Americas CIO View

Summer with EM Asia and U.S. Banks & Communications

S&P near record, further upside needs healthy EPS growth to return in the second half of the year

The S&P 500 is flirting with its record high, we see the index as fairly but fully valued for now. If a new record is set soon, we think it only slightly exceeds 2018's September 2930 high. The sharp rally year-to-date is all from price-to-earnings (PE) expansion. Bottom-up consensus 2019 expectation S&P earnings per share (EPS) fell from $175 at year start to $168 now and the PE on this rose from 14.3 at year start to 17.3 now. First quarter S&P EPS is likely flat vs. last year assuming hearty beats. EPS growth should resume in 2Q albeit at a very slow pace. We expect the S&P to be range-bound (2750-2950) this summer through September until a bipartisan U.S. fiscal 2020 deal is struck this autumn and Britain finally legislates an orderly path for exiting the European Union (EU). When these deals pass and if the U.S. economy appears to be trending towards 2% gross-domestic-product (GDP) growth in 2019's second half and S&P EPS growth returns to a solid 5%+ trend, which we think likely but are not yet certain about, we would expect the S&P to rally to about 3000 by yearend or January. We fine tune our 2019E S&P EPS estimate to $169 from $170 with more details inside.

Summer Strategy: Dial equity risk down a bit, look for fairly priced duration

We think a 5%+ S&P price decline is unlikely near-term, but we trim our cyclical risk (beta) until the S&P is at or below the mid-point of the fair range we see for summer. We cut Equity allocation and raise Fixed Income and Alternatives. In equities we trim U.S., developed market (DM) and emerging market (EM). Within Fixed Income we trim high yield (HY) and add to short-duration. In Alternatives, we think real estate and infrastructure will perform well if the climb in 10yr yields is modest in late 2019 despite indications of a recession still being years away.

Summer Equity Strategy: Stick with Emerging Markets & U.S. Growth OWs

Despite the trim to our overall equity allocation, we maintain a large over-weight (OW) to Emerging Markets. We are equal to the slightest bit over-weight U.S. equities vs. our long-term norm and maintain a preference for large over small cap U.S. equities. We are moderately under-weight foreign developed equity markets. Our U.S. sector strategy and tilt toward EM Asia keeps our preference for Growth over Value. But our tilt to Growth is reduced a bit by lowering S&P Tech to equal-weight.

David Bianco
Chief Investment Officer &
Strategist, Americas

In a nutshell

- S&P near record, further upside needs healthy EPS growth to return in second half of the year

  For the summer, we dial equity risk down a bit, look for fairly priced duration

  Within equities, we stick with Emerging Markets & U.S. Growth OWs

  Value has some catch-up potential, but growth is still preferred

  For our sector strategy, we stick with U.S. Banks and Communications and incorporate Domestic Services as macro factor tilt

Growth still preferred vs. Value, but Value has some catch-up potential

We believe that Growth will outperform Value for the rest of this long-lasting cycle. But for this summer, we see some catch-up potential for Value from big Banks, which we see as well deserved and retainable. There could be some catch-up at Industrials, Materials and Energy, upon a China trade deal with positive surprises and a further climb in oil prices. But we're skeptical about how much or retainable outperformance from Energy and Materials might be and these sectors remain at more risk to downside scenarios. We think oil prices will be challenged despite healthy EM demand to climb further the rest of this cycle given ample potential supply and the stability in China's growth comes with a shift from investment activity and construction related materials demand to consumer goods and services consumption.

Summer S&P Sector Strategy: Stick with U.S. Banks and Communications

We believe the S&P is reaching the top of its spring rally, but we see further upside at big U.S. banks as chances of a 2019 federal-funds-rate cut fade away and the yield curve returns to a slight positive slope. We expect Comprehensive Capital Analysis and Review (CCAR) to confirm strong balance sheets at big banks and permit double-digit dividend hikes in the coming months. We maintain 400bp overweight (OW) on Financials and 300 basis points (bp) OW on Communications within the U.S. equity universe. We know that pricing power is pressured at many Communications companies, but we're attracted to the giant advertising-revenue capturing nets as we see their internet presence and services firmly rooted in consumers' lives. Elsewhere, we tilt to content vs. distribution on vast global selling opportunities. We reduce Technology and Health Care to equal-weight (EW) and raise Industrials, Consumer Staples, Real Estate and Utilities to EW. We stay under-weight (UW) Energy by 300bp and Consumer Discretionary and Materials by 200bp each.

Macro factor tilts incorporated in our sector strategy: Domestic Services

In addition to our normalized earnings and fair intrinsic value estimates for all S&P sectors, we consider macro-factor exposures of our sector tilts. Our sector strategy is neutral beta vs. S&P, but still Growth tilted; what now stands out the most is that we prefer domestic exposure and service providers over foreign exposure and commodity producers and manufacturers. We see a firm dollar, tame inflation and slower but decent capital-expenditure (capex) growth that is more focused on boosting productivity than capacity. Cutting OWs on Tech and Health Care lowered our research and development (R&D) exposure. We're attracted to such intangible assets and will look for an opportunistic return to OW.

Glossary

Beta

Beta is a measure of volatility that captures a security's systematic risk according to the capital asset pricing model.

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.

Duration

Duration is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate changes.

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.

Emerging markets (EM)

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

European Union (EU)

The **European Union (EU)** is a political and economic union of 28 member states located primarily in Europe.

Federal funds rate

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.

Fiscal policy

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

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 strategy

A **growth strategy** is an investment style that is focused on an investor's capital appreciation through capital gains. Investors following this strategy seek to invest in companies whose earnings

are expected to grow at an above-average rate compared to the industry or the overall market.

High Yield (HY)

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

Inflation

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

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.

Relative-value investing strategies

Relative-value investing strategies seeks to take advantage of price differentials between financial instruments by simultaneously buying and selling the different securities, thereby allowing investors to potentially profit from the "relative value."

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.

Yield curve

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.

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