CIO | VIEW

Americas CIO View

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Marketing Material

A JUSTIFIED CORRECTION: OPPORTUNITIES EXIST, BUT RISKS REMAIN

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IN A NUTSHELL

- A sudden and sharp correction from record highs: justified in our view
- S&P 500 at 2950 is about fair in our view as 3300 still a fair 2020 end target
- Huge reset of U.S. interest rates: helps housing / consumers, hurts banks
- We reduce financials to equal-weight, we raise energy to equal-weight
- We cut 2020E S&P 500 EPS from 172 dollars to 168 dollars or from 5% to 2.5% growth
- About 70% of recoveries from 10% plus declines are more W- than V-shaped
- We raise our tactical "next 5% plus S&P 500 price move" from down to balanced

A SUDDEN AND SHARP CORRECTION FROM RECORD HIGHS: JUSTIFIED IN OUR VIEW

For the last several months, we have been tactically cautious on equities; especially non-financial value stocks. We were surprised by the speed of the S&P 500's rally to a record high of 3386 on February 19. Our primary concern was related to excess supply and capacity in global commodity production and industrial manufacturing. We repeatedly noted contracting earnings in 2019 at energy, materials, industrials, auto and many retailers through the fourth quarter of 2019. While acknowledging healthy and accelerating earnings growth at tech and healthcare and the valuation boosting benefits of persistently low interest rates; particularly to companies with good growth trends and high dividend defensives. But we were bothered by the market's leap of faith in an imminent acceleration in global growth and manufacturing. The virus quashed acceleration and made further global slowing likely for 2020. This shift in market expectations brought a one week 12.8% S&P 500 correction, which we consider justified.

S&P 500 AT 2950 IS ABOUT FAIR IN OUR VIEW AS 3300 STILL A FAIR 2020 END TARGET

Despite first half of 2020 S&P 500 earnings-per-share (EPS) estimate cuts, we still see our 3300 yearend S&P 500 target fair; assuming President Trump's reelection and/or a Republican controlled Senate. We do not expect the S&P 500 to reach or exceed its record high until after the election. We expect 3300 or higher if Trump is reelected or 3100 or lower if a Democrat. We think that 10-20% yearend return upside is what investors will demand to tolerate virus risks, which hopefully recede soon, and then about 10% for remaining election risk. We expect equities to remain volatile through the first-quarter reporting in April. Major dislocations across interest rates, currencies, and commodities markets and very fluid monetary-policy expectations and rising tail risks from China's strained economy means that the S&P 500 is likely to stay or revisit sub 3000 levels over the next couple of months.

HUGE RESET OF U.S. INTEREST RATES: HELPS HOUSING / CONSUMERS, HURTS BANKS

U.S. interest rates have been pushed into a record low range. The federal-funds rate remains 1.6%, but a cut is now likely this spring or sooner. The 2-year Treasury yield is 0.94% down from 1.57% at year start and 10-year yield is 1.16% down from 1.92%. We believe this will cushion U.S. housing and consumer spending, but it will weigh on earnings growth for most banks in 2020 and 2021, unless these rates rebound. After the U.S. Federal Reserve (Fed) likely cuts, we expect a very flat and very low curve for the rest of the cycle.

WE REDUCE FINANCIALS TO EQUAL-WEIGHT, WE RAISE ENERGY TO EQUAL-WEIGHT

We have been underweight the energy sector for the last eight years straight. We still see risks at energy and big vulnerabilities should our economic and political outlooks prove wrong. However, given the lost decade suffered by energy investors, and the challenge to banks from the interest-rates collapse, we neutralize our long standing preference for financials vs. energy. That said, we think both energy and financials face high industry-specific regulation and taxation risk under a Democrat sweep. We prefer to bear political risk at tech and even healthcare than at energy or financials.

WE CUT 2020E S&P 500 EPS FROM 172 DOLLARS TO 168 DOLLARS OR FROM 5% TO 2.5% GROWTH

We cut our quarterly 2020E S&P 500 EPS estimates to: 38.50+41.50+43.00+45.00 = 168. From: 41+43+43+45 = 172. The heightened share of S&P 500 EPS from tech and other growth stocks, as covered in our previous Americas CIO View note, makes a second half of 2020 S&P 500 EPS rebound less dependent on a sharp rebound in commodities, manufacturing and interest rates as exists at most value stocks and foreign equities.

ABOUT 70% OF RECOVERIES FROM 10% PLUS DECLINES ARE MORE W- THAN V-SHAPED

We examined all recovery rallies from correction and bear market lows since 1960. We find that about 30% of such recovery rallies are V-shaped and 70% are more W-shaped. Short-term, we expect a W-shaped recovery this time with many months until highs are recovered. But in a year, we expect an about 20% gain from Friday's close. This is the usual result for corrections that do not lead to recessions, but elevated price-to-earnings ratios (P/Es) and the S&P 500 not yet closing with a gain since the dip began keeps short-term risks high.

WE RAISE OUR TACTICAL "NEXT 5% PLUS S&P 500 PRICE MOVE" FROM DOWN TO BALANCED

We have argued further interest-rate declines and the ongoing structural shift of S&P 500 earnings from energy to tech make a 19 to 21 S&P 500 P/E a sustainable long-term norm vs. our prior 18 to 20 fair estimate. However, at moments of stress, it remains to be seen if a P/E about 2 points below the fair range will provide support. Support at 17x 168 dollars is 2850, but at the old 16x support P/E its 2675. Until a 20 P/E lengthens its record of sustainability, we would expect greater turbulence at this P/E altitude.

GLOSSARY

Technically, a bear market refers to a situation where the index's value falls at least 20% from a recent high.

A correction is a decline in stock market prices.

Defensive stocks are stocks from companies whose sales are expected to fluctuate less than the market average as the demand for their products are less tied to business cycles.

The Democratic Party (Democrats) is one of the two political parties in the United States. It is generally to the left of its main rival, the Republican Party.

A dividend is a distribution of a portion of a company's earnings to its shareholders.

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.

The federal funds rate is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

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

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

The Republican Party (Republicans), also referred to as Grand Old Party (GOP), is one of the two major political parties in the United States. It is generally to the right of its main rival, the Democratic Party.

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

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

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

The United States Senate is a legislative chamber consisting of 100 Senators, with each state being represented by two Senators. Senators are elected for six year, overlapping terms in their respective state.

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

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.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

A yield curve shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

APPENDIX: PERFORMANCE OVER THE PAST 5 YEARS (12-MONTH PERIODS)

	02/15 - 02/16	02/16 - 02/17	02/17 - 02/18	02/18 - 02/19	02/19 - 02/20
S&P 500	-0.7%	20.0%	26.4%	-2.3%	21.7%
U.S. Treasuries (2-year)	1.0%	0.3%	-0.1%	2.3%	4.7%
U.S. Treasuries (10-year)	4.7%	-2.9%	-1.3%	4.5%	15.1%

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