2017 Outlook

Another year about sectors...
Overweight CRAP

fundstrat

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S&P 500 Target	1H	YE
	2150	2275

Key drivers:

- Growth accelerates
- Inflation gains
- Deregulation
- First term dynamics
- Ominous yield curve
- Bond proxies hurt S&P 500
- Lower bond supply keeps rates low

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Portfolio Strategy

OW CRAP Computers, Resources, American banks, Phone carriers.

OW Value over growth

OW Small-caps

Top Longs	Top Avoids
Energy	Healthcare
Telecoms	Staples
Financials	Utilities

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For Reg AC certification and other important disclosures, see slide 53.

fundstrat Guiding Principles

1.	**Analysis *not* opinions**	We rely on rigorous empirical analysis, coupled with reasoned judgement (and much self-doubt), rather than opinions.
2.	**Credit *lead* equities**	Stocks "junior" piece of capital structure
3.	**Regimes supercede business cycles**	Regimes drive multi-year, multi-decade cycles which need to be layered on top of business cycle dynamics
4.	**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.
5.	**Consensus lags (not leads)**	Consensus tools and indicators are already discounted by markets and computers.
6.	**"Signal" from Noise**	We look for 1, 2, 3-sigma signals to identify quantifiable investment opportunities.

2017 in one page…

Key drivers for 2017

- **Shift to "Real E" from QE as Fiscal policy takes handoff from Fed.**
- Inflation expectations recover, reversing 4-yrs of disinflationary trends.
- De-regulation is potential significant boost to corporate business activity.
- S&P 500 profits growth to rise 11%, led by Cyclicals

S&P 500 YE '17 Target

2018 EPS		$147
PE	x	15.5X
YE Target	=	**2275**

1H drawdown 5%

- Drawdowns of 5%-7% in 1st year of a New President, usually within first 90 days.
- **Catalyst for drawdown?** Policy risk and/or inflation confusion in bond market.
- Bond market signaling inflation confusion—foreboding flattening LT yield curve.
- Flattening of long-term yield curve generally leads to a 5%-7% sell-off.
- Rates likely contained, however, as coupons > supply of bonds in 2017.
- High-yield supportive but bigger room for quality spreads to rally (CCC-BB)

1H Drawdown Buy Level

68% of 1st terms		-5%
Dec 31, 2016 close		2239
1H17 Target	=	**2150**

Portfolio Strategy

- Buy **CRAP**—Computers, Resources, American banks and Phone carriers—all levered to investment recovery, inflation and de-regulation.
- Generally, we favor:
  —Depressed margin businesses
  —Bull market laggards
  —Wage "insensitive" asset intensive
  —Beneficiaries of de-regulation
- Value over growth, as inflation gains and growth accelerates
- Small-caps given room for quality spreads to rally.

RISKS: Many risks in 2017…

Downside Risks

- A sloppy White House organization creates confusion on US policy, particularly as tweets become policy.
- Washington does not pass infrastructure stimulus.
- Tax reform multiplier is smaller than market is expecting.
- Trump "fires" Janet—Fed becomes fall guy for Trump when equity markets get volatile.
- Fed tightens excessively.
- USD soars.
- Europe migrant issues deteriorates and "crexit" worsens.
- Former President Obama becomes a vocal critic.

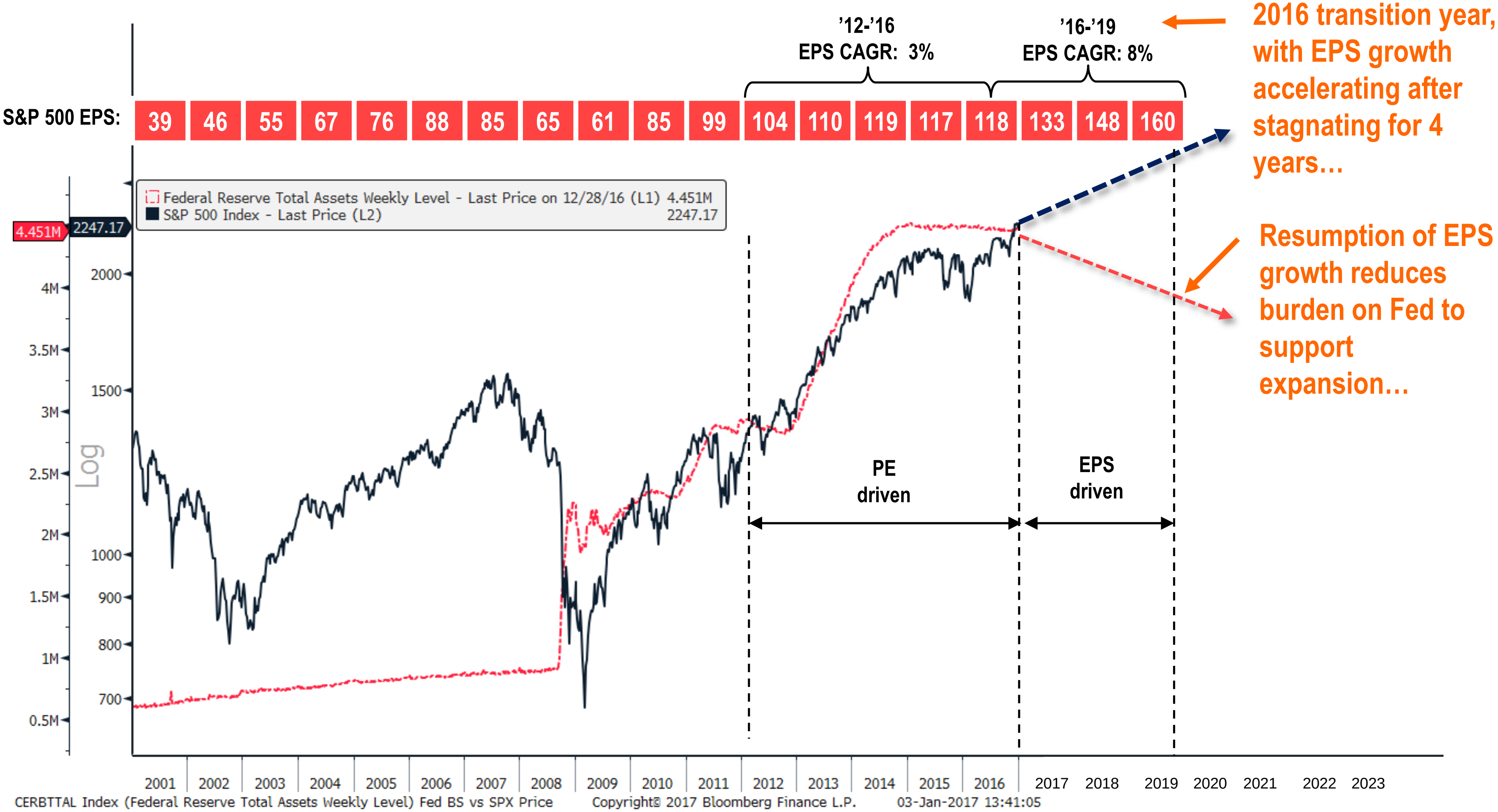
Upside Risks

- Investor pour record money into stocks.
- Global economic growth accelerates.
- Europe economic growth improves and stabilizes political risks.
- Trump surprises and becomes an incredibly popular President.
- China recovery triggers a stronger than expected industrial recovery.
- Wealthy households decide to start buying equities again, leading to a drop in the savings rate.
- Bond supply is actually lower than interest coupons, causing strong demand for corporate bonds, leading to better than expected returns in HY and IG.

Transition from QE to "Real E"

This is the essence of the 2017 story for equity markets… driven by commodity recovery, de-regulation, pent-up demand from US households.

Figure: Federal Reserve Balance sheet versus S&P 500
Since 1999



Source: Fundstrat, Bloomberg.

Global PMIs: better trends into 2017…

As shown below, global PMIs have been steadily improving since the Fall of 2016. In fact, the greatest improvements have been since in developed markets. The drivers, as we noted in past reports, are oil shock fading, pent-up demand and overall increased confidence.

Figure: Majority of PMIs have been rising since the Fall of 2016…
Since 2014

Weak into 2015

Weak into 2016

Global growth outlook on better footing into 2017…

	Manufturing PMI	Source	11/14	12/14	1/15	2/15	3/15	4/15	5/15	6/15	7/15	8/15	9/15	10/15	11/15	12/15	1/16	2/16	3/16	4/16	5/16	6/16	7/16	8/16	9/16	10/16	11/16	12/16
	Global	Markit	51.7	51.4	51.6	51.8	51.5	50.8	51.1	50.9	50.8	50.5	50.4	51.1	51.0	50.7	50.9	50.0	50.6	50.2	50.1	50.4	51.0	50.8	51.0	52.0	52.1	52.7
	Developed Markets	Markit	52.6	52.2	52.3	52.6	52.9	52.1	52.4	52.2	52.5	52.3	52.1	52.9	52.6	52.0	52.3	51.0	51.1	50.7	50.5	51.3	51.6	51.4	51.8	53.0	53.3	54.0
	Emerging Markets	Markit	50.8	50.5	50.8	51.1	50.1	49.5	49.6	49.5	48.8	48.4	48.3	49.0	49.2	49.2	49.3	48.9	50.1	49.6	49.6	49.4	50.4	50.1	50.1	50.9	50.8	51.2
% of countries improving m/m	Total		48%	43%	67%	43%	38%	33%	57%	52%	52%	33%	33%	67%	43%	43%	57%	24%	81%	38%	57%	57%	43%	52%	71%	67%	52%	60%
	Developed		40%	40%	70%	40%	70%	40%	60%	60%	30%	50%	20%	70%	70%	30%	50%	30%	70%	50%	50%	60%	40%	40%	60%	80%	60%	78%
	Emerging		71%	57%	71%	43%	14%	14%	57%	29%	86%	14%	29%	71%	29%	43%	43%	29%	100%	29%	71%	43%	43%	71%	71%	57%	43%	57%
	Commodity		25%	25%	50%	50%	0%	50%	50%	75%	50%	25%	75%	50%	0%	75%	100%	0%	75%	25%	50%	75%	50%	50%	100%	50%	50%	25%
	USA	ISM	57.5	54.9	53.9	53.3	52.3	51.6	53.1	53.1	51.9	51.0	50.0	49.4	48.4	48.0	48.2	49.5	51.8	50.8	51.3	53.2	52.6	49.4	51.5	51.9	53.2	54.7
	Canada	Markit	54.8	51.7	45.2	46.2	48.7	49.9	52.2	54.0	50.2	50.0	49.6	48.4	48.0	45.8	46.5	47.7	51.7	53.1	54.9	54.3	52.0	51.5	50.9	52.1	51.0	49.8
	Eurozone	Markit	50.1	50.6	51.0	51.0	52.2	52.0	52.2	52.5	52.4	52.3	52.0	52.3	52.8	53.2	52.3	51.2	51.6	51.7	51.5	52.8	52.0	51.7	52.6	53.5	53.7	54.9
	Germany	Markit	51.7	52.0	53.5	53.8	55.4	54.1	52.6	53.7	53.7	55.0	54.1	54.2	55.2	55.5	54.5	54.1	54.0	53.6	54.5	54.4	55.3	53.3	52.8	55.1	55.0	55.2
	France	Markit	47.9	49.7	49.3	52.2	51.5	50.6	52.0	53.3	51.5	50.2	51.9	52.6	51.0	50.1	50.2	49.3	50.0	50.2	50.9	49.6	50.1	51.9	52.7	51.6	51.4	53.1
	Italy	Markit	51.2	49.4	51.2	51.0	52.4	53.9	53.7	54.0	53.5	55.0	53.4	53.9	54.3	56.0	53.8	53.7	52.4	53.1	50.8	52.6	52.2	51.9	51.1	51.1	53.4	52.9
	Spain	Markit	53.8	54.3	56.9	56.0	56.9	59.1	58.3	55.8	58.3	58.8	54.6	55.0	56.2	55.2	55.3	54.5	55.1	55.2	54.8	55.7	53.7	54.8	54.1	54.4	55.2	55.5
	UK	Markit	57.6	55.3	56.5	56.6	58.5	58.5	55.9	57.5	56.8	55.2	53.4	55.2	55.7	55.2	56.0	52.7	53.6	52.0	53.1	52.5	47.4	53.5	53.9	54.7	55.2	
	Japan	Markit	52.0	52.0	52.2	51.6	50.3	49.9	50.9	50.1	51.2	51.7	51.0	52.4	52.6	52.6	52.3	50.1	49.1	48.2	47.7	48.1	49.3	49.5	50.4	51.4	51.3	52.4
	Australia	A.I.D.	50.1	46.9	49.0	45.4	46.3	48.0	52.3	44.2	50.4	51.7	52.1	50.2	52.5	51.9	51.5	53.5	58.1	53.4	51.0	51.8	56.4	46.9	49.8	50.9	54.2	55.4
	Mexico	Markit	54.3	55.3	56.6	54.4	53.8	53.8	53.3	52.0	52.9	52.4	52.1	53.0	53.0	52.4	52.2	53.1	53.2	52.4	53.6	51.1	50.6	50.9	51.9	51.8	51.1	50.2
	China	Markit	50.0	49.6	49.7	50.7	49.6	48.9	49.2	49.4	47.8	47.3	47.2	48.3	48.6	48.2	48.4	48.0	49.7	49.4	49.2	48.6	50.6	50.0	50.1	51.2	50.9	51.9
	Taiwan	Markit	51.4	50.0	51.7	52.1	51.0	49.2	49.3	46.3	47.1	46.1	46.9	47.8	49.5	51.7	50.6	49.4	51.1	49.7	48.5	50.5	51.0	51.8	52.2	52.7	54.7	56.2
	South Korea	Markit	49.0	49.9	51.1	51.1	49.2	48.8	47.8	46.1	47.6	47.9	49.2	49.1	49.1	50.7	49.5	48.7	49.5	50.0	50.1	50.5	50.1	48.6	47.6	48.0	48.0	49.4
	Vietnam	Markit	52.1	52.7	51.5	51.7	50.7	53.5	54.8	52.2	52.6	51.3	49.5	50.1	49.4	51.3	51.5	50.3	50.7	52.3	52.7	52.6	51.9	52.2	52.9	51.7	54.0	52.4
	Poland	Markit	53.2	52.8	55.2	55.1	54.8	54.0	52.4	54.3	54.5	51.1	50.9	52.2	52.1	52.1	50.9	52.8	53.8	51.0	52.1	51.8	50.3	51.5	52.2	50.2	51.9	54.3
	India	Markit	53.3	54.5	52.9	51.2	52.1	51.3	52.6	51.3	52.7	52.3	51.2	50.7	50.3	49.1	51.1	51.1	52.4	50.5	50.7	51.7	51.8	52.6	52.1	54.4	52.3	49.6
	Brazil	Markit	48.7	50.2	50.7	49.6	46.2	46.0	45.9	46.5	47.2	45.8	47.0	44.1	43.8	45.6	47.4	44.5	46.0	42.6	41.6	43.2	46.0	45.7	46.0	46.3	46.2	45.2
	Indonesia	Markit	48.0	47.6	48.5	47.5	46.4	46.7	47.1	47.8	47.3	48.4	47.4	47.8	46.9	47.8	48.9	48.7	50.6	50.9	50.6	51.9	48.4	50.4	50.9	48.7	49.7	49.0
	Russia	Markit	51.7	48.9	47.6	49.7	48.1	48.9	47.6	48.7	48.3	47.9	49.1	50.2	50.1	48.7	49.8	49.3	48.3	48.0	49.6	51.5	49.5	50.8	51.1	52.4	53.6	53.7
	Malaysia	Markit	51.3	51.0	49.1	51.1	50.5	48.8	49.5	47.6	47.7	47.2	48.3	48.1	47.0	48.0	48.6	47.8	48.4	47.1	47.2	47.1	48.1	47.4	48.6	47.2	47.1	47.1

Source: Fundstrat, Bloomberg.

Click here to jump ahead

Executive Summary | 2017 Drivers | 1H drawdown | Portfolio Strategy

Disinflation of ’12 to ’16 ending, as inflation expectations gain…

Markets are finally beginning to see a return to reflation—reversing the 4-year “disinflation” seen since 2012.

- **There are several drivers behind the reversal of disinflation: Oil and commodities no longer “over supplied”, USD flattening, China stabilizing, Europe recovering.**
- **CPI is still higher than inflation breakevens, suggesting that inflation breakevens could adjust even higher, as markets see a return to 2.5%-3.0% inflation expectations, or a “normal” inflation environment.**

Figure: 5-year inflation breakevens vs US CPI

Since 1999

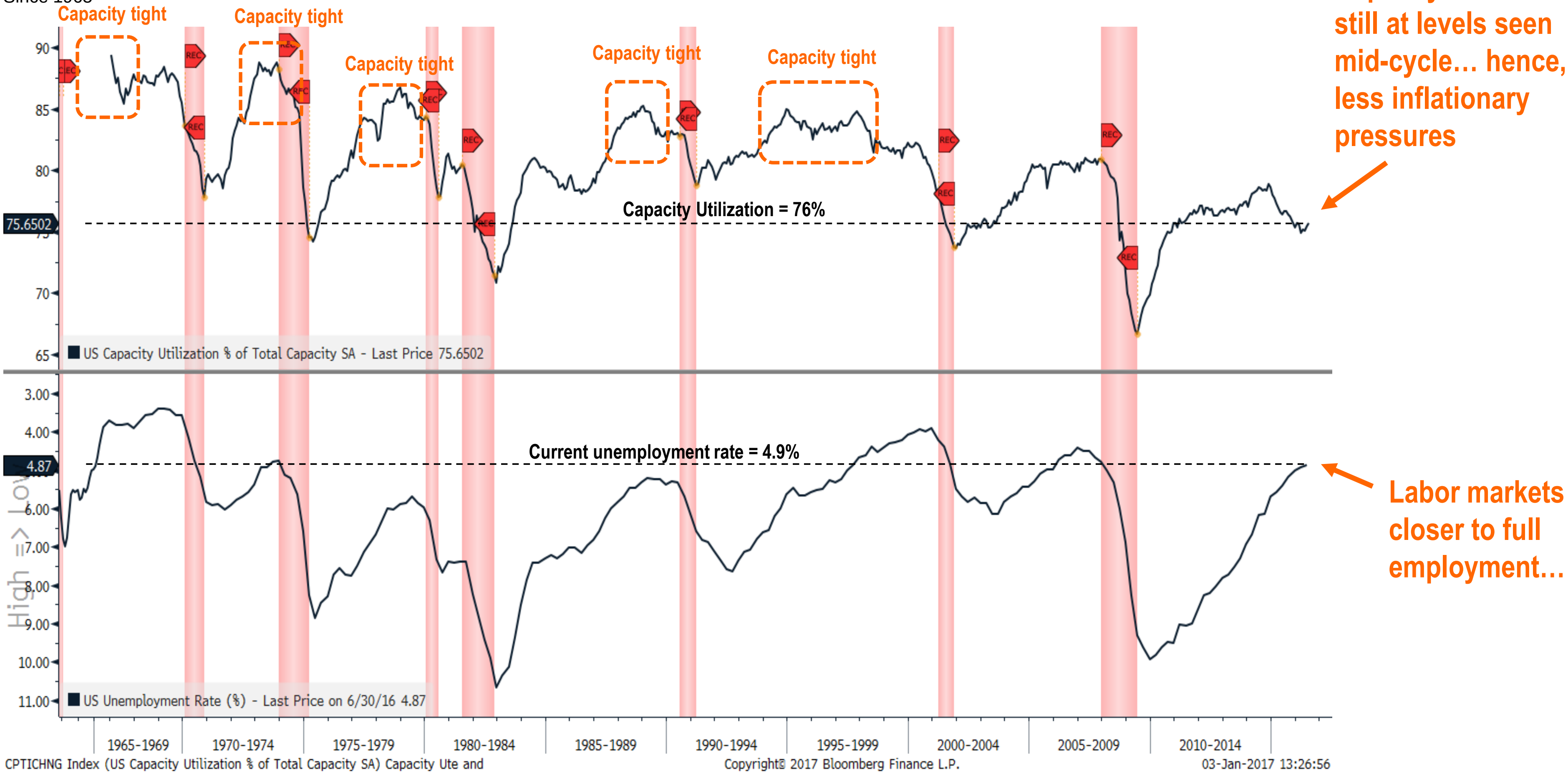
Source: Fundstrat, Bloomberg.

Inflationary pressures in *wages*, not capital assets

As we have discussed in past reports, we see the inflationary pressures developing in labor markets.

- **The first time since the 1950s where labor markets tightened before "assets" tightened.**

Figure: Wage inflation before "capital equipment" inflation
Since 1965



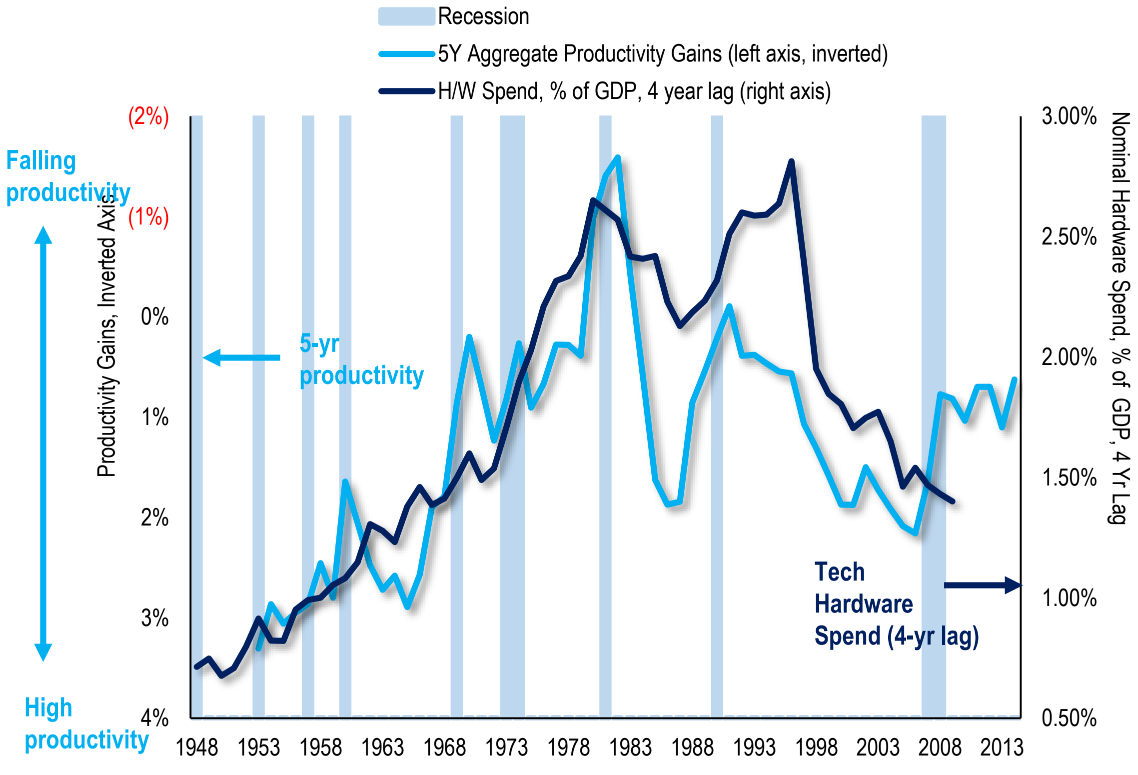
Source: Fundstrat, Bloomberg.

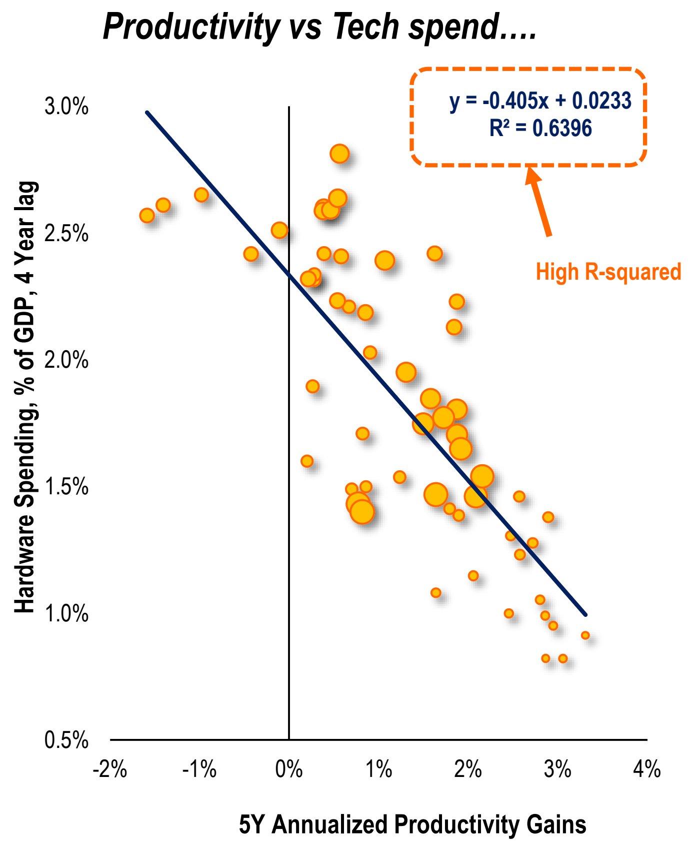
To offset wages, reliance on "automation"…

We have plotted the relationship between low productivity (5-yr rolling) and technology spending (IT hardware).

- **As shown, periods of low productivity are followed by a rise in technology spend.**
- **This is logical, after all, the responses to falling productivity are: automation, export jobs or inflation**

Figure: Historically, cycles of low productivity lead to a surge in Technology spend to boost productivity
Since 1948





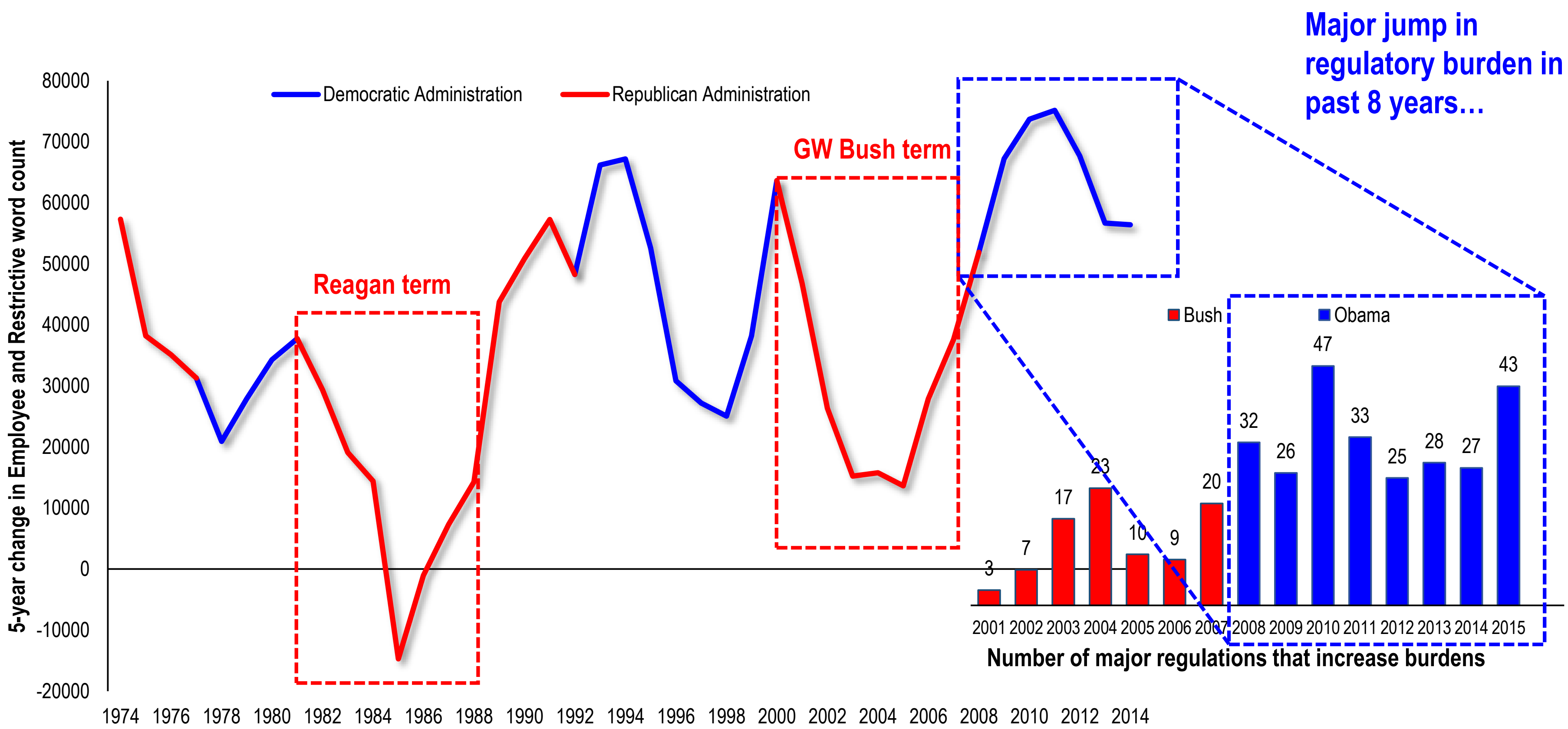
Source: Fundstrat, Bloomberg.

Last 8 years largest jump regulatory burden in 50 years…

Using data from the Mercatus Center, the last 8 years has seen a sharp jump in restrictive regulations for businesses.

- **As shown below, Republican administrations tend to see a decline in regulatory burdens.**

Figure: Regulatory burden 5-year rolling, as measured by change in rise restrictive work and employment regulations
Since 1974. Measured by counting rules and regulations using restrictive wording. 5-year rolling.

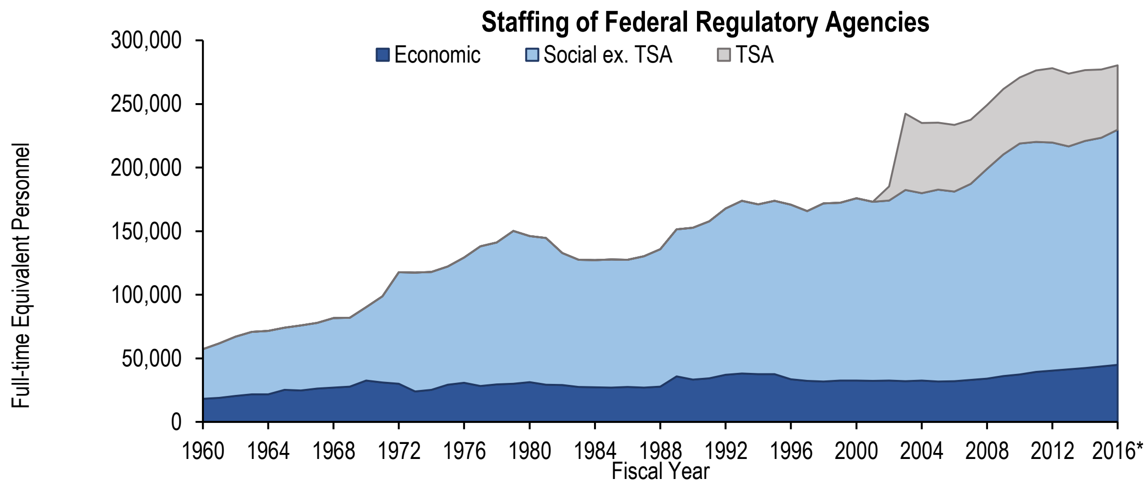


Source: Fundstrat, Mercatus Center

Staffing & Regulatory budgets 2.5X higher since 2000

As shown, spending by regulatory agencies have soared since 2000, far outpacing the rise in inflation,

- **As shown below, regulatory agency spending is $66B in 2016, compared to $25B in 2000.**
- **This growth of 268% far outpaces inflation—if this simply tracked the change in CPI, the regulatory budget would be $40B.**
- Naturally, large budgets and large staffs require “things to regulate”—hence, the rising burden on corporations in the past 16 years.



Spending Summary for Federal Regulatory Agencies (FY, $MN in 'Outlays')

Current (Nominal) Dollars	1960	1970	1980	1990	2000	2010	2014	2015 (Est.)	2016 (Est.)
Consumer Safety and Health	102	222	1,252	1,839	3,650	7,623	8,386	10,081	9,948
Homeland Security	145	335	1,589	3,359	7,874	24,194	25,735	26,507	29,936
Transportation	42	177	550	810	1,493	3,062	2,923	3,239	3,277
Workplace	36	115	748	1,012	1,428	2,083	2,095	2,216	2,331
Environment & Energy	29	248	1,917	4,103	6,564	8,705	9,353	8,492	8,833
Total Social Regulation	354	1,097	6,056	11,123	21,009	45,667	48,492	50,535	54,325
Finance and Banking	40	98	392	1,309	1,968	3,167	4,400	4,722	4,617
Industry-Specific Regulation	91	276	486	513	752	1,271	1,380	1,501	1,691
General Business	48	113	369	738	1,686	3,770	4,838	5,735	6,209
Total Economic Regulation	179	487	1,247	2,560	4,406	8,208	10,618	11,958	12,517
Total Regulation	533	1,584	7,303	13,683	25,415	53,875	59,110	62,493	66,842

Spending by Regulatory agencies up 268% since 2000

Source: Weidenbaum Center, Washington University and the George Washington University Regulatory Studies Center.
'Regulators' Budget Increases Consistent with Growth in Fiscal Budget'

3 sectors poised to benefit most…

Financials—selected regulations

- Dodd-frank: $36B implementation cost
- Pay disclosure ratio (2015)--$1.3B and $0.5B annually.
- Reg. SBSR (2015)—Swap: $0.4B annually
- DOL Fiduciary rule—$11B annually

Energy—selected regulations

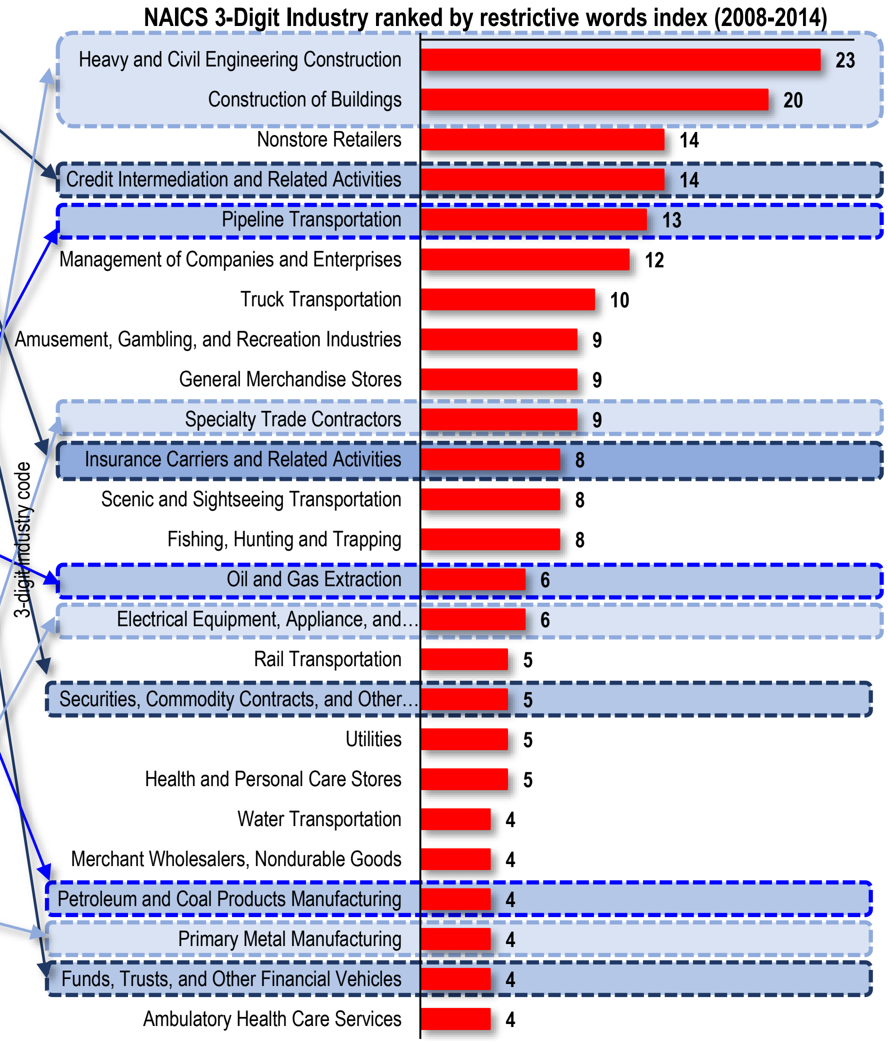
- MATS (Mercury Air Toxics Standard) (2015)—$10B annually
- EPA Clean Power Plan—$10B annually
- EPA methane emissions restrictions(2015)—$0.6B annually
- Curbing methane emissions (May 2016)—$0.8B annually

Manufacturing—selected regulations

- CAFÉ (2009/2012)—$8B annually
- Safety stds pet foods (2015)—$1.7B annually
- Energy conservation stds for lamps (2015)—$0.9B annually
- Energy stds for commercial HVAC (2016)—$0.8B annually

Source: Fundstrat, and various industry news sources and reports

Figure: Industries with greatest rise in regulatory burden since 2008
Based on CAGR of restrictive regulations



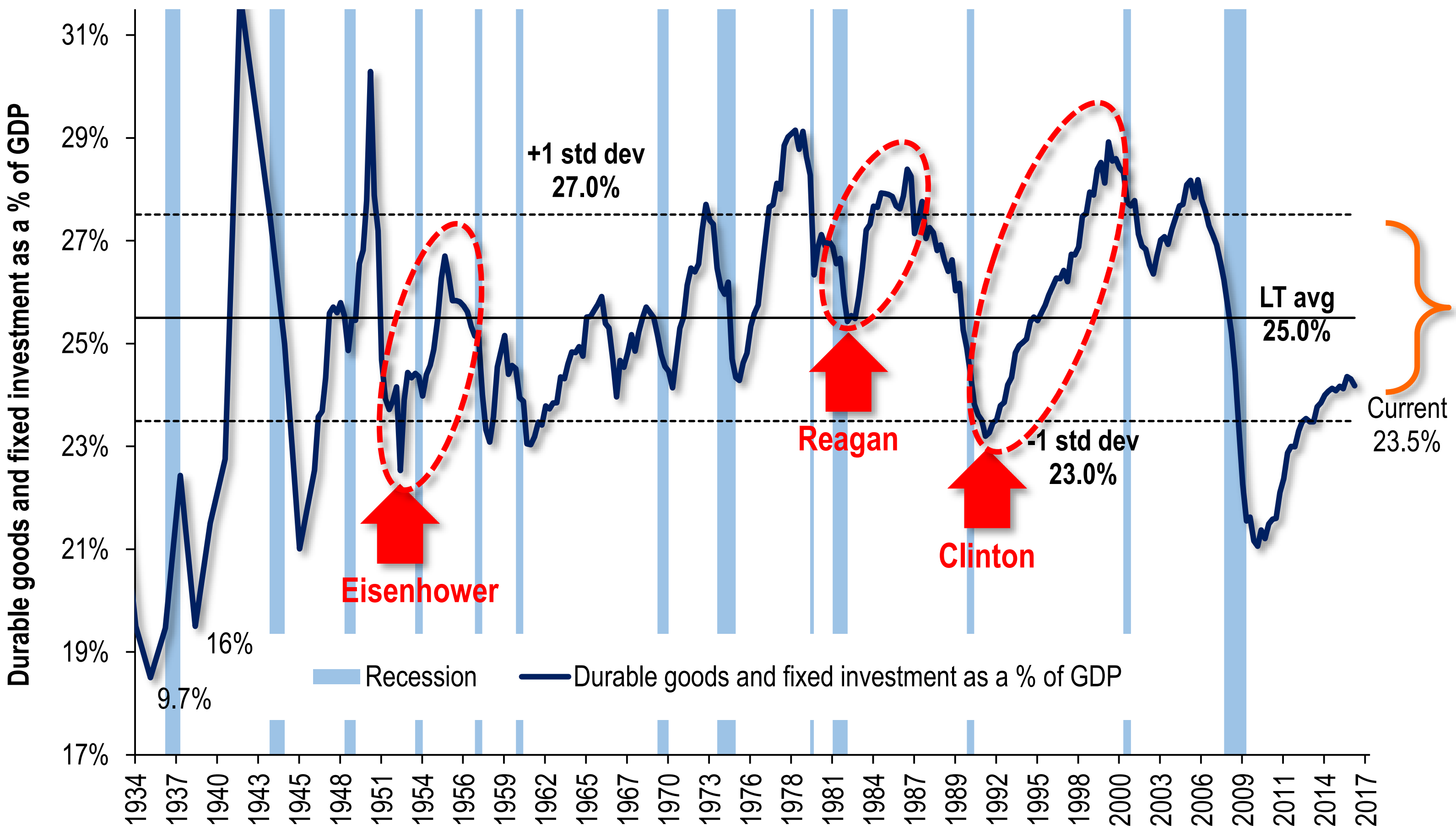
Source: Fundstrat, Mercatus Center

Investment spending is at "recession" levels still….

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

Figure: Investment spend as % GDP

Since 1934



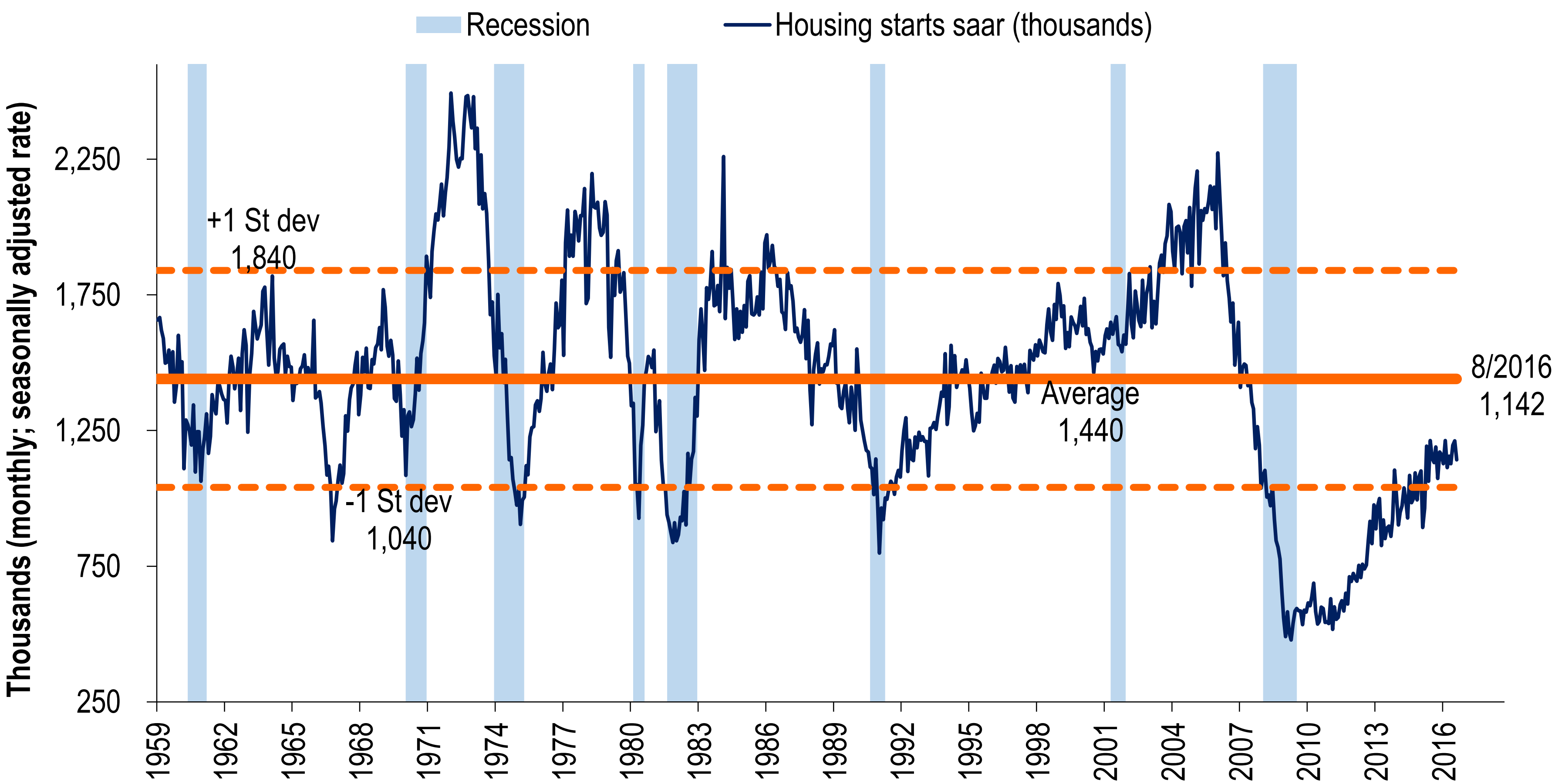
Reaching prior highs is a $700b increase in investment spending…

…over a decade, adds $3.5T to GDP growth….

Source: Fundstrat, Bloomberg

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

Figure: Housing Starts since 1959
Since 1959

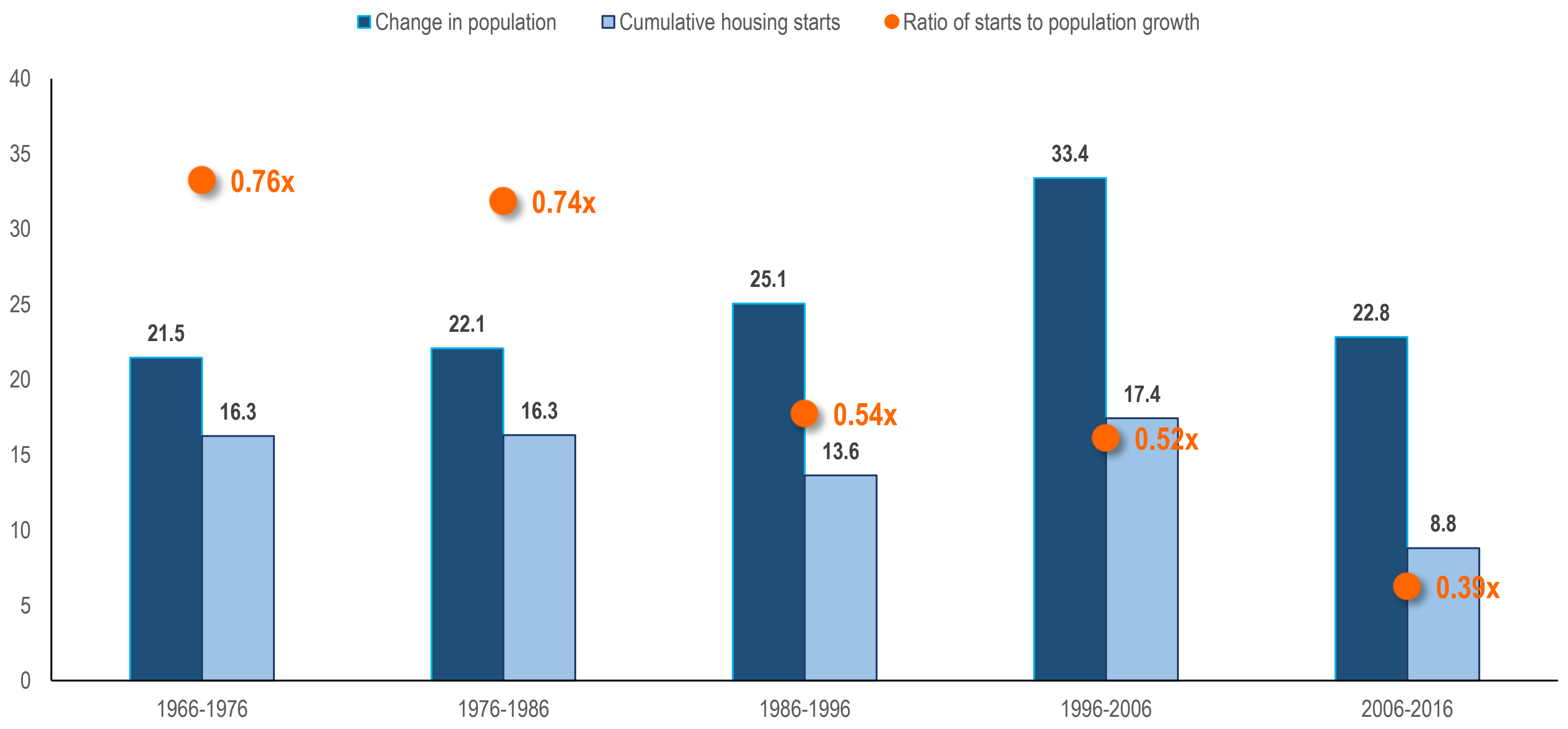


Source: Fundstrat, Bloomberg, BEA.
Note: we are including government fixed investment during the WWII period to account for the reclassification of private property as public property.

U.S. housing market still undersupplied…

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

Figure: Changes in housing starts and population growth
From 1966



Source: Fundstrat, Bloomberg

All points to a sustained EPS recovery…

The combination of oil recovery, rising interest rates and fading of cyclical shocks are leading to a sustained recovery in EPS.

- **We forecast $137 in 2017 EPS, which is $5 above consensus—we see tax cuts as offering limited benefit to stocks.**

Figure: Double-digit EPS growth in 2017…

Cyclicals Financials and Telecoms driving *double-digit* EPS gains…

Double-digit EPS growth

				Fundstrat EPS estimates					Valuation		
				2016E	2017E		2018E		2016E	2017E	2018E
	Sector	Market cap	point contribution	EPS	EPS	% chg y/y	EPS	% chg y/y	P/E	P/E	P/E
Cyclicals	Discretionary	2,491,154	280	$14.75	$15.45	4.7%	$17.40	12.7%	19.0x	18.1x	16.1x
	Industrials	2,054,653	231	$12.50	$12.78	2.3%	$13.98	9.4%	18.5x	18.1x	16.5x
	Materials	571,159	64	$3.27	$4.00	22.5%	$4.21	5.1%	19.6x	16.0x	15.3x
	Technology	4,172,957	469	$26.46	$29.14	10.1%	$31.50	8.1%	17.7x	16.1x	14.9x
Near Cyclicals	Energy	1,495,128	168	$1.14	$5.65	394.2%	$7.42	31.3%	146.9x	29.7x	22.6x
	Financials	2,902,085	326	$21.90	$24.39	11.4%	$26.32	7.9%	14.9x	13.4x	12.4x
	Real Estate	584,298	66	$2.04	$1.79	-12.1%	$1.97	10.1%	32.3x	36.7x	33.3x
Defensives	Staples	2,085,026	234	$11.70	$12.37	5.7%	$12.46	0.7%	20.0x	18.9x	18.8x
	Healthcare	2,709,877	305	$19.58	$20.68	5.6%	$22.61	9.3%	15.6x	14.7x	13.5x
	Utilities	610,878	69	$4.00	$4.05	1.3%	$4.34	7.0%	17.2x	16.9x	15.8x
	Telecom	525,961	59	$3.93	$4.31	9.7%	$4.43	2.6%	15.0x	13.7x	13.4x
Fundstrat	**S&P 500**	**20,203,175**	**2,271**	**$121.27**	**$134.63**	**11.0%**	**$146.63**	**8.9%**	**18.7x**	**16.9x**	**15.5x**
Street Consensus	**S&P 500**			**$121.27**	**$133.15**	**9.8%**	**$145.70**	**9.4%**	**18.7x**	**17.1x**	**15.6x**

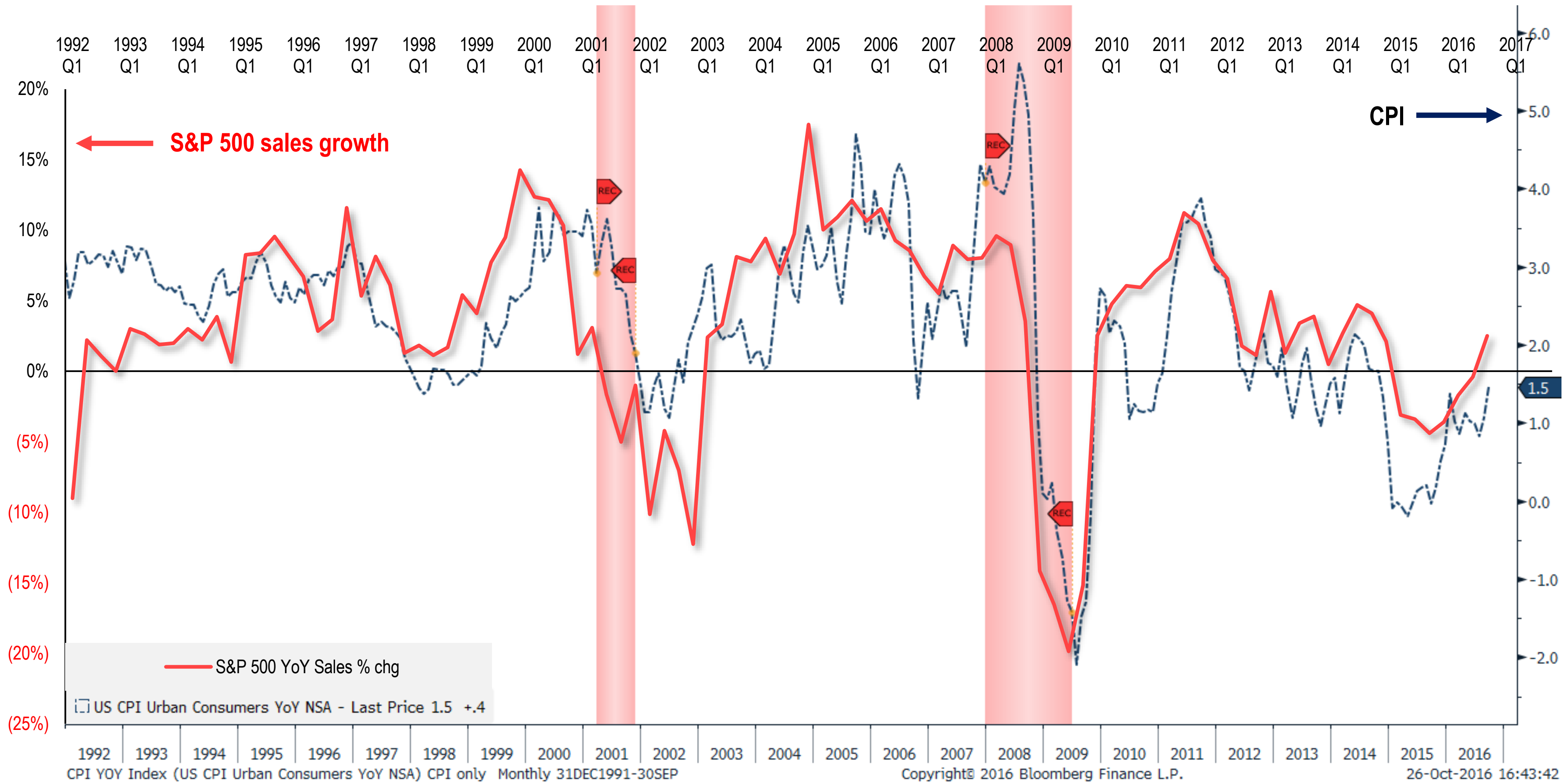
Source: Fundstrat, Thomson Reuters.

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

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

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

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

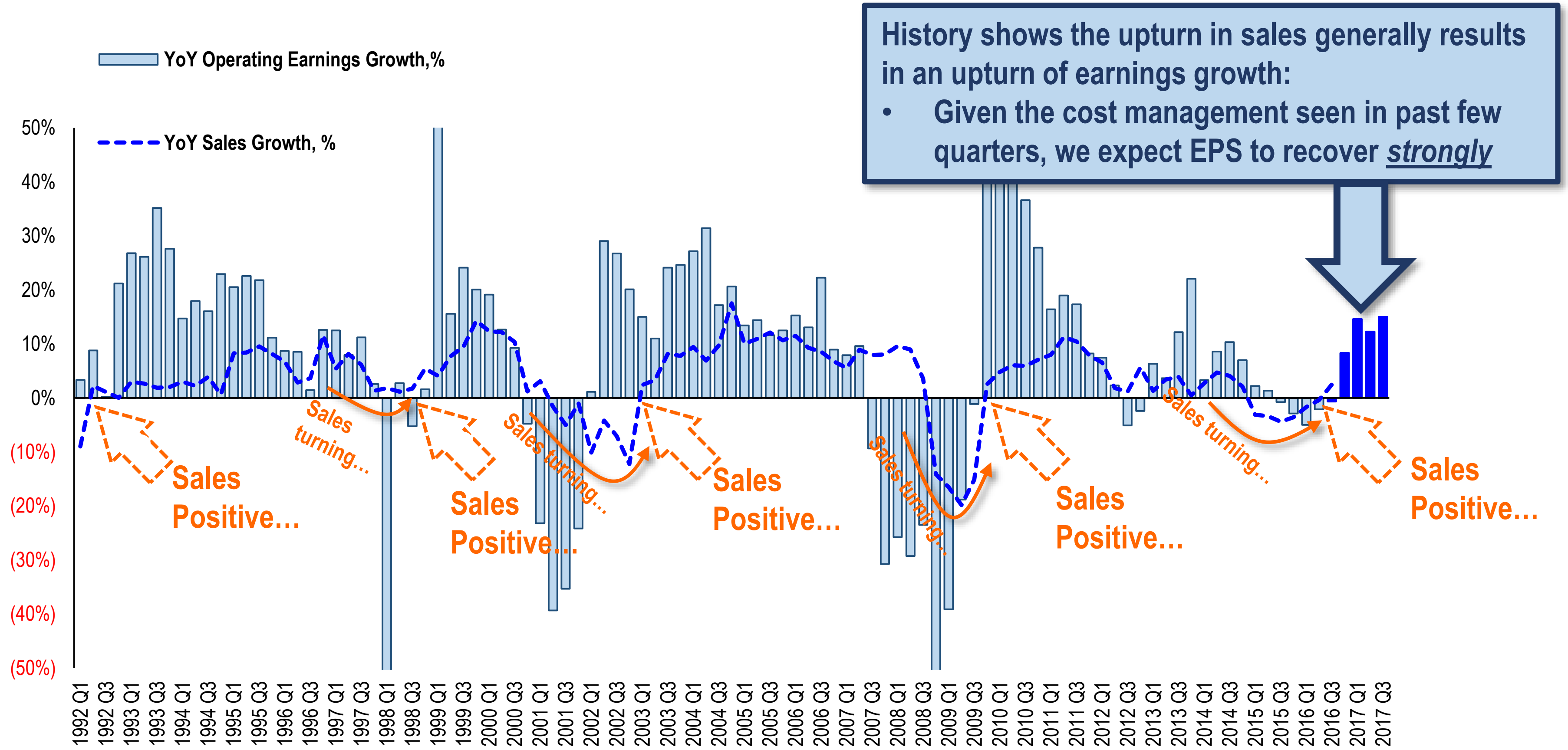


4 of 4 times, sales *inflecting*, *leads* EPS acceleration…

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

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

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



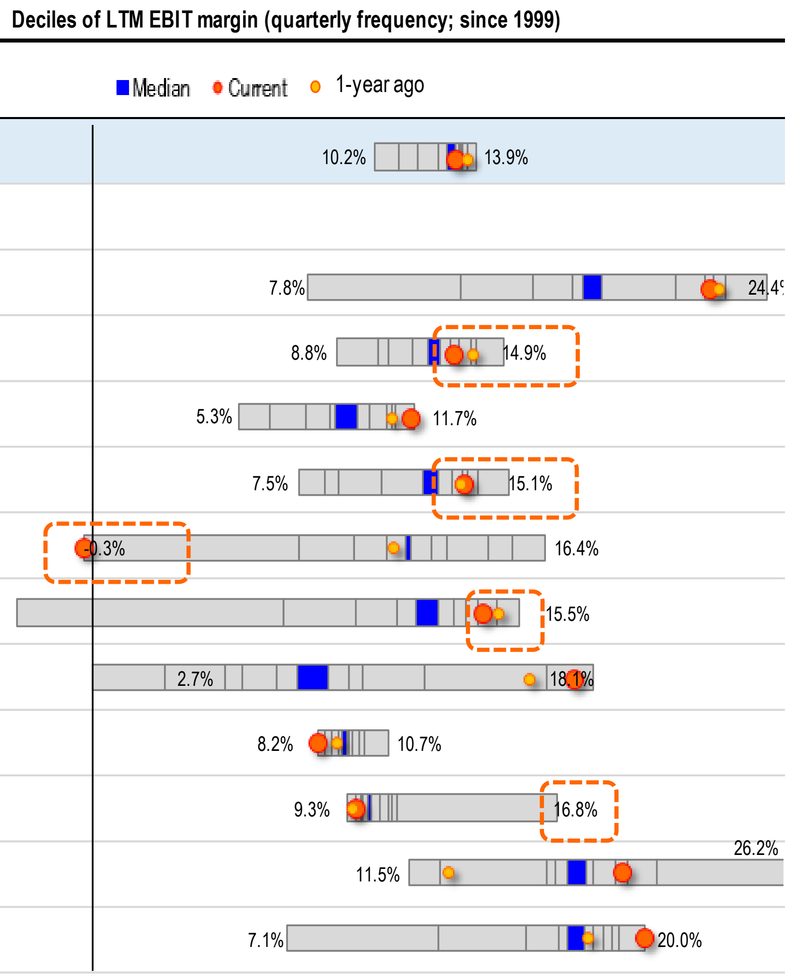
Source: Fundstrat, Thomson Reuters.

Rising inflation supports upside in EBIT margins…

The greatest upside in margins, in our view, is **Energy (oil)** and **Financials (higher rates and de-regulation)**. We see upside in **Industrial (de-regulation and inflation)** margins as well.

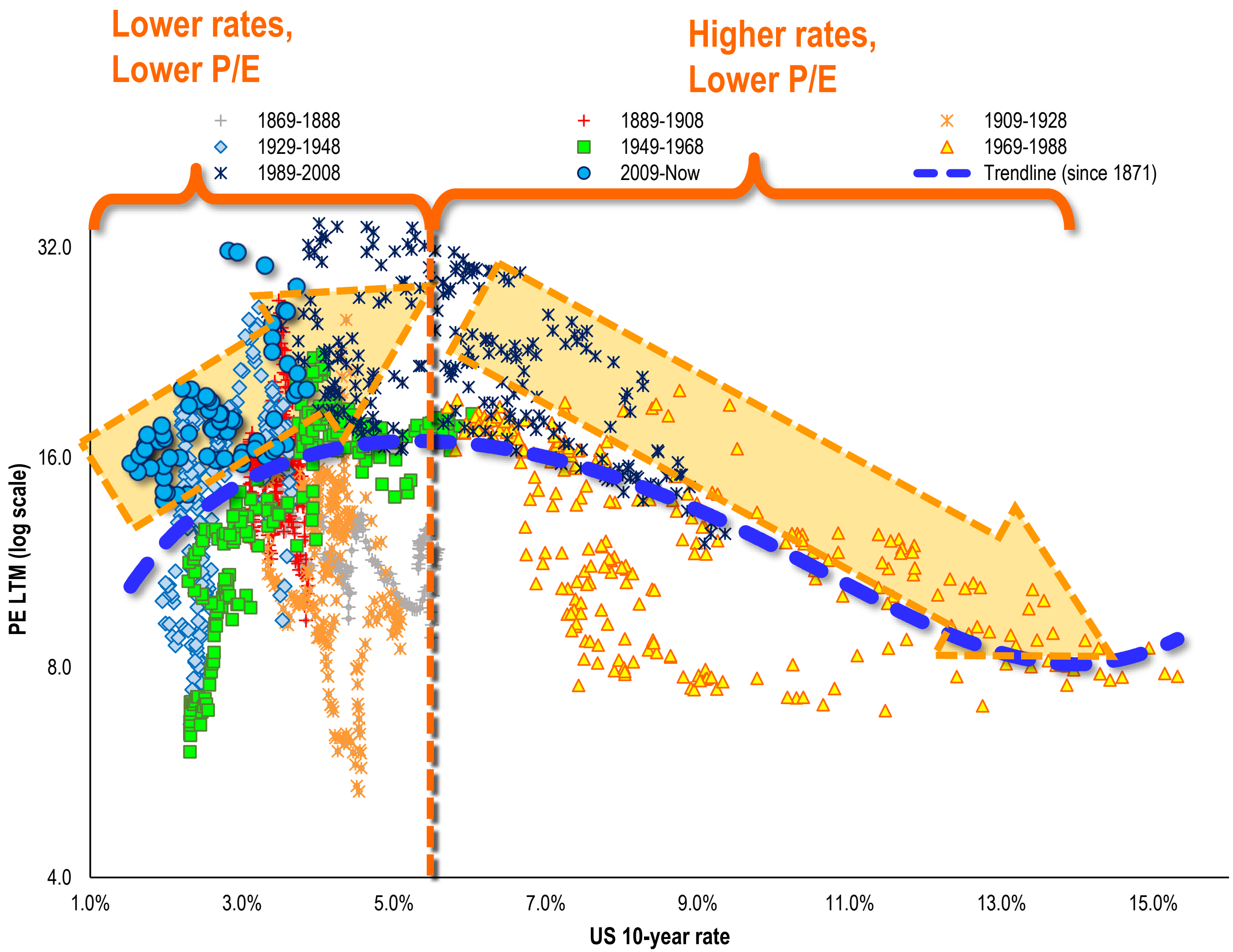
Figure: Deciles of S&P 500 EBIT margins
Since 1999

% contribution to S&P 500 Sales		% contribution to S&P 500 EBIT		Market cap weight		
Sales ($B)	% share	Total EBIT	% share	Market cap	% share	
$8,235	100%	$1,202	100%	$20,281	100%	S&P 500
$1,234	15%	$278	23%	$4,195	21%	Technology
$1,199	15%	$167	14%	$2,058	10%	Industrials
$1,650	20%	$190	16%	$2,523	12%	Consumer Discretionary
$318	4%	$45	4%	$578	3%	Basic Materials
$896	11%	$32	3%	$1,486	7%	Energy
$1,376	17%	$48	4%	$2,897	14%	Financials sector (NET MARGIN)
$81	1%	$22	2%	$587	3%	Real Estate
$1,562	19%	$151	13%	$2,729	13%	Healthcare
$1,593	19%	$150	12%	$2,090	10%	Consumer Staples
$310	4%	$60	5%	$524	3%	Telecom Services
$312	4%	$60	5%	$614	3%	Utilities



Source: Fundstrat, Factset, Bloomberg

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



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

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

Source: Fundstrat, Bloomberg

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

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

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

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

S&P 500 1-year returns…

We are here…

Change in inflation rate

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

Positive…

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

Change in inflation rate

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

Positive…

Change in PE ratio…

Change in inflation rate

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

Positive…

EPS change yoy

Change in inflation rate

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

Positive…

Source: Fundstrat, Bloomberg

Lower supply + higher coupons = smaller net supply

We see a favorable dynamic in fixed income in 2017—slightly higher interest paid (higher rates) and lower supply, means the "net supply of bonds" is close to zero in 2017.

- **This suggests that interest rates may rise less than expected, given the Fed tightening and higher inflation.**

Credit Supply Model

SUPPLY: In 2017, we estimate the "supply" of bonds will be around $1.4T, below the $1.55T issued in 2016 and about the same issuance as in 2015.

INTEREST P AID: we estimate that "interest paid" on existing bonds will rise to $1.36T, above the $1.3T in 2016, reflecting higher rates and higher outstandings.

NET SUPPLY: We estimate the net supply of bonds will be close to zero and the lowest figure since 2008

	2012	2013	2014	2015	2016E	2017E
Treasuries	$1,009	$849	$783	$632	$407	$419
Agency Debt	(188)	(117)	(154)	(133)	70	0
Municipals	(53)	(38)	(80)	(86)	2	(40)
Non-Agy MBS	(197)	(154)	(80)	(66)	(75)	(50)
Agency MBS	70	277	77	187	225	175
CMBS	(46)	(12)	(1)	(17)	(77)	(50)
ABS	(1)	26	31	4	5	10
CLOs	14	16	67	57	20	20
IG corporates	425	439	455	603	641	550
HY corporates	148	175	165	166	125	175
EM corporates	255	291	266	98	122	102
EM sovereign	34	40	29	26	85	56
Total Net Supply	**$1,470**	**$1,792**	**$1,558**	**$1,472**	**$1,550**	**$1,367**

minus Credit Coupon Model

	2012	2013	2014	2015	2016	2017E
Money Market	$2,612	$2,714	$2,903	$2,807	$2,613	$2,613
Treasuries	11,028	11,834	12,481	13,169	13,622	14,041
Federal Agency Securities	1,443	1,574	1,649	1,775	1,876	2,026
Municipals	3,882	3,814	3,772	3,788	3,831	3,742
Mortgages	9,749	9,670	9,671	9,768	9,935	9,870
ABS	1,841	1,513	1,428	1,345	1,267	1,158
Investment grade	5,901	6,184	6,500	6,967	7,207	7,718
High yield	1,145	1,270	1,326	1,199	1,345	1,495
EM Corporates	191	374	412	375	402	504
EM Sovereign	453	494	516	539	637	693
Total Outstandings	**$38,244**	**$39,442**	**$40,657**	**$41,732**	**$42,735**	**$43,860**

X

	2012	2013	2014	2015	2016	2017E
Money Market	0.5%	0.5%	0.4%	0.4%	0.3%	0.3%
Treasuries	2.1%	2.0%	2.0%	2.0%	2.0%	2.1%
Federal Agency Securities	2.5%	2.8%	2.9%	2.7%	2.8%	2.9%
Municipals	3.7%	4.2%	4.2%	3.6%	3.7%	3.7%
Mortgages	4.2%	3.9%	3.9%	3.8%	3.8%	3.9%
ABS	1.2%	1.1%	1.4%	1.7%	1.9%	1.9%
Investment grade	3.3%	3.1%	3.3%	3.4%	3.6%	3.6%
High yield	7.3%	6.1%	6.3%	7.7%	7.5%	7.6%
EM Corporates	5.7%	5.0%	5.6%	6.1%	5.7%	5.7%
EM Sovereign	4.9%	4.8%	5.6%	5.7%	5.7%	5.7%
Total	**3.1%**	**2.9%**	**3.0%**	**3.0%**	**3.0%**	**3.1%**

=

	2012	2013	2014	2015	2016	2017E
Money Market	$13	$12	$13	$10	$7	$9
Treasuries	236	237	250	268	274	290
Federal Agency Securities	35	44	48	47	53	58
Municipals	145	158	158	135	141	139
Mortgages	410	380	373	374	379	381
ABS	23	16	19	22	24	22
Investment grade	196	189	213	240	259	281
High yield	84	78	84	93	101	113
EM Corporates	11	19	23	23	23	29
EM Sovereign	22	24	29	31	36	40
Total	**$1,174**	**$1,157**	**$1,211**	**$1,243**	**$1,297**	**$1,362**

= Net Supply (needing external demand)

	2012	2013	2014	2015	2016	2017E
Net excess Supply	**296**	**635**	**347**	**229**	**253**	**5**

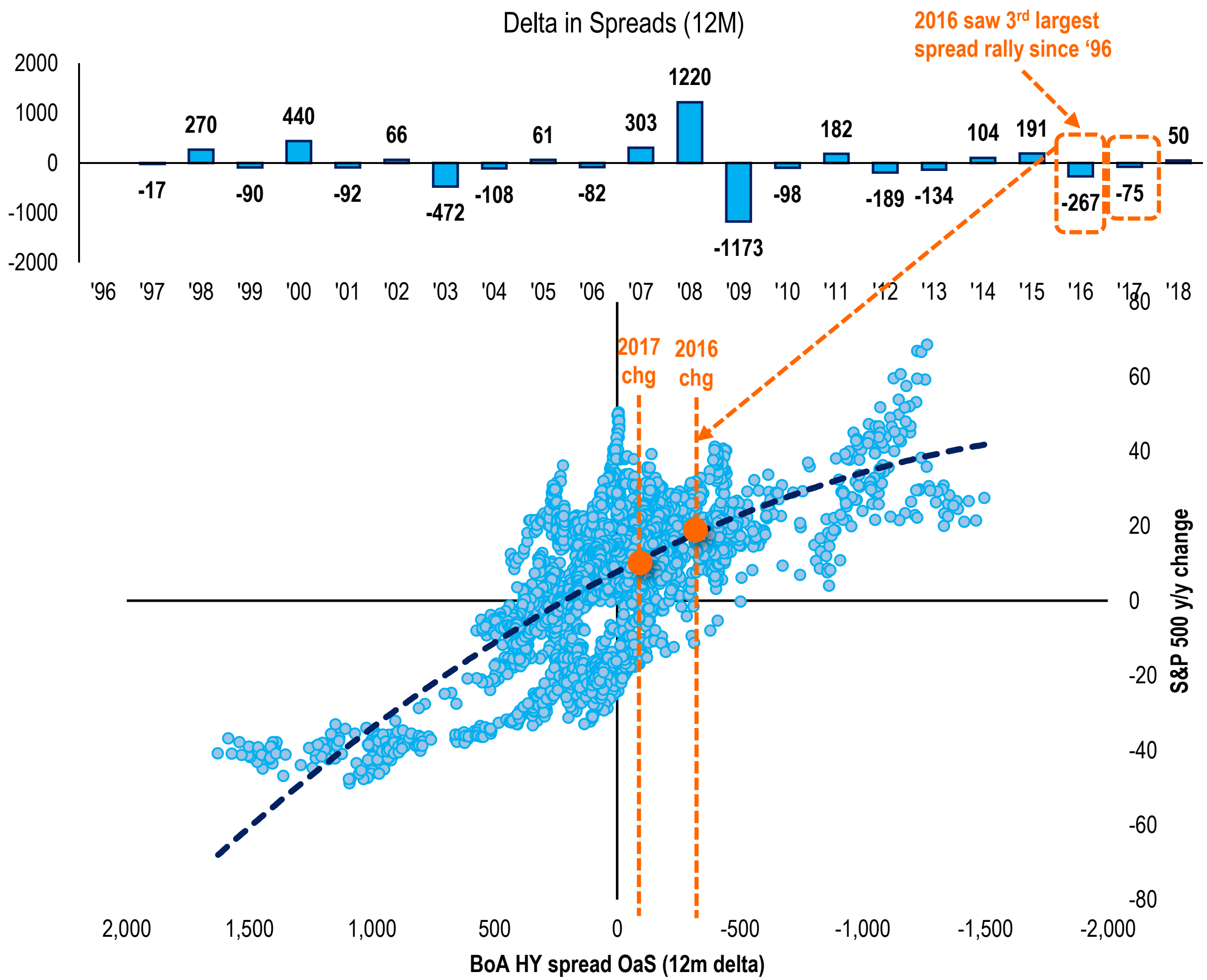
Source: Fundstrat, SIFMA, Bloomberg

High-yield still *supportive*, but less of tailwind

We have long viewed HY as a leading indicator for equity markets. And as the scatter chart on the bottom right shows, equity returns and HY are highly correlated.

- **2016 saw a massive tailwind from high-yield—the 267bp rally in spreads was the 3rd largest rally in spreads ever.**
- **For 2017, we still expect HY spreads to rally by at least 75bp but as discussed on the next slide, the "low" absolute level of yield makes HY risk/reward more balanced in 2017.**

Figure: Comparative Performance of HY and Equities
Since 1996. BofA HY index



Source: Fundstrat, SIFMA, Bloomberg

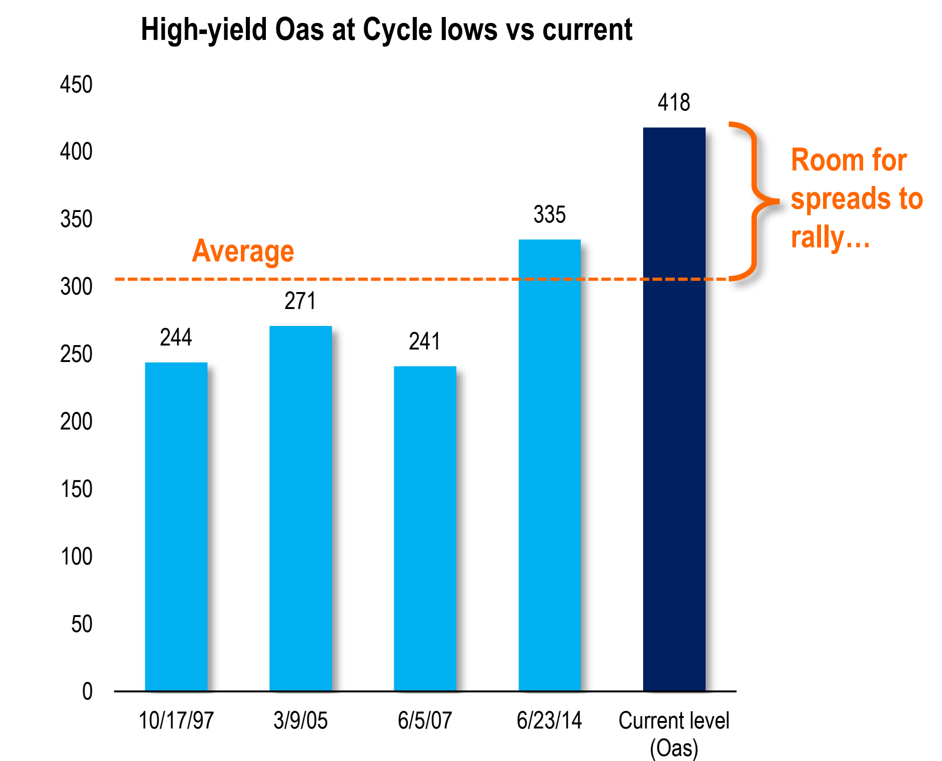
High-yield: Room for spreads to rally, but yields *low*...

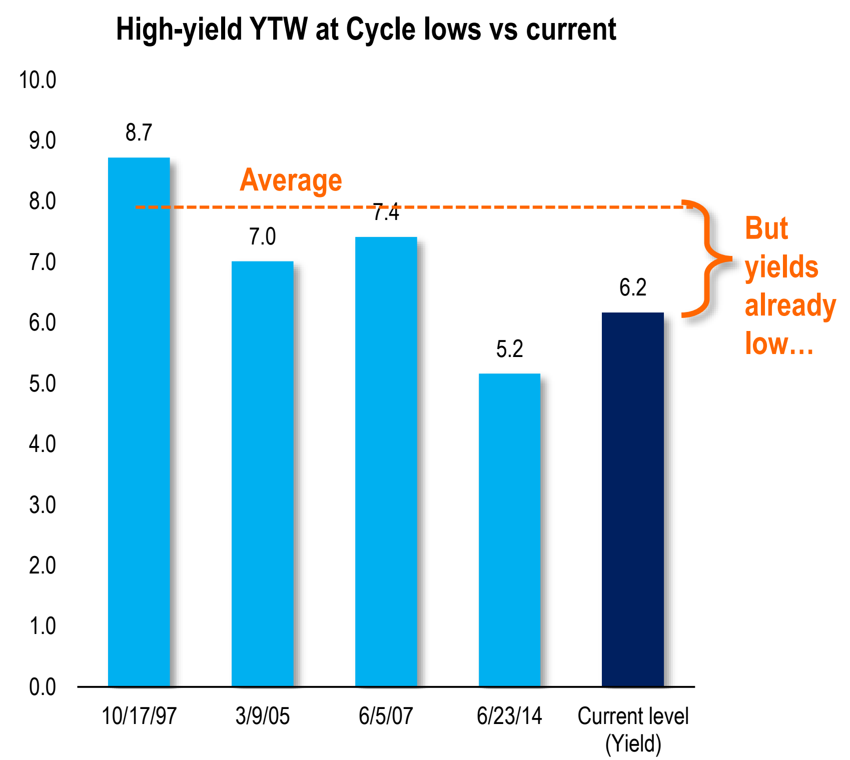
As highlighted below, the current spreads of high-yield (BofA HY index) at 418bp is still above the typical cycle lows of 240-330bp seen in prior cycles.

- **But the level of the yield is actually BELOW those prior cycle lows—yields have a inherent floor as default risk needs to be priced into yield.**

- **The implication is we see less of a tailwind from high-yield, as higher interest rates see spread compression but less absolute upside in HY bonds.**

Figure: Comparative Spreads and Yield of HY today and compared to prior cycle lows
Since 1996. BofA HY index





Source: Fundstrat, SIFMA, Bloomberg

First term: Drawdown *5% or more* 62% of time

As shown below, the chances of a significant market drawdown are sharply elevated in the first term of a new President (1H).

- **The likelihood of a 5% or greater drawdown is double that of other years—in other words, investors should be patient for their entry point in 2017.**

Figure: Distribution of 1H drawdowns—Based on Dec 31 close to 1H Trough
Since 1900

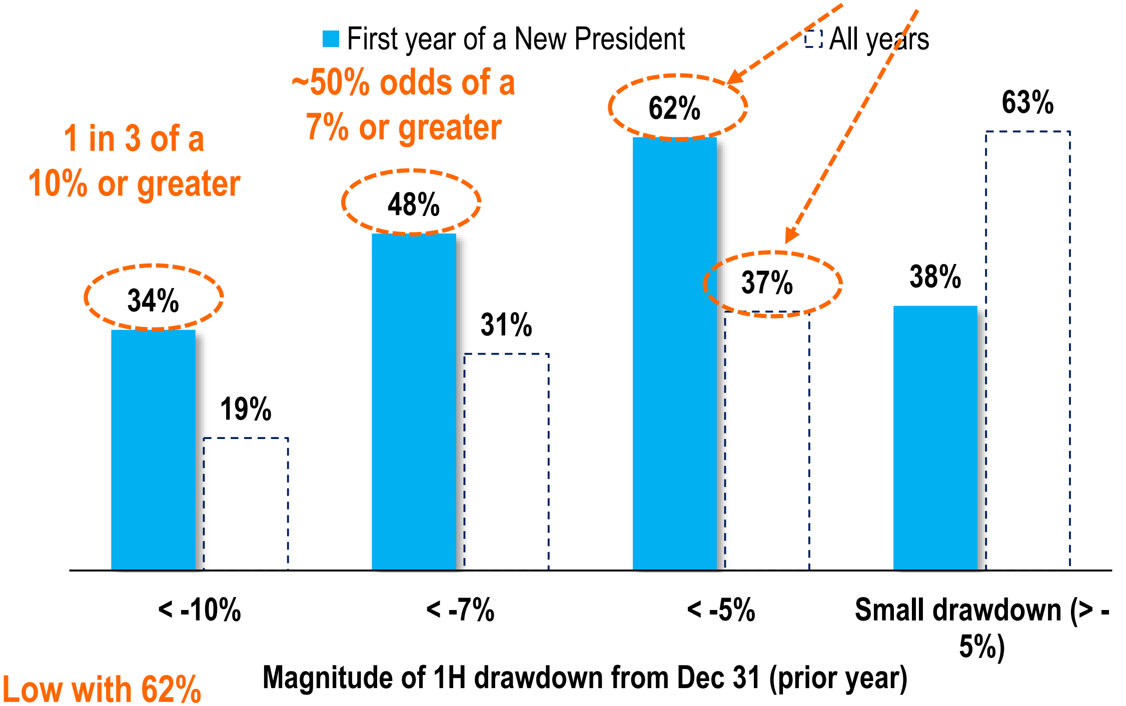
Implied 1H Trough based on drawdown:

1H decline	Implied S&P 500	% of 1st terms
< -5%	2127	62%
< -7%	2082	48%
< -10%	2015	34%

For tactical clients, best entry point in 1H17 is 2150

1H Low with 62% probability...

The probability of a 5% or greater drawdown is 62%-- double the likelihood compared to other years...



Source: Fundstrat, Bloomberg.

The data: by year

We have listed the 29 "First Term" years on the right.

- We have listed the Dec 31 close to 1H trough (far right).
- **As shown, the median 1H drawdown is 7% and only 2 years saw no drawdown. Those two years were 1928 and 2012.**
- **The trough typically happens within 58 trading days, or sometime in the first quarter.**
- Because we do not anticipate a recession, we think the downside risk is closer to 5%-7%--this is 120 to 150 points on the S&P 500/

Figure: 1H drawdowns of First Term of a New President
Since 1900

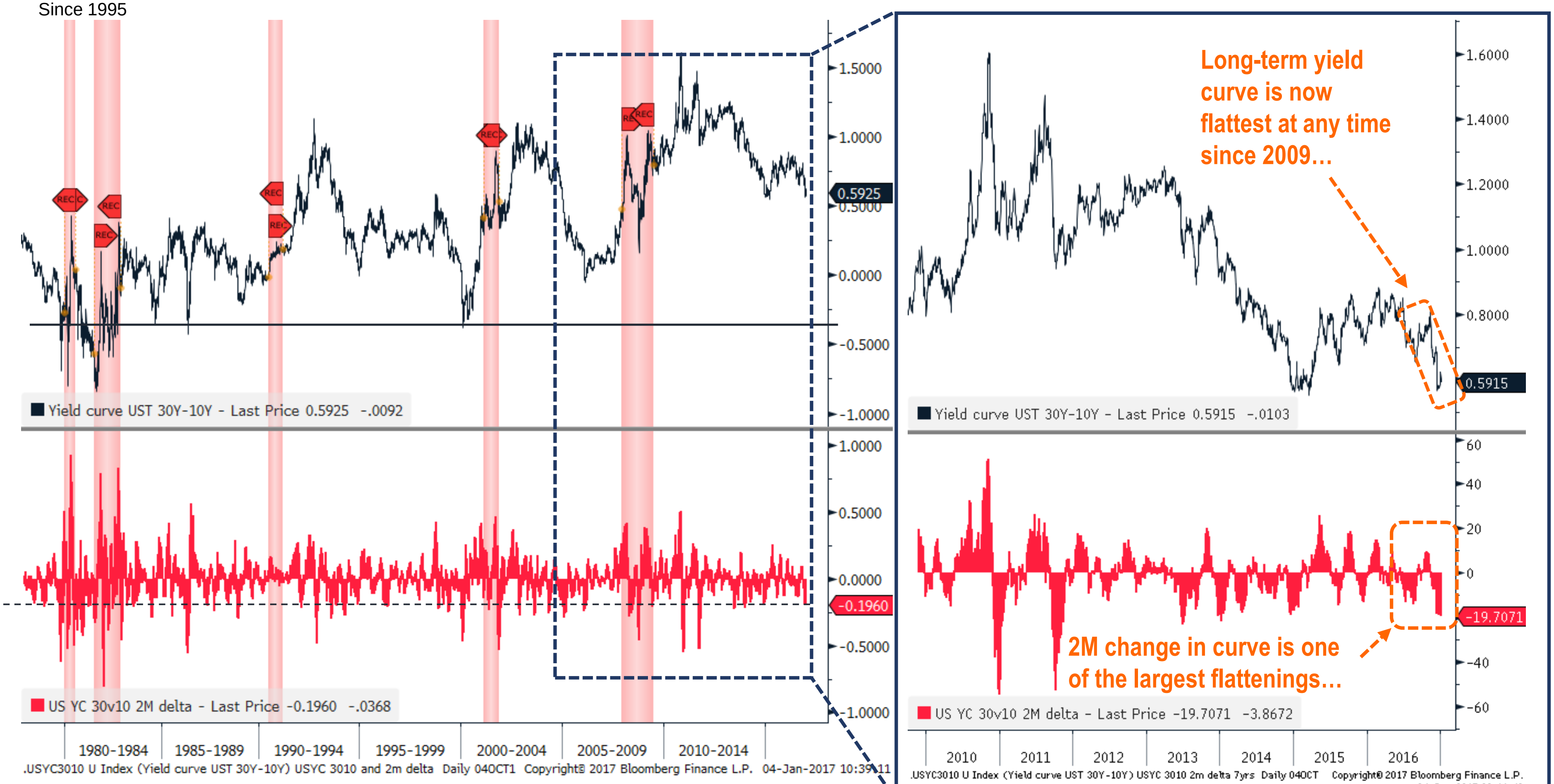
	a	a	b	b	c	c	a --> b	a --> b	a --> c	a --> c
	Election year	Year-end Price	1H Peak of Post-election Year		1H Trough		Year-end to 1H Peak		Year-end to 1H Trough	
			Date	Price	Date	Price	Days	Return	Days	Return
1	1900	6.14	6/17/1901	6.89	1/21/1901	5.71	168	12.1%	21	(7.0%)
2	1904	6.16	4/14/1905	7.37	1/25/1905	6.05	104	19.6%	25	(1.8%)
3	1908	7.56	6/14/1909	8.29	2/23/1909	7.03	165	9.6%	54	(7.0%)
4	1912	7.68	1/9/1913	7.79	6/11/1913	6.35	9	1.5%	162	(17.4%)
5	1916	8.36	1/3/1917	8.73	2/2/1917	7.66	3	4.4%	33	(8.4%)
6	1920	6.16	5/5/1921	7.04	6/20/1921	5.71	125	14.3%	171	(7.3%)
7	1924	10.38	6/30/1925	11.53	3/30/1925	10.12	181	11.0%	89	(2.6%)
8	1928	23.98	6/28/1929	27.41	1/8/1929	24.17	179	14.3%	8	0.8%
9	1932	6.92	6/27/1933	10.98	2/27/1933	5.53	178	58.7%	58	(20.1%)
10	1936	17.27	3/10/1937	18.67	6/28/1937	15.12	69	8.1%	179	(12.4%)
11	1940	10.57	1/10/1941	10.86	5/1/1941	9.30	10	2.7%	121	(12.0%)
12	1944	13.28	6/26/1945	15.37	1/23/1945	13.21	177	15.7%	23	(0.5%)
13	1948	15.28	1/7/1949	15.61	6/13/1949	13.55	7	2.2%	164	(11.3%)
14	1952	26.59	1/5/1953	26.66	6/10/1953	23.54	5	0.3%	161	(11.5%)
15	1956	46.56	6/17/1957	48.24	2/12/1957	42.39	168	3.6%	43	(9.0%)
16	1960	58.11	5/17/1961	67.39	1/3/1961	57.57	137	16.0%	3	(0.9%)
17	1964	84.30	5/13/1965	90.27	6/28/1965	81.60	133	7.1%	179	(3.2%)
18	1968	103.80	5/14/1969	106.16	6/23/1969	96.23	134	2.3%	174	(7.3%)
19	1972	118.05	1/11/1973	120.24	6/25/1973	102.25	11	1.9%	176	(13.4%)
20	1976	106.88	1/1/1977	107.46	5/31/1977	96.12	1	0.5%	151	(10.1%)
21	1980	135.33	1/6/1981	138.12	2/20/1981	126.58	6	2.1%	51	(6.5%)
22	1984	166.26	6/28/1985	191.85	1/4/1985	163.68	179	15.4%	4	(1.6%)
23	1988	277.72	6/27/1989	328.44	1/3/1989	275.31	178	18.3%	3	(0.9%)
24	1992	438.82	3/10/1993	456.33	1/8/1993	429.05	69	4.0%	8	(2.2%)
25	1996	753.85	6/20/1997	898.70	1/2/1997	737.01	171	19.2%	2	(2.2%)
26	2000	1,320.28	1/30/2001	1,373.73	4/4/2001	1,103.25	30	4.0%	94	(16.4%)
27	2004	1,213.55	3/7/2005	1,225.31	4/20/2005	1,137.50	66	1.0%	110	(6.3%)
28	2008	890.64	6/12/2009	946.21	3/9/2009	676.53	163	6.2%	68	(24.0%)
29	2012	1,402.43	5/21/2013	1,669.16	1/1/2013	1,426.19	141	19.0%	1	1.7%
	2016									
	Median						133	7.1%	58	(7.0%)

Yield curve *confused* by wage inflation vs bond supply?

As our clients know, we believe the long-term yield curve is one of the most reliable predictors of business cycle turns. It has flattened sharply since election day.

- **This is negative but the reasons are not entirely clear—we believe bond markets are confused—inflation is rising and Fed is raising. But limited bond supply keeps LT rates low—hence a flattening…**

Figure: Long-term yield curve (30Y less 10Y) and the 2M change in LT yield curve
Since 1995



Source: Fundstrat, SIFMA, Bloomberg

Recent yield curve flattening *negative* equity implications

Since 1996, a flattening of the long-term yield curve has negative implications for equities—and in fact, suggests this is one of the worst times to own stocks.

- **The median 6M return is -5%, implying S&P 500 could fall 110-120 points by June. In fact, as spread flattens (2M trailing), this spells even more trouble for stocks.**

Figure: Return matrix: 6-month S&P 500 under various changes in Yield Curve and Level of LT yield curve

Since 1996. X-axis: 2M Change in LT yield curve. Y-axis: Level of Yield Curve

Top decile flattening

As delta flattens (2M trailing), history says this spells further trouble for stocks…

This is one of the worst times to own equities (next 6m)….

Decile of Yield curve: 30Y les 10Y			Flattening			Decile of Spread Delta (60 days)						Steepening
			1	2	3	4	5	6	7	8	9	10
			-0.58 to -0.15	-0.15 to -0.09	-0.09 to -0.05	-0.05 to -0.02	-0.02 to 0.00	0.00 to 0.03	0.03 to 0.06	0.06 to 0.10	0.10 to 0.16	0.16 to 0.53
Curve Inverted	1	-0.43 to 0.03	6.6%	1.6%	(1.6%)	3.2%	2.4%	(5.5%)	(2.5%)	(5.2%)	(3.0%)	(0.1%)
	2	0.03 to 0.12	3.2%	5.7%	2.8%	7.9%	6.9%	7.8%	6.2%	3.6%	2.5%	(5.3%)
	3	0.12 to 0.19	6.5%	4.8%	2.5%	1.4%	7.5%	8.7%	7.7%	9.1%	11.6%	14.3%
	4	0.19 to 0.27	4.5%	6.6%	11.0%	10.6%	8.0%	8.6%	8.7%	4.2%	7.2%	9.6%
	5	0.27 to 0.35	2.0%	6.4%	4.8%	6.7%	8.0%	10.5%	11.1%	11.5%	10.7%	5.1%
	6	0.35 to 0.53	(2.8%)	(1.5%)	(0.8%)	(1.7%)	(3.8%)	(4.1%)	(1.4%)	(1.6%)	(0.6%)	4.1%
	7	0.53 to 0.74	(5.0%)	(2.9%)	(5.0%)	(8.6%)	(4.9%)	(4.6%)	(4.5%)	(12.5%)	(2.6%)	5.6%
	8	0.74 to 0.85	1.3%	7.3%	3.7%	5.9%	3.6%	7.6%	3.0%	6.3%	5.4%	4.0%
	9	0.85 to 1.02	12.0%	10.2%	9.0%	8.0%	7.2%	8.4%	6.7%	7.4%	9.2%	5.6%
Curve Steep	10	1.02 to 1.60	6.1%	6.5%	4.6%	5.5%	5.7%	6.9%	7.9%	7.8%	8.1%	9.5%

Source: Fundstrat, SIFMA, Bloomberg

Median return is 3% following 10%-years…

Last year (for 2016), we used the analysis below to suggest that double-digit gains follow flat years. In fact, last December 2015, we showed that the odds of a 10% gain or higher were greater than 50% after a flat year.

- **The set-up is different for 2017—equity markets posted double-digit gains and since 1927, the median return following a double-digit gain is 3% and only a 37% chance of greater than 7.5% gain.**
- **By comparison, when looking at all years, markets gain greater than 7.5% 52% of the time—in other words, 2017 likely mediocre.**

Figure: Forward returns, based on *<u>DECILES</u>* of LTM performance

S&P 500 forward return probabilities based on deciles of rolling 12-month performance (since 1927). N=1,068 instances

	Deciles of LTM return			Forward 1-yr return: Median	Forward 1-yr return: Win-ratio	(a) Probability 1-yr return: < -7.5%	Probability 1-yr return: -7.5% to +7.5%	(b) > +7.5%	(b) / (a) Ratio	(c) Probability 1-yr return: < -5%	Probability 1-yr return: -5% to +5%	(d) > +5%	(d) / (c) Ratio
	Top decile	10	31% - 146%	4.8%	63%	26%	33%	41%	1.6 to 1	29%	22%	50%	1.7 to 1
		9	23% - 31%	9.0%	65%	20%	26%	54%	2.7 to 1	27%	15%	58%	2.1 to 1
		8	17% - 23%	10.4%	77%	15%	26%	59%	3.8 to 1	18%	14%	67%	3.7 to 1
		7	13% - 17%	9.0%	74%	14%	30%	55%	3.9 to 1	18%	19%	63%	3.5 to 1
2017 set-up: Prior year +10%		6	9% - 13%	3.2%	59%	13%	50%	37%	2.7 to 1	20%	37%	43%	2.1 to 1
		5	4% - 9%	8.4%	68%	18%	31%	51%	2.8 to 1	21%	18%	61%	2.9 to 1
2016 set-up: Prior year +0%		4	(2%) - 4%	10.0%	70%	14%	30%	55%	3.9 to 1	19%	20%	62%	3.3 to 1
		3	(8%) - (2%)	11.2%	66%	25%	20%	55%	2.2 to 1	28%	13%	59%	2.1 to 1
		2	(17%) - (8%)	11.9%	66%	27%	18%	55%	2.0 to 1	29%	16%	56%	1.9 to 1
	Bottom decile	1	(70%) - (17%)	12.0%	63%	31%	11%	57%	1.8 to 1	33%	7%	60%	1.8 to 1
ALL years Since 1927	ALL periods		(70%) - +146%	8.5%	67%	20%	28%	52%	2.5 to 1	24%	18%	58%	2.4 to 1

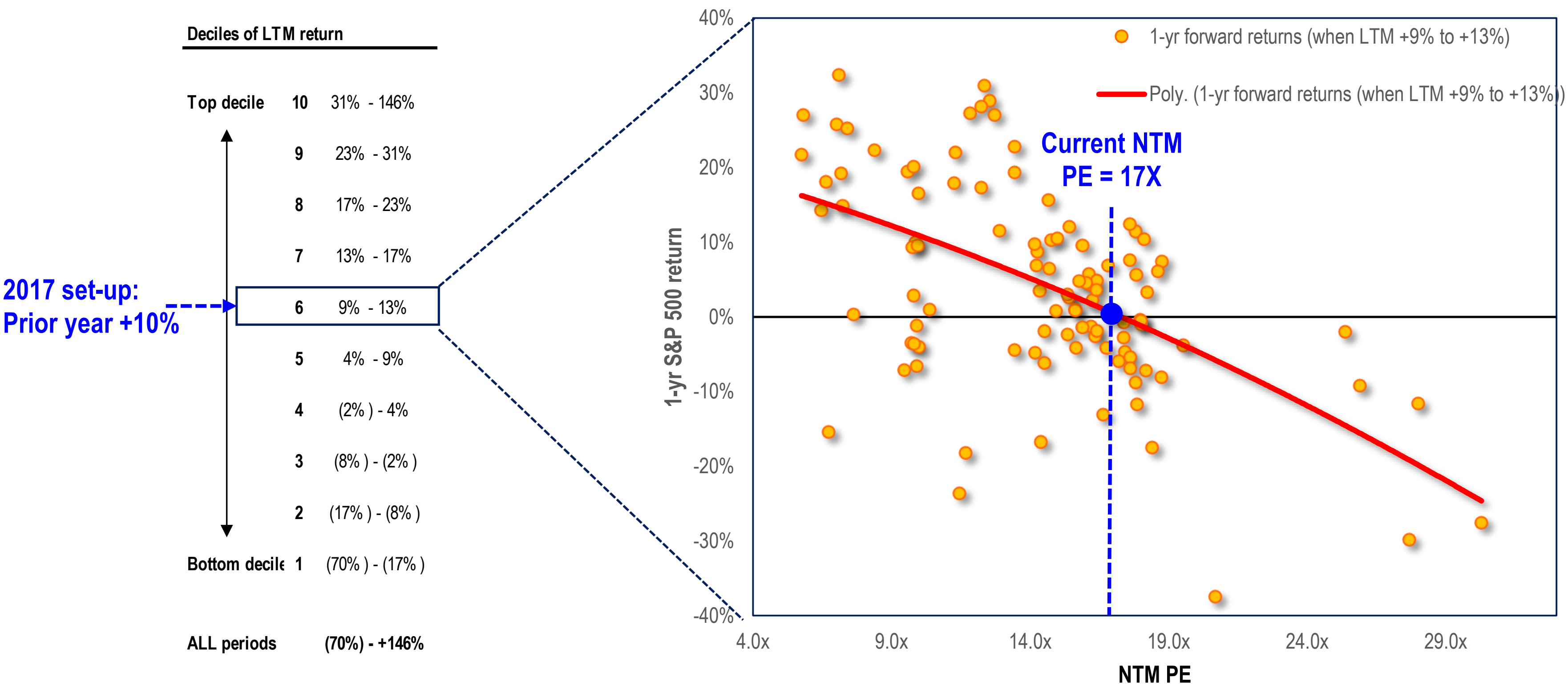
Source: Fundstrat, Bloomberg.

Decile 6: Expected returns *inverse* to starting P/E

We have plotted the comparative return based on starting PE in the 6th decile (LTM returns between 9%-13%). As shown below, the expected return and starting PE are inversely correlated.

- **Based on a current 17X NTM P/E, the trend line suggests the expected return for the S&P 500 is close to zero—in other words, if there is a 1H drawdown, markets would climb their way back.**

Figure: DECILE 6: starting PE and expected 1-year return
Probabilities based on deciles of rolling 12-month performance (since 1927)



Source: Fundstrat, Bloomberg.

Overweight CRAP in 2017

CRAP is an acronym as explained below. But continuing our 2016 theme, we want to buy the bull market laggards—those groups which have lagged the overall market.

CRAP Sectors	C	**Computers (and "industrial technology")**	Levered to positive trends, i.e., automation
	R	**Resources: Energy and Basic Materials**	Inflation sensitives and de-regulation
	A	**American-based Financials**	Higher rates and de-regulation
	P	**Phone carriers and wireless companies**	Re-rate to Utilities PE and de-regulation

CRAP Fundamental Factors	**Depressed margin businesses**	Inflation boosts margins
	Bull market laggards	Laggards were GDP-sensitives
	Wage "insensitive"	Buy high market value/ employee
	Beneficiaries of de-regulation	See report, 3 sectors mainly

Style Factors	**Value over Growth**	7-year cycle **Growth** outperformance ending
	Small-caps	Rally in HY "quality spreads"

Overweight CRAP: EPS upside…

		’17 EPS growth			NTM P/E			Total Return	
		‘16 → ‘17			Now → by YE			EPS % chg + P/E % chg	
		$121 → $135			17X → 15.5X				
	S&P 500	+11%	+		-10%	=		~0%	
C	Technology	+10%	Best EPS growth and upside…	16X	P/E expansion stories			>+7%	
R	Energy	+390%		30X				>+20%	Top pick
	Materials	+20%		16X				>+7%	
A	Financials	+11%		13X				>+7%-10%	Top pick
P	Telecoms	+10%		14X				>+20%	Top pick
Neutrals	Industrials	+2%		18X	Risk of P/E de-rating			0%	
	Discretionary (OW to N)	+5%		18X				0%	
	Healthcare	+6%		15X				-5%-10%	Top avoid
Under Weights	REITS	-12%		37X				-5%-10%	
	Staples	+6%		19X				-5%-10%	Top avoid
	Utilities	+1%		17X				-5%-7%	Top avoid

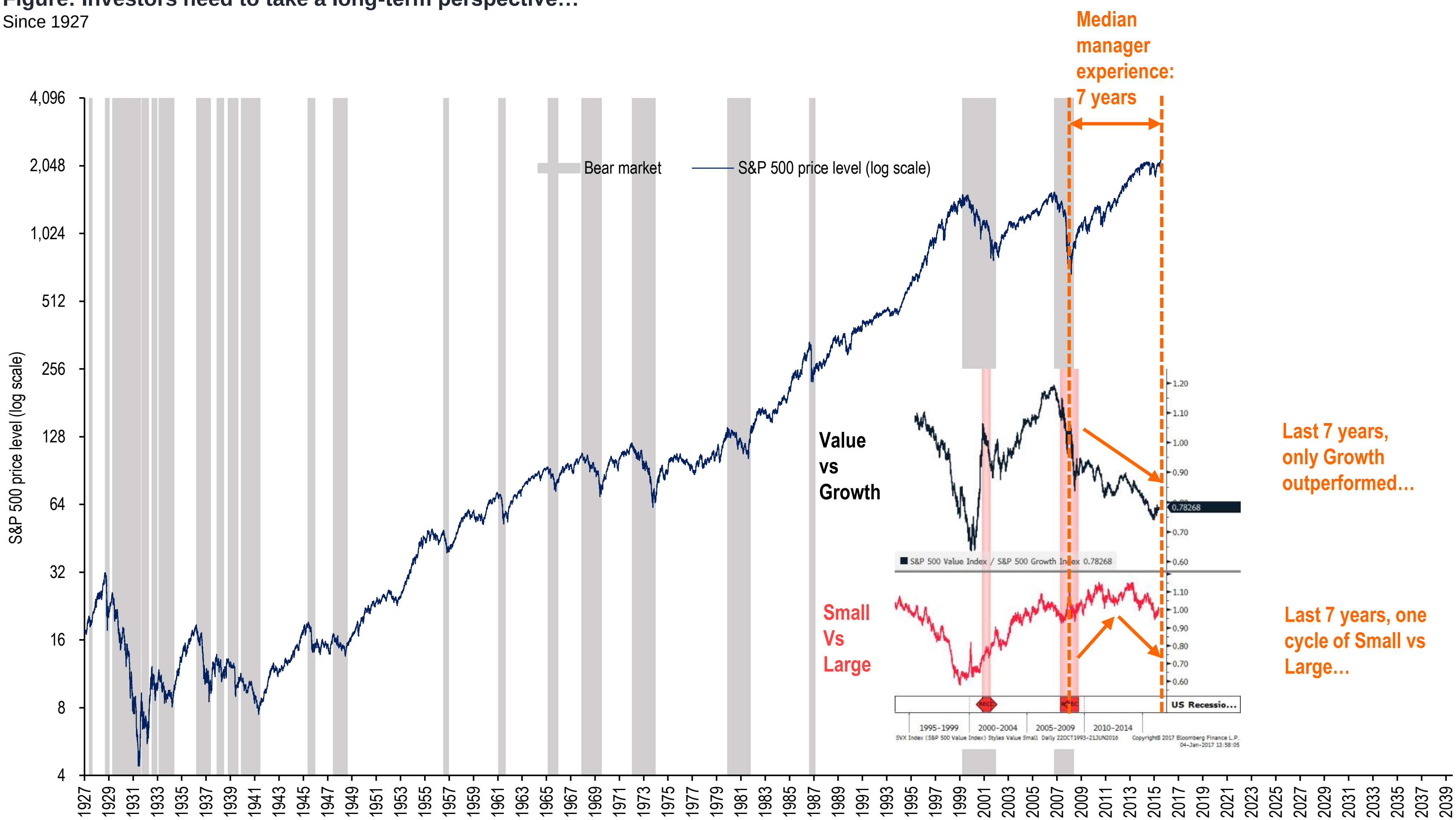
Overweight CRAP: Leverage to positive 2017 trends

		De-regulation	Inflation	Investment recovery
		As noted, we see several sectors poised to gain from de-regulation. Specifically, most levered Energy, Financials and Manufacturing	Inflation, led by wages, will lead to higher returns for capital intensive/ resource sectors. Raising demand for credit as capex gains	Fiscal stimulus, higher "animal spirits" and higher expected nominal return drives investment spending.
C	Technology		↑ Wage gains drives automation	↑ Obvious
R	Energy	↑ Top 3 beneficiary	↑ Obvious	↑ Obvious
	Materials	↑ Beneficiary	↑ Obvious	↑ Obvious
A	Financials	↑ Top 3 beneficiary	↑ Higher rates benefit financials	↑ Credit demand gains
P	Telecoms	↑ Gain on changes in Net Neutrality	↑ Boosts ROIC	↑ Obvious
Neutrals	Discretionary			
	Industrials	↑ Top 3 beneficiary	↑ Industrial automation	↑ Obvious
	Healthcare	↓ Likely to see increased risks...	↑ Generally indexed to inflation	
Under Weights	REITS			
	Staples		↓ Bad for bond proxies	
	Utilities		↓ Bad for bond proxies	

Regime change: 2016 shows long-term perspective needed

The key takeaway from 2016 is the regime changes, particularly the rotation caught a lot of investors off guard. As shown below, it is because the 7-year cycle of Growth outperformance caused risk premia to fall too low in growth—and something many managers missed.

Figure: Investors need to take a long-term perspective…
Since 1927



Source: Fundstrat, 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 1970 (relative to S&P 500)

Sector name	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
S&P 500	0	11	16	-17	-30	32	19	-12	1	12	26	-10	15	17	1	26	15	2	12	27	-7	26	4	7
Value							9	3	-1	2	-8	2	-2	5	2	-3	1	-2	4	-6	-4	-8	2	8
Growth							-9	-4	2	-1	11	-4	3	-4	-3	4	-3	2	-3	7	4	9	-2	-8
Pure Value																								
Pure Growth																								
Technology	-32	-4	-13	-3	-7	0	1	5	10	-15	-13	-19	32	9	-13	-7	-31	10	-14	-37	10	-20	-4	13
Semis					-12	42	-14	-15	14	32	16	-45	39	44	-31	-32	-40	34	-30	-25	4	-2	58	46
IT Hardware	-20	-2	9	-6	-7	-1	2	7	9	-20	-17	-17	41	7	-9	-4	-33	3	-10	-46	14	-24	-7	12
IT Software	-14	-6	9	-8	-4	-12	-5	-1	9	5	-29	-9	-9	-9	-16	5	-6	31	-16	-18	9	23	13	19
Consumer Discretionary	-8	14	-3	-19	-9	29	-5	-7	-9	-14	-16	2	26	3	-7	-2	2	-4	7	-11	-11	12	13	6
Industrials	-6	7	-3	0	-10	5	6	3	14	-2	3	-17	0	9	-8	-5	-7	0	-6	-3	-4	0	2	9
Basic Materials	2	-8	-4	15	3	19	-3	-16	-3	7	-11	-13	-13	8	-16	0	9	11	-6	-10	-10	-5	3	3
Financials	1	6	-6	-4	-4	-15	4	4	1	2	-14	12	-4	1	4	16	-5	-16	2	3	-15	18	15	1
REITs	-10	6	-30	-39	-33	92	-26	10	3	60	16	5	23	2	2	25	10	-7	-4	-17	-41	19	8	27
Energy	21	-9	11	22	1	-12	8	6	4	23	33	-27	-38	1	-1	-16	-2	2	6	4	4	-24	-7	4
Healthcare	-27	14	1	-2	5	-14	-17	3	4	-10	-10	7	3	-10	1	8	13	6	1	13	18	24	-23	-18
HC Eq. & Services	-14	28	15	-3	2	-12	-29	7	-1	4	10	0	10	-28	-18	5	1	8	-5	15	18	12	-18	-20
HC Bio, Pharma, Tools	3	2	20	2	14	-32	-2	-3	12	-2	-5	0	-6	-10	3	13	19	2	-2	9	21	26	-23	-18
Consumer Staples	16	7	8	-9	1	0	-10	6	2	-16	-19	15	11	-5	6	6	10	7	2	14	17	12	-1	-13
Utilities	22	-14	-1	-9	-1	4	-2	12	-13	-16	-25	9	0	-5	15	-4	8	-12	2	0	2	-10	-4	1
Telecom	11	-13	9	8	16	-15	6	7	-2	-24	-33	30	-16	-10	19	5	4	-2	6	27	-11	-18	7	4

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

LAGGARDS: These may be the surprise winners of 2017…

Below, we have compiled a list of 15 industries (of 165 GICS level 4) which have trailed the broader markets over the past 5-8 years, using 3 metrics to measure relative performance. But these groups have some insensitivity to wage inflation as their market value per employee is quite high.

- **We have highlighted those groups which are 4 of 4 (or 3 of 4) in laggards plus that wage attribute.**

Figure: These groups could be the "sleeper" winners of 2017….
Based on Russell 3000 constituents

	Lagging Attributes...						*Wage insensitivity (attractive)*		*Valuation and other*		
	5-year relative return	Rank (of 164, 1=worst)	**% of last 8 years outperformed**	Rank (of 164, 1=worst)	Z-score of LTM EBIT margin	Rank (of 164, 1=worst)	**Market value / employee**	Rank (of 164, 1=best)	P/E	# cos	Market value
Quartile 4 of 4 times											
Electric Utilities	(53%)	121	38%	117	(1.20)	102	$1,661	30	16.6x	22	$417,525
Fertilizers & Agricultural Chemicals	(57%)	122	25%	136	(1.28)	105	$1,665	29	24.6x	6	$78,669
Integrated Oil & Gas	(75%)	132	38%	120	(3.32)	120	$4,398	6	23.9x	3	$649,787
Oil & Gas Exploration & Production	(87%)	137	25%	140	(2.30)	118	$6,300	3	130.7x	30	$415,839
Quartile 3 of 4 times											
Agricultural & Farm Machinery	(46%)	119	38%	116	(1.13)	101	$484	83	24.3x	5	$45,970
Communications Equipment	(38%)	112	25%	132	0.81	39	$1,382	39	13.7x	23	$235,224
Construction Machinery	(57%)	124	38%	118	(1.36)	106	$449	86	22.8x	13	$130,226
Household Products	(43%)	117	25%	134	1.12	31	$1,718	25	21.6x	9	$359,724
Hypermarkets & Super Centers	(39%)	113	38%	113	(2.66)	119	$117	130	19.3x	2	$282,408
Independent Power Producers	(102%)	139	38%	121	(2.09)	117	$372	95	13.4x	2	$11,730
Marine	(157%)	144	0%	144	-	-	$1,723	24	-	15	$18,079
Office REITs	(35%)	107	25%	131	(2.08)	116	$9,899	-	48.5x	13	$91,556
Oil & Gas Equipment & Services	(66%)	129	38%	119	(3.77)	121	$712	68	78.0x	25	$241,130
Oil & Gas Storage & Transportation	(81%)	134	63%	56	(1.41)	108	$4,350	7	31.2x	4	$113,707
Personal Products	(81%)	133	25%	139	(0.71)	94	$532	77	21.3x	6	$40,066

Source: Fundstrat, FactSet, Thomson Reuters, Bloomberg.

LAGGARDS: Where to find the best of the "worst"...

– Top 40 in 3 of 4
– Top 40 in 4 of 4

Figure: Top 40 Laggards by each category

	5-yr relative return			% of last 8 years outperform			Z-score of LTM EBIT margin			Market value / employee	
1	Coal & Consumable Fuels	(160%)	1	Marine	0%	1	Metal & Glass Containers	(4.47)	1	Internet Software & Services	$8,710
2	Marine	(157%)	2	Technology Hardware, Storage &	13%	2	Oil & Gas Equipment & Services	(3.77)	2	Biotechnology	$7,074
3	Diversified Metals & Mining	(136%)	3	Oil & Gas Drilling	25%	3	Integrated Oil & Gas	(3.32)	3	Oil & Gas Exploration & Produc	$6,305
4	Oil & Gas Drilling	(129%)	4	Gold	25%	4	Hypermarkets & Super Centers	(2.66)	4	Real Estate Development	$5,343
5	Gold	(126%)	5	Oil & Gas Exploration & Produc	25%	5	Oil & Gas Exploration & Produc	(2.30)	5	Reinsurance	$4,820
6	Education Services	(117%)	6	Personal Products	25%	6	Independent Power Producers &	(2.09)	6	Integrated Oil & Gas	$4,446
7	Independent Power Producers &	(102%)	7	Steel	25%	7	Office REITs	(2.08)	7	Oil & Gas Storage & Transporta	$4,337
8	Homefurnishing Retail	(91%)	8	Aluminum	25%	8	Casinos & Gaming	(2.07)	8	Distillers & Vintners	$3,563
9	Oil & Gas Exploration & Produc	(87%)	9	Fertilizers & Agricultural Che	25%	9	Real Estate Services	(1.99)	9	Home Entertainment Software	$3,042
10	Department Stores	(83%)	10	Integrated Telecommunication S	25%	10	Publishing	(1.80)	10	Tobacco	$2,986
11	Precious Metals & Minerals	(83%)	11	Household Products	25%	11	Homefurnishing Retail	(1.78)	11	Financial Exchanges & Data	$2,945
12	Oil & Gas Storage & Transporta	(81%)	12	Office Services & Supplies	25%	12	Housewares & Specialties	(1.58)	12	Systems Software	$2,404
13	Personal Products	(81%)	13	Communications Equipment	25%	13	Pharmaceuticals	(1.48)	13	Brewers	$2,235
14	Integrated Oil & Gas	(75%)	14	Office REITs	25%	14	Health Care Equipment	(1.44)	14	Pharmaceuticals	$2,152
15	Apparel, Accessories & Luxury	(68%)	15	Metal & Glass Containers	25%	15	Oil & Gas Storage & Transporta	(1.41)	15	Leisure Facilities	$2,132
16	Steel	(67%)	16	Commodity Chemicals	25%	16	Industrial Conglomerates	(1.37)	16	Water Utilities	$2,116
17	Oil & Gas Equipment & Services	(66%)	17	Thrifts & Mortgage Finance	25%	17	Construction Machinery & Heavy	(1.36)	17	Investment Banking & Brokerage	$2,061
18	Casinos & Gaming	(62%)	18	Food Distributors	25%	18	Fertilizers & Agricultural Che	(1.28)	18	Semiconductors	$1,993
19	Aluminum	(61%)	19	Asset Management & Custody Ban	25%	19	Systems Software	(1.23)	19	Construction Materials	$1,887
20	IT Consulting & Other Services	(59%)	20	Homebuilding	25%	20	Agricultural Products	(1.21)	20	Semiconductor Equipment	$1,871
21	Health Care Technology	(58%)	21	Coal & Consumable Fuels	38%	21	Electric Utilities	(1.20)	21	Internet & Direct Marketing Re	$1,870
22	Construction Machinery & Heavy	(57%)	22	Diversified Metals & Mining	38%	22	Agricultural & Farm Machinery	(1.13)	22	Application Software	$1,813
23	Fertilizers & Agricultural Che	(57%)	23	Education Services	38%	23	Research and Consulting Servic	(1.12)	23	Alternative Carriers	$1,806
24	Electric Utilities	(53%)	24	Independent Power Producers &	38%	24	Electronic Components	(0.99)	24	Marine	$1,731
25	Integrated Telecommunication S	(51%)	25	Integrated Oil & Gas	38%	25	Construction & Engineering	(0.95)	25	Household Products	$1,706
26	Agricultural & Farm Machinery	(46%)	26	Oil & Gas Equipment & Services	38%	26	Food Distributors	(0.94)	26	Asset Management & Custody Ban	$1,687
27	Automobile Manufacturers	(45%)	27	Construction Machinery & Heavy	38%	27	Apparel, Accessories & Luxury	(0.91)	27	Multi-Utilities	$1,679
28	Household Products	(43%)	28	Electric Utilities	38%	28	Managed Health Care	(0.86)	28	Motorcycle Manufacturers	$1,677
29	Computer & Electronics Retail	(41%)	29	Agricultural & Farm Machinery	38%	29	Personal Products	(0.71)	29	Fertilizers & Agricultural Che	$1,672
30	Office Services & Supplies	(41%)	30	Automobile Manufacturers	38%	30	Paper Packaging	(0.61)	30	Electric Utilities	$1,653
31	Residential REITs	(40%)	31	Computer & Electronics Retail	38%	31	Application Software	(0.60)	31	Thrifts & Mortgage Finance	$1,626
32	Hypermarkets & Super Centers	(39%)	32	Hypermarkets & Super Centers	38%	32	Internet & Direct Marketing Re	(0.58)	32	Gas Utilities	$1,592
33	Communications Equipment	(38%)	33	Trading Companies & Distributo	38%	33	Specialty Chemicals	(0.57)	33	Commodity Chemicals	$1,530
34	Trading Companies & Distributo	(37%)	34	Soft Drinks	38%	34	Property & Casualty Insurance	(0.43)	34	Diversified Real Estate Activi	$1,467
35	Industrial Gases	(37%)	35	Construction & Engineering	38%	35	Health Care Technology	(0.41)	35	Cable & Satellite	$1,461
36	Soft Drinks	(37%)	36	Multi-Utilities	38%	36	Technology Hardware, Storage &	(0.39)	36	Industrial Gases	$1,434
37	Specialty Stores	(36%)	37	General Merchandise Stores	38%	37	Specialty Stores	(0.36)	37	Oil & Gas Refining & Marketing	$1,404
38	Office REITs	(35%)	38	Auto Parts & Equipment	38%	38	Department Stores	(0.35)	38	Precious Metals & Minerals	$1,390
39	Retail REITs	(34%)	39	Restaurants	38%	39	Motorcycle Manufacturers	(0.33)	39	Communications Equipment	$1,389
40	Hotel & Resort REITs	(34%)	40	Commercial Printing	38%	40	Health Care Distributors	(0.28)	40	Railroads	$1,366

Source: Fundstrat, FactSet, Thomson Reuters, Bloomberg.

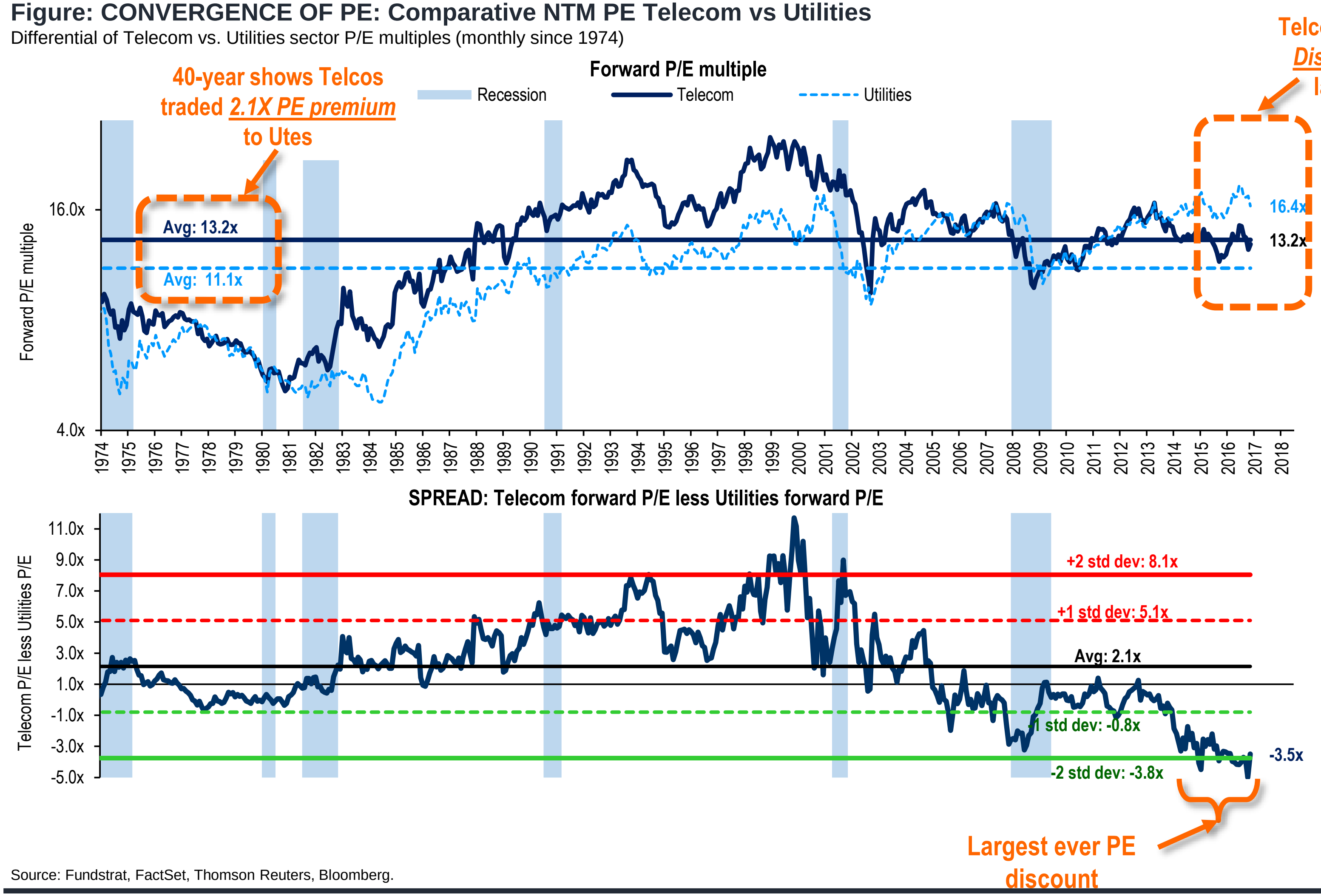
Telcos vs Utilities: Simple as playing PE convergence ~45% upside...

We have highlighted the comparative 40 year PE of Telcos and Utilities. And as shown, we expect to see a convergence of PE

- **The convergence we see is a 6.4X P/E rise of Telcos (vs Utilities) and would be a 45% upside move in Telecoms.**

Figure: CONVERGENCE OF PE: Comparative NTM PE Telecom vs Utilities

Differential of Telecom vs. Utilities sector P/E multiples (monthly since 1974)



The convergence is 6.4X P/E if Telcos (vs Utes) revert to the 40-year PE relationship.

Such a move is 45% upside to Telecom stocks

Source: Fundstrat, FactSet, Thomson Reuters, Bloomberg.

Historically, when Telcos cheap vs Utes, *outperform 380bp*...

Looking back quantitatively, we have compared the forward relative performance of telecom stocks to utilities based on the relative PE.

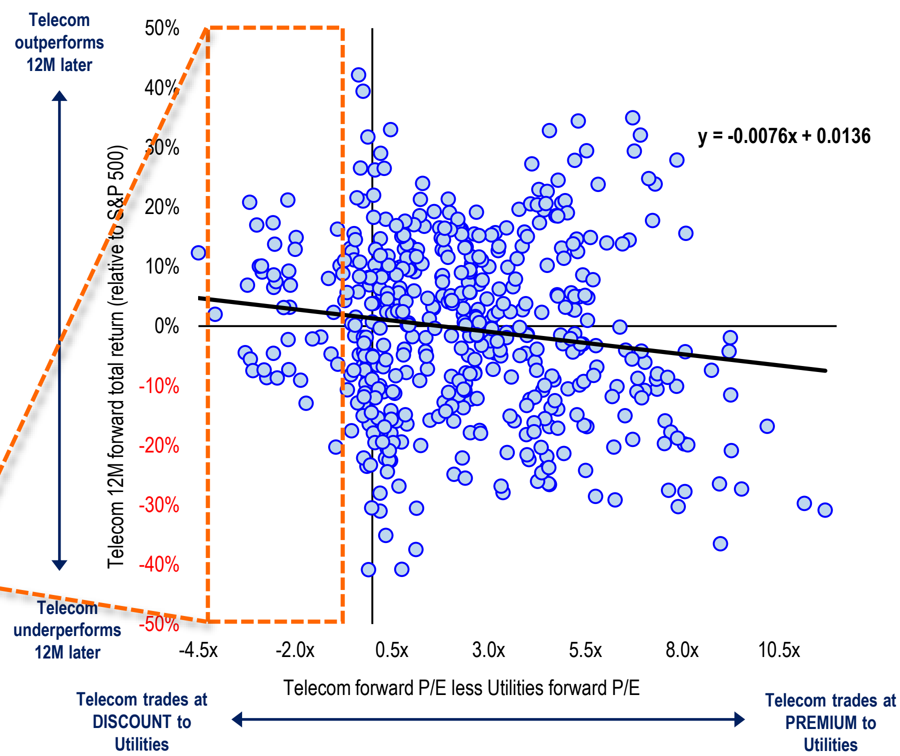
- **As shown, whenever the PE discount of Telecoms is this large, Telecom stocks typically outperform the S&P 500 by 380bp.**

Figure: Tiers of Telco vs. Utes P/E multiple differential and subsequent Telco returns
Based on monthly data since 1974

	Delta: Telecom P/E less Utilities P/E				Avg P/E multiple			Telecom 12M forward total return (relative to S&P 500)	
	Range of P/E delta # std devs	Range of P/E delta	# of instances	% of instances	Telco	Utilities	Delta	Avg total return	Win ratio
	2.0 to 3.3	8.0x to 11.7x	15	3%	23.0x	14.0x	9.0x	-15.9%	7%
	1.0 to 2.0	5.1x to 8.0x	70	14%	18.8x	12.5x	6.2x	-0.7%	40%
	0.0 to 1.0	2.2x to 5.1x	159	31%	13.7x	10.2x	3.5x	-0.2%	49%
	-1.0 to 0.0	-0.7x to 2.2x	212	41%	10.3x	9.7x	0.6x	-0.1%	54%
CURRENT	**-2.3 to -1.0**	**-4.5x to -0.7x**	**54**	**11%**	**13.1x**	**15.6x**	**-2.6x**	**3.8%**	**62%**
Total	-2.3 to 3.3	-4.5x to 11.7x	510	100%	13.2x	11.0x	2.2x	-0.4%	50%

Source: Fundstrat, FactSet, Thomson Reuters, Bloomberg.

Figure: Scatter of relationship between Telco less Utes div yield spread and subsequent Telco performance
X-axis = Telco vs. Utilities P/E differential, Y-axis = Telco 12M forward total return (relative to S&P 500)



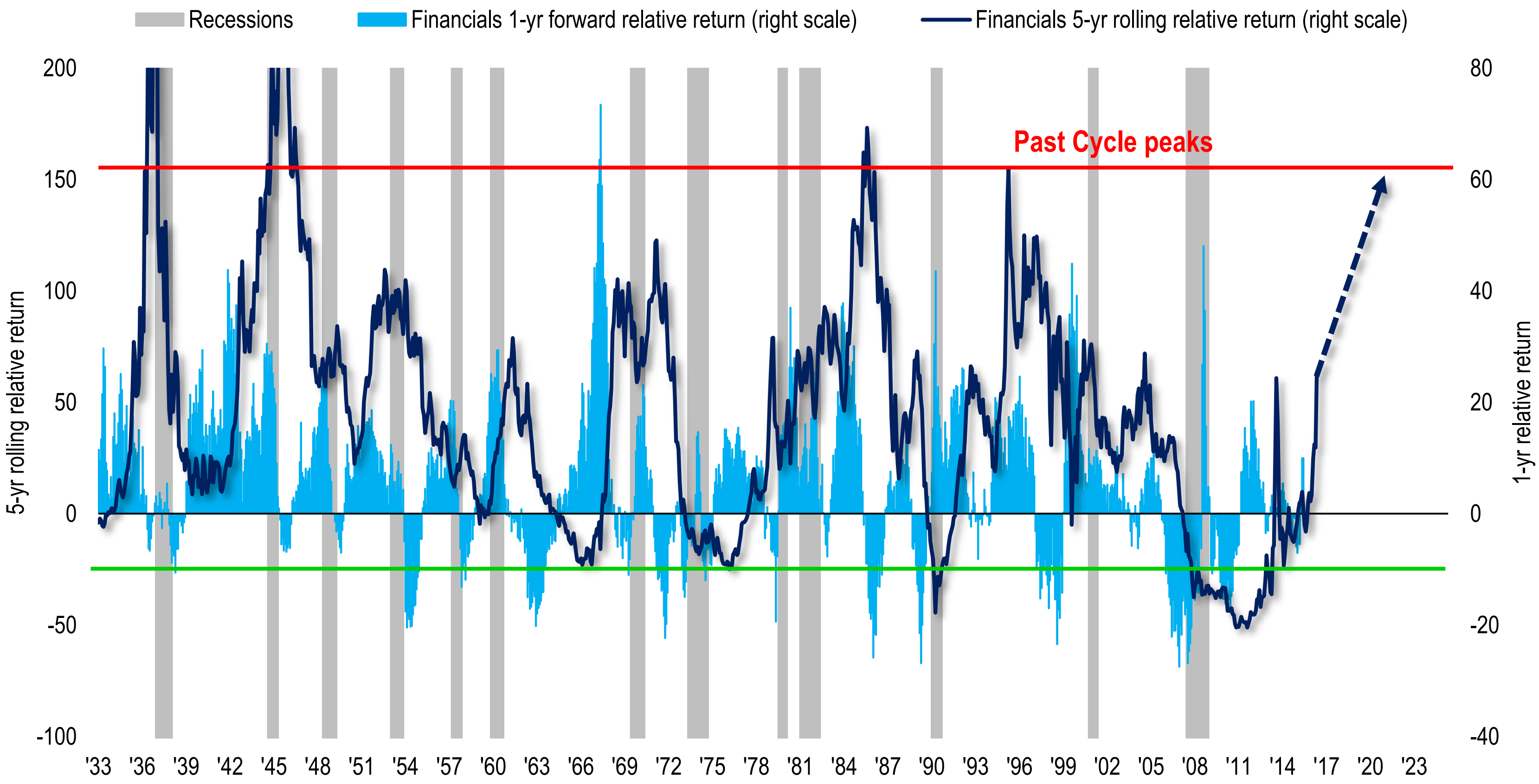
Source: Fundstrat, FactSet, Thomson Reuters, Bloomberg.

Financials: Reversing worst returns in 80-yrs...

We believe Financials have multiple tailwinds in 2017—granted, we realize this is consensus, but see below.

- **Financials have done so poorly for so long, this is multiple years of outperformance ahead of it.**

Figure: Rolling 5-year returns of Financials
Since 1933



Source: Fundstrat, Thomson Reuters.

Financials: Upside to ROE and valuations

There are multiple fundamental drivers for banks to see a recovery in ROE, and therefore EPS—hence, supporting a multi-year rally in Financials.

- **Key levers include: higher rates (NIM), de-regulation (reducing regulatory burden), credit expansion (inv recovery)—hence, multiple ways for ROE to rise from depressed levels today.**

Figure: Financials upside to ROE

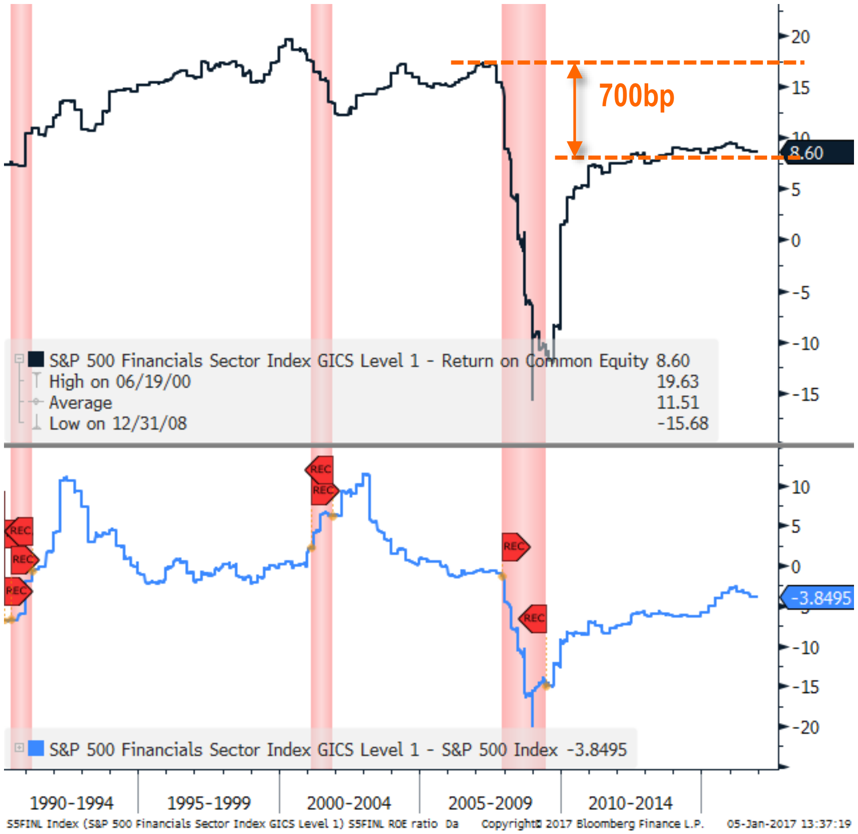
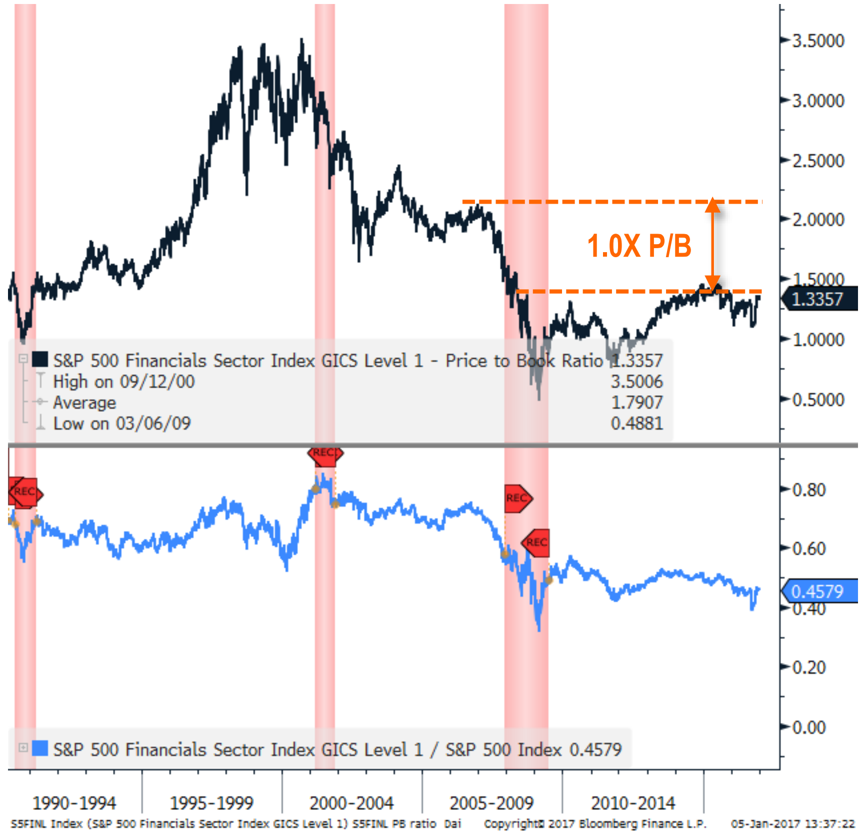


Figure: Financials have a lot of scope to re-rate



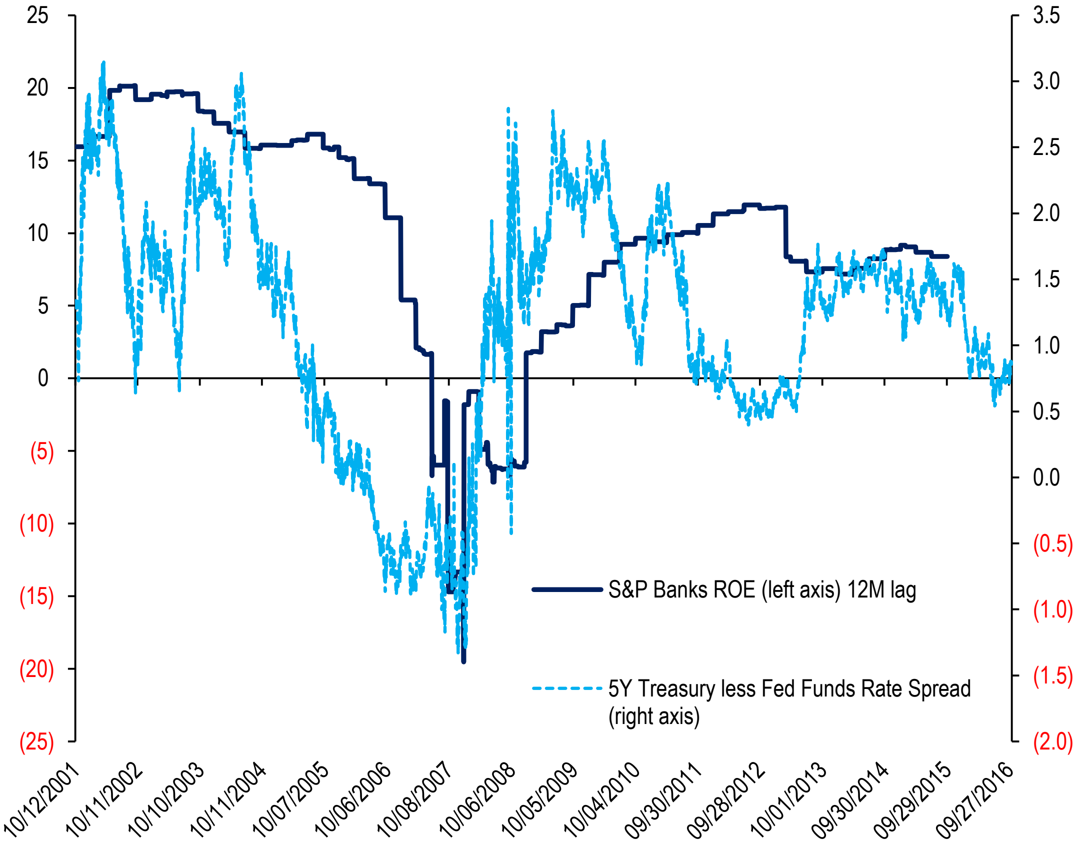
Source: Fundstrat, Thomson Reuters.

Financials: As rates normalize, expect at least 100bp Banks ROE lift…

Another driver of incremental profit is the normalization of rates and the resulting lift to bank profits (via net interest margin and hence ROE).

- **As shown below, Bank ROE is affected by relatively low interest rates—not entirely surprising. And if rates increase, we expect banks to naturally benefit from higher net interest margins (NIM). Such a recovery in NIM, in turn, boosts, ROE. Each 100bp rise in ROE (8% vs 20% a decade ago) is about $1.24 in S&P 500 EPS.**

Figure: S&P 500 Banks index ROE lags the spread between the US 5 year Treasury and Effective Fed Funds Rate…



	S&P 500 Banks Index	S&P 500 Index
Market Cap, $B	$1,057	$19,239
Index Price	$220.9	$2,133
Implied Share Count, Billions	4.784	9.02
Book Value / Share	$234.28	
Total Book Value	$1,121	

	Current	ROE expands 100bp	Delta
Bank Index EPS	$18.62	$20.97	$2.34
Implied Banks Net Income, $B	$89.1	$100.3	$11.21
Implied Banks ROE	7.9%	8.9%	100bp
S&P 500 EPS Contribution	**$9.88**	**$11.12**	**$1.24**

Each 100bp is $1.24 in S&P 500 EPS from Banks

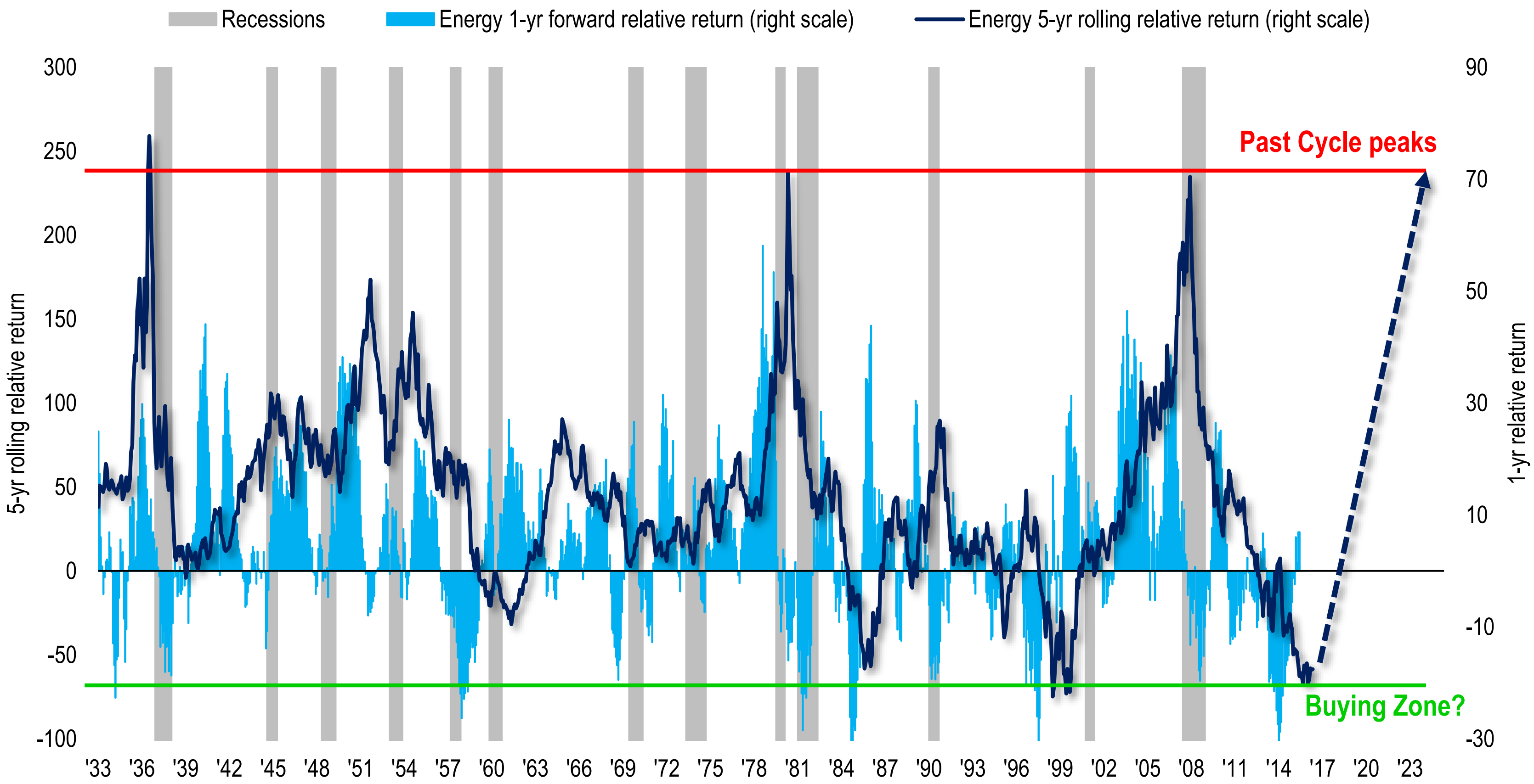
Source: Fundstrat, Thomson Reuters.

Long Energy: Buying at the absolute lows…

As shown below, Energy is emerging from essentially its worst ever returns in 80 years.

- **Energy is highly levered to a recovery in oil—no surprise—and resulting earnings power is impressive**

Figure: Rolling 5-year returns of Energy
Since 1933



Source: Fundstrat, Thomson Reuters.

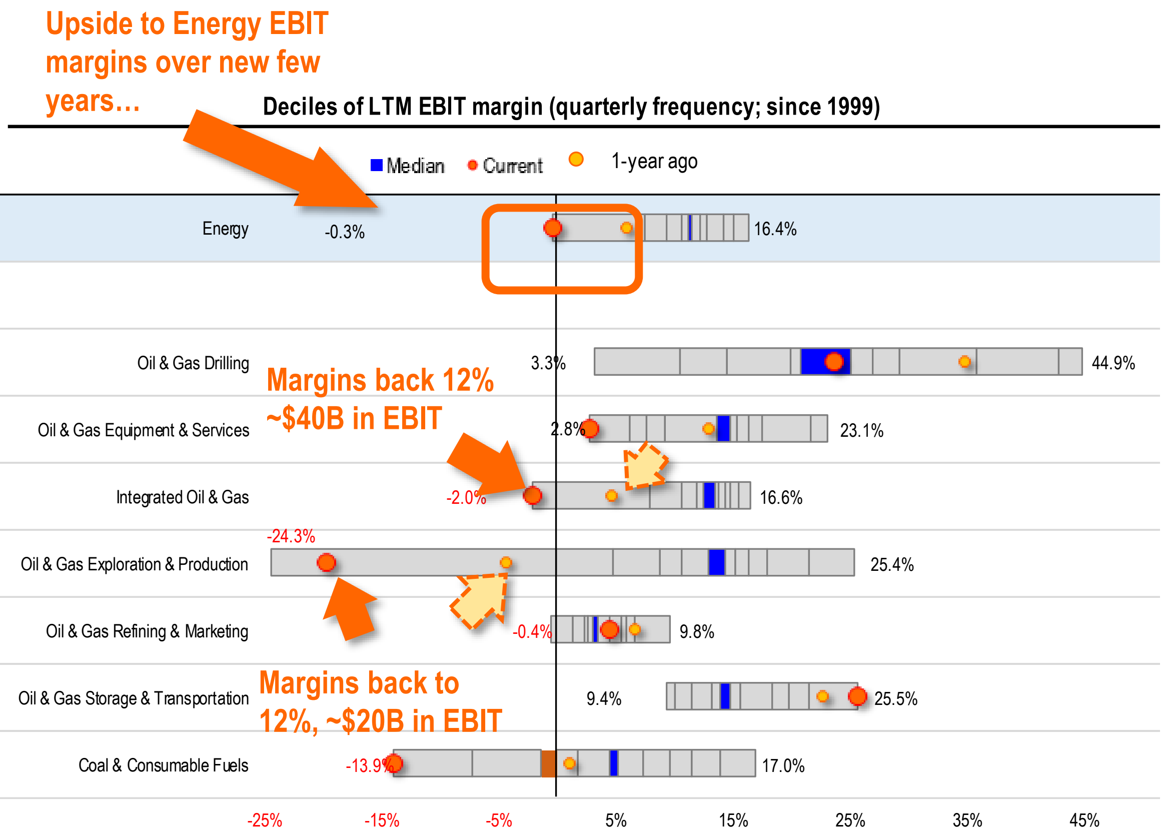
Energy margins are ZERO, *recovery* adds another $7 in 2017

Another big lever to pull is the normalization of profit margins for Energy companies. As shown below, the profit margins of Integrateds and E&Ps are depressed due to the rapid decline in oil prices—look how swiftly margins fell over the past 12 months.

- **A normalization of margins in 2017 for Integrateds and E&Ps could add $60B in EBIT over next 12 months and $5-$8 per S&P 500 share, depending on the magnitude of NOLs.**

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
$748,277	100%	($2,316)	100%	$1,486,281	100%
$6,662	1%	$1,583	-68%	$14,606	1%
$77,589	10%	$2,167	-94%	$217,344	15%
$315,221	42%	($6,432)	278%	$642,611	43%
$91,574	12%	($18,037)	779%	$384,705	26%
$221,641	30%	$10,056	-434%	$112,726	8%
$33,581	4%	$8,627	-372%	$114,290	8%
$2,009	0%	($280)	12%	n/a	n/a



Source: Fundstrat, Bloomberg.

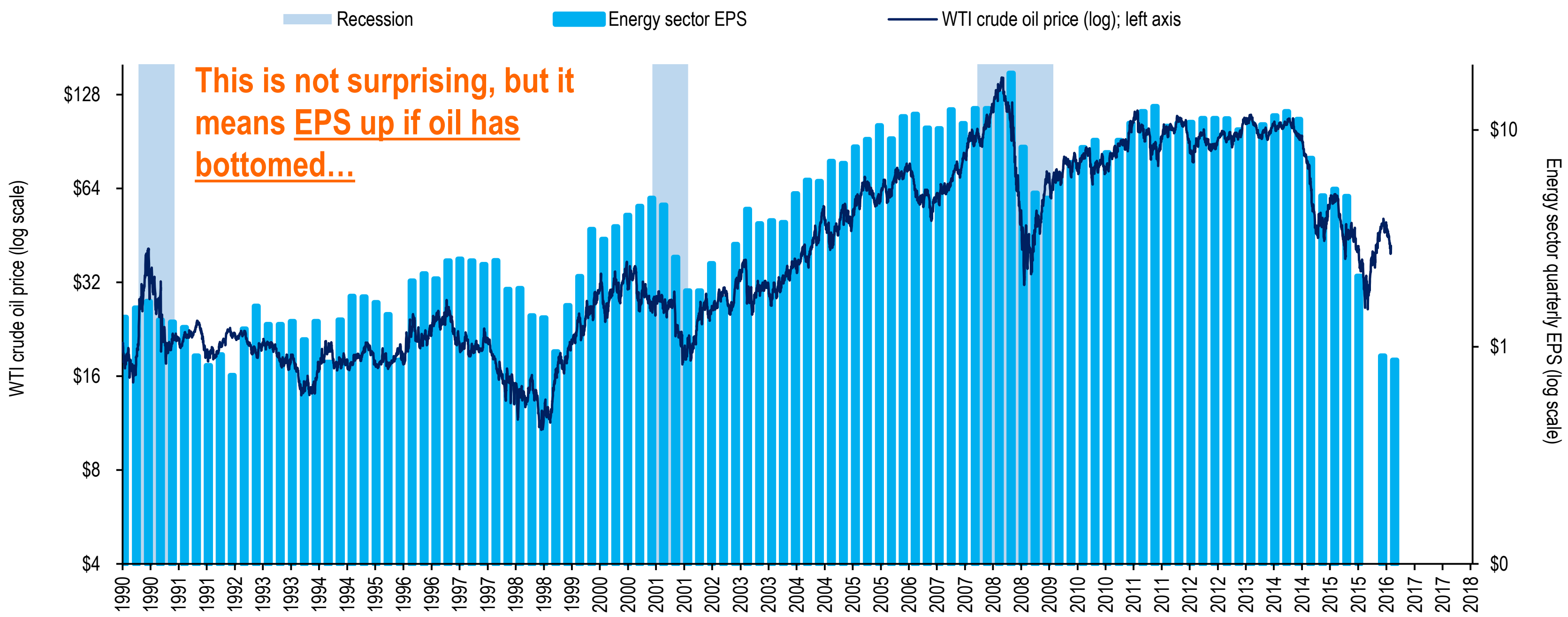
For past 25 years, oil and Energy EPS move in sync…

Apologies for stating the obvious, but oil is the primary driver of Energy earnings as shown below:

- **There is simply no way for Energy companies to generate a higher level of EPS at low oil prices and it is pretty hard for them to lose money when oil prices are high.**
- **This relationship is evident looking at the chart below—for the past 25 years, one could basically predict the Energy Sector EPS just by plotting the price of oil.**

Figure: Energy EPS is all about Oil…

WTI crude oil price (left axis) and S&P 500 Energy sector quarterly EPS (right axis) since 1990



Source: Fundstrat, Bloomberg, FactSet.

TECHNOLOGY: In the '50s–Technology stocks led 10 consecutive years

As shown below, technology stocks outperformed during the 1950s, which is one of the few inflation cycles led by wages and labor.

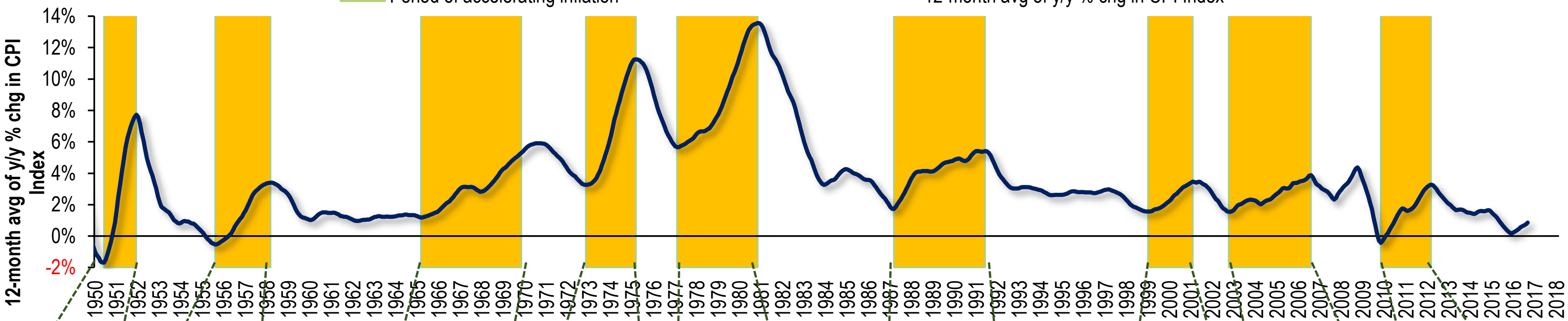
- **In other words, if the inflation cycle plays out like we suspect, Technology stocks, particularly "Industrial technology" will lead for the next few years.**

Figure: CPI since 1950

Tech led 10 consecutive years

Technology (Relative to S&P 500)	'50	'51	'52	'53	'54	'55	'56	'57	'58	'59	'60	'61	'62	'63	'64	'65	'66	'67	'68	'69	'70	'71	'72	'73	'74	'75	'76	'77	'78	'79	'80	'81	'82	'83
	-2	4	1	7	24	5	23	11	11	18	1	-14	-11	6	-5	22	0	50	-35	-3	-32	-4	-13	-3	-7	0	1	5	10	-15	-13	-19	32	9

Technology (Relative to S&P 500)	'84	'85	'86	'87	'88	'89	'90	'91	'92	'93	'94	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09	'10	'11	'12	'13	'14	'15	'17
	-13	-7	-31	10	-14	-37	10	-20	-4	13	21	5	23	-3	51	59	-31	-13	-14	20	-7	-3	-6	12	-5	36	-4	1	0	-3	7	5	3



Wage led inflation cycle...

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

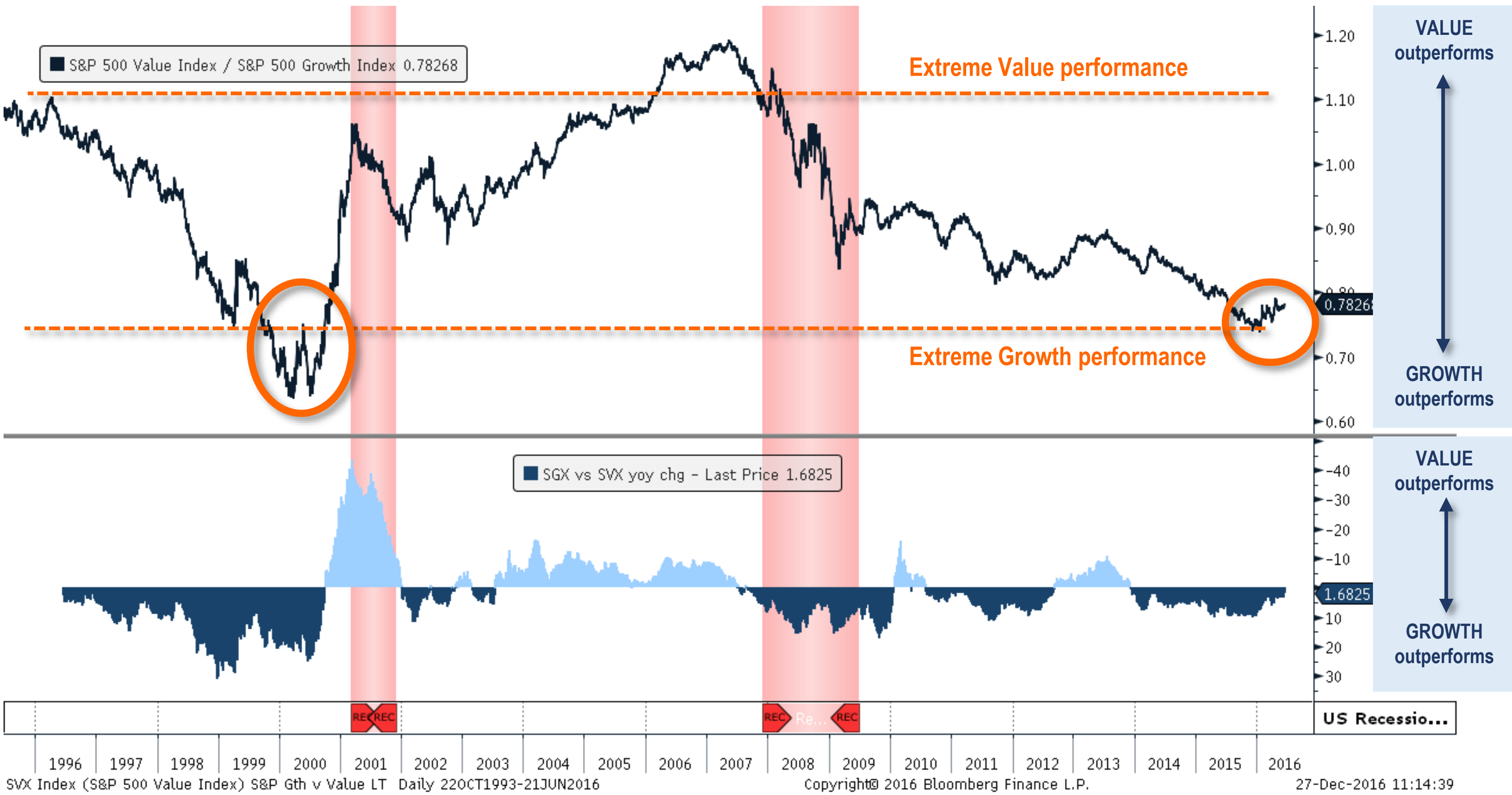
Source: Fundstrat, Bloomberg

VALUE: inflection after weakness *stretched* to 20-year lows…

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: Comparative Price Ratio: Value versus Growth
Since 1996



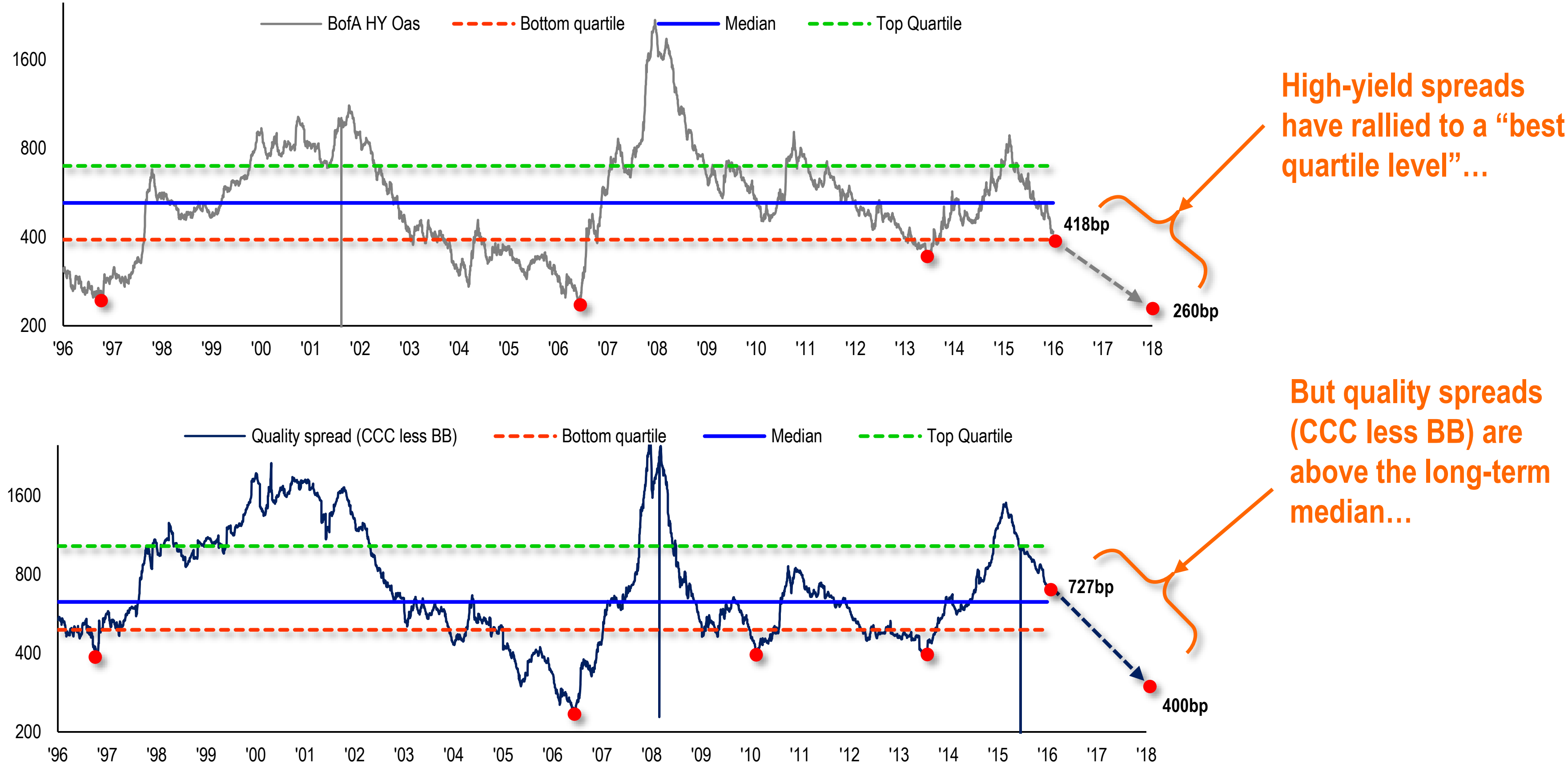
Source: Fundstrat, Bloomberg.

More upside in a "quality spread" rally…

As shown below, we see greater scope for "quality spreads" (CCC less BB) to rally relative to high-yield overall.

- **Quality spreads at 727bp are still above the long-term median (629bp) and well above a top quartile reading—yet, we are already at top quartile for high-yield spreads.**

Figure: BofA High-yield spreads (OAS) and Quality Spreads (CCC less BB)
Since 1996



Source: Fundstrat, Bloomberg.

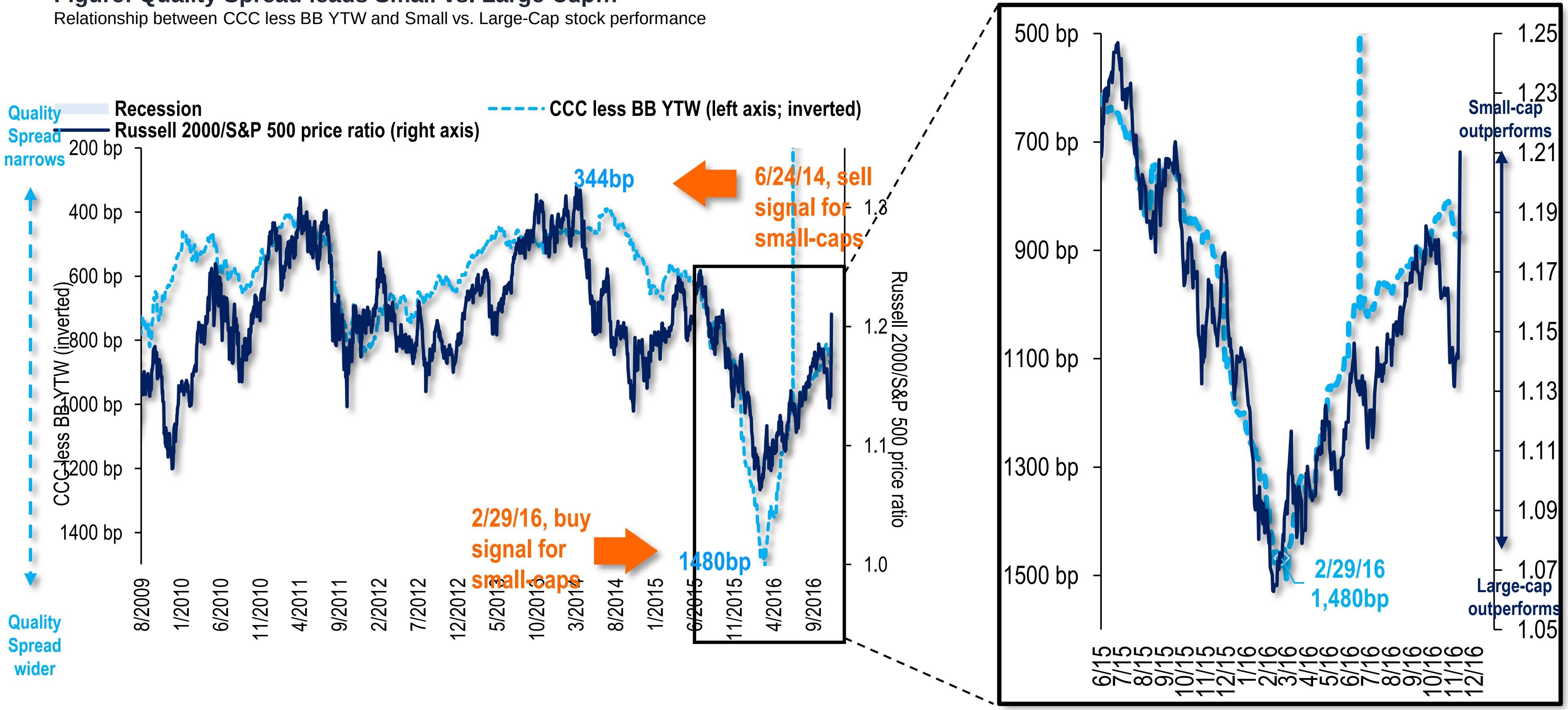
Buy Small-caps: Quality spread rally (BB vs CCC) argues this

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



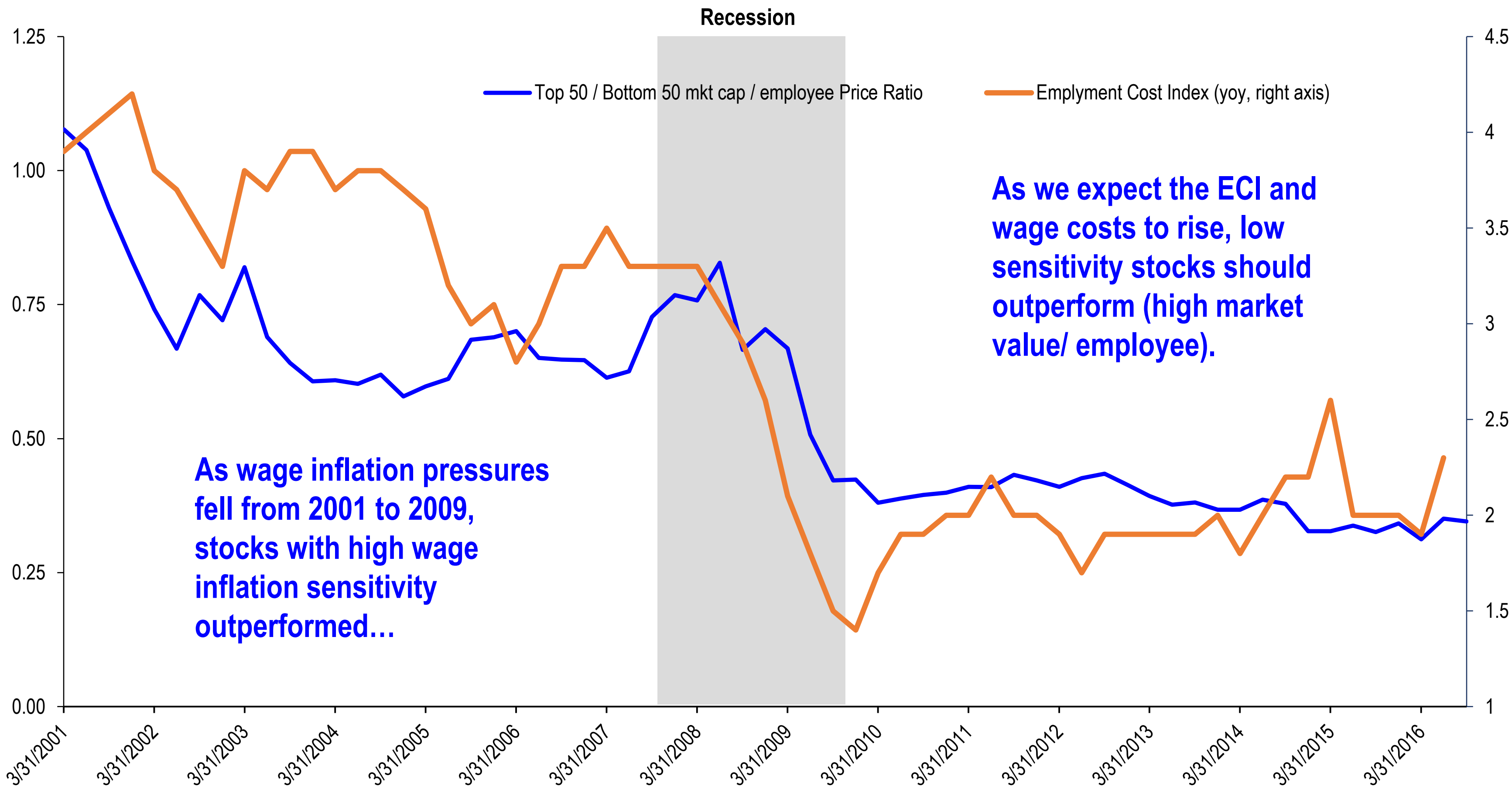
Source: Fundstrat, FactSet, Bloomberg.

Last 16 years, these stocks track labor costs closely…

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

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

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

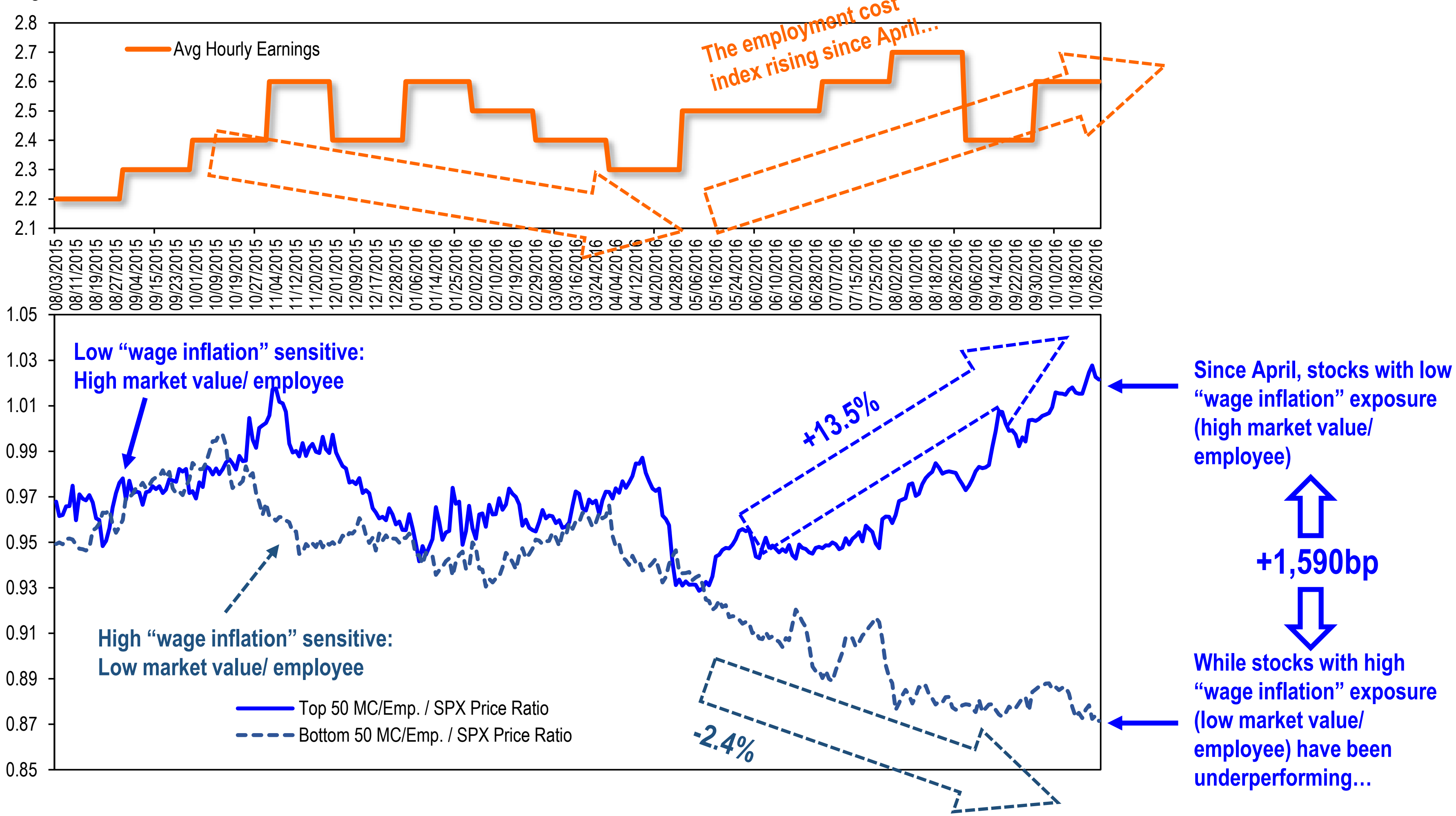


Source: Fundstrat, Bloomberg, Factset

Stocks with low "wage inflation" exposure *outperforming*

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

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



Source: Fundstrat, Bloomberg, Factset

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

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

Figure: Top and Bottom Wage sensitives by Industries

Rank	Industry	# of Companies	Market Cap, $M	Number of Employees	Market Value / Employee ('000s)	Relative Perf, YTD
	S&P 500	500	$20,284,076	24,319,620	$834.1	1.3%
1	Internet Software & Services	6	$995,381	103608	$9,607	2.8%
2	Biotechnology	8	$564,466	77395	$7,293	4.1%
3	Oil & Gas Exploration & Produc	18	$384,705	60957	$6,311	0.3%
4	Integrated Oil & Gas	3	$642,611	146100	$4,398	(2.4%)
5	Oil & Gas Storage & Transporta	4	$114,290	26232	$4,357	1.7%
6	Tobacco	3	$352,546	94600	$3,727	(1.8%)
7	Distillers & Vintners	2	$46,481	13400	$3,469	(3.1%)
8	Home Entertainment Software	2	$52,024	15800	$3,293	1.3%
9	Financial Exchanges & Data	5	$132,328	42303	$3,128	0.8%
10	Commodity Chemicals	1	$36,139	13000	$2,780	2.0%
11	Application Software	5	$164,264	60535	$2,714	1.7%
12	Systems Software	5	$685,141	281062	$2,438	1.2%
13	Brewers	1	$21,398	9100	$2,351	1.1%
14	Data Processing & Outsourced S	11	$517,697	221095	$2,342	1.9%
15	Semiconductor Equipment	3	$64,252	28680	$2,240	(1.2%)
16	Pharmaceuticals	11	$1,015,035	458681	$2,213	2.3%
17	Investment Banking & Brokerage	4	$246,049	111739	$2,202	1.9%
18	Construction Materials	2	$31,238	14486	$2,156	0.7%
19	Semiconductors	13	$578,629	273201	$2,118	(1.9%)
20	Specialized Consumer Services	1	$4,907	2400	$2,044	1.7%
21	Water Utilities	1	$12,982	6700	$1,938	(0.6%)
22	Internet & Direct Marketing Re	5	$525,985	271538	$1,937	2.7%
23	Household Products	5	$355,994	198300	$1,795	0.4%
24	Multi-Utilities	11	$207,070	115336	$1,795	(0.9%)
25	Fertilizers & Agricultural Che	4	$72,469	41800	$1,734	2.0%

Rank	Industry	# of Companies	Market Cap, $M	Number of Employees	Market Value / Employee ('000s)	Relative Perf, YTD
119	Food Retail	2	$40,856	518000	$79	(3.7%)
118	Aluminum	1	$5,605	60000	$93	7.8%
117	Department Stores	3	$24,744	262400	$94	(12.6%)
116	Homefurnishing Retail	1	$6,187	62000	$100	(0.1%)
115	Computer & Electronics Retail	1	$13,382	125000	$107	(1.4%)
114	Hypermarkets & Super Centers	2	$284,252	2426000	$117	(0.4%)
113	Tires & Rubber	1	$8,221	66000	$125	0.7%
112	Household Appliances	1	$13,969	97000	$144	1.0%
111	General Merchandise Stores	3	$79,772	509700	$157	(0.6%)
110	Health Care Facilities	2	$39,316	248600	$158	1.7%
109	Auto Parts & Equipment	2	$27,537	169000	$163	2.0%
108	Office Services & Supplies	1	$2,967	14800	$200	3.8%
107	Construction & Engineering	3	$19,835	95495	$208	0.3%
106	Advertising	2	$29,235	122300	$239	(2.0%)
105	Apparel Retail	6	$115,250	479304	$240	(1.8%)
104	Building Products	4	$64,698	264800	$244	1.1%
103	Restaurants	5	$225,262	883330	$255	(0.6%)
102	Automobile Manufacturers	2	$106,215	414000	$257	3.5%
101	Trucking	2	$14,935	54662	$273	(0.6%)
100	IT Consulting & Other Services	5	$278,822	1012757	$275	0.0%
99	Hotels, Resorts & Cruise Lines	4	$97,044	349500	$278	0.1%
98	Air Freight & Logistics	4	$170,724	587556	$291	(0.7%)
97	Publishing	1	$6,984	24000	$291	2.5%
96	Electronic Manufacturing Servi	1	$24,106	75000	$321	(3.4%)
95	Distributors	2	$23,991	70700	$339	0.2%

Source: Fundstrat, Bloomberg, Factset

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