fundstrat

Fundstrat Global Advisors
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December 9th 2016

FLASH

# Lessons from 1991

## Recalling why 1991 shows after 8 years of a bull, you need to embrace the rotation

**"Age an issue of mind over matter. If you don't mind, it doesn't matter" Mark Twain**

Moving into the final days of 2016 and nearing its 8th year, the equity bull market is re-invigorated. Appropriately, in our view, given the improved inflation expectations, prospects for a retracement of regulatory creep and inflows into equities (of $7T in cumulative savings since 2006, zero has gone into equities).

- **Recalling 1991—first 8 yrs was P/E expansion. Followed by 8 yrs of EPS growth (Slide 4):** By the end of 1991, the bull market that started in August of1982 was passing its 8th year and the second longest in history (there was a 20%-plus pullback in '87, similar to the 20% '11 drawdown). The cumulative gain similar at 222% vs 231% ('09-'16). From '82-'91, P/E expansion drove bulk of gains 10X→27X aided by falling interest rates (sound familiar?). '91-'99 was primarily EPS growth.
- **Consensus was cautious (Slide 6, or see video click here) but S&P 500 then subsequently gained 4X '91-'99:** At end of 1991, pundits and investors were skeptical of equities—noting high P/E, lack of benefit from 11 rate cuts, IPOs—perhaps not surprising given the stagflation that marked the previous decade. But that sure sounds like today…doesn't it?
- **Economic profile changed after '91 with an upshift in investment spending (Slide 8):** From '82-'91, falling inflation (disinflation) caused investment spending to decline to multi-decade lows, but as rates stabilized, investment spending inflected—this again, is analogous to today. In contrast to today, labor markets had more slack (7% UE vs 4.6% today, Slide 9), but capacity utilization higher (80% vs 76%), meaning we are more likely to see wage inflation today versus PPI gains then.
- **Sector Rotation—'91 marked rotation into Cyclicals after 8-yrs Defensives (Slide 10):** In 1991, the shift in economic composition led to an abrupt rotation into cyclicals stocks. From '82-'91, Healthcare and Staples led 8 consecutive years but '91 marked an abrupt shift into Cyclicals (Software led 8 consecutive years, '91-'99). Again, doesn't this sound familiar today?
- **What could go wrong? Policy errors, either by the Fed, by new administration or by RoW policy makers.** While major downside risks not obvious near-term, policy makers are source of incremental risk.

**BOTTOM LINE: The lesson? Embrace the rotation (Slide 11) into Banks.** Since 2009, there is an extremely tight relationship between inflation premia (breakevens less CPI) and relative performance of Banks versus Healthcare. Rising inflation premia means higher rate (good for banks), higher investment spend (good for banks) and faster nominal growth (less good for Healthcare). Using 2001-2004 as a template, this suggests Financials are entering a period of multi-year gains, at the expense of a rotation out of Healthcare. More broadly, regime shift, something we argued at the start of this year, is driving a multi-year shift into Value (from Growth) and laggards become leaders.

**As we move into year-end, below is our publication schedule:**

| | |
|---|---|
| December 16th: | Weekly Flash |
| December 23rd: | Weekly Flash |
| December 30th: | None (unless conditions warrant) |
| January 6th: | **2017 Outlook** |





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| Performance | 1Q16 | 2Q16 | 3Q16 | 4Q16 | YTD |
|---|---|---|---|---|---|
| **S&P 500** | **0.8%** | **1.9%** | **3.3%** | **3.6%** | **9.9%** |
| **Cyclicals** | 2.4% | -1.5% | 7.1% | 3.9% | 12.4% |
| **Near Cyclical** | -3.1% | 4.4% | 3.2% | 16.8% | 22.6% |
| **Defensives** | 1.4% | 5.1% | -2.2% | -4.7% | -0.6% |
| **Value** | **1.5%** | **3.3%** | **2.3%** | **7.2%** | **14.8%** |
| **Growth** | **0.1%** | **0.6%** | **4.3%** | **0.2%** | **5.2%** |

| Valuation | 2016E | 2017E | Target |
|---|---|---|---|
| S&P 500 price | 2246 | → | 2225 |
| Fundstrat EPS | $127 | $142 | |
| P/E (Y+1) | 17.7x | 15.8x → | 15.7x |
| Div Yield | 2.1% | 2.2% | — |

| Cyclicals | | Near Cyclicals | | Defensives | |
|---|---|---|---|---|---|
| Industrials | N | **Energy** | **OW** | Telecom | OW |
| **Materials** | **OW** | Financials | OW | Healthcare | N |
| Technology | OW | Real Estate | — | *Staples* | *UW* |
| **Discretionary** | **OW** | | | *Utilities* | *UW* |

# #1: Trivia question....

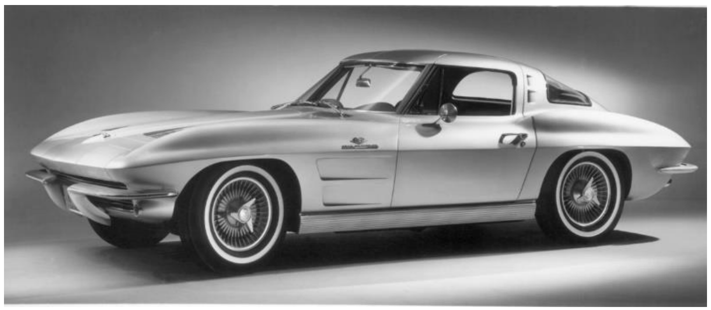
***What do wine, cheese, a classic car and the S&P 500 have in common?***

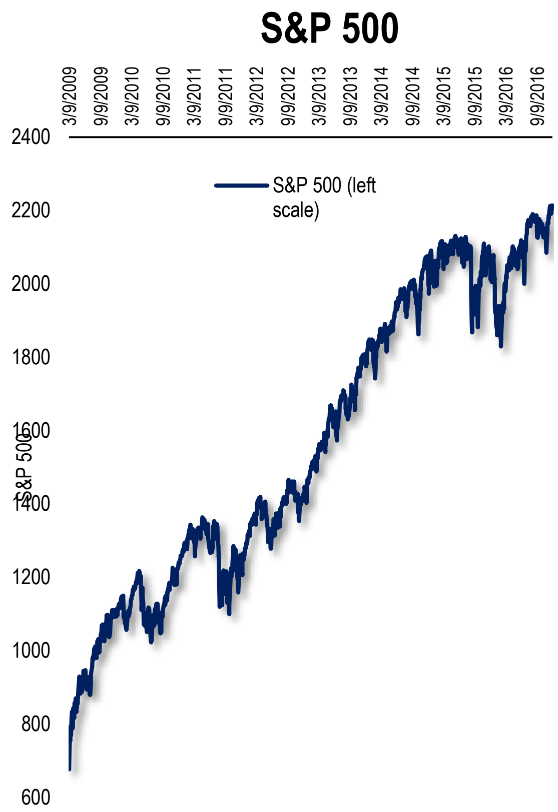
**Figure: Can you guess what these have in common?**

wine

fromage

Stingray






Source: Fundstrat, Bloomberg, Factset

# #1a: Answer: those all aged well….

***BEWARE…some things have not gotten better with time….***

**Figure: Can you guess what these have in common?**

**chia pets**


**Mickey Rourke**

**80s hairstyles**

**Mark Hamill**

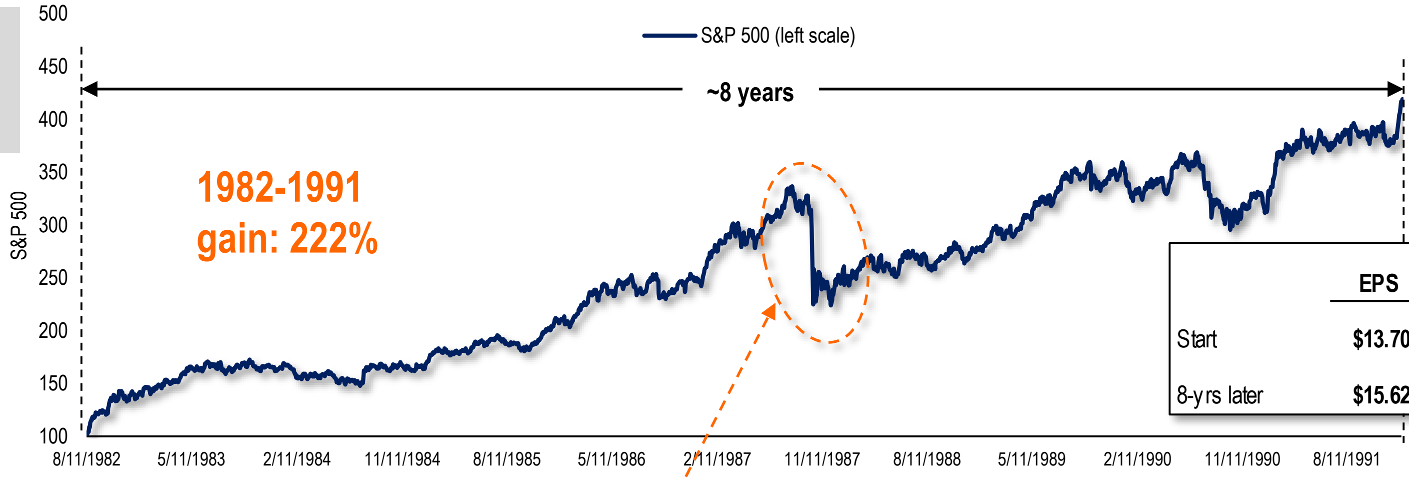
Source: Fundstrat, Bloomberg, Factset

# #2: Current bull market crossing 8 years...a la 1991

By the end of 2016, the current bull market is close to 8 years in age, similar to 1991 when the bull market crossed its 8th year (see below). **P/E expansion was responsible for most of the gains from 1982-1991 and the P/E reached 27X.**

**Figure: Both bull markets are mid-life: 1982-1991 and 2009-2016**
Dates shown

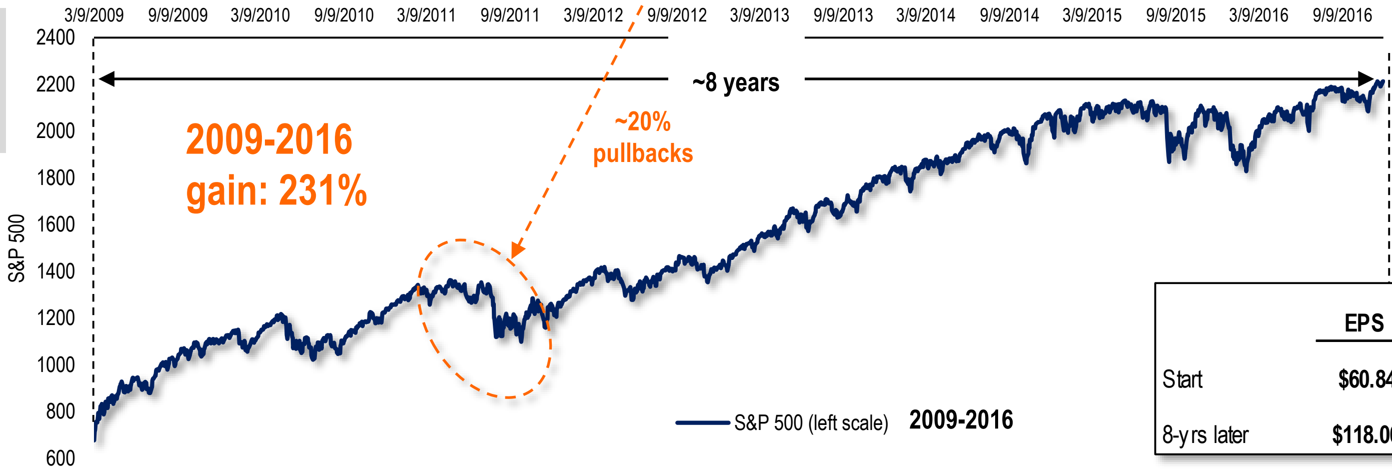
**1982 to 1991**




**1982-1991 was primarily P/E driven… PE hit 27X by 1991**

| | EPS | CAGR | PE | CAGR |
|---|---|---|---|---|
| Start | $13.70 | 2% | 9.8x | 13% |
| 8-yrs later | $15.62 | | 26.7x | |

**2009 to 2016**




**2009-2016 had less P/E expansion….**

| | EPS | CAGR | PE | CAGR |
|---|---|---|---|---|
| Start | $60.84 | 9% | 11.1x | 7% |
| 8-yrs later | $118.00 | | 18.8x | |

Source: Fundstrat, Bloomberg, Factset

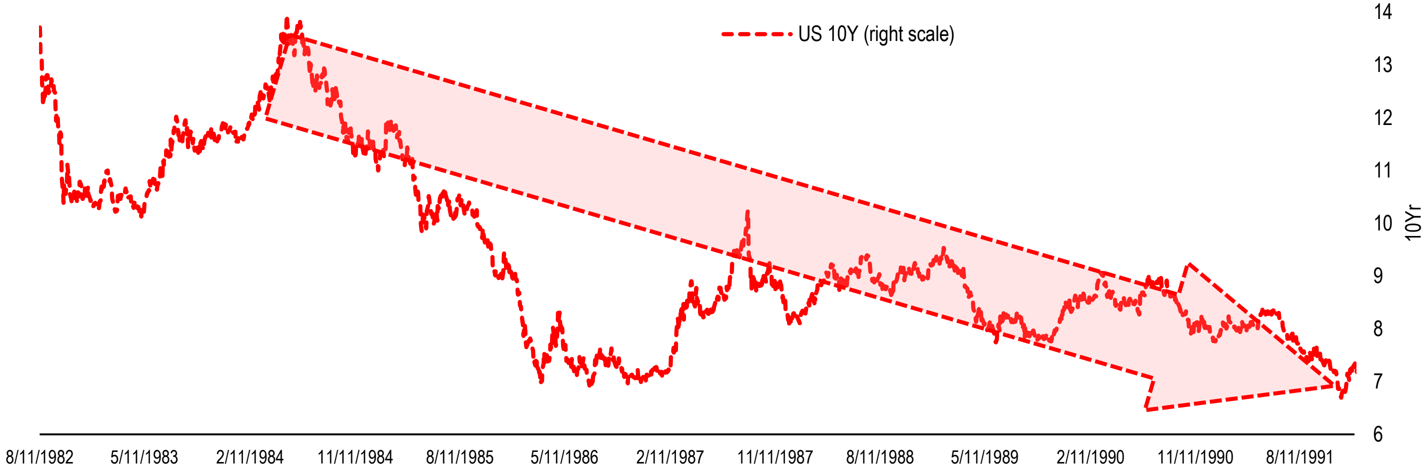
# #3: Falling interest rates a tailwind for initial bull markets…

Interest rates fell in 1982 to 1991, and from substantially greater levels.

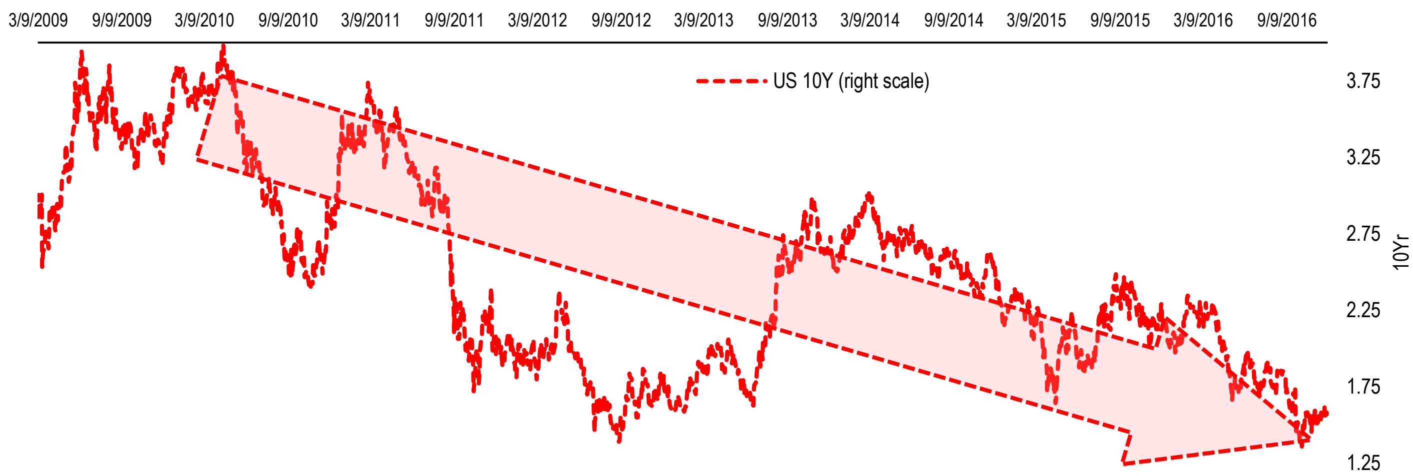
- **But the fall in rates in 1982-1991 was primarily falling inflation, which in turn, hurt corporate profit growth.**

**Figure: Both bull markets are mid-life: 1982-1991 and 2009-2016**
Dates shown

Volkker broke the back of inflation…




This cycle's fall was due to Central bank easing…




Source: Fundstrat, Bloomberg, Factset

# #4: Consensus bearish in 1991… sounds like this could be said *today*

- **Clip can be played here:** https://drive.google.com/open?id=0B4FrHQhMCmOEdE9aYUo3QlVXdzA

8 years into 1982 bull market, fears of a “relapse” to pre-1982 made everyone cautious…

03:37 **Charlie Rose:** What do you say to those people, though, who look and say, stocks are overvalued today, when they look at a P/E ratio of the Dow Jones of 29, of Standard & Poor's of 21. Is there an argument to be made that today stocks are overvalued?

03:51 **Robert Stovall:** Well, sure there is. The P/E's 29, the dividend return is about 3%, we're seeing over 40 new issue offerings a month. That's a danger sign. Last month we had 45 of them.

Few realized that a generational bull market was underway…

04:12 **Dan Dorfman:** There's no question I agree with you, and Bob, putting your money in mutual funds, and a lot of that money, in my mind, not all of it though, a fair amount of that money is going to go into the stock market. Now, I got to tell you. I think a lot of that money is going to get slaughtered.

08:24 **Jim Marquez:** I think there's a structural problem in the economy right now. I think 11 cuts in interest rates in 18 months with no response from the economy is indicative of something different going on, and anything we've seen in the post-World War II experience.

Source: Fundstrat, Bloomberg, Factset

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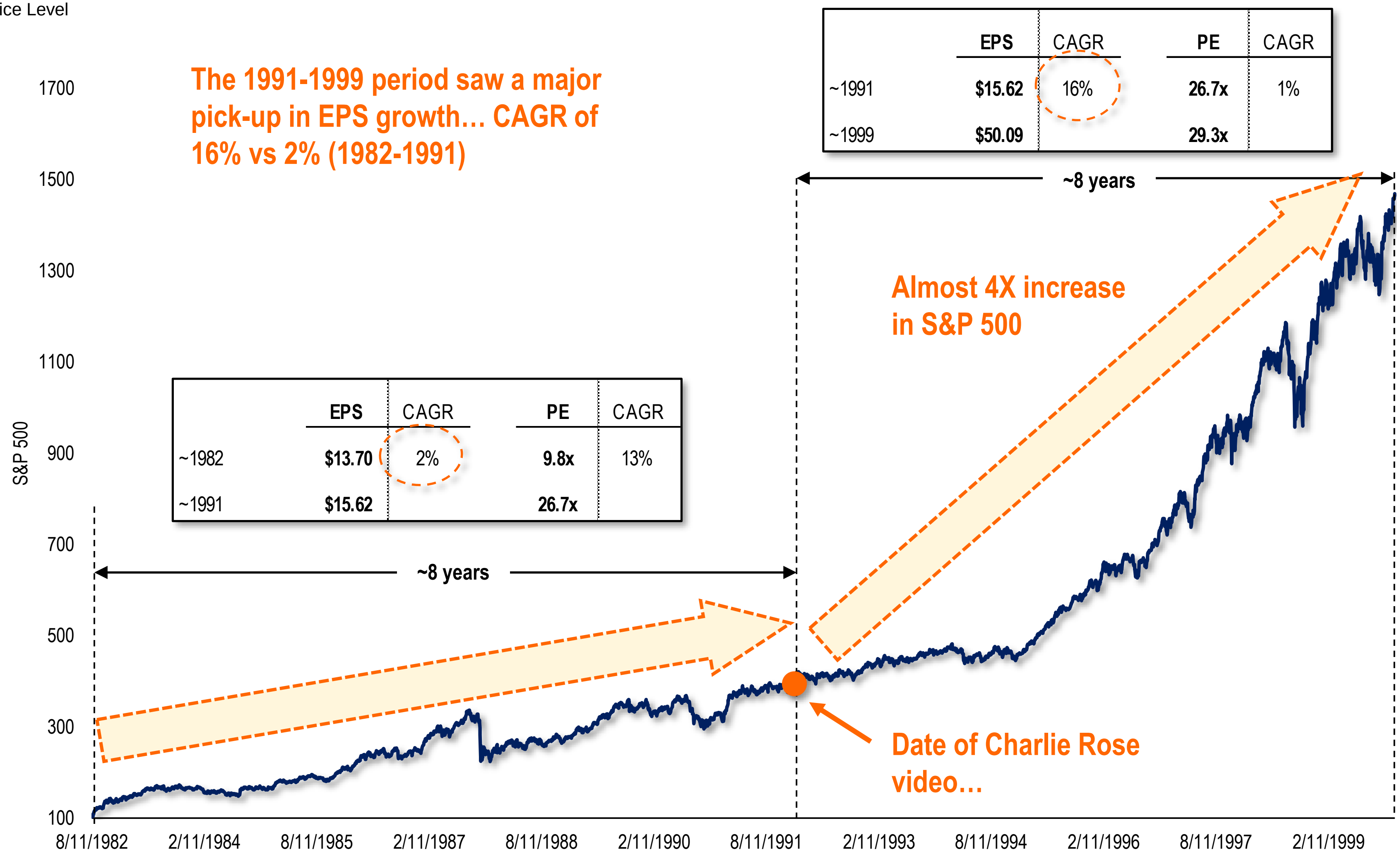
# #5: ...Yet, the S&P 500 rose 4X from 1991 to 1999

Despite cautious sentiment, the S&P 500 managed to rise by 271% from 1991 to 1999

- **P/E expanded to 29X slightly, but the engine for growth was EPS, which expanded from $16 to $50.**

**Figure: S&P 500 from 1982 to 1999**

Price Level



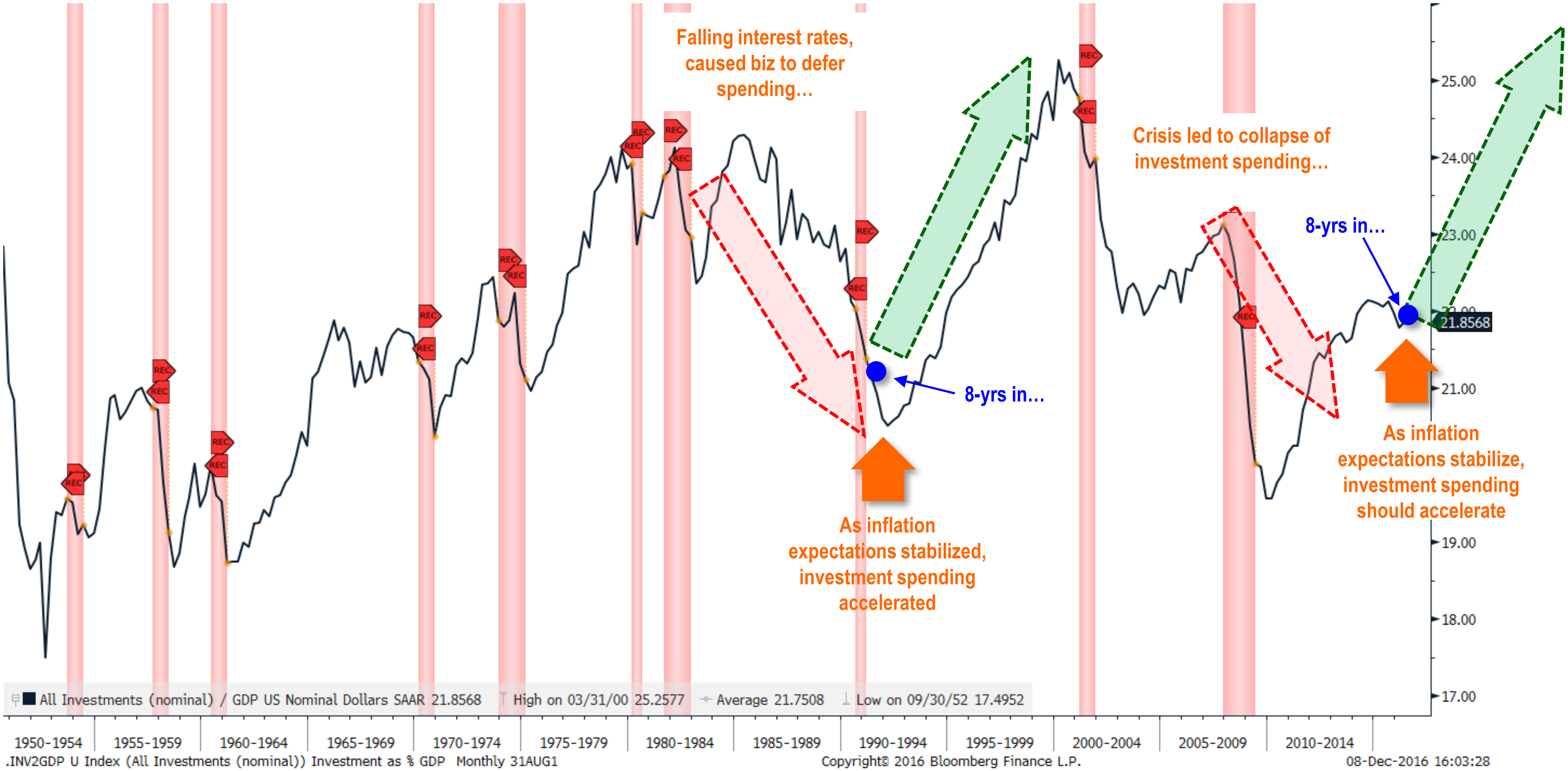

Source: Fundstrat, Bloomberg, Factset

# #6: Post-1991: as interest rates stabilized, investment spend *ignited*

As shown below, in 1991, as interest rates and inflation stabilized, investment spending began to rise. Falling inflation logically leads to deferred spending—if prices are expected to fall (disinflate), spending should be deferred.

- **We think investment spending could accelerate in next few years.**

**Figure: Investment spending (Capex, Housing, Durables and Non-residential construction) as % GDP**
Since 1950



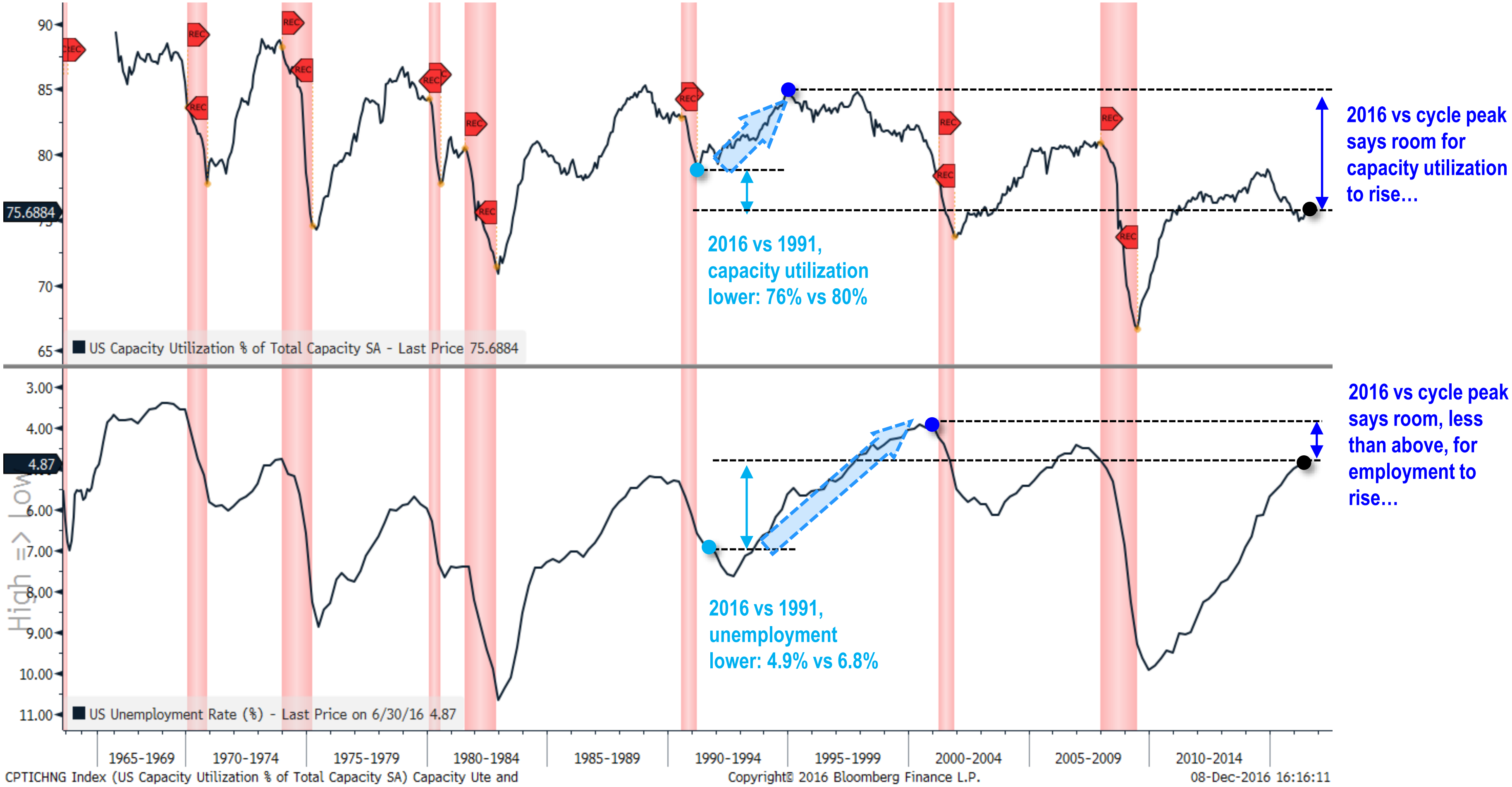

Source: Fundstrat, Bloomberg, Factset

# #7: 1991 vs 2016: More room for capacity utilization gains vs employment

We have compared capacity utilization and employment today versus 1991 and as shown below, some differences.

- **Capacity utilization at 76% is lower than 1991, implying greater room for capex growth.**
- **But employment is tighter (lower UE rate) meaning we should see wage inflation gains first…**

**Figure: Capacity utilization and Unemployment rates**
Since 1950




Source: Fundstrat, Bloomberg, Factset

# Portfolio Strategy: Do you see *the rotation* in 1991 to Cyclicals

**We believe 2016, as reflation takes root, will drive a multi-year rotation into Cyclical stocks.**

- **Like the juncture in 1991, an upturn in investment spending drives the acceleration of EPS, justifying that rotation.**

**Figure: The rising in inflation expectations should drive a multi-year rotation into Cyclical stocks**
Annual relative returns

### 1982-1991

Falling interest rates meant Defensive and "stable growth" outperformed…

| Sector name | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|---|---|---|---|
| S&P 500 | 15 | 17 | 1 | 26 | 15 | 2 | 12 | 27 | -7 | 26 |
| Technology | 32 | 9 | -13 | -7 | -31 | 10 | -14 | -37 | 10 | -20 |
| Semis | 39 | 44 | -31 | -32 | -40 | 34 | -30 | -25 | 4 | -2 |
| IT Hardware | 41 | 7 | -9 | -4 | -33 | 3 | -10 | -46 | 14 | -24 |
| IT Software | -9 | -9 | -16 | 5 | -6 | 31 | -16 | -18 | 9 | 23 |
| Consumer Discretionary | 26 | 3 | -7 | -2 | 2 | -4 | 7 | -11 | -11 | 12 |
| Industrials | 0 | 9 | -8 | -5 | -7 | 0 | -6 | -3 | -4 | 0 |
| Basic Materials | -13 | 8 | -16 | 0 | 9 | 11 | -6 | -10 | -10 | -5 |
| Financials | -4 | 1 | 4 | 16 | -5 | -16 | 2 | 3 | -15 | 18 |
| REITs | 23 | 2 | 2 | 25 | 10 | -7 | -4 | -17 | -41 | 19 |
| Energy | -38 | 1 | -1 | -16 | -2 | 2 | 6 | 4 | 4 | -24 |
| Healthcare | 3 | -10 | 1 | 8 | 13 | 6 | 1 | 13 | 18 | 24 |
| HC Eq. & Services | 10 | -28 | -18 | 5 | 1 | 8 | -5 | 15 | 18 | 12 |
| HC Bio, Pharma, Tools | -6 | -10 | 3 | 13 | 19 | 2 | -2 | 9 | 21 | 26 |
| Consumer Staples | 11 | -5 | 6 | 6 | 10 | 7 | 2 | 14 | 17 | 12 |
| Utilities | 0 | -5 | 15 | -4 | 8 | -12 | 2 | 0 | 2 | -10 |
| Telecom | -16 | -10 | 19 | 5 | 4 | -2 | 6 | 27 | -11 | -18 |

### 1991-1999

As inflation rates stabilized, investment spending accelerated, driving an upturn in Cyclical stocks

| Sector name | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|---|---|---|---|
| S&P 500 | 4 | 7 | -2 | 34 | 20 | 31 | 27 | 20 |
| Technology | -4 | 13 | 21 | 5 | 23 | -3 | 51 | 59 |
| Semis | 58 | 46 | 18 | 1 | 56 | -22 | 38 | 47 |
| IT Hardware | -7 | 12 | 22 | 4 | 18 | -6 | 51 | 57 |
| IT Software | 13 | 19 | 19 | 6 | 34 | 8 | 53 | 62 |
| Consumer Discretionary | 13 | 6 | -8 | -16 | -10 | 1 | 13 | 5 |
| Industrials | 2 | 9 | -3 | 2 | 2 | -6 | -17 | 0 |
| Basic Materials | 3 | 3 | 5 | -17 | -7 | -25 | -35 | 3 |
| Financials | 15 | 1 | -5 | 16 | 12 | 14 | -17 | -17 |
| REITs | 8 | 27 | -5 | -16 | 17 | -2 | -50 | -32 |
| Energy | -7 | 4 | 1 | -8 | 1 | -9 | -29 | -4 |
| Healthcare | -23 | -18 | 12 | 20 | -1 | 11 | 16 | -31 |
| HC Eq. & Services | -18 | -20 | 7 | 11 | -10 | -17 | -10 | -41 |
| HC Bio, Pharma, Tools | -23 | -18 | 14 | 23 | 1 | 18 | 21 | -29 |
| Consumer Staples | -1 | -13 | 8 | 2 | 3 | 0 | -13 | -36 |
| Utilities | -4 | 1 | -16 | -9 | -20 | -13 | -17 | -32 |
| Telecom | 7 | 4 | -7 | 3 | -22 | 6 | 23 | -2 |

### 2009-2016

Notice the outperformance of Defensives 2011-2016 in falling rate world? Now look for rotation…

| Sector name | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|
| S&P 500 | 23 | 13 | 0 | 13 | 30 | 11 | -1 | 10 |
| Technology | 36 | -4 | 1 | 0 | -3 | 7 | 5 | 2 |
| Semis | 31 | -5 | -1 | -18 | 4 | 21 | -2 | 15 |
| IT Hardware | 41 | -1 | 0 | 2 | -13 | 16 | -11 | 3 |
| IT Software | 32 | -7 | 3 | 3 | 3 | -1 | 17 | -1 |
| Consumer Discretionary | 15 | 13 | 4 | 8 | 11 | -3 | 9 | -3 |
| Industrials | -6 | 11 | -3 | -1 | 8 | -4 | -4 | 8 |
| Basic Materials | 22 | 7 | -12 | -1 | -7 | -7 | -10 | 8 |
| Financials | -9 | -2 | -18 | 13 | 4 | 2 | -3 | 12 |
| REITs | -3 | 15 | 8 | 3 | -31 | 15 | 2 | -10 |
| Energy | -12 | 5 | 3 | -11 | -7 | -21 | -23 | 14 |
| Healthcare | -6 | -12 | 10 | 2 | 9 | 12 | 6 | -16 |
| HC Eq. & Services | 8 | -9 | 6 | 0 | 4 | 14 | 8 | -7 |
| HC Bio, Pharma, Tools | -12 | -13 | 13 | 2 | 12 | 11 | 5 | -20 |
| Consumer Staples | -12 | -2 | 11 | -6 | -7 | 1 | 4 | -9 |
| Utilities | -17 | -12 | 15 | -16 | -21 | 13 | -8 | -1 |
| Telecom | -21 | 0 | 1 | -1 | -23 | -13 | -1 | 3 |

Source: Fundstrat, Bloomberg, Factset

# Portfolio Strategy: See this rotation into Banks from Healthcare?

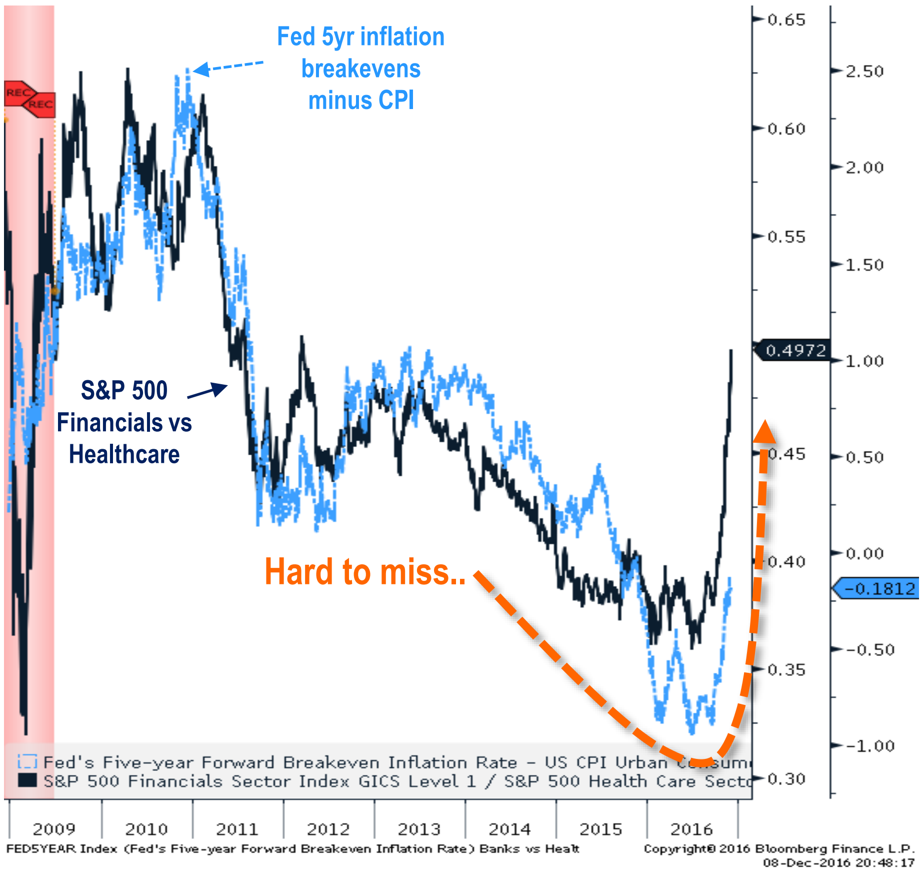
The rise in inflation expectations (more specifically, the premia vs CPI) should drive a rotation into banks.

- **The logic is that rising inflation raises interest rates (good for banks), higher investment spend (good for banks) and coupled with overall GDP growth (less good for Healthcare). Hence, this rotation.**

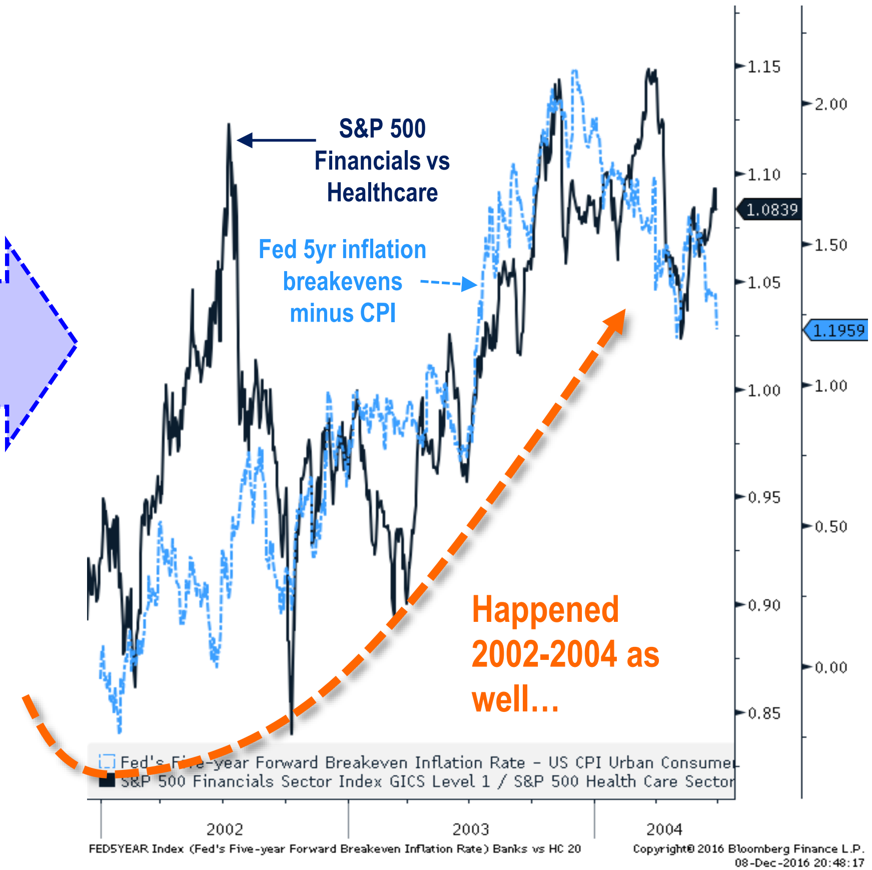
**Figure: The rising in inflation expectations should drive a multi-year rotation into Banks**

Light blue line: Fed 5-yr breakevens less CPI. Dark line: S&P 500 Financials vs Healthcare

Since 2009, inflation premia has explained rotation between Banks and Healthcare…




In 2002, when inflation rose, this same rotation into Banks from Healthcare took place…




Source: Fundstrat, Bloomberg, Factset

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

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

| | Fundstrat Strategy | Execution of Strategy | Added/ Removed | 1Q16 | 2Q16 | 3Q16 | Post-Trump | 2017 | |
|---|---|---|---|---|---|---|---|---|---|
| | De-regulation | Focus on industries benefitting from de-regulation: | | | | | ???? | → | |
| | Focus on Inflation trades | We said wage inflation would drive CPI, first time since 1950s | October 2016 | | | On 10/16, we argued investors need to OW stocks less exposed to wage inflation | → | → | |
| Contrarian | Buy Small-caps | Due to quality spread-rally and ISM recovery. | April 2016 | | On 4/16, we said HY move favors OW small-caps | → | → | → | +1,464bp |
| Contrarian | Oil bottoms and HY improves | Buy “inverse correlation” to HY spreads: **Buy Value and Low-quality** | December 2015 | On 2/12, we noted oil reached contango that marked the last 2 30-yr lows | → | → | → | → | +417bp |
| | Stocks are the “new bonds” | div yield> company’s LT bond yield | On 11/15, we said OW stocks “yield parity” | → | → | → | → | → | +1,083bp |
| Contrarian | Laggards become Leaders | Industry groups that underperformed 4-plus consecutive years | On 12/15, we downgraded Healthcare…OW Energy and Materials | → | → | → | → | → | +925bp |
| Contrarian | FANG ends with a “dang” | Buy last years’ losers over FANG | On 11/15, we said FANG would underperform laggards | → | → | → | → | → | +1,263bp |
| Contrarian | Growth as cheap as Value | Buy stocks both Growth and Value, with a div yield > bond yield | On 12/15, we said Growth 7-yr run was ending. OW Value | → | → | → | → | → | -442bp |
| | Favor Cyclical/ reflation trades | OW Financials, Technology, Energy, Materials, Industrials | On 12/15, we saw Cyclicals as EPS growth turns in 3Q16 | → | → | → | → | → | +893bp |

Source: Fundstrat, Bloomberg

# Portfolio Strategy: Summary of Performance

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

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

**Figure: Fundstrat Portfolio Strategy Recommendations for 4Q16**

**4Q16 Fundstrat Recommendations**

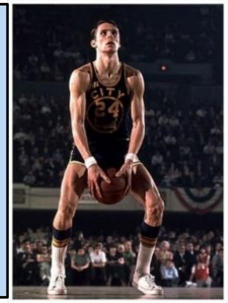
| | Fundstrat Strategy | Execution of Strategy | Added/ Removed | Relative performance (vs S&P 500) 1Q16 | 2Q16 | 3Q16 | 4Q16 QTD |
|---|---|---|---|---|---|---|---|
| | USD outright weakens | “inverse correlation” to USD: **Buy Energy, Materials, Telecoms** | December 2015 | +630bp | -190bp | (deleted 7/16) | |
| | Oil bottoms and HY improves | Buy “inverse correlation” to HY spreads: **Buy Value and Low-quality** | December 2015 | -60bp | -110bp | (deleted 7/16) | |
| Current Strategies | Stocks are the “new bonds” | div yield> company’s LT bond yield | November 2015 | +890bp | +320bp | +10bp | -137bp |
| Current Strategies | Laggards become Leaders | Industry groups that underperformed 4-plus consecutive years | December 2015 | +230bp | +570bp | -114bp | +239bp |
| Current Strategies | FANG ends with a “dang” | Buy last years’ losers over FANG | December 2015 | +540bp | +410bp | +255bp | +58bp |
| Current Strategies | Buy Small-caps | Due to quality spread-rally and ISM recovery. | April 2016 | | +150bp | +555bp | +749bp |
| Current Strategies | Growth as cheap as Value | Buy stocks both Growth and Value, with a div yield > bond yield | July 2016 | | | -65bp | -377bp |

Source: Fundstrat, Bloomberg.

# 4Q16 "granny shots"

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

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



**Growth**
**-4.7% (YTD relative)**
**(319 stocks)**

Growth as cheap as Value

**Both Value Growth**
**+3.3% (YTD relative)**
**(171 stocks)**

**Value**
**+5.0% (YTD relative)**
**(359 stocks)**

The Intersect
+4.0% (YTD relative)

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

Stocks are the new bonds

**Div yield > LT co bond yield**
**+10.8% (YTD relative)**
**(currently 54 stocks)**

Laggards become Leaders

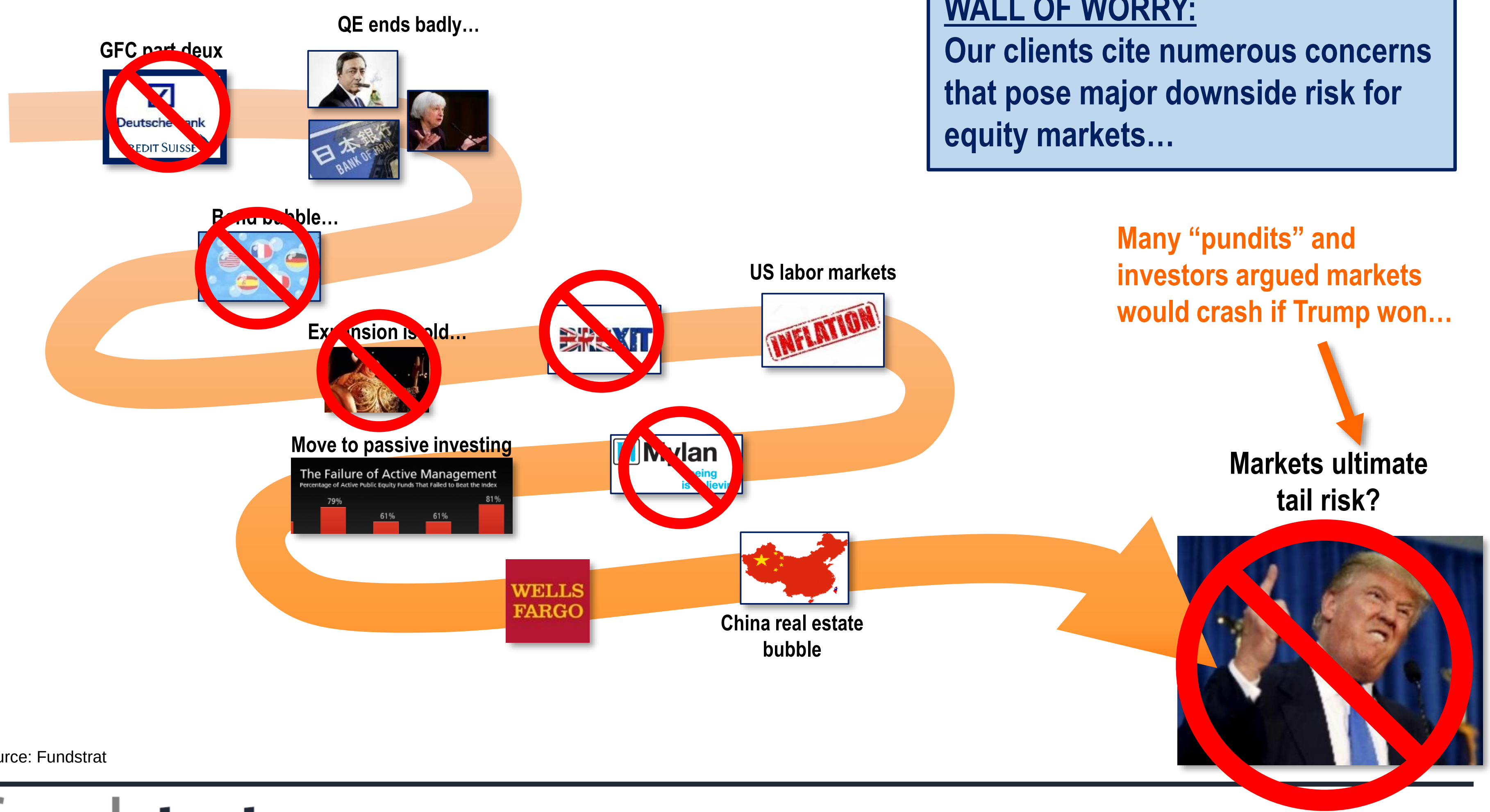
**Lagged**
**4-plus years**
**+21.0 (YTD relative)**
**(68 stocks)**

# FOLLY OF BEARS? Black swan happened… but we lived

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

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

**Figure: The path of destruction of global asset markets…**




Source: Fundstrat

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Positive (+): The analyst expects the performance of his industry/sector coverage universe over the next 6-18 months to be attractive vs. the relevant broad market benchmark, being the S&P 500 for North America.

Neutral (N): The analyst expects the performance of his or her industry/sector coverage universe over the next 6-18 months to be in line with the relevant broad market benchmark, being the S&P 500 for North America.

Negative (-): The analyst expects his or her industry coverage universe over the next 6-18 months to underperform vs. the relevant broad market benchmark, being the S&P 500 for North America.

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