CIO | VIEW

Americas CIO View

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Marketing Material

U.S. CORPORATE EXPANSION: IF CAN'T GO EAST, GO SOUTH?

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IN A NUTSHELL

_ Equity rally retreats as slowing growth and threats to profits intensify.
_ Ignore the beat/miss metrics: We expect third quarter 2019 S&P 500 EPS to be down by 3%+.
_ Neither the U.S. nor China, or Trump or Xi, need a deal economically or politically.
_ U.S. shifting to a new favored emerging-market region?: If not America, then Americas first.
_ 10 reasons why now is in our opinion the wrong time to rotate into cyclical-value stocks.

EQUITY RALLY RETREATS AS SLOWING GROWTH AND THREATS TO PROFITS INTENSIFY

As September and the quarter draw to a close, we assess the up and downside risks for markets into year-end. We think it is unlikely that equities rally to new highs, even if a goodwill mini trade deal emerges, as U.S. and global gross domestic product (GDP) have dropped into a very slow trend that is difficult to escape. S&P 500 earnings per share (EPS) likely declines in the third quarter and stays below its third quarter 2018 peak well into 2020. The most important questions into year-end:

1. Will a meaningful and confidence- / capex-boosting trade deal be reached soon?

2. When will the deceleration in global GDP and contraction in manufacturing stop?

3. Where will overnight and longer-term interest rates be at year-end and what is the outlook?

4. What will third quarter S&P 500 EPS tell us about current earnings power and the 2020 outlook?

5. Who will emerge as the front-runner Democratic Presidential candidate?

IGNORE THE BEAT/MISS METRICS: WE EXPECT THIRD QUARTER 2019 S&P 500 EPS TO BE DOWN BY 3%+

We expect third quarter 2019 S&P 500 EPS to finalize below 41 U.S. dollars (USD) or to be down 3%+ year-over-year. This will mark a full year of quarterly S&P 500 EPS being flat to down sequentially since third quarter of 2018, when S&P 500 EPS was 42.75 USD. Strong sequential growth is needed in the fourth quarter of 2019 to reach our 163.50 USD 2019E (estimate) S&P 500 EPS. Our 2019E S&P 500 EPS by quarter remains: USD 39+41.25+40.75 +42.50.

Unless results exceed our expectations, we are likely to cut our 2020E EPS to 170 USD. At current dollar exchange rates, commodity prices, capex/manufacturing indicators, interest rates, we think about 170 USD (the low end of our long standing 170-175 USD range) is the most reasonable 2020E S&P 500 EPS unless existing tariffs are significantly cut.

If tariffs are increased again, we would likely adopt a 165-170 USD S&P 500 EPS outlook.

NEITHER THE UNITED STATES NOR CHINA, OR TRUMP OR XI, SEEMS TO NEED A DEAL ECONOMICALLY OR POLITICALLY

The economies of both China and the United States and the world would be stronger with more trade, but neither country seems to need a deal to avoid a recession and the conflict could serve both leaders politically. The United States and China are cooling their economic integration owing to ideological differences. Differences that came more to the forefront recently given increased geopolitical tensions in many parts of the world, where the United States and China see different desired paths forward. While the trade conflict began with issues of trade balance, intellectual property protection and treatment of foreign companies in China, it is now as much or more about China's global diplomacy policies, military expansion, adherence to Hong Kong's special 50-year administrative agreement[1], and now if China will

[1]Under the principle "one country, two systems" Hong Kong and Macau retained their own economic administrative systems during the reunification of China in the early 1980s.

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abide with sanctions on Iran. We think that China has big decisions to make about whether it wants to be a member of the established world order or try to reshape it. A decision it will not make over the next several weeks. We expect U.S. tariffs to stay.

U.S. SHIFTING TO A NEW FAVORED EMERGING-MARKET REGION?: IF NOT AMERICA, THEN AMERICAS FIRST

As China celebrates its 70th anniversary this week, it can claim an economic miracle. Their progress accelerated over recent decades as they partnered with the United States. Perhaps China and the United States think they do not need each other anymore and go off separately. We hope not, but if so, each likely turns more to others than inward. The migration crisis to the south of the United States is a reminder that not all regions of the world enjoyed economic miracles in recent decades. Many Central and South-American countries suffered failed economies. This brought much poverty, human suffering and political instability to a region that the United States considers its sphere of influence. We think the United States will take more interest in promoting more trade and investment with Mexico and southward. U.S. multinational executives are certainly growth minded and while they are reevaluating the extent of their China partnerships, they might not turn inward.

10 REASONS WHY NOW IS IN OUR OPINION THE WRONG TIME TO ROTATE INTO CYCLICAL-VALUE STOCKS:

1. It is a record long expansion and growth is slowing to subpar, both in the United States and the world

2. Interest rates across the curve failed to get anywhere close to pre-crisis norms

3. Commodity / oil prices remain weak, despite a long expansion and recent conflict

4. Dollar remains strong, despite recent U.S.-Federal-Reserve (Fed) cuts, further cyclical upside risk exists

5. Profit margins under pressure, it is more difficult to offset pressures without growth

6. Labor costs are more of a challenge for the slow-growth value-oriented industries

7. Trade conflict threatens cyclicals and value more than defensive or growth stocks

8. Growth is more sensitive to service consumption and productivity investment

9. Value is more sensitive to goods consumption and capacity-addition investment

10. Our analysis shows, except for Banks and Tech services, price-to-earnings ratios at S&P 500 big caps are not unusually divergent. We prefer bond substitutes most, then still growth over value.

GLOSSARY

Capital expenditures (capex)
Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

Earnings per share (EPS)
Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Gross domestic product (GDP)
The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Growth stocks
Growth stocks are stocks from companies that are expected to grow significantly above market average for a certain period of time.

Price-to-earnings (P/E) ratio or multiple
The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

Profit Margin
Profit Margin is an accounting figure which describes profit in relation to revenue in percent.

Recession
A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

S&P 500
The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

U.S. dollar (USD)
The **U.S. dollar (USD)** is the official currency of the United States and its overseas territories.

U.S. Federal Reserve (Fed)
The **U.S. Federal Reserve**, often referred to as **"the Fed"**, is the central bank of the United States.

Value stocks
Value stocks are stocks from companies that are trading at prices close to their book value and that are therefore cheaper than the market average on that metric.

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