Market Outlook
Q2 2017

Morningstar Equity and Credit Research
Report Released 29 March 2017

Contents

Stock Market Outlook: Lofty Valuations Call for Careful Stock-Picking

Given general valuation levels, careful individual stock selection is more important now.

By Elizabeth Collins, CFA
Director of Equity Research,
North America

- The Morningstar Global Markets Index has returned more than 6% year to date and 16% over the past year.

- The market-cap-weighted price/fair value estimate ratio for our equity analysts' coverage universe is 1.06.

- Healthcare is the most undervalued sector, with a price/fair value estimate ratio of 0.98. Basic materials is the most overvalued sector, with a price/fair value estimate ratio of 1.44.

Healthcare is top of mind as one of our most undervalued sectors—if only on a relative basis—and the one facing the most immediate possible changes under the Trump administration and Republican-controlled Congress in the United States. Both are looking to fulfill the long-standing promise of repealing the Affordable Care Act.

The road to repeal is rough, as the proposed reform ideas could lead to eliminating coverage for millions of Americans, and Republicans hold only a narrow majority in the Senate. The House vote on the American Health Care Act scheduled for Friday, March 24, was called off for lack of support, making the ultimate outcome even more uncertain, given opposition from both very conservative and moderate members within the Republican party. Most Republican proposals would lead to fewer insured Americans, weaker coverage, and higher out-of-pocket costs. Our analysts view the drug industry as best positioned for potential changes, with Roche RHHBY and Allergan AGN trading at attractive valuations.

Consumer cyclical is another sector where we see a decent amount of value in a generally overvalued market. Consumer confidence has remained high since the U.S. presidential election, but as consumers become increasingly comfortable making purchases online, companies relying on foot traffic in brick-and-mortar locations have continued to come under pressure.

Still, we think companies like Hanesbrands HBI and Williams-Sonoma WSM are positioned well to be profitable in the long term. Hanesbrands is distribution-channel-agnostic, and thanks to strong brand recognition and consistency, consumers should feel comfortable purchasing items online. Meanwhile, Williams-Sonoma has strong brands that command some loyalty and pricing power.

On the other side of the valuation spectrum, metals and mining stocks look especially expensive. Commodity prices have rallied since early 2016 thanks to China's stimulus, but mines previously shut down are now coming back on line, and greater production has already started from high-cost producers of bulk commodities. We view both the stimulus and the production curtailments as unsustainable, and see significant downside risk in stock prices. China optimism is also unduly propping up U.S. steel producer valuations, in our view, and these stocks are also baking in expectations for a material increase in infrastructure spending that could prove hard to deliver in reality.

Elizabeth Collins, CFA, does not own shares in any of the securities mentioned above.

Credit Markets: Bond Indexes Perform Well as Spreads Tighten Further

Both the investment-grade and high-yield indexes are trading much tighter than their long-term historical averages.

By Dave Sekera, CFA
Managing Director
Corporate Bond Strategist

- Rising federal-funds rate did not preclude fixed-income indexes from rising in the first quarter.
- Corporate credit spreads remain near the tightest quartile they have registered over the long term.
- The market continues to expect a couple more rate hikes this year.

Fixed-income indexes performed well during the first quarter of 2017, as interest rates held relatively steady and credit spreads tightened slightly. Corporate credit markets have been supported by a combination of generally improving credit metrics and the market's expectation that possible revisions to tax and regulatory policies enacted by the Trump administration will reinvigorate economic growth and earnings.

Morningstar's Core Bond Index, our broadest measure of the fixed-income universe, rose 0.90% in the first quarter through March 27. The return has been generated by a combination of the yield carry on the underlying securities, as interest rates have generally been flat thus far this year, and by a slight tightening in corporate credit spreads. Representative of the Treasury market, the Morningstar U.S. Government Bond index rose by 0.82% and the Morningstar Agency Bond Index rose 0.71%. Inflation expectations have also held relatively steady, and the Morningstar Treasury Inflation-Protected Securities Index has risen 1.40%.

In the corporate bond market, the Morningstar Corporate Bond Index (our proxy for the investment-grade bond market) rose by 1.41%, and in the high-yield market, the Bank of America Merrill Lynch High Yield Master Index rose 1.67%. However, while corporate bonds performed well in the U.S., the Morningstar Euro Corporate Bond Index declined 0.33%. Corporate credit spreads were relatively unchanged this past quarter, and U.S. long-term interest rates were generally steady, but in the eurozone, underlying sovereign interest rates rose as the European Central Bank began to intimate that it is nearing the time it will begin to wind down its easy monetary policy. For example, the yield on Germany's 10-year bond almost doubled, rising 18 basis points to 0.39%.

The emerging-markets fixed-income indexes posted the strongest returns in the first quarter among the fixed-income universe, as the Morningstar Emerging Market Composite Index rose 3.49%. Underlying the composite index, the Morningstar Emerging Market Sovereign Index rose 4.18%, and the Morningstar Emerging Market Corporate Index rose 3.09%.

Exhibit 1 Fixed-Income Index Returns

	YTD	2016	2015	2014	2013	2012	2011
Broad Market Index							
Core Bond	0.90	2.64	0.98	6.07	-1.89	4.41	7.97
Sector Indexes							
US Gov't Bond	0.82	0.97	0.91	5.08	-2.74	1.98	9.35
Agency	0.71	1.67	0.72	3.01	-1.03	1.96	5.24
Corporate Bond	1.41	5.81	-0.46	7.20	-1.50	10.54	7.21
BofAML High Yield Master II	1.67	17.49	-4.64	2.50	7.42	15.58	4.38
Eurobond Corp	-0.33	4.66	-0.59	8.35	1.94	12.67	2.94
TIPS	1.40	4.68	-1.60	3.95	-8.53	6.93	13.49
Emerging Markets Indexes							
Emerging Mkt Composite	3.49	9.94	0.62	5.06	-4.39	16.25	2.65
Emerging Mkt Sovereign	4.18	9.25	1.15	7.69	-3.40	13.75	3.98
Emerging Mkt Corporate	3.09	11.30	0.08	3.47	-2.81	15.32	0.18

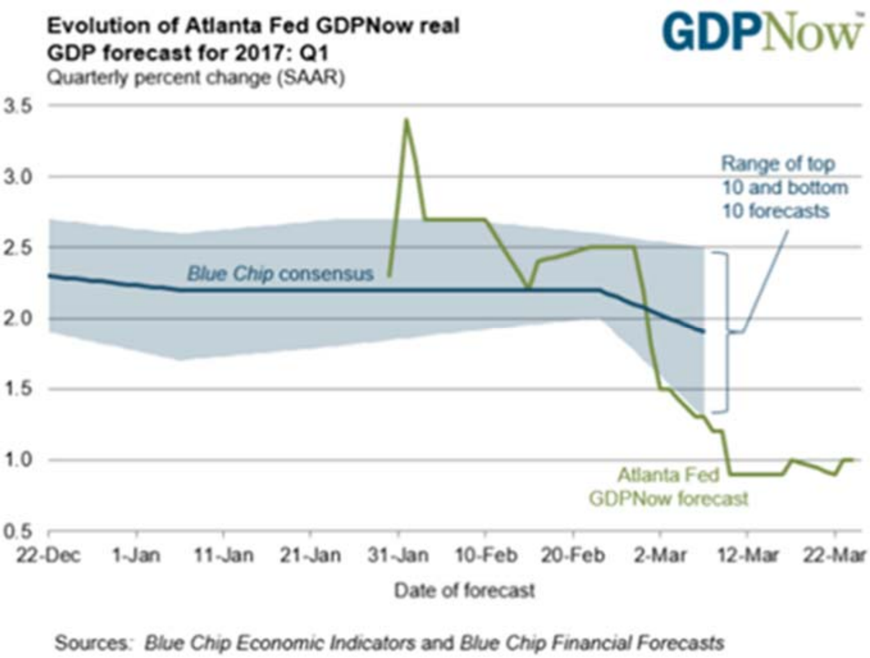
Source: Morningstar, Inc., Bank of America Merrill Lynch Global Indexes. Data as of 03/27/2017.

While the corporate bond market has been pricing in the expectation that revisions to tax and regulatory policies that might be enacted by the Trump administration will reinvigorate economic growth, recent economic activity appears to have slowed in the first quarter. Robert Johnson, Morningstar, Inc.'s director of economic analysis, is expecting that GDP growth in the first quarter will only be about 1.0%. He expects economic growth will rebound in the second quarter to 2.1% and will range between 1.75% to 2.0% for full-year 2017.

While his first-quarter estimate is below the average expectations of Wall Street economists, it is in line with the GDPNow estimate produced by the Federal Reserve Bank of Atlanta. Data over the past few weeks has led the Atlanta Federal Reserve to lower its GDPNow estimate for economic growth in the first quarter of 2017 to 1.0% from as high as 2.5% as recently as Feb. 27. Factors that have led to the lower estimate include weakening construction spending, light vehicle sales, and manufacturing reports. However, even at this slower pace, our corporate credit analysts expect economic growth should be enough to generally support the credit quality of corporate issuers and financial institutions.

Among Johnson's other forecasts, he expects that at the end of this year, the yield on the 10-year U.S. Treasury will be 3.00% to 3.50% and that the run rate of inflation will be 2.00% on a fourth-quarter over fourth-quarter basis.

Exhibit 2 GDPNow - Federal Reserve Bank of Atlanta



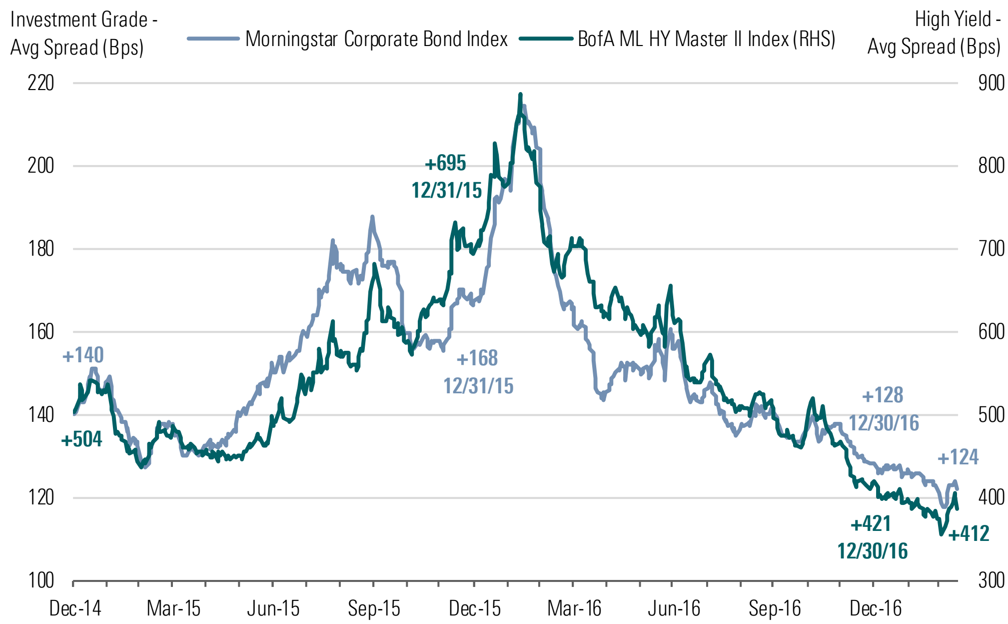
Source: Federal Reserve Bank of Atlanta.

Corporate Credit Spreads Have Tightened Modestly in the First Quarter

Since the end of last year, the Morningstar Corporate Bond Index, our proxy for the investment-grade bond market, tightened 4 basis points to +124, whereas the Bank of America Merrill Lynch High Yield Master Index tightened 9 basis points to +412.

Much of the tightening has occurred in sectors that are either highly correlated to improving economic conditions or to higher interest rates. For example, in the first quarter, the basic industries sector has tightened the most, as underlying commodity prices have risen off of the early 2016 lows and have held steady thus far this year. Manufacturing has also been one of the better-performing sectors this year. The rise in oil prices has improved the outlook for companies that manufacture equipment used in the oil sector, and the expectation of protectionist policies from the Trump administration has lifted companies that have significant U.S. manufacturing operations. The expectation of rising interest rates has led to outperformance by the finance sector because banks are expected to be able to raise their net interest income margins.

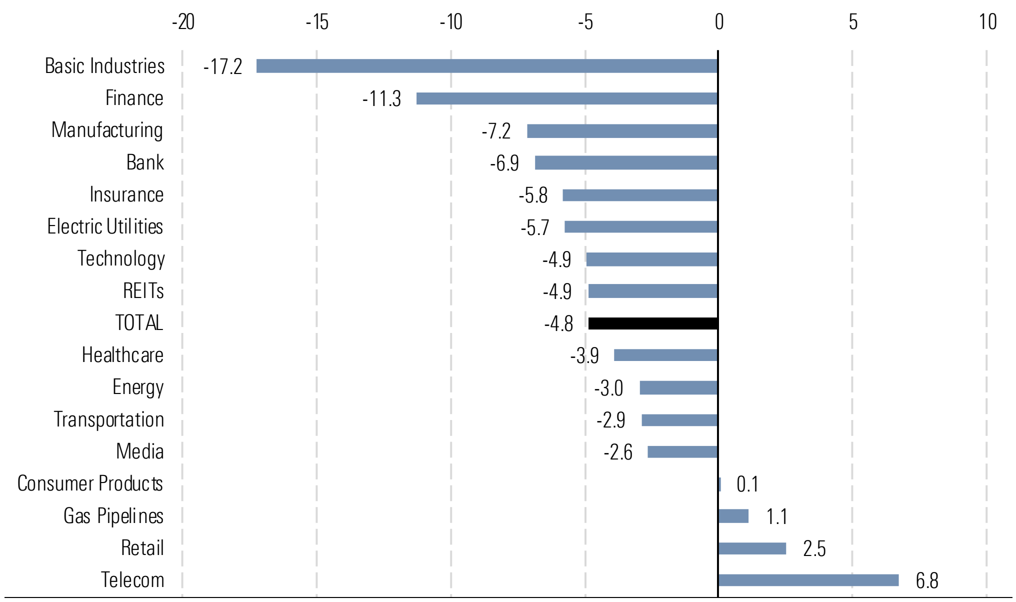
Exhibit 3 Corporate Bond Credit Spreads



Source: Morningstar, Inc., Bank of America Merrill Lynch Global Indexes. Data as of 03/27/2017.

The retail and telecommunications sectors have performed poorly. In the retail sector, lower same-store sales and a shift away from traditional retailers to e-commerce have led to declining credit quality. In the telecommunications sector, the decline in credit quality has mainly been self-inflicted, as management teams look to increase growth through strategic acquisitions, which have been funded by greater amounts of debt, leading to worsening credit quality.

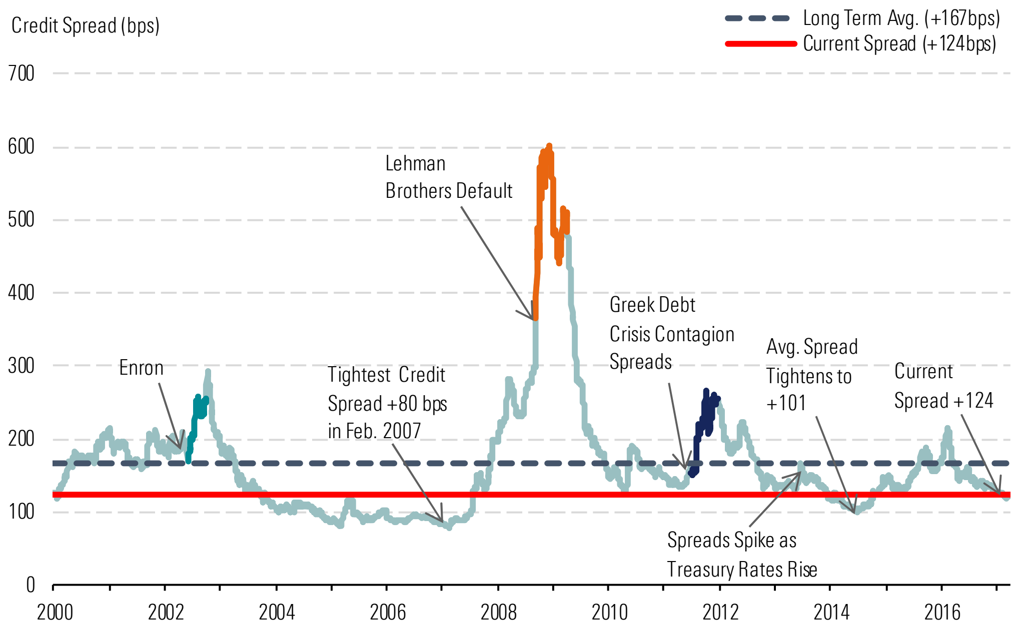
Exhibit 4 Morningstar Corporate Credit Index YTD Spread Change



Source: Morningstar, Inc. Data as of 03/27/2017.

At current levels, both the investment-grade and high-yield indexes are trading much tighter than their long-term historical averages. Since the end of 1998, the average spread of our investment-grade index is +168, and since the end of 1996, the average spread of the high-yield index has averaged +580. As an indication of how tight corporate credit spreads have become compared with their historical averages, since the beginning of 2000, the average spread of the Morningstar Corporate Bond Index has registered below the current level only 26% of the time. In addition, not only are credit spreads tighter now than in much of the recent past, the average credit quality of the Morningstar Corporate Bond Index is lower than it has been much of the time. Currently, the average credit quality of the Morningstar Corporate Bond Index is A-, whereas since 2000, the average credit quality has been either closer to, or a single A for much of the time.

Exhibit 5 Morningstar Corporate Bond Index Average Credit Spread



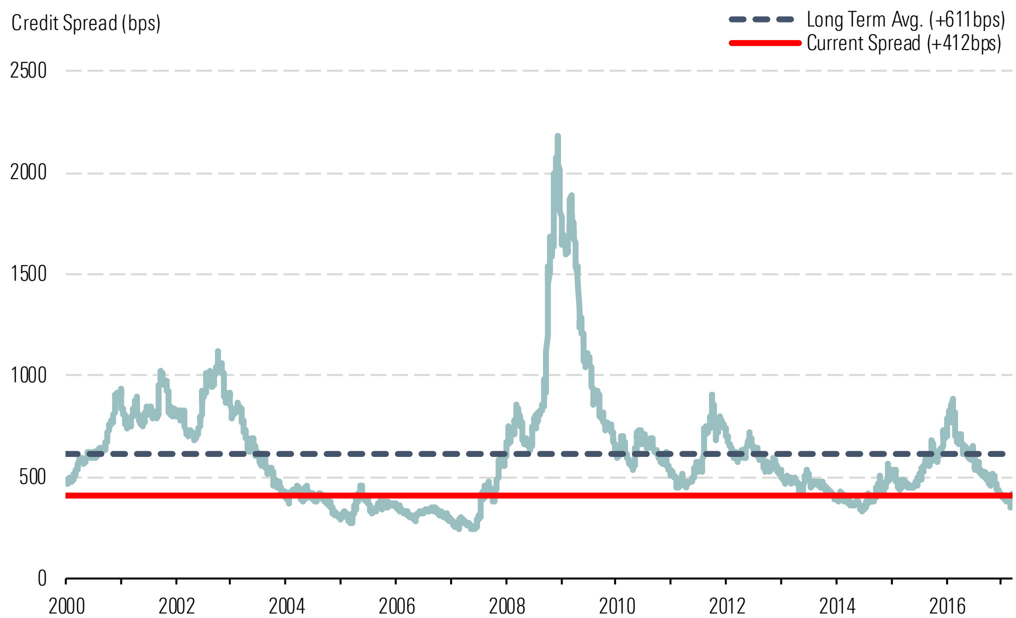
Source: Morningstar, Inc. Data as of 03/27/2017.

Exhibit 6 Morningstar Corporate Credit Index Average Rating

Source: Morningstar, Inc. Data as of 03/27/2017.

In the high-yield market, the average spread of the Bank of America Merrill Lynch High Yield Master Index has registered below its current level less than 25% of the time over the past 17 years. Most of the time that these corporate bond market indexes were tighter than the current credit spread was during the buildup to the 2008-09 credit crisis. In 2004 through 2007, corporate credit spreads were pushed to new historically tight levels as new structured investment vehicles were engineered to arbitrage the differentials in expected default risk; however, once the credit crisis emerged, investors found that many of these vehicles did not perform as advertised.

Exhibit 7 Bank of America Merrill Lynch U.S. High Yield Option-Adjusted Spread



Source: Bank of America Merrill Lynch Global Indexes. Data as of 03/27/2017.

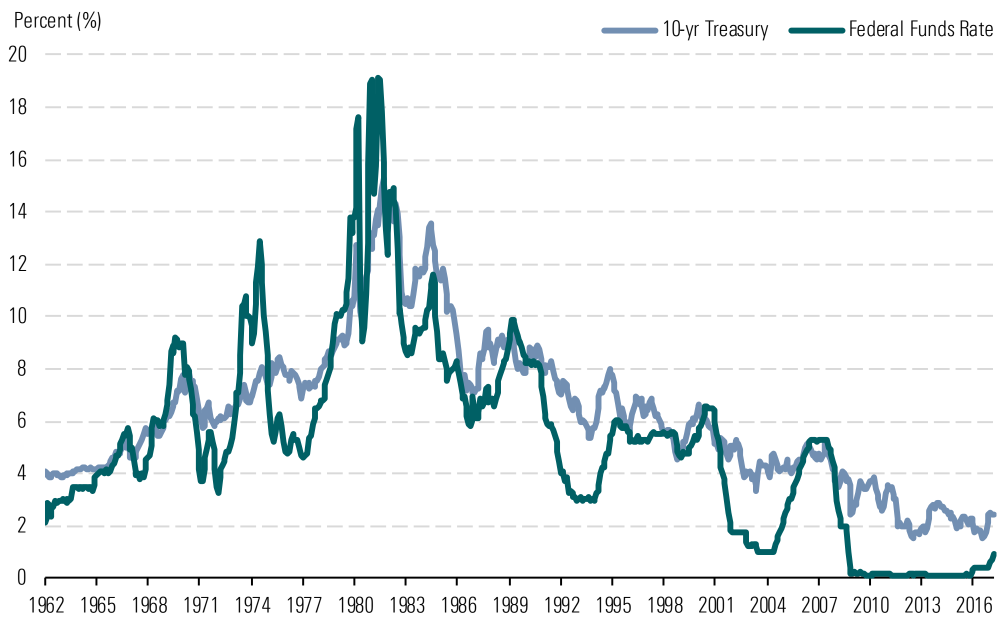
Futures Market Pricing in Additional Fed Rate Hikes

The Federal Reserve raised the federal-funds rate in March by 25 basis points to a range of 0.75% to 1.00%. At the beginning of the year, the market-implied probability of a rate hike so early in the year was very low, but that rose quickly a few weeks before the March meeting of the Federal Open Market Committee, as Federal Reserve officials intimated within several public speeches that a rate hike was in the offing. However, even after this rate hike, the market continues to expect a couple more this year. The Fed's median forecast for the federal-funds rate at the end of 2017 is 1.4%.

According to data from the CME, the market-implied probability priced into the federal-funds futures market that the Fed will hike the federal-funds rate after the June meeting is 53%. The probability that it will be over 100 basis points after the December meeting is 89%. Additionally, the market-implied probability that there will be two more rate hikes this year is 55%. If the Fed were to hike interest rates two more times this year, the federal-funds rate would range between 1.25% and 1.50% at the end of this year. That would be the first time since 2008 that the federal-funds rate has risen above 1% and will finally bring it back above its previous historical low, which was reached in 2003, when the U.S. was recovering from the tech bubble.

While the Fed is tightening monetary policy in the U.S., the ECB has held its course and remains in an easy monetary policy stance. Earlier in March, the ECB decided to keep its short-term interest rates at negative yields and will maintain its EUR 60 billion monthly purchase program through year-end. However, ECB President Mario Draghi recently alluded to signs of strengthening in the eurozone and the re-emergence of inflation. Many investors took this to mean that the ECB is edging closer to dialing back its dovish monetary policy.

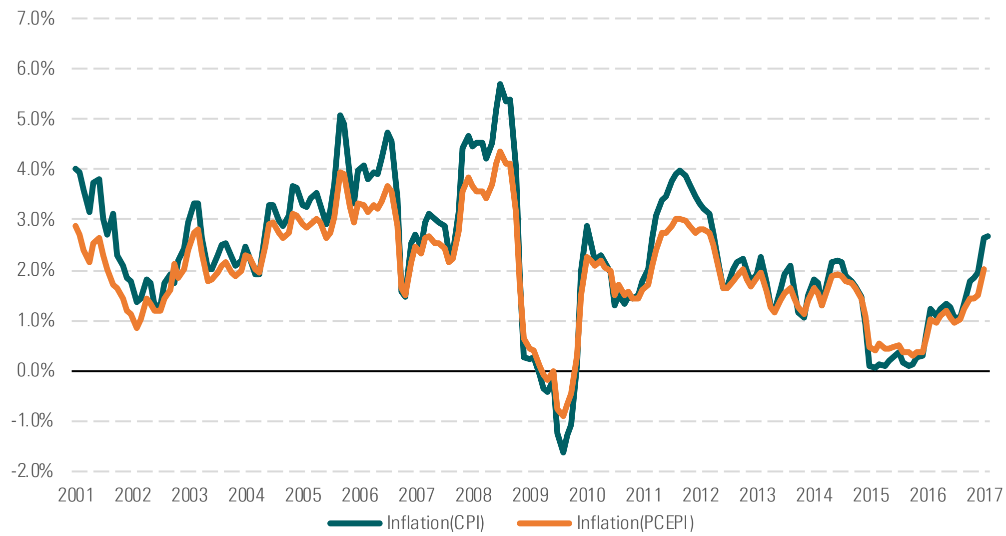
Exhibit 8 Federal-Funds Rate vs. 10-Year Treasury Yield



Source: Federal Reserve Bank of St. Louis. Data as of 03/27/2017.

The reason the Fed is raising the federal-funds rate is that many of the measures it watches have normalized and are either at or near their targeted levels. Unemployment is at its lowest level since 2007, and both inflation and inflation expectations have rebounded and stabilized near the Fed's 2% inflation target. For example, since oil bottomed out in February 2016, both the Consumer Price Index and the personal consumption expenditure price index (the Fed's preferred measure of inflation) have steadily risen toward, or above, the Federal Reserve's 2% inflation target.

Exhibit 9 U.S. Consumer Price Index vs. Personal Consumption Expenditure Price Index



Source: Federal Reserve Bank of St. Louis. Data as of 03/27/2017.

In addition, the 5-year, 5-year forward inflation expectation rate rose above 2% in November and has held relatively steady since then.

Exhibit 10 5-year, 5-year Forward Inflation Expectation Rate

Source: Federal Reserve Bank of St. Louis. Data as of 03/27/2017.

CMBS: Tempered New-Issue Volume as Risk-Retention Fears Recede

As the market adjusts to the risk-retention rules, soft borrower demand, a slack loan securitization pipeline, rising interest rates, and a lower payoff rate for securitized loans will constrain issuance in the first half.

By Robert Grenda,
Senior Vice President
CMBS New Issue Analyst

- An upswing in maturity defaults will nudge the delinquency rate for nonagency CMBS loans higher, as many borrowers with maturing loans will not qualify for new financing.
- Tighter lending standards are tamping borrower demand for CMBS loans.
- The impact of the retention rules has been largely positive, and the perception among investors is that the latest CMBS offerings have better collateral than noncompliant deals, which has resulted in tighter spread levels in some cases.
- Commercial real estate remains healthy, but fundamentals are shifting in some markets as rent growth moderates and property valuations level off.

Notwithstanding the strong start this year, there are signs that issuance of commercial mortgage-backed securities in the first two quarters will not match last year's tallies. While concerns over the mechanics of the risk-retention rules have diminished, Morningstar Credit Ratings, LLC forecasts a decline in CMBS new issue volume this year to roughly $65 billion to $70 billion, down from last year's $76 billion. Securitization lenders are facing tighter underwriting standards, competition from balance-sheet lenders, expected rising interest rates, and a potential slowdown in the growth in commercial real estate values. Moreover, we are projecting a drop in the payoff rate for maturing securitized loans, which will dampen demand for new loans. The one bright spot will be agency CMBS issuance, which should meet or exceed last year's record volume of $51.2 billion.

Indications are that volume for CMBS conduit transactions will be shy of the $19.01 billion floated in the first half of 2016, below the pace required to reach our full-year estimate. A thin pipeline of nonagency loans originated for securitization is one of the factors. In the fourth quarter, lenders moved aggressively to pare down their loan warehouses ahead of the implementation of the risk-retention rules in December. This boosted new-issue volume in the fourth quarter, but the increase came at the expense of maintaining an adequate pipeline of loans for future conduit deals. It may take several months for issuers to generate an ample supply of loans before the pace of issuance accelerates.

Rebuilding the pipeline will be challenging. First, Morningstar Credit Ratings projects a lower payoff rate this year, which will reduce the supply of securitizable loans. We expect the payoff rate will drop to about 60% from 75.6% in 2016. We estimate that 40% of the $67.01 billion of CMBS loans, most underwritten at the peak of prior real estate cycle, coming due this year are overleveraged and unlikely to get takeout financing at maturity. Separately, we expect the delinquency rate, which has hovered near 3% for the past eight months, to edge higher. Among major markets, we forecast weakness in suburban Chicago and suburban Washington, D.C. We expect average loss severity on liquidated loans to intensify in the first half of the year, and the average loss to be 40%-45% of the unpaid principal. Again, the key driver is the number of 2007-vintage loans that could default at maturity because of overleverage. In many cases the collateral properties for these loans will end up being sold, some at a substantial loss.

Second, the timing of the new regulations will result in fewer lending opportunities for some originators, because the rules have forced stricter lending standards at a time when many CMBS borrowers—particularly those with overleveraged loans—need looser loan terms. We expect lending standards to remain tight. According to the Federal Reserve's January 2017 Senior Loan Officer Opinion Survey on Bank Lending Practices, 77.9% of respondents said that they expect lending standards for loans secured by nonfarm nonresidential properties to "remain basically unchanged," over 2017, while 17.6% reported they expect standards to "tighten somewhat."

Third, portfolio lenders such as banks and insurance companies will increase their share of commercial real estate lending. Last year, while volatility in bond spreads and uncertainty surrounding risk retention dealt a double blow to CMBS originators, balance-sheet lenders originated loans at or near record levels, according to the Mortgage Bankers Association. Portfolio lenders will continue to put competitive pressure on CMBS conduit shops.

Finally, higher interest rates will make it more difficult for some borrowers to obtain financing. While the number and magnitude of rate increases is unclear, Federal Reserve policy makers could raise rates again this year. Capitalization rates, which are used to value commercial real estate, tend to track changes in interest rates and could move higher. This will pull some property values lower and could stymie the refinancing efforts of some borrowers.

On the positive side, we anticipate that Freddie Mac's securitization volume will be robust, given that banks will receive the best capital treatment for multifamily loans under Basel III. Multifamily loans receive a 100% risk weight during the first year after origination but are eligible for a 50% risk weighting thereafter if the loan meets specific credit requirements; all other commercial real estate exposures are subject to 100% or 150% risk weighting.

Risk-Retention Fears Have Abated

The long-term effects of risk retention are unknown, but fears about the rules causing a significant disruption in the CMBS industry have lessened. Market participants will adjust to the new regulatory and structural landscape, and we expect to see issuers continue to experiment with retention structures to achieve the best execution for their deals.

We view risk retention as a positive development for the CBMS sector in the short term. The requirement has expedited the exit of a handful of smaller originators and more may follow. Less competition from fewer loan shops should lead to more stable underwriting standards and better loan quality. That said, because of the idiosyncratic nature of commercial real estate properties and loans, investor demand will be driven by collateral quality, regardless of the retention structure used for individual transactions.

Under the retention rules, issuers have various options for compliance. They can retain a vertical slice of the capital stack, comprising 5% of each certificate class, a horizontal slice consisting of the bottom 5% of the market value of the capital structure, an L-shape strip that combines the first two options, or sell all or part of their retention obligation to a B-piece buyer, which is an investor who buys the below-investment-grade portion of CMBS deals. So far, issuers have relied primarily on the vertical option. The first deal to adopt an L-shape strategy was rolled out in January, and more issuers are likely to employ this option, which should appeal to issuers, B-piece buyers, and investors alike. The first conduit CMBS to use the horizontal option priced in early March, and we expect more issuers to test this option in the second quarter.

Commercial Real Estate Fundamentals Remain Sound

Commercial real estate is poised for a positive year. The industry is experiencing a period of protracted rent growth in most major property types, low vacancy rates, and rising property values. One reason for optimism is the domestic economy, driven by gains in job growth and consumer spending. Limited new construction has helped propel rents and property values higher for the past several years. However, the dynamics of supply and demand are changing in some submarkets because of new construction. Some areas already are witnessing a slowdown in rent growth, while others are experiencing declining rents and rising vacancies. These include the Northwest Chicago and Stamford, Connecticut, office submarkets, the Kansas City, Missouri, and Philadelphia retail markets, and the New York City multifamily market.

Two big unknowns for commercial real estate are whether the Trump administration will be successful pushing a pro-growth agenda, and the timing and pace of interest-rate increases. The Fed has been cautious about raising rates, and if this approach continues, a series of small rate increases should not have widespread negative effects on real estate, especially if the prospects of higher economic output are the driving force.

Capitalization rates, a measure of the rate of return on real estate properties, are likely to move higher with interest rates, which would put downward pressure on property values. However, the magnitude of any increases in cap rates is likely to be small, less than 50 basis points, in the short run. This is in part because the spread between the yield on the 10-year Treasury note and cap rates is wide, and this difference may act as a cushion that can absorb increases in the Treasury yield without leading to a significant increase in cap rates. Other factors, such as the availability of capital and construction of new properties, which also affect cap rates, suggest a modest short-term increase.

Among major commercial property types, the two to watch are hospitality and retail. Prior to the November election there was a consensus that hotels, which are highly cyclical, were in the late phase of the current cycle. But as the second quarter begins, it looks like the lodging industry may still have legs, primarily because of the projections for modest economic expansion. The sector is projected to see moderating demand growth through 2017, according to STR, Inc., as new supply begins to outpace demand. We expect growth in occupancy rates and average daily rates to slow in most markets, and for Houston, Miami, and New York City to underperform. STR projects that supply growth will exceed 6% in Austin, Texas, and Charlotte, North Carolina, and, as a result, we think many hotels there will come under pressure.

We expect Airbnb Inc. to expand further in well-performing markets with the highest growth in revenue per available room, a key performance benchmark in the lodging industry. Demand for Airbnb should be strong among both leisure and business travelers.

The retail sector is highly segmented by location quality and tenant type. Properties in the best locations will deliver robust sales and command the highest valuations, while the opposite will be true for those centers in markets with stagnant or declining demographics. Demand for space will take a hit from another wave of store closures that are expected this year, which could halt the trend of declining vacancy.

Changes in consumer demographics and buying habits will pressure many brick-and-mortar retailers. Department-store chains will go through another round of store closures in the coming quarters. CoStar Group, Inc. projects that in the coming years some 1 billion square feet of retail space will be shuttered, converted to other uses, or face prospects of lower rents, and the bulk of this change will affect department stores and apparel retailers. For owners of the best regional and super-regional malls in markets with a strong demographic profile, department-store closures will create opportunities to improve foot traffic, enhance consumers' shopping experience, and drive rents higher.

In the second quarter, we expect CMBS new issuance volume to remain lackluster, and for 2017 issuance to fall short of last year's total. The delinquency rate for securitized loans, hovering near 3%, will edge higher, as the CMBS loan payoff rate will slide and loss severities will worsen. Commercial real estate will benefit from low interest rates and a stable U.S. economy. Nonetheless, many markets are experiencing significant increases in deliveries, and this will weigh on rent and occupancy growth.

Basic Materials: The Most Expensive Sector We Cover

With shares propped up by unsustainable Chinese demand, basic materials stocks are trading at a whopping 44% premium to our estimate of intrinsic value.

By Daniel Rohr, CFA
Director of Basic Materials Equity Research

- On a market-capitalization-weighted basis, our basic materials coverage trades at a 44% premium to our estimate of intrinsic value, making it the most expensive sector we cover.

- Metals and mining stocks look especially expensive. Metals prices have been propped up by a combination of Chinese stimulus and supply cuts, but neither source of strength looks sustainable.

- U.S. housing plays remain among the pockets of opportunity in an otherwise overvalued sector. We expect housing activity will continue to build momentum in the remainder of the year.

- The remaining obstacles to major consolidation within the seeds and crop chemicals industry are likely to be overcome. We expect all three major deals to close this year.

Mined commodity prices remain elevated heading into the second quarter, and we see considerable downside for prices and producer shares. The pricing rally that kicked off in early 2016 has begun to elicit a supply response, with mines previously shut down now coming back on line. We have already begun to see greater production from high-cost producers of bulk commodities. As Chinese demand for these commodities fades following the stimulus-led demand uptick in 2016, we expect significant downward pricing pressure on key industrial commodities such as aluminum, iron ore, met coal, thermal coal, and copper.

This dynamic also weighs on our global steel outlook. At the regional level, U.S. steel stocks have performed especially well in recent months, thanks to investor optimism stemming from a potential infrastructure spending boost and supply-side reform in China. However, we believe the long-term impact of both factors will disappoint relative to the expectations that seem to be reflected by current share prices. We expect Chinese steel demand will soften as the benefits of stimulus measures fade. This will limit the global impact of supply-side reform in China and weigh heavily on steel prices.

Momentum in the U.S. housing market has been promising as we enter 2017. Household formation among younger adults, which has hamstrung the housing recovery thus far, is set to improve as tighter labor markets buoy wages and pull more workers off the sidelines. Meanwhile, new housing supply is changing to meet nascent millennial demand, as homebuilders' mix shifts to affordable starter homes. Housing starts rose to an annualized rate of roughly 1.27 million through February, up substantially from an annualized pace of 1.18 million in 2016. With for-rent and for-sale vacancies below historical norms, housing demand will increasingly rely on the construction of new homes.

Given that new residential construction and remodeling make up roughly half of lumber demand, we expect lumber demand to rise substantially through 2021. As demand drives operating rates higher in North America, we expect higher pricing to substantially increase earnings across wood products companies.

The seeds and crop chemicals portion of the agriculture space is still amid a merger and acquisition shakeup, with several big potential deals on the table. State-owned ChemChina has agreed to purchase Swiss agrochemical giant Syngenta SYT. Dow Chemical DOW and E.I. du Pont de Nemours & Co DD are set to combine in a merger of equals, with plans to eventually split into three separate companies. And after several months of negotiations, genetically modified seed leader Monsanto MON accepted a takeout bid from Bayer BAYRY.

We think all these deals are likely to close. There just isn't insurmountable product overlap between the seed and crop chemical portfolios of the M&A partners, and we think overlap that does exist will be solved by divestitures. None of these deals has yet gained final regulatory approval, but with recent reports that the EU is set to approve both ChemChina-Syngenta and Dow-DuPont, we think approvals will come this year.

Top Picks

Canfor CFP
Star Rating: ★★★★
Economic Moat: None
Fair Value Estimates: CAD 22.00
Fair Value Uncertainty: High
5-Star Price: CAD 13.20

We like Canadian lumber producer Canfor for its leverage to U.S. housing. The drivers of lumber demand gained strength in 2016, and should improve further in 2017. U.S. housing starts increased 5% year over year in 2016. Improvement was particularly evident in single-family construction, which rose 10%. (Single-family units require roughly twice as much lumber and paneling as multifamily units.) In 2017, we expect continued improvement, with starts rising roughly 11% to 1.3 million. As housing starts march higher, so too should lumber demand, driving up industry capacity utilization, and with it, prices. We believe operating rates will exceed 90% in 2017 as strengthening household formation drives stronger housing starts and wood product demand. We see real lumber prices exceeding $480 per thousand board feet by the end of the decade, versus $410 today.

Cameco CCJ
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: $18.00
Fair Value Uncertainty: High
5-Star Price: $10.80

We think the market is mispricing narrow-moat uranium miner Cameco. Uranium offers a rare growth opportunity in metals and mining. China's structural slowdown portends the end of a decadelong boom for most commodities—but not for uranium. China's modest nuclear reactor fleet uses little uranium today, but that's set to change in a major way. Beijing is pivoting to nuclear in order to reduce the country's heavy reliance on coal. We believe the market overemphasizes the current supply glut caused by delayed Japanese reactor restarts, and this situation won't last much longer. We expect global uranium demand to grow 40% over the next 10 years, a staggering amount for a commodity that saw near-zero demand growth in the past 10 years. Supply will struggle to keep pace. We believe uranium prices will rise from about $20 a pound currently to $65 a pound (constant dollars), as higher prices are required to spur new mine investment. As one of the largest and lowest-cost producers globally with expansion potential, Cameco should benefit meaningfully from higher uranium prices.

Compass Minerals CMP
Star Rating: ★★★★
Economic Moat: Wide
Fair Value Estimate: $91.00
Fair Value Uncertainty: Medium
Consider Buying: $63.70

Compass Minerals produces two primary products: de-icing salt and sulfate of potash, a specialty fertilizer. We think the company has carved out a wide economic moat based on cost advantage, thanks to its massive rock salt mine in Goderich, Ontario, which benefits from both location and geology advantages. The company also sits toward the low end of the cost curve in specialty potash. Following a couple mild winters in Compass' important U.S. Midwest markets, the company's profits have been dented, and high customer inventories darken the near-term outlook for salt volumes and pricing. However, over the long run, we think a return to more normal snow in the Midwest, and thus more normal salt volumes for Compass, will help catalyze a rebound in shares. Further, we think the market may be underappreciating the company's ability to control unit costs, as recent capital improvements at Goderich are set to put a lid on Compass' future salt costs.

Daniel Rohr, CFA has a position in the following securities mentioned above: CMP MON.

Consumer Cyclical: Still Opportunity in a High U.S. Confidence Environment

Many discretionary companies have benefited from positive sentiment following the U.S. presidential election, and some still have attractive margins of safety.

By Dan Wasiolek,
Senior Equity Analyst

- On a valuation basis, the consumer cyclical sector is fairly valued, trading at a median price/fair value of 1.00 as of Feb. 1, 2017.
- Bolstered by an improving job market and demographics, the travel industry remains one of the most resilient consumer cyclical categories, despite uncertainty surrounding President Trump's proposed travel ban and its impact on the economy.
- Brick-and-mortar apparel continues to face headwinds from the shifts to e-commerce and lack of enticing new fashion.
- The continued global shift to online purchases continues to aid players with leading networks.

We believe that the consumer cyclical sector is poised for growth again in 2017, as consumers have become increasingly confident following the November U.S. election, and given the continuation of an improving job market. Although the consumer cyclical universe is fully valued at a median price/fair value estimate ratio of 1.00, we still see opportunities for investors in stocks with an attractive margin of safety.

Following the U.S. presidential election, consumer confidence has remained high, and many discretionary companies have benefited from positive sentiment. The Consumer Confidence Index reached multiyear highs of 114.8 in February, while the S&P has risen another 6.5% in the year to date through March 15. One industry that has remained resilient is travel. To illustrate, shares of hotel operators have gained 6% and 18% in the year to date (through March 15) and since the U.S. election, respectively, while cruise lines have rebounded 18% and 25%, respectively. We believe stocks of these businesses have risen due to rhetoric around lower corporate tax rates, deregulation of the financial sector, and infrastructure spending, all of which could lift consumers' willingness and ability to spend. Further, the continued expansion of China's traveling consumer class, which we believe currently numbers around 100 million individuals, will more than double over the next decade, aiding global travel. That said, the timing and magnitude of actual policy remains difficult to predict, and the economic impact from President Trump's proposed travel ban creates some uncertainty, in our opinion.

Mainstream apparel retailers continue to report slowing traffic to stores and excess inventory in the market. We think this is due to a few factors. First, there is no compelling new fashion trend to draw shoppers into stores. Second, the shift to online purchases continues to take traffic away from physical units. Third, department stores and mass-merchant subsectors still look overstored. Fourth, off-price retailers have benefited from both a multitude of buying opportunities, given excess inventory and demand increases as consumers have remained price-sensitive.

While the idea of e-commerce as a disruptive force is not exactly a new concept, consumers continue to become increasingly comfortable making everyday purchases online or through mobile devices across many developed economies. This global shift to online consumption continued to benefit leading networks in the first quarter. Shares of consumer and travel network companies have increased 19% on average in the year to date through March 15.

Top Picks

Hanesbrands HBI
Star Rating: ★★★★★
Economic Moat: Narrow
Fair Value Estimate: $34.00
Fair Value Uncertainty: Medium
5-Star Price: $23.80

We have a high degree of confidence in the defensibility of Hanesbrands' competitive position, given advantages that are difficult for competitors to replicate: the firm's large owned and controlled supply chain, core product positioning in a space where brand is more important than price, and economies of scale achieved through a growing portfolio of synergistic brands. We think earnings per share can increase about 50% in the next five years on pricing premiums, further leverage of the global supply chain, and additional acquisitions synergistic to core products.

The company operates 52 manufacturing facilities, mostly in Asia, Central America, and the Caribbean Basin. In 2016, approximately 72% of units sold were from finished goods manufactured through a combination of owned and operated facilities and third-party contractors that perform some steps (cutting/sewing). When Hanes can internalize high-volume styles, we estimate that it saves as much as 15%-20%, and we see the company moving toward producing 85%-90% internally over time, providing a significant operating margin driver.

Using this manufacturing platform, Hanesbrands has succeeded in making acquisitions to drive earnings growth. Through acquisitions, the company has increased operating profit by $120 million, with the addition of $170 million in synergies over the past couple of years.

Recently, Hanesbrands' top line has come under pressure, partly from what we view are short-term headwinds (the basics category experienced a low-single-digit decline in 2016) and partly from secular trends toward online sales (only 8% of U.S. revenue was e-commerce). However, Hanesbrands is distribution-channel-agnostic, and we think these trends affect only the near term and create an attractive entry point for investors. The company continues to gain market share, with 2016's flat basics revenue topping industry growth, and the transition to e-commerce is proceeding well, with the online revenue growth rate accelerating throughout 2016. As online sales increase as a mix of business (we model penetration topping 20% in three years), we think total company growth will rebound to our expected 2%-3% rate.

Bed Bath & Beyond BBBY
Star Rating: ★★★★★
Economic Moat: None
Fair Value Estimate: $64.00
Fair Value Uncertainty: Medium
5-Star Price: $44.80

No-moat Bed Bath & Beyond's shares have fallen in tandem with many soft-line retailers as consumers have shifted their spending in recent periods to more durable categories. However, we think the firm still has a defensible business model as a best-in-class merchandiser in the home, baby, and beauty goods spaces. While we think the cadence of couponing is unlikely to slow over the near term, we believe Bed Bath & Beyond's improving omnichannel presence, disciplined real estate expansion process, and still-robust international opportunities will help offset the company's inability to price at a premium, ultimately leading to lower operating margins than in the past (10.6% in 2020 versus a 14% average over the past five years). Incorporating 2% top-line growth (supported by our mid-single-digit outlook for spending in the repair and remodel market through the end of the decade) with moderate selling, general, and administrative expense leverage over time underlies our fair value estimate. We believe the shares have become attractive and are out of favor as a result of consumers' temporary shift away from lower-price discretionary items.

Williams-Sonoma WSM
Star Rating: ★★★★★
Economic Moat: Narrow
Fair Value Estimate: $71.00
Fair Value Uncertainty: Medium
5-Star Price: $49.70

Narrow-moat Williams-Sonoma's shares have declined about 10% over the past year, as high-end home furnishing peers have forced an increasingly promotional environment, pressuring the firm's ability to generate higher merchandise margins. Coming off inventory mismatches due to West Coast port delays in 2015 and increased discounting in 2016, Williams-Sonoma appears better positioned than its peers to meet consumer demand, thanks to its robust trove of consumer analytics that allows the company to forecast unit demand on a more localized level, but margins remain compressed from discounting. While some pricing pressure from peers could persist, we believe Williams-Sonoma's evolving real estate strategy, supply-chain optimization, and still-growing global reach will help returns on invested capital rise to 16% over the next five years (versus our weighted average cost of capital of 9%). We expect store sales can rise roughly 3%-4% on average over the next decade, while e-commerce will grow at a faster clip of around 8% on average. These growth rates bring us to top-line growth of 5%-6% over our explicit forecast, in line with the mid- to high-single-digit outlook of the company. With operating efficiencies building as scale ticks up, low-double-digit earnings growth persists throughout the majority of our outlook.

Dan Wasiolek does not own shares in any of the securities mentioned above.

Consumer Defensive: Still Thirsty for Growth

Although growth remains sluggish, opportunities in consumer defensive stocks are still available for selective investors.

By Zain Akbari, CFA
Equity Analyst

- Consumer defensive sector valuations have edged higher, with shares trading about 5% above our fair value estimates, reversing the approximately 4% discount we saw in the last quarter.

- Top-line growth is hard to come by, with prices relatively stable and commodity costs still reasonably low; we expect the environment to persist short term before reverting to more normal patterns of inflation.

- Cost-cutting and share buybacks have dominated as firms try to preserve EPS growth in a soft revenue environment; while much of the efficiency benefit should prove durable as conditions normalize, firms run the risk of underinvesting in their brands and growth infrastructure.

- **Kraft Heinz**'s KHC failed bid for **Unilever** UL has spurred speculation that the firm could look to other targets as it continues its consolidation efforts; **Reckitt Benckiser**'s RBGLY pending $17 billion purchase of **Mead Johnson** MJN also indicates M&A activity remains robust in the sector.

While opportunities still exist, sector valuations currently outpace our fair value estimates by about 6%, reversing a 4% discount last quarter and returning to the premiums we had seen about a year ago. Although we believe margins of safety have compressed after the recent run-up (in part due to M&A speculation, in our view), we continue to see opportunities in certain parts of the consumer landscape where idiosyncratic factors have obscured firms' long-term potential. Broadly, however, investors are looking for firms with a competitive edge that are likely to be able to fend off rivals amid volatile, slowing growth around the world.

Unimpressive top-line outlooks across the industry are driven by intense competition and low input costs, limiting companies' ability to raise prices. However, the input cost environment has generally failed to translate into higher margins, with the competitive picture often leading firms to use savings to reduce list prices (as a means by which to take share) or increase trade spending. The most competitive, commodity-linked industries have seen the greatest pressure, such as meat processors (including **Tyson** TSN, **Pilgrims Pride** PPC, and **Sanderson Farms** SAFM), as lower beef prices have pushed all animal proteins cheaper while leaving firms' cost profiles unchanged. Although we continue to see emerging markets as a long-term growth source across the broader consumer products landscape (driven by explosive population growth, urbanization, and rising incomes), we have a less rosy view of the short-term picture, apart from companies in the earlier stages of growth, such as **Blue Buffalo** BUFF in premium pet food.

With top-line growth muted and creating associated cost deleverage pressure, firms have looked to reduce expenditures as a means to protect earnings. While we generally have a favorable view of efforts to improve operational efficiency, firms risk cutting too far and underinvesting in advertising, innovation, and other brand-building activities. As a result, we have paid special attention to the source of savings in this recent round of corporate austerity.

The prevalence of intangible asset-based moats among the firms we cover in the sector means much of companies' value depends on the degree to which they can use their brands to ward off competition, either by gaining consumers' esteem or by building deep relationships with retailers. Maintaining these advantages amid intense competition requires investment, and so we look at current cost reductions with a long-term lens to determine whether management teams are mortgaging the future to meet investor demand for near-term earnings growth. Similarly, we are skeptical that the margin expansion that firms like Kraft Heinz and **Campbell** CPB have seen will prove sustainable given the need to reinvest more behind brands to offset competitive pressures and bolster the top line. Additionally, as firms have redeployed funds to favor share repurchases in the current slow-growth environment, we take a cautious view of the buybacks as sector valuations are high, potentially making this capital allocation strategy value-destructive despite the EPS benefit (for example, Tyson).

While we anticipate that elevated valuations across the space reflect the consistent cash flows and returns consumer product firms boast combined with the income streams offered to shareholders, we also surmise that speculation surrounding further industry consolidation has placed upward pressure on stock prices. In that vein, Kraft Heinz's $143 billion attempt to take over Unilever failed, but speculation that the firm's appetite for consolidation is undeterred has led potential targets to rebound from levels seen when the proposed deal was first announced. We anticipate acquisitions will remain an avenue for growth in the sector as firms attempt to use synergies to boost efficiency amid a slow sales growth environment, and suspect the packaged food industry could be particularly active, with firms like **Mondelez** MDLZ and **Pinnacle Foods** PF serving as potential targets for larger peers. That said, because we see sector valuations as high (in part due to acquisition premiums already built into share prices), the line between a synergistic acquisition and a value-destructive purchase at an overly optimistic price can be perilously thin.

Top Picks

Symrise SY1
Star Rating: ★★★★★
Economic Moat: Narrow
Fair Value Estimate: EUR 78.00
Fair Value Uncertainty: Low
5-Star Price: EUR 62.40

As the world's fourth-largest supplier of flavors and fragrances, with an 11% market share, we believe Symrise stands to benefit as emerging-markets populations grow, urbanize, and increase processed food consumption as female workforce mobilization rises. With developing economies accounting for 43% of sales, Symrise is poised to augment developed-market demand drivers stemming from an increased focus on health and wellness issues and clean labeling. While pricing power is limited, we assign Symrise a narrow moat rating on the basis of the switching costs clients face, as the firm's customers hesitate to take risks with other suppliers that would face the daunting task of replicating proven tastes or fragrances (around 95% of sales are customized). Shares trade at an attractive price/fair value ratio of 0.8, which we believe offers a favorable risk/reward profile.

Pilgrims Pride PPC
Star Rating: ★★★★
Economic Moat: None
Fair Value Estimate: $28
Fair Value Uncertainty: High
5-Star Price: $16.80

While its shares have risen about 15% thus far in 2017, we believe market sentiment still modestly underestimates Pilgrims' ability to use its balanced portfolio, premium products, and Mexican operations to generate 3%-4% average annual top-line growth even as the industry benefits from contracting changes that have reduced risk. Pilgrims' no-moat rating is consistent with industry peers, but we believe the company can use its diverse mix of bird sizes to benefit from increased protein and poultry consumption across all parts of the retail and foodservice spectrum. With corn and soybean meal prices still attractive, we believe the company should be able to weather price deflation spurred by falling ground beef prices. Recent avian influenza outbreaks remain a concern, but we are encouraged that regulators globally are increasingly taking a regionalized approach to import bans from affected areas rather than the country-wide restrictions seen in years past. We also do not see recent pricing scandals in the chicken industry (in particular, concerns regarding the composition of a price benchmark and potential indirect collusion) as likely to affect leading producers such as Pilgrims'. As the stock still trades at about a 20% discount to our valuation, we would suggest that long-term investors looking to gain exposure to the industry should consider building a position in Pilgrims Pride shares.

Danone DANOY
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: $16
Fair Value Uncertainty: Medium
5-Star Price: $11.20

We see Danone at a crossroads, and believe the painful ride investors have seen over the past several years should yield to strengthening prospects as a new management team centralizes the firm's structure and refocuses on profitability. Although medium-term growth looks likely to undershoot management's 2020 guidance (though our 4%-5% annual organic growth estimate for the next five years still outpaces most packaged food competitors), we expect it to be high-quality, helping to drive 280 basis points of margin improvement in the medium term. We contend there is little reason Danone cannot sustain an operating margin closer to its peers of around 15%. In our view, the firm's early-life nutrition unit should drive improvement beyond market expectations that seem to assume that segment margins will simply be maintained. While we see the firm's competitive positioning, derived from its leadership and near leadership in multiple categories, as middle-of-the-pack (and worthy of a narrow, rather than wide, moat rating) due to its vulnerability against some of its large-cap competitors, we view the shares' current trading level, which correspond to about a 10%-15% discount to our valuation, as an attractive entry point for investors looking to build a position.

Zain Akbari, CFA, does not own shares in any of the securities mentioned above.

Energy: Coming Shale Growth a Major Threat to Oil Prices

Rapid U.S. production growth is looming and puts the nascent oil price recovery at risk.

By Joe Gemino, CPA
Equity Analyst

- Short-term oil market fundamentals are the best in years, but underlying supply dynamics make plain that such conditions are unlikely to be sustainable. Rapid U.S. shale growth in the next six to nine months is now all but inevitable, which will meaningfully increase U.S. oil supply.

- It's very possible that OPEC will extend its production cuts to Dec. 31 at its May meeting, because although shale activity increases to date are enough to generate strong U.S. crude growth, this incremental supply will take time to flow through. Supply responses from rising (or falling) U.S. shale investment take about six months—the time it takes for the average well to begin production after it is drilled. We thus believe it's likely that onshore U.S. production won't begin meaningfully increasing until the second quarter, and it's possible that it could be summertime before it becomes apparent to all market participants that U.S. crude production is on a very dangerous trajectory.

- OPEC has said that production cuts are unlikely to extend past December. The exact timing is uncertain, but the math is clear: Full OPEC production and rapidly growing U.S. output are likely to outstrip near-term demand growth and could easily tip the industry back into oversupply in 2018.

- Energy sector valuations remain a bit frothy at current levels, with an average price/fair value estimate of 1.13.

OPEC's production cuts and strong demand growth have 2017 crude fundamentals in their best shape since oil prices crashed two years ago. The consensus is that market fundamentals are now strong enough to remain healthy even after OPEC returns to higher production. This might have been possible a few months ago, but the odds of this scenario playing out have markedly worsened. Major increases in shale activity now have U.S. oil production on a path toward rapid growth, even if shale rig counts don't increase from current levels. This growth—plus the eventual production increases from OPEC—is probably enough to erase any market tightness and throw crude markets back into oversupply within the next 12-18 months.

Current oil prices provide economics that are very attractive to the major U.S. shale producers. This has created the conditions that will allow tight oil to grow rapidly and is a reality that even forthcoming cost inflation will not change. Unless shale producers become more disciplined or OPEC resigns itself to permanently ceding share to U.S. producers—neither of which is likely to occur—oil markets have major problems looming on the horizon.

Nevertheless, there remains a good chance that oil prices could rise further in the coming months if OPEC compliance remains high or production cuts are extended past June 30 (when cuts are scheduled to lapse). Because surging shale production won't move the supply needle until the second half of the year, OPEC discipline would allow for significant global inventory draws in the interim. This could bolster the perception that oil market fundamentals are continuing to improve. However, oil prices above current levels at any point in the coming months would be pouring gasoline on the fire, since this would encourage even higher levels of U.S. shale investment and production. Nothing is ever certain in the world of oil, but a crude awakening for energy investors could be at hand.

Top Picks

HollyFrontier HFC
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: $44.00
Fair Value Uncertainty: High
5-Star Price: $26.40

HollyFrontier operates a high-quality set of refining assets located solely in the Midcontinent, Rockies, and Southwest regions. Currently, the company is suffering from weak product margins, narrow crude spreads, and high renewable fuel supply costs. While we do not expect these poor conditions to persist, the market appears to be discounting a continuation for several years. Furthermore, we think the market is not fully crediting Holly for its self-improvement initiatives. As a result, we think the shares are significantly undervalued. We expect product margins to improve with continued strong demand and a rebalancing of inventories. Meanwhile, crude spreads should widen with future U.S. production growth. Renewable fuel supply costs are likely to persist into 2017, but a new administration increases the probability of reform that ultimately reduces compliance costs. The current price/fair value estimate of 0.60 offers an attractive entry point for long-term investors.

Tesoro TSO
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: $124.00
Fair Value Uncertainty: High
5-Star Price: $74.40

We see Tesoro's competitive position improving over the next several years as the firm gains greater access to cost-advantaged crude. Given this, combined with operational improvements including increasing distillate yields, integrating the acquired Carson refinery, and leveraging its marketing and retail operations, Tesoro should become one of the better-positioned refiners in the challenging California market. Meanwhile, the acquisition of Western Refining diversifies its refining asset base, strengthens its retail network, and adds additional midstream growth opportunities in the Permian Basin for a reasonable price.

RSP Permian RSPP
Star Rating: ★★★★
Economic Moat: None
Fair Value Estimate: $56.00
Fair Value Uncertainty: High
5-Star Price: $33.60

Best Idea RSP Permian is a very lean company that operates exclusively in the Permian Basin, which is widely considered to be the lowest-cost tight oil play in North America (or at least one of them). Though the entire industry is focusing on cutting costs and enhancing efficiency, RSP is well ahead of the curve. Operating expenses, including exploration and general and administrative, add up to less than $12 per barrel of oil equivalent, and the per-barrel cost of finding and development is around $20. That translates to a West Texas Intermediate break-even of just under $40 a barrel, well below our midcycle forecast.

These competitive economics look sustainable. The firm recently doubled its Permian footprint with the acquisition of Silver Hill Energy Partners, gaining entry to the Delaware side of the basin, which is at least as profitable as the Midland, where RSP's core acreage is. As a result, the firm has several decades of cost-advantaged runway. We forecast a 50% compound annual growth rate for production through 2020. RSP is trading at a price/fair value estimate of 0.72.

Joe Gemino, CPA, does not own shares in any of the securities mentioned above..

Financial Services: Weighing the Strategic Tradeoffs of the Fiduciary Rule

The global financial sector is in the midst of financial advice moving toward a fiduciary-like standard and fees becoming more transparent.

By Michael Wong, CFA, CPA,
Senior Equity Analyst

- The financial services sector is slightly overvalued, trading at a 5% premium to our fair value estimates.
- The move toward increased fiduciary standards across the globe continues on a bumpy road.
- Australia's economic outlook is brighter following the better-than-expected fourth-quarter 2016 national accounts.

The global financial sector is in the midst of financial advice moving toward a fiduciary-like standard and fees becoming more transparent. In Canada, Client Relationship Model Phase 2, or CRM2, which greatly increased fee disclosures and investment performance, has been fully phased in for more than six months, while the European Union's Markets in Financial Instruments Directive, or MiFID II, is set to take effect in January 2018. In the United States, after an executive order from President Donald Trump, the Department of Labor has proposed to delay the applicability date of its conflict-of-interest rule in order to restudy the rule's costs and benefits. Regardless of when certain financial regulations are implemented, the ongoing shift in business models, financial products, and client demand will cause changes in profits and market share across the sector.

Increased fiduciary standards primarily affect the asset-management and wealth-management industries. We believe that asset managers will increasingly have to demonstrate their value to clients by increasing their investment performance, decreasing their fees, and emphasizing how their products fulfill client goals. Based on the specific regulation, many asset managers will also undergo a change in how they sell their funds, such as eliminating distribution payments. In preparation for the Department of Labor's rule in the United States, asset managers are creating "T" shares that have more standardized sales charges and "clean" shares where many charges are eliminated.

Wealth-management firms will also increasingly have to justify their fees and value to clients. With the emergence of robo-advisors, or digital advice, the price of basic asset allocation has become fairly transparent. In order for financial advisors to charge more than a robo-advisor, they will have to emphasize the additional value that they add, such as through financial planning and behavioral coaching. Please see Morningstar's paper "Alpha, Beta, and Now…Gamma" for a look at some of our research on quantifying the value of intelligent financial planning. At the firm level, the increased transparency of fees and restrictions on payments from asset managers could cause revenue pressure, while the new regulations increase costs. For example, we recently estimated that the U.S. Department of Labor's fiduciary rule could lead to an annual $70 million-$150 million of class-action lawsuit settlements.

Australian Banking Outlook

By David Ellis

Australia's economic outlook is brighter following the better-than-expected fourth-quarter 2016 national accounts. As we have long argued, recession fears are overblown, with exports, consumption, and public-sector spending underpinning broader economic activity, despite soft wage growth. Respectable real GDP growth of 2.4% for 2016 supports modestly positive operating conditions for Australia's four wide-moat major banks. Despite GDP growth remaining below-trend, it is in line with our medium-term GDP growth rate estimate of approximately 2.5% per year. In February 2017, the Reserve Bank of Australia's updated outlook predicts GDP growth of around 3% in 2017 and 2018, with inflation to slowly return to the 2%-3% target band by 2018 and unemployment likely to remain around 5.75%. **Westpac Banking** WBC and **Commonwealth Bank of Australia** CBA are fairly valued, with **Australia and New Zealand Banking Group** ANZ and **National Australia Bank** NAB trading above our fair value estimates by 10% and 6%, respectively.

Despite the surprising strong December-quarter GDP outcome, the four Australian major banks continue to face challenging conditions, with Australia's below-trend growth economy susceptible to a range of risks. Political uncertainty is not helping business confidence; weak wage growth is a drag on consumption and the RBA's inflation target; businesses continue to underinvest in growth initiatives; and external shocks such as the Brexit vote, the U.S. Presidential election, and softer economic conditions globally could detract. Sudden economic shifts in China could have "first order" impacts on the Australia economy, the financial system, and, by extension, the Australian major banks. The most damaging negative risk to future bank earnings is the potential for an exogenous shock triggering a global downturn that drags the Australian economy into recession—but this is not our base case.

Top Picks

Platinum Asset Management PTM
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: AUD 6.30
Fair Value Uncertainty: Medium
5-Star Price: AUD 4.41

Platinum Asset Management is a highly successful Australian fund manager specializing in international equities, with a narrow economic moat thanks to its strong brand and customer switching costs. It derives its income predominantly from base management fees on funds with specific mandates, though performance fees can add meaningfully in good years. Earnings growth is primarily driven by growth in funds under management, which is a function of performance and net inflows. Key positives include strong brand recognition stemming from excellent long-term fund performances and a tailwind from

Australia's growing pool of superannuation savings. We believe international equities will be an increasing part of individual retirement savings strategies in Australia, as we expect that over time, Australia's investable asset pool will not be large enough to meet the increasing flow of superannuation fund contribution, as well as the opportunity to invest in a more diverse range of industries offshore than are available on the Australian market. Platinum is well positioned in this regard, with a long presence and investment track record in this space. With minimal capital expenditures and a very strong balance sheet, the firm can pay out practically all profit as fully franked dividends. Short-term investment underperformance and fear of weakening equity markets are currently weighing on the share price. Platinum is attractively priced, and while there are short-term pressures, we expect earnings to recover, given its strong brand and long-term investment performance track record. The ability of Platinum funds to take short positions provides it with opportunities to outperform in most market conditions. Downside risks come from protracted investment underperformance of key funds and funds' net outflows.

American International Group AIG
Star Rating: ★★★★
Economic Moat: None
Fair Value Estimate: $74.00
Fair Value Uncertainty: Medium
5-Star Price: $51.80

We believe previous management's focus on growth and lack of discipline are the root causes of AIG's poor historical performance, and the current management team's focus on risk-adjusted returns and operational efficiency sets a course in the opposite direction. When AIG recently announced that it would be taking a $5.6 billion reserve development charge, the market's confidence in management dimmed, and the stock now trades at a significant discount to book value. Given the shift in strategy and the quantifiable and achievable opportunities for improvement, we think this is overly skeptical and creates an opportunity, especially as the recent reinsurance deal with Berkshire Hathaway largely mitigates reserve development risk going forward. We think a valuation close to book value is appropriate, as our view is that AIG will improve returns to a level on par with our estimate of the cost of equity within the next two years. In essence, our assumptions assume AIG is able to bring results in line with other no-moat insurers, a fairly low bar to clear. We recognize the uncertainty the nonbank SIFI designation creates, but we see a slim probability of this leading to a material negative impact on our valuation. Further, AIG's plan to return $25 billion to shareholders through 2017 shows that this is not a meaningful obstacle at this point, and buying back large amounts of stock at a substantial discount to book value will allow AIG to further leverage the operational improvements we anticipate.

New York Community Bancorp NYCB
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: $17.00
Fair Value Uncertainty: Medium
5-Star Price: $11.90

New York Community Bancorp recently failed to acquire New York peer Astoria after a 14-month approval process, and it will return to its search for the next deal, an effort that has been in process since 2011. Without acquired deposits to fuel lending growth, and with the bank's existing 135% loan/deposit ratio hindering organic lending, along with its self-imposed barrier at the $50 billion asset mark, growth and earnings have been stagnant. We expect the bank to use 2017 to continue searching for another acquisition while it also waits for clarity regarding potential new bank regulations from the new administration. If it cannot find a bank to acquire in 2017, we believe the bank will cross over the $50 billion mark organically in 2018, likely becoming a systemically important financial institution in 2019.

The environment for regional banks, particularly ones that have yet to cross the SIFI threshold, is bright. The possibility of raising the CCAR threshold to around $250 billion from $50 billion would allow New York to pursue an aggressive acquisition strategy with limited pushback, and lower taxes and reduced regulations could certainly accelerate the tailwinds for New York Community. One area of concern is the 21% drop in loan originations in 2016, suggesting that New York multifamily developers are operating cautiously in 2017. M

Michael Wong, CFA, CPA does not own shares in any of the securities mentioned above.

Healthcare: Stock-Picking Increasingly Important as Valuations Rise

We think ACA repeal efforts are unlikely to lead to major legislative changes.

By Damien Conover, CFA,
Director of Healthcare Equity Research

- As concerns surrounding pricing power for drugs is partially abating, market valuations in healthcare have increased over the past quarter, with drug companies rallying. The recent aggregate healthcare price to fair value of 0.98 is up from 0.87 last quarter, but we still see a few undervalued stocks, including **Express Scripts** ESRX, **Roche** RHHBY, and **Allergan** AGN.

- The core of research and development productivity at drug firms continues at a steady pace, creating innovative drugs that help to offset some pricing pressures from pharmacy benefit managers.

- With Donald Trump as president and the Republicans in control of Congress, we expect a high degree of political effort calling for the repeal of the Affordable Care Act (ACA), but major healthcare changes seem unlikely as the ACA has provided millions with healthcare insurance that will be difficult to strip away.

- Redeployment of capital by the large healthcare companies continues to drive valuations with a focus on mergers and acquisitions, stock buybacks, and steady dividends.

Concerns over pricing power for drugs appears to have partially abated with the drug stocks posting strong gains in the first quarter. We continue to expect near-monopolistic drug pricing as a result of patent protection that supports the core of our moat ratings for the large drug and biotech companies. While drug prices will likely continue to soften in therapeutic areas with less innovation such as respiratory and diabetes, the innovative therapeutic areas of cancer, immunology, multiple sclerosis, and vaccines are poised for strong pricing power as the innovation is powerful enough to provide the drug companies better leverage in negotiations with the payer groups.

Overall, we continue to see steady gains from research and development. Drugs in certain areas of cancer (especially immuno-oncology) are reaching the market at half the time of drugs developed a decade ago, partly due to major advancements in science and clinical designs but also due to more accommodative healthcare regulatory groups. Recent approvals in lung cancer by immuno-oncology drugs look particularly well positioned to drive a major source of drug spending. We expect immuno-oncology drugs to eventually cover most of the major cancer indications.

On the political landscape side, seeking to fulfill the long-standing Republican promise to repeal the Affordable Care Act, Congress faces a tough road to success for several reasons. First, the reality of insurance markets and economics associated with adverse selection are in contradiction to Republican assurances that a replacement plan would cover everyone with quality insurance and cost less money.

Second, Republican reform ideas could lead to eliminating of coverage of more than 20 million Americans newly insured under the ACA, which would likely result in major political backlash. Third, Republicans only wield a narrow majority in the Senate, which means less than a handful of Republican senators are able to scrap a reform bill. Fourth, and perhaps most importantly, there is significant—potentially irreconcilable—disagreement among Republican camps about what policy should replace the ACA.

Turning to the redeployment of capital allocation, large healthcare companies continue to support dividends, share buy backs, and acquisitions. **Johnson & Johnson**'s JNJ high-cost acquisition of Actelion in the quarter shows the heightened need of larger firms to acquire growth coupled with the low interest rate costs fueling excessive takeover valuations. Further, any change in lowering of the U.S. corporate tax rate by the new U.S. government would likely increase the acquisition activity as more international profits would be less restricted by tax losses in bringing the cash back to the U.S. Overall, the low interest rates combined with the need for scale and growth should continue to drive healthcare acquisitions over the next six months.

Top Picks

Express Scripts ESRX
Star Rating: ★★★★★
Economic Moat: Wide
Fair Value Estimate: $100.00
Fair Value Uncertainty: Medium
5-Star Price: $70

We believe market participants are underestimating the long-term growth potential for Express Scripts and overestimating the effects of a maturing industry. Additionally, near-term uncertainty regarding the effect of private exchanges on Express Scripts has pressured its stock. We believe private exchange health insurance providers will still need the negotiating leverage and expertise of pharmacy benefit managers. Additionally, the brisk pace of movement toward and the total number of businesses moving to private exchanges will be materially less than what some market participants currently expect, in our view. Overall, we view Express Scripts in a solid position with its wide economic moat, solid growth potential, dominant market position, and attractive valuation.

Roche RHHBY
Star Rating: ★★★★★
Economic Moat: Wide
Fair Value Estimate: $42.50
Fair Value Uncertainty: Low
5-Star Price: $34.00

We think the market underappreciates Roche's drug portfolio and industry-leading diagnostics that conspire to create sustainable competitive advantages. As the market leader in both biotech and diagnostics, this Swiss healthcare giant is in a unique position to guide global healthcare into a safer, more personalized, and more cost-effective endeavor. Roche's collaboration between its diagnostics and drug-development groups gives the firm a unique in-house angle on personalized medicine. Also, Roche's biologics constitute three fourths of its pharmaceutical sales, and biosimilar competitors have seen development setbacks while Roche's innovative pipeline could make these products less relevant by their launch.

Allergan AGN
Star Rating: ★★★★
Economic Moat: Wide
Fair Value Estimate: $300
Fair Value Uncertainty: Medium
5-Star Price: $210

Unlike its most of its peers in specialty pharma, Allergan retains one of the most attractive product portfolios and innovative pipelines, particularly in its core markets of aesthetics, ophthalmology, gastro, and central nervous system. Allergan's diverse portfolio, key durable products including Botox, and healthy pipeline support a wide economic moat and high-single-digit organic growth over the next five years, in our view. The firm has used a nice mix of focusing on core internal research and development strengths while supplementing its pipeline with M&A, which creates numerous capital deployment opportunities following the $40 billion sale of its industry-leading generics unit to Teva in 2016.

Damien Conover, CFA, does not own shares in any of the securities mentioned above.

Industrials: Solid Fundamentals, but Few Screaming Buys

GM, Johnson Controls, and Stericycle are our favorites.

By Keith Schoonmaker, CFA
Director of Industrials Equity Research

- We view the industrials sector as slightly overvalued on average, with a market capitalization-weighted price/fair value estimate of 1.10, representing our belief that industrials stocks are about 10% overvalued as whole. That said, we do see value in select stocks, with some value concentrated in aerospace and automotive shares.

- Industrial activity is plowing forward. North American transports are hauling more freight than in the year-ago period, and industrial indicators remain firm.

- U.S. housing demand continues to improve, in line with our midterm projections for expansion. Auto sales remain robust, though we view U.S. light-vehicle sales as having leveled off and likely to decline modestly in each of the next few years. In our view, global auto demand is adequate to fuel healthy performance as automakers refine their operations.

- M&A activity continues among industrials. Major sector transactions announced this year include **Intel**'s INTC $15 billion acquisition of auto supplier **Mobileye** MBLY, **GM**'s GM sale of much of its European business, **Johnson Controls**' JCI $2 billion sale of its Scott Safety business to **3M** MMM, and **Wood Group**'s GBP 3 billion takeout of **Amec Foster Wheeler** AMFW.

Industrial activity is steadily plowing forward, and we are optimistic about demand and operating execution at most firms we cover. Industrial indicators remain firm, and transports are hauling more freight than in the year-ago period. That said, we think stock market prices fairly reflect our expectations of good performance in most instances, leaving few shares on sale at material discounts to our fair value estimates.

The Institute for Supply Management Purchasing Managers' Index for manufacturing in the United States was 56.0 in January and 57.7 in February, and 17 of 18 manufacturing industries reported growth in February. The February National Bureau of Statistics of China Manufacturing PMI rose 30 basis points from January to 51.6 in February, and the private Caixin Manufacturing PMI was 51.7 in February; it has exceeded the 50 demarcation in 7 of the past 12 months. The Markit Eurozone Manufacturing PMI was 55.4 in February, slightly above January's 55.2; this index has scored above 50 since mid-2013.

U.S. industrial production was unchanged in February after declining 10 basis points in January, but manufacturing advanced for the sixth consecutive month (up 50 basis points). U.S. manufacturing improved 1.2% from February 2016. In January 2017, EU28 industrial production rose 50 basis points sequentially and 130 basis points year over year. Eurozone industrial production has been on the climb since mid-2013. Underpinning February's industrial production index expansion was capital goods production growth, up 2.4% sequentially and 80 basis points year over year. China's industrial production increased 60 basis points from January to February 2017 and on a year-over-year basis grew 6.1% and 6.2% in January and February.

North American trucking and rail demand is still improving over prior-year levels, albeit with rails lapping easy comparisons. The latest (February) seasonally adjusted ATA Truck Tonnage Index declined 0.1% from January after improving 2.9% sequentially from December to January; January improved 2.6% year over year, and February declined 2.8% year over year (February 2016 was strong). Year-to-date (January and February) tonnage is down 10 basis points from the same period in 2016. The most recently reported Cass Shipments increased a strong 7.0% from January to February and 1.9% from February 2016; Cass Expenditures rose 5.1% month to month and 3.2% year over year.

Through March 11, North American railcar traffic improved a robust 5.7% year to date, and intermodal gained 70 basis points. Leading the growth are coal (up 14%), metallic ores and metals (up 17%), agricultural products (up 3%), and nonmetallic minerals (up 9%). While consolidated volume is strong, volumes of three significant commodities are lower than in the prior-year period: Chemicals, forest products, and motor vehicles and parts are down 3%-6%. After nearly two years of railroad freight recession, this growth offers significant relief and reflects much more positively on the health of these economies.

U.S. housing demand is improving, and we believe U.S. residential construction growth will be robust over the coming decade, but the road to a fuller recovery has proved longer than expected. Household formation is building momentum, but slowly, especially among younger adults. Year-to-date housing starts have been running near a 1.3 million seasonally adjusted annual rate, in line with our forecast for total housing starts in 2017. Within this total starts projection, we expect 2017 single-family starts to grow 19% to 935,000 units and we expect multifamily starts to slip to 375,000 from 2016's 380,000. Single-family permits, which typically lead starts by about one month, have risen in early 2017, whereas multifamily permits have begun to flatline amid tighter credit and ample new supply. Homebuilders note the immense demand potential from millennials and are building smaller, more affordable homes to attract these first-time buyers. Labor markets have tightened, catalyzing the first real wage growth since early 2015 for those aged 18-34. With job opening levels at prerecession highs across numerous industries, we expect further wage gains to support rising household formation in the coming quarters. Our updated forecast assumes that momentum in single-family starts continues, thanks to firmer labor markets and early signs of a more affordable mix shift in single-family construction. We expect starts to peak at 1.9 million by 2021 before falling back to a demographically sustainable 1.5 million.

Auto sales remain robust, though we view U.S. light-vehicle sales as having leveled off and likely to decline modestly in each of the next few years. We do not see the U.S. market peaking and then immediately crashing, in part because the U.S. fleet remains quite old at 11.6 years. Instead, we anticipate a gradual decline for a few more years, giving **General Motors** GM (and others) a chance to complete restructuring while also generating healthy profits. In our view, global demand is adequate to fuel healthy performance as automakers refine their operations. February U.S. auto sales carried on the trend of a slight decline year over year that the industry posted in January. Total units sold came in at

1.33 million, down 1.1% from February 2016, while Automotive News put the seasonally adjusted annualized selling rate at 17.57 million vehicles compared with 17.69 million vehicles in February 2016. Ford said the retail channel part of the industry mix was flat to slightly down, and we think incentives are being used to prop demand up to a degree. ALG estimated last week that February incentive spending per unit rose 13.5%, to $3,443, with spending up for every major automaker except **BMW** BMW. This trend is not shocking as automakers have to play a delicate balancing act between remaining competitive and profitability, but demand kept up by incentives is one reason we predict a decline in full-year sales to 17.0 million-17.2 million from 17.54 million in 2016. GM bucked the industry trend of a sluggish month, with total sales up 4.2% and retail channel up 4.9%. All four brands increased average transaction prices, with the company's overall ATP rising $570 a unit, or 1.7%, to a February record of $34,900. We discuss GM shares a bit more below.

Let's turn to one other sector that has attracted some investors at least in part because of Warren Buffett's indicated interest. Airline stocks have sold off on the back of deteriorating unit revenue guidance and are now trading at an average price/fair value estimate of 0.97 compared with 1.09 in December. Among the U.S. airlines we cover, **United** UAL looks the most attractive from a valuation standpoint, followed by **American Airlines** AAL and then **Delta** DAL. We like United's new management team and believe the turnaround story has not yet played out. The stock is trading at a 0.87 price/fair value estimate ratio. We think air travel demand should remain firm over 2017, resulting in an improving outlook for the airlines. While the recent downward pressure on oil prices could exacerbate near-term fare weakness as airlines give away cost savings in the form of lower ticket prices, we think decreases in fuel prices should still be a positive over the mid- to long term. Corporate tax reform could also be another positive for the U.S. airlines—particularly after their net operating loss carryforwards burn off in 2018-19—due to limited overseas earnings and high effective tax rates. With these potential catalysts on the horizon and the sell-off well underway, we think investors should give airline stocks another look. Despite all the negative momentum, we think investors are overlooking the solid air traffic growth forecast for 2017 and still-prudent capacity management by most U.S. airlines. In January, air traffic increased a relatively solid 3.4% year over year, and although United has raised its capacity guidance, other airlines are staying with their original capacity expansion plans. Barring any shocks, we think the current economic environment will support enough air traffic growth for a unit revenue recovery toward the back half of 2017, and over the midterm, lower fuel prices will keep a key expense down for the airlines, which have now largely eschewed fuel hedging.

M&A activity has been quite high among industrials this year. Major sector transactions announced this year include **Johnson Controls'** JCI sale of a safety business to **3M** MMM and Wood Group's takeout of **Amec Foster Wheeler** AMFW, plus several automotive deals. Johnson Controls agreed to sell its Scott Safety business to 3M for $2 billion. We expect the deal to close in the second half of 2017. Scott Safety, a legacy Tyco business that was acquired with the recent Johnson Controls-Tyco merger, is a leader in respiratory protection products. Tyco acquired the Scott business in 2001 for $391 million; since then, the business has increased its top line at about a 5% compound annual rate to $570 million. Although the deal valuation metrics seem to favor Johnson Controls at 3.5 times trailing 12-month sales and 13 times trailing 12-month EBITDA, after adding the deal proceeds and removing the Scott business from our model we see a net neutral impact on Johnson Controls' valuation. We therefore maintain our $54 fair value estimate and think the shares are undervalued. On a pro forma basis, sale proceeds reduce Johnson Controls' net debt from about $12.9 billion (improving the net debt/capital ratio from 39% to 35%). The company intends to use the sale proceeds to repurchase shares and pay down a portion of its merger-related debt.

Wood Group announced that it will acquire Amec Foster Wheeler, with shareholders receiving 0.75 share of Wood Group stock in exchange for each AMFW share—roughly a 29% premium of the 30-trading-day average price per AMFW share and a 15% premium to the March 10 closing price. AMFW shareholders will own roughly 44% of the combined company. We believe there is only a modest probability of a higher bid emerging, given the premium Wood Group offered, lagging prospects in Amec Foster Wheeler's core energy activities, and the uncertain status of ongoing restructuring. In our opinion, the timing of the deal reflects in part the mediocre prospects for Amec Foster Wheeler's and Wood Group's core engineering and project management activities for higher-cost offshore and oil sands-based energy exploration and production.

Automotive M&A this year includes **Intel**'s INTC acquisition of auto supplier **Mobileye** MBLY and GM's sale of much of its European business, on which the firm has lost money every year of this century. In other automotive deals, **Ford** F will acquire most of Argo AI for $1 billion paid out over time, and **Tesla** TSLA made a $150 million purchase of a stamping firm in January. Mobileye, a designer and developer of system-on-chip advanced driver assist and autonomous driving technology, agreed to be acquired by Intel at a 16% premium to our stand-alone $55 fair value estimate. The acquisition price places a 34% premium on Mobileye's stock price before the announcement, valuing the equity at $15.3 billion. Our technology team sees little challenge from regulators, given the limited amount of product overlap between Intel and Mobileye. Even though it's plausible that another bid may arise, Morningstar believes the potential for a competing semiconductor company bid is limited as others lack the financial resources of Intel or have other major deals in process. Furthermore, tech companies like **Alphabet** GOOGL and **Apple** AAPL do not have the strategic positioning enabled by the complementary product portfolio that Intel brings to the deal. In our opinion, a competing Tier I supplier bid is also limited not only on the basis of a comparative lack in financial resources but, most important, on the basis of strategic positioning.

We increased our GM fair value estimate to $51 per share from $50 after incorporating the deal announced on March 6 to sell Opel/Vauxhall to PSA Group. GM Europe has not been profitable on an annual basis in this century and has lost over $22 billion. We think it would have taken GM well into next decade to possibly bring GM Europe to meaningful profitability, so we do not mind that it becomes less of a global automaker by selling a business that made up about 12% of its 2016 unit volume. The fair value estimate increase comes from the net impact of our capital expenditure forecast for 2018-21 declining 4.5% compared with our prior model, removing an unprofitable business, cash sale proceeds of about $1.9 billion, selling part of GM Financial, and GM contributing $400 million (beyond issuing $2.8 billion in new debt) to fund the active employees' pensions that will be transferred to PSA. GM will retain the retirees' pensions. GM still has interesting EU options. Once Cadillac has a more complete lineup and more cachet, GM could still re-enter Europe. To give GM some benefit should PSA succeed in turning around Opel/Vauxhall, GM receives nine-year warrants in PSA exercisable starting five years after the deal closes (end of 2017) with a strike price of EUR 1. These warrants equate to 4.2% of PSA shares and are valued for deal purposes at about $700 million.

Top Picks

General Motors GM
Star Rating: ★★★★
Economic Moat: None
Fair Value Estimate: $51
Fair Value Uncertainty: High
5-Star Price: $30.60

We believe General Motors remains misunderstood and is not done transforming itself into the formidable global automaker it will be. GM pays a dividend yielding over 4%, and we love that the firm is devouring its stock while it’s undervalued, a central reason for our recent fair value estimate increase.

Our investment thesis is based on great product and manufacturing efficiencies rather than top-line growth, and the company isn’t done reducing its cost base—it is $4 billion into removing $6.5 billion of costs through 2018 from year-end 2014 levels, up from previous guidance of $5.5 billion. Further reductions in platforms and partnering with suppliers to gain purchasing scale and save on shipping costs are starting to have an impact, but the transformation is not complete.

Another upside catalyst comes from Cadillac, a premium brand that we think has plenty of untapped potential given its low number of crossover offerings that will increase considerably this decade. Further cost reductions, along with a complete new lineup of crossovers when that segment is white hot with Americans, should enable the company to stay relevant with consumers in 2017.

The company continues to beat **Toyota Motor** TM in J.D. Power Product Surveys at times and is not overproducing and overdiscounting vehicles like it would have under Old GM. We see GM remaining viable even in an autonomous world, as it is making the right investments now. Examples are its Maven car-sharing brand, taking about a 9% stake in Lyft, bringing the all-electric Chevrolet Bolt to market well before Tesla’s Model 3 and with a better range, and testing autonomous cars, all while also dominating the full-size SUV segment, which should remain popular with consumers outside dense cities in an autonomous world. We see many reasons to remain optimistic about GM, and we do not think the U.S. market peaking means only bad news for the company.

Johnson Controls JCI
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: $54
Fair Value Uncertainty: High
5-Star Price: $32.40

Johnson Controls' shares are currently trading at about a 20% discount to our fair value estimate. The company operates two distinct businesses. Its building technologies and solutions segment manufactures, installs, and services HVAC systems, building management systems and controls, industrial refrigeration systems, and fire and security products. The power solutions segment manufactures vehicle batteries that are sold to automakers and aftermarket retailers.

Before its recent transformation, Johnson Controls was long viewed as an automotive-parts company, given that it had historically generated two thirds of its revenue from the automotive industry. Company veteran Alex Molinaroli stepped into the CEO role in 2013, and Johnson Controls embarked on a mission to transform itself into a true multi-industrial company by divesting noncore assets and acquiring businesses that complemented the building efficiency segment.

The most transformative transactions came in 2016, when the company merged with Tyco International and spun off its automotive seating business (Adient). Johnson Controls is now a more profitable and less cyclical business with much lower exposure to the automakers (was 59% of sales, now 6%) and more exposure to higher-margin, recurring service and aftermarket revenue, which now represents over 40% of sales.

Tyco, the global leader in security and fire-protection products and services, should nicely complement Johnson Controls' legacy building efficiency business, which is a global leader in HVAC systems and building automation and controls, and the combination should result in meaningful synergies and enhanced market penetration as the company eliminates redundant costs, streamlines operations, leverages research and development capabilities, and goes to market with a more comprehensive portfolio of products and services.

In addition to synergy realization, Johnson Controls should benefit from secular growth trends. We expect global urbanization, increased demand for smart building technology, and growing aftermarket and retrofitting activity to act as tailwinds for Johnson Controls' enhanced building technology business. Johnson Controls' power solutions segment is the largest producer of lead-acid automotive batteries in the world, with a 36% global market share. It is the leading supplier in the Americas and Europe and the third-largest supplier in China. The inelastic aftermarket battery business (74% of segment sales) yields stability, while emerging markets and start-stop vehicle technology provide substantial growth opportunities.

Stericycle SRCL
Star Rating: ★★★★
Economic Moat: Wide
Fair Value Estimate: $105
Fair Value Uncertainty: Medium
5-Star Price: $73.50

Stericycle is the largest domestic provider of regulated medical waste management to large-quantity generators (such as hospitals and pharmaceutical companies) and small-quantity generators (such as medical and dental offices). The company also provides risk management platforms, such as returns and recalls management, as well as compliance training and secure document destruction. Recent pricing pressure in the small-quantity customer category (pressuring discounts of 30%-35% in hospital-owned small-quantity customers and 10%-15% in independent doctor offices) has weighed on Stericycle's shares. We expect this headwind to remain in place through at least 2017 as the company progresses through a three-year contract cycle. In the meantime, we believe Stericycle's efforts to re-energize organic growth will largely come from strategic sales deployment, which has the potential to offset price declines via new customer additions, as well as increasing penetration of ancillary services. While this will come with higher-than-average selling, general, and administrative spending, we believe investments in sales are long overdue and will support our forecast for midcycle organic revenue growth of 5% and EBIT margin of 20%. We believe these assumptions address the cyclical pressures inherent in the industrial hazardous waste business while acknowledging the strengths of the core medical waste business, as well as growth in scalable solutions such as patient communications. In our view, secular growth of patient admissions due to an aging population, a recurring revenue base subject to price escalators, and the ability to seamlessly offer healthcare customers cost-saving bundled service solutions can support this admittedly lower but more mature state of organic growth relative to Stericycle's historical high-single-digit average.

Keith Schoonmaker, CFA, has a position in the following securities mentioned above: GM

Real Estate: Playing Defense in an Uncertain Market

Look to retail for opportunity within a fairly valued REIT sector.

By Brad Schwer
Equity Analyst

- Morningstar's real estate coverage is trading at a 3% discount to our fair value estimates.

- We view themes in commercial real estate as generally defensive in nature, with lingering concerns about increasing bond yields pressuring property stocks globally by double-digit percentages. However, we continue to focus on underlying performance, which has remained healthy overall, as REITs have been focused on repositioning and strengthening their portfolios, deleveraging, and capital recycling. Construction of new property continues, however, as firms look for higher returns, putting into question levels of new supply as economic uncertainty remains.

- At current pricing, we think retail REITs under our coverage present interesting investment opportunities. **Simon Property Group** SPG, **GGP** GGP, and **Kimco Realty** KIM are trading at noteworthy discounts to our respective fair value estimates.

Morningstar's real estate coverage looks fairly valued, trading at a 3% aggregate discount to our fair value estimate. Investors should continue to be particularly discriminating, as we expect actions by the new administration, as well as potential for increased central bank interest-rate activity throughout the remainder of the year, to continue to affect property and capital markets activity, asset pricing, and overall volatility in the near term. Following the recent widely expected rate hike in March, it's clear that the market anticipates more hikes in store this year for the Federal Reserve.

As the new administration settles in, details surrounding proposed policy changes are still vague. Speculation regarding potential trade policy, healthcare reform, infrastructure spending, and general deregulation, among many other matters, had the markets hitting all-time highs on the increased expectation for overall economic growth while also sending 10-Year U.S. Treasury yields beyond 2.6% by mid-March.

Upward movement in Treasury yields, often used as a benchmark for real estate valuation, and interest-rate expectations have thus hurt REIT share prices over the quarter. Given the circumstances, many investors continue to wonder whether we are near the peak of the commercial real estate cycle; higher interest rates could put pressure on growth rates, cap rates, return expectations, and ultimately asset prices. Also, to the extent that low interest rates have diverted investor funds to REITs searching for higher yield and capital preservation, the same funds could flow out of REITs if interest rates rise, further pressuring commercial real estate valuations.

Despite the recent rise, U.S. interest rates are expected to remain historically low in the near term, which we view as a plus for real estate in general. Additionally, several economic signals, including unemployment levels, wage growth, and GDP growth, support the case for positive momentum going into the next administration. While we now expect increased near-term volatility as market speculation and expectations eventually converge with economic reality over the next several months (or years), the same perceived positive catalysts for the market that have affected interest rates should only help to support fundamental demand for real estate and offset pressure on relative valuations.

That said, much of our U.S. REIT coverage still enjoys healthy underlying operating performance. Most portfolios are characterized by historically high levels of occupancy and durable balance sheets, and they benefit from in-place leases that can potentially be re-leased at higher current market rents, giving these firms embedded cash flow growth if not a safety cushion for future economic weakness. While growth has slowed from elevated levels seen in recent years, we believe the market has been expecting this slowdown and has priced it into the sector. Many firms have also continued to recycle capital, trading out of weaker, more vulnerable assets into stronger assets with better long-term growth prospects and risk profiles. While near-term uncertainty has affected leasing and transaction volumes, private-market asset values have largely stayed intact and should continue to serve as an anchor for public-market valuations.

However, as we get deeper into the cycle, increased new supply in localized markets (such as New York and San Francisco) and asset classes (including office, multifamily, and senior housing) have become greater concerns. Furthermore, a wave of legacy, peak-market property debt maturing over the remainder of the year may cause significant disruption in real estate property and capital markets. And if effective debt yields ultimately rise relative to overall performance, we would expect asset values and performance to be increasingly challenged. As investors and businesses become weary and return expectations decrease, a reduction in overall investment will slow demand and reinforce negative outlooks.

Given that our real estate coverage is nearly fairly valued as a whole, it’s important that investors enter the sector with caution. Historically high asset prices for existing, stabilized institutional real estate is progressively railroading many capable U.S. REITs into allocating more capital toward value-creation opportunities such as the redevelopment of existing assets or the development of new properties to further increase and achieve required returns. While we still acknowledge the opportunity for prudent capital allocation to achieve excess returns, we are cautious of firms overextending themselves into riskier investments. Reasonably leveraged companies with solid prospects for long-term growth that can weather the natural cyclicality of the real estate markets are our preferred investment vehicles.

At current pricing, the most attractive investment opportunities focus on retail REITs within our coverage. We still like owners of high-quality regional malls and retail properties such as Simon Property Group and GGP, in addition to shopping center REIT Kimco Realty. Retail property firms have been negatively pressured from news of store closures, bankruptcies, and overall disappointing retailer performance amid continued growth in online retailing and changing consumer behavior. However, we believe physical retail strategies will remain critical marketing, service, and distribution points for retailers, with demand consolidating into well-located and ultimately profitable store locations, such as those owned by these firms. With all three REITs trading at roughly 20% discounts to our respective fair value estimates, we think the market is presently overly cautious toward class A regional malls and grocery-anchored shopping centers, which should maintain relatively steady demand.

In the office space, we see some opportunity for owners of Class A office and retail properties. Exciting developments related to the $25 billion Hudson Yards project in Manhattan are bringing much change to the area and opportunities for investors to capitalize on the shift away from midtown and into a new frontier. Management of firms focused in this area are hopeful that the newly popularized area will increase rent and bring added traffic to retail locations—current estimates expect an additional 65,000 people per day will frequent the area surrounding the project. Additionally, we view the new administration as an additional catalyst for growth in this asset class. Financial-sector jobs make up a large portion of Class A office space, so we think deregulation and lower taxes will help drive this market.

Self-storage names have decelerated from explosive growth in recent years, and we see this as the new normal for the asset class. In terms of strategy, we view development as the safer play compared with acquisition. We've seen cap rates at all-time lows in recent years, and yields are tight for purchased facilities. Additionally, we fear that a pullback in asset prices will have a meaningful impact on acquisitive firms relative to their development-focused counterparts.

Australian Real Estate Outlook

Contributed by Tony Sherlock

Within our Australian regional coverage, few stocks screen as undervalued, with our best picks being **Westfield** WFD and **Aveo Group** AOG. Westfield's portfolio comprises premium shopping malls in the USA and London, in highly affluent areas. We expect these assets to outperform the broader retail sector, reflecting their focus on a demographic with high disposable income. Aveo owns and develops retirement villages and stands to benefit from a material increase in the number of Australians reaching 75, the age at which they typically enter a retirement village. The immediate challenge for the Australian market is the upward trajectory in U.S. interest rates, which will trigger portfolio reallocations by many yield-focused investors. We see this, along with higher levels of short interest in the sector, as weighing on prices over the near term at least.

Singapore Property Outlook

Contributed by Michael Wu

For the Singapore property sector, our preference for developers over REITs, as noted last quarter, saw the developers outperform the REITs in the first quarter of 2017. The outperformance for the developers was boosted in March as the Singapore government and regulator Monetary Authority of Singapore jointly announced adjustments to the restrictive measures on residential properties. The timing of the move was a surprise and we saw the announcement as a positive signal that the authorities are proactive in easing restrictive measures in a weak residential property market. However, the measures should have a limited impact on residential transaction volume, as the additional buyer stamp duties and loan/value limits remain in place. While there is less value after the share price rally in the first quarter, we maintain our view the developers will fare better in a rising interest-rate environment.

We have raised our fair value estimates for **CapitaLand** C31 and **City Developments** C09, two developers under our coverage, after their respective fiscal 2016 results last month. At the time, we remained positive, as we believe concerns over a slowdown in the residential property market were priced into their share prices. Both developers were trading below their respective book value, and we did not anticipate their equity book value to track backward. CapitaLand's earnings are supported by recurring income from its mall and serviced-residence business, while hotels and investment properties underpin earnings for City Development.

Still, the REIT sector reported resilient fourth quarter results despite weakening economic conditions. Our preference remains for high-quality REITs such as **CapitaLand Commercial Trust** C61U and **CapitaLand Mall Trust** C38U, which are trading at discounts of 10% and 16%, respectively, to our fair value estimates. With high-quality assets in the office and retail space, we expect rents to soften but occupancy levels to remain high, as they did in previous business cycles. Both trusts are also supported by strong balance sheets, with a large majority of their debt fixed. We reaffirm our view that medium-term concerns over the pace of rising U.S. interest rates will continue to pressure the sector. The REITs took advantage of the low-interest-rate environment by fixing their debt in the near term and remained conservative in their asset valuation. Capitalization rates generally compressed between 15 and 30 basis points from 2010 to 2015. We see an expansion of capitalization rates to have a limited impact on the net asset value for the trusts.

Japanese Property Outlook

Contributed by Mari Kumagai

For the Japanese property sector, despite muted performance over the past three months, we maintain our preference for major developers over the J-REITs. Despite a rising interest-rate environment globally, we anticipate that the pace of the interest-rate increase will be considerably slower in Japan. Our long-term risk-free rate for Japan is unlikely to exceed 0.4% during our explicit forecast horizon. We do not anticipate a material rise in the inflation rate, as aging demographics will become stronger headwinds when fighting against deflationary pressures. Several factors related to the aging demographic will likely contribute to structural deflationary pressures, including (1) a lower labor participation rate; (2) lower economic growth expectations; and (3) a lower propensity for consumption. This structural disinflationary pressure of negative 0.25% can be temporarily offset by inflationary factors, mainly from the external environment, including (1) rising commodity prices; (2) a weaker Japanese yen from a wider yield gap among countries; and (3) higher demand for investment in overseas assets. We agree that Japan's strong monetary policy remains in the liquidity trap, reducing the policy effectiveness to some extent. However, strong policy framework will likely keep low inflation stable during our explicit forecast horizon by pushing real rates to negative if necessary to rehabilitate the economy. The central bank's liquidity infusions, with annual repurchases of JPY 90 billion targeted at J-REITs, continues to inflate investor confidence, with larger downside risks extending into the years beyond our forecast horizon.

For the past three months, Tokyo's prime office investments have maintained an attractive value proposition, with the latest average expected total returns tracking above 7.5%, while softer capital returns are supported by stable income returns at around mid-4%. For the past three years, low new office supply offset softer demand, keeping prime office vacancy rates low trailing below 3%. For the next three years, we still expect Tokyo Grade A office property to maintain a stable rental income trend. Adjusting for larger loss from abolished buildings, the Tokyo central business district office market is likely to see only a modest increase in net leasable area of 1.2%/2.2%/1.9% for the next three years. For comparison, our forecast demand growth is 1.5% for the same period. We still prefer **Mitsubishi Estate** 8802, although we have yet to confirm the level of additional investment appetite under the new management team from April 2017. This will mark the end of the firm's six-year leadership under Hirotaka Sugiyama, who has led the conservative balance sheet management ahead of its peers.

Hong Kong and China Property Outlook

Contributed by Phillip Zhong

In Hong Kong, developers' shares have rallied during the first quarter of the year, along with the rest of the market. The physical property market has continued to move higher despite restrictive government measures. Developers are taking advantage of the positive sentiment and launching projects with higher asking prices. This will likely result in better margins when these projects are booked. However, once the physical market begins to retreat under the weight of higher interest rates, lower liquidity, and increased supply, Hong Kong developers' shares will likely suffer as well. As the best name among Hong Kong developers, in our opinion, **Cheung Kong Property Holdings**' 1113 shares are currently trading at 11 times earnings and 0.7 times book, which is attractive relative to historical averages. The company has entered into several yield-focused businesses outside the property sectors to deploy its excess cash. Thus, it will be less exposed than its peers to the Hong Kong property market, shielding it from the inevitable volatilities on the horizon.

In China, major developers' shares also rallied in the year to date. Concluding a successful 2016 with robust sales for many developers, government policies will gradually tighten with regard to the real estate sector. Yet, the successful destocking in 2016 means there will be supply constraints across many upper-tier cities. While sales volume will be down relative to a year ago, prices will likely stay firm. The land market has also heated up in China, as many developers are looking to replenish their landbanks. Despite the policy headwind, we remain positive on large developers with a track record of earnings growth through fast asset turn and portfolio acquisitions. We remain positive on **China Overseas Land & Investment** 00688, currently trading at a P/E and P/B of approximately 8 times and 1 times, respectively. The CITIC acquisition a year ago should have bolstered the company's growth with a pipeline of projects at reasonable cost.

Top Picks

Simon Property Group SPG
Star Rating: ★★★★★
Economic Moat: Narrow
Fair Value Estimate: $213.00
Fair Value Uncertainty: Low
5-Star Price: $170.40

Simon owns and operates a diversified portfolio of regional mall, outlet, and other retail properties throughout North America, Europe, and Asia. These high-quality assets tend to be dominant hubs for retail, entertainment, and dining offerings and have proven highly productive in terms of tenant sales, allowing the properties to maintain high demand, occupancies, and consistent rent growth. This, along with its fortress balance sheet, generates greater cash flow for Simon to reinvest into its properties, allowing the company to adapt and insulate its portfolio from e-commerce headwinds.

GGP GGP
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: $29.00
Fair Value Uncertainty: Medium
5-Star Price: $20.30

In the aftermath of the financial crisis, GGP has made significant progress in building and refining one of the largest portfolios of Class A regional malls throughout the United States. The firm's quality-focused strategy has helped largely insulate it from recent high-profile retailer store closures like those of **Macy's** M and **JC Penney** JCP, and we believe demand for its properties will remain steady despite turbulence throughout the retail industry. We expect GGP to continue actively managing its assets and portfolio with redevelopment and capital recycling, while also further reducing leverage.

Kimco Realty KIM
Star Rating: ★★★★
Economic Moat: None
Fair Value Estimate: $29.00
Fair Value Uncertainty: Medium
5-Star Price: $20.30

Since 2010, Kimco has refocused its strategy and portfolio toward higher-quality shopping-center assets and markets. Through billions of dollars of acquisitions, dispositions, and development projects, the firm has simplified its core business model while fortifying its balance sheet and freeing up liquidity. In addition, significant below-market leases should promote future performance and operational flexibility. Overall, we think Kimco's strategy will better support long-term demand and decrease risk for the company's portfolio, ultimately benefiting investors.

Brad Schwer does not own shares in any of the securities mentioned above.

Tech: Overvalued Overall, but Opportunities Remain

Valuations in general are painting overly rosy scenarios, but we still see pockets of value in areas such as enterprise software and IT services.

By Brian Colello, CPA,
Director of Technology, Media, and Telecom Equity Research

- Overall, we view the tech sector as slightly overvalued at a market cap weighted price/fair value of 1.06.
- We see a tectonic shift toward enterprise cloud computing.
- The **Intel** INTC and **Mobileye** MBLY merger highlights the fight for automotive chip leadership, although valuations in semis more than exceed the hype.

Overall, we view the tech sector as modestly overvalued today at a market-cap-weighted price/fair value of 1.06, versus a ratio of 0.98 last quarter. Large-market-cap contributors like **Apple** AAPL reported strong fourth-quarter results that contributed to a rise in valuation toward our fair value. Meanwhile, several key semiconductor firms still see bright business conditions, while software vendors are bouncing back nicely as well.

In general, we still believe that valuations across tech are painting overly rosy scenarios in new and emerging technologies around artificial intelligence, for example. Some growth prospects, like rising demand from the automotive sector, are properly being considered by the market, in our view. We still see some pockets of value in tech, such as enterprise software and IT services.

Perhaps the single most important trend in technology is the ongoing shift toward cloud computing, which we think is having ramifications on dozens of stocks across our coverage. In short, both startups and enterprises, in efforts to reduce the high fixed costs associated with running on-premise IT hardware and software, are shifting more and more workloads to infrastructure-as-a-service, or IaaS, vendors, such as **Amazon**'s AMZN Web Services, **Microsoft** MSFT Azure, and **Google** GOOGL. In turn, IaaS vendors, along with software-as-a-service (SaaS) vendors, are seeing tremendous growth, while legacy IT vendors face ongoing headwinds. **Adobe** ADBE and Microsoft have been especially adept at transitioning to the SaaS model, as selling subscription software, rather than charging for upfront licenses, has expanded their customer bases. **Oracle** ORCL, for one, has been relatively slower to pivot, in our view, although it has shown recent signs of progress.

Across our coverage universe, some of our most undervalued names are SaaS providers like **Salesforce.com** CRM and **ServiceNow** NOW. Both firms are good examples of software vendors that should continue to gain market share and see outsized revenue growth over the next decade as they continue to ride SaaS and cloud tailwinds. Yet we think that future operating leverage in both business models is being discounted. Both firms are generating minimal profits today as they continue to spend on customer acquisition in a land grab. As we look further out, beyond the next one or two years, future spending by SaaS leaders should lead to customer retention, which is far less costly than customer acquisition spending today. In turn, we foresee many SaaS vendors like Salesforce.com and ServiceNow benefitting from tremendous operating leverage and earning robust profitability, similar to software leaders like Oracle today.

On the other hand, semiconductors are some of the most overvalued names within the tech sector, albeit for different reasons. We remain fond of the growth opportunities for semis within the automotive sector, in particular, as cars are adding more and more electronic features around infotainment systems, electric drivetrains, and advanced driver assistance systems, or ADAS, which require processors and other types of chip content.

Intel's $15 billion acquisition of Mobileye is the latest big move by a chip leader to stake a claim in the car. Yet we think that semiconductor valuations have already priced in strong growth in the automotive sector, while ignoring cyclicality within the industry and less-rosy prospects in other end markets. For example, stocks like **Nvidia** NVDA and **AMD** AMD are significantly overvalued, in our view, as the hype around their graphics chips used in artificial intelligence far exceeds our expectations for how revenue growth will truly materialize. In analog semis, we view high-quality, wide-moat leaders in this space as roughly 10%-20% overvalued. Automotive and industrial chip demand remains bright, but their growth prospects in smartphones and telecom infrastructure are muted, in our view.

All the while, semis are priced as if revenue and margins will grow in a straight line and recent strong quarterly results will last forever. Yet whenever there is any sort of macroeconomic turbulence or slowdown in end-market demand beyond chipmakers' control, we often see sharper cuts in chip orders that lead to industry downturns. We typically like buying high-quality names during selloffs and industry downturns, but simply see the inverse of this situation today.

Top Picks

Cognizant Technology Solutions CTSH
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: $70.00
Fair Value Uncertainty: Medium
5-Star Price: $49.00

We view Cognizant as a leader in the IT services market. The company has a track record of providing differentiated industry-relevant solutions that have led to significant client intimacy and recurring sticky business, as evidenced by our narrow economic moat rating. The firm has a fine balance between the consulting-centric incumbent operating model and the offshore industrial model that relies on lower-cost delivery, allowing the company to appear as either a U.S. or Indian firm, as circumstances dictate. We believe that Cognizant's level of reinvestment has been a key to its above-industry growth performance and, while the firm does not pay a dividend, we think its focused capital allocation has led to differentiated intellectual property and particularly strong positions in the healthcare and financial services industries. In our opinion, Cognizant is also well positioned to address the burgeoning digital and cloud agendas of clients, which will be an area of long-term growth for the company. As a result, we expect Cognizant to sustain its long-term leadership in the IT services market. Finally, we also believe that Cognizant has relatively less exposure within Europe, a region where we don't foresee tremendous growth in the near-term.

Salesforce.com CRM
Star Rating: ★★★★
Economic Moat: Wide
Fair Value Estimate: $99.00
Fair Value Uncertainty: High
5-Star Price: $59.40

Salesforce.com is one of our Best Ideas in the technology sector, as we believe the shares of this wide-moat software firm have meaningful upside to our $99 fair value estimate.

Salesforce is the world's leading software-as-a-service provider, and although it has had extraordinary success since its launch in 1999, we believe the market is underappreciating the broad opportunity that awaits Salesforce as the enterprise cloud migration still has plenty of runway left. Salesforce's primary customer relationship management suite is the most cloud-ready, scalable offering on the market, in our view.

Although Salesforce has built its suite via a mix of internally developed technology and acquisitions, the company has been highly selective in how it builds and integrates software products (in particular, limiting itself to purchases of cloudnative application vendors such as ExactTarget), allowing it to build a complete, end-to-end customer relationship management platform. The firm's flagship salesforce automation is the largest and most mature product, but the company is seeing more than 20% revenue growth across its other major product categories, including Service Cloud, Marketing Cloud, and App Cloud, the last of which is one of the most promising offerings in the rapidly broadening platform-as-a-service market. Further, as the firm's billing mix tilts more toward renewals versus new business, Salesforce should generate significant operating leverage via sales and marketing and research and development spending, yielding consistent margin expansion for several years.

Guidewire Software GWRE
Star Rating: ★★★★
Economic Moat: Wide
Fair Value Estimate: $67.00
Fair Value Uncertainty: High
5-Star Price: $40.20

Although Guidewire Software has appreciated considerably from its late-February lows near $42 per share, we see meaningful upside today compared with our $67 fair value estimate.

Guidewire is the runaway leader in property and casualty insurance software, holding relationships with roughly half of the world's Tier 1 insurance companies. Over the past several quarters, the company has broadened its product portfolio to include add-on services around predictive analytics and digital portals to improve operational efficiency and customer experience for insurance companies, providing further avenues for revenue growth and increasing its customers' switching costs.

We think investors have become too hung up on Guidewire's somewhat surprising reversal into investment mode, but we believe this reversal signals a long-term positive for the business. A significant amount of the incremental investment Guidewire is undertaking in fiscal 2017 revolves around a digital greenfield opportunity with a large insurance company. This particular deal spans Guidewire's entire core insurance suite in addition to several add-on products and cloud-based delivery, the latter of which remains a rare choice for large property and casualty insurers.

While we believe large insurers will choose to deploy Guidewire's software on-premises for the foreseeable future, we believe this project will give the company a strong reference for providing a multifaceted, cloud-based solution for large insurers that will lead to larger wins and faster implementations. Although the nature of this project could create lumpiness in Guidewire's quarterly results in the near term, we expect the firm will maintain GAAP profitability this year. We expect the digital greenfield project will begin making revenue contributions by the end of fiscal 2017, and the company will probably return to consistent gains in operating leverage in fiscal 2018 and beyond amid a backdrop of shifting revenue mix toward high-margin license revenue and away from low-margin services revenue, a shift that is being aided by a growing list of system integration partners, including the addition of Accenture in EMEA earlier this year. This particular addition is notable, as Accenture came on board after selling a majority stake in Guidewire's chief North American competitor, Duck Creek, which we believe underscores the strength of Guidewire's offering and market position.

Qualcomm QCOM
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: $68.00
Fair Value Uncertainty: High
Consider Buying: $40.80

We have added Qualcomm to our Best Ideas list, as we see an adequate margin of safety in this narrow-moat chip leader. Recent allegations levied against the firm by South Korea, the U.S., and **Apple** AAPL have caused the firm's licensing business to be called into question. As a result, Qualcomm's stock has fallen considerably. We believe the litigation process will be lengthy, particularly as it occurs on multiple fronts with regulatory agencies and major customers alike. Additionally, we surmise the financial fallout will be fines on the order of $1 billion from the regulatory lawsuits, a considerable sum, but not debilitating for Qualcomm. Nonetheless, we expect our fundamental thesis on Qualcomm, as it pertains to its ability to collect fair and reasonable royalties on its essential patent portfolio, to be upheld. Our fair value estimate is $68 per share, and implies a fiscal 2017 price/adjusted earnings ratio of 14 times.

On the chip side, we forecast a steeper decline in modem business from Apple, given its recent suit against Qualcomm and dual-sourcing endeavors. Along with an increasing trend of smartphone OEMs to use internally developed chips, we expect chip sales to be down 6% for fiscal 2017. We think licensing revenue will rise in the low single digits in fiscal 2017 via a combination of better China collections and less than expected declines in smartphone average selling prices. Regarding the pending tie-up with NXP Semiconductors, we expect revenue synergies to take into effect a few years after the close (projected by the end of calendar 2017). Our valuation incorporates our preliminary view on potential revenue and cost synergies, particularly with respect to the automotive and Internet of Things end-markets. With shares currently trading at 11 times our adjusted fiscal 2017 earnings estimate, we believe prospective investors should find this an attractive entry point.

Brian Colello, CPA does not own shares in any of the securities mentioned above.

Telecom: Firms Strive to Be More Than 'Dumb Pipes'

U.S. telecoms are working to diversify away from being pure wireless network providers.

By Brian Colello, CPA,
Director of Technology, Media, and Telecom Equity Research

- Overall, we view the communications services sector as fully valued at a market-cap-weighted price/fair value of 1.01.
- U.S. telecom continues to combat the fear of being a "dumb pipe."
- **China Mobile** CHL still dominates in broadband even as the mobile subscriber market evens out a bit.

U.S. Telecom Continues to Combat the Fear of Being a 'Dumb Pipe'

Perhaps the most important trend we're seeing in U.S. telecom is the ongoing shift in strategy to diversify away from being a pure wireless network provider. **AT&T** T, in particular, continues to move away from wireless and into satellite television and over-the-top, or OTT, TV via its acquisition of DirecTV and, more recently, the firm's pending entry into the media content space via its acquisition of **Time Warner** TWX.

Ultimately, we think the industry fears being just a supplier of "dumb pipe," where it becomes a commoditylike business with no ability to differentiate based on network quality or reliability. We still see **Verizon** VZ as a bit of a holdout on this front, as the firm touts its network quality as a differentiator over AT&T, **Sprint** S, and **T-Mobile** TMUS. Verizon's acquisitions of AOL and Yahoo represent a far smaller bet (both strategically and financially) on advertising platforms.

T-Mobile continues to execute well and offer aggressive pricing in order to capture customers, including many from Verizon, which reported notably disappointing quarterly results. Sprint continues to face challenges associated with capturing and retaining customers as well as building out a high-quality network.

Perhaps the most exciting news for both T-Mobile and Sprint investors is the potential for a merger between the two firms during Donald Trump's administration, as the Federal Communications Commission has been visibly focused on deregulation and might allow for such a merger to go through.

China Mobile Still Dominates in Broadband Even as the Mobile Subscriber Market Evens Out a Bit

In the Chinese telecom market, we see wireless competition evening out a bit (albeit in a slower-growing market than in years past) but still see China Mobile as the dominant player in broadband.

As background, from the beginning of 2009 until the end of 2013, the "3G era," China Mobile dominated the Chinese telecom industry, capturing half of new customers, while the remainder were split between China's other two large telcos, **China Telecom** CHA and **China Unicom** CHU. China Mobile's wireless dominance extended into 4G, gaining 77% of net new customers in the mobile market in 2014 and 2015, with China Telecom adding 16% and China Unicom adding 7%. On the surface, in 2016 we have seen a fightback from the smaller operators, with China Mobile's share of net new adds at 44%, China Telecom at 34%, and China Unicom at 22%. Yet even these numbers are skewed, as a majority of net new 4G customers are still in China Mobile's favor, courtesy of its much bigger base of 2G customers, which it has been migrating up to 4G without impacting its overall net market share.

However, the story in broadband is very different, with China Mobile cutting a swath through that market, adding 64% of new customers over 2016 compared with 28% for China Telecom and only 8% for China Unicom. While China Mobile's fixed broadband average revenue per user is only around half of the incumbent fixed-line operators, it is taking most of the new growth at over 65% of new fixed broadband customers in the market over 2016.

China Mobile's already-mentioned very strong balance sheet combined with its relatively low dividend payout ratio mean it can easily invest heavily in this market and make life difficult for its two competitors in the fixed-line market. Indeed, at the result briefing, management indicated it viewed an integrated fixed and mobile broadband offering as essential and set itself an ambitious target of adding a further 20 million fixed broadband customers in 2017, a slight increase on 2016 net adds.

Top Picks

China Mobile CHL
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: $66.00
Fair Value Uncertainty: Medium
5-Star Price: $46.20

We expect narrow-moat China Mobile to generate earnings per share growth of around 10% annually over the next five years, putting it toward the upper end of Asia-Pacific telecom companies in terms of growth. We expect China Mobile's strong market share gains from moving to 4G technology to drive this growth. Also driving growth are the upgrading of around 40% of its customer base to phones supporting mobile data, cost savings from the tower company, and a potential rerating in its stake in the tower company when it lists.

Telefonica TEF
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: $14.00
Fair Value Uncertainty: High
Consider Buying: $8.40

Telefonica is leading the European communications market into converged services. Additionally, it is laying extensive amounts of fiber to better compete with cable operators in providing fixed broadband services. It acquired E-Plus In Germany and GVT in Brazil, which strengthens its position in both countries and provides lots of opportunities for cost savings. We don't believe the market appreciates how well the firm is positioned and its margin expansion opportunities, which has caused its stock to trade around a 40% discount to our fair value estimate.

Millicom International Cellular MIICF
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: $83.00
Fair Value Uncertainty: High
Consider Buying: $49.80

Despite the decline in the stock due to the Colombian peso's continued weakness, Millicom is still one of our Best Ideas. We expect the acquisition of UNE, the second-largest cable TV operator in Colombia, to enable Millicom to generate revenue growth even after currency declines in Colombia and other countries. We expect the firm to generate organic revenue growth in local currency terms in excess of 6% for the next five years, the fastest growth rate of any of the European communication companies we cover. On an enterprise value/EBITDA basis, Millicom trades below 4 times our estimate of 2016 EBITDA, the lowest in our European coverage. The stock also yields in excess of 4%, a dividend that we believe is safe.

Brian Colello, CPA does not own shares in any of the securities mentioned above.

Utilities: Is There Enough Growth to Offset Higher Interest Rates?

Utilities stocks keep rewarding investors with attractive yields and growth, dispelling the long-held notion that rising interest rates will hurt sector returns.

By Travis Miller,
Director of Utilities Equity Research

- On a global basis, utilities continue to be overvalued, with a 1.07 market-cap-weighted price/fair value ratio as of mid-March. U.S. utilities have a 1.13 equal-weighted median P/FV, down from their peak 1.21 P/FV in mid-2016. We see more value among the large European diversified utilities, but those come with higher uncertainty ratings and weaker economic moats.

- We've long told investors that a wide spread between utilities' dividend yields and interest rates would dampen the market's reaction to rising rates. That has played out. Even as 10-year U.S. Treasury rates have climbed to 2.6% in early March, utilities' average dividend yields fell to 3.5% now.

- We think large-cap U.S. utilities offer the most value right now given their combination of growth, yield, and quality. Utilities like **Dominion Resources** D, **Duke Energy** DUK, **Southern Company** SO, and **American Electric Power** AEP trade at a discount to their peers based on our valuations and their combinations of yield and growth.

- Rising interest rates and a dearth of potential acquirers has quashed the M&A market, which could pressure the premium valuations that many small- and midsize regulated utilities have enjoyed for several years.

Utilities have cast aside conventional stock investing wisdom. Defensive income-oriented stocks like utilities should be suffering in this market. The economy shows signs of improving, interest rates are rising, the U.S. Fed remains hawkish, and politicians appear set to implement expansionary fiscal and tax policies. Yet utilities have been keeping pace with the market. The Morningstar U.S. Utilities Sector Index hit an all-time high on March 15. Utilities are up 6% year to date and 10% since the U.S. presidential election, both in line with the S&P 500.

So, what's the catch? One catch is that utilities' relative performance has suffered since interest rates started rising. Utilities are mostly flat since interest rates bottomed in mid-2016, while the S&P 500 is up 15%, both including dividends.

The other catch is that utilities have lost their yield cushion and could become more sensitive to interest-rate changes going forward. When interest rates bottomed last year, utilities' 3.6% dividend yield was 220 basis points higher than the 10-year U.S. Treasury yield. As interest rates have climbed, that spread has closed. The current spread between utilities' 3.5% average dividend yield and the 2.5% 10-year U.S.

Treasury yield is still higher than long-term historical averages but is in line with spreads since interest rates began falling in 2008.

Going forward, we think utilities investors should keep a couple of points in mind:

First, relative performance likely will continue to suffer. Two thirds of the U.S. utilities we cover trade at more than a 10% premium to their fair value estimates. This is above Morningstar's overall market valuation after adjusting for the low uncertainty ratings we assign to most utilities.

Second, investors should be able to earn solid cash returns from utilities based on the combination of current dividend yields and our projected dividend growth. Among the U.S. utilities we cover, we forecast 5.5% median annual dividend growth during the next four years. Combining this growth with the sector's 3.5% average dividend yield, produces cash returns that exceed what we think is a fair equity return for utilities. The risk is that valuations will contract and falling stock prices will sap some of that cash return when an investor sells.

Third, U.S. utilities in general are in excellent financial health, and we have high confidence that most utilities can meet our dividend growth forecasts. All have taken advantage of this long stretch of low interest rates to refinance debt and issue new debt for value-accretive investment. Most utilities have another half-decade of good visibility into growth investment. Renewable energy and gas-related infrastructure are key investment areas that typically receive support from all stakeholders.

Fourth, keep a cautious eye on politics. **Electricite de France** EDF and **Engie** ENGI have the most to lose if Marine Le Pen is elected France's new president this spring and implements her proposed retail gas and electricity tariff cuts. We estimate that a 5% cut in tariffs could represent 17% downside for EDF and a 4% downside for Engie. In the U.S., President Donald Trump will appoint three new commissioners to the five-person Federal Energy Regulatory Commission. We expect a conservative-leaning FERC will be more likely to support energy infrastructure growth and competitive markets, both positives for our top utilities picks.

Top Picks

Calpine CPN
Star Rating: ★★★★★
Economic Moat: None
Fair Value Estimate: $19
Fair Value Uncertainty: High
5-Star Price: $11.40

Calpine's competitively advantaged fleet and management's smart capital allocation make it the only power producer with a positive moat trend rating. Management plans to ease balance sheet worries by paying down $2.7 billion of debt by 2019. Calpine also continues to build out its retail platform, which should provide a strong natural hedge to Calpine's generation fleet in a stubbornly low commodity environment. The disconnect between private market transactions and Calpine's public market valuation remains. Comparable power generation fleets have sold in the private market for nearly $750 per kilowatt, well above the market's current implied $425/kw Calpine valuation. Our $19 per share fair value estimate values Calpine's fleet at approximately $525/kw.

RWE RWE
Star Rating: ★★★★
Economic Moat: None
Fair Value Estimate: EUR 18.50
Fair Value Uncertainty: High
5-Star Price: EUR 11.10

After RWE's Innogy share issue in early October, RWE now owns a 75% stake in the regulated grid infrastructure, renewable energy, and supply businesses. It retained the conventional generation, trading, and gas midstream businesses, which we think the market underappreciates. Our EUR 18.50 per share consolidated RWE fair value estimate implies a EUR 36 per share value for Innogy. The key uncertainty for RWE is the economic value of its future nuclear decommissioning costs and other provisions. A recent settlement with the German government eliminates some of that uncertainty, but we expect RWE's stake in Innogy will remain an important source of capital to fund any nuclear-related cash needs. We still think the stock has upside if the market realizes the long-term capacity value of its legacy conventional generation fleet.

Duke Energy DUK
Star Rating: ★★★
Economic Moat: Narrow
Fair Value Estimate: $86.00
Fair Value Uncertainty: Low
5-Star Price: $68.80

Duke Energy became the largest utility in the United States after it merged with Progress Energy in 2013 and has completed its transition to a predominantly regulated utility. We believe investors should pay attention to Duke's strong management team, which has long focused on regulated capital investment opportunities. In 2017-21, we anticipate $42 billion of capital investment in grid modernization, new power generation, and natural gas infrastructure. We anticipate that Duke will be able to recover these costs through constructive regulatory outcomes, supporting our 6% annual earnings and dividend growth outlook.

Travis Miller does not own shares in any of the securities mentioned above.

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