EVERCORE ISI

Portfolio Strategy | Early Thought

Macro Note

February 19, 2019

Dennis DeBusschere
212-446-9481
Dennis.DeBusschere@evercoreisi.com

Brian Herlihy
212-446-9498
Brian.Herlihy@evercoreisi.com

Sophia Wang
212-653-9036
Sophia.Wang@evercoreisi.com

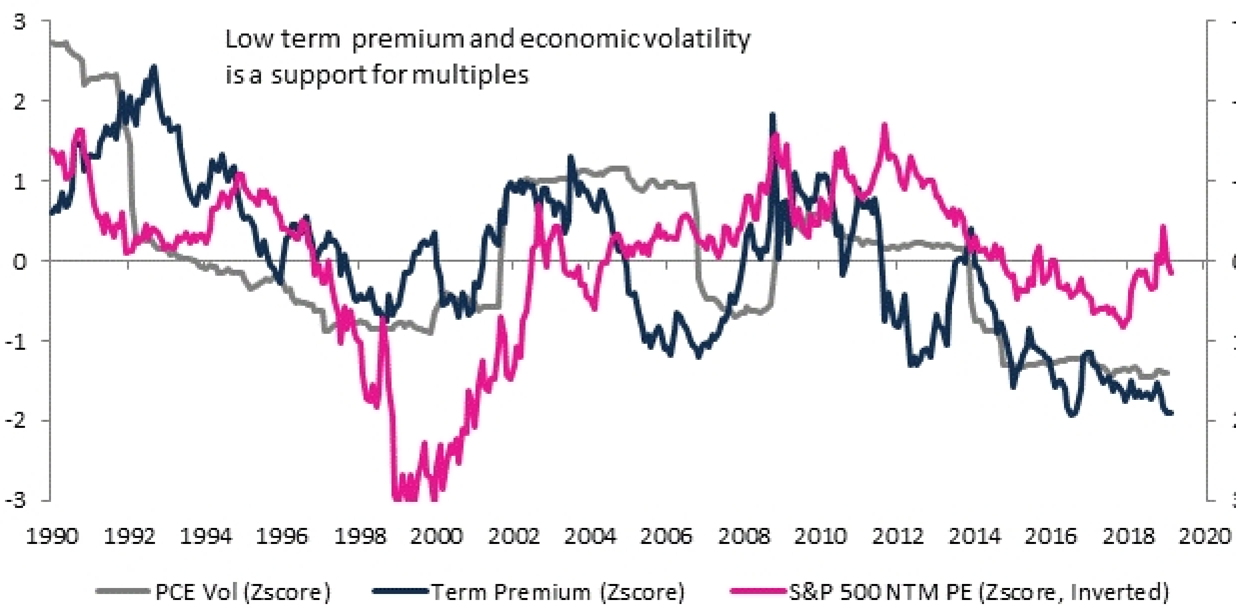
Kevin Brocks
212-446-5619
kevin.brocks@evercoreisi.com

Policy Support & the Risk-On Rotation; Deteriorating EPS Outlook; Sector Comments

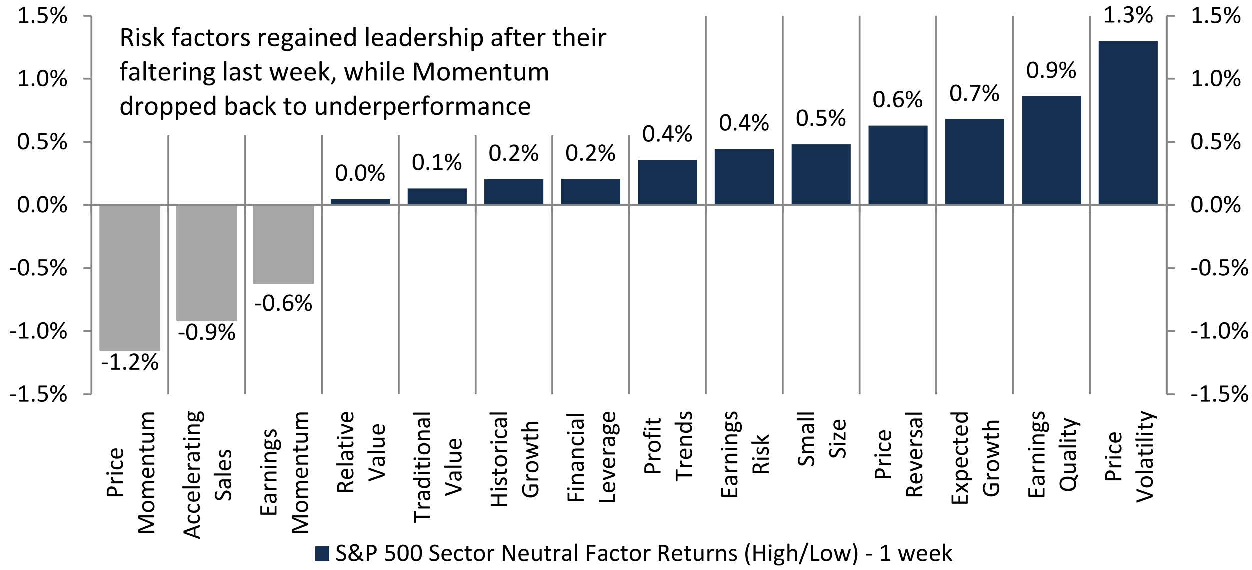
SUMMARY: The annualized S&P return has increased to 112%, bringing the market within 4.5% of our 2019 target of 2900. As long as U.S.-China trade negotiations go well and the global growth outlook stabilizes, equity markets should finish the year modestly higher, but the pace of returns should slow significantly. Valuations have increased, but remain within their normal range. Companies continue to pay out 85% of cash flow in dividends and buybacks, and recession risk remains low, supporting a higher average level of multiples.

M2 growth in China was better than expected (+8.4% YoY vs est of +8.2%, +8.1% prior), supporting the global growth outlook and commodity prices. As David Raso, EISI's Industrial Machinery analyst noted that improving growth in China is a support his names as well. Global policy makers continue to respond to fears about a sharp slowdown in global GDP.

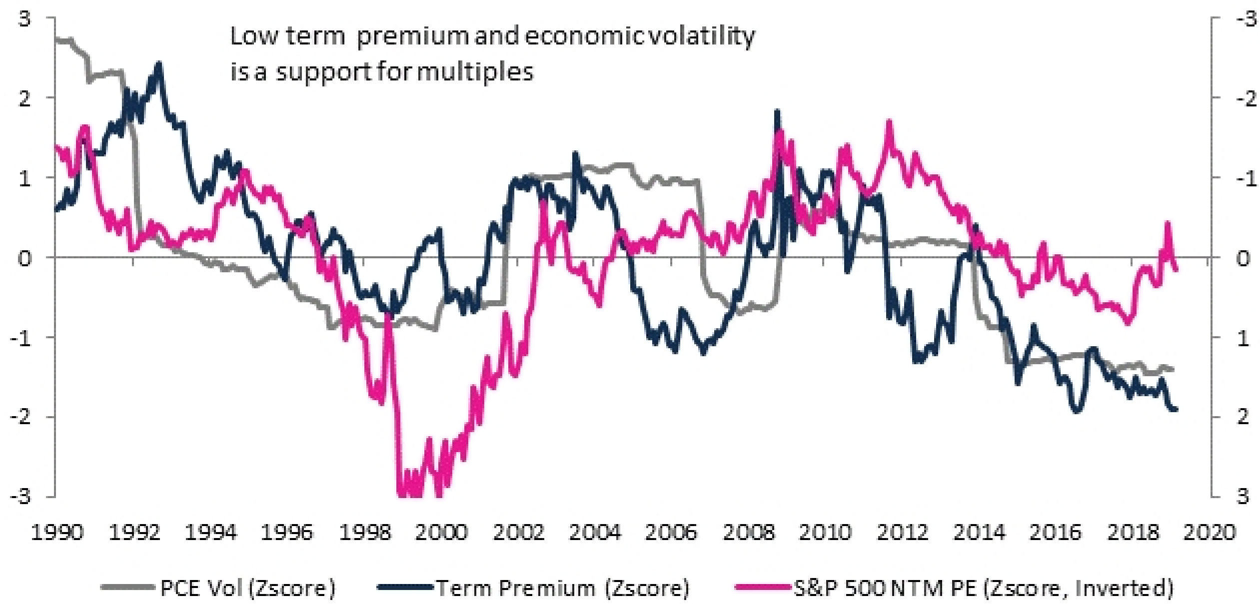
Internally, Risk factors have led the market higher alongside sectors levered to improving economic growth. As Krishna Guha noted last Friday, the Fed is closer to accepting higher inflation near term, which lowers the chance improved economic growth will be met with tighter monetary policy.



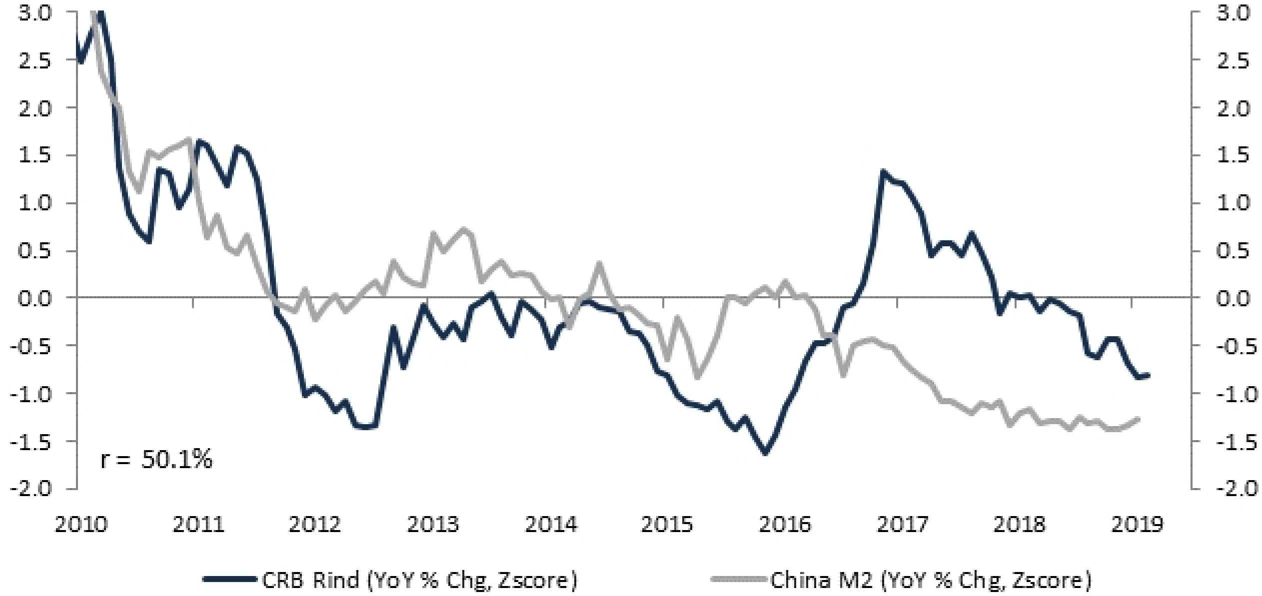
MARKET VIEWS: Risk assets are lower this morning after the annualized pace of S&P gains increased to 112% last week. As long as the trade war negotiations go well and global economic growth remains stable, markets should finish the year modestly higher, but the pace of returns should slow significantly. Internally, Risk factors have led the market higher alongside sectors levered to improving economic growth. As Krishna Guha noted last Friday, the Fed is closer to accepting higher inflation near term, which lowers the chance improved economic growth will be met with tighter monetary policy.



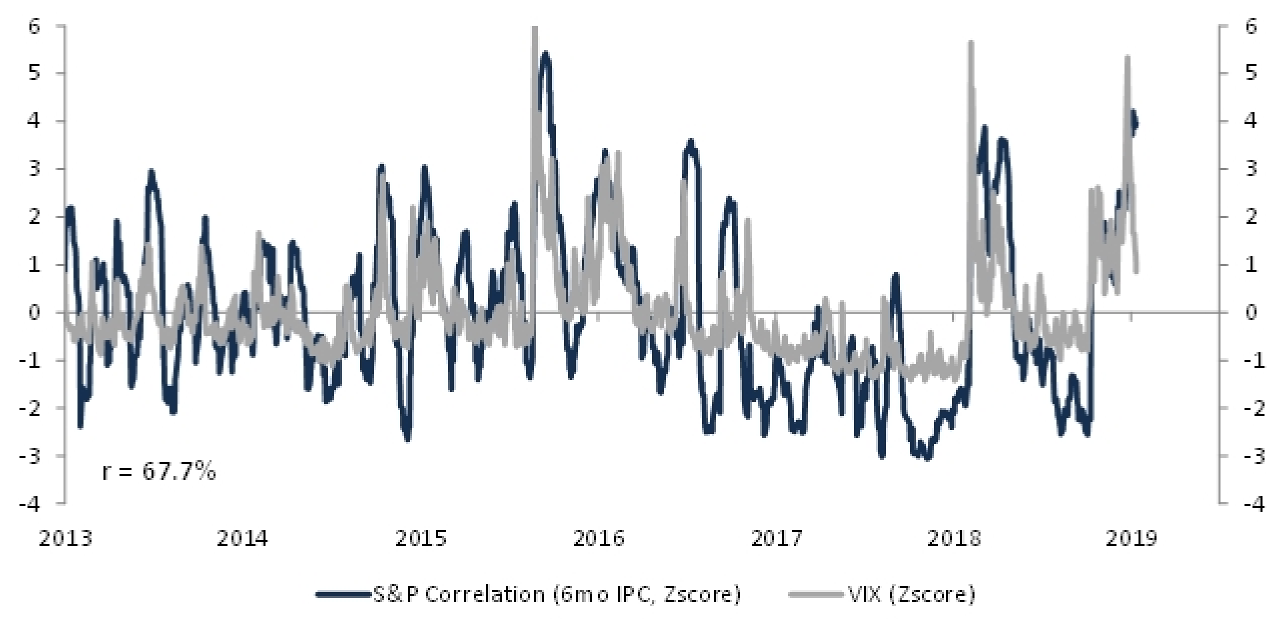
Valuations have risen quickly as the S&P has rallied and earnings outlooks have declined. If trade negotiations unravel and China stimulus fails, markets will move significantly lower. However, the likely extended pause in the Fed rate hike cycle, low recession risk and companies continuing to pay out 85% of their cash flow in dividends/buybacks, all support a higher than normal average level of multiples.



M2 growth in China was better than expected (+8.4% YoY vs est of +8.2%, +8.1% prior), supporting the global growth outlook and commodity prices. New Yuan loans in China hit a record 3.23 trillion in January, well above estimates, and the EISI Sales to Europe and China surveys both increased last week Global policy makers continue to respond to fears about a sharp slowdown in global GDP.



INTERESTING PAPER: Michael Mauboussin highlighted an academic study by Blake LeBaron at Brandeis that found that population diversity falls during the run-up to a crash. Investors begin to use similar trading strategies reinforced by their common positive performance. With investors increasingly focused on trade negotiations and stimulus measures in China, Assuming “positive” outcomes to those events, the diversity of topics investors focus on should increase, leading to lower volatility and correlations.

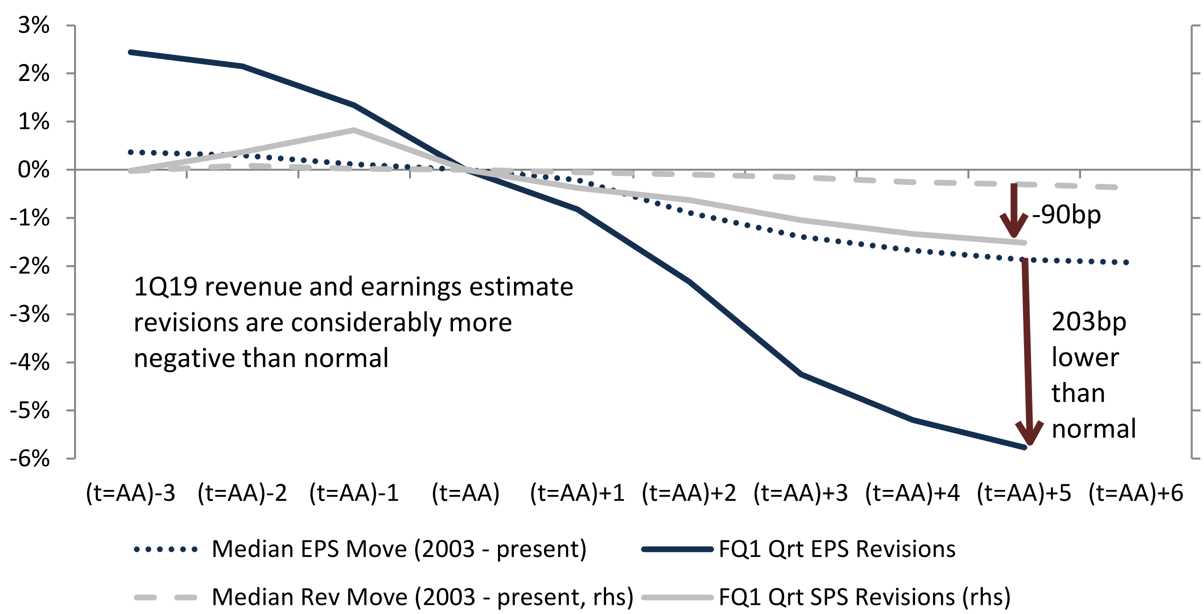


DETERIORATING EARNINGS OUTLOOK: With nearly 80% of the S&P having reported, 4Q18 revenue growth is tracking 6.6% and earnings have expanded 11.1% YoY. The percentage of the index beating earnings growth forecasts has been slightly weaker than normal and positive revenue growth surprises have been concentrated around the 1% level. Earnings growth peak in 3Q18, but the 4Q readings remain strong. A larger concern is the path of estimate revisions.

S&P 500 4Q18 Earnings Scorecard (79.2% Reported)

Sector	# of Cos Reported	Total	% of Cos Reported	Rev Growth	Op EPS Growth	Positive Surprises	% positive Surprises	Negative Surprises	% Negative Surprises
S&P 500	**396**	**500**	**79.2%**	**6.61%**	**11.06%**	**279**	**70.5%**	**107**	**27.0%**
Energy	18	30	60.0%	11.99%	98.90%	10	55.6%	7	38.9%
Materials	20	24	83.3%	2.00%	-1.67%	10	50.0%	10	50.0%
Industrials	60	69	87.0%	6.75%	18.91%	53	88.3%	7	11.7%
Discretionary	39	64	60.9%	7.60%	12.97%	28	71.8%	9	23.1%
Staples	25	33	75.8%	3.19%	5.28%	17	68.0%	7	28.0%
Health Care	51	61	83.6%	8.42%	11.32%	38	74.5%	12	23.5%
Financials	67	68	98.5%	3.02%	-1.36%	39	58.2%	24	35.8%
Technology	57	68	83.8%	0.71%	4.95%	47	82.5%	10	17.5%
Communications	21	22	95.5%	13.03%	21.05%	16	76.2%	4	19.0%
Utilities	12	27	44.4%	5.09%	-2.19%	6	50.0%	6	50.0%
Real Estate	26	32	81.3%	13.06%	6.96%	14	53.8%	11	42.3%

1Q19 revenue and earnings growth forecasts have moved steadily lower over the course of 4Q reporting. Negative revisions to FQ1 EPS estimates have been 2pp lower than normal, pushing expected EPS growth in 1Q down to -2.5%, the first contraction in YoY quarterly earnings since 2016.



SECTOR COMMENTS: U.S. markets returned to their risk-on rotation last week with the S&P rising another 2.5% as U.S. political uncertainty declined and Fed rhetoric remained supportive. Global equities ex the U.S. were essentially flat WoW, leaving their YTD gain at 8.6%. Energy led the rally at the sector level and mature-growth cyclicals in general rose with Industrials, the best performing sector YTD, and Materials both outperforming. Mature cyclicals are levered to global growth and have reacted positively to signs of a U.S-China trade agreement. Despite weakening economic data out of Europe, bond yields have also risen on, putting further downward pressure on the rate-sensitive defensives that led during the 4Q market decline, and pushing Financials higher. The rebound since the late-December low in equities has pushed the S&P 18% higher even as forward earnings growth estimates have moved lower, leaving the markets forward PE at 16.2x, up 0.8 points. Since the start of the year, the annualized pace of gains has increased to 112%, bringing the S&P to within 4.5% of our year end price target of 2,900. As long as the trade war negotiations go well and global economic growth remains stable, we expect markets will finish the year modestly higher, but the pace of returns should slow significantly.

2019 S&P 500 Sector Allocation

		Grouping	Recommended Allocation	Index Weight	2019 Return	Rank (1 = highest)	
S&P 500 Composite	2,775.6		Long	100.0%	10.7%		2019 Target 2900 (4.5%)
Industrials		Cyclical	Market Weight	9.7%	17.3%	1	Slowing global growth and the ongoing/deepening US-China trade war are headwinds
Consumer Discretionary		Cyclical	Overweight	9.9%	10.7%	5	Consumer borrowing costs are rising, but tight labor markets are finally translating into higher real wage growth; consumer confidence remains high
Consumer Staples		Defensive	Overweight	7.2%	7.0%	10	Consumer spending trends continue to support overall US economic growth; Staples are well positioned for a further deterioration in economic growth
Healthcare		Defensive	Overweight	15.1%	7.2%	9	Strong pricing power; insulated from slowing economic growth; modest earnings growth expectations
Financials		Rate Sensitive - Cyclical	Market Weight	13.3%	10.6%	6	The term premium is back to its QE low despite Fed rate hikes, rising inflation and faster growth. Barring a recession rates and curves should be biased higher
Real Estate		Rate Sensitive - Defensive	Underweight	3.0%	12.7%	3	The same yield increases that are tailwinds for Financials represent headwinds for Real Estate
Energy		Cyclical	Market Weight	5.5%	14.6%	2	Oil prices have fallen sharply, discounting a recession that is still unlikely over the coming quarters. Macro headwinds limit the chances of a near term rebound
Information Technology		Cyclical	Market Weight	20.3%	12.1%	4	SPLIT: Overweight growth Tech well positioned for slower growth and lower rate volatility. Underweight Value Tech
Materials		Cyclical	Underweight	2.7%	7.8%	8	Levered to global and emerging market growth prospects in particular. Weak pricing power with high tariff risk
Communication Services		Cyclical	Overweight	10.1%	10.5%	7	Dominated by Tech-like growth companies
Utilities		Defensive - Rate Sensitive	Market Weight	3.2%	4.9%	11	Fed funds and bond yields are biased higher over 2019, weak expected earnings growth and no pricing power

GENERAL DISCLOSURES

This report is approved and/or distributed by International Strategy & Investment Group LLC (“ISI Group LLC”), a U.S. licensed broker-dealer regulated by the Financial Industry Regulatory Authority (“FINRA”) and by International Strategy & Investment Group (UK) Limited (“ISI UK”), which is authorised and regulated in the United Kingdom by the Financial Conduct Authority. The institutional sales, trading and research businesses of Evercore Group and IDI UK collectively operate under the global marketing brand name Evercore ISI ("Evercore ISI"). Both Evercore Group and ISI UK are subsidiaries of Evercore Partners Inc. ("Evercore Partners"). The trademarks, logos and service marks shown on this report are registered trademarks of Evercore Partners Inc.

This report is provided for informational purposes only. It is not to be construed as an offer to buy or sell or a solicitation of an offer to buy or sell any financial instruments or to participate in any particular trading strategy in any jurisdiction. The information and opinions in this report were prepared by registered employees of Evercore ISI. The information herein is believed by Evercore ISI to be reliable and has been obtained from public sources believed to be reliable, but Evercore ISI makes no representation as to the accuracy or completeness of such information. Opinions, estimates and projections in this report constitute the current judgment of the author as of the date of this report. They do not necessarily reflect the opinions of Evercore and are subject to change without notice. In addition, opinions, estimates and projections in this report may differ from or be contrary to those expressed by other business areas or groups of Evercore and its affiliates. Evercore ISI has no obligation to update, modify or amend this report or to otherwise notify a reader thereof in the event that any matter stated herein, or any opinion, projection, forecast or estimate set forth herein, changes or subsequently becomes inaccurate. Facts and views in Evercore ISI research reports and notes have not been reviewed by, and may not reflect information known to, professionals in other Evercore affiliates or business areas, including investment banking personnel.

Evercore ISI does not provide individually tailored investment advice in research reports. This report has been prepared without regard to the particular investments and circumstances of the recipient. The financial instruments discussed in this report may not suitable for all investors and investors must make their own investment decisions using their own independent advisors as they believe necessary and based upon their specific financial situations and investment objectives. Securities and other financial instruments discussed in this report, or recommended or offered by Evercore ISI, are not insured by the Federal Deposit Insurance Corporation and are not deposits of or other obligations of any insured depository institution. If a financial instrument is denominated in a currency other than an investor’s currency, a change in exchange rates may adversely affect the price or value of, or the income derived from the financial instrument, and such investor effectively assumes such currency risk. In addition, income from an investment may fluctuate and the price or value of financial instruments described in this report, either directly or indirectly, may rise or fall. Estimates of future performance are based on assumptions that may not be realized. Furthermore, past performance is not necessarily indicative of future performance.

Evercore ISI salespeople, traders and other professionals may provide oral or written market commentary or trading strategies to our clients that reflect opinions that are contrary to the opinions expressed in this research. Our asset management affiliates and investing businesses may make investment decisions that are inconsistent with the recommendations or views expressed in this research.

Electronic research is simultaneously available to all clients. This report is provided to Evercore ISI clients and may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of Evercore ISI. Receipt and review of this research report constitutes your agreement not to redistribute, retransmit, or disclose to others the contents, opinions, conclusion or information contained in this report (including any investment recommendations, estimates or target prices) without first obtaining express permission from Evercore ISI.

This report is not intended for distribution to, or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

For investors in the UK: In making this report available, Evercore makes no recommendation to buy, sell or otherwise deal in any securities or investments whatsoever and you should neither rely or act upon, directly or indirectly, any of the information contained in this report in respect of any such investment activity. This report is being directed at or distributed to, (a) persons who fall within the definition of Investment Professionals (set out in Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the “Order”)); (b) persons falling within the definition of high net worth companies, unincorporated associations, etc. (set out in Article 49(2) of the Order); (c) other persons to whom it may otherwise lawfully be communicated (all such persons together being referred to as “relevant persons”). This report must not be acted on or relied on by persons who are not relevant persons.

Applicable current disclosures regarding the subject companies covered in this report are available at the offices of Evercore ISI, and can be obtained by writing to Evercore Group LLC, Attn. Compliance, 666 Fifth Avenue, 11th Floor, New York, NY 10103.

In compliance with the European Securities and Markets Authority's Market Abuse Regulation, a list of all Evercore ISI recommendations disseminated in the preceding 12 months for the subject companies herein, may be found at the following site: https://evercoreisi.mediasterling.com/disclosure.