MORNINGSTAR®

Market Outlook
3Q 2018

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Stock Market Outlook: Some Values to Be Found in Defensive Sectors

Healthcare, breakfast, and gassing up the car are always necessary, even during downturns.

By Daniel Rohr, CFA
Director of Equity Research,
North America

- The Morningstar Global Markets Index has edged up 1% year to date.
- Weighted by market capitalization, our coverage universe looks fairly valued.
- We see proportionately more opportunities in less-cyclically sensitive sectors such as consumer defensive and healthcare.

Our global equity coverage universe appears fairly valued, in aggregate. The market-cap-weighted price/fair value ratio across our coverage of roughly 1,600 stocks is 1.00. Generally speaking, we're more positive on sectors that are less sensitive to the economic cycle, which might not be too surprising given the global economy is now in its ninth consecutive year of expansion. Consumer defensive ranks among the more undervalued sectors, trading at a price/fair value of 0.94 on a cap-weighted basis.

One of our top picks here is **General Mills** GIS, shares of which have suffered amid volume softness across the packaged food space as well as skepticism related to the acquisition of natural pet food company Blue Buffalo. We're more optimistic about the firm's ability to reinvigorate growth through reinvestment in its brands, and to integrate and grow Blue Buffalo by following the same playbook it did with Annie's, which it acquired in 2014.

Healthcare, another sector that tends to hold up well when the economy heads south, trades at 0.98 price/fair value. One of the names we like here is **Allergan** AGN. In contrast to most of its peers in specialty pharma, the firm boasts an attractive product portfolio and innovative pipeline thanks to a successful mix of internal research and M&A. At the other end of the spectrum, the basic materials, energy, and industrials sectors all trade above to our estimates of intrinsic value on a cap-weighted basis. In energy, we believe the market continues to underestimate the shale industry's capacity to throw oil markets back into oversupply. Crude prices have largely held above $65 per barrel for West Texas Intermediate, or WTI, in 2018, which provides attractive economics for many U.S. producers. But the reckoning may not happen as quickly as we previously thought amid supply disruptions. Eventually, we expect pain for oil prices as growing U.S. production serves as the primary weight to tip oil markets back into oversupply. Our midcycle forecast for WTI is still $55/bbl.

Canadian midstream company Enbridge is one of our top picks in this generally overbought space. We see nearly 50% upside in the stock, as we believe the market doesn't realize the potential of the company's growth portfolio. M

Daniel Rohr, CFA, does not own shares in any of the securities mentioned above.

Credit Market Insights: Investment Grade Struggles While High Yield Strengthens

Most Fixed-Income Indexes Decline in Second Quarter as Rising Interest Rates Take Their Toll

By Dave Sekera, CFA
Managing Director, Credit Ratings

- The yield curve continues to flatten.
- Outflows among high-yield open-end funds overwhelm ETF inflows
- Downgrades edge out upgrades during the second quarter

Summary

Most fixed indexes continued their declines over the course of the second quarter as interest rates rose and investment-grade corporate credit spreads widened out. However, with its shorter duration and higher correlation to economic growth, the high-yield sector was one of the few standouts that registered gains this quarter.

Morningstar's Core Bond Index, our broadest measure of the fixed-income universe, declined 0.42% in the second quarter through June 25 and has fallen a total of 1.94% year to date. The decline was mainly driven by the increase in interest rates across the entire yield curve but was also under pressure from widening investment-grade corporate credit spreads. Underlying the Core Bond Index, Morningstar's Short-Term Core Bond Index was able to post a small gain of 0.15% even as short-term rates rose to their highest levels in over a decade. This gain in the second quarter helped to offset earlier losses and this index is now down only 0.24% for the year. The Intermediate Core Bond Index declined 0.11% during the quarter and has dropped 1.39% year to date. With its longer duration and greater price sensitivity to interest rates, the Long-Term Core Bond Index fell by 1.63% this quarter and had registered a 4.75% loss this year as falling bond prices from rising rates more than offset the yield carry from the underlying bonds in this index.

In the Treasury market, the Morningstar U.S. Government Bond index fell by 0.14% and has declined 1.34% thus far this year. Similarly, the Morningstar Agency Bond Index declined 0.16% in the quarter and 0.70% year to date. One of the bright spots this quarter was in the Treasury Inflation Protected Securities market. As inflation measures edge up, investors looked to TIPS, which led the Morningstar TIPS Index to a gain of 0.42%; however, that gain was not enough to offset the losses incurred in the first quarter and the index remains in the red to the tune of 0.35% for the year.

During the second quarter, through June 25, the yield on the 2-year Treasury bond rose another 26 basis points on top of the 38 basis points it rose in the first quarter. At its current yield of 2.53%, the 2-year is trading at its highest yield since August 2008. The yield on the 5-year Treasury bond rose 19 basis points to 2.75%, which rivals its highest yield since 2010. Along the long end of the curve, the yield in the 10-year Treasury rose 14 basis points to 2.88%. The yield on the 10-year briefly broke through the psychological ceiling at 3% but was quickly driven back down as concerns that a global trade war would

emerge drove a flight to safety. At the longest end of the curve, the 30-year rose only 5 basis points to 3.02%. As short-term rates have continued to rise faster than long-term rates, the spread between the 2-year Treasury and the 10-year Treasury has since compressed to 35 basis points, representing the flattest the yield curve has registered since fall 2007.

In the corporate bond market, the Morningstar Corporate Bond Index (our proxy for the investment-grade bond market) declined 1.25% this quarter as the combination of higher interest rates and wider credit spreads pushed bond prices down. Year to date, our corporate bond index has lost 3.46%. In contrast, in the high-yield market, the Bank of America Merrill Lynch High Yield Master Index rose 0.48% in the second quarter as credit spreads tightened and the higher yield carry of the index more than offset the impact of higher interest rates. Year to date, the high-yield market has risen 1.43%. Among European fixed-income markets, the Morningstar Euro Corporate Bond Index rose 0.11% as the benefit from the decline in underlying interest rates on benchmark German bonds offset the amount that corporate credit spreads widened. Year to date, the European Corporate Bond Index has registered a loss of 0.19%.

Once again, the emerging-markets fixed-income indexes were among the worst-performing fixed-income asset classes following significant losses in the first quarter. Quarter to date, the Morningstar Emerging Market Composite Index fell 2.60%, as the underlying Morningstar Emerging Market Sovereign Index declined 4.03% and the Morningstar Emerging Market Corporate Index fell 1.79%. Morningstar's Emerging Market High Yield Index dropped by 4.68%. Year to date, the composite index has fallen 4.23%, the sovereign index has dropped 5.96%, the corporate index has declined 3.24%, and the high-yield index has plunged by 5.88%.

Exhibit 1 Fixed-Income Index Returns

Broad Market Index	*QTD*	*YTD*	*2017*	*2016*	*2015*	*2014*	*2013*	*2012*
Core Bond	-0.42	-1.94	3.64	2.64	0.98	6.07	-1.89	4.41
Short-Term Core	0.15	-0.24	1.12	1.46	0.79	1.04	0.57	1.75
Intermediate Core	-0.11	-1.39	2.63	2.22	1.96	5.56	-1.07	4.25
Long-Term Core	-1.63	-4.75	8.39	5.10	-1.55	15.10	-6.88	8.32
Sector Indexes								
US Gov't Bond	-0.14	-1.34	2.41	0.97	0.91	5.08	-2.74	1.98
Agency	-0.16	-0.70	2.10	1.67	0.72	3.01	-1.03	1.96
Corporate Bond	-1.25	-3.46	6.40	5.81	-0.46	7.20	-1.50	10.54
BofAML High Yield Master II	0.48	1.43	7.48	17.49	-4.64	2.50	7.42	15.58
Eurobond Corp	0.11	-0.19	1.81	4.66	-0.59	8.35	1.94	12.67
TIPS	0.42	-0.35	3.10	4.68	-1.60	3.95	-8.53	6.93
Emerging Markets Indexes								
Emerging Mkt Composite	-2.60	-4.23	8.24	9.94	0.62	5.06	-4.39	16.25
Emerging Mkt Sovereign	-4.03	-5.96	9.31	9.25	1.15	7.69	-3.40	13.75
Emerging Mkt Corporate	-1.79	-3.24	7.85	11.30	0.08	3.47	-2.81	15.32
Emerging Mkt High Yield	-4.68	-5.88	9.34	15.17	1.42	2.63	-4.99	24.07

Source: Morningstar, Inc., Bank of America Merrill Lynch Global Indexes. Data as of June 25, 2018.

A Tale of Two Bond Markets: Investment Grade Struggles While High Yield Strengthens

It's been a tale of two cities across the corporate bond markets thus far this year. Since the end of last quarter, through June 25, the average credit spread of the Morningstar Corporate Bond Index, our proxy for the investment-grade bond market, widened 13 basis points to +128; however, in the high-yield market, over the same time period, the Bank of America Merrill Lynch High Yield Master Index has tightened 32 basis points to +347. Year to date, the investment-grade index has widened 32 basis points, whereas the high-yield index has tightened 16 basis points.

At its current level, the average credit spread in the investment-grade market is at its widest level this year and is at its highest level since the beginning of 2017. At that time, the corporate bond markets were still recovering from an earlier plunge in oil prices which bottomed out in 2016. In contrast, the average credit spread of the high-yield index is not that far off of its tightest levels since prior to the 2008–09 credit crisis. Since the beginning of 2000, the high-yield index has only ever traded below the current level approximately 12% of the time.

Exhibit 2 Corporate Bond Credit Spreads

Source: Morningstar, Inc., Bank of America Merrill Lynch Global Indexes. Data as of June 25, 2018.

There are several factors in play that have led to this divergence. Investment-grade credit spreads are more susceptible to sell-offs in relation to debt-leveraged mergers and acquisitions than are high-yield spreads. Following a recent court ruling in which the Justice Department lost its attempt to block the proposed merger between **AT&T** T and Time Warner, investment-grade portfolio managers have become increasingly concerned that the potential for mega-mergers and acquisitions that may not have passed antitrust regulators in the past, may now be possible. For example, as soon as the Department of Justice announcement was made, **Comcast** CMCSA commenced a bidding war by making a counter offer to

acquire certain assets from **Twenty-First Century Fox** FOX, for which **Disney** DIS had made a prior offer. Typically, mergers and acquisitions are funded with significant amounts of newly issued debt, which heighten default risk and often lead to rating downgrades. However, more often than not, high-yield companies are purchased by larger, investment-grade companies and the outstanding debt of those acquired high-yield companies are upgraded to the same rating as the acquirer.

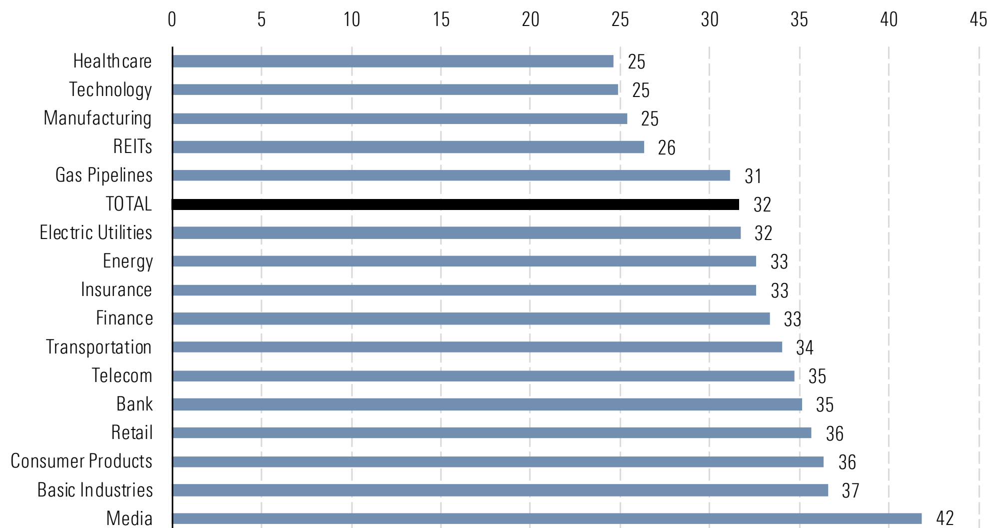
While investment-grade has struggled, the high-yield market has outperformed thus far this year as the performance of the underlying companies in the high-yield universe are more affected by changes in economic activity, which has been robust this quarter. Whether it has been driven by the implementation of the tax cuts earlier this year, or some other reason, economic activity has been on a tear recently and is much stronger than was expected at the beginning of the quarter. In its most recent GDPNow estimate based on current economic metrics, the Federal Reserve Bank of Atlanta is projecting that second-quarter GDP growth will be 4.7%. This rate of growth would represent the second strongest quarterly growth rate over the past four years, surpassed only in third-quarter 2014.

Rising interest rates have also played a significant part in the divergence between the performance of the investment-grade and high-yield markets. With their lower credit spread and longer average duration, investment-grade bond performance is more closely correlated to movements in interest rates than high-yield bonds. High-yield bonds typically have shorter durations and wider credit spreads, which are more closely tied to the performance of the underlying companies. Similar to the credit spread widening that occurred during the "taper tantrum" in mid-2013, investors are requiring additional credit spread to compensate for the risk that interest rates rise further.

The impact to corporate credit spreads on the investment-grade market from issuers that engage in large, debt-funded M&A can be seen in the performance of Disney and Comcast notes. As the bidding war for the Fox assets between the two rages on, the credit spreads for those company's bonds have widened out as investors price in a higher probability that debt leverage will increase significantly for whichever firm emerges as the winner. With its higher credit rating, Disney's notes had been outperforming the market earlier this year, but this month Disney's 2027 notes widened 18 basis points and are 33 basis points wider than at the end of 2017. While the credit spread on Comcast's 2028 notes was unchanged in June, the notes have widened 48 basis points since the end of last year. This compares to the index which widened 8 basis points in June and 32 basis points year to date.

Among the winners and losers this quarter, those companies with a significant amount of cash that had previously been held overseas to avoid tax payments upon repatriation, performed well as the new tax laws took effect. Both the healthcare and technology sectors outperformed the overall investment-grade index thus far this year as both sectors have a high percentage of issuers that fit this description. To the downside, the media sector has far underperformed the overall market as debt-financed M&A ravages the credit quality for many of the issuers within that sector.

Exhibit 3 Morningstar Corporate Credit Index YTD Spread Change



Source: Morningstar, Inc. Data as of June 25, 2018.

Yield Curve Continues to Flatten as Rates Rise

In conjunction with the hikes in the federal funds rate, short term rates have continued their march higher. However, the rise in long term rates has lagged the rise in short-term rates, which has led to further flattening of the yield curve. On the shorter end of the curve, the yield on the 2-year Treasury bond rose 26 basis points this quarter to 2.53%, rivaling the highest yield it has traded at this year and the highest yield the 2-year has registered since mid-2008. Along the longer end of the curve, after breaking above the 3% psychological barrier a few weeks ago, the 10-year has rallied once again and sunk below that threshold to 2.88%. The bid for longer-term U.S. Treasuries coincided with the increasing rhetoric surrounding global trade re-negotiations and the rising risk that new tariffs will be imposed and the responding retaliatory tariffs will impede global economic growth. This drove the spread between the 2-year and 10-year Treasury to 35 basis points, representing the flattest the yield curve has been since fall 2007.

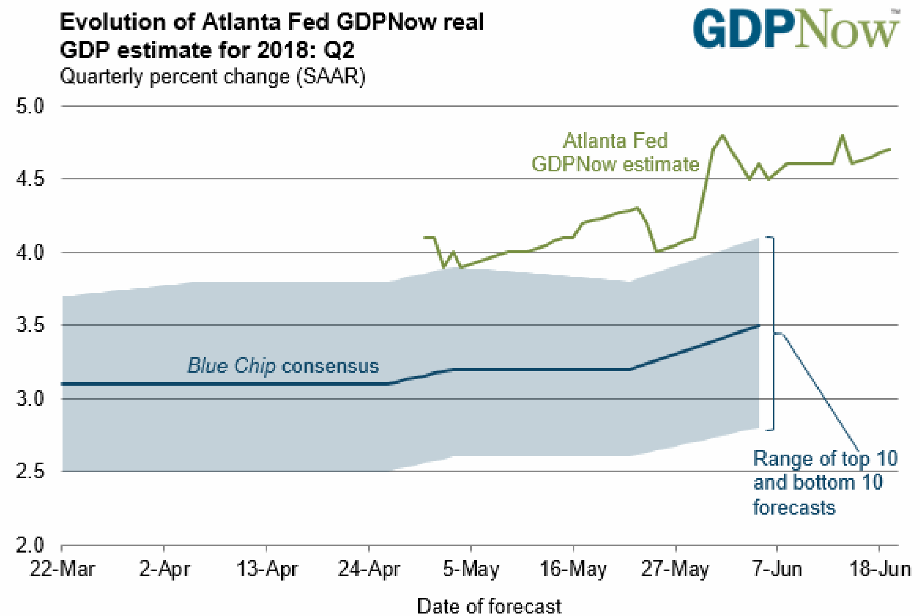
Exhibit 4 10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity

Source: Morningstar, Inc. Data as of June 25, 2018

The yield curve has been on a multiyear flattening trend since the Fed began to raise short-term rates in its pursuit to normalize monetary policy and this trend may not yet have fully run its course. According to the CME FedWatch Tool, the market is pricing in additional hikes to the federal funds rate (currently 1.75%–2.00%) over the course of the year. The probability that the federal funds rate at the end of 2018 will be greater than 2.00% is 91% and the probability that the federal funds will be 2.25% or higher is 50%. At the beginning of the year those probabilities were 44% and 13%, respectively.

In the past, it has often been an indicator of a weakening economy and in many cases portended an impending recession when the yield curve has been flattening and then inverting. This time around, this signal may not be foreshadowing a near-term recession risk, as it is being heavily influenced by global central bank actions and current economic activity hasn't shown any indications of slowing down. In fact, as an indication of the current economic strength, the Atlanta Fed's GDPNow model forecast for second-quarter 2018 real GDP growth has risen throughout the second quarter to 4.7%, which would be a strong acceleration from the 2.3% GDP growth rate in the first quarter and would be the strongest quarterly growth rate since the third quarter of 2014.

Exhibit 5 GDPNow—Federal Reserve Bank of Atlanta

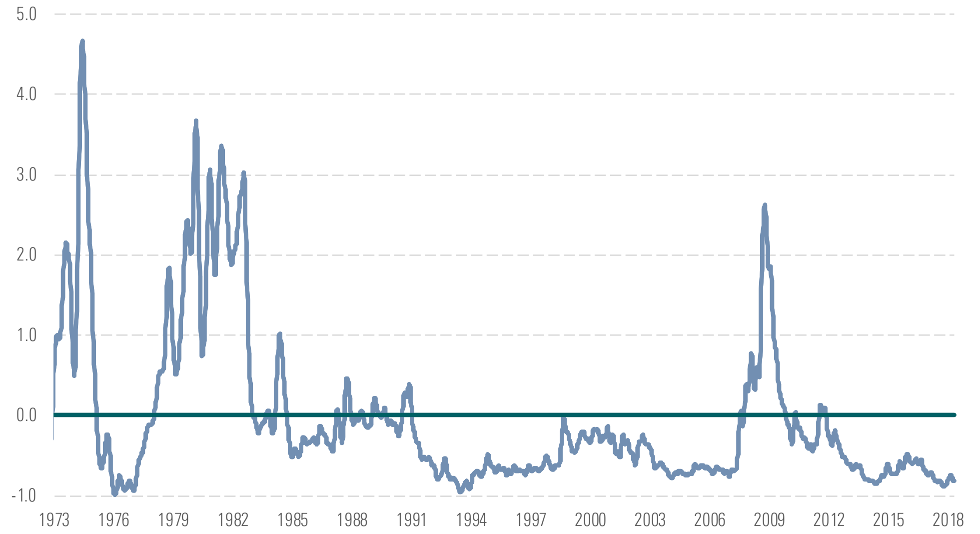


Source: Federal Reserve Bank of Atlanta as of June 19, 2018.

While the Fed's monetary policy actions have been directly impacting short-term rates in the U.S., rates in other developed markets continue to be influenced by their central bank interventions. For example, at its most recent news conference, the ECB disclosed its plans to keep its deposit rate at a negative yield of (0.40)% through summer 2019. Furthermore, although the ECB announced that it will begin to taper its asset purchases this fall, it will continue to purchase EUR 30 billion of debt securities per month through September and then reduce the purchases to EUR 15 billion per month until the end of the year. Even though the 10-year U.S. Treasury is yielding only 2.88%, that yield has been attractive to global bond investors as the yield on Germany's 10-year bond is only 0.33% and the yield on Japan's 10-year bond is only barely positive at 0.04%.

Supporting the Atlanta Fed's GDP forecast, the level of the National Financial Conditions Index remains near the strongest readings it has ever registered and is currently indicating that financial conditions remain near their loosest since October 1994. This index is published by the Federal Reserve Bank of Chicago and measures more than 105 variables to gauge how "loose" or "tight" financial conditions are among U.S. capital markets, as well as the traditional and shadow banking systems. These variables include credit availability and cost, leverage, risk, interest rates, and credit spreads. Index levels above zero indicate tighter than average conditions, whereas levels below zero represent looser-than-average conditions.

Exhibit 6 Chicago Fed National Financial Conditions Index



Source: Federal Reserve Bank of Chicago. Data as of June 25, 2018.

CMBS: Could Macro Speed Bumps Slow Market's Roll?

Delinquency rates remain low, but rising interest rates could put the brakes on new issuance.

By Steve Jellinek
Vice President, CMBS Research

- The CMBS delinquency rate has remained low, as liquidations and originations outnumber new problem loans. As servicers wind down their legacy (pre-2010) portfolios throughout the year, we expect the delinquency rate to stay low.
- Retail consolidation will continue to make headlines in 2018; however, in contrast to 2017, we do not expect a wave of regional mall defaults.
- The multifamily sector, which has been the star performer of this real estate cycle, could experience slower growth, especially in markets that have had sharp increases in supply, but we expect secondary markets with weaker supply growth to outperform.

Despite concerns about rising interest rates and the Federal Reserve's self-imposed downsizing of its balance sheet, fewer maturities in need of refinancing, and signs of overbuilding in certain commercial real estate sectors, commercial mortgage-backed securities issuance started 2018 strong, and Morningstar Credit Ratings, LLC expects it to continue to be robust through the third quarter. By the end of June, new issuance will total $44.30 billion, according to Trepp, LLC, a healthy increase over the $34.45 billion issued in the first half of 2017. Issuance volume for single-asset, single-borrower CMBS deals will remain strong in 2018, as most of the year-to-date gains came from the continuing surge of SASB transactions. Trepp expects SASB issuance will total $18.06 billion by the end of the second quarter, versus $11.88 billion from the same period a year ago. Some of the factors behind the market's growing appetite are the ease of re-underwriting the collateral, better credit enhancement, and the higher-quality assets backing the deals. Fueled primarily by heavy deal flow on trophy skyscrapers in major metropolitan areas, office loans made up the largest portion of total issuance with $4.48 billion, or 29.1% of 2018 volume.

Exhibit 1 Issuance Volume Comparison ($ Bil)

	Conduit	Single-Asset Single-Borrower	Floating Rate	Total
Expected Through June 2018	16.44	18.06	9.80	44.30
First Half 2017	19.57	11.88	3.00	34.45

Source: Trepp LLC

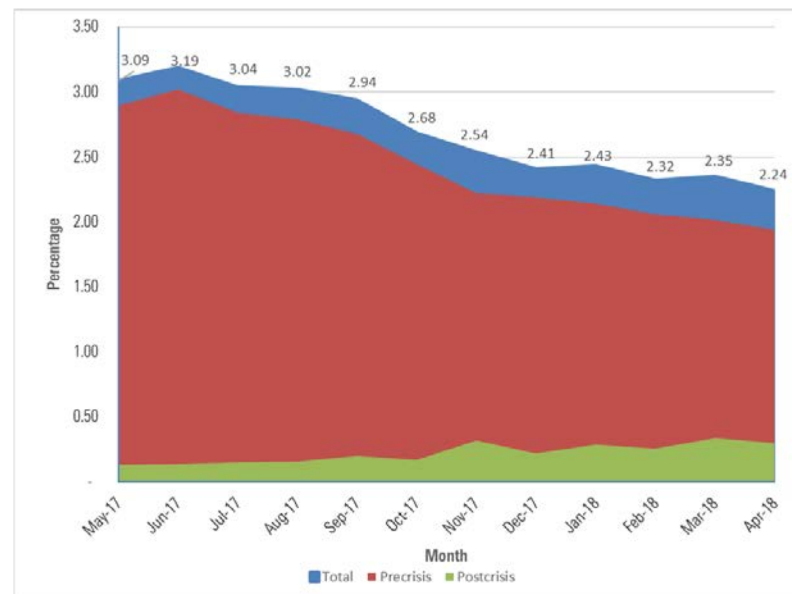
After contracting during the first quarter of 2018 spreads on new issuance CMBS bonds began to widen during the second quarter, according to Commercial Mortgage Alert. Spreads on 10-year AAA rated

conduit bonds, which averaged 80 basis points over swaps for the previous 52 weeks, were at 83 basis points over swaps as of June 6, an increase of 4 basis points from a week earlier. The widening at the BBB- level was similar; having averaged 356 basis points over swaps for the past 52 weeks, they were 337 basis points over swaps on June 6, 12 basis points wider than a week earlier. Regardless, we don't see a clear commercial real estate-specific catalyst that would send spreads wider.

Fewer Delinquencies

Driven by the liquidation activity of specially serviced legacy loans, delinquency rates should remain low. The delinquency rate hit a postcrisis low of 2.24% in April and is down 90 basis points from a year ago. With steady new issuance volume pushing the outstanding balance of CMBS loans higher and special servicers actively resolving or liquidating assets, we believe the delinquency rate will hold below 2.5% for the rest of the year. Delinquencies from deals issued from 2010 through 2018 represent just 0.3% of the CMBS universe, while delinquent precrisis loans account for 1.9%.

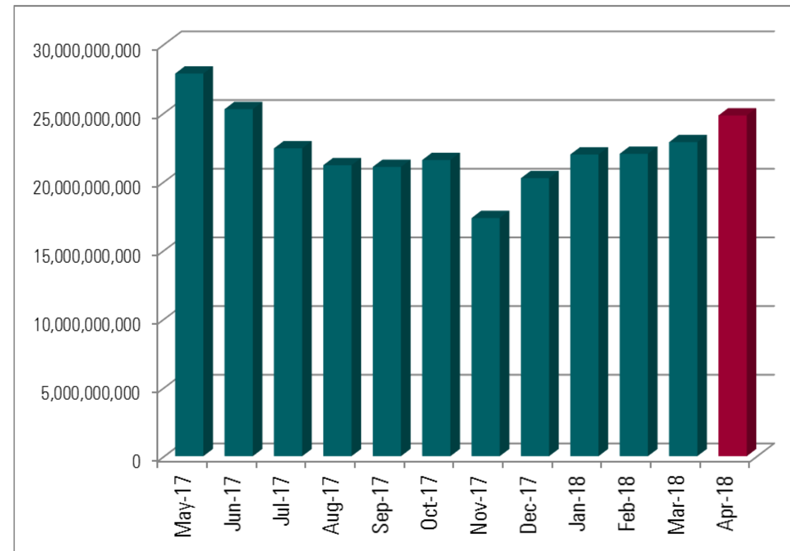
Exhibit 2 Monthly Delinquency Rate



Source: Morningstar Credit Ratings, LLC

However, driven in part by continuing retail weakness, especially in shopping centers with exposure to troubled tenants, the volume of watchlist loans should continue its gradual upswing in the coming month. The wave of retail bankruptcies that began in 2017 and has continued into 2018 could lead to higher vacancy rates over the next year. In addition, consolidation in the grocery and apparel sectors could result in further store closures, especially at Class B and C assets.

Exhibit 3 Monthly Watchlist Volume ($)



Source: Morningstar Credit Ratings, LLC

The wave of mall defaults should subside in 2018. We have discovered that mall loans tend to default more often at maturity, rather than during the loan term, and fewer mall loans are scheduled to mature over the next few years. As long as cash flow remains above break-even on these assets, mall owners have little incentive to hand properties back to their respective trusts prior to loan maturity and will collect cash flow until then. However, as valuations on Class B and C malls adjust to lower levels of revenue, borrowers are often unable or unwilling to invest additional capital to refinance.

Retail and Office Concerns Remain, Multifamily Secondary Markets to Outperform

Morningstar expects property fundamentals will remain stable in the coming year. While there may be some pockets of risk, continued economic growth should buoy demand across most sectors. The industrial sector may be the prime beneficiary, and the multifamily, hospitality, and office sectors may slow after several years of gains and more new construction. Retail could be at higher risk, as the industry consolidates and attempts to cope with the increased competition from online retailers.

While talk of a retail apocalypse is likely overblown, we have concerns for the sector in 2018. The wave of bankruptcies in 2017 has increased vacancy rates. In addition, consolidation in the grocery and apparel sectors could result in further store closures, especially at Class B and C assets. Grocery-anchored properties could be of particular concern as **Amazon** AMZN, via its Whole Foods acquisition, competes more heavily against the traditional players, and discounters, like Aldi and Lidl, expand their presence in the United States. Lenders have traditionally held the view that grocery-anchored centers are less risky assets, allowing for smaller risk premiums in capitalization rates and higher leverage. This paradigm may shift as margins in the industry are further compressed and the Amazon effect could shrink size needs over time.

Other anchors that affect CMBS loans include Bon-Ton, which began liquidation sales in April, and Toys 'R' Us, which started closing down its U.S. operations in March. Our ongoing concerns include office supply chains—Staples and Office Depot—**Macy's** M, JCPenney, Sears/Kmart, and PetSmart. Although high-quality assets will likely have little difficulty in backfilling the spaces left vacant as these chains shutter stores, Class B and C assets may have more persistent vacancy.

Meanwhile, we are most cautious on the office sector given a combination of the late stage corporate credit cycle, less demand as companies become more efficient, and potential disruption from technology, reducing space requirements. Further, new construction in the office market may weigh on occupancy in the coming year. CBRE projected 73 million square feet in new office space in 2018, the highest level since 2008. While economic growth should help maintain strong absorption, this likely signals a turn in the market. Through 2021, CBRE forecasts the national vacancy rate will rise to 14.8% from 13.0% as of 2017. The increased availability may slow rent growth, particularly in markets that are seeing the greatest increase in supply. The four most active construction markets are New York, Washington, D.C., San Francisco, and Seattle.

On the other hand, the multifamily sector has been a star performer in this economic cycle but may take a breather after several years of strong growth. Apartment owners had reasons to cheer as millennials eschewed homeownership in favor of rentals and improved multifamily fundamentals across the country. According to the Federal Reserve Bank of St. Louis, the U.S. homeownership rate bottomed out at 62.9% in second-quarter 2016 from about 69% before the crisis. In addition, between 2010 and 2017, the national vacancy rate dropped to 5% from over 7% according to CBRE Econometric Advisors, while asking rents soared. However, the average asking rent growth has since stabilized to a more sustainable 2.0% after topping out 4.6% in 2015, and CBRE projects a more moderate annual rent growth of 0.4% over the next two years as demand in gateway markets slows. Secondary markets with weaker supply growth and stronger growth in professional services employment are expected to outperform gateway markets in demand growth. Among markets topping the rent growth forecast are Orlando, Florida; Oakland, California; Colorado Springs, Colorado; and Sacramento, California, while CBRE forecasts lower-than-average rent growth for gateway cities such as New York, San Francisco, Washington, D.C., and Chicago. Primary coastal markets such as Miami, San Diego, and Seattle will lag, according to CBRE.

Guarded Optimism

Despite macro catalysts that could tap the brakes on the CMBS market, borrowers seeking to lock in low rates should help maintain the robust volume of CMBS issuance. Meanwhile, a growing number of yield-hungry investors tied to large projects too capital intensive to finance via other lending vehicles will likely turn to CMBS. The lower tax rate stemming from the recently passed GOP tax legislation will provide additional incentives to partake in acquisition and development activity, while Morningstar expects spreads and the delinquency rate to hold steady. M

Basic Materials: Overpriced, With Significant Downside Ahead for Commodities

Few basic materials stocks currently offer risk-adjusted return potential amid our negative outlook for commodity prices.

By Andrew Lane
Director of Basic Materials,
Equity Research

- On a market-capitalization-weighted basis, our basic materials coverage trades at a 25% premium to our estimate of intrinsic value, remaining the most overvalued sector. Our bearish perspectives on most mining and metals companies are the primary drivers of this.
- Miners and industrial metals companies we cover remain substantially overvalued, reflecting our expectation of a structural change in demand growth from China as its economy matures and makes the transition toward less commodity-intensive and more consumption-driven growth.
- Gold is among the few mined commodities that isn't directly tied to the fortunes of Chinese fixed-asset investment, but as the U.S. Federal Reserve continues to pursue rate increases, prices look primed to fall. Higher inflation has buoyed gold prices but should only strengthen the central bank's resolve.
- Unfavorable weather conditions weighed on first-quarter results for many of the agriculture companies we cover, as a delayed start to the U.S. planting season reduced sales across every crop input category. While seed sales should bounce back in the second quarter, we expect planters to use less total nitrogen and crop chemicals in 2018 as the late start reduces midseason application volumes. However, stronger potash demand outside of North America should more than offset stagnant or slightly reduced demand in North America.
- The **Bayer** BAYRY acquisition of Monsanto closed in June after receiving all regulatory approvals. All major agriculture deals from companies under our coverage have now closed.
- U.S. construction activity has continued to gain momentum during the first quarter, with housing starts following builder confidence higher. However, lumber companies look expensive following short-term supply disruptions. We remain optimistic on long-term infrastructure spending, leading to positive outlooks for aggregate and cement companies.

The Trump administration's imposition of steel and aluminum tariffs made waves early in 2018, driving share prices for steel and aluminum producers sharply higher. Although we've increased our forecasts for near-term U.S. steel prices and the U.S. Midwest aluminum premium, we maintain a negative long-term outlook for both industries. We expect substantial global overcapacity will cause most industrial metals companies to fall short of earning their cost of capital over the decade to come. Additionally, with the tariff program now in place, we contend that all near-term positive catalysts have now been exhausted and we see asymmetrical downside risk due to our outlook that both steel and aluminum prices will decline materially in the years to come.

On the demand side, the key factors underpinning our bearish outlook are our below-consensus forecast for Chinese fixed-asset investment and fading benefits from the Chinese stimulus. While some may look hopefully upon India to pick up the slack, we believe India remains several years away from being the next major driver of global metals consumption. On the supply side, we expect Chinese structural

overcapacity to remain in place for both steel and aluminum, as elevated metals prices have created incentive for the addition of new supply.

With few exceptions, we still see mined commodity and miner share prices as overvalued, propped up by the sustained Chinese stimulus. Iron ore's relative buoyancy since early 2016 is emblematic of most industrial commodities. Recent conditions have been highly favorable for miners, particularly the bulk miners, as exemplified by 2017 adjusted earnings for **Rio Tinto** RIO, which were up nearly ninefold from 2015 levels.

We do not expect this to last. With China's credit growth slowing, we still expect mined commodity prices for products such as copper, iron ore, and alumina to fall materially and for share prices to follow. Accordingly, the miners we cover are substantially overvalued. We expect a structural change in demand growth from China as its economy matures and makes the transition toward less commodity-intensive and more consumption-driven growth. High-cost miners and those with outsize exposure to iron ore and coking coal tend to look the most overvalued.

Gold is among the few mined commodities that isn't directly tied to the fortunes of Chinese fixed-asset investment. Despite the Fed's ongoing rate hikes and balance sheet reduction, gold investment in exchange-traded fund holdings remains as high as it did when rates were meaningfully lower. As real yields on U.S. Treasuries and other safe-haven asset prices rise, the opportunity cost of holding gold will rise. Through the second quarter, however, prices have hovered around $1,300 per ounce.

On the back of weak investment demand, we forecast that gold prices will fall to $1,225 per ounce by the end of 2018. Nevertheless, we still believe gold has a promising future, and we forecast the nominal gold price to recover to $1,300 per ounce by 2020. We expect that in the long term, Chinese and Indian jewelry demand will fill the gap left by waning investor demand. However, the rise of consumer demand will take time, which points to downside risk in the near term. Although we see limited opportunities in gold miners, we consider **Goldcorp** GG undervalued, as we believe execution risk surrounding its 20/20/20 growth plan is overstated. This plan aims to boost production and reserves while cutting costs by 2021.

Strong global demand for potash should support prices throughout 2018. So far this year, reduced supply has boosted potash prices. In potash, new delays via lower-than-expected potash production from both **Sociedad Quimica Y Minera De Chile** SQM and K+S have led to a tighter market. We expect this dynamic to continue throughout the year, and we've raised our 2018 potash price forecast to $270 per metric ton. Our long-term price forecast for potash is unchanged at $270 per metric ton.

From a valuation standpoint, potash producers are trading at a larger discount to fair value than the rest of our ag coverage. This is primarily because of our long-term outlook that potash prices will remain flat, in real terms, while we forecast real price declines in nitrogen and phosphate. **Nutrien** NTR and **Mosaic** MOS currently offer the most upside based on current prices.

The acquisition of Monsanto by Bayer closed in June after receiving all necessary regulatory approvals. In order to gain regulatory clearance, Bayer had to divest a portfolio of agriculture assets that generated around $2.2 billion in sales in 2017 primarily to **Basf** BASFY.

The seasonally slower first quarter yielded considerable catch-up building activity. Single-family construction has gradually gained momentum, while multifamily activity has strongly rebounded in recent months. We expect total starts to climb nearly 8% in 2018 to 1.3 million units as homebuilders capitalize on buoyant confidence and higher prices.

Over the past year, lumber and panel prices have surged because of short-term supply disruptions. Hurricanes in the Southeast, wildfires in the Northwest, and considerable rail congestion throughout Canada have reduced the amount of product coming to market. This has launched prices beyond what we believe will be sustainable for at least another two years, despite industry operating rates falling thus far in 2018. We believe valuations for wood product companies are currently stretched, despite our bullish long-term outlook. As these disruptions ease later in the year, we expect pricing to fall by 20%–30%.
However, our long-term outlook for housing is bright. In the wake of the Great Recession, adults in their 20s and 30s are living with family to record-setting ages. We expect them to eventually break out on their own as they begin to form families, driving greater demand for homebuilding. A combination of restrictive trade policies implemented by the Trump administration, an already-stretched North American lumber market, and constrained panel capacity will lead product pricing higher in the coming decade, as supply struggles to keep up with rising demand. This will lift cash flows for lumber companies **Canfor** CFP and **West Fraser Timber** WFT and panel companies **Norbord** OSB and **Louisiana-Pacific** LPX.

Although U.S. nonresidential construction activity has remained strong, U.S.-focused aggregates and concrete share prices declined by more than 10% through the end of April. Since then, shares have started to recover and we still see some upside in the sector. We expect strong underlying demand will continue to drive volume gains, price increases, and margin expansion. We see value in **Martin Marietta Materials** MLM and **U.S. Concrete** USCR, as current share prices underestimate the significant profit growth to come.

Top Picks

Cameco CCJ
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: $17
Fair Value Uncertainty: High
5-Star Price: $10.20

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 decade-long 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 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 is easing with production cuts announced by Cameco and NAC KazAtomProm. We expect global uranium demand to grow 40% by 2025, 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 long-term uranium prices will rise from about $30 a pound in May to $65 a pound (constant dollars) by 2021, 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: $83
Fair Value Uncertainty: High
5-Star Price: $49.80

Compass Minerals produces two primary products: deicing salt and sulfate of potash, a specialty fertilizer. 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 geological and geographical advantages. The company also sits toward the low end of the cost curve in specialty potash. While the Goderich mine has experienced some near-term operational challenges, we ultimately expect a rebound in Compass' profits as the mine is fully restored and the company's cost-reduction plan comes to fruition.

We see multiple near-term catalysts that should boost Compass' salt profits and drive share prices higher. Based on our analysis of more than 120 years of weather history, winter weather exhibits mean reversion tendencies over a multiyear period. After a couple of mild winters in Compass' important U.S. Midwest markets, the 2017–18 winter bounced back with above average snowfall and higher salt demand. Historically, harsher winters have led to increased deicing salt prices as local governments need to replenish inventories. This should provide a much-needed profit boost for Compass. 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 reduce Compass' future salt expenses on a unit production basis.

Martin Marietta Materials MLM
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: $265
Fair Value Uncertainty: High
5-Star Price: $159

Martin Marietta's share price declined through the first few months of 2017 because of an underwhelming Trump infrastructure plan that lacked specifics. However, we believe this created an attractive entry point. Despite near-term challenges, the outlook for construction activity for residential, nonresidential, and road projects remains strong. As a result, we expect Martin Marietta's EBITDA to surge 140% by 2022, as strong demand drives higher volume and supports robust price increases.

A recovery in construction activity is still in the early stages, as U.S. aggregates consumption remains below prerecession levels. Moreover, current demand doesn't include the backlog of projects created from the recession and years of underspending on infrastructure. Historically, limited funding has prevented this demand from being unleashed, but we think the money will be there because of medium-term funding through the FAST Act and bipartisan support for infrastructure that should deliver longer-term funding. M

Andrew Lane does not own shares in any of the securities mentioned above.

Communication Services: Undervalued With a Case of Merger Fever

U.S. telecom consolidation is in the works with a T-Mobile-Sprint merger.

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

- Overall, we view the communications services sector as undervalued at a market-cap-weighted price/fair value of 0.82.
- U.S. telecom consolidation is in the works with a T-Mobile-Sprint merger.
- In Europe, telecom is focused on convergence and increased build-outs of fiber and 4G.
- In telecom and cable, we continue to see migration from traditional pay-TV providers to over-the-top, or OTT, offerings.

In the U.S., after two prior failed attempts, **T-Mobile** TMUS and **Sprint** S have reached a long-anticipated agreement to merge the two firms, with T-Mobile retaining its brand and management team as part of the planned merger. The deal will likely face hefty regulatory scrutiny, as it shrinks the number of nationwide wireless telecom providers from four to three. Yet both T-Mobile and Sprint are behind the industry leaders, **AT&T** T and **Verizon** VZ, and a deal would be a panacea for Sprint in particular as the business strives to keep pace. We currently believe the deal has a 50/50 chance of passing through the current regulatory environment, as the loss of a fourth player may lead to higher wireless data prices for consumers in the United States. T-Mobile and Sprint touted the number of U.S. jobs that would be added by a merger, perhaps in an attempt to pre-emptively alleviate any regulatory concerns, yet job additions would likely reduce the combined firm's ability to extract cost savings, and we're not yet convinced that the comments made by both T-Mobile and Sprint will be enough to sway regulators. We don't expect a regulatory decision on this deal until 2019, but it would obviously shift the U.S. telecom landscape if consummated.

Elsewhere in telecom-related mergers and acquisitions, we have seen competing bids from **Twenty-First Century Fox** FOXA and **Comcast** CMCSA in attempts to acquire U.K. satellite TV provider **Sky** SKY. Although we were previously skeptical of a bidding war between the two firms for Sky, recent regulatory announcements suggest that Fox's prior advantages when it comes to buying Sky (such as being the first bidder and already owning 39% of Sky shares) have been essentially nullified. Complicating the matters further is **Walt Disney**'s DIS bid to acquire assets from Fox, although the U.K. recently announced that if Fox were to gather enough support from shareholders to buy Sky, and Fox were then able to sell Sky News to Disney, the Fox-Sky merger might be more likely to receive regulatory approval. Nonetheless, we note that the latest price to acquire Sky is at our stand-alone fair value estimate for Sky, so any higher bids from here may result in a "winner's curse" for either Fox or Comcast.

In Europe, the main telecom themes still remain the move to convergence, along with increased build-outs of fiber and 4G. Spain has long been the leader in convergence, with around 80% of broadband customers subscribing to a wireless service from the same company. France has also been pushing convergence but isn't as far along. Germany was slower at pushing convergence but is pushing it

increasingly. Now even the U.K. and Italy, which have been big laggards, are starting to offer converged services. The movement toward convergence is enhanced by the faster broadband speeds being offered by fiber. Historically, cable-TV operators have enjoyed an advantage with broadband speeds, owing to networks that were designed for video and include more fiber and coax rather than copper. However, in order to better compete, telecom operators are increasingly laying fiber that provides equivalent speeds to the cable operators. Europe has been much slower at moving to 4G than the U.S. or Asia, but 4G has really taken off in the past year. However, penetration rates are still behind the U.S. and parts of Asia. Thus, we expect the transition to 4G to continue as operators extend their 4G networks further. While the transition to 4G continues in Europe, the U.S., Japan, and South Korea are preparing for the jump to 5G. Several companies in these countries have discussed initial offerings by the end of this year.

For pay-TV distributors, we continue to see migration from traditional providers, such as Comcast and **Dish** DISH, to the newer OTT providers, such as Sling TV, DirecTV Now, and YouTube TV. We believe that the more concentrated bundle and the lower price point will continue to attract cord-shavers and possibly even some cord-cutters. The major OTT providers now have over 4.5 million subscribers in the U.S., and we project that this number will continue to increase. For traditional video providers with a broadband offering, we expect these providers like Comcast to shift margin from the video piece of the bundle to the broadband side. While Dish is benefiting from this transition because of its Sling TV product, the margins on OTT pay TV are considerably lower and the firm lacks a competitive broadband offering. Among media companies, wide-moat firms such as Disney and Fox have placed their most important channels across all major OTT TV platforms, while smaller firms like **Discovery** DISCA and **Viacom** VIAB have struggled to gain carriage. We believe that these smaller firms will remain locked out, particularly if the new OTT platforms continue to add new subscribers.

Top Picks

Telefonica TEF
Star Rating: ★★★★★
Economic Moat: Narrow
Fair Value Estimate: $15
Fair Value Uncertainty: High
5-Star Price: $9

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 at a wide discount to our fair value estimate.

BT Group BT
Star Rating: ★★★★★
Economic Moat: Narrow
Fair Value Estimate: $24
Fair Value Uncertainty: High
5-Star Price: $14.40

While narrow-moat BT Group has had some issues in the past two years that caused its stock to decline, we believe the sell-off is overdone. BT is the incumbent telecom operator in the United Kingdom. In 2016, it acquired EE, the largest wireless telecom operator in the country. The company now has the largest fixed-line telephone, broadband, and wireless telephone subscriber bases in the country. Additionally, it is the only operator in the U.K. that owns both a retail fixed-line and wireless network. We believe this provides BT with an advantage in selling a converged package of these services plus pay TV. The company has been slow to market its converged services, but now that it has reached an agreement with telecom regulator Ofcom regarding Openreach, its U.K. business that owns its fixed-line network and wholesales access to it to other operators, we expect a more aggressive marketing push into converged services during calendar 2018.

BT has been hurt by the widening underfunding of its pension plan as interest rates have declined in the U.K. We think interest rates have bottomed and they are more likely to increase from here. We believe the benefit on the pension will be greater than the hit on higher interest on its bonds, the reverse of what happened as interest rates declined. We also think the company has dealt with its problems in Italy and will be able to improve its revenue in its global services division. The market appears to believe the problems BT has seen will continue and potentially get worse, whereas we believe business can improve over the next few years. In the meantime, the stock yields 6.3% and the company has increased its dividend for each of the past seven years. Additionally, as it is a U.K.-domiciled company, there is no foreign tax withholding on the dividend.

Comcast CMCSA
Star Rating: ★★★★
Economic Moat: Wide
Fair Value Estimate: $42
Fair Value Uncertainty: Medium
5-Star Price: $29.40

Like its traditional pay-TV distributor peers, Comcast has suffered from the growth in cord-nevers and cord-shavers, particularly as OTT offerings like Sling TV, DirecTV Now, and YouTube TV gain traction. This ongoing deterioration in pay-TV economics has negatively affected the share price of Comcast and its peers. However, the combination of the hostile bid for Sky and the potential bid for the Fox assets has had a larger impact, as shares are down over 18% since the Feb. 27 announcement of the Sky offer. We believe that a shift in focus toward M&A from returning capital to shareholders has spooked some investors. While management appears ready to ramp up leverage at the firm to acquire both of its

targets, we currently project that the original bidders (Fox/Disney in the case of Sky, and Disney for the Fox assets) will prevail over Comcast.

After the M&A headlines disappear, we believe Comcast is the best-positioned U.S. communications firm. Irrespective of the challenges faced by traditional pay TV, broadband demand continues to accelerate. We believe Comcast is better situated to benefit from this trend, owing to its faster Internet speeds, than many of its telco peers. The current regulatory environment is favorable because of the reversal of Title II and net-neutrality rules. With the threat of pricing regulation diminished, Comcast can potentially offset deteriorating pay-TV economics with higher broadband prices. M

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

Consumer Cyclical: The Themes Driving Retail's Rebound

Amazon continues to linger as a disruptive threat, but the market is coming around to those retailers offering specialization, convenience, and experience.

By R.J. Hottovy, CFA
Senior Equity Analyst

- Consumer cyclical sector valuations remain slightly elevated with a weighted average price/fair value ratio of 1.05, edging higher from last quarter's 1.04. We attribute this to healthy consumer sentiment, low unemployment rates, and stable asset market valuations.
- We've long held the belief that those physical retailers that offer a combination of specialization, convenience, and experience were best positioned to compete in an Amazon world. While concerns about potential disruption from Amazon linger, we've seen a rebound among several traditional retailers that have embraced these qualities in 2018.
- We continue to have a favorable view of the specialized auto part retail industry's trajectory. Although growth in miles driven has slowed and fuel prices are rising, we believe that low unemployment and fleet characteristics should propel industry results.
- Retailers that have shown a willingness to invest in convenience and in-store experience—Williams-Sonoma and Nordstrom come to mind—continue to outperform peers across multiple channels.

The market continues to favor consumer cyclical names, with the group continuing to trade at a weighted average price/fair value of 1.05 (roughly in line with the 1.04 ration the group traded at last quarter). We continue to attribute the bullish market sentiment on a number of factors, including healthy consumer sentiment in the U.S. and many other developed nations, low unemployment rates and wage rate increases that are helping to drive middle class consumption globally, and equity and housing market conditions that have been conducive to wealth effect spending.
However, we believe market valuations also reflect the fact that consumer cyclical companies are starting to reap the benefits of recent omnichannel investments. We've long held the belief that those physical retailers that offer a combination of specialization, convenience, and experience were best positioned to compete in an **Amazon** AMZN world. While it's not easy for a retailer to successfully blend each of these qualities, we still believe those players that can combine a specialized product assortment (including retailers that offer unique, often hard-to-ship products and in-store personnel that would be hard to replicate); an integrated, convenient approach to ordering, fulfillment, and logistics across all channels (in-store, mobile, and online); and experiential retail environments are the best positioned to at least keep Amazon at bay, at least over the immediate future. For this reason, we believe the market had previously overreacted on several names across the retail sector, and not giving credit to those operators who understand how the retail space continues to evolve and will use the potential of competing with Amazon as a way to evolve their businesses. However, we're seeing a rebound in many of the names that have embraced specialization, convenience, and experience.

We believe the auto parts category is a perfect example of how specialized retailers can stay ahead of Amazon. Retailers like **Advance Auto Parts** AAP have prioritized improving part availability and service

levels. On its most recent quarterly update, Advance management noted that its do-it-yourself units sold per transaction has risen for eight straight weeks, which is important as management indicates that a 10-basis-point improvement results in roughly $70 million of incremental segment sales. While the difference between Advance and its peers (1.9–2.0 units versus around 2.4) still reflects a long-standing performance gap, the momentum suggests Advance's changes are resonating in a way that can boost revenue.

We continue to have a favorable view of the auto part retail industry's trajectory. Although growth in miles driven has slowed (1% over the past 12 months as of February versus 3% in 2016) and fuel prices are rising, we believe that low unemployment and fleet characteristics should propel industry results. We concur with **AutoZone** AZO management's view that gas prices would have to rise past $4 per gallon for the sector to be significantly affected, particularly as the industry rebounds from the relatively small model year 2008–11 cohort of vehicles' move into sellers' sweet spot. As repair needs grow for 2012 and newer cars and trucks, we expect industry conditions to strengthen, with large retailers showing incremental benefit from a consolidation dynamic driven by their superior standard of service versus subscale peers. Furthermore, as retailer results continue to indicate that sector pricing dynamics have not changed, we remain convinced that digital-only retailers such as Amazon do not pose a material threat to scaled incumbents, at least over the next several years.

Convenience is also becoming as critical as purchase price when consumers are making purchasing decisions. Fifty-eight percent of consumers surveyed by KPMG said that they shopped online because they had the ability to shop 24/7. Another 40% said that it saved time, while 39% said they used the distribution channel to avoid going to shops. With a study by Harris Group showing that 78% of millennials prefer to spend more money on experiences than on material things, it makes sense that they would want to buy the material goods they do need as efficiently as possible because they derive little pleasure from the activity. In fact, 67% of millennials and 56% of Generation X prefer to shop online rather than in-store, according to BigCommerce. **Shopify** SHOP, citing a 2016 Walker Sands Future of Retail Study, highlights that 88% of respondents said free shipping was more persuasive than easy returns or same-day shipping. Retailers have heeded customer sentiment, and free shipping availability has been on the rise. We think that steady growth in the number of retailers offering free shipping will drive further e-commerce purchases, as the most significant price differential is removed. We expect transactions with free shipping to grow 2% on average annually, reaching 70% of transactions by first-quarter 2021 from 48% in first-quarter 2013, with the increase in transactions per person contributing to our 15% average annual growth in e-commerce forecast over the next five years. Although free shipping is one of consumers' largest decision factors, other distribution-related conveniences are important. The Shopify article also highlighted that 69% of consumers would be more likely to shop online with one-day shipping, 68% with free returns/exchanges, 58% with easier online returns, 49% with same-day shipping, and 44% with easier in-store returns.

A good example of a retailer that has embraced evolving consumer views on convenience is **Williams-Sonoma** WSM. The retailer has carved out a solid niche in the fragmented $116 billion domestic home furnishing market, launching most of its brands organically in underserved segments. The firm's brand

intangible asset has historically been the supporting factor in its top- and bottom-line growth, as its ability to drive repeat business relies on customer loyalty and smart marketing and merchandising. Relative to its peer group, Williams-Sonoma is in good position to outperform its competitors and hold its share; we think the firm still has access to some of the best analytics in retail.

Williams-Sonoma relies on its e-commerce business (53% of total 2017 sales) to build the brand cost-effectively and leverage costs, driving operating margin improvement (e-commerce EBIT margins are 22% versus 9% in retail). The firm should enjoy opportunities to build the brand globally while improving the cost structure, thanks to an improving supply chain and distribution network as a result of direct sourcing and furniture delivery operations. Additionally, the firm's expanding global footprint could help improve sourcing and distribution costs longer term, improving operating margins. Global expansion allows access to a wider profile of consumer preferences, lending to better local merchandising and marketing, which could facilitate higher unit sales as supply increasingly matches demand.

Last, customer experience is often thrown out by retail management teams, but we've found that very few retailers have been willing to make the investment or operational changes necessary to build a retail model that stands out from peers. In our opinion, **Nordstrom** JWN is one of those companies, building a brand worthy of significant pricing power through a best-in-class service model, a localized curated product selection, and unique in-store offerings capabilities. Evidence of brand power is featured in Nordstrom's 2% average annual comp sales growth over the past five years versus **Macy's** M moderately negative comp sales growth and **Kohl's** KSS flat growth. This is despite continued overall U.S. department store retail market share declines (from 5.2% of retail sales in 2010 to 3.0% in 2017). We think much of this results from a curated and differentiated product selection, featuring partnerships such as TopShop at Nordstrom and Madewell, as well as the dual full-price and off-price offering.

Notably, Nordstrom has been able to maintain its price points and reputation for superior service and in-store experience despite its aggressive rollout of off-price Nordstrom Rack. Successful balance and differentiation of the two brands has enabled Nordstrom to take advantage of the high-growth off-price retail space without cannibalizing its core business. Nordstrom Rack is an important source of new customers, adding 6 million shoppers in 2017. We believe this channel has been a rich source of younger purchasers. It has also allowed Nordstrom to maintain industry-leading inventory turns (with about 75 days inventory in 2017, versus over 100 at Macy's and Kohl's), which enables higher full-price selling at Nordstrom and higher conversion rates with the increased stream of new products. This inventory capability enhances the brand's reputation as a cutting-edge source of new trends, in our opinion.

Top Picks

L Brands LB
Star Rating: ★★★★★
Economic Moat: Wide
Fair Value Uncertainty: Medium
5-Star Price: $42

Although wide-moat L Brands still has work ahead, we believe that improving comparable sales growth throughout fiscal 2017 (from a 9% decline in the first quarter to 2% growth in the fourth quarter) and easing gross margin pressure (from a 280-basis-point decline to 37.1% in the first quarter to a 100-basis-point decline to 42.3% in the fourth quarter) point to a recovery in progress. We continue to believe that L Brands can return to comparable sales growth in fiscal 2018 and that gross margin pressure will ease with the comping of swim and apparel exits and mix challenges.

In our opinion, L Brands has a wide economic moat, with brand strength in a category characterized by high levels of consumer brand loyalty and prioritization of quality and fit over price. In the near term, we see multiple catalysts for an inflection point in sales and margin performance with discontinued categories being comped, bralette penetration stabilizing, Victoria's Secret Beauty improving, and new structured bra introductions. Further, we believe the company has a healthy long-run growth opportunity in China. With recovering comparable sales pointing to intact brand strength, we think the current discount to our $69 fair value estimate is unjustified and view this as an attractive entry point for investment.

Hanesbrands HBI
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Uncertainty: Medium
5-Star Price: $20.30

We have a high degree of confidence in the defensibility of Hanesbrands' competitive position, given advantages that are difficult for competitors to replicate: the efficiency of 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 the company is poised to post significant operating margin growth through recognition of synergies ($85 million in 2018 and 2019), $100 million in net cost savings from Project Booster, and $30 million–$40 million in manufacturing efficiencies.

The company operates 50 manufacturing facilities, mostly in Asia, Central America, and the Caribbean Basin. In 2017, more than 70% of units sold were from own plants or those of dedicated contractors. When Hanesbrands can internalize high-volume styles, we estimate that it saves as much as 15%–20%.

Utilizing this manufacturing platform, Hanesbrands has been successful in making acquisitions to drive earnings growth.

Hanesbrands' top line has come under pressure from secular trends to online sales (only 11% of revenue globally was online in 2017, and retailers were hit with bankruptcies and downsizing). 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 transition to e-commerce is proceeding well, with the online revenue growth rate hitting 22% in the fourth quarter of 2017. As online sales increase as a mix of business (we model penetration reaching the midteens percentage of total sales in 2018), we think total company growth will rebound and see 1% organic revenue growth in 2018 (versus a slight decline in 2017) as well as contributions from acquisitions.

Myer Holdings MYR
Star Rating: ★★★★
Economic Moat: None
Fair Value Uncertainty: High
5-Star Price: AUD 0.40

For investors seeking exposure to the Australian department store sector, no-moat-rated Myer provides the greatest leverage: All of Myer's operating earnings are generated by department stores. However, times are tough for Australian department stores, and this pressure is unlikely to let up soon. We expect Amazon to prove similarly disruptive to incumbent retailers in Australia as in the U.S., compounded by a continued decline in the sector's relevance to consumers as they shift their spending to entertainment, leisure, and specialty shops.

Myer is undeniably in a hard spot, but management is following a clear strategy to cope with the challenges facing the sector. Key strategic targets include a more concentrated physical footprint, greater cost efficiencies, productivity gains, and investment in online capabilities to drive sales and profitability. M

R.J. Hottovy, CFA does not own shares in any of the securities mentioned above.

Consumer Defensive: Attractive Opportunities in Competitively Advantaged Stocks

Lackluster fundamentals and competitive pressures persist but fail to warrant the recent retreat in shares.

By Erin Lash, CFA
Director of Consumer Equity Research

- Across our global consumer defensive coverage universe, valuations have continued to languish, trading at a 5% discount to our fair value estimates on a market-cap-weighted basis.
- Despite a focus on extracting costs, top-line acceleration has remained elusive across the sector. As a result, M&A again took center stage, including **Nestle**'s NESN purchase of **Starbucks**' SBUX consumer products range, **Procter & Gamble**'s PG acquisition of German-based **Merck**'s MRK consumer healthcare brands, and **Walmart**'s WMT tie-up with Flipkart (following the sale of its Asda business to **Sainsbury** SBRY).
- Further, this tepid growth has piqued activist investor interest.

Valuations throughout the consumer defensive sector have retreated, now trading 5% below our fair value estimates. We posit that the combination of lagging fundamentals and rising interest rates (and subsequently slightly less attractive dividend yields) have weighed on shares, but we don't believe this should prevent investors from building a position in these competitively advantaged names.

While margin improvement has taken top billing over the past several years, top-line trajectories have generally remained quite stagnant. And we don't believe these pressures stand to abate. The growth of the hard discounters in Europe, Australia, and increasingly in the U.S., and the emergence of the e-commerce channel, are lowering barriers to entry in the consumer defensive space and intensifying price competition. Meanwhile, the consumer is looking for alternatives to the big brands, either seeking better value from unbranded alternatives, or trading up to more niche, artisan products such as craft beer.

Further, in terms of profitability, the trajectory of margin gains for a number of operators has not been as pronounced of late. As such, while we view cost savings efforts as prudent in the aggregate, we think the combination of increased brand spend (both in terms of product innovation and marketing support) combined with inflationary trends (both with regards to commodities and transportation and logistics costs) stand to constrain profit potential.

Partially stemming from the pressures on organic financial gains, a number of firms have opted to seek out inorganic growth opportunities. For one, wide-moat Nestle inked a deal with Starbucks to acquire the firm's consumer product offerings. We surmise that expanding into premium coffee could position it to reignite its sales base, as innovation opportunities are more plentiful in the premium segment. And that as a result, stronger price/mix could ensue, something that Nestle has clearly been lacking in recent quarters.

Further, **Mondelez** MDLZ continues to act as a consolidator, announcing its intentions to add Tate's Bake Shop (a domestic premium cookie manufacturer, with a portfolio centered on using simple ingredients). Despite the immaterial size, we believe the strategic rationale of the tie-up extends beyond building its presence in an attractive space to assisting Mondelez to grease the wheels of its own innovation cycle. In our view, firms throughout the industry have been tripped up by not responding to evolving consumer trends in a timely fashion. Conversely, nimbler niche startups like Tate's haven't been constrained by this factor, as evidenced by the fact that its retail sales through measured channels have soared 40% during the first three months of 2018 and have quadrupled from five years ago.

On the retail defensive side of the aisle, Walmart was also quite active in the quarter, announcing the sale of its U.K. grocery business (Asda) and the purchase of a 77% stake in Flipkart (a leading e-commerce retailer based in India). We believe that this showcases the firm's efforts to prioritize building out its footprint in faster-growing regions and online at the expense of ultra-competitive markets, where it has struggled to carve out an edge. From our vantage point, each of these moves stands to level the playing field with one of its biggest foes in **Amazon** AMZN.

But this lack of sustainable fundamental improvement has also made the sector ripe for activist investor interest. In this vein, Jana Partners disclosed a nearly 10% stake in **Pinnacle Foods** PF. Jana (which is pushing for a sale but may also seek an altered board composition or cost structure) has long sought change in food-related businesses, notably taking a stake in Whole Foods before its 2017 sale to Amazon. We believe its **Conagra** CAG stake could presage an outcome for Pinnacle, as the two food manufacturers have long been seen as potential merger partners. We believe the two frozen food portfolios (including Pinnacle's Bird's Eye lineup and Conagra's Healthy Choice and Marie Callender's brands) would be complementary, and could deliver value given Pinnacle's successful premiumization efforts that extend to its baking and gluten-free offerings. Regardless of outcome, we contend that the Jana push aligns with a consolidation theme in packaged food that should continue.

And although we don't believe activist investor Nelson Peltz's recent addition to P&G's board stands to accelerate change, we continue to posit that the proxy battle in of itself will ensure management remains squarely focused on delivering sustainable top-line gains longer term. In this vein, P&G announced its intentions to terminate its healthcare joint venture with no-moat **Teva** TEVA as well as a deal to acquire German-based narrow-moat Merck's consumer healthcare brands for $4 billion (3.7 times TTM sales and 20 times EBITDA). In our view, this tie up stands to replace the scale and technological know-how lost following the dissolution of its joint venture partnership. At just 1%–2% of sales, we surmise this addition evidences management's openness to selectively bolstering its reach in attractive categories (consumer health growing midsingle digits) and geographies. Further, we don't believe management maintains an appetite for more transformational deals. Instead, we think the firm will pursue select acquisition opportunities as a way to enhance its competitive capabilities or grant it entry into less penetrated geographic regions and distribution channels.

Top Picks

Imperial Brands IMBBY
Star Rating: ★★★★★
Economic Moat: Wide
Fair Value Estimate: $53
Fair Value Uncertainty: Low
5-Star Price: $42.40

Tobacco stocks are out of favor, with the four large caps under our coverage falling by an average of almost 20%, year to date. Our pick of the group on valuation is Imperial Tobacco, which has derated slightly less than the group after having not fully benefited from the group's rerating last year. Although we regard Imperial as being one of the lowest quality of the large cap tobacco manufacturers, primarily because of its more price-sensitive consumer base and its position as a price taker in many markets, we still believe it has a wide moat because of the low price elasticity of demand and room for price increases in many markets. Although investors have been focused on heated tobacco for the next leg of earnings growth in this space, we think Imperial's wait-and-see approach is sensible, and we believe the value of the first mover advantage is being overestimated by the market. Trading at less than 10 times next year's earnings, the sell-off of Imperial looks overdone, and we think the stock offers an attractive entry point. Absent an acquisition, however, which we think is a low probability event, the rerating in Imperial may be a slow burn, given the deflated expectations around emerging categories and the rising interest rate environment, but with a comfortably covered dividend yield of just under 8%, investors will be paid to wait.

British American Tobacco BTI
Star Rating: ★★★★★
Economic Moat: Wide
Fair Value Estimate: $67
Fair Value Uncertainty: Low
5-Star Price: $53.60

Tobacco stocks have derated this year, and we believe there is upside to British American. It has doubled-down on the combustible business with its acquisition of Reynolds American, and we view Reynolds as an incredibly strong asset in a market with plenty of remaining potential for raising prices. The bigger question for investors, however, is whether the growth of Glo, and its low-margin devices, is contributing to a slowdown in the company's margin expansion trajectory. After the significant pullback in the stock over the past seven months, we now believe this risk is accounted for in the market price. However, with heated tobacco growth beginning to slow, there appear to be few top-line catalysts in the near term.

General Mills GIS
Star Rating: ★★★★★
Economic Moat: Wide
Fair Value Uncertainty: Low
5-Star Price: $47.20

We think the market's confidence in wide-moat General Mills' ability to restore top-line growth has faltered, considering continued softness in volume across the packaged food space as well as skepticism around the acquisition of natural pet food company Blue Buffalo. While the deal carries some inherent risk as General Mills enters a category in which it has limited experience, we remain confident in the firm's ability to efficiently integrate Blue Buffalo and extract cost synergies from combining these operations. We believe General Mills will rely on the same strategy used for its previous acquisitions of niche players, enabling its pet food unit to benefit from its supply chain and distribution capabilities while largely leaving the acquired firm's operating model intact, which we think ensures these niche brands stay in touch with the preferences of their core customer bases. We think this approach has proved successful in the past, as exemplified by Annie's, which has increased distribution around 80% since being acquired in 2014.

Further, we expect General Mills' stringent cost management focus will facilitate additional reinvestment in its brands through research and development and advertising; we expect brand-related spending as a percentage of sales to tick up over the long term, totaling 7% of sales over our forecast, or 180 basis points above General Mills' fiscal 2017, which should support top-line gains as General Mills expands the distribution of Blue Buffalo's fare in mass-market channels. Given its discounted price (we see at least 20% upside to our current valuation) and a 4%-plus dividend yield, we think the stock provides an attractive entry point for long-term investors. M

Erin Lash, CFA, does not own shares in any of the securities mentioned above.

Energy: Despite Geopolitical Wildcards, the Reckoning Is Still Coming for U.S. Shale Producers

The longer the delay, the worse the supply onslaught becomes.

By Joe Gemino, CPA
Equity Analyst

- Crude fundamentals look healthier than they've been for years, largely because of voluntary curtailments from OPEC and its partners. By giving up 1.8 million barrels per day, or mmbpd, combined, this group has engineered a temporary supply shortage in an effort to realign global inventories with long-term averages.
- Helping OPEC's efforts are geopolitical supply disruptions. Venezuela remains in crisis, and its oil production has slumped further after an initial plunge in the fourth quarter of 2017. President Trump's decision to abandon the Iran nuclear accord is likely to widen this year's crude oil supply-demand imbalance, accelerating the decline of global inventories and potentially leaving the market with fewer days of supply on hand by year-end than it has had at any point in the past eight years.
- However, we believe the market continues to underestimate the capacity of the shale industry to throw oil markets back into oversupply. Crude prices have largely held above $65 per barrel for West Texas Intermediate in 2018, which provides attractive economics for many U.S. producers. But the reckoning may not happen as quickly as we previously thought amid supply disruptions. Eventually, we expect pain for oil prices as growing U.S. production serves as the primary weight to tip oil markets back into oversupply.
- Our midcycle forecast for WTI is still $55/bbl. We think oil bulls are failing to recognize the vast potential for further productivity gains from U.S. producers and are unduly worried about prime shale acreage running out more quickly than it really will.
- Despite our bearish outlook for long-term oil prices, we see pockets of opportunity in the oil and gas space. Energy sector valuations look fairly valued at current levels with an average price to fair value estimate of 1.00.

We previously viewed the late 2017 decline in global crude stockpiles as a temporary respite, to be derailed by the shale surge that still looks likely this year. However, economic malaise in Venezuela has triggered precipitous output declines, and it isn't clear how quickly this can be rectified, if at all. The likelihood of hefty outages in Iran has soared now that Trump abandoned the Iran nuclear accord. And other OPEC producers are fanning the flames with even steeper cuts than they originally agreed to. All this creates a supply vacuum this year that can easily offset U.S. growth, however strong, and prolong the illusion that shale isn't a threat. Regardless, oil prices must pare back eventually to prevent catastrophic growth from U.S. shale.

What's obvious by now is that 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 market share to U.S. producers, oil markets have major problems looming on the horizon. Neither is likely to occur.

Geopolitical disruptions have always been a feature of global oil markets, and such disruptions can have a lasting impact. The shortages faced this year by Venezuela (and potentially Iran) may take months or even years to overcome. But neither affects our long-term outlook. We already believe that the growth trajectory of U.S. shale will cause problems for oil markets eventually. Adding rigs and accelerating drilling operations further will only fan the flames. Yet that is the likely response if West Texas Intermediate crude remains in the $65/bbl area.

The U.S. light tight oil rig count has spiked above 650, which is well above the medium level that keeps the market balanced in the long run, setting up a shale surge that could overwhelm the market after 2018. But the industry hasn't recognized the danger. Because of the long lag between adding rigs and seeing a production response, the impact of the most recent additions hasn't been felt yet. And to make matters worse, temporary equipment bottlenecks and labor shortages are still slowing completions and masking shale's growth potential (only 70% of Permian Basin wells drilled in 2017 were completed). When these are resolved, the shale industry will find itself rapidly overheating unless producers start slowing down, and only a drop in oil prices can persuade them to do that. Nothing is ever certain in the world of oil, but a crude awakening for energy investors could very well be near at hand.

Looking past the near term, we expect a midcycle price of $55/bbl WTI. This estimate is based on our cost outlook for U.S. shale production, which we expect to be the marginal source of global supply. Sustainably lower shale breakevens mean the era of low-cost oil is here to stay. Our view on lower shale costs is driven in large part by our expectations for minimal inflation in proppant and pressure pumping costs.

Top Picks

Enbridge ENB
Star Rating: ★★★★★
Economic Moat: Wide
Fair Value Estimate: $50
Fair Value Uncertainty: Medium
5-Star Price: $35

Wide-moat Enbridge represents our Best Idea for investors in the Canadian midstream sector. We see nearly 50% upside in the stock, while on average the Canadian midstream sector looks modestly undervalued. We believe the market doesn't realize the full potential of the company's growth portfolio, which is highlighted by the Line 3 replacement project (Canadian Mainline pipeline expansion). Investors appear to be skeptical that the project will obtain its final approval amid continued protests and opposition. As detailed in our Jan. 22 Select presentation "Best Idea Enbridge Is a Triple Threat," we believe the project will obtain the remaining approval from the state of Minnesota. A final decision is expected by July, which we think will serve as a catalyst for the stock. Accordingly, we expect Enbridge to generate significant free cash flow, allowing the company to increase its dividend at approximately

10% annually over the next three years. The company is currently yielding approximately 6.3%. As detailed in our May 23 Select presentation "Investors' Concerns Over Enbridge's Dividend Are Overblown," we believe that Enbridge can meet its targeted dividend growth, regardless of the ruling on Line 3.

Petroleo Brasileiro SA Petrobras PBR
Star Rating: ★★★★
Economic Moat: None
Fair Value Estimate: $16
Fair Value Uncertainty: High
5-Star Price: $9.60

While Petrobras trades at one of the greatest discounts to our fair value estimate in the energy sector, we'd advise investors to proceed with caution. Recent revisions to the domestic product pricing formula and the subsequent resignation of the CEO, who was instrumental in righting the ship the last few years, have heightened the risk of government intervention in Petrobras' affairs. That said, we think the market is overly discounting the impact of those revisions and barring further intrusion into pricing or capital allocation decisions, shares are undervalued. As such, Petrobras should deliver long-term rewards as it continues to grow highly profitable pre-salt volumes and reduces debt in the coming years.

Cenovus Energy CVE
Star Rating: ★★★★
Economic Moat: None
Fair Value Estimate: $17
Fair Value Uncertainty: Very High
5-Star Price: $8.50

Cenovus is our best pick among our Canadian integrated stocks and one of our Best Ideas. The stock is currently trading at a 40% discount to its fair value estimate, while on average the industry looks fairly valued. As detailed in our October Select presentation, "The King in the North: Cenovus Energy," we believe that the market is narrowly focused on the company's temporarily high leverage levels and overlooking the immense growth potential in the company's oil sands reserves that can be brought on line with industry-leading, low-cost SAP technology. Furthermore, the market is underestimating the application of SAP technology to the company's recent FCCL acquisition, which will provide Cenovus with ample opportunities to bring on low-cost bitumen production. Growth projects that once faced challenged economics are now positioned to add significant value to shareholders over the long term. Consequently, we believe that the stock presents an attractive opportunity for long-term investors. M

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

Financial Services: A Positive Outlook for U.S. Banks, More Consolidation to Come for Asset Managers

While tightening of financial regulations is uneven across the globe, rising deposit costs are nearly universal.

By Michael Wong, CFA, CPA
Director of Financial Services Research

- We assess the global financial-services sector as approximately fairly valued. It has recently traded at a market-cap-weighted price/fair value estimate ratio of 0.94—a 6% discount to what our analysts believe the sector is worth.
- While the economy remains relatively strong, increased competition among banks shown in rising funding costs are slowing net interest margin growth, and uncertainty regarding credit costs is increasing.
- There is a general easing of financial regulation in the United States, but some tightening in China and Europe.

Americas Financials Update

By Brett Horn, Eric Compton, Greggory Warren, and Michael Wong

U.S. Asset and Wealth Management Firms: Scrutiny of the Securities and Exchange Commission's package of best interest regulations is moving to the forefront with firms focused on wealth management, as the U.S. Department of Justice chose to not appeal the vacating of the U.S. Department of Labor's fiduciary rule to the U.S. Supreme Court during the second quarter. We envision the trend toward increased fiduciary duties continuing in the United States, with both the SEC and multiple states expected to roll out their own fiduciary rules in the near to medium term. As such, we expect many of the changes that advisors, broker/dealers, and asset managers have made to their business models the past several years to persist.

Looking more closely at the U.S.-based asset managers, we see the following five issues impacting the industry in the near to medium term:

1) A weaker regulatory environment for financial-services firms.
2) Ongoing disruption of the retail-advised distribution channels.
3) Continuation of the shift from active funds to passive products.
4) A greater focus on relative fund investment performance and fees.
5) Industry consolidation

On the consolidation front, our general take has been that consolidation is inevitable for the industry. Active asset managers, and even some passive managers, have a need to add scale to offset a lower fee and profitability environment as the U.S. and other developed markets are forced to address the ongoing movement of investors into lower-cost options—primarily index funds and ETFs. We expect fund companies that cater to retail customers to consolidate their funds not only internally to increase scale

and eliminate underperforming offerings, but externally as well, with midsize to large asset managers pursuing deals that increase the scale and/or product breadth of their operations.

We expect most of the U.S. firms we cover to consolidate internally where it makes sense, increasing the scale of individual funds under the direction of solid active managers that are more likely to provide them with the best chance to keep fee cuts to a minimum while still gaining access to third-party platforms. This can be a double-edged sword, though, as funds tend to underperform the larger they get, so managing that differential will be critical to long-term success. As for external consolidation, we view most of our U.S.-based asset manager coverage as buyers rather than sellers. However, unlike past rounds of consolidation that involved buying up managers to either fill in product sets or expand distribution reach, we expect future deals to be done more for scale than anything else.

In these type of deals, we envision midtier asset managers (those with \$250 billion–\$750 billion in AUM) acquiring small to mid-size firms (those with \$25 billion–\$250 billion in AUM), understanding that they could lose a fair amount of AUM as they consolidate the acquired company's funds into their own. Although there are plenty of firms out there that fall well below the threshold of a small firm, we don't expect much buying activity of these types of firms for scale. If anything, we could see deals of that size done to fill product holes or as product-enhancement moves.

At this point, we're still in the early innings of the expected consolidation wave, with the deals that have been done so far—such as the merger between U.S.-based **Janus Capital Group** and U.K.-based **Henderson Group** JHG (announced in October 2016)—being much more selective, with firms looking to fill product set, distribution and geographic holes. That said, we should point out **Invesco**'s IVZ purchases of the ETF operations at Source and Guggenheim this past year as being driven more by scale enhancement, with the company picking up \$26 billion and \$38 billion, respectively, which increased its total ETF AUM by some 50% and should allow it to take some pricing actions in some parts of its ETF operations.

U.S. Insurers: The property and casualty insurance industry was buffeted by a flurry of natural catastrophes in 2017, with multiple hurricanes and wildfires hitting companies' bottom lines. Typically, industry pricing firms up after large catastrophes, and the early indication is that this will be the case again. However, the increases look to be modest, and lower than what we've seen in the past, as the industry remains well-capitalized. In our view, this adds up to an underwriting environment where moaty firms should still be able to use their competitive advantage to generate modest excess returns. Looking across the main areas of P&C insurance, we see some divergence. Personal lines, particularly auto, are currently enjoying strong pricing increases, which in most cases is more than offsetting a recent rise in claims and leading to strong profitability. The outlook in commercial lines is much more mixed, and it is questionable if pricing increases are keeping pace with claims increases. We remain most concerned about reinsurance lines, however, as we see catastrophe bonds as a growing source of capital, and believe structural overcapacity could leave pricing inadequate even if prices rise modestly in 2018.

U.S. Banks: With tax cuts being signed into law, good reasons to expect more economic growth, regulatory relief already playing out, and a normalizing rate environment, the near-term outlook for bank performance is positive. Overall, bank stock market values today are much higher than they were a year ago. We think this is warranted to some degree, as we now believe returns for banking will continue to improve and will end up roughly in between precrisis return levels and the returns seen in the past 10 years since the crisis. However, this also means that bargains within the U.S. regional banks are few and far between.

For U.S. banking in general, we believe four key themes will play out in 2018. First, we see higher loan growth in 2018 as uncertainty surrounding tax reform abates and companies are incentivized to invest given increased capital expenditure deductibility during the next five years. Second, we see more room for expense savings as banks continue to automate more functionality, embrace more technological change, and decrease or better optimize branch footprints. Over time, we think this trend favors the largest banks, which have the most scale and the most money to spend on new technology. Scale and technology should only increase in importance, and this should be a major factor in determining the winners and losers within banking over the next decade. Third, we believe regulatory spending likely peaked in 2017, and we expect the explicit regulatory spending burden to be flat to down in 2018, and the burden from holding excess capital on the balance sheet should only decline over the medium term. Finally, we see continued but measured federal-funds rate hikes in 2018. We also see increasing deposit betas offsetting the benefits of higher asset yields, as banks are forced to begin giving back more of each rate hike to their clients.

We think the U.S. Federal Reserve's cautious approach to raising interest rates is the correct one given the state of the economy. In our view, the Federal Reserve is walking a fine line as it attempts to normalize rates. Returning to a "normal" interest-rate environment would give the central bank more ability to fight a recession, and the combination of low unemployment rates and solid economic growth arguably shows the economy is ready for higher rates. However, tightening too quickly—before inflation data proves the need for higher rates—could cut short a long and fragile recovery. We continue to expect a slow and steady normalization, in line with the Fed's commentary.

In June, the Federal Open Market Committee raised its target for the federal-funds rate to 1.75%–2%. We think the advantages of a sticky retail deposit base are likely to shine through as rates rise. **Regions Financial** RF and **M&T Bank** MTB are particularly well positioned—about 37% of deposits at these banks bear no interest expenses. Unfortunately, each of these banks is more than 15% overvalued, by our estimation. We are finding more value in liability-sensitive card lenders like **Capital One** COF and **American Express** AXP, and note that these companies could benefit more from continued growth in consumer spending and falling unemployment than the average regional bank.

Asian Financials Update

By Iris Tan, Jay Lee, and Michael Wu

China Banks: Chinese banks' H-shares under our coverage are trading at a price/fair value of about 0.77. Current valuation level implies 0.5–0.8 times 2018 price/book value for the Chinese banks we cover with **China Merchants Bank** 600036 the exception. This is the lowest level over the past three years due to the market's renewed credit quality concerns, amid climbing refinancing risks for the corporate sector as a result of tightened shadow bank regulations and shrinking growth in credits. As financial deleveraging has become one of the government's top priorities, we believe this trend will continue in the near term, while the marginal impact on banks will gradually mitigate. We are more optimistic on the banks than the general market, as we believe such negative impacts are primarily regulation driven and short-term in nature. Tighter regulations and ongoing reform should benefit both the industries and wider economy in the long run, as it marks an important step by the government to de-risk the financial sector and a push for more rational pricing for credits.

As for Chinese banks, there are five industry trends worthy of attention in 2018. First, bank lending rates will continue to climb as a result of tighter credit availability and rising interbank rates. Average lending rate has increased 57 basis points to 6.01% by the end of March 2018 from the trough in end-2016. Second, deposit costs face greater pressures in 2018 as competition further heats up given M2 growth slowed to 8.2% in 2017 from the average of 13% during 2011–16. This was also exacerbated by mounting threats from deposit substitutes including money market funds and savings-type insurance products, while banks' wealth management products become less attractive as they no longer carry implicit guarantees by banks and yield lower returns as their investment in shadow credits are banned.

Third, bank loans will maintain its steady growth at around 13% in 2018 as credit demands are still strong. This also helps partially make up for the unfilled financing gap left by ongoing shadow banking curbs. Contrary to market belief, we do not expect the banks are able to shift a majority of their off-balance-sheet shadow banking exposure into their books, given stringent regulations including requirements on capital, provisioning and loan quota. Fourth, there is a higher level of credit costs uncertainty in 2018. This is attributable to stricter rules in bad debt recognition in 2018, despite the gradually declining bad debt formation ratio since mid-2016. Besides, the banks are likely to increase provisions given climbing credit quality risks amid ongoing bond defaults as shadow bank borrowers are now facing refinancing pressure.

Finally, fee income growth will temporarily be dragged lower by ongoing regulations in wealth management products. We have seen wealth management business slow pending the upcoming release of detailed regulations by the regulator. We expect wealth management products will shrink in scale as both supply and demand for shadow bank credits are subject to strict controls.

We believe the larger Chinese banks will steer through such challenges better than peers given their very limited shadow bank exposure and prudent operations. **Agricultural Bank of China** 601288 and **Bank Of China** 601988 are the most undervalued, trading at around 23% discount to our fair value

estimate respectively. **Industrial and Commercial Bank Of China** 601398 is also undervalued, trading at a 20% discount. These banks will benefit from rising lending rates as they can better defend their deposit market shares amid rising competition. Given their conservative bad debt recognition and relatively high provisioning level, they should face less provision pressure if credit quality deteriorates and tighter lending rules are in place.

Hong Kong Banks: There is no change to our view that the Hong Kong banks are overvalued, and the key focus is on net interest margin improvements and the prospect of further loan growth in 2018 as regional economies continue to improve. There is no change to our view that net interest margins will rise steadily in the medium term as stronger economic conditions underpin the normalization of interest rates globally. The Hong Kong Interbank Offer Rates, or Hibor, continue to edge higher in the second quarter as liquidity exited Hong Kong. The latter saw the Hong Kong Monetary Authority intervening in the foreign currency market to maintain the Hong Kong dollar peg. The higher Hibor should underpin rising net interest margins but get offset by competition. As noted previously, the Hong Kong banks continue to see pressure on lending spreads for both corporate and commercial loans. In our view, competition could ease as rising interbank rates increase funding costs across the industry, particularly banks without a large deposit franchise. We believe narrow-moat **Bank Of China Hong Kong** 03988 and **Hang Seng Bank** 00011 will fare better than peers given its large Hong Kong dollar deposit base, as funding costs for its low-cost, sticky current and savings account deposits should rise at a slower pace.

The strong system loan growth continued in the first quarter and remains a key positive. Year to April system loan growth of 7.4% should see overall loan growth in line with last year. The strong increase last year was across both corporate loans and loans to individuals. Demand for offshore loans also saw strong growth on higher demand for investments in mainland China and elsewhere in the region. With the Chinese economy continuing to moderate at a controlled pace and global economic conditions strengthening, we expect the strong loan growth to be sustained for the remainder of fiscal 2018.

Japan Banks: We maintain our preference for **Mitsubishi UFJ Financial Group** MUFG, between the three megabanks as Mitsubishi is trading at the largest discount to fair value of over 20%. After a sharp appreciation of the bank's share price close to our fair value estimate in early 2018, its share price declined in line with global equity markets at the end of the calendar first quarter. The decline accelerated post the bank's fourth quarter fiscal 2018 result, which we attribute to a smaller-than-expected buyback and dividend, as well as a fairly soft profit guidance. Our forecasts conservatively factored in slightly higher than guidance credit cost.

Credit cost was benign for the Japanese banks in the fourth quarter, in line with banks in the region. We are forecasting higher provisioning thereafter as Mitsubishi has a larger exposure to international loans, which we deem slightly riskier. However, we believe the risk is priced into the current share price. **Mizuho Financial Group** MFG and **Sumitomo Mitsui Financial Group** 8316 both have lower levels of international exposure, with Mizuho in particular having a conservative loan portfolio concentrated in high-quality domestic corporates.

We do not expect a significant increase in non-performing assets in the medium term and credit cost should remain low for the remainder of 2018. Interest rates are expected to remain low in Japan as inflation growth remains weak. While the low interest rate should result in a lower level of credit cost, net interest margin will continue to be pressured. This is further compounded by weak loan demand domestically and we expect net interest income to remain largely steady.

Finally, Sumitomo announced a long-awaited share buyback plan, which was expected after clarification from regulators on Basel 3.5 at the end of 2017. It announced buybacks of up to 1.3% of outstanding shares, which was greater than expectations. We view this as a positive step to allow Sumitomo to rightsize its balance sheet for higher returns, while still maintaining healthy cushions in regulatory capital.

Singapore Banks: The Singapore banks' share prices softened in line with the wider market in the second quarter. While **Oversea-Chinese Banking Corp.** O39 and **United Overseas Bank** U11 are trading at close to an 8% discount to their respective fair value, we do not believe their margin of safety is large enough and both banks remain 3-star-rated. While we reiterate our view that **DBS Group** D05 will benefit the most from a rising interest rate environment, given its larger than peer Singapore deposit market base and a larger proportion of lower-cost current and savings deposits, the upside is currently priced in.

All three banks reported solid first-quarter results, reflecting the favorable operating environment as global economic activities ramps up. Higher net interest income was driven by both improving net interest margins and stronger loan growth, while favorable capital markets saw rising demand for investment products and wealth management, underpinning increases in fee and commission income. Credit costs were extraordinarily low, which also benefited from the write-down of their oil and gas non-performing assets last year. With global economic conditions maintaining its upward trajectory, we expect the above trends to continue for the remainder of the year.

Australian Financials Update
By David Ellis

The otherwise solid earnings outlook for Australian major banks has been completely overshadowed by very damaging revelations and accusations raised to date at the Royal Commission into misconduct in the banking, superannuation and, financial-services industry. Despite the potential for damaging industry consequences, the Australian banks continue to be supported by solid economic fundamentals as global and domestic economic conditions improve. Australian GDP growth for the March quarter came in at a respectable 3.1% year on year, with strong employment growth, continued positive net immigration, solid credit growth of around 5% and record high infrastructure investment. House prices are easing, and we expect further modest house prices weakness in the year ahead.

At current prices, **Westpac Banking** WBK and **National Australia Bank** NAB are most undervalued, trading 19% and 16%, respectively, below our valuations. **Commonwealth Bank of Australia** CBA and

Australia and New Zealand Banking Group ANZ are trading 15% and 10%, respectively, below our valuations. We are comfortable with our modest earnings forecasts, with EPS expected to grow an average of 2.3% per year to fiscal 2022, and near-term catalysts to drive share prices materially higher are difficult to find. As always, there are plenty of risks to earnings and stock prices for the major banks, not the least being regulatory, economic conditions in Australia, the Royal Commission, the long-running fear of an economic correction in China, and of course Australia's housing markets. Global tightening of liquidity could raise Australian bank wholesale funding costs if conditions persist. In these circumstances, bank net interest margins could contract if variable borrowing rates are not increased for Australian corporate, commercial, and housing borrowers.

Political and regulatory risk is increasing, with a range of issues unfolding. Commonwealth Bank recently agreed to settle civil proceedings raised by the Australian government's anti-money laundering agency, Australian Transaction Reports and Analysis Centre, or Austrac. Under the agreement, the bank will be fined with a civil penalty of AUD 700 million, a record settlement made by an Australian bank. We are treating the AUD 700 million Austrac provision as a significant item and excluding it from our unchanged fiscal 2018 cash profit forecast of AUD 9.9 billion. The financial impact of the provision is immaterial to our valuation or to the AUD 123 billion market capitalisation. Longer term, the high-quality franchise, strong market positions and reinvigorated senior management will support Commonwealth Bank's earnings and dividend sustainability.

Despite the political and regulatory risks, we expect improved productivity and benign credit quality to support future fully franked dividends delivering attractive dividend yields in the 6%–7% range. We forecast average annual dividend growth of just 1.3% to fiscal 2022, with average payouts forecast to decline to 73% in fiscal 2022 from 76% in fiscal 2017. Major bank forward price/earnings ratios have contracted to an average around 11 times from 13 times eight months ago and are now below longer-term averages around 12 times. Returns on equity are expected to average above 14% during the next five years, with Commonwealth Bank to stand out at around 16%. Political uncertainty is not helping business confidence, while weak wages growth is a drag on consumption and the Reserve Bank of Australia inflation target. The most damaging negative risk to 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.

European Financials Update

By Johann Scholtz and Henry Heathfield

European Banks: For many parts of Europe, the themes for 2018 have hardly changed compared with 2017. For 2018, U.K. banks within our coverage are hopeful on the U.K. economy despite the ongoing Brexit. The consensus view is that GDP growth will be at similar levels to that in 2017, which in our view should be supportive of banking assets and balance sheet growth. **Lloyds Banking Group** LYG expects the U.K. economy to maintain its resilient stance and overall macroeconomic outlook to benefit from GDP growth. Along with unemployment at an all-time low, the bank expects continued stable consumption.

On the other hand, low growth in pay (which remains below inflation) will continue to pressure household finances.

As of the start of 2018, IFRS 9 is now in full operation for European banks. In July 2017, EBA guided that common equity Tier 1 ratios are expected to decrease by up to 45 basis points on average, driven by an increase in the impairment charges. While banks have been emphasizing that the impact on capital ratios will somehow be lower than that guided by EBA, they have been reiterating their guidance on the topic with their full-year results. Management of **Svenska Handelsbanken** SHB A guided that the impact from adopting IFRS 9 in first-quarter 2018 is limited and is not expected to affect the bank's capital ratios, whereas in the U.K., Lloyds' management team guided that while the initial impact of IFRS 9 will be around 30 basis points, it will be phased in over the next five years. The bank added that the full impact of the new regulation on annual capital generation will amount to 170–200 basis points.

Finally, at **Nordea**'s NDA SEK annual general meeting in March, shareholders reached an agreement on moving its headquarters from Stockholm to Helsinki in the banking union area, due to the heavy regulatory burden imposed by the Swedish FSA. As a result, we believe Europe's Single Supervisory Mechanism, or SSM, has now proved itself to be a widely respected supervisor. As we have emphasized previously, we view Nordea moving its headquarters as neutral to fair value, and so we maintain our narrow-moat and stable moat trend ratings, while we believe lower regulatory costs will be a long-term positive for the firm's P&L. The move of headquarters will only affect around 50 employees, and there will be no move of physical headquarters; thus, any impact on operational cost should be negligible.

European Insurance: European insurers are slightly undervalued with our coverage trading at 0.95 times P/FV. We continue to believe the main theme within the European insurance sector is the increasing importance of asset management divisions within these businesses and also increased attention on disciplined underwriting.

European insurance companies have been repositioning their asset management businesses and offerings to something more in line with the unit-linked business that is generally becoming more prominent. A significant part of the attraction for life insurance and pension products is the savings element they carry. And we have seen non-life insurers establish strong third-party asset management businesses.

The acquisition of XL by **AXA** AXAHY has put large-scale acquisitions on the agenda, and **Allianz** AZSEY is discussing following suit. However, we largely think that this is not the way forward to build a lasting and highly profitable business. The XL acquisition by AXA shows that it is trying to tilt its portfolio to non-life and gain greater exposure to more specialist lines that require greater expertise to underwrite, although what it is ultimately doing is blending quite different businesses.

There has not been news out regarding the breakup of **Prudential plc** PUK, but we still think this is a good template business for life insurers to follow: strong and disciplined underwriting, with decent asset management arms, though the latter has been slightly lacking. Undisciplined underwriting can have

serious implications for the profitability of a business, as well as its reputation and the returns to policyholders. That is why it needs to come first and foremost, with good asset management serving as a thick layer of icing.

While distribution is the means of collection, ultimately in mature markets, advisers and consumers will gravitate to the best product. And those will be proven, as with Prudential, time over time.

Top Picks

American International Group AIG
Star Rating: ★★★★
Economic Moat: None
Fair Value Estimate: $76
Fair Value Uncertainty: Medium
5-Star Price: $53.20

We believe previous management's focus on growth and lack of discipline are the root causes of AIG's poor historical performance, and now the company has set a course in the opposite direction. When AIG announced that it would be taking a $5.6 billion reserve development charge in the fourth quarter of 2016, the market's confidence in management dimmed and the stock still trades at a significant discount to book value. CEO Peter Hancock departed in light of this disappointment.

We see Brian Duperreault as a strong choice to replace Hancock, as his extensive background in commercial property-casualty lines contrasts with Hancock's lack of experience on the underwriting side and inspires confidence that Duperreault can solve the one issue that Hancock failed to make progress on.

Given the potential for improvement, we think the market valuation is overly skeptical and this creates an opportunity, especially as the recent reinsurance deal with Berkshire Hathaway BRK.B partially 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, we assume AIG is able to bring results in line with other no-moat insurers, a fairly low bar to clear.

The company's first-quarter results were poor overall, but contained some positive glimmers, and we think Duperreault deserves some patience. To that end, we are encouraged by his goal to generate an underwriting profit in P&C lines by the fourth quarter. In our view, if the company is able to achieve this on a sustainable basis, it should be in position to generate an acceptable overall return.

Capital One COF
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: $123
Fair Value Uncertainty: Medium
5-Star Price: $86.10

Capital One is beginning to realize the sizable benefits from lower credit losses that we believe will result in earnings per share growth of more than 30% in 2018. Capital One's improving earnings will likely enable the company to increase share repurchases and its dividend. Furthermore, we believe the company's improving results and brightened prospects for increasing capital returns could serve as a catalyst for the company's shares. If Capital One were to maintain its recent dividend payout ratio of around 20%, the company would be able to increase its annualized dividend by about 25% resulting in a dividend yield of more than 2% based on today's share price. Currently, Capital One trades at a more-than 25% discount to our fair value estimate of $123 per share.

For months, we've been monitoring monthly credit card delinquencies, anticipating that moderating, but still healthy, growth will result in substantial improvements in consumer credit quality. As we correctly anticipated, decreases in credit card delinquencies began earlier this year. We believe Capital One's increasing credit losses the past few years represented an overhang in the company's shares. Given this uncertainty appears to be going away, we believe investors in Capital One will be rewarded.

Although a majority of Capital One's results are driven by its credit card business, auto loans also play a role in the company's fortunes. Used car prices continue to outperform our expectations, though we believe Capital One is seeing greater competition within auto lending. Eventually, this competition should pressure Capital One's growth and possibly lower margins on new loans. For now, it appears that Capital One will benefit from minimal charge-offs as used-car prices remain high. However, in recent months, Capital One has seen a deceleration in auto loan originations. In our view, we believe this is a minor offset to Capital One's improving results within domestic credit cards.

Invesco IVZ
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: $40
Fair Value Uncertainty: Medium
5-Star Price: $28

While there are several U.S.-based asset managers trading at steep discounts to our fair value estimates, narrow-moat Invesco remains our top pick among the group. The company continues to transform itself into a much tighter organization capable of generating profitability and cash flows on par with the higher-quality names in our asset manager overage and overcoming any hurdles that might be thrown in its way.

The company closed out May with $977.3 billion in managed assets, up 13.8% year over year. Excluding the impact of the Source and Guggenheim acquisitions, total AUM was up 6.3% when compared with May 2017, which is still respectable given the volatility in the markets since the start of the year.

While Invesco's organic growth did weaken during the first quarter of 2018, we believe that the firm's three- and five-year investment performance should be good enough to spur 1%–2% annual organic growth during our forecast period. Assuming Invesco hits our end-of-year AUM target of between $900 billion and $1.1 trillion, we expect the firm to generate mid-single-digit revenue growth during 2018, with adjusted GAAP operating margins of 24%–26%.

The market tends to reward both organic growth and operating profits in the U.S.-based asset managers, which explains why **BlackRock** BLK and **T. Rowe Price** TROW have tended to trade at 10%-plus premiums to the group (and are currently trading at 50% and 35% premiums, respectively) when looked at on a price/earnings basis. Over the past five years, Invesco generated an average annual organic growth rate of 1.8% with one of the lowest standard deviations (of 1.6%) relative to peers. Only BlackRock and T. Rowe Price posted lower standard deviations (of 1.5% and 1.4%, respectively).

That said, Invesco has generally traded at a slight discount to the group, which we've always believed was warranted as its operating margins averaged 24.2% annually during 2013–17. At today's prices, though, the stock is trading at a 25% discount to the group multiple (based on 2018 consensus earnings estimates) and a 35% discount to our $40 per share fair value estimate. A valuation that implies that the firm has as much as 25% less in managed assets than it is currently reporting. M

The authors of this sector outlook don't own shares in any of the securities mentioned above.

Healthcare: Drug Pricing Concerns Weigh on Valuations, Creating Opportunities

Innovation, consolidation, and a mixed regulatory picture for healthcare stocks in the second quarter.

By Damien Conover, CFA,
Director of Healthcare Equity Research

- Overall, healthcare valuations have slightly fallen to a price/fair value of 0.98, down from 1.01 at the end of the first quarter and 1.04 at the start of the year, but the differences in industry valuations continue to suggest drug, biotech, and drug supply chain industries are the most undervalued areas. Within these industries, our top picks are **Allergan** AGN, **Roche Holding** RHHBY, and **McKesson** MCK.
- U.S. governmental reforms addressing drug pricing should not have a material impact on the most profitable region of the world, which should ease pricing concerns that are weighing on the drug and biotechnology industries.
- Research and development trends continue to deliver strong data in areas of unmet medical need, such as cancer and immunology, which should drive strong long-term growth for drugs with solid pricing power.
- The strong cash flows of the largest healthcare companies continue to focus on acquisitions and share repurchases and we expect an acceleration of acquisitions through the reminder of the year.

U.S. governmental rhetoric on bringing drug pricing down will not likely have a major impact on the largest drug market in the world, despite concerns that we believe have weighed on valuations. The Trump administration's policy paper titled "The Trump Administration Blueprint to Lower Drug Prices and Reduce Out-of-Pocket Costs" largely supports increasing generic drug competition, slightly strengthening Medicare drug price negotiations, improving drug price transparency, and providing more information to help patients lower out-of-pocket costs, all of which we believe have a limited impact on branded U.S. drug prices. In aggregate, we think the proposals would likely impact less than 1% of U.S. drug spending, excluding the potential changes to negotiations for Medicare Part B drugs, which could offer another 1%–2% reduction in U.S. drug spending depending on the exact implementation.

Within the backdrop of pricing concerns, drug and biotech firms are focusing development on innovative drugs in areas of unmet medical need where pricing power remains strong. Major advancements in immuno-oncology drugs from **Merck** MRK, Roche Holding, and **Bristol-Myers Squibb** BMY should change the paradigm of treatment for lung cancer, one of the most prevalent deadly diseases. Additionally, drug advancements in immunology led by **AbbVie** ABBV, **Johnson & Johnson** JNJ, **Eli Lilly** LLY, and **Novartis** NVS are offering new treatments that are significantly more effective and safer in areas of rheumatoid arthritis, psoriasis, and inflammatory bowel disease.

Turning to capital redeployment, acquisitions, share repurchases, and dividends continue to be the focus for the larger healthcare companies. Mergers in the healthcare supply chain, including **Cigna** CI buying **Express Scripts** ESRX and **CVS Health** CVS acquiring **Aetna** AET, remain on track and both look to create scale to lower costs. Additionally, share repurchases continue with AbbVie's recent $7 billion-plus share

repurchase showing an example of significant capital use in buying back stock. We expect the large healthcare firms will continue to buy back shares and likely accelerate acquisitions to boost earnings-per-share growth.

Top Picks

Allergan AGN
Star Rating: ★★★★★
Economic Moat: Wide
Fair Value Estimate: $263
Fair Value Uncertainty: Medium
5-Star Price: $184.10

Unlike 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, gastroenterology, and central nervous system. Allergan's diverse portfolio, key durable products including Botox, and healthy pipeline support a wide economic moat and mid-single-digit organic earnings growth over the next five years, in our view. The company 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 Pharmaceutical** TEVA back in 2016.

McKesson MCK
Star Rating: ★★★★
Economic Moat: Wide
Fair Value Estimate: $210
Fair Value Uncertainty: Medium
5-Star Price: $147

Despite major near-term headwinds, McKesson should remain an essential link in the pharmaceutical supply chain. Several headwinds have pressured the firm's operations and stock. The loss of material volume as a result of customer consolidation, slowing branded drug price inflation, a mix shift toward specialty drug products that are costlier to distribute, and increased competition for small/independent pharmacy market share have formed a confluence of negative variables that have built in significant near-term uncertainty for the drug distributor. However, we believe these are near-term issues and McKesson will be able to power through the recent volatility, as it is a critical partner to both retail pharmacy clients and drug suppliers. This has given investors an opportunity to acquire shares of a wide-moat company at a material discount. While there are some remaining headwinds associated with a changing pharmaceutical supply chain, we believe McKesson will be able to effectively offset this issue, win its share of contracts in the future, and thrive long term. McKesson is in the process of better positioning itself as a critical player in the lucrative specialty pharmaceutical market niche, which will eventually bolster its wide economic moat.

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

As the market-leading pure play in medical technology, Medtronic has an unmatched, extensive product portfolio, stretching from surgical consumables to implantable devices for cardiac conditions. We think the market is overly focused on the waning of some of Medtronic's product cycles in key cardiac device markets and underappreciates how the firm has shifted the dynamics of competition away from innovation exclusively. Medtronic has pioneered ways to benefit from the shift to value-based reimbursement through risk-based contracting, which has gained a foothold with providers and payers. We expect Medtronic's efforts to solidify preference at that level should better insulate its products from competition, even when the firm is in an unfavorable product cycle.

Roche Holding RHHBY
Star Rating: ★★★★★
Economic Moat: Wide
Fair Value Estimate: $41
Fair Value Uncertainty: Low
5-Star Price: $32.80

We think the market underappreciates Roche's drug portfolio and industry-leading diagnostics, which 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, more cost-effective endeavor. The collaboration between its diagnostics and drug-development groups gives Roche a unique in-house angle on personalized medicine. Also, Roche's biologics constitute three fourths of its pharmaceutical sales; biosimilar competitors have seen development setbacks while Roche's innovative pipeline could make these products less relevant by their launch. M

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

Industrials: Despite Bullish CEO Talk, Few Values

Among a mostly fairly valued industrials sector, some good values remain.

By Joshua Aguilar
Equity Analyst

- At a gathering of diversified industrial CEOs at the end of May, bullishness was a predominant theme. Nearly every CEO reiterated that the macroeconomic outlook was extremely healthy, as was the case last year. Even so, we find few values in the general industrials sector, as the market-cap-weighted price/fair value estimate stands at 1.03, suggesting that industrials stocks are trading within a realm of reasonableness.
- The CEOs also touted tax reform. We see wide-moat-rated industrial firms with operations based primarily in the U.S. disproportionately benefiting from this reform. Specifically, the latest changes to the Internal Revenue Code of 1986 encourage capital expenditures by allowing companies to expense these investments on a temporary basis.
- After General Electric CEO John Flannery appeared to waffle on his company's commitment to its 2019 dividend at a recent industrials conference, GE's board reaffirmed that commitment by declaring a quarterly dividend of $0.12 per share on June 8, 2018. Even so, we believe the company will continue to struggle with three primary issues, including weakness at its power segment, liabilities in the capital segment, and the need for capital, both for reinvestment and the dividend.

At a recent industrials conference in Florida, CEOs consistently preached macroeconomic bullishness, and nearly all expressed a near-uniform commitment to share buybacks. Implicit in these endorsements is that the underlying stocks of their companies are cheap. Even so, in aggregate, we find few bargains in industrials. Currently, the market-cap-weighted price/fair value estimate for the sector stands at 1. Fundamentals, however, remain attractive. **Honeywell International** HON CEO Darius Adamczyk said he's "quite bullish on 2018, 2019 and to the extent he can see 2020," and added that "overall, the markets look very, very good, almost without exception." Honeywell has the advantage of several long-cycle businesses in its portfolio. Adamczyk said that he observes Honeywell's aerospace backlog increasing, as well as healthy order activity from some of its technology and automation offerings. Representatives for **3M** MMM were also enthusiastic about certain newer, innovative offerings, particularly in the data center space, which we also see also as a faster-growing line of business. 3M's immersion cooling, which allows data center companies to dip their electrical components into a nonconducting liquid to prevent overheating, is the latest response to this rapid growth.

Tax reform was also at the forefront of the conference. We expect certain firms to disproportionately benefit from the Tax Cuts and Jobs Act of 2017, including those that have operations based in the United States; pay high effective tax rates; avoid a high amount of leverage in the capital structure; earn high returns on capital; and have high capital expenditures as a percentage of sales. Clearly, U.S.-based wide-moat industrial firms fit the bill, so it's understandable that tax reform was a prevailing theme in CEOs' discussions.

Finally, on June 8 **GE** GE reaffirmed its commitment to its dividend by declaring a quarterly dividend of $0.12 per share. Only a few weeks earlier, the market was spooked when Flannery appeared to visibly waffle when sell-side analysts pressed him on the firm's dividend commitment. Even so, we think the issues that have plagued GE recently persist. As we see it, the three most critical issues facing the firm are GE's power segment, which continues to face overcapacity issues, as well as competition from renewables from a levelized cost of electricity standpoint; GE capital and its potential liabilities, including its shuttered subprime mortgage unit WMC, as well as long-term care in the firm's run-off insurance business; and adequate levels of capital, both from a standpoint of maintaining dividend coverage and meeting the firm's reinvestment needs. Even so, we think Flannery is the right person for the job as he has patiently shed exposure to some of the firm's less attractive assets in order to focus on its core three segments: power, aviation, and healthcare.

Top Picks

GEA Group G1A
Star Rating: ★★★★
Economic Moat: Wide
Fair Value Estimate: EUR 47
Fair Value Uncertainty: Medium
5-Star Price: EUR 32.90

We believe management's clumsy handling of its restructuring program has clouded the market's view of wide-moat GEA's long-term value. At issue is a disappointing margin performance and guidance combined with a top line has that suffered in the past two years from overcapacity in dairy processing equipment, as well as an extraordinarily weak milk price, hurting dairy farming orders. We continue to expect margin expansion over the next several years but believe the market has overlooked the nearer-term opportunity for earnings growth to return in 2018 from orders outside of dairy. Our analysis of the company's order intake shows that while dairy processing orders have been declining by 8% per year for the past three years, the rest of the order intake has grown by 3%. Food (bakery, ingredients, and pasta, for example) is now the largest category and grew at 5% organically over the same period.

GEA supplies food and dairy processing equipment, specializing in decanters and separators that determine a product's texture and consistency, essential to brand creation for food companies, and together with food safety standards create high switching costs for its customers. Nearly another third of its equipment is used in food processing to make products such as edible oils, instant coffee, and baked goods. As GEA is a leading global supplier and number-one or -two player in nearly all its markets, it will benefit over the long term from increasing food production demand to feed the world's growing population as well as urbanization increasing demand for convenience food.

Anixter International AXE
Star Rating: ★★★★★
Economic Moat: Narrow
Fair Value Estimate: $107
Fair Value Uncertainty: Medium
5-Star Price: $74.90

As a result of the market's overreaction to narrow-moat Anixter International's unremarkable first-quarter results, the company's shares are deeply undervalued. As Anixter's end markets strengthen, we think shareholders will be rewarded with consistent earnings growth and occasional outsize special dividends over at least the next few years.

Over the past three years, Anixter has completed three transactions that have bolstered its market presence, growth potential, and operating flexibility. After acquiring Tri-Ed, selling its capital-intensive OEM supply fastener business, and purchasing HD Supply's utility distribution business, Anixter is now the global leader in network and security distribution, a major player in electrical distribution, and the leading utility power solutions distributor in North America. Anixter's focus on value-added technical and supply chain services across a global platform differentiates the firm from many of its competitors. In many cases, Anixter is not the low-cost leader, but its value-added services can provide its customers with the lowest cost of ownership.

We see key growth drivers for each of Anixter's segments over the next five years. With the addition of Tri-Ed, Anixter's network and security solutions segment is set to gain share with midsize system integrators and in residential end markets. This segment should also benefit from cross-selling security products to utilities customers as they invest in security solutions to comply with regulatory standards. Growth in wireless and cloud-related products should augment network and security growth. Anixter's electrical and electronic solutions business has suffered from industrial end-market weakness and has been generating depressed EBITDA margins. As industrial end markets recover, we expect this segment to return to growth and normalized profitability. After acquiring HD Supply's power solutions business, the utility power solutions segment was created, which has industry-leading scale and should benefit from market share gains and improving utility capital spending.

Anixter's capital-allocation strategy has favored returning cash to shareholders through special dividends and share repurchases. Once Anixter achieves its targeted leverage ratio of 2.5–3 times EBITDA, which we think could happen by 2019, we expect it to resume returning cash to shareholders.

Johnson Controls International JCI
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: $53
Fair Value Uncertainty: High
5-Star Price: $31.80

Narrow-moat Johnson Controls was long viewed as an auto-parts company, given that it historically generated about two thirds of its annual revenue from the automakers. However, over the past few years, Johnson Controls has been on a mission to transform itself by selling noncore assets and acquiring businesses that complement the building efficiency segment. The most transformative transactions came in 2016, when the company merged with Tyco International in September and spun off its automotive seating business (now called Adient) to shareholders in October. As a result of these transactions, Johnson Controls is a more profitable and less cyclical business with much lower exposure to the automakers (was 59% of sales, is 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, nicely complements Johnson Controls' legacy building efficiency business, which is a global leader in HVAC systems and building automation and controls. 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. Over the next three years, Johnson Controls is targeting $1.2 billion (about $1.10 in earnings per share) of cost and revenue synergies.

Johnson Controls should also 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 technologies and solutions business. Johnson Controls' power solutions segment is the largest producer of lead-acid automotive batteries in the world, manufacturing approximately 154 million annually. The company has 36% global market share; it is the leading supplier in the Americas and Europe and the third largest in China, with aspirations to become the second largest by 2020. Power solutions' significant exposure to the inelastic aftermarket business (76% of segment sales) yields stability, while the segment's participation in emerging markets and start-stop vehicle technology provide substantial growth opportunities.

Former Tyco CEO and Johnson Controls COO George Oliver recently succeeded Alex Molinaroli as chairman and CEO. With Oliver at the helm, we commented that we saw an increased probability of the company divesting its power solutions segment. On March 12, Johnson Controls announced that it is exploring strategic alternatives for the power solutions business, which should be completed "over the next several months." While it's true that the power solutions business has limited synergies with Johnson Controls' building technologies and solutions segment, power solutions is growing faster and is

more profitable than the firm's buildings business. That said, we certainly see how a well-structured spin-off or a favorable selling price could create shareholder value. M

Joshua Aguilar does not own shares in any of the securities mentioned above.

Real Estate: Strong Fundamentals Persist—As Do Opportunities

REITs should have several more years of solid growth in property fundamentals as the economic cycle continues and many sectors have the peak in supply growth behind them.

By Kevin Brown
Equity Analyst

- Morningstar's real estate coverage appears fairly valued at current levels. It is currently trading at a market-cap weighted, price/fair value estimate of 0.98, only a 2% discount to what we believe the stocks in the sector are worth.
- We view themes in commercial real estate as generally defensive in nature, with lingering concerns about increasing bond yields associated with future rate hikes.
- Despite these concerns, 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 as firms look for higher returns, though supply may have peaked in many markets and sectors. Rising construction costs may lead to slowing supply growth over the next few years.
- At current price levels, we see attractive investment opportunities scattered across various asset classes within our REIT coverage.

U.S. Real Estate Outlook

Contributed by Kevin Brown

After falling in the first quarter due to pressure from rising interest rates, the U.S. real estate market performed in line with the broader U.S. market in the second quarter. The 10-year U.S. Treasury yield increased rapidly at the start of the year but has stayed near the 2.85% rate since mid-February, bringing relative stability to real estate stocks. Given the circumstances, many investors wonder whether we are near the peak of the commercial real estate cycle—higher interest rates could pressure growth rates, cap rates, return expectations, and ultimately asset prices. Also, to the extent that low interest rates have steered investors searching for higher yield and capital preservation toward REITs, the same funds could flow out of REITs if interest rates rise, further pressuring commercial real estate valuations.

However, rising interest rates also signal that the economy is healthy enough to support a rising interest rate environment. Continued economic growth will support the fundamentals of all commercial real estate. Real estate companies will benefit from the continued stabilization and growth of the acquisitions and developments they completed this cycle. Higher interest rates will make financing more expensive, not only reducing the return potential on new acquisitions and developments but also reducing the number of construction starts. REITs strengthened their balance sheets during the low interest rate environment, reducing near-term maturities and locking in low rates on long-term debt.

There is still a shrinking but significant spread between real estate cap rates and interest rates, which combined with growing net operating income supports current real estate prices. Future interest rate increases should be more gradual, and the growth of the underlying fundamentals should support current valuations.

The Trump administration could have an impact on several real estate sectors. Policies such as infrastructure spending, tax reform, general deregulation, and many other matters have extended the length of the current economic cycle. Additionally, several economic signals, including unemployment levels, wage growth, and GDP growth, support the case for positive momentum as we enter the back half of the year. However, the potential for a trade war with China could have an impact on several real estate sectors, particularly retail and industrials. Rising prices on steel and lumber would increase construction costs, making accretive development more difficult and reduce the number of construction starts for all sectors. Finally, increased immigration enforcement could increase labor costs, increasing expenses for industries that rely on immigrant labor, such as the lodging industry.

Much of our U.S. REIT coverage still enjoys healthy underlying operating performance. Historically high levels of occupancy and durable balance sheets characterize most portfolios. Although 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. Supply has peaked and started to decelerate for sectors like apartments, industrials, and senior housing. Higher construction costs and tighter construction lending should reduce supply growth further even as demand continues to support fundamental growth through the cycle. 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. Although 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. Given that our real estate coverage is fairly valued as a whole, investors should enter the sector with caution. Our preferred investment vehicles are reasonably leveraged companies with solid prospects for long-term growth that can weather the natural cyclicality of the real estate markets.

Australian and New Zealand Property Outlook

Contributed by Tony Sherlock

Among our Australian and New Zealand property coverage, only retirement village operator **AVEO Group** AOG screens as attractive, with a 4-star rating. We see numerous attractions and potential earnings catalysts ahead for vertically integrated industrial heavyweight **Goodman Group** GMG and **Ryman Healthcare** RYM, but they are fairly valued at current levels. The lack of attractively priced Australasian property stocks is a combination of property of all classes trading at record low yields and an outlook for bond yields to rise. Higher bond yields will weigh on the value of listed property because of a range of factors. First, yield-focused investors will rotate out of asset class to bonds, causing selling pressure. Second, valuers will reduce their assessment of property values as they increase the discount rates implicit in their valuations. Third, higher borrowing costs will weigh on cash flows hence REITs' long-term distributions. Our central scenario is for bond yields to rise over a protracted period, but the sector

and property values are particularly susceptible to a sharp rise, which could be triggered by dislocation in credit markets.

Negative media attention in June 2017 had a negative impact on Australian retirement village operator and developer Aveo, and we think the firm has been oversold. The retirement living industry has very favorable underpinnings of limited supply and sharply increasing demand over the next five years. Aveo also stands to generate solid redevelopment gains as it upgrades and then resells units in older villages. The firm is not without risks as its reputation has not yet fully recovered from the negative coverage and the firm looks likely to have to trim prices if Australian dwelling prices retrace further.

Global demand for industrial property exposure is perhaps the strongest it has ever been, as wholesale investors clamor to increase their weighting to this previously out-of-favor subsector. The escalation in demand for industrial property is being driven by institutions' rotation away from Internet-impacted retail shopping centers, toward modern logistics facilities serving high growth Internet retailers like **Amazon** AMZN and **JD.com** JD.

Goodman Group is particularly well placed to benefit from the heightened interest in industrial as it focuses on owning warehouses in strategically important locations. Demand for these is robust as they enable logistics firms to steal a lead on competitors in speed of delivery and cost. Goodman is already reaping rewards from its focus on premium logistics assets, with the portfolio having very low vacancy and superior rent growth. Goodman also has a series of potential earnings catalysts ahead, which include an acceleration in the volume of development work as it become more active in North America and Brazil. As most of the developed assets, will be acquired by Goodman managed funds, we foresee strong uplift in fund management earnings from an expanding asset base and also an acceleration in performance fees. The firm has negligible gearing and undrawn debt and equity of AUD 10 billion, providing ample capacity to acquire quality assets should there be a retracement in property values.

Singapore Real Estate Outlook

Contributed by Michael Wu and Ken Foong

Office rental rates have troughed in first-half 2017 and continued to recover into first-quarter 2018, with average monthly rental for Grade A office space increasing by 8.4% to SGD 9.70 per square foot in first-quarter 2018 compared with SGD 8.95 per square foot in first-half 2017. We expect the worst to be over for office rentals as new office supply is slowly digested by the market and there is limited new office supply from 2018 onward. We expect the office rental recovery to continue for the next few years. However, this will not flow through to the rental reversions for **CapitaLand Commercial Trust** C61U, the main office REIT under our coverage, and negative rental reversion is expected this year as average expiring rents in 2018 are above the current average market rent for Grade A office space. We remain positive on the Singapore office property sector in the long term and we expect strong regional growth to underpin office demand from multinational corporations, absorbing the new office supply, which we view largely as a timing issue, as highlighted in our previous notes.

In view of limited investment opportunities in the Singapore Grade A office space market, CapitaLand Commercial Trust made its first foray into overseas markets by acquiring a 94.9% stake in Gallileo, a Grade A freehold commercial property in Germany. We view this transaction positively as it provides the trust with an opportunity to diversify into foreign markets and acquire a freehold asset. The trust also managed to take advantage of the current low interest rate environment in Germany. In the industrial property space, Ascendas Real Estate Investment Trust has also stated it is looking at investment opportunities in the U.S. and Europe. We think that the trusts' active portfolio management and overseas diversification are the right strategies going forward as these will help to drive growth for the trusts.

Within our Singapore REIT coverage, we continue to prefer **CapitaLand Mall Trust** C38U given the trust is trading on the largest discount to our fair value estimate with a price/fair value estimate ratio of 0.87 times. We believe that active portfolio management, ongoing asset enhancement initiatives, adaptive to technology advancement and redevelopment of its properties will continue to generate long-term growth for its unitholders. In the medium term, growth will be supported by the redevelopment of Funan.

Of the two developers under our coverage, there is no change in our view **City Developments** C09 will benefit more from a recovery in the residential property market in Singapore. For CapitaLand, the group has prudently participated in land auctions in Singapore, but a more geographically diversified operation sees capital allocation considered across all divisions. While the group has lower exposure to Singapore residential development, it benefits from a greater number of opportunities across the region. This is most prominent in its exposure in China, with a large portfolio of investment properties including malls and serviced residence, and a residential property development business. With a strong rally in City Developments' share price late last year, we see CapitaLand as better valued. Trading at a 20% discount to our fair value estimate of SGD 4.20, we believe the upside from CapitaLand's more diversified business and upside from its China operation is not factored into current share price.

Hong Kong and China Real Estate Outlook

Contributed by Phillip Zhong

In Hong Kong, the physical property market continued to trend higher, with the Centaline Leading Index up 10.7% through beginning of June. This is on top of a double-digit rise last year. However, the torrid pace of activity seen at the beginning of the year has slowed; total number of transactions are up 4% through May, compared with 60% in January. In particular, primary market sales are down 25% compared with a year ago.

Mirroring the U.S. Federal Reserve's rate hike, the Hong Kong Monetary Authority, or HKMA, lifted the base rate by another 25 basis points to 2.25% in mid-June. The impact of the rate hikes are gradually spreading throughout the system. The Hong Kong Interbank Offer Rate, or Hibor, continues to edge higher in the second quarter as liquidity exited Hong Kong, with the one-month rate hitting a 10-year high. The latter saw the HKMA intervening in the foreign currency market to maintain the Hong Kong

dollar peg. We maintain our view that stronger U.S. economic conditions underpin the normalization of interest rates, translating into higher interbank rates for Hong Kong. We expect the tightening liquidity will be a headwind to the Hong Kong property market.

The Hong Kong office market is still robust while the retail sector continues to recover. We continue to see highly valued transactions in the private market at very low capitalization rates, with Chinese corporates being the sole buyers. We prefer those with effective capital management by recycling proceeds from asset disposals into higher-yield assets outside of Hong Kong or returning capital to investors through share buybacks or special dividends.

The Chinese property sector continued to slow under the weight of government policy, with year-to-April sales volume up 0.4% year on year, compared with 13% a year ago. Sales by values are up 10%, indicating continued growth in average selling price. The 70-city price index from Bureau of Statistics showed a faster and broader price growth in May, with second-tier cities gaining the most.

Listed developers are still seeing strong sales growth due to continuing consolidation trend, albeit at a slower rate than before. We expect the tightening policy to persist, capping volume and price growth, maintaining the current headwind for the sector. Growth is likely to be modest compared with a year ago, especially for mass residential developers. We favor the quality names with operational focus in higher-tier cities that typically have more constrained supplies and solid demand. Major Chinese developer shares spiked higher in January along with the market before retreating. Some quality names are reasonably priced including **China Vanke** 02202 and **China Overseas Land & Investment** 00688.

Top Picks

Welltower WELL
Star Rating: ★★★★
Economic Moat: None
Fair Value Estimate: $74
Fair Value Uncertainty: High
5-Star Price: $44.40

Welltower currently trades at roughly a 23% discount to our $74 fair value estimate. We think that the shares have traded down over the past six months on issues that are short-term in nature and are already baked into our estimates. Longer term, we believe the top healthcare real estate stands to disproportionately benefit from the Affordable Care Act, as there is an increased focus on higher-quality care in lower-cost settings. The best owners and operators in the industry, which can provide better outcomes while driving greater efficiencies, should see demand funneled to them from the best healthcare systems. Additionally, the baby boomer generation is starting to enter its senior years and the 80-and-older population, which spends more than 4 times on healthcare per capita than the national average, should almost double over the next 10 years. While shares of healthcare REITs have underperformed due to expectations of lower senior housing growth in 2018 from high supply and a

severe flu season, growth should pick up in the next few years as supply growth falls off and demand picks up significantly. Additionally, first quarter fundamentals came in above expectations, suggesting that the near-term weakness may not be as bad as previously feared.

Boston Properties BXP
Star Rating: ★★★★
Economic Moat: None
Fair Value Estimate: $143
Fair Value Uncertainty: Medium
5-Star Price: $100.10

We still like high-end Class A office providers such as Boston Properties, which is currently trading at a 17% discount to our $143 fair value estimate. The company operates its portfolio of office buildings across five key geographic markets (Boston, Washington, D.C., New York, San Francisco, Los Angeles). The company has a large, multi-billion dollar development pipeline that are creating new office properties and spaces that are attractive to young, professional talent and should be increasingly filled by technology and life science firms. While the company's portfolio has become increasingly suburban-focused where there are fewer barriers to entry and new supply can easily enter the market, we think the life science and healthcare industries are attractive industries to partner with from a leasing perspective. Management has been prudent in recycling capital over the years, maintaining a modern portfolio of assets that continue to meet tenant demand in an evolving labor market. M

The authors of this sector outlook don't own shares in any of the securities mentioned above.

Technology: Data Security and Privacy Remain on the Forefront

Data security and privacy remain at the forefront of technology.

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

- Overall, we view the tech sector as modestly overvalued at a market cap weighted price/fair value of 1.02.
- Enterprise cloud computing remains the most important story in tech.
- Data security and privacy remain at the forefront of technology.
- We still see a hot M&A sector, particularly in semis and software.

Overall, we view the tech sector as slightly overvalued today at a market cap weighted price/fair value of 1.02 as of May 31, versus 1.05 as of the end of February and 1.08 at the end of November. The Nasdaq index has risen about 4% from mid-March to mid-June and is up about 11% year to date in 2018 as of mid-June.

In our view, the single most important trend in technology remains the ongoing shift toward cloud computing, which we think is having ramifications on dozens of stocks across our coverage. We continue to see several undervalued names with healthy cloud computing exposure, such as **Microsoft** MSFT and **Salesforce.com** CRM. In short, both startups and enterprises, in efforts to reduce the high fixed costs associated with running on-premises 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 Azure and **Google** GOOGL. In turn, IaaS vendors, along with "software-as-a-service" vendors are seeing tremendous growth while legacy IT vendors face ongoing headwinds. In SaaS, **Adobe** ADBE and Microsoft have been especially adept at transitioning to the SaaS model, as selling subscription software, rather than charging for upfront licenses, have expanded their customer bases. **Oracle** ORCL, for one, has been relatively slower to pivot, in our view, albeit with some signs of optimism at times.

Perhaps the most newsworthy items in technology over the past few months have been Facebook's privacy, data security, and regulatory struggles. Cambridge Analytica gained access to data on a reported 87 million **Facebook** FB users, casting a spotlight on the details of data captured, maintained, and shared by the social network, along with how Facebook uses such data to monetize its business. Separately, Europe recently passed its General Data Protection Regulation, which strives to standardize data capture, privacy, and distribution requirements for businesses as well as set guidelines to enable citizens to better understand their rights associated with user data. Finally, as part of the debate around Facebook's user policies, **Apple** AAPL's Worldwide Developer Conference highlighted several new features embedded within its Safari browser and iOS operating system that will strive to protect user data, restrict browser tracking, and allow users to set limits to their screen time and interactions in certain applications. While we anticipate that Facebook will weather the storm around increased near-term data scrutiny, and note that the stock has bounced back in recent weeks after a Cambridge-related dip, data security and privacy will continue to be hot topics for debate among several tech titans.

Another ongoing trend within technology remains M&A. In the second quarter, two notable deal announcements were Adobe's bid to enter into commerce by acquiring Magento and Microsoft's $7.5 billion valuation of developer community Github. We anticipate more and more software deals in the years ahead, as leading vendors like Adobe, Microsoft, Salesforce, Oracle, **Workday** WDAY, and others continue to branch out from their core product lines and tack on adjacent opportunities. Similarly, non-traditional software vendors, like **Cisco** CSCO and Amazon, may make software-related deals as well, as software is becoming a more important portion of their enterprise offerings. We believe that the ability to provide customers with additional software offerings leads to a stickier customer base and raises customer switching costs, which underpins our moat ratings for many software leaders. We have not seen a sizable merger in the semiconductor space in the past couple of months, but this sector remains a hot one. Recent deals include **Microchip** MCHP's bid for Microsemi, **Marvell** MRVL's acquisition of **Cavium** CAVM, and **KLA-Tencor** KLAC's deal for **Orbotech** ORBK. We still anticipate consolidation in the semiconductor industry as larger players seek scale and diversification while still being able to strip out excess costs and drive operating leverage.

Top Picks

Synaptics SYNA
Star Rating: ★★★★
Economic Moat: None
Fair Value Uncertainty: Very High
Consider Buying: $32

Synaptics is a leading-edge smartphone component provider whose touch, display, and fingerprint solutions are ubiquitous across premium mobile devices, including the Apple iPhone and Samsung Galaxy. We expect greater adoption of organic light emitting diode displays, integration of touch and display, and fingerprint sensors to drive average revenue growth in the midsingle digits for Synaptics. Despite its current technology lead, major customers such as Apple and **Samsung** SSNGY have sought to develop their own internal solutions to replace those provided by the likes of Synaptics. Combined with the recent deceleration in smartphone growth and cutthroat nature of the smartphone component supply chain, we assign no-moat Synaptics a very high uncertainty rating. With the shares trading at a wide discount to our fair value estimate, we believe the current risk/reward balance favors investors with a long-term horizon.

Criteo CRTO
Star Rating: ★★★★
Economic Moat: None
Fair Value Uncertainty: Very High
Consider Buying: $18.50

Criteo, one of the leading ad-tech companies in the growing digital ad market, is currently trading well below our fair value estimate, creating an attractive buying opportunity, in our view. While significant

changes in the retail industry, possible increasing competition from the two dominating firms in digital advertising, and various data tracking changes brought about by companies such as Apple have increased risks faced by Criteo, we believe they are more than priced in to the stock. In our view, given the disruption in the overall retail environment, the firm is taking the right steps in investing in new product development to attract more retail ad and marketing dollars. Criteo is further integrating its engine with its clients' CRM systems to gather more consumer purchasing behavior data. Such data can be utilized for more timely and higher yielding online retargeting and multichannel marketing campaigns. We also think Criteo is well aware of possible threats from its friends/enemies Google and Facebook, which is why it continues to invest in new offerings and in expanding its services into new geographic regions. Also, we have taken such competition from the two behemoths into account as we continue to give Criteo a negative moat trend rating.

Microsoft MSFT
Star Rating: ★★★★
Economic Moat: Wide
Fair Value Uncertainty: Medium
Consider Buying: $85.40

We view Microsoft as one of two top-flight public cloud infrastructure- and platform-as-a-service vendors in the world alongside Amazon, and we think it is poised to amass greater market share. We think the market opportunity for IaaS and PaaS numbers in the hundreds of billions, as large public cloud vendors will consolidate IT spending that was once allocated to disparate vendors around a small handful of strategic providers. We view Microsoft as one of those strategic providers, and we believe its Azure offering will grow at a 31% compound annual growth rate over the next 10 years, eventually contributing north of 35% of total revenue by the end of our explicit forecast period compared with an estimated 9% in fiscal 2018. We also view the opportunity around Office 365 as one of the most important long-term growth stories for the firm. Office 365 is now larger than the legacy Office business, and we expect Microsoft to enjoy the natural uplift in lifetime customer value that comes with a migration to a high-retention subscription model. We think the firm provides a better value to consumers across applications and storage, reflected in the firm's 30-million-plus consumer subscribers. Microsoft remains one of the highest-quality operators in enterprise software today, and we believe the business is starting to pick up steam as it works through declines in its legacy businesses. Finally, shareholders can also reap the benefits of a robust capital return program that has returned more than $70 billion to shareholders in the past three years by way of dividends and share repurchases. M

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

Utilities: Back to Fair Value With Some Emerging Opportunities

Utilities investors have buying opportunities but should pick carefully.

By Travis Miller
Senior Equity Analyst

- On a global basis, utilities now trade mostly in line with our fair value estimates at a 1.0 price/fair value ratio. Most utilities across our coverage universe have aggressive investment plans with mostly constructive public policy support. As long as energy prices remain stable, we expect 5%–7% annual earnings and dividend growth across the sector during the next few years.
- For income investors, U.S. utilities' dividend yield premium relative to interest rates has evaporated as interest rates have continued to climb. The spread between utilities' 3.5% dividend yield and 3% 10-year U.S. Treasury yield is the smallest since 2009 and near the 25-year average spread. Utilities had enjoyed a 200-basis-point yield premium as recently as late 2016, which helped cushion the sector from the sharp rise in interest rates. But with little yield premium left, we expect utilities will become more sensitive to interest rate changes.
- On the active M&A front, Great Plains Energy and Westar Energy closed their merger, creating **Evergy** EVRG. We still expect AltaGas to close its acquisition of **WGL Holdings** WGL and we wouldn't be surprised if industry consolidation continues. **CenterPoint**'s CNP acquisition bid for Vectren could be a model for future deals. **Dominion Energy** D and **Scana** SCG likely will find out by year-end if South Carolina regulators will bless their merger proposal.

Utilities have had a rough road the past six months, down 9% since they peaked in November while the S&P 500 is up 9% since then, both including dividends. No other sector has performed so poorly during that time period. We don't see that trend reversing any time soon. A strong economy and a steady climb in interest rates rightfully could send investors away from utilities.

The sector downturn has made valuations much more reasonable, but we still don't think investors should get overly excited about the sector as a whole. On a median basis, utilities now trade in line with our fair value estimates, both globally and in the U.S. This is the cheapest the sector has been since 2015. In the U.S., this is a sharp reversal since mid-November when utilities reached a peak 1.18 price/fair value ratio.

The sector pullback does create some select opportunities for income and value investors, as we highlight below. We think income investors should pick wisely among those utilities with yields above 4% and decent growth prospects. Value investors have opportunities among a few utilities that risk-averse income investors have abandoned. Two of those, Scana and **PG&E** PCG, likely won't pay dividends the rest of the year but offer 25% or more upside if they clear their respective hurdles with minimal harm. We think the market is pricing in a worst-case outcome for both.

Sector fundamentals remain strong. For the most part, U.S. utilities have strong balance sheets and reasonable payout ratios that should support dividend growth for at least the next few years. We see

plenty of growth opportunities in the sector. Low gas prices are supporting infrastructure investment to give more customers access to low-cost energy. Low gas prices also are driving a continued shift away from coal power generation to gas generation despite the Trump administration's efforts to save coal. We think policy efforts are doomed as long as gas prices stay low.

Renewable energy is another source of global near-term and long-term growth for utilities. In the U.S. wind generation costs have come down such that wind can compete with natural gas as the generation fuel of choice to meet public policy objectives and serve electricity demand growth. Solar is on the same falling cost trajectory. Utilities like **Xcel Energy** XEL, **NextEra Energy** NEE, **CMS Energy** CMS, and others have made renewable energy investment their primary source of growth during the next five years. Infrastructure to support electric vehicles offers more growth potential.

Top Picks

The utilities sector continues to trade near its market-cap weighted fair value globally. Valuation multiples such as P/E and P/B remain slightly above 10-year averages but are down markedly in the past nine months. This is as cheap as the sector has been in several years, creating some select buying opportunities for income and value investors.

Scana SCG
Star Rating: ★★★★★
Economic Moat: Narrow
Fair Value Estimate: $57
Fair Value Uncertainty: Medium
5-Star Price: $39.90

In January, Dominion stepped in as a potential savior for Scana investors who have been punished since management abandoned its new nuclear project in mid-2017. The market remains skeptical that Dominion and Scana have the charm to win over South Carolina politicians, regulators and customers despite what Dominion called the largest proposed financial giveaway to utility customers in U.S. history. We think the companies have a 75% chance of winning support for the all-stock deal. The market has warmed to our thinking as the merger spread closed from 30% to 18% since March even as Scana suspended its dividend. The alternative is a long legal and regulatory morass as Scana tries to recover some $5 billion of sunk capital and avoid potential bankruptcy if regulators and politicians deny cost recovery and force refunds. We don't think regulators will go that far and we like Scana's core business, so we think this is a good risk-reward trade-off for investors.

PPL PPL
Star Rating: ★★★★★
Economic Moat: Narrow
Fair Value Estimate: $35
Fair Value Uncertainty: Low
5-Star Price: $28

PPL has attractive regulated growth opportunities that could produce 6% annual rate base growth through 2022, supported by PPL's operations in constructive regulatory jurisdictions. Some 70% of PPL's planned capital expenditures will have little or no regulatory lag. During the next five years, PPL plans to spend $15.4 billion at its regulated utilities and on additional transmission opportunities, supporting our projected 5.5% annual earnings growth through 2022. The U.K. distribution utility continues to be the focus of investor concern. U.K. politicians are pressuring regulators to reduce the region's high power prices. Much of the political focus has been around the electric suppliers to which PPL has no exposure. Ultimately, we think the U.K. regulatory environment remains constructive, albeit with lower allowed returns.

Dominion Energy D
Star Rating: ★★★★★
Economic Moat: Wide
Fair Value Estimate: $84
Fair Value Uncertainty: Low
5-Star Price: $67.20

Dominion Energy's investments in energy infrastructure projects in the Eastern United States should result in wide-moat businesses generating approximately 50% of operating earnings by 2021, up from about 30% in 2016. The remaining earnings are primarily from narrow-moat regulated gas and electric utilities in states with long histories of constructive regulatory frameworks, industry-leading sales growth, and high-return investment opportunities. In addition, the 2016 Questar acquisition added a 2,700-mile pipeline network in Utah, Wyoming, and Colorado that we believe will offer wide-moat investment opportunities into the next decade. These opportunities and the earnings power of its core businesses should allow Dominion to increase its dividend 10% in 2019 and in line with earnings through the next decade. Dominion's wide moat, secure and growing dividend, and long-term earnings growth outlook have the potential to deliver double-digit total annual returns for conservative investors for the foreseeable future. M

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

Venture Capital Outlook: With Ample Available Capital, Growing Venture Market Is Subject to Inflationary Pressures

We expect startups to continue securing outsize financing as private capital remains available, giving rise to inflationary market effects.

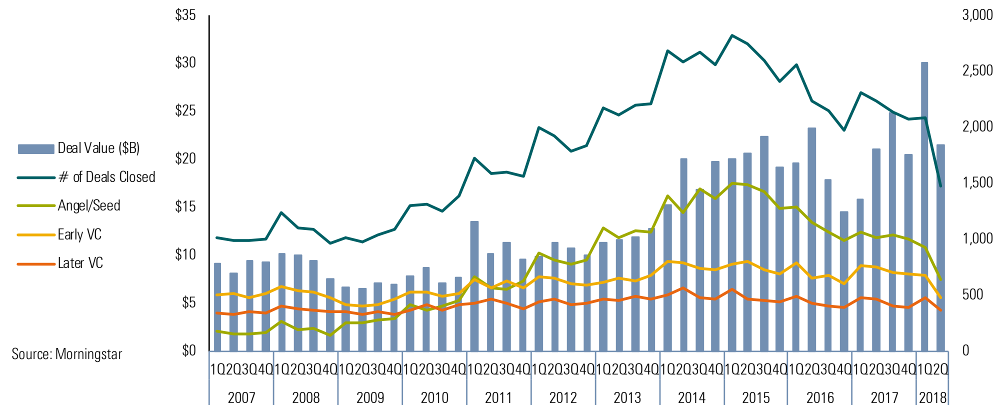
By Joelle Sostheim
Analyst, Venture Capital, PitchBook

- Although the number of deals has leveled out in the past few quarters, startups continue to secure massive financing rounds compared with historical levels.
- Despite a slight uptick in tech IPOs, exits remain subdued as startups stay private for longer periods, spurring investors to pursue innovative exit routes and secondary activity.
- As startups command greater sums in initial and follow-on financing, we believe venture fund sizes will continue to grow as managers seek to maintain equity positions and avoid dilution.

As institutional investors continue to search for outperforming asset classes to fulfill future funding obligations, capital has continued to flow into the private markets at an extraordinary rate. Both startups and venture funds have secured unprecedented amounts of capital, with General Catalyst, New Enterprise Associates, and 10 other venture capital firms raising funds of $1 billion or more since 2016. Ample dry powder in venture capital funds has facilitated 129 venture capital rounds larger than $50 million closed in the first quarter alone, a 115% increase year over year. We believe inflated venture funds and financing are a product of a maturing U.S. venture market, with high competition for deals spurred by both domestic and international investors like SoftBank. We also believe this dynamic has led investors to become more selective in their deployments, shifting the entire venture market toward funding fewer but more mature companies at each stage of development.

U.S. startups collectively raised over $70 billion in funding each year since 2014 and have already secured over $51 billion so far in 2018. Deal count has steadily declined, however, as more mature companies have secured larger sums to supplement their development. This is evidenced by a swift decline in angel and seed activity, while late-stage deal-making has seen sustained strength.

Exhibit 1



Source: Morningstar

We believe the effects of this trend have manifested in an upward shift in the entire venture ecosystem, especially affecting companies at the earliest stages of venture-backing. A few years ago, venture investors and startup founders were remarking that "seed is the new Series A"; as that shift has occurred, competition among startups and investors at the earliest stages has led to the emergence of a stage referred to as "pre-seed." Because startups that in the recent past would have received early-stage financing are now seeking out seed capital, less developed companies must look to "pre-seed" investors for capital. Our research indicates that investors at this very early stage are acting more selectively while taking larger equity stakes to compensate for the higher risk. We see this creating greater barriers for startups looking to raise initial funding rounds, as seed-stage companies will need to reach more milestones if they hope to get funded.

With more-developed companies raising capital at each stage, round sizes and valuations have increased correspondingly. Angel & seed and early-stage valuations have both increased at a steady clip in recent years. At the same time, late-stage valuations have spiked in 2018, reaching $75 million in the first quarter, a 19% increase year over year.

In terms of exits, capital availability has provided both drawbacks and benefits for investors. With ample supply, some startups have opted to stay private longer because the capital they traditionally would need to access via public markets is now readily available in private markets, with fewer strings attached. This has subsequently extended the time it takes to exit venture-backed companies, leaving investors with extended hold periods and return horizons. On the other hand, outsize exits have also become increasingly common in the presence of well-developed late-stage companies commanding higher valuations at time of exit. Exits of $100 million or more made up 16% of all disclosed exits, and 92% of all exited capital in the first half of 2018. With a strong pipeline of late-stage unicorns preparing for exits, we expect 2018 will outpace the previous year in terms of unicorn exits; however, we also expect to see continued secondary activity as venture capitalists search for additional means of achieving liquidity.

Exhibit 2 Exits (#) by Size

Source: PitchBook

Private Equity Outlook: Firms Revamp the Traditional PE Playbook

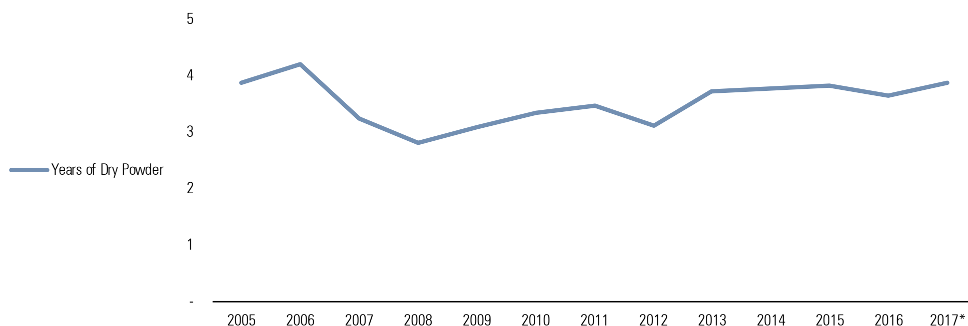
As capital continues to build up from strong fundraising and competition for deals across the spectrum heats up, PE firms are adapting to a more challenging environment.

By Wylie Fernyhough
Analyst, Private Equity, PitchBook

- Private equity funds have seen strong inflows in 2018 as institutional investors continue increasing their private equity allocation.
- Though fundraising and dry powder have proliferated in recent years, private equity deal-makers have accelerated their investment pace to put that capital to work.
- Private equity firms are utilizing new value creation levers, including add-on acquisitions and longer hold periods, to adapt the traditional LBO model for a climate of higher prices and increasing competition.

Fundraising in 2018, and the years prior, has been strong as large institutions continue to increase their allocation to private markets, especially private equity. Fueled by this strong fundraising, private equity firms deployed more capital from 2015 to 2017 than any other three-year stretch in history. Even though investment activity has been strong, uncalled capital has continued building up, leading to record dry powder figures. Rather than focusing on the absolute number, we prefer to put it in perspective by normalizing dry powder for current levels of investment activity. Looking at the average amount of capital allocated over the trailing three-year period, we find that private equity firms have 3.9 years of dry powder on hand. In other words, if private equity firms were to cease fundraising immediately, it would take 3.9 years to invest all available capital. While still below the 2006 peak of 4.1 years, this figure has been steadily trending up since the global financial crisis.

Exhibit 1



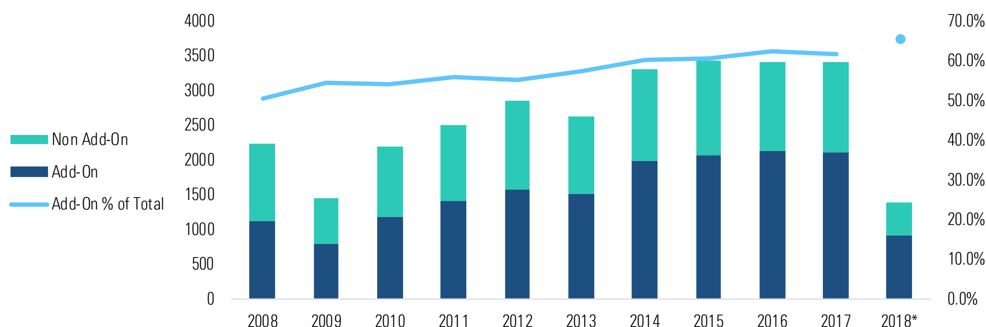
Source: PitchBook

Heightened competition in the buyout market has led to elevated EV/EBITDA purchase-price multiples. The recent corporate tax rate reduction outlined in the Tax Cuts and Jobs Act ought to further inflate

EV/EBITDA multiples, with lower corporate tax bills translating to increased free cash flow. Given current multiples, many private equity firms are modeling deals without factoring in any multiple expansion at exit, and some are even expecting multiple contraction. Without counting on what has traditionally been one of the largest drivers of return, private equity firms are increasingly using the "buy-and-build" strategy, whereby one—or many—add-on acquisitions are used to generate value from portfolio companies. The strong trend is visible in the data, which shows that add-ons are increasing in frequency and proportion, now representing nearly two thirds (65%) of all buyouts. The goal of these add-on acquisitions is to build scale, drive revenue growth and increase returns. Additionally, add-ons are often acquired at lower multiples than the original platform, thereby "blending down" the aggregate multiple for the combined company.

KRG Capital Partners, Mountaingate Capital and PennantPark partnered together and executed this strategy to drive strong returns for their investment in Convergint Technologies, undertaking 20 add-ons between September 2013 and February 2018. During this time, Convergint's value grew from $345 million to $1.62 billion, while the GPs were able to realize additional value by completing a dividend recap two years in to their hold period. Add-ons can be an effective means of value creation, but the strategy takes more time and resources. Despite the effort required, we believe the number of add-ons will continue to rise as private equity firms feel an increased pressure to put dry powder to work.

Exhibit 2



Source: PitchBook.

Growing reserves of dry powder have also prompted many GPs to pursue larger deals. And as the number of multibillion-dollar transactions has increased, PE firms have lost many bidding competitions to corporate acquirers. In response, some PE firms are changing the structure of their funds to make longer-term transactions viable, and hopefully better position themselves to compete with corporate acquirers by enabling a decade-plus value creation plan. These long-dated and evergreen (that is, permanent capital) funds give companies more time to digest additional add-on acquisitions and pursue longer-term growth opportunities unavailable with the standard four to six-year holding period.

While these long-dated funds open new opportunities to private equity firms, they also benefit LPs. Longer hold times create fewer taxable events, allowing capital to compound longer before paying

capital gains. The longer funds also save LPs time and money by reducing the frequency of new fund commitments and the requisite manager due diligence. Fees tend to be lower than the traditional 2/20 as well, with Carlyle Global Partners reportedly charging a 1% management fee and 15% carry, with no fees charged on uncalled capital. We believe these longer dated funds will gain in stature as the private equity industry continues to mature and offer LPs additional investment strategies.

Private equity continues to adapt to rising valuations and elevated dry powder levels, finding new ways to put capital to work. We expect to see private equity firms continue to undertake value-creation methods beyond those available to the plain-vanilla LBO. We believe the remainder of 2018 will see unique fund offerings—such as long-dated funds—become a more common, and add-ons to proliferate further. M

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