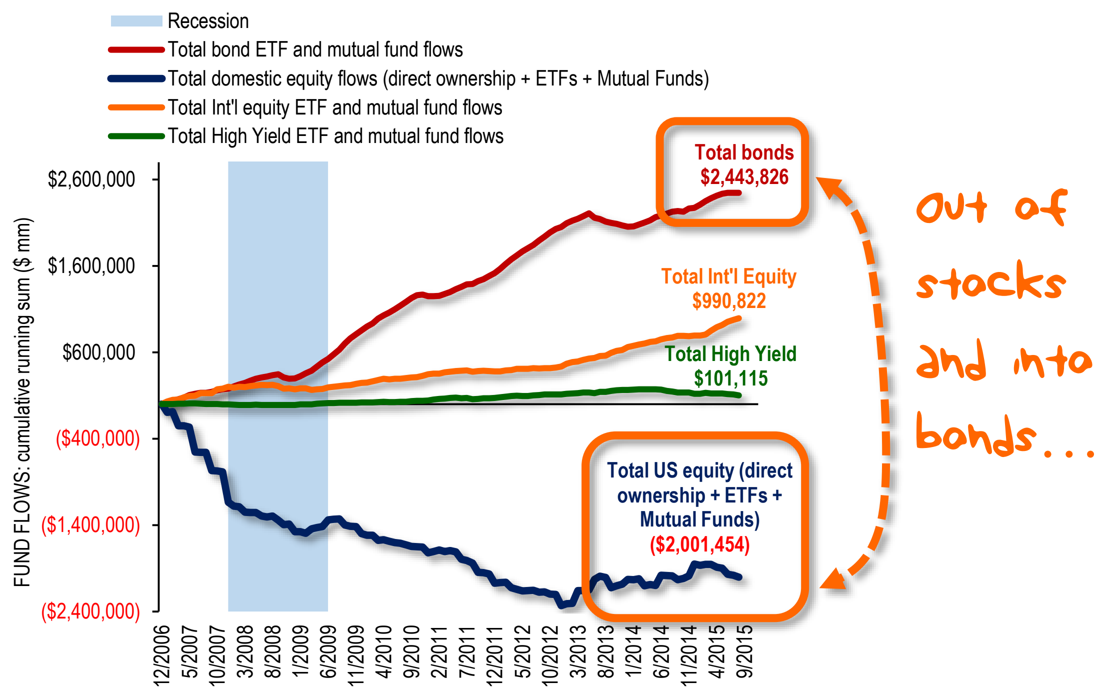
Cumulative U.S. equity flows since 2007 ($ mm)



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.

RATIONALE #4: Historical liquidation of stocks will reverse…

To appreciate the magnitude of liquidation of equities, take a look at the chart on the bottom left. We calculate what percentage of annual household savings is allocated to equities. As shown, householders have been "net sellers" since 2007.

- This is the largest liquidation in history and surpasses the 10% liquidation during the decade from 1979 to 1989—that was the precedent decade before the massive inflows into equities in the 1990s.
- **We believe this "net selling" is a factor behind the more pronounced cyclicality of equities in the past few years. Intuitively, this makes sense—after all, without natural buyers, equities would be more volatile.**
- **Given the attractive relative value of stocks and the tendency of mean reversion, we believe we will see equity flows reverse and turn positive in the new few years.**

Figure: Annual HH allocation to equity as % of fin assets acq

Since 1956. Equity flows include mutual funds, ETFs, and HH direct ownership of stocks

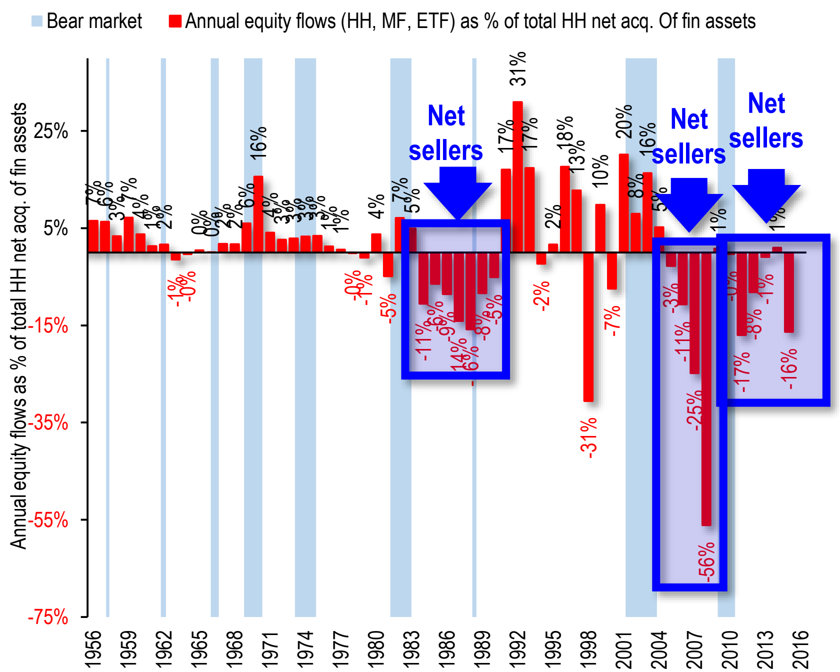
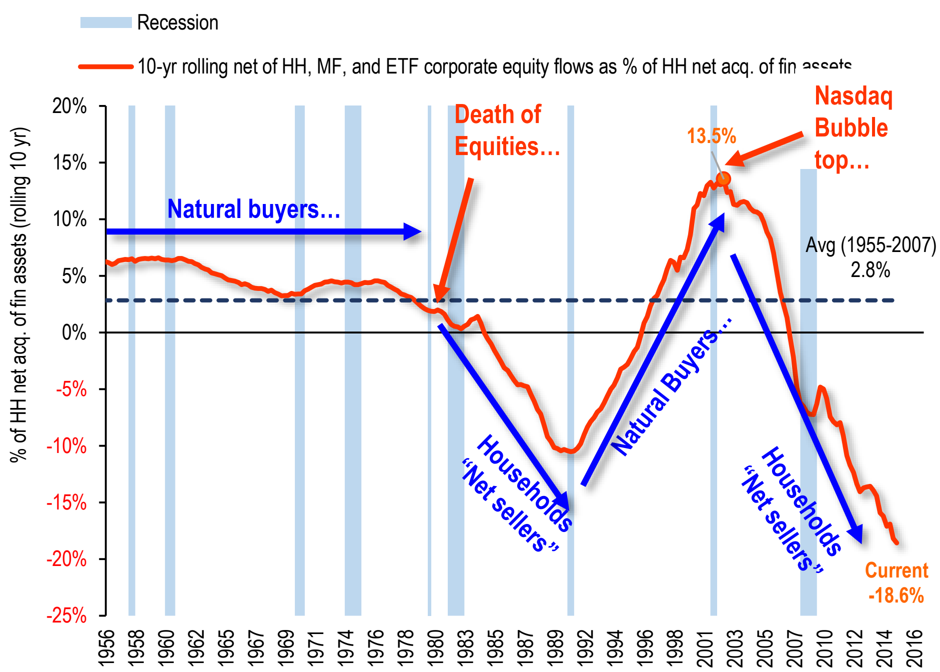


Figure: Households have been massive net-sellers of equities

Since 1956



Source: Fundstrat, Bloomberg, Federal Reserve.

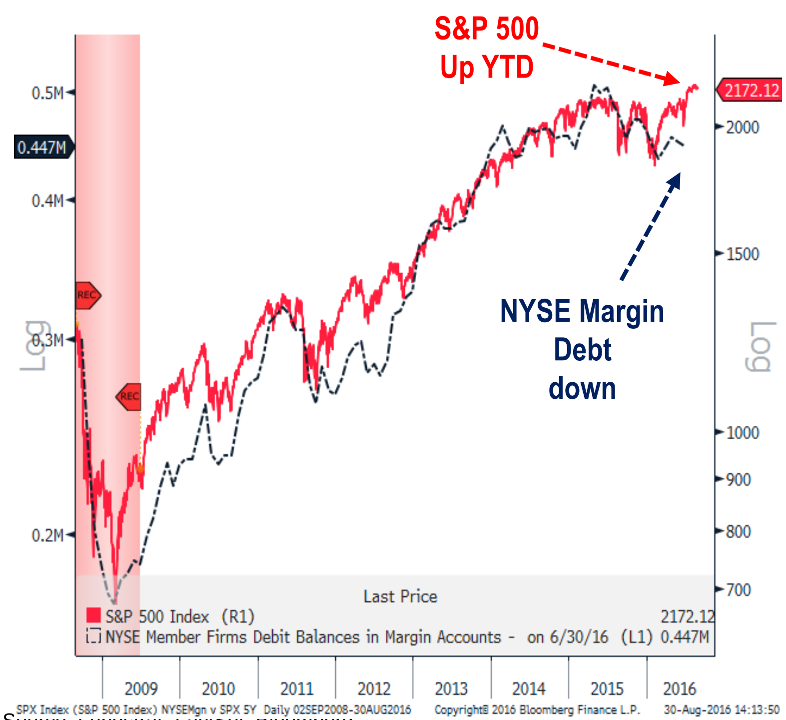
MARGIN DEBT: Since January, NYSE margin diverged from S&P 500

As shown below, since 2008, the S&P 500 and margin debt balances generally tracked pretty closely—not entirely surprising as this is the historical relationship. As markets rise, margin debt gains.

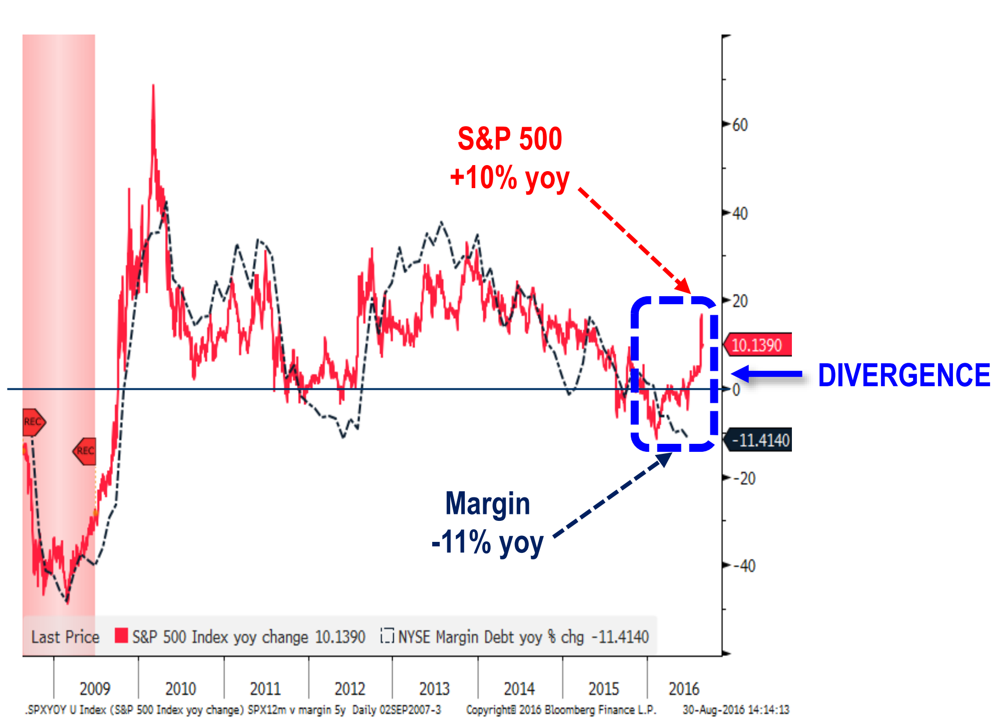
- **However, since the start of 2016, the two have diverged as shown on the bottom right chart—the S&P 500 is up year over year while margin debt has fallen.**

Figure: Since start of 2016, NYSE Margin Debt and S&P 500 have diverged…
Since Fall 2008

S&P 500 Index vs NYSE Margin Debit Balances ($ billions)



S&P 500 Index vs NYSE Margin % chg YoY



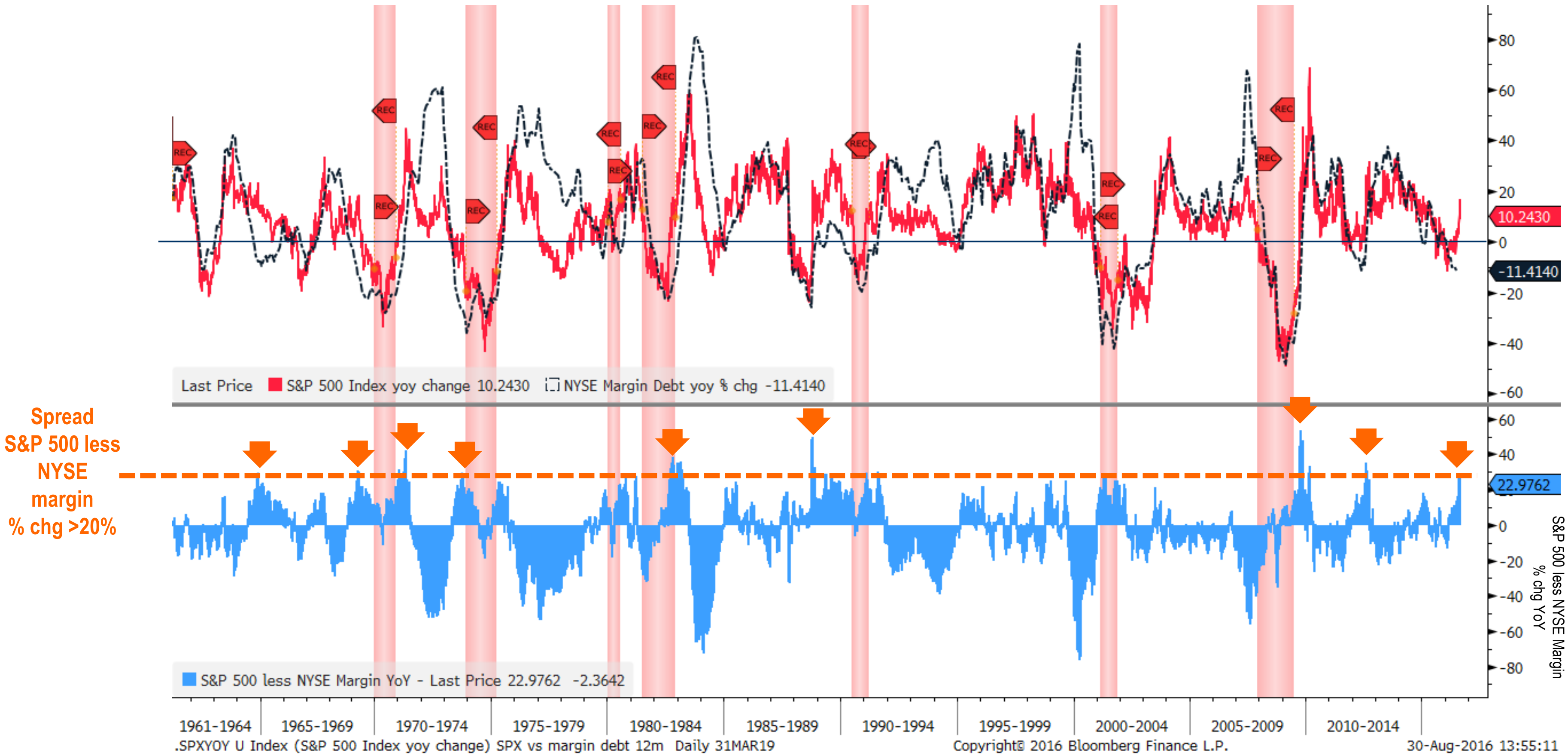
Source: Fundstrat, FactSet, Bloomberg

MARGIN DEBT: Divergence unusual, S&P 500 and margin *usually* move together…

Look at the relationship since 1960, one can appreciate this divergence is pretty unusual. **As shown below, since 1960, the S&P 500 and margin debt have tracked each other pretty closely.**

- **We have highlighted the divergences on the lower chart—measuring the change in S&P 500 versus the change in margin debt and the 20% differential, is quite unusual.**

Figure: Second time since 1960 that margin debt fell >10% yoy while S&P 500 posted gains…
Since 1960



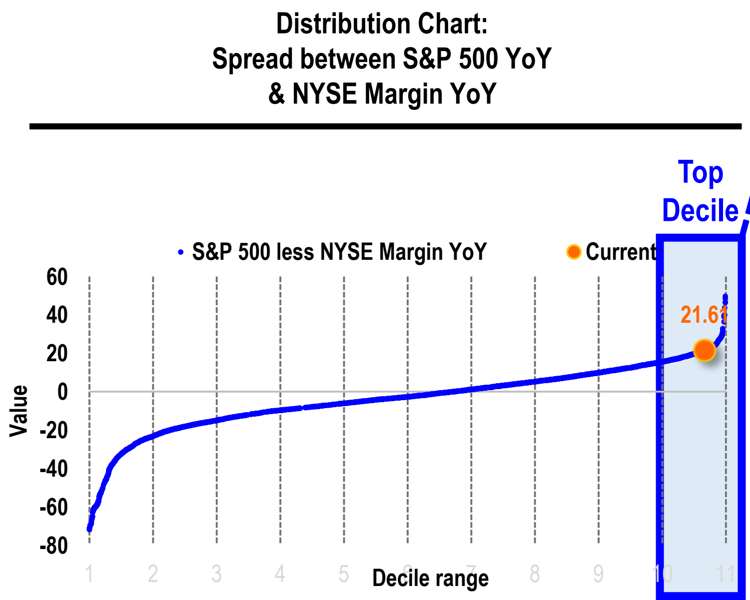
Source: Fundstrat, FactSet, Bloomberg

MARGIN DEBT: OW small-cap value when NYSE margin diverges…

The spread in YoY change in margin debt and the S&P 500 is pretty unusual and is a top decile differential (N=7k data points).

- **We have highlighted the comparative performance of sectors and styles when S&P 500 and NYSE margin divergences. As shown, the most notable performer is small-cap value (Russell 2000 Value). Outperforming 94% of the time.**

Figure: Comparative Sector/Style Returns on Top Decile Margin Change (vs S&P 500)
Since 1983



Data:	S&P 500 less NYSE Margin YoY	Latest data value:	21.606
BBG code:	.SPXMGN12 U Index	Current decile:	10
		Total # data points:	7689

		% return			win-ratio (%)		
		1M	3M	6M	1M	3M	6M
S&P 500	**Total Return**	**0.8%**	**1.5%**	**2.4%**	**62%**	**60%**	**64%**
Relative to S&P 500							
Growth or	S&P 500 Growth	0.1%	0.3%	(0.3%)	50%	52%	42%
Value	S&P 500 Value	(0.1%)	(0.4%)	0.3%	50%	48%	55%
Small vs	Russell 2000	0.5%	0.3%	0.8%	57%	48%	56%
Large	Russell 2000 Growth	1.3%	1.5%	2.8%	65%	55%	67%
	Russell 2000 Value	1.6%	4.6%	10.1%	73%	82%	94%
Relative to S&P 500							
Cyclicals	Information Technology	1.4%	1.5%	(2.3%)	60%	47%	39%
	Semiconductors & Semiconductor Equip	2.1%	3.5%	0.1%	51%	55%	49%
	Technology Hardware & Equipment	1.2%	0.2%	(3.6%)	57%	48%	47%
	Software & Services	2.2%	4.3%	(0.0%)	66%	55%	46%
	Consumer Discretionary	1.6%	3.7%	4.4%	86%	92%	77%
	Industrials	0.3%	0.8%	2.0%	60%	62%	64%
	Materials	0.2%	0.7%	2.4%	55%	60%	59%
Near	Financials	0.5%	0.9%	3.0%	60%	60%	74%
Cyclicals	Real Estate Investment Trusts	0.6%	2.8%	8.3%	50%	68%	73%
	Energy	(1.0%)	(1.3%)	(0.3%)	47%	36%	44%
Defensives	Health Care	(0.6%)	(0.6%)	(0.3%)	43%	43%	49%
	Health Care Equipment & Services	(0.0%)	0.9%	3.0%	52%	53%	65%
	Pharmaceuticals Biotechnology & Life Sc	(0.8%)	(1.1%)	(1.3%)	40%	42%	44%
	Consumer Staples	(1.1%)	(1.1%)	1.9%	38%	39%	62%
	Utilities	(2.6%)	(6.2%)	(6.7%)	23%	18%	9%
	Telecommunications Services	(1.9%)	(3.5%)	(6.1%)	33%	28%	27%

SMALL-CAP VALUE outperforms 94% of the time During such margin divergences…

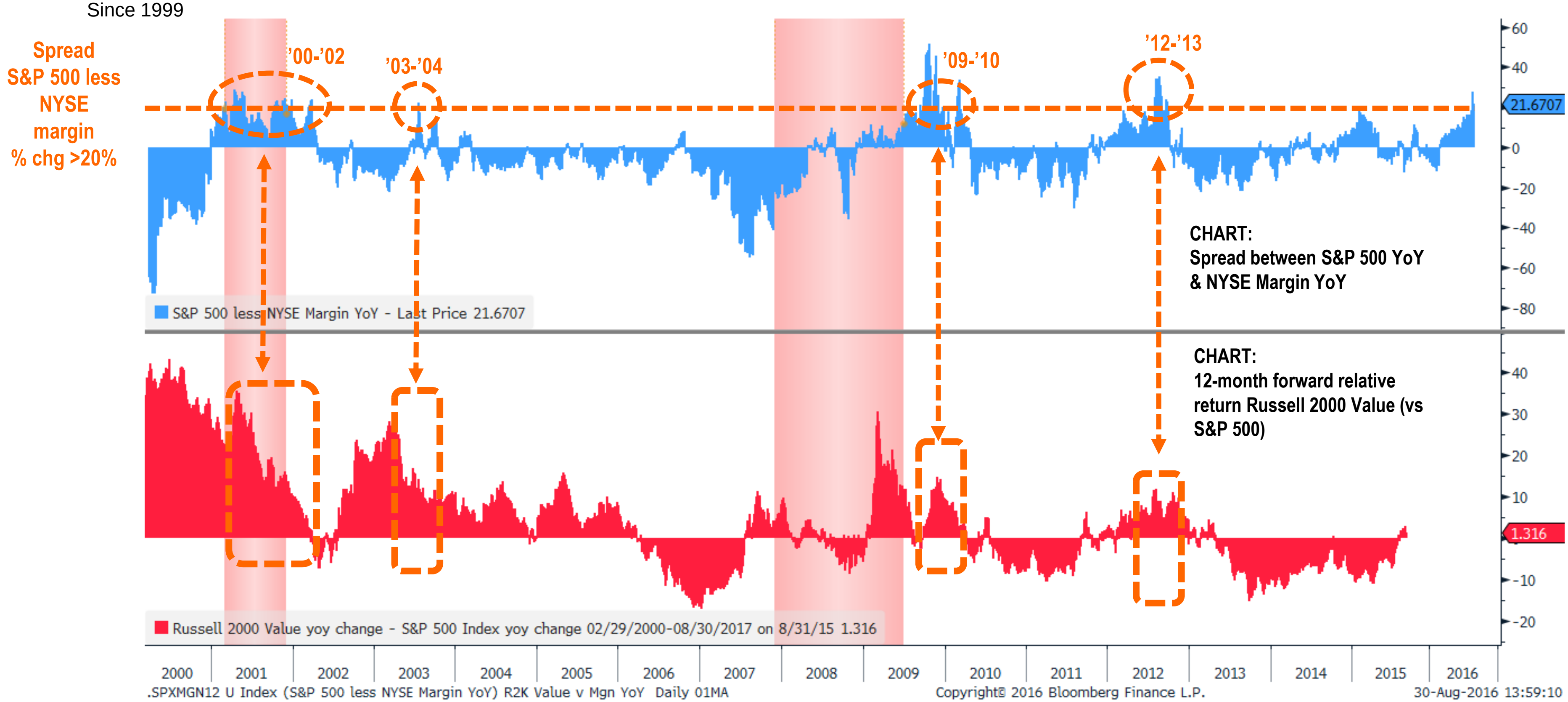
Source: Fundstrat, FactSet, Bloomberg

MARGIN DEBT: Small-value outperforms when NYSE margin trails S&P 500

We have plotted the comparative differential between S&P 500 YoY and NYSE margin YoY and subsequent relative performace of Russell 2000 Value (vs S&P 500).

- **As shown below, there are 4 episodes where S&P 500 diverged from margin. And as shown below, they are associated with strong relative returns of small-cap value. In each case, we saw extended outperformace of small-cap value over the following 12-18 months.**
- **We believe this reflects the "performance chasing" element as equities outpace holdings of managers (who kept dry powder).**

Figure: S&P 500 vs NYSE margin (yoy) and 12M forward return of Russell 2000 Value (vs S&P 500) and
Since 1999



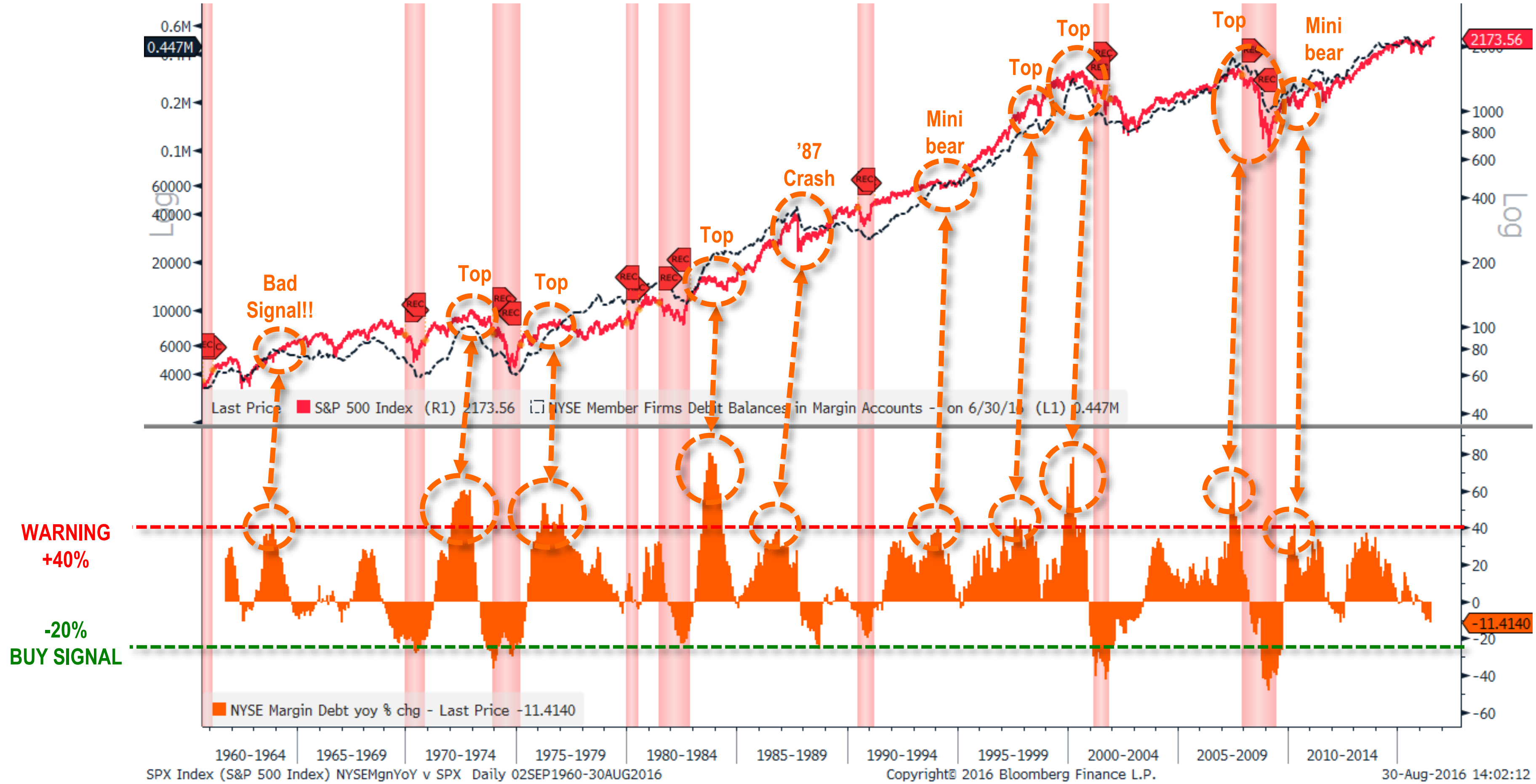
Source: Fundstrat, FactSet, Bloomberg

MARGIN DEBT: Lot of "dry powder" as margin debt surges at tops…

The fact that margin debt is down tells us there is a lot of dry powder on the sidelines. Why? Because as shown below, of the 10 times NYSE margin debt rose greater than 40% yoy, the market topped 9 of 10 times. **In fact, in front of the '87 crash, margin debt rose 40% yoy.**

- **Recently, margin debt has been down 11% yoy, which we see as a tactically positive signal, implying investors are underweight equities.**

Figure: Be wary when margin debt surges 40%...precedes every major market top…
Since 1960



Source: Fundstrat, FactSet, Bloomberg

Executive Summary

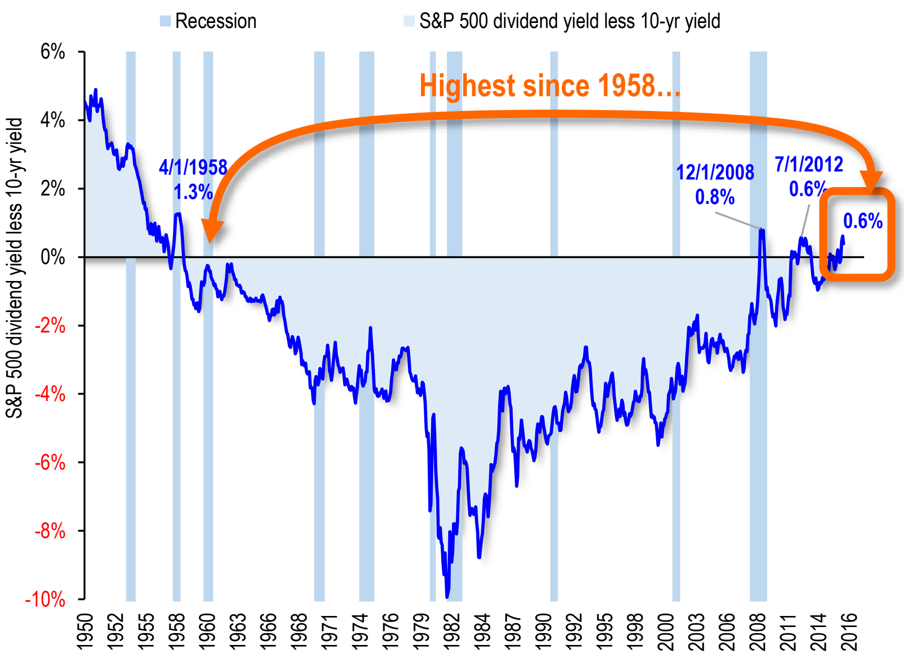
Tactical	Portfolio Strategy	Sectors and styles
Credit	Stocks are new bonds	Regime Shift
FX / Commodities	Laggards become leaders	Cyclicals
Economy	Growth as cheap as value	Energy
Earnings Outlook	FANG ends with a D@#G!	Financials
Market outlook	Buy small-caps	Defensives

"Stocks are the 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.

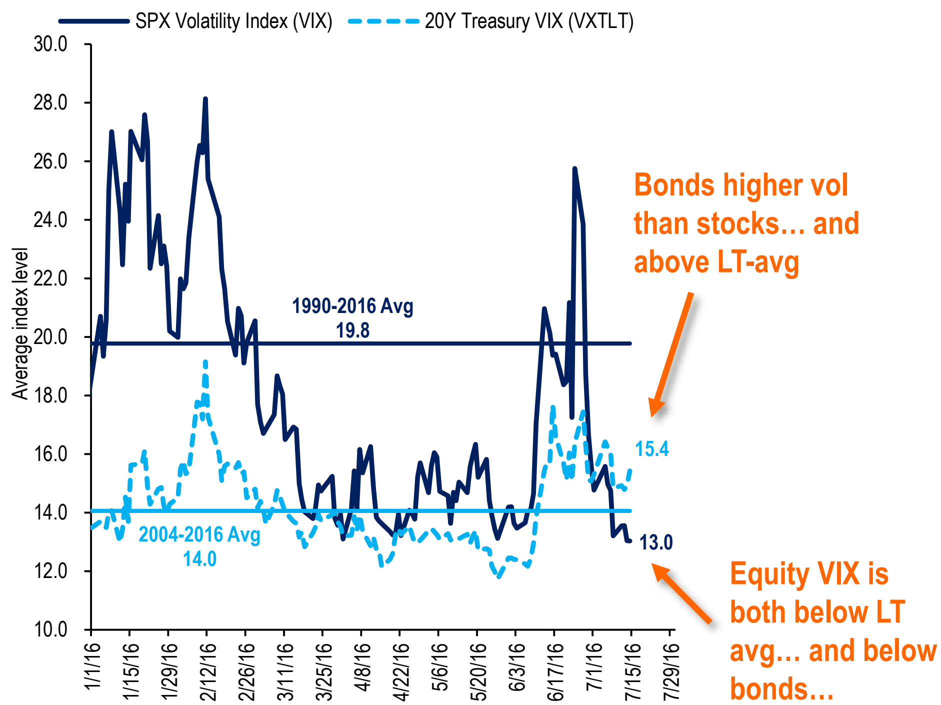
- **Logically, the dividend yield should always be lower than the bond yield of the same issuer—particularly as dividend yields generally grow. The global search for carry is further amplifying the differences as interest rates are falling and as a consequence, the dividend yield of the S&P 500 exceeds 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.

Portfolio Strategy | Stocks are new bonds | Laggards become leaders | Growth as cheap as value | Fang ends with a D@#G! | Buy small-caps

Sector	#	Ticker	Company name	Current Price	Mkt cap ($ mm)	3m avg daily liquidity ($ mm)	YTD perf (relative to S&P 500)	Dividend Payout Ratio	a Regular Dividend Yield	b Special Dividend + Buyback Yield	c = a+b CASH RETURN Yield	d = a + 0.25*b Adjusted CASH RETURN yield	e Adjusted Bond Yield	f = a - e Dividend Yield less Bond Yield	g = d-e CASH RETURN yield less Bond yield	2017E P/E	Issuer Rating
Discretionary	1	RL	Ralph Lauren Corp	$103.66	$8,527	$119.7	(13.7%)	40.8%	1.9%	5.1%	7.0%	3.2%	0.0%	193	321	18.7x	A
	2	TGT	Target Corp	$69.97	$40,223	$387.6	(10.3%)	48.5%	3.4%	11.0%	14.5%	6.2%	3.0%	41	317	12.8x	A
Industrials	3	BA	Boeing Co/The	$132.49	$82,648	$474.5	(15.1%)	45.6%	3.3%	9.4%	12.7%	5.6%	2.9%	35	270	13.7x	A
	4	CAT	Caterpillar Inc	$83.39	$48,719	$341.0	16.0%	122.4%	3.7%	4.1%	7.8%	4.7%	3.1%	63	165	23.2x	A
	5	EMR	Emerson Electric Co	$52.54	$33,811	$192.5	3.2%	63.9%	3.6%	3.0%	6.6%	4.4%	2.5%	110	185	18.1x	A
	6	MMM	3M Co	$179.74	$108,635	$312.2	12.6%	53.2%	2.5%	4.2%	6.7%	3.5%	2.5%	-1	104	20.3x	AA-
	7	PCAR	Paccar Inc	$57.48	$20,148	$125.9	14.6%	149.4%	1.7%	3.7%	5.4%	2.6%	0.0%	167	260	15.8x	A+
	8	UPS	United Parcel Service-Cl B	$109.43	$96,087	$256.3	6.9%	54.4%	2.9%	2.9%	5.8%	3.6%	2.3%	53	127	17.7x	A+
Technology	9	CSCO	Cisco Systems Inc	$31.78	$159,844	$681.1	10.3%	45.6%	3.3%	2.5%	5.7%	3.9%	2.9%	34	95	12.8x	AA-
	10	IBM	Intl Business Machines Corp	$161.57	$154,436	$523.3	10.5%	37.3%	3.5%	2.6%	6.1%	4.1%	2.5%	99	164	11.5x	AA-
	11	INTC	Intel Corp	$36.44	$172,398	$738.8	(1.0%)	54.4%	2.9%	2.4%	5.3%	3.5%	2.7%	14	74	13.4x	A+
	12	MSFT	Microsoft Corp	$57.59	$448,771	$1,593.9	(2.9%)	67.7%	2.5%	3.3%	5.8%	3.3%	2.7%	-16	66	18.8x	AAA
	13	QCOM	Qualcomm Inc	$62.57	$92,206	$501.6	18.5%	57.4%	3.4%	7.8%	11.1%	5.3%	3.3%	12	206	13.0x	A+
	14	TXN	Texas Instruments Inc	$69.36	$69,583	$362.1	19.8%	48.5%	2.2%	3.7%	5.9%	3.1%	2.0%	23	115	20.2x	A+
	15	XLNX	Xilinx Inc	$53.80	$13,637	$100.1	7.9%	56.9%	2.5%	3.3%	5.7%	3.3%	2.6%	-16	65	23.2x	A-u
Materials	16	APD	Air Products & Chemicals Inc	$156.93	$33,983	$147.4	13.8%	45.0%	2.2%	0.0%	2.2%	2.2%	1.9%	28	28	18.7x	A
	17	PX	Praxair Inc	$122.06	$34,815	$135.7	12.3%	52.8%	2.5%	0.9%	3.4%	2.7%	2.0%	46	69	20.2x	A
Energy	18	CVX	Chevron Corp	$102.59	$193,538	$661.4	7.3%	292.2%	4.2%	0.0%	4.2%	4.2%	2.5%	169	169	22.1x	AA-
	19	OXY	Occidental Petroleum Corp	$77.20	$58,971	$276.1	7.6%		3.9%	1.0%	5.0%	4.2%	3.1%	88	114	55.9x	A
	20	SLB	Schlumberger Ltd	$78.56	$109,250	$463.9	5.9%	142.8%	2.5%	1.3%	3.9%	2.9%	2.5%	7	40	39.9x	AA-
	21	XOM	Exxon Mobil Corp	$88.06	$365,154	$965.4	6.3%	117.3%	3.4%	0.5%	3.9%	3.5%	2.6%	79	92	20.6x	AA+
Financials	22	AMP	Ameriprise Financial Inc	$100.49	$16,221	$99.3	(12.5%)	32.1%	3.0%	11.3%	14.3%	5.8%	2.8%	22	305	9.6x	A
	23	AVB	Avalonbay Communities Inc	$178.40	$24,497	$136.8	(9.8%)	93.0%	3.0%	0.0%	3.1%	3.0%	2.7%	30	31	37.5x	A-
Financials	24	BBT	Bb&T Corp	$37.79	$30,776	$141.6	(6.8%)	38.0%	3.2%	0.1%	3.3%	3.2%	2.8%	38	41	12.3x	A-
	25	BLK	Blackrock Inc	$372.33	$61,126	$195.8	2.7%	48.4%	2.5%	2.3%	4.7%	3.0%	2.5%	-2	55	16.7x	AA-
	26	IVZ	Invesco Ltd	$31.48	$12,904	$125.3	(12.7%)	55.3%	3.6%	5.9%	9.4%	5.0%	2.6%	97	244	11.9x	A
	27	JPM	Jpmorgan Chase & Co	$67.12	$242,418	$917.6	(5.0%)	35.0%	2.9%	2.9%	5.7%	3.6%	2.8%	10	82	10.9x	A-
	28	MET	Metlife Inc	$42.87	$47,109	$327.2	(17.8%)	36.4%	3.7%	2.1%	5.9%	4.3%	3.9%	-22	31	7.5x	A-
	29	PSA	Public Storage	$225.09	$39,031	$212.2	(15.8%)	108.8%	3.2%	0.0%	3.2%	3.2%	1.7%	145	145	29.9x	A
	30	SPG	Simon Property Group Inc	$218.51	$68,663	$251.1	5.7%	107.0%	3.0%	0.0%	3.0%	3.0%	2.7%	28	28	27.9x	A
Staples	31	KO	Coca-Cola Co/The	$43.58	$188,071	$501.6	(5.3%)	87.1%	3.2%	2.4%	5.6%	3.8%	2.5%	73	133	21.7x	AA-
	32	PEP	Pepsico Inc	$106.99	$153,981	$417.2	0.2%	60.6%	2.8%	2.7%	5.5%	3.5%	2.7%	15	83	20.8x	A
	33	PG	Procter & Gamble Co/The	$87.99	$234,879	$706.1	4.1%	71.0%	3.0%	3.6%	6.7%	3.9%	2.5%	56	147	21.7x	AA-
	34	PM	Philip Morris International	$101.81	$157,941	$444.7	9.1%	97.6%	4.0%	0.0%	4.0%	4.0%	2.5%	149	150	20.7x	A
Healthcare	35	LLY	Eli Lilly & Co	$78.44	$86,585	$300.5	(13.8%)	75.5%	2.6%	0.7%	3.3%	2.8%	2.5%	12	30	19.1x	AA-
	36	MRK	Merck & Co. Inc.	$62.81	$173,669	$588.7	12.2%	84.6%	2.9%	2.3%	5.3%	3.5%	2.3%	63	121	16.3x	AA
	37	PFE	Pfizer Inc	$34.75	$210,751	$746.3	0.9%	57.5%	3.5%	2.2%	5.7%	4.0%	3.2%	26	83	13.1x	AA
Utilities	38	CNP	Centerpoint Energy Inc	$23.26	$10,018	$106.2	20.0%	91.9%	4.4%		4.4%	4.4%	3.4%	100	100	19.3x	A-
	39	DUK	Duke Energy Corp	$80.81	$55,669	$255.7	6.5%	71.5%	4.2%		4.2%	4.2%	3.3%	98	98	17.1x	A-
	40	PPL	Ppl Corp	$34.83	$23,615	$181.0	(4.7%)	69.2%	4.4%	0.0%	4.4%	4.4%	3.2%	115	115	15.9x	A-
	41	SO	Southern Co/The	$52.29	$51,177	$290.1	5.1%	74.6%	4.3%	0.0%	4.3%	4.3%	3.6%	72	72	17.6x	A-
		Average			$103,280	$397.7	2.3%	75%	3.2%	2.9%	5.9%	3.8%	2.6%	57	125	19.5x	
		Median			$68,663	$312.2	5.1%	59%	3.2%	2.4%	5.5%	3.6%	2.6%	41	104	18.7x	

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

Subtractions (div yield lower than bond yield)

Deletions	Company name	Returns since 4/8/16 Absolute	Relative
ADP	Automatic Data Proc	6%	0%
GE	General Electric Co	7%	1%
CMI	Cummins Inc	14%	8%
HSBC	Hsbc Holdings PlC	9%	3%
CME	Cme Group Inc	10%	4%
USB	Us Bancorp	5%	-0%
WFC	Wells Fargo & Co	4%	-2%
PRU	Prudential Financial I	7%	1%
NOV	National Oilwell Varc	18%	12%
ABBV	Abbvie Inc	7%	1%
JNJ	Johnson & Johnson	13%	7%
HSY	Hershey Co/The	19%	13%
MO	Altria Group Inc	9%	3%
KMB	Kimberly-Clark Corp	-1%	-7%
CL	Colgate-Palmolive C	6%	-0%
WEC	Wec Energy Group I	9%	3%
ES	Eversource Energy	2%	-4%
XEL	Xcel Energy Inc	7%	1%
ED	Consolidated Edison	4%	-2%
D	Dominion Resources	6%	-0%
Avg		8.0%	2.0%
Win ratio		95%	65%

Source: Fundstrat, Bloomberg, Factset,

Stocks are the New Bonds: SMID Cap

Sector	#	Ticker	Company name	Current Price	Mkt cap ($ mm)	3m avg daily liquidity ($ mm)	YTD perf (relative to Russell 3000)	Dividend Payout Ratio	a: Regular Dividend Yield	b: Special Dividend + Buyback Yield	c = a+b: CASH RETURN Yield	d = a + 0.25*b: Adjusted CASH RETURN yield	e: Adjusted Bond Yield	f = a - e: Dividend Yield less Bond Yield	g = d-e: CASH RETURN yield less Bond yield	2017E P/E	Issuer Rating
Discretionary	1	ABG	Asbury Automotive Group	$59.29	$1,313	$17.3	-17.9%	0.0%		23.4%	23.4%	2.6%	5.8%	-	6	9.0x	BB+
	2	BBY	Best Buy Co Inc	$31.69	$10,228	$152.2	-0.3%	47.6%	3.6%	7.9%	11.5%	2.6%	3.6%	1	199	10.4x	BB+
	3	DDS	Dillards Inc-Cl A	$62.79	$2,169	$35.5	-10.2%	4.3%	0.4%	25.8%	26.2%	2.6%	5.7%	-524	120	10.7x	BBB-
	4	EAT	Brinker International Inc	$47.86	$2,666	$57.4	-6.0%	36.2%	2.7%	13.3%	16.0%	2.6%	3.7%	-105	228	13.5x	BBB-
	5	GNC	Gnc Holdings Inc-Cl A	$26.69	$1,825	$45.1	-19.7%	25.4%	3.1%	50.2%	53.3%	2.6%	6.8%	-367	888	8.7x	BB+
	6	GPS	Gap Inc/The	$23.95	$9,531	$150.3	-8.8%	46.1%	4.0%	8.1%	12.1%	2.6%	5.6%	-156	45	11.6x	BB+
	7	HOG	Harley-Davidson Inc	$48.26	$8,739	$145.4	0.5%	34.2%	2.9%	17.1%	20.0%	-	3.3%	-41	388	11.3x	A-
	8	HRB	H&R Block Inc	$23.85	$5,259	$96.4	-34.2%	52.0%	3.7%	38.4%	42.1%	2.6%	4.3%	-57	902	13.0x	BBB
	9	JWN	Nordstrom Inc	$40.46	$7,017	$183.6	-24.6%	227.4%	3.7%	29.2%	32.9%	3.3%	4.1%	-42	689	13.8x	BBB+
	10	KSS	Kohls Corp	$38.97	$7,159	$145.6	-24.0%	62.0%	5.0%	14.0%	19.0%	2.6%	5.2%	-20	330	10.0x	BBB
	11	SPLS	Staples Inc	$9.04	$5,842	$86.8	-10.3%	86.1%	5.4%		5.4%	2.6%	4.4%	96	96	9.7x	BBB-
	12	TUP	Tupperware Brands Corp	$58.07	$2,933	$36.0	-1.4%	68.3%	4.7%		4.7%	2.6%	3.5%	122	122	12.5x	BBB-
	13	WEN	Wendy'S Co/The	$9.75	$2,599	$35.7	-15.3%	46.7%	2.5%	43.6%	46.0%	2.6%	7.0%	-452	637	22.9x	B
	14	WYN	Wyndham Worldwide Corp	$75.51	$8,453	$91.5	-1.8%	35.4%	2.7%	8.0%	10.7%	2.6%	3.5%	-78	122	12.1x	BBB-
Industrials	15	AYR	Aircastle Ltd	$22.10	$1,742	$7.6	0.0%	64.8%	4.6%	2.9%	7.5%	2.6%	4.8%	-20	52	9.9x	BB+
	16	PBI	Pitney Bowes Inc	$18.74	$3,535	$31.8	-15.035893	39.0%	4.2%	7.5%	11.6%	2.6%	3.9%	28	214	9.0x	BBB
	17	TKR	Timken Co	$31.53	$2,498	$25.0	4.5%	67.4%	3.3%	10.0%	13.3%	2.6%	4.2%	-88	163	14.6x	BBB
Technology	18	CSC	Computer Sciences Corp	$48.22	$6,715	$90.8	41.8%	366.4%	1.1%	24.7%	25.8%	2.6%	3.7%	-254	363	14.9x	BBB *-
	19	NCR	Ncr Corporation	$30.64	$3,796	$31.7	19.5%	0.0%		31.9%	31.9%	2.6%	5.6%	-	233	9.6x	BB+
	20	NTAP	Netapp Inc	$25.54	$7,153	$77.9	-9.5%	56.9%	3.1%	13.4%	16.5%	3.3%	3.3%	-19	317	10.4x	BBB+
	21	NUAN	Nuance Communications Inc	$16.08	$4,490	$45.8	-24.9%	0.0%		19.5%	19.5%	2.6%	3.9%	-	99	9.5x	BB-
Materials	22	GEF	Greif Inc-Cl A	$38.71	$2,149	$9.5	19.9%	194.5%	4.3%	7.3%	11.6%	2.6%	3.6%	69	251	14.2x	BB
	23	PKG	Packaging Corp Of America	$73.17	$6,886	$63.1	10.3%	47.3%	3.2%	3.7%	6.9%	2.6%	3.4%	-25	68	15.6x	BBB
Energy	24	TRGP	Targa Resources Corp	$41.32	$6,812	$103.8	46.9%	71.8%	8.4%		8.4%	2.6%	6.3%	217	217	110.2x	BB-
Financials	25	AWH	Allied World Assurance Co	$35.50	$3,183	$17.9	-10.3%	343.6%	3.0%	8.3%	11.3%	3.3%	4.0%	-108	100	14.3x	BBB+
	26	AXS	Axis Capital Holdings Ltd	$53.12	$4,936	$27.0	-11.3%	25.8%	2.6%	18.8%	21.3%	-	3.4%	-79	390	12.0x	A-
	27	BGCP	Bgc Partners Inc-Cl A	$8.99	$2,466	$10.1	-14.1%	113.3%	7.4%	2.9%	10.3%	2.6%	4.8%	257	330	9.1x	BBB-
	28	BOKF	Bok Financial Corporation	$65.54	$4,336	$15.4	3.8%	43.9%	2.8%	4.4%	7.2%	3.3%	3.4%	-60	50	14.5x	BBB+
	29	CNA	Cna Financial Corp	$31.70	$8,574	$4.3	-9.4%	260.2%	3.2%	6.3%	9.5%	2.6%	3.4%	-23	135	10.0x	BBB
	30	NAVI	Navient Corp	$13.77	$4,551	$38.9	14.5%	36.3%	4.9%	19.0%	23.9%	2.6%	8.1%	-318	156	7.0x	BB
	31	PBCT	People'S United Financial	$15.39	$4,784	$68.7	-10.5%	76.5%	4.5%	0.1%	4.6%	3.3%	3.6%	98	100	16.1x	BBB+
	32	TRMK	Trustmark Corp	$25.84	$1,747	$10.5	6.4%	54.8%	3.7%		3.7%	3.3%	3.3%	37	37	14.7x	BBB+
Staples	33	FLO	Flowers Foods Inc	$18.72	$3,872	$38.4	-18.7%	65.6%	3.4%	2.8%	6.2%	2.6%	3.1%	31	101	17.3x	BBB
	34	VGR	Vector Group Ltd	$22.36	$2,768	$14.1	-11.0%	342.1%	7.1%		7.1%	2.6%	5.1%	200	200	28.0x	B
Utilities	35	ABY	Atlantica Yield Plc	$19.84	$1,988	$8.0	-2.9%		8.3%		8.3%	2.6%	7.4%	92	92	24.5x	B+
	36	AES	Aes Corp	$12.51	$8,244	$53.1	24.9%	97.2%	3.5%	6.3%	9.8%	2.6%	5.1%	-155	2	11.2x	BB
		Average			$4,804	$57.6	-3.3%	90%	4%	16%	17%	3%	5%	-53	234	15.7x	
		Median			$4,413	$38.7	-9.1%	55%	4%	12%	12%	3%	4%	-25	159	12.0x	

Source: Fundstrat, Bloomberg, Factset,

LEADERS AND LAGGARDS: History says Resources rebound…

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

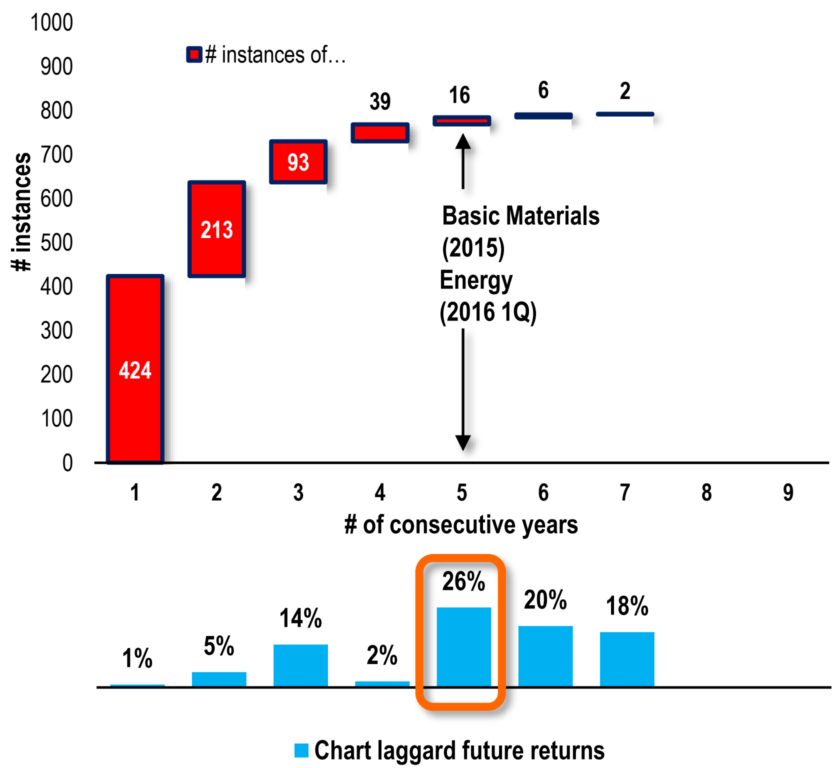
History shows that when a group has been a leader or a laggard for more than 3 consecutive years, that is when investors need to start paying attention:

- 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

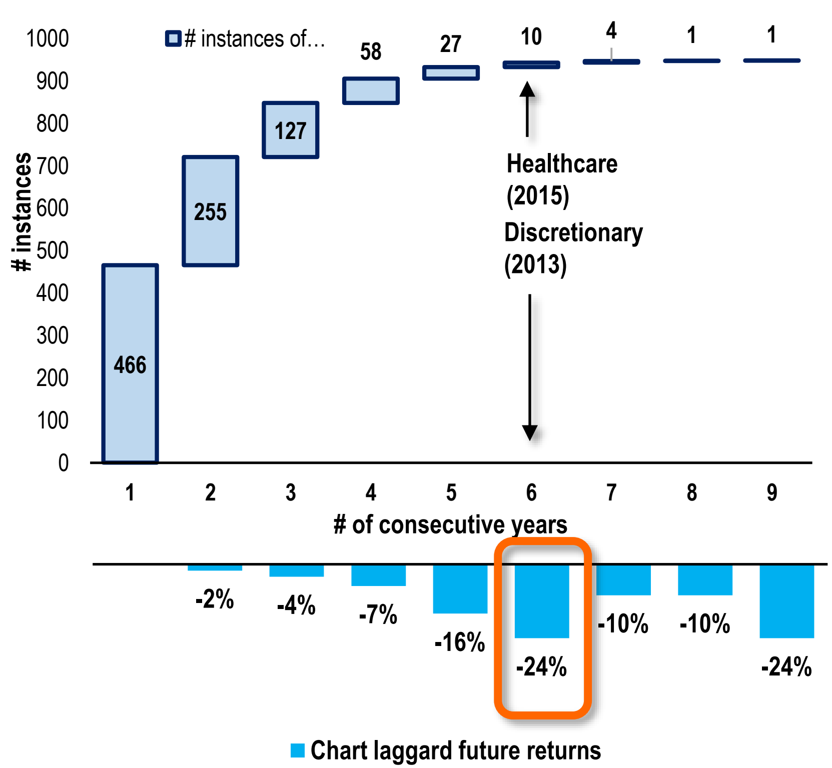
Figure: Comparative likelihood of Laggards "staying laggards" and Leaders "staying leaders"

Since 1927

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



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



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

Group name	Bloomberg ticker	Consecutive yrs of under-performance	a Cumulative under-performance	2015 relative return	b YTD 2016 relative return	c = (b / a) 2016 return as % of cumulative
Oil & Gas Drilling	S5OILD	6	-145%	-31%	-15%	10%
Steel	S5STEL	6	-126%	-18%	17%	13%
Oil & Gas Exploration & Productio	S5OILP	6	-110%	-35%	16%	15%
Communications Equipment	S5CMEQ	6	-69%	-13%	10%	14%
Coal & Consumable Fuels	RGUSELCO	5	-155%	-79%	133%	86%
Diversified Metals & Mining	S5DIVM	5	-150%	-70%	49%	32%
Gold	S5GOLD	5	-133%	-4%	122%	92%
Construction & Farm Machinery &	S5CSTF	5	-92%	-31%	18%	20%
Oil & Gas Equipment & Services	S5OILE	5	-82%	-20%	7%	8%
Integrated Oil & Gas	S5IOIL	4	-74%	-16%	7%	9%
Apparel, Accessories & Luxury Go	S5APAC	4	-69%	-24%	-4%	5%
Trading Companies & Distributors	S5TRAD	4	-69%	-20%	2%	3%
IT Consulting & Other Services	S5ITCS	4	-62%	-3%	5%	8%
Integrated Telecommunications Ser	S5ITEL	4	-53%	-1%	11%	20%
Household Products	S5HOPR	4	-31%	-7%	2%	8%
Industrial Gases	S5INDG	4	-40%	-12%	12%	31%
Average			-91%	-24%	24%	23%
% outperforming					88%	

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

Group name	Consecutive yrs of out-performance	a Cumulative out-performance	2015 relative return	b YTD 2016 relative return	c = (b / a) 2016 return as % of cumulative
Health Care Distributors	9	146%	6%	-9%	6%
Apparel Retail	7	335%	2%	-6%	2%
Distillers & Vintners	6	252%	33%	5%	2%
Housewares & Specialties	6	230%	16%	5%	2%
Home Improvement Retail	6	223%	22%	-3%	1%
Cable & Satellite	6	139%	4%	15%	11%
Biotechnology	5	247%	6%	-18%	7%
Data Processing & Outsourced Ser	5	134%	11%	-3%	2%
Drug Retail	5	92%	6%	-7%	7%
Building Products	4	150%	25%	10%	7%
Application Software	4	75%	21%	1%	1%
Real Estate Services	4	65%	2%	-25%	39%
Property & Casualty Insurance	4	34%	8%	3%	9%
Electronic Manufacturing Services	4	26%	3%	-14%	53%
Average		153%	12%	-3%	11%
% outperforming				43%	

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

Source: Fundstrat, FactSet, Bloomberg.

Laggards that also sport a margin of safety

We identified 15 laggards stock ideas using the following criteria:

i. The stock is a member of one of the 16 “Laggard” industries we identified (see slide 7 for the list of industries).

ii. The stock’s dividend yield is greater than its own long-term corporate bond yield.

Figure: 15 “Laggards become Leaders” stock ideas

Priced as of 7/14/2016

	15 Stock Ideas								Company fundamentals				Stocks new bonds, Value, Growth			
									2016 Street estimate revision		Valuation					
		Ticker	Name	Industry	Current price	Market cap ($B)	2015 relative return	YTD relative return	Sales	EPS	P/E ('16E)	Div yield	Div yield > bond yield	Value	Growth	Value & Growth
Technology	1	CSCO	Cisco Systems Inc	Communications Equipment	$29.76	$150	-2%	4%	0.2%	2.0%	12.4x	3.6%	x	x	x	x
	2	IBM	Intl Business Machines Corp	IT Consulting & Other Services	$160.28	$154	-13%	11%	1.4%	-0.3%	11.8x	3.3%	x	x	x	x
Consumer Discretionary	3	RL	Ralph Lauren Corp	Apparel, Accessories & Luxury	$98.92	$8	-39%	-17%	-5.7%	-12.8%	18.3x	2.1%	x	x		
Industrials	4	CAT	Caterpillar Inc	Construction Machinery & Heavy	$80.06	$47	-25%	12%	-2.4%	-2.7%	29.7x	3.8%	x	x		
	5	PCAR	Paccar Inc	Construction Machinery & Heavy	$54.07	$19	-30%	8%	-1.6%	-0.1%	14.1x	4.2%	x	x		
Materials	6	APD	Air Products & Chemicals Inc	Industrial Gases	$148.90	$32	-9%	9%	-2.7%	0.1%	19.5x	2.5%	x	x	x	x
	7	PX	Praxair Inc	Industrial Gases	$118.35	$34	-20%	10%	1.5%	0.3%	20.6x	3.2%	x	x	x	x
Energy	8	HP	Helmerich & Payne	Oil & Gas Drilling	$68.37	$7	-20%	22%	-13.5%	-42.4%	n/m	4.0%	x	x		
	9	SLB	Schlumberger Ltd	Oil & Gas Equipment & Services	$79.10	$110	-18%	8%	5.9%	-30.9%	73.5x	2.5%	x	x		
	10	CVX	Chevron Corp	Integrated Oil & Gas	$106.70	$201	-19%	13%	5.5%	13.4%	37.4x	4.1%	x	x		
	11	OXY	Occidental Petroleum Corp	Integrated Oil & Gas	$77.21	$59	-15%	8%	-2.0%	6.5%	n/m	3.9%	x	x	x	x
	12	XOM	Exxon Mobil Corp	Integrated Oil & Gas	$94.95	$394	-15%	16%	6.3%	15.9%	27.8x	4.0%	x	x		
Consumer Staples	13	PG	Procter & Gamble Co/The	Household Products	$85.87	$229	-12%	2%	-0.2%	-1.0%	22.3x	3.2%	x	x		
Telecom Services	14	T	At&T Inc	Integrated Telecommunication S	$42.77	$263	3%	18%	-1.1%	0.4%	14.9x	4.5%	x	x		
	15	VZ	Verizon Communications Inc	Integrated Telecommunication S	$55.84	$228	-0%	15%	-2.1%	-2.1%	14.4x	4.1%	x	x	x	x
		Average				**$129**	**-16%**	**9%**	**-0.7%**	**-3.6%**	**24.4x**	**3.5x**				
		Median				**$110**	**-15%**	**10%**	**-1.1%**	**-0.1%**	**19.5x**	**3.8x**				
		Win ratio					**7%**	**93%**	**40%**	**47%**			**100%**	**100%**	**40%**	**40%**

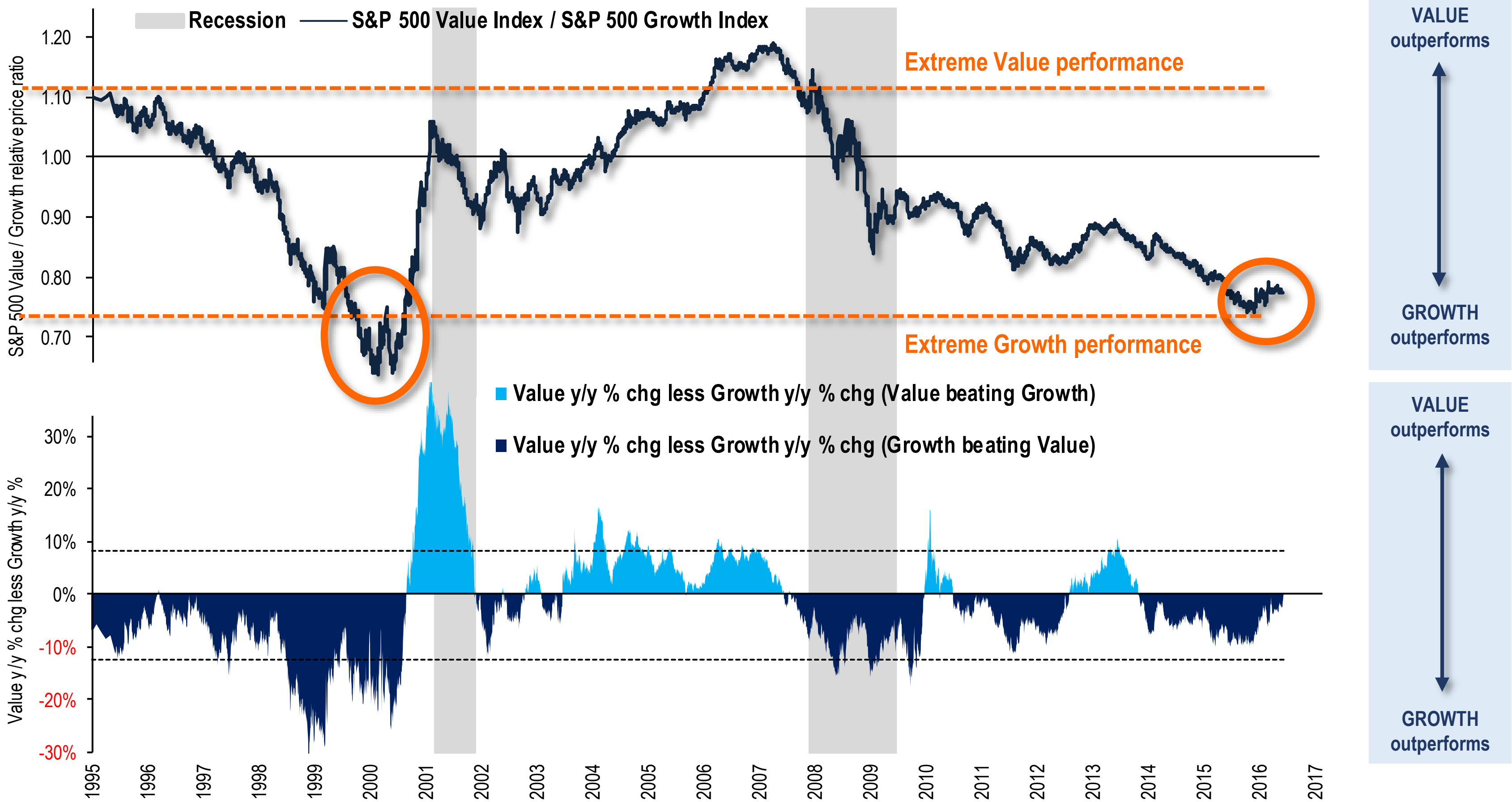
Source: Fundstrat, FactSet, Bloomberg.

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



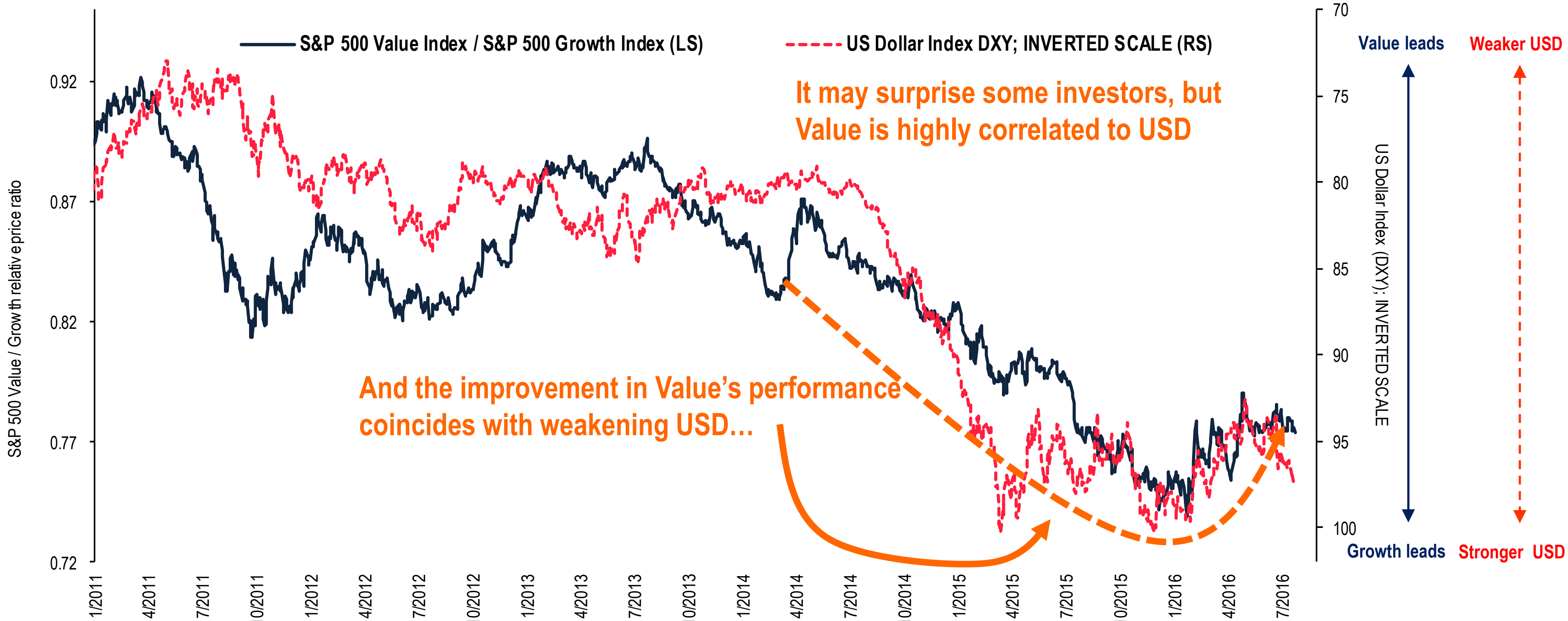
Source: Fundstrat, Bloomberg.

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.

"Growth as cheap as Value" with margin of safety

Stocks that are in both the S&P 500 Value and Growth Index (172 names) are up 11% YTD, outperforming the S&P 500 by 420bp. We have spoken with many growth managers who are challenged to find value ideas that work—hence, what is compelling is that these stocks are likely to appear to both Growth managers as well as Value managers. The screened list of stocks below are:

i. In both the **S&P 500 Value** and **S&P 500 Growth** Index;

ii. Dividend yield > LT bond yield of same company

Figure: 18 "Growth as cheap as Value" stocks with a margin of safety

Priced as of 7/14/2016

								2016 consensus estimate revision			a	b	c = (a - b)		
		Ticker	Name	Industry	Current price	Market cap ($M)	YTD relative return	Sales	EPS	P/E ('16E)	Div yield	Bond yield	Div yield less bond yield	Value	Growth
Technology	1	CSCO	Cisco Systems Inc	Communications Equipment	$29.76	$149,684	3.7%	1.2%	4.0%	12.4x	3.6%	2.9%	**63 bp**	x	x
	2	IBM	Intl Business Machines Corp	IT Consulting & Other Services	$160.28	$153,863	10.6%	-4.3%	-9.4%	11.8x	3.3%	2.5%	**86 bp**	x	x
	3	INTC	Intel Corp	Semiconductors	$35.20	$166,214	-3.7%	4.9%	1.4%	14.4x	3.0%	2.7%	**26 bp**	x	x
	4	TXN	Texas Instruments Inc	Semiconductors	$64.81	$65,084	12.4%	-1.5%	2.4%	20.6x	2.4%	2.0%	**45 bp**	x	x
	5	XLNX	Xilinx Inc	Semiconductors	$47.84	$12,117	-4.0%	3.1%	n/m	22.4x	2.7%	2.6%	**8 bp**	x	x
Industrials	6	MMM	3M Co	Industrial Conglomerates	$180.90	$109,718	14.2%	0.3%	8.6%	21.7x	2.5%	2.5%	**7 bp**	x	x
	7	UPS	United Parcel Service-Cl B	Air Freight & Logistics	$111.50	$98,418	10.0%	5.4%	6.3%	19.1x	2.8%	2.3%	**53 bp**	x	x
Materials	8	APD	Air Products & Chemicals Inc	Industrial Gases	$148.90	$32,174	8.6%	1.0%	12.0%	19.5x	2.5%	1.9%	**55 bp**	x	x
	9	PX	Praxair Inc	Industrial Gases	$118.35	$33,761	9.7%	-4.4%	-4.5%	20.6x	3.2%	2.1%	**114 bp**	x	x
Financials	10	AMP	Ameriprise Financial Inc	Asset Management & Custody Bar	$95.76	$15,878	-15.9%	-0.6%	3.4%	9.7x	3.1%	3.1%	**1 bp**	x	x
	11	BLK	Blackrock Inc	Asset Management & Custody Bar	$355.19	$58,590	-1.6%	-0.1%	-0.2%	17.1x	2.7%	2.5%	**22 bp**	x	x
	12	SPG	Simon Property Group Inc	Retail REITs	$222.17	$68,743	8.4%	1.9%	1.4%	35.8x	3.0%	2.7%	**24 bp**	x	x
Energy	13	OXY	Occidental Petroleum Corp	Integrated Oil & Gas	$77.21	$58,968	8.4%	-11.2%	-476.1%	n/m	3.9%	3.1%	**86 bp**	x	x
Healthcare	14	LLY	Eli Lilly & Co	Pharmaceuticals	$80.59	$88,958	-10.2%	3.9%	4.0%	22.3x	2.5%	2.5%	**4 bp**	x	x
	15	PFE	Pfizer Inc	Pharmaceuticals	$36.92	$223,914	8.5%	4.9%	4.5%	15.3x	3.3%	3.2%	**10 bp**	x	x
Staples	16	KO	Coca-Cola Co/The	Soft Drinks	$45.69	$197,664	0.5%	-4.1%	-2.6%	23.3x	3.1%	2.5%	**61 bp**	x	x
	17	PEP	Pepsico Inc	Soft Drinks	$109.96	$158,250	4.2%	-0.4%	2.9%	22.2x	2.8%	2.7%	**10 bp**	x	x
	18	PM	Philip Morris International	Tobacco	$103.19	$160,075	11.5%	-0.0%	1.2%	22.3x	4.1%	2.6%	**146 bp**	x	x
		Average				**$102,893**	**4.2%**	**-0.0%**	**-25.9%**	**19.4x**	**3.0%**	**2.6%**	**48 bp**		
		Median				**$93,688**	**8.4%**	**0.2%**	**2.4%**	**20.6x**	**3.0%**	**2.5%**	**45 bp**		
		Win ratio						**50%**	**71%**						

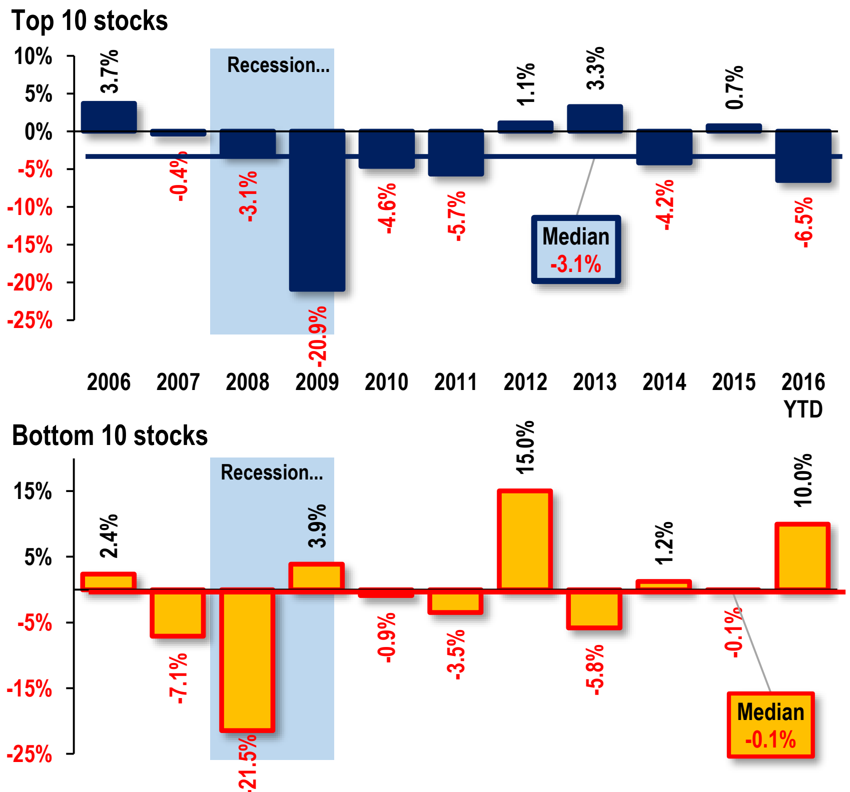
Source: Fundstrat, FactSet, Bloomberg.

Since 2006, investors better off buying prior years losers…

In December 2015, we highlighted how buying the prior years losers generally outperforms buying the prior year's winners (see "FANG likely ends with a DANG" dated 12/11/15). And this is indeed playing out in 2016.

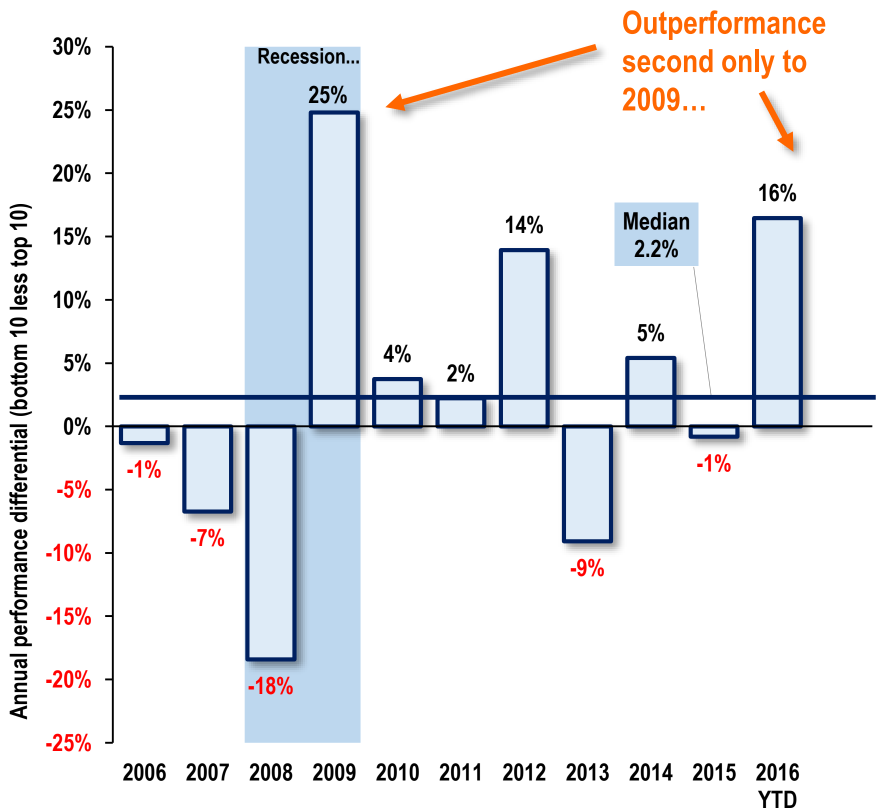
- **The annual performance differential is the second largest since 2006—the other years where this was similar in magnitude or greater was 2009 and 2012.**
- **This, in our view, speaks to the greater divergence in performance in 2015—the search for performance pushed investors into the same stocks.**

Figure: Returns of buying last year's top / bottom stocks



Source: Fundstrat, FactSet, Bloomberg.

Figure: Differential of buying last year's bottom vs top



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
F	1	AMZN	Amazon.Com Inc	118.5%	**4.4%**
	2	GOOGL	Alphabet Inc-Cl A	47.3%	**-11.8%**
A	3	MSFT	Microsoft Corp	20.2%	**-8.9%**
	4	FB	Facebook Inc-A	34.9%	**5.7%**
	5	GE	General Electric Co	24.0%	**-1.0%**
N	6	HD	Home Depot Inc	26.7%	**-4.6%**
	7	V	Visa Inc-Class A Shares	19.0%	**-5.2%**
G	8	SBUX	Starbucks Corp	47.1%	**-10.3%**
	9	NFLX	Netflix Inc	135.1%	**-20.7%**
	10	NKE	Nike Inc -Cl B	30.7%	**-12.7%**
		Average		**50.4%**	**-6.1%**
		Win ratio		**100%**	**20%**

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%	**14.6%**
2	XOM	Exxon Mobil Corp	-15.0%	**16.1%**
3	KMI	Kinder Morgan Inc	-64.0%	**34.2%**
4	BRK/B	Berkshire Hathaway Inc-Cl E	-11.3%	**4.7%**
5	CVX	Chevron Corp	-19.1%	**13.2%**
6	QCOM	Qualcomm Inc	-32.0%	**3.8%**
7	ORCL	Oracle Corp	-18.0%	**8.3%**
8	UNP	Union Pacific Corp	-33.6%	**15.7%**
9	PG	Procter & Gamble Co/The	-12.1%	**3.0%**
10	AAPL	Apple Inc	-3.9%	**-12.4%**
	Average		**-23.7%**	**10.1%**
	Win ratio		**0%**	**90%**

Wow....

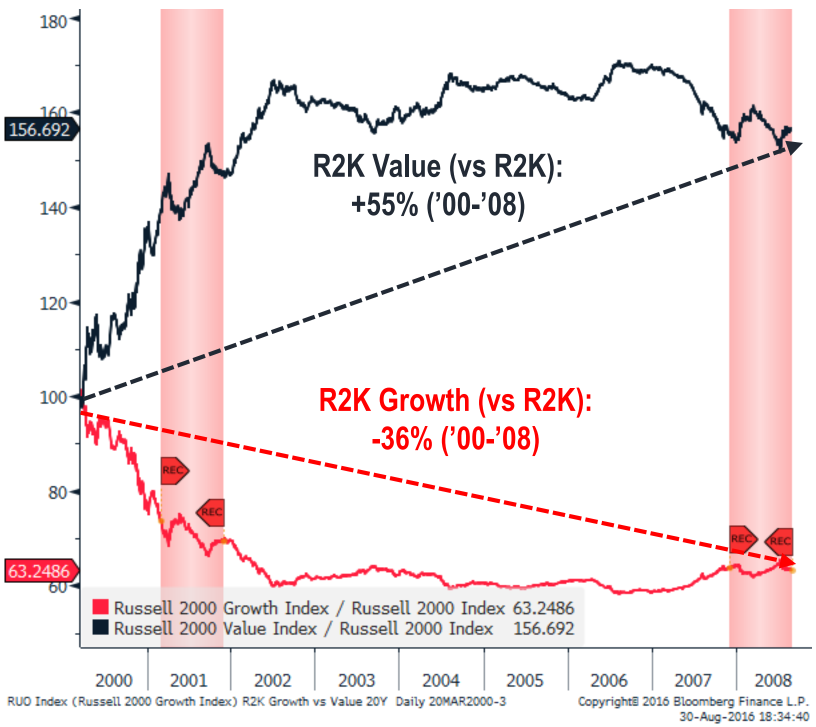
Source: Fundstrat, FactSet, Bloomberg.

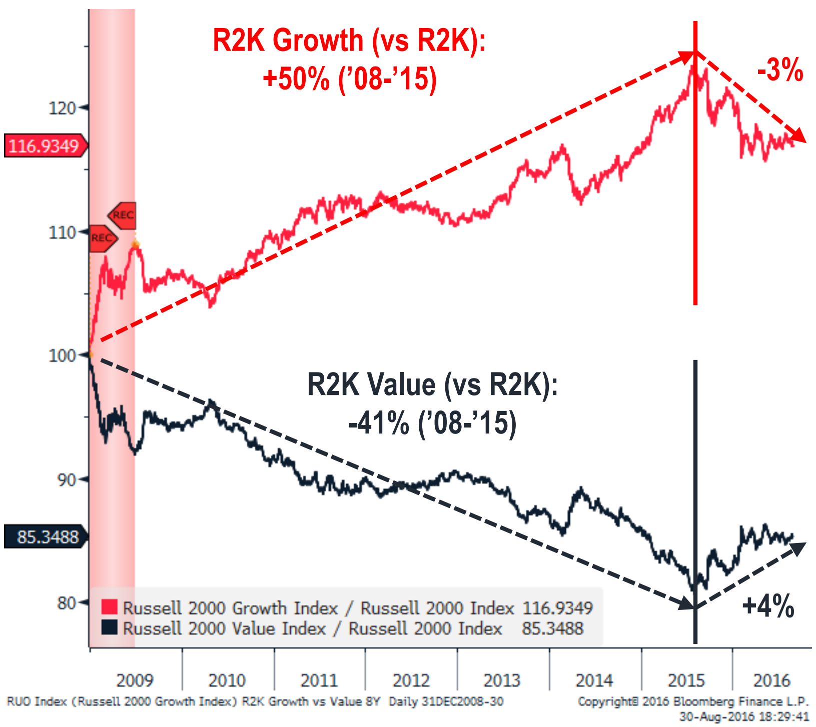
Is this an 8-year cycle turning to small-cap value?

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: <u>Relative</u> Performance of Russell 2000 Growth and Value (vs Russell 2000)
Since 2000





Source: Fundstrat, FactSet, Bloomberg

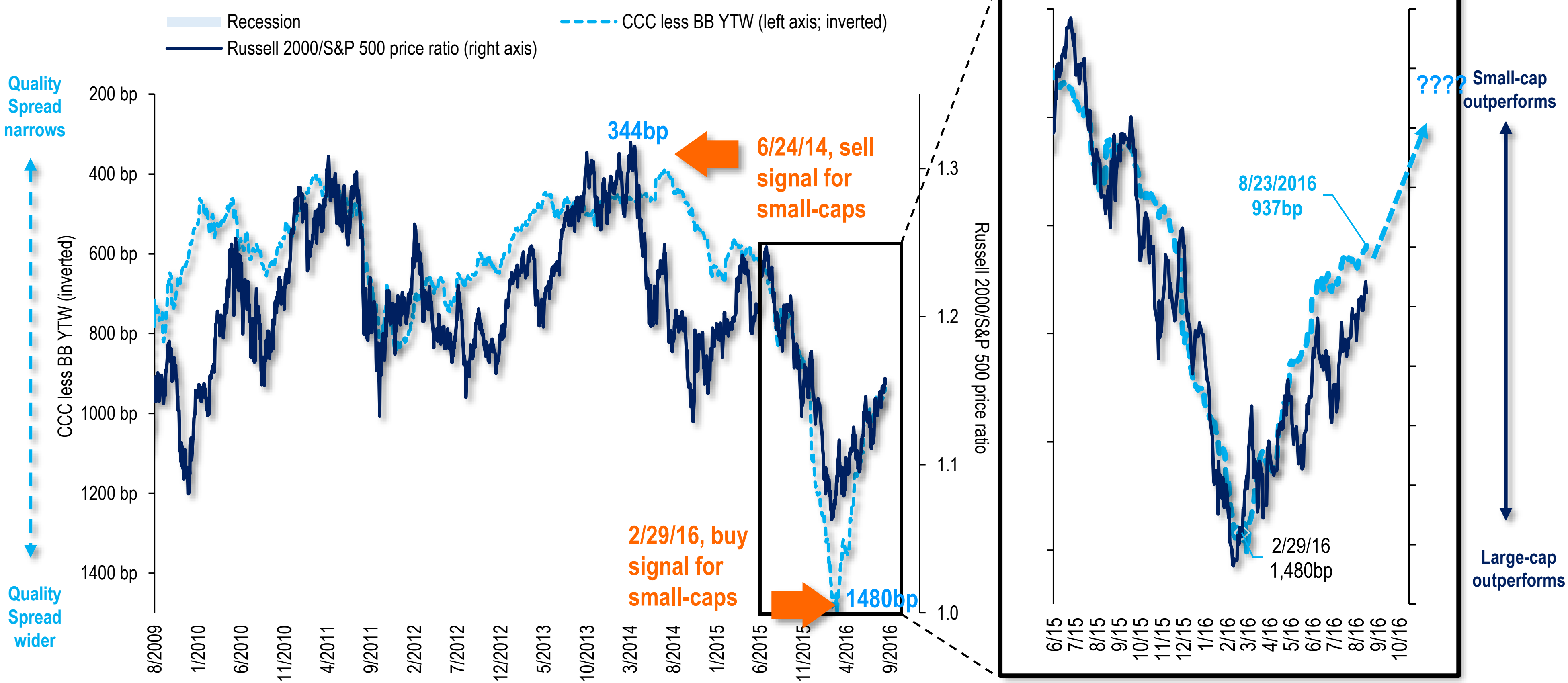
Buy Small-caps: Quality spread rally (BB vs CCC) argues this

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.

Best strategies are Small-caps and Tech on quality spread rally

- **More specifically, small-caps see further gains after a quality spread rally (73% of time, beating S&P 500).**
- **Technology also outperforms, with Technology Hardware beating 85% of the time.**

Figure: Factor and Sector Comparative Return
Since 1996. Based on the top decile quality spread rally

	Range of 6M chg in CCC less BB spreads			#	S&P 500 return (%)		
	Low	-	High	instances	1M	3M	6M
Decile 1	-1,705.0	-	-286.9	499	1.4%	4.7%	8.6%
Decile 2	-286.9	-	-143.0	499	0.0%	-0.5%	0.0%
Decile 3	-143.0	-	-99.0	500	1.0%	2.0%	3.5%
Decile 4	-99.0	-	-48.0	498	0.3%	1.3%	5.3%
Decile 5	-48.0	-	5.0	502	1.0%	3.1%	6.4%
Decile 6	5.0	-	60.0	504	0.8%	1.0%	4.1%
Decile 7	60.0	-	114.0	492	0.6%	1.3%	1.4%
Decile 8	114.0	-	199.8	498	-0.8%	-2.3%	-6.4%
Decile 9	199.8	-	333.9	499	-0.1%	0.7%	-2.2%
Decile 10	333.9	-	2,328.0	498	1.1%	3.2%	8.7%

Data:	6M chg in CCC less BB spreads	Latest data value:	-538
BBG code:	6M chg in CCC less BB spreads	Current decile:	1
		Total # data points:	4989

		% return			win-ratio (%)		
		1M	3M	6M	1M	3M	6M
S&P 500	**Total Return**	**1.4%**	**4.7%**	**8.6%**	**72%**	**82%**	**78%**
Relative to S&P 500							
Growth or	S&P 500 Growth	0.0%	(0.2%)	(0.7%)	50%	39%	32%
Value	S&P 500 Value	(0.0%)	0.2%	0.6%	50%	61%	67%
Small vs	Russell 2000	0.5%	2.6%	5.7%	60%	69%	73%
Large	Russell 2000 Growth	0.5%	2.3%	5.6%	54%	63%	68%
	Russell 2000 Value	0.6%	2.8%	5.6%	66%	71%	75%
Relative to S&P 500							
Cyclicals	Information Technology	0.7%	1.8%	4.5%	63%	64%	73%
	Semiconductors & Semiconductor Equipme	1.4%	3.3%	8.3%	59%	64%	61%
	Technology Hardware & Equipment	0.6%	2.0%	6.0%	65%	73%	85%
	Software & Services	0.4%	0.4%	0.6%	55%	43%	52%
	Consumer Discretionary	0.4%	2.0%	3.6%	63%	81%	70%
	Industrials	0.4%	1.7%	2.6%	62%	75%	71%
	Materials	0.3%	1.1%	1.4%	46%	54%	57%
Near	Financials	0.5%	0.9%	0.5%	51%	60%	65%
Cyclicals	Real Estate Investment Trusts	0.8%	2.5%	4.3%	55%	63%	56%
	Energy	(1.1%)	(2.6%)	(3.3%)	38%	28%	25%
Defensives	Health Care	(0.1%)	(1.0%)	(3.0%)	45%	37%	34%
	Health Care Equipment & Services	0.4%	1.7%	1.8%	56%	60%	62%
	Pharmaceuticals Biotechnology & Life Scier	(0.3%)	(2.0%)	(4.8%)	40%	33%	25%
	Consumer Staples	(0.3%)	(1.5%)	(3.2%)	46%	30%	25%
	Utilities	(1.1%)	(3.8%)	(6.0%)	33%	22%	13%
	Telecommunications Services	(1.9%)	(4.7%)	(4.7%)	33%	22%	28%

Source: Fundstrat, FactSet, Bloomberg

Executive Summary

Tactical	Portfolio Strategy	Sectors and styles
Credit	Stocks are new bonds	Regime Shift
FX / Commodities	Laggards become leaders	Cyclicals
Economy	Growth as cheap as value	Energy
Earnings Outlook	FANG ends with a D@#G!	Financials
Market outlook	Buy small-caps	Defensives

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 — Annual performance (relative to S&P 500)

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 — Annual performance (relative to S&P 500)

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 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 1982 (relative to S&P 500)

Annual performance (relative)

Sector name	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
S&P 500	15%	17%	1%	26%	15%	2%	12%	27%	-7%	26%	4%	7%	-2%	34%	20%	31%	27%	20%	-10%	-13%	-23%	26%	9%	3%	14%	4%	-38%
Value	-2%	5%	2%	-3%	1%	-2%	4%	[illegible]	-4%	-8%	[illegible]	[illegible]	[illegible]	[illegible]	-2%	-4%	-14%	-9%	14%	-0%	1%	3%	4%	1%	4%	-4%	-3%
Growth	3%	-4%	-3%	4%	-3%	2%	-3%	7%	4%	9%	-2%	-8%	2%	2%	2%	4%	14%	8%	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	4%	3%
Pure Value	—	—	—	—	—	—	—	—	—	—	—	—	—	—	-7%	-0%	-19%	-25%	19%	21%	3%	11%	14%	8%	4%	-10%	-11%
Pure Growth	—	—	—	—	—	—	—	—	—	—	—	—	—	[illegible]	[illegible]	[illegible]	11%	40%	2%	-5%	-9%	15%	7%	4%	-7%	2%	-1%
Technology	30%	13%	-10%	-5%	-28%	11%	-12%	-35%	7%	-20%	[illegible]	13%	21%	5%	23%	-3%	51%	59%	-31%	-13%	-14%	20%	-7%	-3%	-6%	12%	-5%
Consumer Discretionary	25%	6%	-5%	-1%	3%	-3%	8%	-10%	-8%	12%	13%	6%	-8%	-16%	-10%	1%	13%	[illegible]	-11%	15%	-1%	10%	3%	-10%	4%	-18%	4%
Industrials	1%	11%	-6%	-3%	-6%	1%	-5%	-2%	[illegible]	[illegible]	[illegible]	[illegible]	-3%	2%	2%	-6%	-17%	0%	15%	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	6%	-3%
Basic Materials	-12%	9%	-14%	0%	9%	11%	-5%	-9%	[illegible]	[illegible]	[illegible]	[illegible]	5%	-17%	-7%	-25%	-35%	3%	-8%	14%	[illegible]	[illegible]	[illegible]	[illegible]	2%	16%	-9%
Financials	-3%	2%	5%	17%	-4%	-15%	2%	4%	-18%	18%	15%	1%	-5%	16%	12%	14%	-17%	-17%	34%	3%	7%	2%	-1%	1%	3%	-24%	-18%
Energy	-36%	-1%	-2%	-17%	-4%	1%	5%	2%	5%	-24%	-7%	4%	1%	-8%	1%	-9%	-29%	-4%	23%	1%	10%	-4%	20%	26%	9%	29%	3%
Healthcare	5%	-9%	3%	9%	14%	6%	2%	14%	21%	24%	-23%	-18%	12%	20%	-1%	11%	16%	-31%	46%	0%	3%	-13%	-9%	2%	-8%	2%	14%
Consumer Staples	12%	-4%	7%	7%	11%	8%	3%	15%	19%	12%	-1%	-13%	8%	2%	3%	-0%	-13%	-36%	25%	5%	17%	-17%	-3%	-2%	-2%	8%	21%
Utilities	-5%	-12%	8%	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	-10%	-4%	1%	-16%	-9%	-20%	-13%	-17%	-32%	62%	-19%	-10%	-5%	11%	10%	3%	12%	7%
Telecom	-17%	-15%	15%	2%	1%	[illegible]	[illegible]	[illegible]	-11%	-18%	7%	4%	-7%	3%	-22%	6%	23%	-2%	-30%	-1%	-13%	-23%	7%	-12%	19%	5%	5%

Value regime
Growth regime
PURE Value regime
Technology 1992-1999
Discretionary 1991-1993
Energy and Banks 2000-2008
Healthcare/Staples 1983-1991

Source: Fundstrat, Bloomberg, FactSet, Thomson Reuters Datastream.

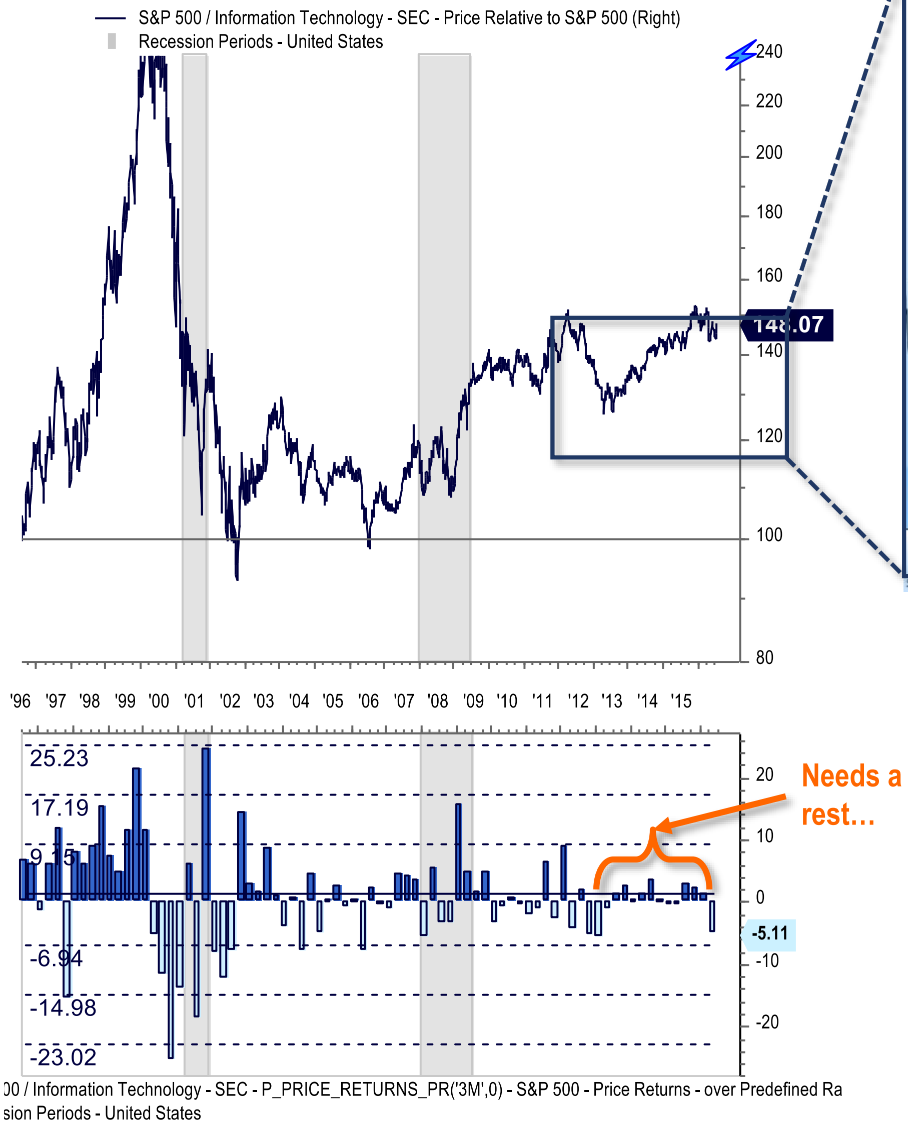
LAGGARDS TO LEADERS: Hallmarks of regime change

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.**

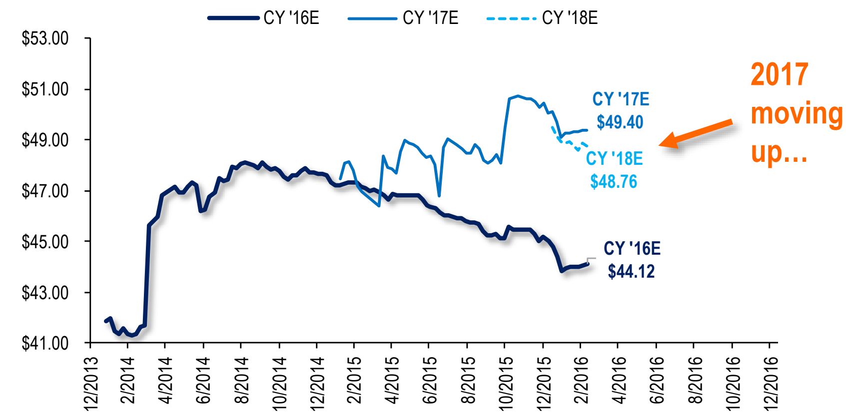
	1982-1990	1990-1999	2000-2006	2007-2015	2016-future…
Global growth driver	Japan	US and DM Technology boom	China and Commodity producers Housing	China	US and G7
Saving Flow	To: Japan From: G7	To: Asia From: Japan/G7	To: Commodity producers From: G7	To: US & Chinese consumers From: Commodity producers	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

Technology (OW): The next "Staples"…



Source: Fundstrat, Factset

Figure: EPS Forecasts FY1 and FY2
Past 24 months



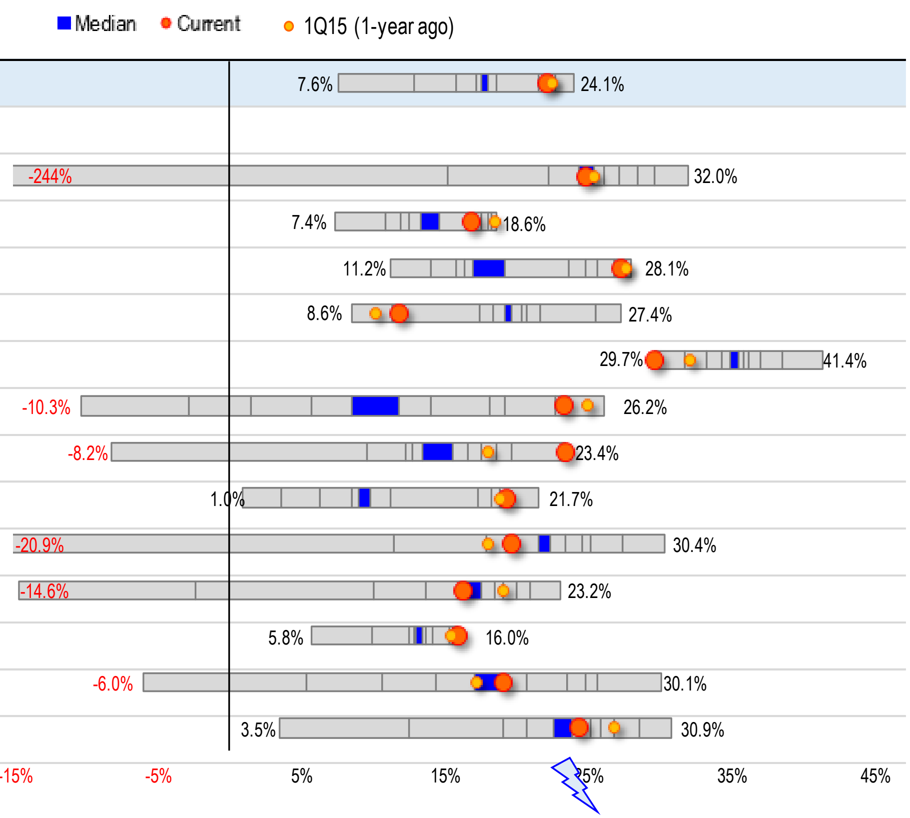
Source: Fundstrat, Factset

Technology sector EBIT margins

Figure: Deciles of Technology sector EBIT margins
Since 1999

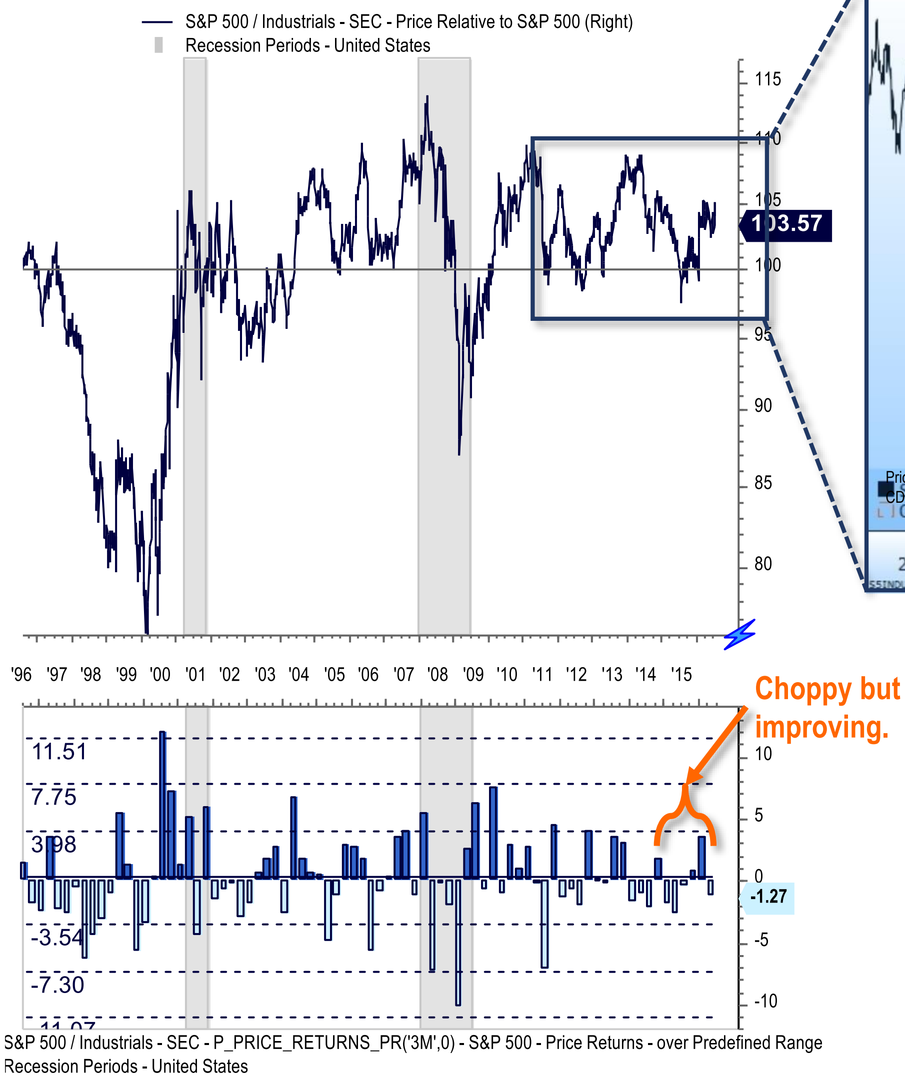
	% contribution to sector Sales		% contribution to sector EBIT		Market cap weight	
	Total Sales ($ mm)	% of total sector Sales	Total EBIT ($ mm)	% of total sector EBIT	Mkt cap ($ mm)	% weight in sector
Technology	$1,264,613	100%	$280,745	100%	$3,704,773	100%
Internet Software & Services	$181,933	14%	$45,211	16%	$800,423	22%
IT Consulting & Other Services	$133,794	11%	$22,652	8%	$258,267	7%
Data Processing & Outsourced Services	$94,492	7%	$25,878	9%	$451,621	12%
Application Software	$21,672	2%	$2,568	1%	$156,342	4%
Systems Software	$136,542	11%	$40,553	14%	$592,723	16%
Home Entertainment Software	$8,956	1%	$2,091	1%	$50,507	1%
Communications Equipment	$68,464	5%	$16,050	6%	$178,155	5%
Technology Hardware, Storage & Peripherals	$434,137	34%	$83,877	30%	$654,760	18%
Electronic Equipment & Instruments	$1,557	0%	$307	0%	$4,130	0%
Electronic Components	$14,660	1%	$2,400	1%	$38,564	1%
Electronic Manufacturing Services	$12,017	1%	$1,925	1%	$20,713	1%
Semiconductor Equipment	$18,302	1%	$3,510	1%	$49,015	1%
Semiconductors	$138,087	11%	$33,723	12%	$449,552	12%

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

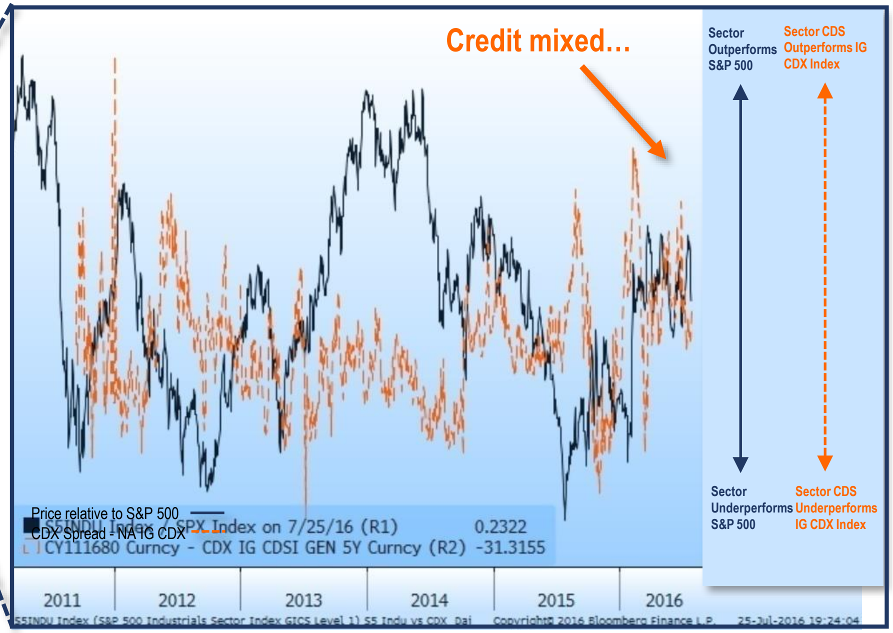


Source: Fundstrat, Factset, Bloomberg

Industrials (OW): Global momentum recovering… choppy but there…



Source: Fundstrat, Factset



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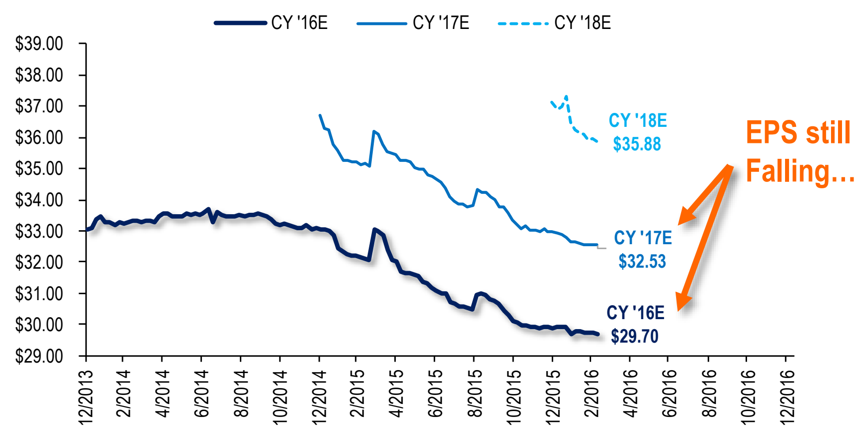
Past 24 months



Source: Fundstrat, Factset

INDUSTRIALS: Conglomerates and Machinery key to upside

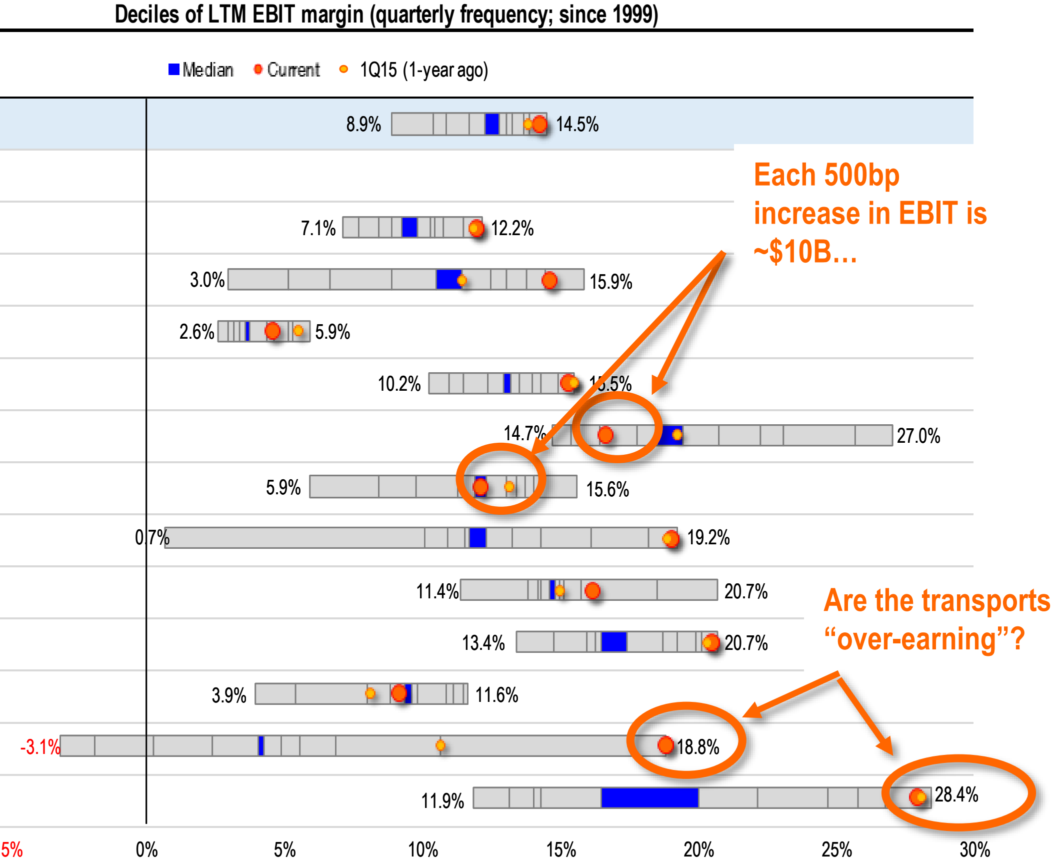
We all know about the industrial recession that has been underway for several years.

- **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

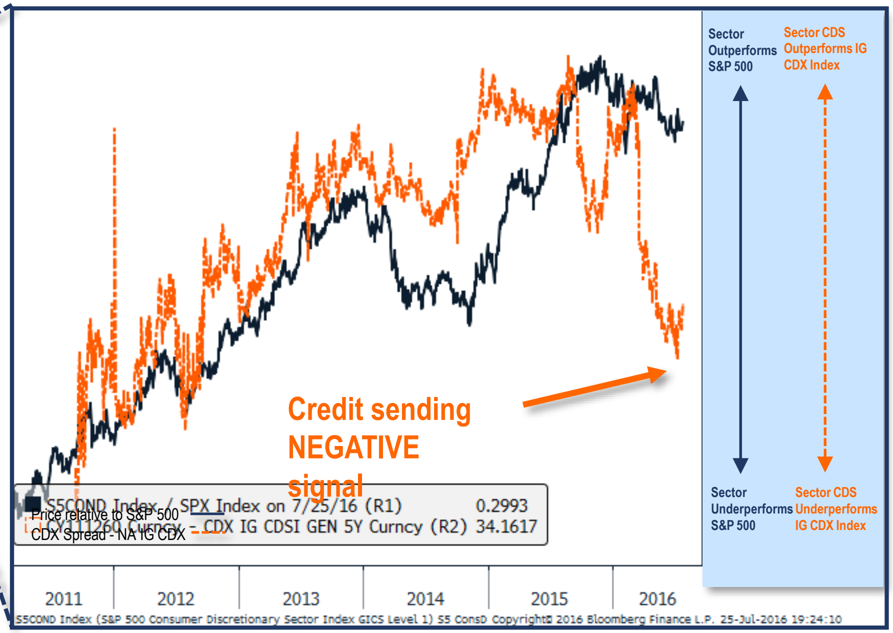
% contribution to sector Sales		% contribution to sector EBIT		Market cap weight		
Total Sales ($ mm)	% of total sector Sales	Total EBIT ($ mm)	% of total sector EBIT	Total market cap ($ mm)	% weight in sector	
$1,216,919	100%	$173,533	100%	$1,839,720	100%	Industrials
$344,460	28%	$41,165	24%	$475,176	26%	Aerospace & Defense
$9,210	1%	$1,347	1%	$16,873	1%	Building Products
$37,462	3%	$1,709	1%	$16,213	1%	Construction & Engineering
$55,221	5%	$8,443	5%	$96,768	5%	Electrical Equipment
$176,783	15%	$29,401	17%	$457,477	25%	Industrial Conglomerates
$188,180	15%	$22,798	13%	$232,106	13%	Machinery
$19,660	2%	$3,739	2%	$32,390	2%	Trading Companies & Distributors
$43,108	4%	$6,975	4%	$82,198	4%	Commercial Services & Supplies
$17,636	1%	$3,610	2%	$55,845	3%	Professional Services
$126,705	10%	$11,596	7%	$132,781	7%	Air Freight & Logistics
$139,180	11%	$26,195	15%	$101,335	6%	Airlines
$59,313	5%	$16,556	10%	$140,557	8%	Road & Rail



Source: Fundstrat, Bloomberg, FactSet

Discretionary (N): Buy "margin stories" like AMZN and Building products

Source: Fundstrat, Factset



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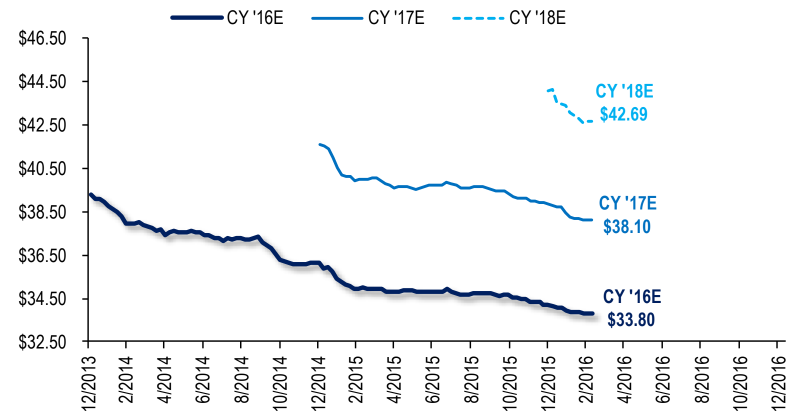


Source: Fundstrat, Factset

Consumer Discretionary sector EBIT margins

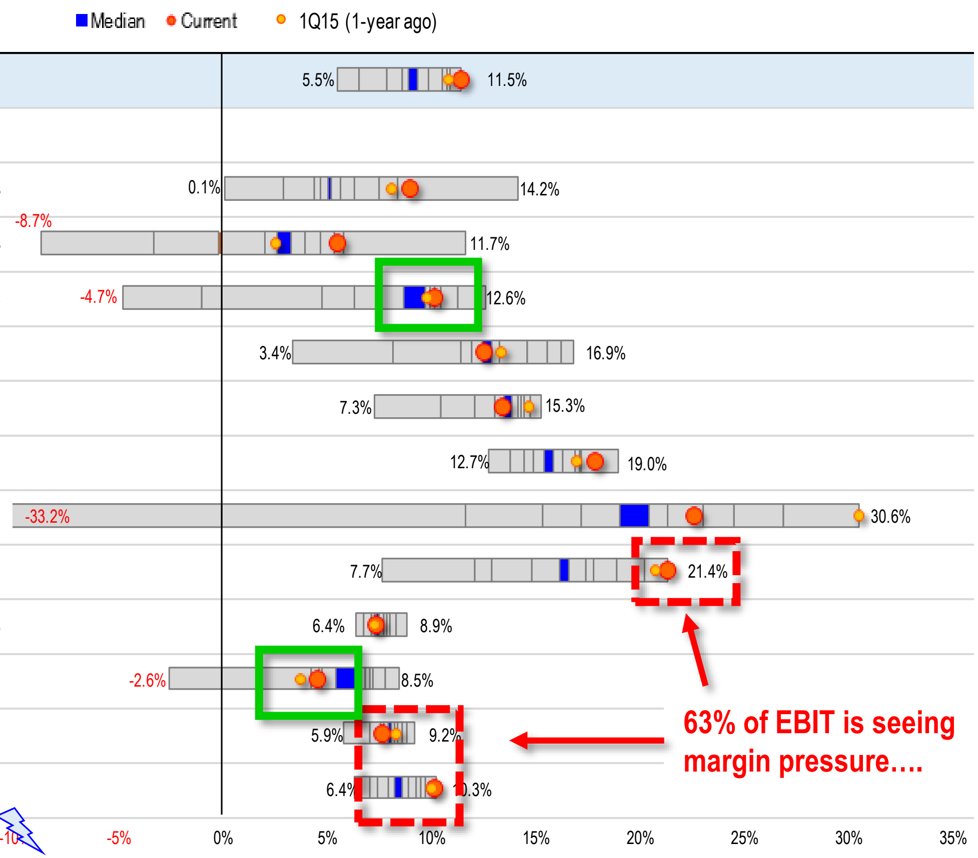
Focus on the "low margin" players like AMZN and margin growers like household durables.

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

Figure: Deciles of Consumer Discretionary sector EBIT margins
Since 1999

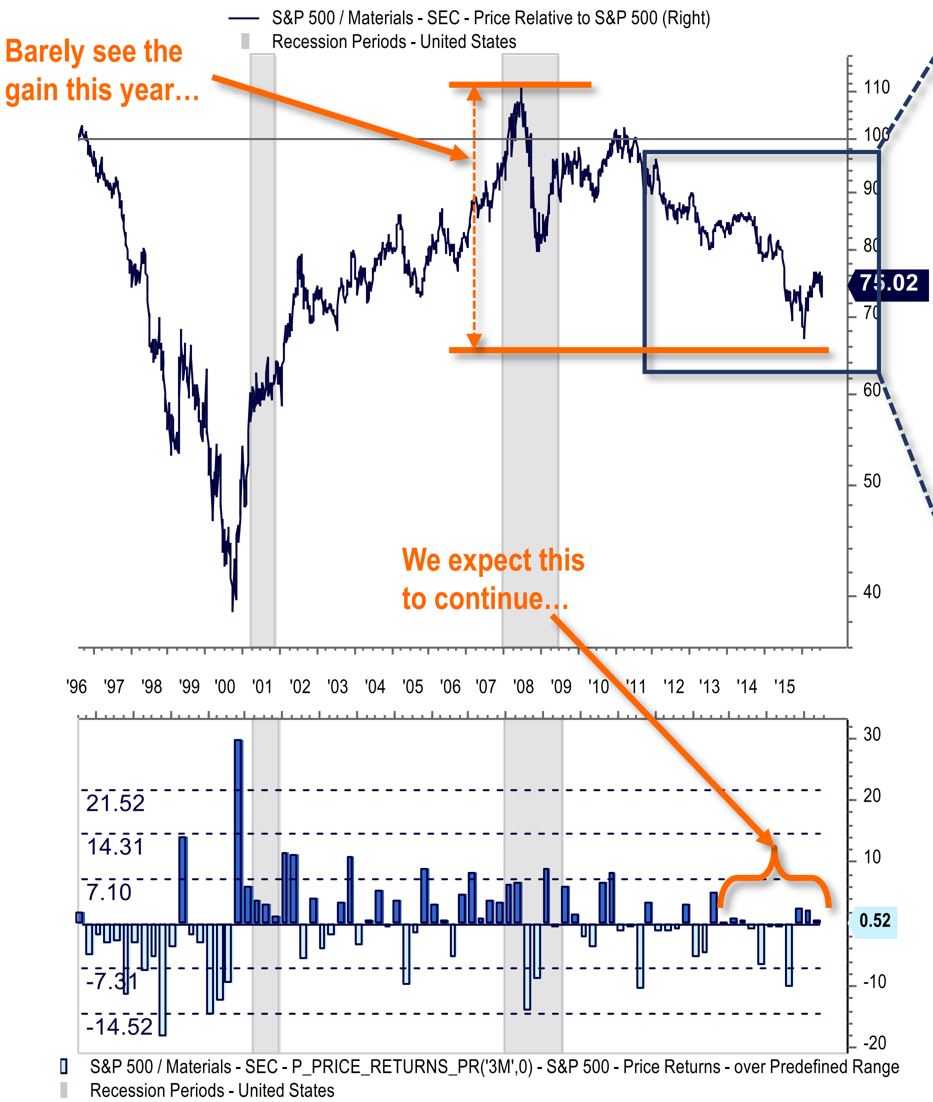
% contribution to sector Sales		% contribution to sector EBIT		Market cap weight		
Total Sales ($ mm)	% of total sector Sales	Total EBIT ($ mm)	% of total sector EBIT	Market cap ($ mm)	% weight in sector	
$1,705,421	100%	$195,678	100%	$2,356,977	100%	Discretionary sector
$76,117	4%	$6,836	3%	$60,008	3%	Auto Components
$307,909	18%	$17,070	9%	$106,342	5%	Automobiles
$74,472	4%	$7,576	4%	$94,783	4%	Household Durables
$10,159	1%	$1,274	1%	$21,153	1%	Leisure Products
$81,803	5%	$11,024	6%	$155,403	7%	Textiles, Apparel & Luxury Goods
$123,515	7%	$22,127	11%	$332,386	14%	Hotels, Restaurants & Leisure
$3,042	0%	$688	0%	$4,499	0%	Diversified Consumer Services
$325,040	19%	$69,467	36%	$520,705	22%	Media
$15,280	1%	$1,124	1%	$23,806	1%	Distributors
$131,174	8%	$5,966	3%	$454,724	19%	Internet & Catalog Retail
$170,372	10%	$13,036	7%	$104,405	4%	Multiline Retail
$386,538	23%	$39,489	20%	$478,762	20%	Specialty Retail

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



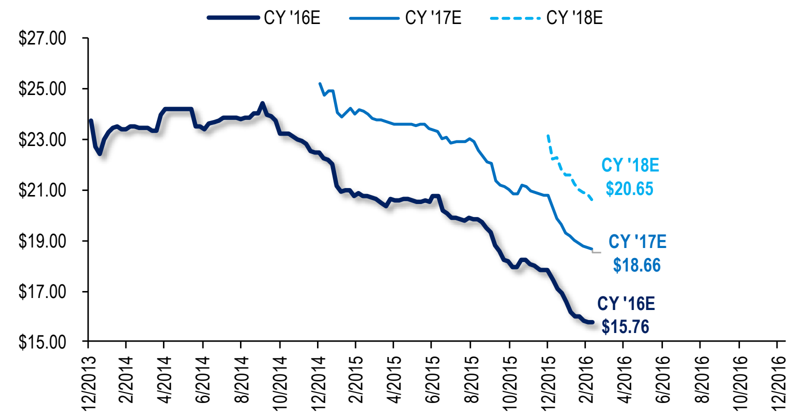
Source: Fundstrat, Factset, Bloomberg

Basic Materials (OW): 7 years lagging does not end with 6-mo rally…



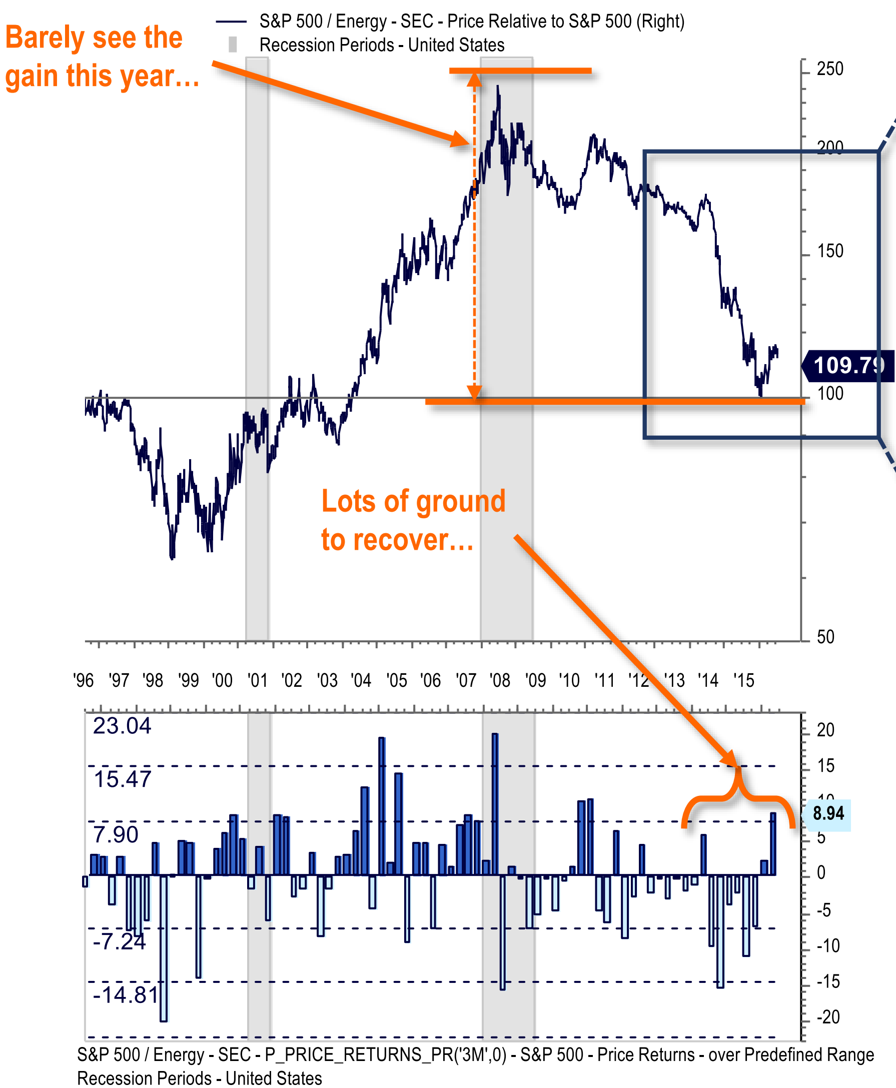
Source: Fundstrat, Factset

Figure: EPS Forecasts FY1 and FY2
Past 24 months



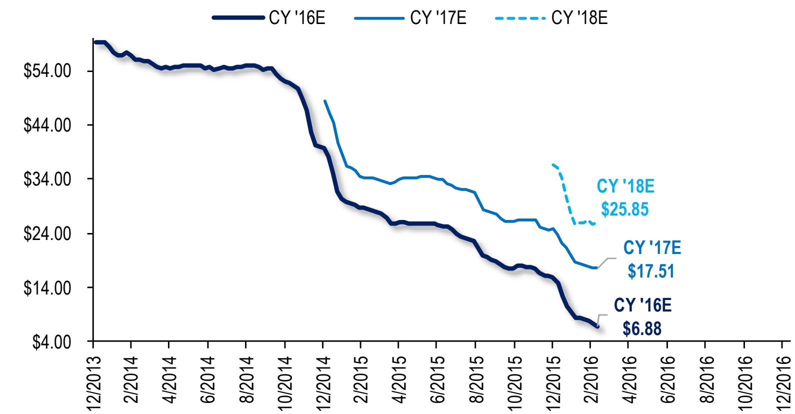
Source: Fundstrat, Factset

Energy (OW): Energy always works when oil recovers….



Source: Fundstrat, Factset

Figure: EPS Forecasts FY1 and FY2
Past 24 months



Source: Fundstrat, Factset

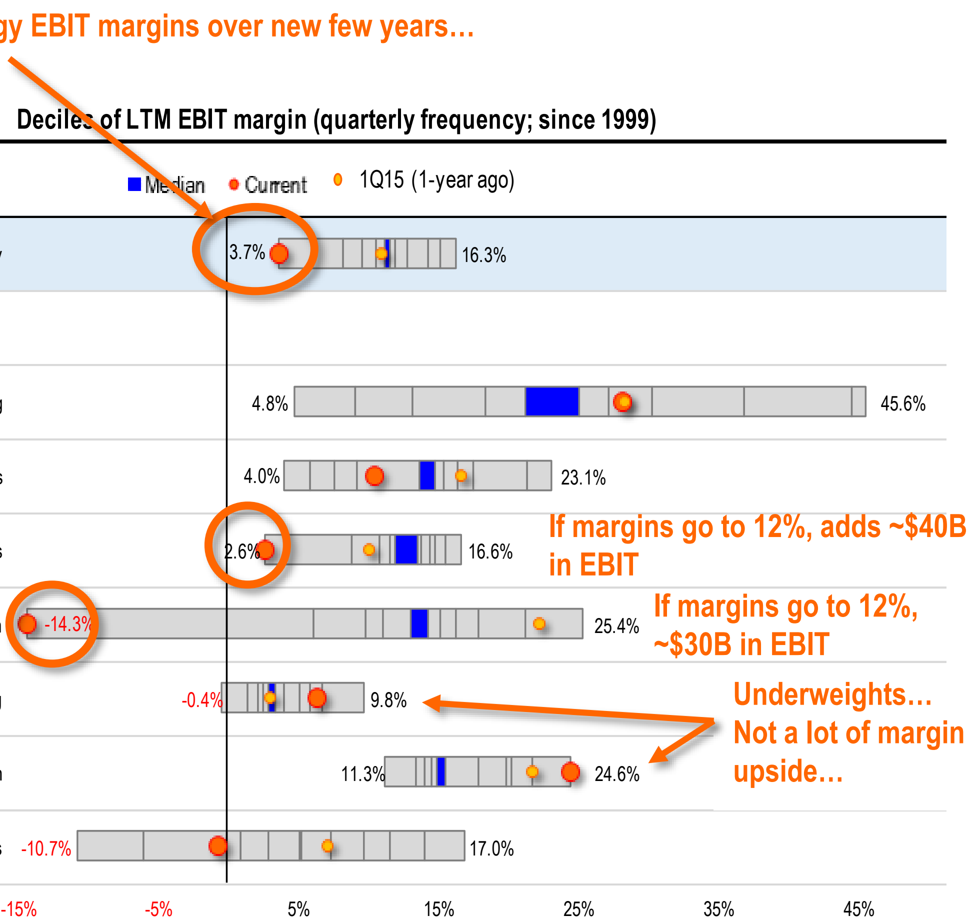
ENERGY EPS UPSIDE: Integrateds and E&Ps may add $70b in EBIT in 2017

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.**

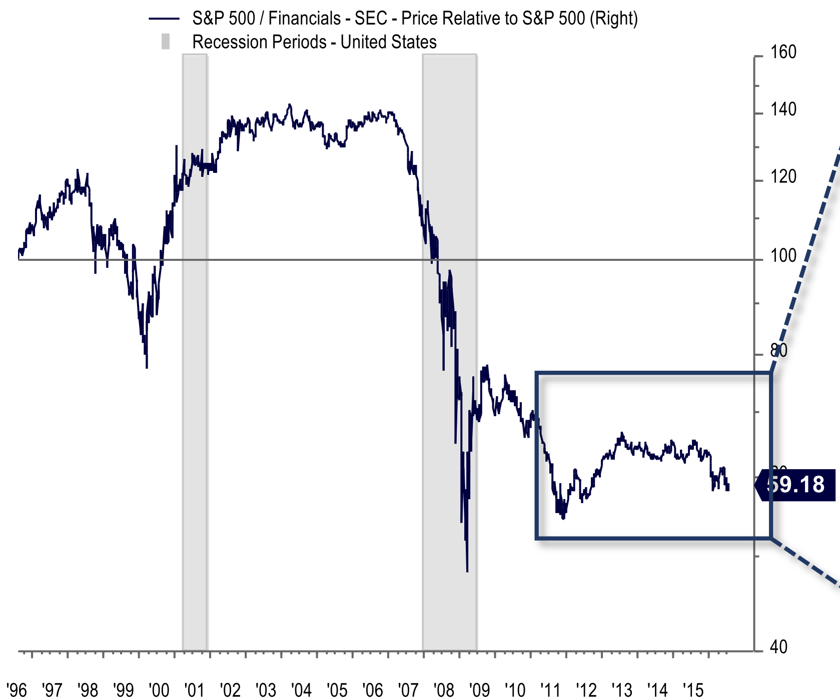
Figure: Deciles of Energy Sector EBIT margins
Since 1999

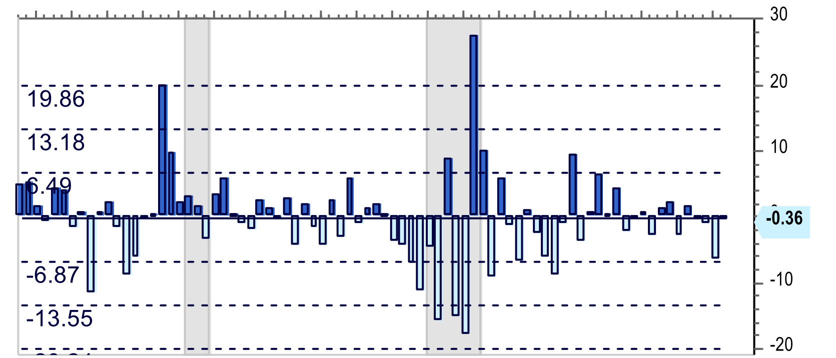
% of total sector Sales		% of total sector EBIT		Market cap weight		
Total Sales ($ mm)	% of total sector Sales	Total EBIT ($ mm)	% of total sector EBIT	Total mkt cap ($ mm)	% weight in sector	
$902,836	100%	$33,309	100%	$1,309,219	100%	Energy
$12,402	1%	$3,501	11%	$12,857	1%	Oil & Gas Drilling
$96,070	11%	$10,028	30%	$177,662	14%	Oil & Gas Equipment & Services
$379,151	42%	$9,915	30%	$616,019	47%	Integrated Oil & Gas
$111,293	12%	($15,945)	-48%	$312,076	24%	Oil & Gas Exploration & Production
$265,933	29%	$17,111	51%	$94,572	7%	Oil & Gas Refining & Marketing
$35,486	4%	$8,715	26%	$96,033	7%	Oil & Gas Storage & Transportation
$2,501	0%	($16)	-0%	n/a	n/a	Coal & Consumable Fuels



Source: Fundstrat, Bloomberg, FactSet

Financials (OW): More moats, even with falling rates…

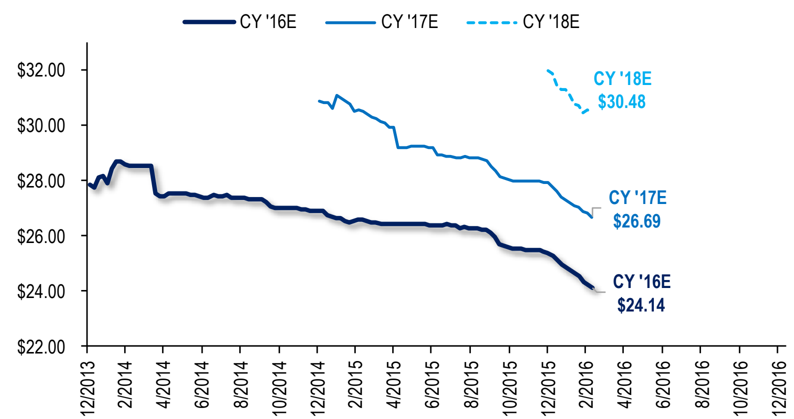




S&P 500 / Financials - SEC - P_PRICE_RETURNS_PR('3M',0) - S&P 500 - Price Returns - over Predefined Range
Recession Periods - United States

Source: Fundstrat, Factset

Figure: EPS Forecasts FY1 and FY2
Past 24 months



Source: Fundstrat, Factset

Healthcare (N): Buy "low margins" like Pharma, Devices, etc.

Healthcare has been massive since 2009… but credit is sending a different signal

Source: Fundstrat, Factset

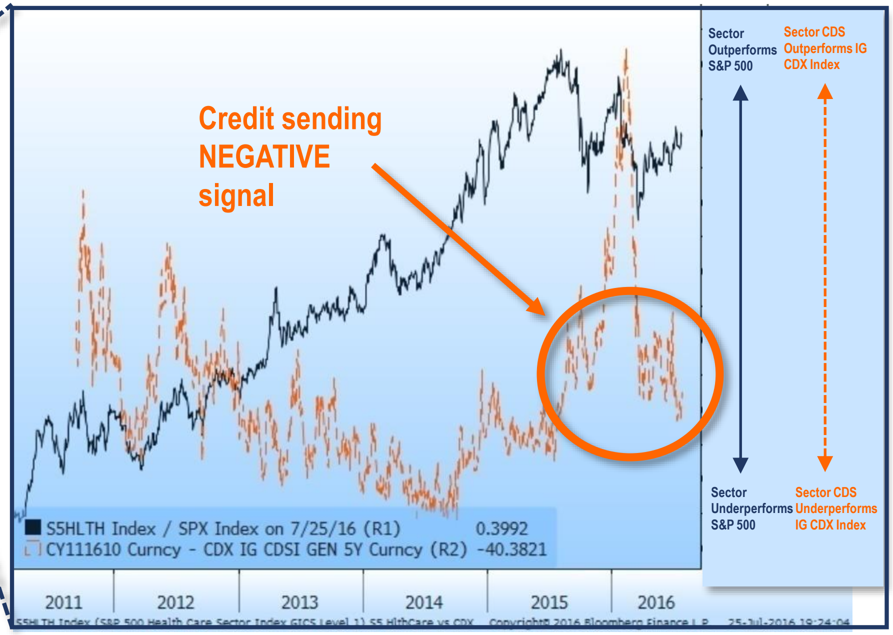
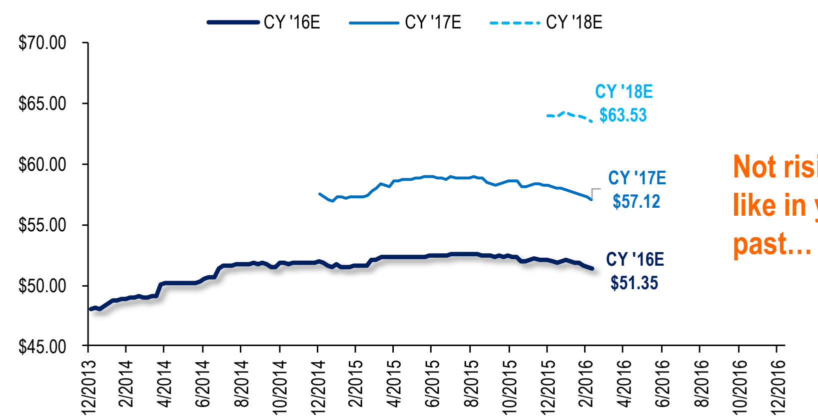


Figure: EPS Forecasts FY1 and FY2
Past 24 months



Not rising like in year's past…

Source: Fundstrat, Factset

Healthcare sector EBIT margins

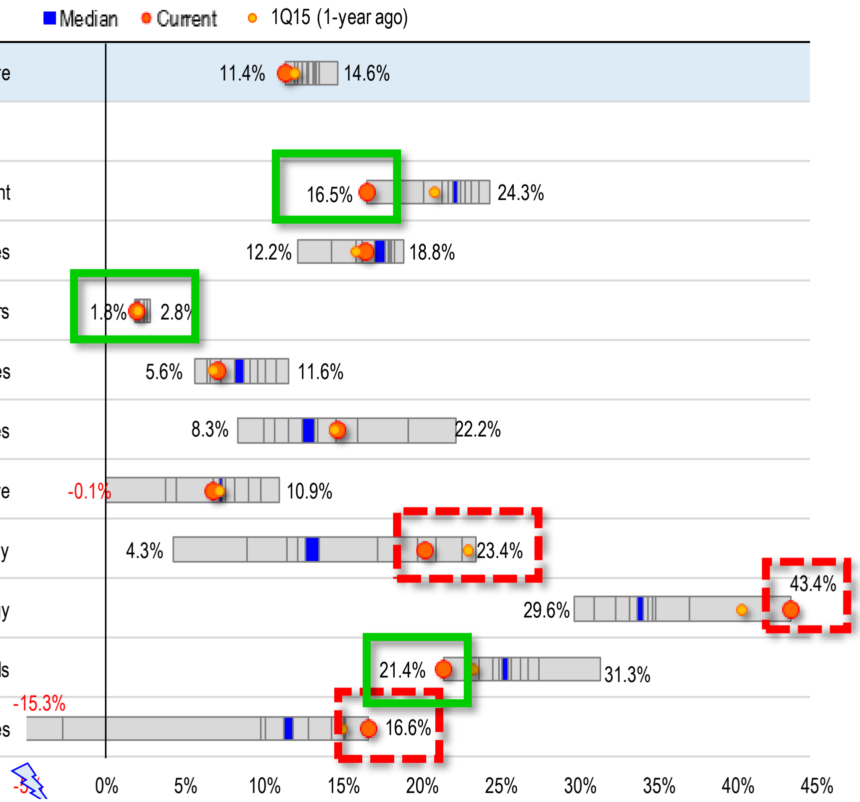
The group's most attractive, in our view, are those with lower EBIT margins.

- **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	
$1,540,742	100%	$175,010	100%	$2,655,765	100%	Healthcare
$113,193	7%	$18,720	11%	$421,268	16%	Health Care Equipment
$2,674	0%	$438	0%	$14,138	1%	Health Care Supplies
$456,347	30%	$8,608	5%	$99,513	4%	Health Care Distributors
$131,707	9%	$9,260	5%	$85,702	3%	Health Care Services
$48,721	3%	$7,162	4%	$41,659	2%	Health Care Facilities
$411,790	27%	$27,824	16%	$265,044	10%	Managed Health Care
$4,425	0%	$895	1%	$18,304	1%	Health Care Technology
$108,225	7%	$46,972	27%	$579,119	22%	Biotechnology
$236,130	15%	$50,568	29%	$1,020,444	38%	Pharmaceuticals
$27,530	2%	$4,563	3%	$110,575	4%	Life Sciences Tools & Services

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



Source: Fundstrat, Factset, Bloomberg

Consumer Staples (UW): PE "pinned" but rather buy "stocks new bonds"

Source: Fundstrat, Factset

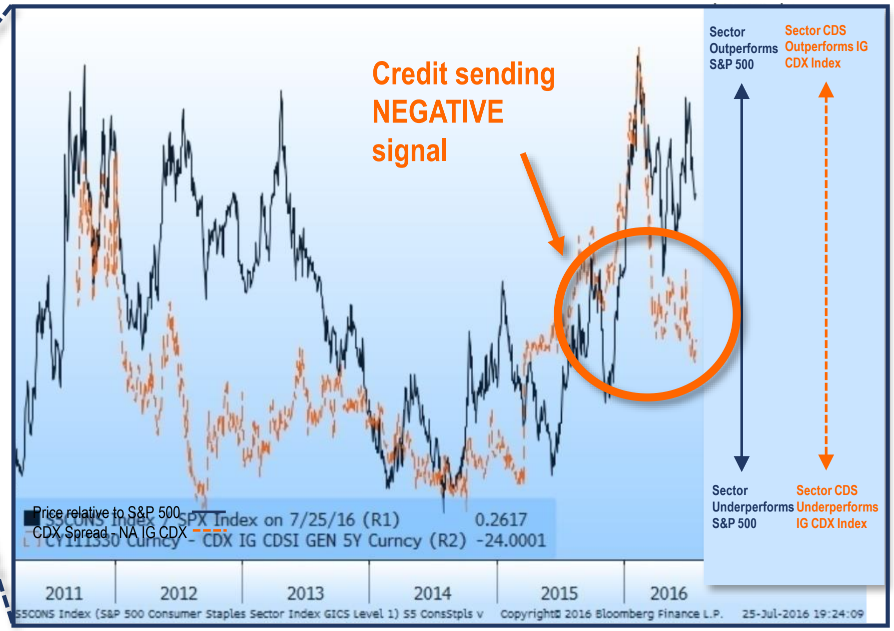
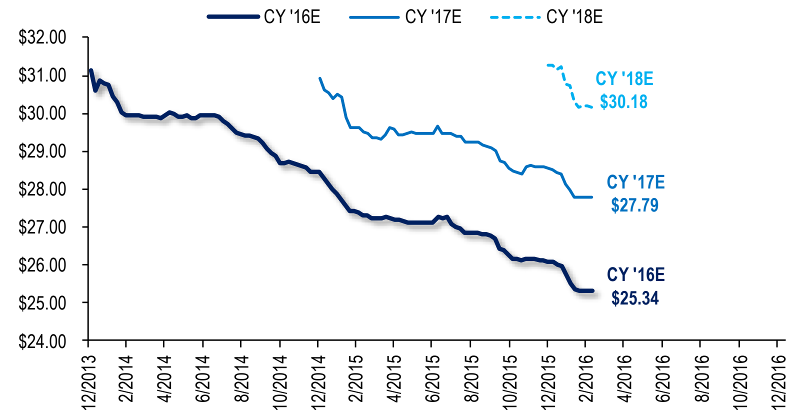
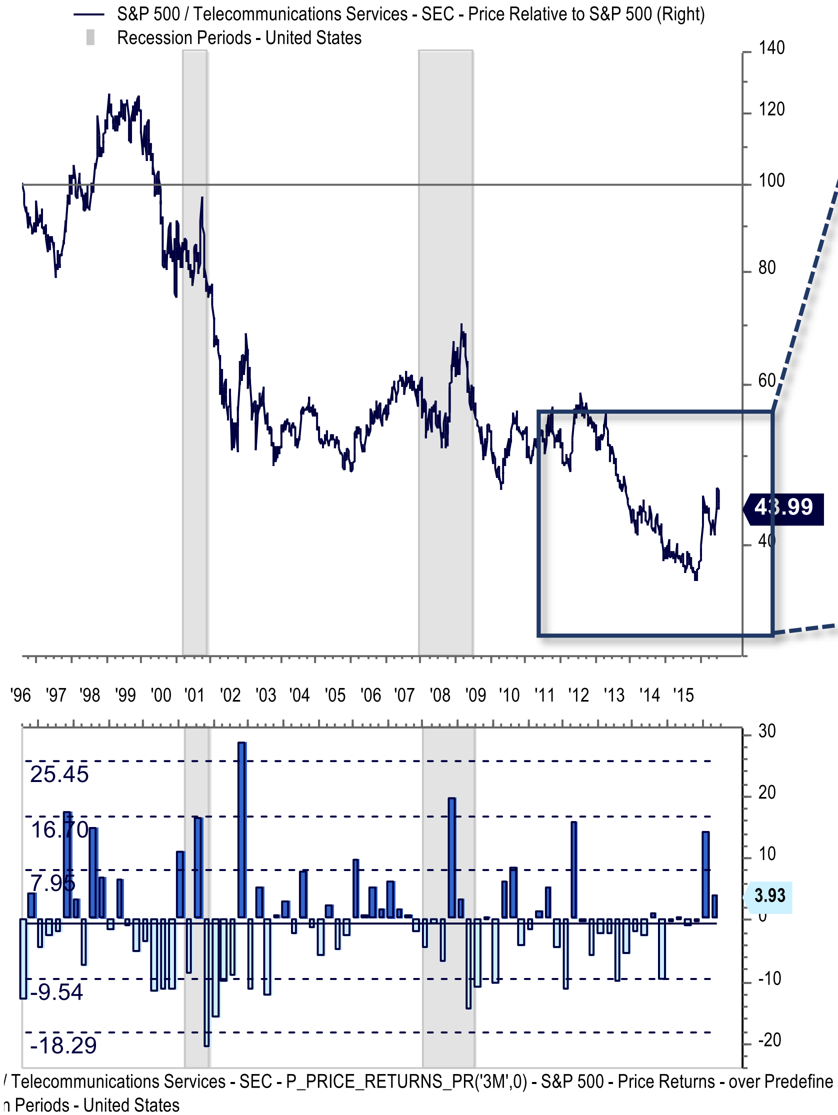


Figure: EPS Forecasts FY1 and FY2
Past 24 months



Source: Fundstrat, Factset

Telecom Services (OW): Reflation play… long runway to outperform



Source: Fundstrat, Factset

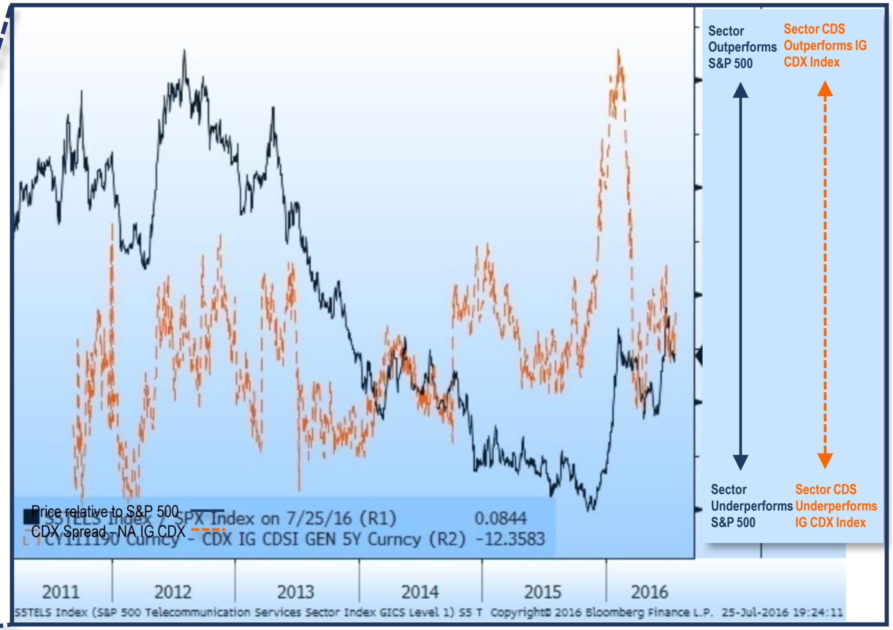
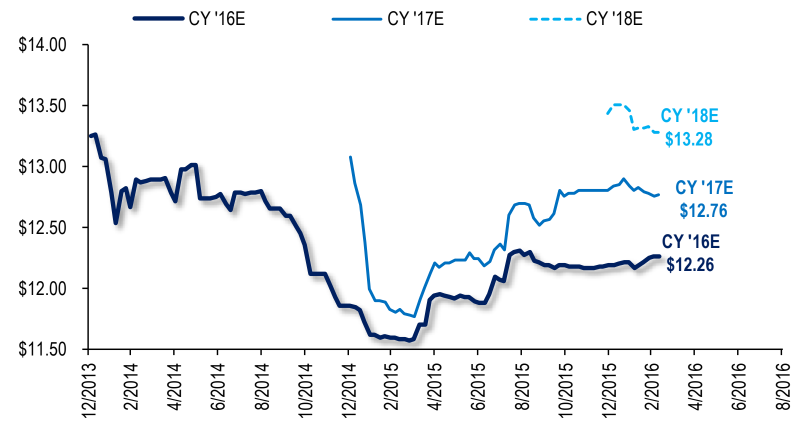


Figure: EPS Forecasts FY1 and FY2
Past 24 months



Source: Fundstrat, Factset

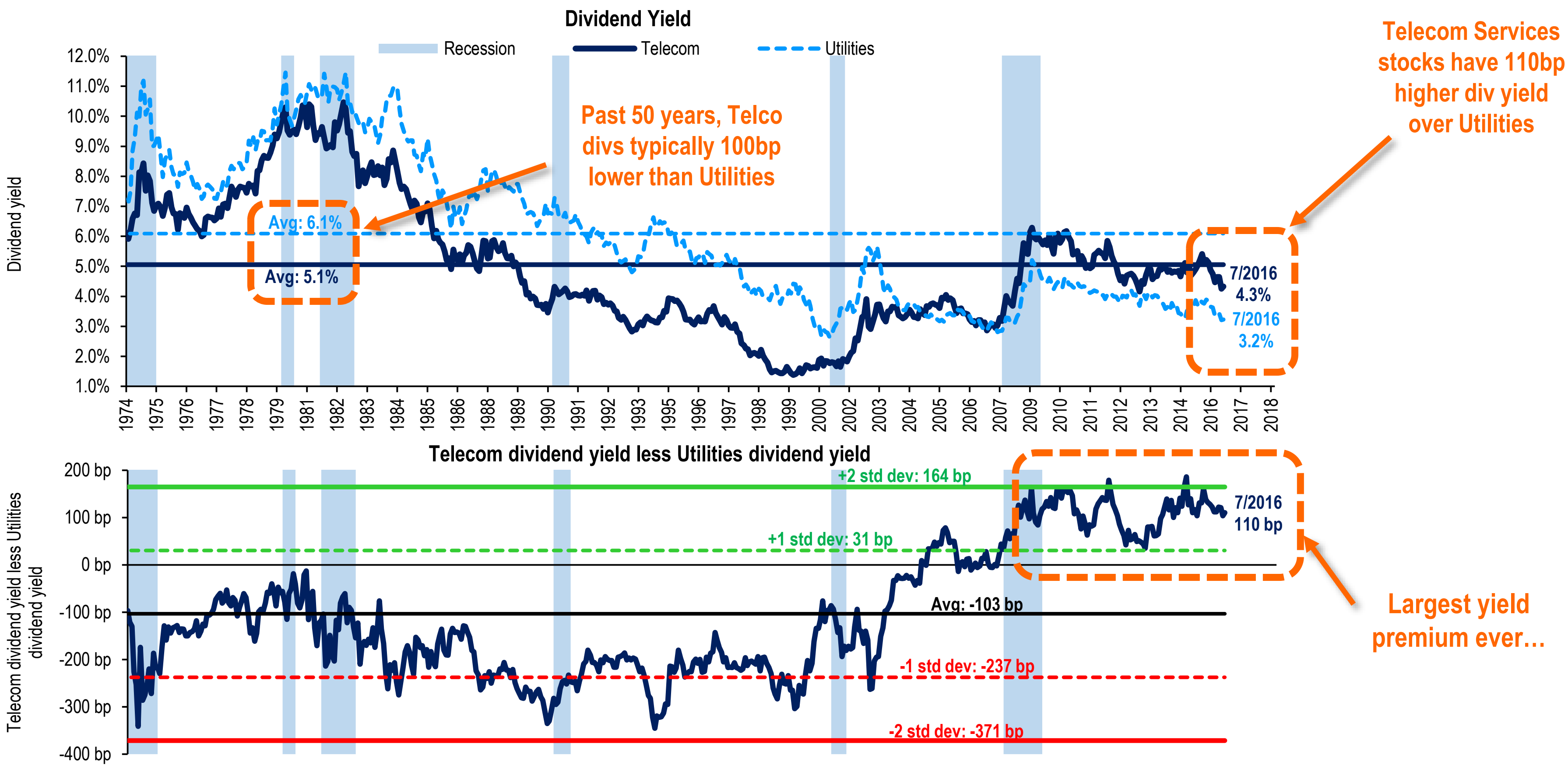
#4: Yield convergence (vs Utes): Essentially highest differential ever

Over the past 40 years, Telecom dividend yields were typically 100bp below that of Utilities and that relationship existed from the 1970s to 2010 or so.

- **But as shown below, in the past few years, Telco dividend yields are now 110bp above that of Utilities. We do not see Utility dividends rising, but rather Telecom stocks re-rate to bring down their dividend yield.**

Figure: The differential between Telco and Utilities div yield is near a 2 std dev high

Differential of Telecom vs. Utilities sector dividend yields (monthly since 1974)



Source: Fundstrat, FactSet, Thomson Reuters, Bloomberg.

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