Market Outlook
Q3 2016

June 29, 2016

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Stock Market Outlook: A Year of Contradictions

The best-performing sectors thus far in 2016—utilities, consumer staples, energy, and basic materials—all look overvalued to our analysts.

By Matt Coffina, CFA, Editor of Morningstar StockInvestor

- The S&P 500 has rallied since bottoming in mid-February and is back within a few percentage points of its all-time high. As a result, our analysts once again don’t see much value in the market as a whole.

- This has been a year of contradictions, with the market’s best-performing sectors coming from opposite ends of the risk spectrum: utilities and consumer staples on the defensive side and energy and basic materials on the cyclical side. Our analysts find all of these sectors overvalued.

- While no sectors are deeply undervalued, we’re finding the best opportunities among out-of-favor financial-services, consumer cyclical, and healthcare stocks.

Interest Rates, Economic Fears, and TINA

After a rough start to the year—the S&P 500 fell more than 11% in the first six weeks of 2016—the market abruptly reversed course. Although the “Brexit” vote caused volatility in recent days, we’re still within a few percent of the all-time high, and our analysts find the average stock in our coverage universe to be trading close to fair value.

The fears that had gripped investors early in the year haven’t exactly gone away: Economic growth is still sluggish to nonexistent around the world, corporate earnings are moving in the wrong direction, and valuations remain well above historic norms. However, investors appear to be coalescing around a worldview that’s even gained its own endearing acronym: TINA, as in “there is no alternative” to stocks.

Defying previous expectations for multiple Federal Reserve interest-rate increases this year, long-term Treasury yields have drifted lower since the beginning of 2016. At first, this was seen as reason for concern. If the Fed isn’t in a position to raise rates now—seven years into the recovery and with unemployment at just 4.7%—then there must be something seriously wrong with our economy.

But TINA thinking is overtaking economic jitters. Sure, corporate earnings have been terrible. And sure, the S&P 500 was recently trading for 21 times trailing 12-month operating earnings—a level not seen since the cyclically depressed earnings of 2009. But investors have
to put their money somewhere. Even overvalued stocks are better than a 10-year Treasury yielding 1.5%, right?

**Commodity Price Rebound: Real or Illusory?**

The drop in interest rates explains half of the year’s best-performing sectors: Defensive stocks like utilities, REITs, and consumer staples—widely viewed as the most bondlike stocks—have been on a tear. The other half of the story can largely be attributed to a rebound in commodity prices ranging from oil to iron ore. Commodity prices are still well below their levels of a couple years ago, but they’re well above the recent lows, giving investors hope that the worst may be behind us. As a result, energy and basic materials have joined the most defensive sectors in leading the market higher in 2016—one of the stranger correlations you’ll see.

Unfortunately, our analysts believe investors have already overreacted to the runup in commodity prices. This is especially true for industrial commodities, where our bearish view on China’s infrastructure spending causes us to believe that current commodity prices are unsustainable. As of May 31, energy and basic materials were both trading more than 25% above our market-cap-weighted average fair value estimates, making them the most expensive sectors by far. Long-suffering commodity investors may want to take this relief rally as a chance to run for the exits.

Defensive, interest-rate-sensitive sectors also look overvalued to our analysts, though not to the same extent as energy and basic materials. We recently pegged utilities’ market-cap-weighted average price/fair value ratio at 1.07 and consumer defensive’s price/fair value at 1.04. These companies may be insulated from economic ups and downs, but many of them struggle to deliver attractive revenue and earnings growth.

**Financial Services, Consumer Cyclical, and Healthcare Offer Better Values**

No sector looks obviously cheap in this fully valued market, but we’re finding relatively better values among beaten-down financial-services, consumer cyclical, and healthcare stocks. These sectors carried average price/fair value ratios of 0.88, 0.93, and 0.95, respectively, as of May 31.

Diminishing expectations for interest rates have been a significant headwind for financial services. Banks have seen steady erosion in their net interest margins, and were counting on Federal Reserve rate hikes to reverse this situation. For valuation purposes, our analysts still assume a long-term, normalized 10-year Treasury yield around 4.0%—4.5%. In a discounted cash flow framework, this long-term assumption matters more than the path taken to get there.

Within consumer cyclical, we believe investors have overreacted to the challenges facing apparel retailers. E-commerce poses a serious long-term threat, but there are also cyclical elements to recent weak apparel results, including excess inventory and a lack of
new fashion trends. We think off-price retailers and branded apparel manufacturers, especially those selling basic replenishment goods like undergarments, are best positioned for the long run. Traditional retailers and department stores look most at risk.

As for healthcare, we see improved pipeline productivity driving growth at pharmaceutical and biotechnology firms. Despite political rhetoric around drug pricing, we expect pricing power to remain strong as companies deliver innovative new therapies in areas of unmet medical need, such as oncology and immunology. New immuno-oncology drugs are reaching the market in half the time of drugs developed a decade ago thanks to both scientific advancements and a more accommodative regulatory environment.

*Matt Coffina, CFA, does not own shares in any of the securities mentioned above.*
Credit Markets: Snap-Back Rally Stalled

The impact of the ECB’s asset purchase program should at least partially offset Brexit-related volatility.

By Dave Sekera, CFA, Managing Director, Corporate Bond Strategist

- The corporate bond market will be pressured by the uncertainty caused to the global economic outlook by the U.K.’s decision to exit the EU. However, the impact of the ECB’s asset purchase program should at least partially offset this volatility.

- As credit spreads in Europe tighten and new supply of U.S. corporate bonds diminish, it will naturally result in tighter credit spreads in the U.S. as well.

- Between the reduced probability of a near-term rate increase and the flight-to-safety spurred by Brexit, long-term interest rates are lower across the yield curve than at the end of last quarter and have added to gains in the fixed-income market in the second quarter.

The snap-back rally that began in mid-February stalled out in May, and corporate credit spreads have traded in a relatively narrow trading range since then. In the near term, the corporate bond market will be pressured by the uncertainty caused to the global economic outlook by the U.K.’s decision to exit the EU; however, at least partially offsetting this volatility, corporate bonds will benefit from new demand spurred by the ECB’s expanded asset purchase program, which started purchasing non-financial corporate bonds in June. With over $10 trillion of sovereign debt trading at a negative yield, the yield on U.S. fixed income securities appear attractive to global investors.

In our Credit Weekly Highlights dated May 2, we highlighted that the snap-back rally in the investment-grade corporate bond market had run out of steam (Investment-Grade Corporate Bond Rally Runs Out of Steam). Since then, the average spread of the Morningstar Corporate Bond Index has traded within a relatively narrow range. Earlier in the year, at the end of February, after credit spreads had widened dramatically in sympathy with declining oil prices and signs of global economic disruption, we noted that U.S. economic metrics were coming in better than expected and that oil prices had appeared to find a near-term bottom. Considering credit spreads at that time were near levels more consistent with recessionary periods, we opined that with the improvement in the economy and further recovery in oil prices, credit spreads could tighten in a snap-back rally.

As oil prices bounced and economic metrics stabilized, the corporate bond market quickly recovered much of its losses in March and April. However, as credit spreads normalized and approached their long-term averages, we noted in May that, in our view, the current level of corporate credit spreads appeared to reasonably balance risk and reward. This is based
on our assessment that over the near term, corporate credit risk will be balanced between continued slow domestic economic growth that will generally support credit quality, which will be offset by sector-specific weakness and idiosyncratic catalysts.

Over the past quarter, credit spreads on investment-grade corporate bonds tightened in early April, but have traded within a narrow range over the remainder of the quarter. Quarter-to-date, the average spread of the Morningstar Corporate Bond Index (our proxy for investment-grade corporate bonds) has tightened 11 basis points to +154. In the high-yield space, credit spreads tightened over the first half of the quarter and then remained within a relatively narrow trading range over the latter half of the quarter. Thus far this quarter, the average spread of the BankAmerica Merrill Lynch High Yield Master Index has tightened 72 basis points to +633.
Treasury bond yields rose in April when investors began to price in a higher probability that the Fed may raise rates at the June meeting; however, after a discouraging May payrolls report revealed unexpected weakness in the labor market, the market-derived probability of a June rate rise fell precipitously into the single digits. Between the reduced probability of a near-term rate increase and the flight-to-safety spurred by Brexit, long-term interest rates are lower across the yield curve than at the end of last quarter and have added to gains in the fixed-income market in the second quarter.

While corporate credit spreads widened slightly in May, year to date, returns in the corporate bond market have been substantially higher than our original expectations for the year. Gains have been driven by a combination of declining interest rates, tightening credit spreads, and yield carry. Since the end of last year, yields on long-dated sovereign bonds, including U.S. Treasuries, have fallen with several reaching new historic lows and in some cases are now priced to deliver negative yields. Demand for sovereign bonds has stemmed from the ECB’s asset purchase program, requirements for banks to hold greater amounts of government debt as capital, and investors apprehension as to whether the stock market can make further gains as earnings expectations have diminished.
In the near term, the corporate bond market will be pressured by the economic uncertainty caused by the Brexit; however, the impact of the ECB’s asset purchase program should at least partially offset this volatility. Corporate bonds will benefit from new demand spurred by the ECB’s expanded asset purchase program, which started purchasing nonfinancial corporate bonds in June.

Based on the amount of purchases the ECB has made thus far, if the ECB continues at the same pace, it would acquire between EUR 8 billion to EUR 10 billion per month. These purchases will effectively remove supply of corporate fixed-income securities from the public markets and create new cash that must then be reinvested. As this cash is then reinvested, bond traders may have to push prices up on European corporate bonds, thus lowering credit spreads, in order to buy bonds to reinvest the proceeds. Furthermore, companies will likely shift new bond issuance toward euro-denominated bonds to take advantage of the lower all-in yields. As credit spreads in Europe tighten and new supply of U.S. corporate bonds diminish, it will naturally result in tighter credit spreads in the U.S. as well.

Our outlook is based on the following forecasts:

- Real US GDP growth will average 2.2% in the second half of 2016.
- Downgrades will continue to outpace upgrades.
- Earnings will remain under pressure as the stronger dollar and weaker global growth hampers earnings growth.

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Sources: Morningstar, Bank of America Merrill Lynch. Data as of 6/24/16.
Energy prices, specifically oil, will trade in a seesaw fashion, or “fits and starts,” through the second half of 2016 with the overall trend being slightly higher.

Still there remains significant potential for heightened downward volatility. The main risks to our outlook are:

- U.S. economic growth stumbles and enters a recession.
- Oil tumbles back below $40.
- Chinese and emerging-markets’ economic activity slows down meaningfully, resulting in a global economic slowdown.
- Heightened idiosyncratic risk (that is, renewed debt funded M&A boom, oversize share buyback programs, and so on)
- The re-emergence of European sovereign debt and banking crisis.

However, with the expansion of monetary stimulus and extension of the ECB’s asset purchase program to include corporate bonds, the degree of downside volatility should be suppressed as compared with the amount that corporate credit spreads widened out during the first quarter. In addition, the Fed appears to be on hold for the near term; whereas, earlier this year the market expected several increases in the federal funds rate. Finally, other global central banks, such as the Bank of Japan and the Bank of China, continue to pursue seemingly ever easier monetary policies, which add to the amount of global liquidity.
CMBS: Issuance Rebounding, but Hurdles Ahead

The pace of new issuance of commercial mortgage-backed securities could return to last year’s levels this summer, but upcoming regulations raise uncertainty.

By Ken Cheng, Managing Director CMBS, Structured Credit Research and Ratings

- Morningstar Credit Ratings, LLC ("Morningstar") expects to see an uptick in CMBS issuance beginning in August, but impending risk-retention requirements may temper loan originations later in the year.

- It will become progressively more difficult for CMBS loans underwritten during the market’s peak in 2006–07 to pay off at maturity.

- Loans in CMBS deals issued since 2008 continue to perform well, with notable exceptions such as those related to markets where the once-booming shale oil extraction industry has faltered.

After a lackluster start to the year, lenders are again actively originating commercial mortgages, and beginning in August, the pace of new issuance of commercial mortgage-backed securities could return to levels seen last year. However, risk-retention regulations set to take effect on Christmas Eve may lead to another pullback in loan originations beginning in November.

Since widening to 170 basis points on the benchmark AAA securities on Feb. 24 and 802 basis points on the BBB- securities on March 9, CMBS conduit spreads have rebounded, recording levels of 116 basis points for the AAA slice and 621 basis points for the BBB- slice as of June 8. Encouraged by a period of spread tightening since mid-March, lenders are again actively originating loans.

As of June 10, U.S. CMBS new issuance totaled $29.5 billion, down 39.5% from the year-earlier period. The CMBS market will fall well short of the $101.01 billion in volume issued last year and will likely end this year between $55 billion and $60 billion.

Risk-Retention Regulations Raise Issuance Uncertainty

The risk-retention rule aims to dissuade lenders from originating lower-quality loans by requiring them to retain exposure to potential losses. Under the rule, mandated by the Dodd-Frank Act, securitization sponsors must keep 5% of their deals or offload the responsibility to non-investment-grade buyers. The sponsors, typically large banks, can fulfill the requirement by maintaining a so-called vertical strip, or a portion of each tranche. They are, however, reluctant
to retain the bonds because separate risk-based capital regulations require banks to reserve capital against the retained bonds, and guidelines as to the amount required are unclear.

Alternatively, the rules can be fulfilled by non-investment-grade buyers holding a horizontal strip, but the B-piece buyers have concerns, as details of the rule requiring B-pieces to be sold intact conflict with B-piece buyers’ strategy to garner higher yields and desire for liquidity. The horizontal strip approach necessitates the B-piece buyers to take down the bottom 5% of the deal proceeds, including the interest-only strips. This requires B-piece buyers to purchase securities higher up the capital structure with lower yield than they traditionally target.

Amid the uncertainty, alternative solutions have surfaced. One possible approach involves B-piece investors becoming issuers themselves by purchasing the loans from lenders and securitizing them. By stepping into the shoes of the issuer, the B-piece buyer satisfies the risk-retention rule by holding the vertical strip and is not subject to sales constraints under the horizontal-strip approach. As a nonbank entity, the B-piece buyer is also not subject to capital charges on its retention. This approach, however, requires substantial capital and exposes B-piece investors to the SEC’s Regulation AB disclosure guidelines, which require a senior executive of the issuer to certify that the information provided to investors is accurate, potentially leaving the signer vulnerable to civil lawsuits by investors.

**Maturity Wall Shows Signs of Cracks**
Among loans packaged at the market’s peak in 2006–07, Morningstar sees signs of concerns. Unlike residential mortgages, which typically have terms of 15 or 30 years, commercial mortgages generally have terms of five, seven, or 10 years. Some $152.57 billion in CMBS loans will mature through this year and next, and some of them brought to market with rosy underwriting assumptions that were never realized will have difficulty paying off.

Morningstar expects paying off these loans to become progressively more challenging. The payoff rate for CMBS loans that matured in May sank to 65.3%, its lowest level in more than two years, dropping the payoff rate for all CMBS loans that matured this year to 81.7%. The CMBS market peaked in 2007 with issuance amounting to $228.56 billion, according to Commercial Mortgage Alert, a trade publication. We forecast that the payoff rate could drop below 65% for the $100.64 billion in CMBS loans maturing in 2017, based on their Morningstar loan-to-value ratios of more than 80%. A loan’s ability to refinance is based on several factors, including amortization, ability to meet existing bond obligations, and risks related to tenant lease expirations. That said, we have found an 80% LTV to be a reasonable barometer for estimating refinancing prospects.

**Postcrisis CMBS Performing**
Deals issued after the 2007–08 crisis have performed well. Much of this is attributable to the combination of more conservative underwriting relative to legacy deals, significantly higher credit-support levels throughout the capital structure, and improving U.S. economic conditions. As of June 2, Morningstar has upgraded ratings on 94 classes of securities and downgraded
only three classes. Of the $550.30 billion of outstanding postcrisis CMBS loan principal balance, only $1.08 billion, or 0.2%, have been transferred to the special servicer, and an additional $6.16 billion, or 1.1%, are on Morningstar’s Watchlist. By placing a loan on our Watchlist, we believe that the loan has elevated credit risk, but it will not necessarily default.

Despite the generally sound performance of CMBS deals issued postcrisis, there are some concerns. For example, loans originated in 2013 and 2014 backed by multifamily and hotel properties in the oil and gas patch of North Dakota ran into trouble, as the price of oil slumped throughout 2015 and early this year, with properties near the core of the Bakken formation particularly hard hit.

Many of the properties, constructed to house employees at the Bakken and Three Forks oil fields, drastically reduced rents and experienced higher vacancy as the number of operational rigs and workers needed to run them plunged. Of the 40 loans totaling $331.5 million exposed to the principal North Dakota locations abutting the oil fields as of May, 17 of the loans, or 45.9% by outstanding balance, have transferred to the special servicer. We project losses totaling $60.0 million on 14 of these loans. In addition to the loans with the special servicers, Morningstar placed seven loans backed by North Dakota collateral on our Watchlist. Fortunately, these loans should have minimal impact, if any, on their deals.

One CMBS conduit deal was significantly affected by the performance of a single loan. The $49.3 million loan backed by the Hudson Valley Mall in Kingston, New York, has been on our Watchlist for 16 months and with the special servicer for more than a year. This loan, the largest in CFCRE 2011-C1, accounts for 17.7% of the portfolio balance. At the time of origination five years ago, the mall, anchored by Macy’s, JCPenney, and Sears, had an occupancy rate of 95%. Since then, JCPenney and Macy’s vacated the mall, and occupancy has dropped to below 70%. Expiring leases within the next 12 months and kick-out clauses that afford tenants the option of terminating their leases or reducing their rents should their sales fail to improve within 12 months could erode occupancy by an additional 24%. Morningstar lowered its value of the property to about $17.4 million, or 64.8% less than the loan balance and 80% less than the appraised value at issuance. This resulted in downgrades to some subordinate classes of CFCRE 2011-C1 certificates.

A Recap of the First Six Months
The $29.5 billion of U.S. CMBS new issuance as of June 10 has fallen well short of expectations. There are several reasons for this. First, spreads—the difference between what issuers expect to receive and what investors are willing to pay—hampered issuance. Macroeconomic weakness earlier in the year caused debt-market spreads to widen significantly, and CMBS proved no exception.

The uncertainty in deal execution and prospects of losing money through securitization resulting from spread volatility caused CMBS lenders to curtail loan originations, and a few shops shut down their conduit operations. With spreads tightening since mid-March, CMBS
lenders have turned the origination spigot back on, restoring hope for improved issuance for the remainder of the year.

Since the beginning of this year, the benchmark AAA CMBS conduit spread widened by 33 basis points, with securities pricing at a peak of swaps plus 170 basis points in late February. Factoring in the spread widening during the second half of 2015, this benchmark spread widened a whopping 84 basis points since its tightest level mid-May of last year. Similarly, the BBB- CMBS spread widened by 254 basis points since the start of the year, with securities pricing at swaps plus 802 basis points in early March. Since its low point in mid-March of last year, the BBB- spread widened 443 basis points.

The CMBS spread volatility decimated profits on warehoused loans and forced lenders to reprice loans that had not yet rate-locked, much to the chagrin of borrowers. Origination of new loans came to a standstill in February and March as lenders offered uncompetitive spreads or declined to provide quotes.

B-piece investors, those who buy the riskiest slice of a securitization, remain diligent kicking out loans they deem too aggressively underwritten, backed by properties in locations deemed too risky or possessing unacceptable tenant exposure. According to Commercial Mortgage Alert, as much as 30% of an original portfolio has been rejected by a B-piece buyer. In addition to keeping deal sizes typically in the $700 million to $800 million range and holding down total issuance volume, the kick outs have heightened lender fears of having to go back to borrowers to renegotiate loan terms, being forced to hold onto a loan, or having to sell it possibly at a loss. This has kept underwriting standards from further deteriorating, as many lenders prefer to pass on aggressive opportunities rather than risk having to sell loans at a loss.
Basic Materials: Recent Commodity Rallies Leave Few Opportunities

The market overestimates the sustainability of recent commodity rallies, leaving the basic materials sector severely overvalued.

By Kristoffer Inton, Equity Analyst, and Daniel Rohr, CFA, Director of Basic Materials Equity Research

- Optimism continues to reign in the basic materials sector year to date, but investors are overestimating the sustainability of recent commodity price rallies. The basic materials sector remains severely overvalued, with a market-cap weighted price/fair value estimate of 1.26 as of May 31.

- The reasons for rallies in steel, iron ore, and gold differ, but we don’t expect any of the price gains to hold. Limited impact from steel trade cases and significant oversupply will bring pain to steelmakers and iron ore miners, respectively, in the second half of 2016. The recent Brexit vote helped extend the 2016 gold rally as interest rate hikes are potentially delayed through the second half of the year. However, pending rate hikes—though now further out—still weaken the outlook for gold miners into 2017.

- While multifamily starts and permits have slowed down amid tighter lending standards, strengthening housing formation still bodes well for housing starts in the long term.

- A bumper crop of seed and crop chemical mergers is reshaping the industry as competitors try to jumpstart their businesses amid a stagnant operating environment. However, consolidation is unlikely to generate significant synergies or improved competitive positioning.

Optimism continues to reign in the basic materials sector year to date, but investors are overestimating the sustainability of recent commodity price rallies. The basic materials sector remains severely overvalued, with a market-cap weighted price/fair value estimate of 1.26 as of May 31. Nevertheless, the sector is not without opportunity, as U.S. housing still offers significant upside for investors. Mergers and acquisitions have significantly picked up in seed and crop chemicals. But, consolidation is unlikely to either generate significant benefit for the combined companies or destroy shareholder value.
Steelmakers have rallied sharply year to date, but we maintain a negative outlook on the steel industry. Every U.S. steelmaker under our coverage is trading well above our estimate of fair value, and we urge investors to approach the space with caution. We argue that U.S. steel prices are at or near a cyclical peak and will likely decline materially by the end of 2016. In our view, the benefits of steel trade cases that are currently under investigation will prove less impactful than many investors expect. Additionally, market fundamentals remain highly unattractive amid weak demand and massive overcapacity in China. Looking forward, improved second-quarter earnings results that will be filed in late-July might inspire hope that a recovery is in store. However, we anticipate that market conditions will deteriorate in the second half of the year and see more pain ahead.

While the iron ore rally has lost some steam, we think the decline in prices isn’t done. After rallying more than 80% from their December trough to a peak of $69 per metric ton in April, iron ore prices have since given back some ground to trade around $50 per metric ton. Still, we see more downside as the long term outlook for demand remains weak. The recent acceleration in Chinese fixed asset investment, driven by debt-burdened SOEs, looks fragile. Meanwhile, private FAI continues to decelerate. We continue to expect Chinese steel demand to decline by roughly 60 million metric tons by 2020, with iron ore demand faring worse as scrap availability improves. Despite tempering near term production expectations, the major miners (BHP, Rio, Vale, and FMG) continue to grow production and reiterated their long-term volume targets. The recent rally in iron ore prices has also increased the likelihood of smaller, higher cost iron ore miners to remain in or return to the market, exacerbating the supply glut. We continue to believe iron ore prices should fall to $35 per metric ton in 2017 and to $30 per metric ton (in real terms) by 2025.

The massive 2016 gold price rally has continued to hold. Furthermore, the June jobs report spooked the Federal Reserve, with chances of rate hikes falling amid weaker-than-expected job creation in May. Worse still, the passing of the June referendum for the United Kingdom to leave the European Union severely hurt the chances for interest rate hikes this year. Although the outlook for rate hikes in 2016 is now more muted, we think rate hikes will at least continue in 2017, which leads to a weaker outlook for gold. When it comes to gold investment, it’s not just interest rates that matter, but inflation, too. While unemployment and Brexit have caused a change in the rate outlook, inflation weakness continues to linger, as well. While flat rates mean it remains relatively “cheap” to hold gold for now, its attractiveness only improves if inflation rises, too. We continue to consider gold and gold miners overvalued given what we see as over-exuberant market views on future interest rates.

In one of the few bright spots in basic materials, we continue to see opportunity in U.S. housing. In the first four months of 2016, multifamily residential starts and permits have contracted amid apparently tighter lending standards for new projects. As a result, we’ve reduced our residential construction forecast to 1.22 million starts in 2016, down from 1.30 million starts. While a decrease of 80,000 starts may appear substantial, we believe this merely represents the continued deferral of household formation. Our long-term outlook on U.S. housing remains unchanged. We continue to expect starts to peak at nearly 1.9 million in 2020, as household
formation strengthens amid tighter labor markets and looser financial constraints. Longer term, we expect starts to fade to 1.5 million as this source of pent-up demand is fully exhausted.

A stagnant operating environment has driven a recent bumper crop of seed and crop chemical deals, poised to reshape the industry. Yet in contrast to emerging consensus, we doubt the integrated seed-chemical model is likely to generate meaningful synergies or strengthen competitive advantages. For example, Syngenta SYT has employed an integrated model for years with middling results compared with its agriculture peer group. We do think that agriculture moats could be strengthened and even widened through long-term innovation that develops novel seed and crop chemical systems similar to Roundup, but we question whether merger and acquisition activity is necessary to achieve these benefits. We view collaborative agreements, which are common in the industry, as a cleaner and more effective path to innovation.

Still, we don't view the deals as value destructive, as they occur amid a cyclical trough for the industry and fairly depressed share prices. We doubt anti-trust regulators will stand in the way of the consolidation trend as product overlap between the various merger partners is fairly limited. Modest seed divestitures would allow the Bayer/Monsanto and Dow/DuPont deals to clear regulatory hurdles. The likelihood of the ChemChina/Syngenta deal closing is only a coin flip because of U.S. government scrutiny of a Chinese acquisition.

**Top Picks**

**Canfor CFP**

| Star Rating: | ★★★★★ |
| Economic Moat: | None |
| Fair Value Estimate: | CAD 26 |
| Fair Value Uncertainty: | High |
| Consider Buying: | CAD 15.60 |

Canfor Corp is a softwood lumber company that also owns around half of Canfor Pulp. It is active throughout North America, with lumber mills in British Columbia, Alberta, and the Southeastern United States.

We like Canadian lumber producer Canfor for its leverage to U.S. housing. Rising housing starts should lead lumber demand higher, driving up industry capacity utilization and, with it, prices. Our bullish housing outlook is predicated on the notion that tighter labor markets and improved mortgage availability will unleash enormous pent-up demand from the extended housing bust. Canfor is particularly attractive in light of recent poor share price performance, which is disconnected from fundamentals. As of June 10, shares are down 46% from June 2015. Meanwhile, framing lumber prices are up 13% from the same period last year. As momentum continues to build for U.S. housing, we see nearly 85% upside in the stock.
**Cameco** CCJ
Star Rating: ★★★★☆
Economic Moat: Narrow
Fair Value Estimate: $18
Fair Value Uncertainty: High
Consider Buying: $10.80

Cameco produced 27.2 million pounds of uranium in 2015, making it one of the world’s largest uranium producers. The flagship McArthur River mine in Saskatchewan accounted for 50% of output. Cameco intends to increase annual uranium production substantially over the next several years. In addition to its large uranium mining business, Cameco owns a uranium marketing business and operates uranium conversion and fabrication facilities.

Shares of blue-chip uranium miner Cameco have fallen in concert with the rest of the mining sector over the past two years, losing nearly 50% of their value in the process. Cameco’s sympathetic sell-off affords investors an attractive entry point into one of the last remaining China-led commodity growth stories. While China’s structural slowdown will continue to weigh on the mining industry’s main moneymakers — copper, coal, and iron ore — the country’s uranium demand is set to quadruple over the next decade. We expect Cameco to outperform mining industry peers over the next several years as impending uranium supply shortfalls catalyze higher prices and a re-rating of Cameco shares.

**West Fraser Timber** WFT
Star Rating: ★★★★☆
Economic Moat: None
Fair Value Estimate: CAD 60
Fair Value Uncertainty: High
Consider Buying: CAD 36.00

West Fraser Timber is a softwood lumber company that also produces wood panels and pulp products. The company is active throughout North America, with lumber mills in British Columbia, Alberta, and the southeastern United States.

Lumber and panel producer West Fraser is well positioned to take advantage of rising U.S. housing demand. Nearly 40% of lumber capacity now resides in the Southeast United States, close to its core end use, U.S. housing. A swelling portion of the population is now entering their peak home-buying years, and this will be further incentivized by easing loan standards and rising wages. West Fraser trades at a nearly 45% discount to our fair value estimate, out of step with lumber and panel prices, which remain above levels seen last summer.

*Neither Kristoffer Inton nor Daniel Rohr own shares in any of the securities mentioned above.*
Consumer Cyclical: Market Underestimating Apparel and E-Commerce

The market is now pricing in long-term cash flow assumptions that are more conservative than those baked into our longer-term consumer cyclical valuation assumptions.

By R.J. Hottovy, CFA, Consumer Sector Strategist

- The consumer cyclical companies under our coverage trade at a median price/fair value ratio of 0.93, and we believe the market is underestimating longer-term revenue growth and margin expansion opportunities from this group.

- We think that we are at a low point in the apparel retail cycle and that there is future upside. We do not believe brick-and-mortar apparel retailing is dead, but rather think it will look significantly different in the future as retailers convert to modern responsive supply chains and the athleisure fashion trend winds down.

- We believe the market is overlooking the powerful network effect that many of the leading e-commerce companies have developed over the past several years, not to mention a host of other leading players in more nascent e-commerce markets that are successfully bridging the transition to a business-to-consumer from consumer-to-consumer marketplace through enhanced payment, financing, logistics, and branded store offering.

- We see the increased home-share laws as a small positive for hotels and as largely neutral for OTAs.

Our consumer cyclical coverage trades at an average price/fair value ratio of 0.93, reinforcing our views that the market is underestimating longer-term revenue growth and margin expansion opportunities from this group. Although we acknowledge the possibility of more-volatile consumer spending trends than we’ve become accustomed to across the globe, especially when factoring in Brexit-related uncertainty in Europe as well as supply/demand inventory imbalances during 2016, we believe the market is now pricing in long-term cash flow assumptions that are more conservative than those baked into our longer-term consumer cyclical valuation assumptions.

Sentiment among affluent consumers generally remains healthy, even after recent market volatility, and we still expect growth out of our discretionary names, albeit at a decelerating pace. We continue to monitor consumption trends among high-end consumers, who take spending cues from asset/equity market valuations. A meaningful reversal in high-end spending not only would adversely affect discretionary names, but could have implications across the broader sector.
What We Make of the Near-Term and Long-Term Apparel Retail Environment

Given the recent negative performance of many apparel retailers and some calls that traditional apparel retailing is dead, we thought it would be useful to address our thoughts on these issues and discuss which subsectors and companies we see as positioned best for long-term success.

In our opinion, there has been a secular shift in apparel retailing that we see as a persistent force. We believe the current trend toward value over brand is here to stay. Unless a product can perform notably better than the competition (keep you warmer, keep you drier, perform better in athletic situations), the consumer appears unwilling to pay a premium simply to own a brand. We also think shifts in wallet share are here to stay, with experience (travel, restaurants) valued over apparel and other costs (including healthcare, education, and housing) rising in share. Finally, we think the shift in distribution channel toward digital will persist. As a result, we agree that apparel retail growth will probably not return to historical levels.

Having acknowledged that, we believe that we are at a low point in the apparel retail cycle and that there is upside in the future. We do not believe brick-and-mortar apparel retailing is dead; rather, we think that it will look significantly different in the future. We think there is a place for stores where consumers can touch fabrics, try sizes, and check fit. However, the apparel industry has experienced much self-inflicted near-term malaise. Many management teams have been overly optimistic regarding inventory levels and have not converted to modern responsive supply chains. This has resulted in a highly promotional retail environment that has forced even well-run companies to discount to remain competitive. Second, we think we are nearing the end of the athleisure fashion trend. With consumers having enough skinny and yoga pants to clothe themselves for a while and no new fashion must-have, nothing is driving discretionary purchases.

Therefore, in the near term, we see downside risk to many firms under our coverage, as company guidance for the full year may not have accurately reflected the unexpected decline in consumer demand for apparel that played out over the first quarter. We think these issues will take time to correct and are cautious on the space in 2016. That said, we do think there is long-term upside, as both inventory management and fashion newness can be corrected. When we look at our coverage, we think the off-price, replenishment, and apparel manufacturers are best positioned for future success. We think traditional retailers and department stores are most at risk.

Off-price retailers are uniquely positioned to capitalize on consumer demand for value and a very responsive inventory management system. This enables the companies to respond quite quickly to what the consumer wants, no matter how volatile the demand. Their buying system enables them to capitalize on overstock situations and to maintain their margin, no matter how promotional the environment. As a result of this and the benefit of scale in buying, we think these players are somewhat insulated to new competitors. In our coverage, TJX (TJX), Ross Stores (ROST), and Nordstrom (JWN) fall into this category.
We also favor products that are replenishment-focused in nature and where brand is valued more than price. The innerwear category falls into this camp. Price is actually the fifth decision point for consumers in this category, making the customer much more brand loyal than the general apparel universe. In excess inventory situations, basic undergarments can often be stored and sold later at full price. Finally, consumers tend to replace these products as they wear out, making them slightly less discretionary in nature. We highlight Hanesbrands (HBI), Gildan Activewear (GIL), and L Brands (LB) as companies under our coverage that fall into this camp.

Finally, we think apparel manufacturers can be strong performers, provided that there is solid management execution. Although apparel manufacturers are more exposed to the cyclicality of the industry than the above subsectors, they are channel-agnostic, which provides defense to online trends. In fact, we think many will benefit from this, as they can now do business directly with consumers instead of being reliant on other retailers’ merchandising and foot traffic. For example, VF (VFC)’s channel exposure is only 4% department stores, 4% midtier, 12% mass, 25% direct to consumer, and 55% specialty stores. Ralph Lauren (RL), in contrast, is over 50% direct, but nearly 25% of its wholesale is Macy’s (M).

Therefore, we think well-positioned brands that deliver either value or technological innovations that outperform competitive offerings will survive and grow. From our coverage, we would highlight Gildan, Hanesbrands, and VF in this category. Our thesis on Ralph Lauren is that longer-term growth in international, particularly Asia, and growth in accessories and its own stores can offset the department-store issues.

We think department stores are most at risk in the long term. As these retailers carry many of the same goods as online retailers, we think they are often forced to compete on price, which puts margin at risk. Furthermore, the sector continues to underperform the general apparel retail environment, and we think it is in a state of secular decline, as the format has become tired compared with new retailers. Of our coverage (Macy’s, Kohl’s (KSS), and Nordstrom), we think Nordstrom is best positioned in the long term because it carries many smaller brands that cannot move direct to consumer and it provides real value in carefully curating a selection of products for a very defined niche consumer, almost like a large boutique.

Many of the Leading Global E-Commerce Players Still Trading at Discounts
Broadly speaking, Morningstar’s global e-commerce coverage—home to some of the widest economic moats in the consumer space—continues to trade at a discount to our fair value estimates. While we acknowledge the possibility of more-pronounced economic headwinds for consumers across the globe in 2016 and the implications for discretionary consumer spending, we believe the market is overlooking the powerful network effect many of these companies have developed over the past several years, not to mention a host of other leading players in more-nascent e-commerce markets that are successfully bridging the transition to a business-to-consumer from a consumer-to-consumer marketplace through enhanced payment, financing, logistics, and branded store offerings.
Amazon AMZN remains our favorite company in the North American e-commerce space, and we regard as unlikely market concerns over the firm potentially embarking on a major logistics investment cycle after posting solid profitability gains this year. We anticipate some investment for incremental fulfillment-center capacity—especially given the greater-than-expected Fulfillment by Amazon, or FBA, demand from third-party users this past holiday season—but not a massive transformation into an independent third-party parcel carrier. Besides, we think some of the incremental fulfillment capacity would probably be offset by FBA price hikes, reinforcing Amazon’s pricing power among sellers. Additionally, although they face slowing or contracting economic conditions in their respective regions, we believe Alibaba BABA and MercadoLibre MELI are receiving insufficient credit for recent platform enhancements for buyers and sellers alike—including improved logistics capabilities, a vastly branded product selection, and payment innovations—which we believe will solidify their leading e-commerce positions for years to come.

Moreover, looking at the past decade, we’ve found economic downturns can actually be conduits for e-commerce adoption rates, given their competitive pricing, the rapidly expanding product selection, and the convenience of expedited shipping these platforms generally offer, something we don’t believe is reflected in current stock prices across the group. While e-commerce volume trends typically slow during the onset of a recession, we believe value-seeking consumers flock to these marketplaces as economic headwinds persist; in turn, these firms recover before other consumer cyclical companies. Additionally, with online grocery expected to be one of the fastest-growing e-commerce categories over the next several years, we expect the mix of consumer purchases online will become more defensive in nature, further insulating many of the leading e-commerce marketplaces from potential recessionary conditions.

Once e-commerce players amass more than 10% of their operating regions’ population as active users, it becomes very difficult for competitors to unseat them, potentially leading to a multidecade period of excess economic returns. With several e-commerce players enjoying well-entrenched network effects in key markets, these players have more recently taken steps to lock in these customers through membership and other subscription-based services, while leveraging their network effects into new growth categories such as mobile payments, cross-border trade, third-party fulfillment, and online-to-offline services such as restaurant delivery. While some of these business extensions are already meaningful cash flow contributors—Amazon Prime in particular—we believe many of these other endeavors are natural extensions of these companies’ network effect moat source, and that they should drive improved profitability over an extended horizon.

**Stricter Enforcement of Home-Share Laws Supports Long-Held View That Airbnb Is a Manageable Risk**

We have long held the view that Airbnb is a manageable risk to hotels and online travel agencies, or OTAs, and that it could also face increased regulation at some point. This stance is supported by recent enforcement of existing home-share laws that restrict use in Berlin and
San Francisco. We see the increased regulation as a small positive for hotels, while it is largely neutral for OTAs.

Berlin and San Francisco face tight housing markets that have aided a high-cost-of-living environment, driven in part by the year-round rental of units to visitors versus residents. As a result, Berlin passed a law in April 2014 stating that one could only rent out rooms that are less than 50% of total square footage of the unit, and that those who break the law could face a $113,000 fine. The law gave owners two years to adjust before being implemented May 1.

In San Francisco, the law was passed 18 months ago, allowing short-term apartment rentals for up to 90 days each year if the unit was registered. In order to be registered, an owner could post only one unit, which would be set as his or her primary unit. Since then, just 20%–25% of Airbnb’s listings in the city have been registered, and third-party analyses have concluded that the majority of revenue generated on the platform is from multiple-owned units renting out to visitors year-round. As a result, the city board of supervisors voted 10-0 this month to begin charging platform operators penalties of up to $1,000 per day for listings that don’t comply.

The increased focus on having Airbnb listings comply with existing laws is likely to slow its listings and overall growth, which should provide a marginal tailwind for hotels that have seen some impact during compression events. We never viewed Airbnb as having much effect on either Priceline PCLN or Expedia EXPE, and we see recent events as having largely neutral implications for these OTAs, as a potentially smaller Airbnb network is offset by the vacation rental presence the two have, which would also stand to be affected by enforcement of apartment-sharing laws.

It seems likely that other cities could increase enforcement of laws similar to those in Berlin and San Francisco. We also expect home-sharing operators to fight these laws by saying that they unfairly support hotels, and that home-sharing has a positive impact on a local economy, as it generates income for individuals and tourism for cities.

**Top Picks**

**Bed Bath & Beyond BBJY**
Star Rating: ★★★★★
Economic Moat: None
Fair Value Estimate: $64.00
Fair Value Uncertainty: Medium
Consider Buying: $44.80

No-moat Bed Bath & Beyond’s shares have fallen in tandem with many softline retailers as consumers have shifted their spending in recent periods to more-durable categories. However, we think the firm still has a defensible business model as a best-in-class merchandiser in the home, baby, and beauty goods spaces. While we think the cadence of couponing is unlikely to slow over the near term, we believe Bed Bath & Beyond’s improving omnichannel presence,
disciplined real estate expansion process, and still-robust international opportunities will help offset the company’s inability to price at a premium, ultimately leading to modestly higher operating margins over the next decade (11.6%) from forecast 2015 levels. Incorporating 2% top-line growth (supported by Morningstar’s mid-single-digit outlook for spending in the repair and remodel market through the end of the decade) with moderate selling, general, and administrative expense leverage over time underlies our fair value estimate. We believe the shares have become attractive and are out of favor as a result of consumers’ temporary shift away from lower-price discretionary items.

**Swatch Group** SWGAY

*Star Rating: ★★★★★*

*Economic Moat: Wide*

*Fair Value Estimate: $28*

*Fair Value Uncertainty: High*

*Consider Buying: $16.80*

Headwinds continue for the Swiss watch industry despite lapping the 2014 Hong Kong protests and China’s anti-gift-giving laws of 2013. Exports to Hong Kong, one of the main retail trading areas for Swiss watches, are still down. Apple Watch worries have subsided (for now), but as Swatch has just introduced a number of new products, from Sistem51 to its partnership with UnionPay in China, it remains to be seen if sales growth can be rekindled.

Although other luxury companies’ stock prices have fallen mostly on worries over the macro-economy in China, and the watch industry appears to be highly exposed there, we continue to prefer Swatch Group for its discount to our fair value estimate and the value of the portfolio of brands and technologies it holds.

While the Apple Watch launch has underwhelmed, the number of other fitness and smart devices is accelerating as sports and health companies enter the market. We believe interest in new wrist products will benefit the whole watch industry, especially for microbatteries and low power use where Swatch has significant know-how. We are also of the opinion that Swatch’s partnership with UnionPay in China may be underestimated and that NFC payments are the one application for smartwatches that might catch on. In the long run, we believe new products and technologies could be growth drivers for the watch industry, and even though the United States is the largest single consumer, mechanical watches are still proportionately underpenetrated there.

Swatch enjoys a dominant position as the leading manufacturer of watch parts, where there are high barriers to entry. Technologies will necessitate a further retail buildout for Swatch brands and enable increased automation in production, driving long-term margins. Currencies remain a risk to demand and profitability, but stabilization should work its way in consumer purchase decisions and cost and pricing strategies. While weakness in global equity markets creates uncertainty for high-end spenders and risk to near-term sales figures, a rebound in retail sales would reverse destocking and risk aversion at wholesale.
Ralph Lauren RL
Star Rating: ★★★★★
Economic Moat: Narrow
Fair Value Estimate: $150
Fair Value Uncertainty: Medium
Consider Buying: $105.00

Ralph Lauren possesses a portfolio of brands that can be priced at a premium to competitors, and its solid returns on capital are testament to the power that 50 years of image-making has instilled in the Ralph Lauren name. Yet despite a solid record of growth and profitability, headwinds ranging from currencies and changes in tourist flows to increased infrastructure spending, combined with slower growth, have caused the stock to trade at a wide discount to our fair value estimate.

Despite share price improvement and further bad news from U.S. department stores, we still see Ralph Lauren’s stock as undervalued. Although the risks remain, we don’t believe the current short-term domestic headwinds for wholesale clients are harbingers of pending economic malaise in the consumer sector.

We believe the brand’s relatively low penetration in China and emerging markets leaves significant growth opportunities. In addition, Ralph Lauren can continue to take share in accessories, where it has less than 10% of its sales, and in its women’s categories, which (unlike at most luxury goods firms) are smaller than men’s.

*R.J. Hottovy, CFA does not own shares in any of the securities mentioned above.*
Consumer Defensive: Not a Lot to Feast On

Consumer defensive names look rich, but a handful of firms remain undervalued.

By Ken Perkins, CFA, Equity Analyst, and Erin Lash, CFA, Senior Equity Analyst

- Consumer defensive valuations have continued to trend higher over the past several months, leaving the sector slightly overvalued at a price/fair value ratio of about 1.04.

- In light of slowing growth prospects around the world, expectations for sluggish revenue growth appear reasonable.

- We expect cost-cutting and brand-building to remain key areas of focus over the coming quarters, but think that the market is overly optimistic in terms of the profit gains that are likely to be realized in some cases.

- From our vantage point, a handful of consumer defensive firms look attractive, with overly pessimistic margin assumptions baked into their shares.

  Valuations within the consumer defensive sector have remained elevated, trading at around a 4% premium to our fair value estimate. From our vantage point, this premium reflects a rotation into higher-quality names amid the uncertainty within the global macroeconomic landscape, along with investors’ appetite for yield, the strong shareholder returns that characterize the sector, and continued optimism for merger and acquisition activity in the space.

  The first quarter of 2016 was a challenging one for many consumer companies; as expected, however, defensive firms delivered more stable results than many firms on the consumer cyclical side (especially apparel retailers). In general, organic revenue growth remains positive but relatively uninspiring across the consumer defensive landscape.

  Although the consumer staples space tends to be fairly defensive in a more challenging market climate, global consumer spending, particularly in emerging markets, remains tepid. But beyond these pressures, we expect the pace of emerging-market growth to exceed more developed markets in the longer term, given favorable demographic and disposable income trends. Given that most competitively advantaged firms in the sector are relatively mature (although some are benefiting from increasing exposure to emerging markets), we think market expectations for low- to mid-single-digit revenue growth are reasonable. We don’t see many firms mispriced based on unrealistic revenue growth assumptions.
In light of the persistent pressure to accelerate top-line growth, cost-cutting remains a key area of focus for consumer defensive firms looking to drive bottom-line growth. But in this ultracompetitive environment, we don’t believe the bulk of the savings derived from cost-cutting activities will merely drop to the bottom line; rather, we contend that these initiatives offer an effective means by which to free up funds to support brand investments and, ultimately, a firm’s competitive positioning.

But this take hasn’t always aligned with the market. We still believe that the market’s overly optimistic outlook regarding the long-term market expansion trajectory for Campbell Soup CPB has sent shares of the leading soup manufacturer to lofty heights. Admittedly, Campbell’s adjusted gross margins climbed 240 basis points to 37.4%, and its adjusted operating margins increased nearly 300 basis points to slightly more than 19% through the first nine months of fiscal 2016. However, we don’t believe that all of the factors presently propping up its margins will persist in the longer term, a stance that the market doesn’t seem to share.

For instance, we think that the potential for more-pronounced commodity-cost inflation, increased investment behind its brands in an effort to withstand intense competitive pressures, and a shifting mix toward the lower-margin natural and organic channel (which accounts for more than 10% of its consolidated sales) and away from the highly profitable soup category are poised to hinder material margin gains off of recent levels. Campbell’s shares trade more than 20% above our fair value estimate, and we’ve failed to warm to its valuation.

However, while few moaty firms in the consumer-defensive space are screaming bargains, we see value in a handful of competitively advantaged firms that have more muted margin assumptions baked into their shares. For example, we think the market is overlooking the margin opportunity for Danone DANOY. Medium-term guidance has been provided on margins in the dairy segment, but we think the infant formula business has the potential to increase margins significantly as well, driven by fixed-cost absorption and price/mix. We see 15% upside to owning Danone’s shares.

We also see long-term upside to owning higher-risk European grocers, such as Tesco TSCO (no moat) and Carrefour CA (narrow moat), although near-term results could be volatile. These firms still face intense price competition from discounters, alongside general market deflation (driven by lower commodity prices). These dynamics have resulted in declining sales and margins for several quarters, prompting many investors to give up hope that these firms will recover. However, traditional U.K. grocers such as Tesco are progressing toward competitive price architectures, more sustainable margins, and healthy volume increases, giving us confidence that conditions could normalize over the medium term.
Top Picks

Carrefour CA
Star Rating: ★★★★★
Economic Moat: Narrow
Fair Value Estimate: EUR 32
Fair Value Uncertainty: High
Consider Buying: EUR 19.20

As the largest retailer in Europe and the second-largest on the planet, Carrefour boasts economies of scale and attractive properties that are worthy of a narrow economic moat. Further, we believe its recent initiatives—including efforts to drive higher private-brand penetration, incremental price investments, and more decentralized merchandise decisions—are poised to stabilize sales and margins in France. From our vantage point, investors remain understandably concerned about evolving competitive dynamics between formats, as well as macroeconomic and currency headwinds in Asia and Latin America. Nevertheless, we view Carrefour as a strong operator with the scale to defend its turf in multiple channels at home and lead industry consolidation in emerging markets. Over the long term, we think the firm should generate healthy cash flows; as such, we believe Carrefour could be a good way for long-term investors to gain exposure to the European, Latin American, and Asian grocery retail markets.

Sainsbury SBRY
Star Rating: ★★★★★
Economic Moat: None
Fair Value Estimate: GBX 280.00
Fair Value Uncertainty: Medium
Consider Buying: GBX 196.00

As one of the largest grocers with a well-known history in the United Kingdom, Sainsbury has enough scale to compete with other large rivals on price while also touting its areas of differentiation. Sainsbury has been one of the few traditional firms to increase market share over the past few years, and its solid online and convenience-store presence should continue to fuel growth. In addition, the firm’s above-average private-label penetration, Nectar loyalty program, and consumer banking services could bolster customer loyalty and drive solid like-for-like sales growth. However, switching costs are virtually nonexistent in the grocery industry, and it’s not clear that no-moat Sainsbury’s points of differentiation are strong enough to ensure that excess returns on capital can be sustained over the long term. Despite numerous challenges, Sainsbury is well positioned to capture incremental share in the faster-growing convenience store channel, in our view, and we view shares as attractive at current levels.
Tesco TSCO
Star Rating: ★★★★
Economic Moat: None
Fair Value Estimate: GBX 235.00
Fair Value Uncertainty: High
Consider Buying: GBX 141.00

Given its standing as the largest food retailer in the U.K., we portend that Tesco’s scale should allow the company to invest in its value proposition and ultimately maintain its leading U.K. market share position. Price cuts remain a headwind, though, as Tesco attempts to improve the competitiveness of its products relative to those of discounters. While these price cuts could continue to weigh on profits, we see signs that Tesco’s shift to more everyday low prices is having a positive effect. With Tesco’s challenges so clear for all to see, we believe the market’s forecast—which projects declines in like-for-like sales to persist for a decade and operating margins around 2.5%—is a bit dire. As such, we contend that Tesco’s positive traffic trends, sharper prices, and solid online and convenience-store businesses are getting less credit than they deserve.

*Neither Ken Perkins, CFA, nor Erin Lash, CFA, own shares in any of the securities mentioned above.*
Energy: Supply Glut Continues, but Some Respite on Pricing

The glut in crude supply will take several more quarters to work through.

By Peggy Connerty, Equity Analyst

- Declining U.S. oil production over the next several quarters will help reduce global oversupply, but that alone won’t fix the imbalance before 2017.

- Reduced investment will eventually translate to stronger output declines and help markets rebalance.

- Energy sector valuations are a bit frothy at current levels.

The most pressing question on the minds of energy investors: How long will it take for the industry to work through the current period of oversupply and rebalance itself? The answer: Not anytime soon. Current supply imbalances are such that oil production as of today is effectively running two years ahead of demand.

Thanks to ongoing productivity improvements, cost reductions, and slowing decline rates, U.S. shale’s cost-competitive growth potential is much greater than the market currently realizes. U.S. tight oil has fundamentally altered the global supply picture, ensuring the industry has more low-cost resources to develop than it will need. Instead of a return to high long-term prices, the industry needs to find the oil price that can keep a lid on U.S. shale activity, which we think will be $60 per barrel Brent.

Declining U.S. oil production over the next several quarters will help reduce global oversupply, but in our opinion, that alone cannot quickly fix the current global imbalances. For the market to approach any semblance of normalcy before 2017—and likely for prices to respond accordingly—requires one or more of the following:

- Saudi Arabia reverses course from its approach of maintaining market share at all costs and cuts production

- global demand surprises to the upside from current expectations of 95 million barrels a day in 2016 and 95.9 mmb/d in 2017, or

- a geopolitical event occurs (for example, political upheaval in Venezuela or another oil-exporting nation)
Without one or more of these occurring, “lower for longer” looks to be the unavoidable near-term course for the industry.

The potential for a significant amount of resources to become economically stranded is likely to foster continued pressure to drive down development and operating costs across the industry. This will result in cost compression at the marginal part of the cost curve, so that higher-quality oil sands and offshore projects can compete head-to-head with U.S. shale. These areas of the industry don’t have a choice; otherwise, U.S. shale will produce them right off the map.

We continue to believe upstream capital spending in the United States will fall sharply in 2016 for the second consecutive year as producers struggle to align budgets with cash flows. Reduced investment will translate to stronger output declines, and while it won’t happen overnight, this will eventually help markets rebalance.

Sharp curtailments in oil-directed drilling activity could reduce U.S. natural gas production growth in the near term, but the wealth of low-cost inventory in areas like the Marcellus and Utica ultimately points to continued growth through the end of this decade and beyond. Based on a more optimistic outlook for low-cost production—primarily as a result of slowing declines in associated gas volumes, as well as improved productivity and resource potential from the Marcellus and Utica—we recently lowered our long-term marginal cost for U.S. natural gas to $3 per thousand cubic feet from $4/mcf. We see more and more evidence that U.S. shale producers can survive (and in a few cases thrive) at much lower prices than we previously assumed.

With an overall price/fair value estimate of 1.254, we view energy sector valuations as a bit frothy at current levels, but we do think the names below are worth further investigation from investors.

**Top Picks**

**Chevron** CVX  
Star Rating: ★★★  
Economic Moat: Narrow  
Fair Value Estimate: $95  
Fair Value Uncertainty: Medium  
Consider Buying: $66.50

Chevron remains our preferred play in the integrated space, given its greater leverage to an oil price recovery and superior production growth, which should drive greater earnings growth over the next several years. The completion of new projects and the accompanying reduction in capital expenditures means the firm’s cash flow break-even oil price will fall during the next several years, ensuring the dividend and eventually allowing for growth. Its valuation is the most compelling of the group as well.
**HollyFrontier** HFC
Star Rating: ★★★★★
Economic Moat: Narrow
Fair Value Estimate: $47
Fair Value Uncertainty: High
Consider Buying: $28.20

HollyFrontier operates high-quality refining assets that are advantageously located solely in the midcontinent and typically deliver high returns. However, current market conditions, specifically weak gasoline margins and narrow light crude differentials, have reduced earnings and prompted a sell-off in the shares. As a result, the current share price is now overly discounting long-term earnings potential and the probability spreads widen. A solid balance sheet and strong cash flow keeps the dividend safe and should allow management to fulfill its commitment to repurchase shares.

**Magellan Midstream Partners** MMP
Star Rating: ★★★
Economic Moat: Wide
Fair Value Estimate: $76
Fair Value Uncertainty: Low
Consider Buying: $60.80

With its portfolio of great assets, we continue to view Magellan Midstream as one of the more attractive names in the midstream sector. The firm benefits from a conservative business run by a stellar management team. Magellan is primarily a fee-based business, with margins generated by low-risk transportation- and storage-related activities, which constitute 85% of total operating profits. Below-average commodity exposure cushions Magellan somewhat from volatile swings in commodity prices. Magellan also possesses a strong balance sheet and solid coverage ratio that provide it with a cushion during periods of commodity and economic volatility. This will allow the firm to raise its cash distributions by a minimum of 10% in 2016.

*Peggy Connerty does not own shares in any of the securities mentioned above.*
Financial Services: Accounting for Brexit and the Fiduciary Rule

Brexit increases the uncertainty around global financials, and the United States Department of Labor’s fiduciary standard rule will reshape many business models in the sector.

By Michael Wong, CFA, CPA, Senior Equity Analyst

- The financial services sector remains reasonably undervalued and trades at a market-cap-weighted price to fair value estimate ratio of 0.88.

- We see Brexit as having negative implications for the U.K. economy and bank moats. We are currently reviewing our fair value estimates and economic moat ratings for affected financials.

- We believe that Brexit effects on interest rates, currency exchange rates, asset price levels, and capital market volatility will likely be more material to capital-markets firm earnings than the potential disruption caused by relocating operations out of the United Kingdom to other European Union countries.

- In terms of advised retirement assets, we initially estimated that the fiduciary rule primarily affected $3 trillion of advised, commission-based IRA assets. In addition to the $3 trillion of IRA assets, we further estimate that advice services are being offered to approximately $4 trillion of private, defined-contribution-plan-participant assets, and there are upward of $800 billion of plan assets that are using advice and could be subject to the rule.

- In regards to product and service offering, we continue to see the acceleration of three key wealth management trends—a move to fee-based from commission-based accounts, increased usage of digital advice offerings, and a shift to more passive investment products from actively managed.

We're Scrutinizing European Bank Moats and Near-Term Forecasts in Light of Brexit

The Brexit vote will have wide-reaching implications for our European financials coverage universe. We plan to lower the fair value estimates for several U.K. banks such as Barclays BCS, Royal Bank of Scotland RBS, and Lloyds LYG, and we will review others such as Banco Santander SAN, which has U.K. exposure. This raises the strong possibility that we may change our moat trend ratings for Lloyds, Royal Bank of Scotland, and Barclays to negative from stable.

We do expect the U.K. system and the broader European Union to experience substantial uncertainty and volatility going forward, as the U.K. seeks to renegotiate trade agreements with other countries, unwind other legal agreements with the EU over the next several
years, and deal with the political aftermath of Prime Minister David Cameron’s resignation. We also now see the strong possibility of Scotland seeking independence, causing further turmoil to the overall system, particularly the Edinburgh-based banks Lloyds and Royal Bank of Scotland, which may need to re-domicile. Although the impact of Brexit is far reaching, we do see an undervalued opportunity with HSBC, primarily due to its relative lack of U.K. exposure and its pivot toward Asia.

There are several fairly immediate considerations for banks. We would expect to see higher funding costs for U.K. banks, sharply lower loan growth (as we expect anywhere between a 3%–6% impact to U.K. GDP), and a significant drop-off (potentially 40%–50%) in investment banking fees. Asset management and trading operations will be impacted by the stock, bond, and currency volatility, and we expect trading losses as well as lower asset management fees. Foreign banks, such as JPMorgan Chase, will likely incur millions of dollars in legal and personnel costs as they move employees to other countries from London to facilitate capital markets activity. Again, we see particular risks for Barclays and Royal Bank of Scotland, as these banks have large investment-banking operations and are wholesale funded. We would expect to see lower scale and cross-firm synergies for banks in London and ultimately a negative impact on profitability.

Our impression on Brexit for U.S.-based capital market-related companies is that their earnings may be more affected by the knock-on macro effects of Brexit than the future operational disruption. Based on our current understanding, a relatively simple response to Brexit is for institutions to open a subsidiary in the EU to continue enjoying trade privileges similar to the ones in the United Kingdom. Some additional capital may be locked up for regulatory requirements and duplicative expenses will be incurred, but overall we don’t expect it to be material.

More material to near- to intermediate-term earnings will be Brexit effects on macro factors. Global uncertainty shifts central bank policy to a more accommodative stance. Firms leveraged to rate hikes, such as retail brokerages, may have to wait longer to receive earnings boosts. Companies with material earnings denominated in European currencies will have EPS-depressing translation effects—25% of Goldman Sachs’ GS and 15% of Morgan Stanley’s MS revenue comes from EMEA.

Wealth and asset management firms that bill based on client asset levels will also have their fortunes affected by any decrease in asset prices and assets denominated in foreign currencies. Volatility will increase trading volumes, definitely helping trading platforms like the financial exchanges, while having a somewhat mixed effect on brokerages that will have higher trading volumes potentially offset by valuation marks on their trading inventories. Continued capital market volatility will also dampen underwriting and advisory revenues.

In regards to the Deutsche Boerse and the London Stock Exchange (LSE), unless the merger is restructured, we think it is less likely to go through, and we are dropping our assumed chance of the deal happening to 25% from 50%. While management teams from both companies have said they are moving ahead with the deal and presumably had considered the
Brexit possibility in behind-the-scenes negotiations, we think it will be more difficult to obtain regulatory approval for the deal from Germany and the European Union. We also think increased uncertainty tends to decrease shareholder enthusiasm, and the latest turn of events is likely to be no exception.

The U.S.-based asset managers we cover are not quite as exposed as firms based in the U.K. or Europe. That said, most of the asset managers we cover have exposure to the region by virtue of investing in the stocks and bonds of European-based firms, while a handful also have exposure by way of clients being domiciled in the region—namely, BlackRock BLK, Franklin Resources BEN, Invesco IVZ, Legg Mason LM, AllianceBernstein AB, and Affiliated Managers Group AMG. Less exposed firms include T. Rowe Price TROW, Federated Investors FII, Eaton Vance EV, Janus Capital Group JNS, Waddell & Reed WDR, and Cohen & Steers CNS. The longer-term problem for those operating in the region will be the increased costs associated with having to operate in a less cohesive market.

We expect all of these firms to be caught in the undertow of declining global markets in the near term. Although there is likely to be a fair amount of market and currency turmoil, primarily because most market participants were caught flat footed by the vote (having believed the British people would vote to remain in the EU), we’re not anticipating making wholesale changes to the fair value estimates of the companies we cover.

Over the longer term, we also see largely negative impacts for U.K. financials. We would expect a lower level of normalized GDP growth for the U.K., as it has been one of the strongest beneficiaries of GDP growth in the EU since it was formed. We also believe the reorganizations that will take place at many U.K. banks will lower the overall importance of London as a key financial center, making it harder for banks to compete for talent and the relationships that drive fee income and help retain deposits.

There are also renewed concerns regarding several countries in the European Union, such as Italy, France, and Spain, where citizens have expressed strong interest in holding their own referendums and seeking to leave the European Union. Again, the impact for the banks we cover within those systems, such as UniCredit UCG, Intesa Sanpaolo ISP, and Societe Generale GLE, would likely result in higher costs and slower growth, which combined with weak capital levels would be quite concerning. However, if more countries split off the European Union, we believe that brokerages, exchanges, and financial information providers stand to benefit. More countries with their own currencies and monetary authorities with disparate interest rate policies would lead to higher currency and rates trading volumes. Information providers collecting and disseminating these new data points will also be more valuable.

**Strategic and Financial Effects of the Department of Labor Fiduciary Rule Are Substantial**

During the quarter, the U.S. Department of Labor released its finalized conflict-of-interest, or fiduciary standard, rule for financial advisors, and we believe it will disrupt many business models in the industry. We’ve already seen the exit of several foreign banks (Barclays, Credit
Suisse CS, Deutsche Bank DB) from the U.S. wealth management landscape, sale of life insurance retail advisory businesses (AIG AIG, MetLife MET), and restructuring of wealth management platforms (LPL Financial, RCS Capital, Waddell & Reed) in anticipation of the rule. We agree that the Department of Labor’s finalized rule is in many ways more lenient than the initial proposal, especially in terms of the operational feasibility of the best-interest contract exemption. That said, a couple of areas of the rule were made even more restrictive, and the rule still has teeth through the best-interest contract as a litigation-based enforcement mechanism. In fact, we foresee that compliance with some of the rule’s provisions may not only cause changes in how financial advisors service retirement accounts, but also how they serve taxable accounts.

In terms of advised retirement assets, we initially estimated that the rule primarily affected $3 trillion of advised, commission-based IRA assets. In addition to the $3 trillion of IRA assets, we further estimate that advice services are being offered to approximately $4 trillion of private, defined-contribution-plan-participant assets and that there are upward of $800 billion of plan assets that are using advice and could be subject to the rule. Advice providers to private defined-contribution plan participants need to double-check that how they formerly advised or managed assets on behalf of retirement plan participants remains in line with the Department of Labor’s updated rules. More than $200 billion of annual IRA rollovers are also receiving professional advice that fall under the rule. Advisors, including fee-based RIAs, will have to document why a rollover will be in the best interest of an individual.

In regards to product and service offering, we continue to see the acceleration of three key wealth management trends—a move to fee-based from commission-based accounts, increased usage of digital advice offerings, and a shift to more passive investment products from actively managed. The proportion of fee-based assets increased 1- to 3-percentage points at several of the large wealth management firms in 2015. Digital advice assets continue to ramp up and more than doubled at the leading players in 2015. Since the beginning of 2016, we’ve already seen major partnerships being inked—such as by BlackRock’s Future-Advisor—between digital advice solution providers and traditional wealth management firms. We continue to see the potential total market opportunity for passive investment products from the fiduciary rule as $1 trillion with a reasonable prospect of a $140 billion increase in broker-dealer advisor use of just the ETF portion of the passive investment market.

We believe that the beneficiaries from the Department of Labor fiduciary rule will be discount brokerages, financial technology companies including robo-advisors, and providers of passively managed products (primarily index funds and exchange-traded products like ETFs). There will be a mixed effect on active asset managers and full-service wealth management firms, while certain alternative asset managers and life insurance companies will be challenged. Overall, the rule will spur changes in wealth management firm operations, market share shifts among financial products, creation of new financial service offerings, and greater need for substantiation of financial advisors’ adherence to their clients’ best interest and value that they provide.
**Top Picks**

**Synchrony Financial** SYF  
Star Rating: ★★★★★  
Economic Moat: Narrow  
Fair Value Estimate: $40  
Fair Value Uncertainty: High  
Consider Buying: $24.00

We believe Synchrony Financial is deeply undervalued and poised to outperform as consumer spending on private label continues to thrive. The indiscriminate recent selling off of bank stocks following the Federal Reserve’s increased reluctance to increase interest rates in 2016 offers a compelling opportunity to purchase this unique private-label card franchise at a significant discount. Investor misunderstanding of Synchrony centers on the attractive nature of the firm’s closed-loop model, particularly its retail sharing agreements, funding picture, and growth prospects. Retail sharing agreements with Synchrony offer more detailed information on consumer behavior and lower interchange fees. For cardholders, Synchrony offers unique discounts and rewards on future purchases. Given this attractive proposition, Synchrony’s receivables growth has been double that of general purpose cards over the past few years, and we expect these growth trends and market share gains to continue. Credit losses in the 4%—5% range are easily offset by significantly higher net interest margins, and we believe the market overestimates future credit risk.

**Citigroup** C  
Star Rating: ★★★★★  
Economic Moat: Narrow  
Fair Value Estimate: $68  
Fair Value Uncertainty: High  
Consider Buying: $40.80

Over the past five years, management has reduced compensation expense by 11%, occupancy expense by 14%, and boosted common equity by $42 billion. Yet Citigroup’s stock is now trading at 2011 levels. We think Citigroup will benefit from an improved U.S. housing market over the next three years—expenses related to crisis-era mortgage lending still account for about 10% of the total. In the meantime, risks related to emerging-market and energy exposures are manageable, representing 150% and 33% of common equity Tier 1 capital, respectively. Over the next three years, we expect the company’s stock price will reflect significantly higher earnings per share and dividend payouts.
Commerzbank CBK
Star Rating: ★★★★★
Economic Moat: None
Fair Value Estimate: EUR 10
Fair Value Uncertainty: High
Consider Buying: EUR 6

Commerzbank reported a difficult first quarter in a volatile market environment and indicated that its 2016 goals will be challenging to reach. The bank faced several headwinds during the quarter. The first is market volatility, which contributed to a sizable decline in capital markets profits to EUR 70 million from EUR 250 million last year. Second, within its Mittelstandsbank division, low loan demand, negative interest rates that pressured deposit margins, and intense competition for market share caused profits to decline to EUR 209 million from EUR 364 million. The bank is attempting to convince clients to move excess deposits elsewhere and is already charging certain large corporate clients to keep deposits on hand. However, the bank has made substantial progress in terms of wrapping up its noncore assets, and we think investors have sold off many European banks indiscriminately in 2016, providing undervalued opportunities.

*Michael Wong, CFA, CPA does not own shares in any of the securities mentioned above.*
Healthcare: Stock Selection Increasingly Important

Despite healthcare valuations increasing, we still see some stocks as undervalued, with opportunities in the drug and device areas.

By Damian Conover, CFA, Director of Healthcare Equity Research

- Buoyed by increasing sentiment, market valuations in healthcare have improved over the last quarter with a recent aggregate price to fair value of 0.95, up from 0.90%, but we still see opportunities with several underappreciated stocks, including Allergan AGN, Biogen BIIB, and Elekta EKTA B.

- Strong drug launches and excellent rapidly progressing clinical data in specialty-care areas, such as oncology and immunology, are supporting increased productivity at drug and biotech companies.

- Within the United States, we expect pricing power for drug and biotech companies to remain strong even as presidential candidates make claims to lower drug costs.

- While tapering off a bit, mergers and acquisitions continue at a solid pace as large conglomerates look for external innovation and opportunities to redeploy capital to increase growth.

In looking at the core pillar of economic moats of innovation in healthcare, drug companies are rapidly increasing the speed of generating excellent clinical data in areas of unmet medical need, particularly in areas such as oncology and immunology. Advances in immuno-oncology drugs are reaching the market at half the time of drugs developed a decade ago, partly due to major advancements in science, but also due to more accommodative healthcare regulatory groups. We expect the shift to continue and to increase drug-development productivity and strengthen the moats for drug companies, especially as the improving productivity are in areas of development that carry strong drug pricing power and steep launch trajectories. While the patient populations tend to be smaller in these specialty areas, the strong pricing power can easily turn the drugs into blockbusters. In immunology and oncology, drugs tend to carry annual prices of $25,000 and more than $100,000, respectively, supporting major markets despite smaller patient incidence rates as compared with historical areas of focus such as high blood pressure.

On the political side, while we expect the political rhetoric on lowering drug prices will probably continue as presidential candidates vie for voters, we don’t see any major shifts in U.S. drug prices over the next several years. Nevertheless, we expect drug pricing concerns to cause increased volatility in pharmaceutical and biotechnology stocks. However, without a
major structural reform and a willingness by patients and doctors to limit treatment options, we don’t see any major changes in U.S. drug prices.

Turning to mergers and acquisitions, while the pace of deals is slowing, companies continue to acquire and merge to increase their growth potential through creating scale, cutting costs, and focusing on key strategic areas. The persistent low interest rates are also fueling merger and acquisition trends because cheap capital is available to fund acquisitions. Beyond the heavy prevalence of M&A in the drug space, we are seeing further consolidation in healthcare devices. Abbott’s ABT acquisition of St. Jude helps improve growth prospects while helping Abbott to compete more effectively in the medical device area. We expect the acquisitions will continue but at a slower rate than 2015, partly due to smaller firms holding out for higher takeover valuations.

**Top Picks**

**Allergan** AGN  
Star Rating: ★★★★★  
Economic Moat: Wide  
Fair Value Estimate: $370  
Fair Value Uncertainty: Low  
Consider Buying: $296

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

**Biogen** BIIB  
Star Rating: ★★★★★  
Economic Moat: Wide  
Fair Value Estimate: $356  
Fair Value Uncertainty: Medium  
Consider Buying: $249

Biogen is the leader in the multiple sclerosis market, with a range of options for patients seeking injectables (Avonex and Pledigridy), orals (Tecfidera), or high-efficacy treatments (Tysabri). Competition in MS is heating up, but we still think Biogen has a dominant portfolio that can withstand this pressure, and we assign the firm a stable wide moat rating. We remain bullish on upcoming clinical data over a longer time horizon (2016–18) and think the firm has a
promising collection of neurology-focused pipeline candidates. Recent prices appear to be giving the firm little credit for pipeline programs, including Alzheimer’s drug aducanumab. The spinal muscular atrophy program (partnered with Isis) should generate Phase III data in late 2016 or early 2017, and we’re bullish on its potential in this rare pediatric indication.

**Elekta** EKTA B

Star Rating: ★★★★
Economic Moat: Wide
Fair Value Estimate: SEK 90
Fair Value Uncertainty: Medium
Consider Buying: SEK 63

We believe Elekta is well positioned in the radiotherapy market, which has tremendous growth potential as improvements in technology, increasing awareness of the clinical benefits, and a favorable cost/benefit proposition should dramatically increase global adoption over the next decade. Further, we think Elekta carries a wide moat, based on a solid position in a market that is characterized by high barriers to entry, high switching costs, and strong intellectual property. This field has evolved into a duopoly over the past decade with virtually no new entrants, and the main two players (Elekta and Varian) have built durable franchises and are well positioned for growth.

_Damien Conover, CFA does not own shares in any of the securities mentioned above._
Industrials: Valuations Stretched, but Opportunities Still Exist

The sector has outperformed in conjunction with several months of positive manufacturing and housing data; however, we still see some compelling names.

By Brian Bernard, CFA, CPA, Equity Analyst

- The industrials sector has outperformed the broader market since early February, and the sector is now trading at a 2% premium to our fair value estimates. However, we think some stocks remain undervalued, including BorgWarner BWA, Embraer ER, and Stericycle SRCL.

- U.S. manufacturing data has turned slightly positive in recent months, while manufacturing across the rest of the world has been challenged.

- New single-family home construction has been a bright spot, and we project new single-family starts will increase nearly 10% this year. We expect homebuilder and building materials companies to benefit from increased new-home demand.

- We generally see improving conditions within auto manufacturing in certain geographic markets, particularly China and Europe. Until the U.K. referendum on European Union membership, global auto demand was on track to increase 2%–4% in 2016 led by a 10% and 7% year-to-date increase in the EU 28 member states and China, respectively. We also expect the aerospace and defense industry to benefit from a growing U.S. defense budget. The rail, trucking, and freight brokerage industries continue to navigate a difficult environment.

After reviewing our global coverage of industrial stocks, we noted that only two companies currently boast 5-star ratings. One hundred and twenty-four companies (or 71% of our coverage) have lower than a 4-star rating, indicating that our analysts believe these stocks are, at best, fairly valued. We have highlighted stocks that we believe offer compelling value to investors: auto-parts supplier BorgWarner, regional aircraft manufacturer Embraer, and regulated waste management firm Stericycle.

Manufacturing data turned positive in the U.S., but remained challenged in foreign markets. In May, the U.S. Institute for Supply Management, or ISM, manufacturing purchasing managers’ index, or PMI, came in at 51.3. This was indicative of manufacturing expansion, but was still below peak readings achieved in 2015 (53.9) and 2014 (58.1). May marked the third consecutive month of expansionary readings in the U.S. The ISM New Orders Index also remained strong in May, which is indicative of a sustainable recovery despite the strong dollar and weak commodity prices. Manufacturing data was less rosy throughout the rest of the world. The Markit Eurozone Manufacturing PMI registered 51.5—still expansionary, but the lowest
reading in three months. New European export order growth was at a 16-month low, as businesses reported difficult domestic and export markets. The Caixin China Manufacturing PMI contracted in May to 49.2, versus 49.4 in April. The China Manufacturing PMI has been below the 50.0 neutral level for 15 consecutive months. Finally, the Markit Brazil Manufacturing PMI dipped to 41.6 as businesses reported worsening economic conditions. May marked the worst reading for Brazil since February 2009, and 87 consecutive months below the 50.0 neutral level.

U.S. residential construction continued to gain momentum during the second quarter of 2016. Total starts are up 11% from the same period in 2015, driven by single-family starts, which are up 18% for the year to date, and offset by weaker multifamily starts, which are down 1.5% for the year to date. While we believe our 2016 forecast of 845,000 single-family starts is attainable, we have reduced our forecast for multifamily starts to 375,000, as multifamily construction lending appears to be tightening and permit activity has been down. Our long-term outlook on U.S. housing remains unchanged. We still expect starts to peak at nearly 1.9 million in 2020, as household formation strengthens amid tighter labor markets and looser financial constraints. Our bullish forecast hinges on a sustained recovery in household formation. Data from the Census Bureau’s Housing Vacancies and Homeownership Survey suggests that 2015 marked a turning point. The U.S. headship rate, the percentage of adults that head a household, improved to 45.2% in 2015, up from 44.8% in 2014, the largest increase we have seen since 1996. Still, headship rates remain well below historical standards, especially among younger adults hit hardest by the financial crisis. As the milennial generation enters its thirties, marriage and childbirth will become headship tailwinds as those individuals strike out on their own. Nearly a decade of anemic property development since 2006 will require resurgence in U.S. homebuilding to shelter these new families.

We expected weak numbers for May U.S. light-vehicle sales relative to April’s seasonally adjusted annual rate, or SAAR, of 17.42 million, as there were two fewer selling days in May compared with May 2015. Industry sales slid 6.1% year over year; however, the SAAR held firm despite the reduction in selling days, coming in at 17.46 million, compared with 17.71 million in May 2015. We do not see weakness across every vehicle segment, and the most expensive segments, light-trucks and premium/luxury, remained healthy. Nor do we believe there is a demand problem or an industry on the verge of a recession. Instead, we think the U.S. industry is plateaing and expect demand to remain healthy for some time to come. The fleet remains old, miles driven have increased, credit is available, and gas prices, although up recently, are bringing consumers into showrooms to buy crossovers, pickups, SUVs, or vans. For example, the industry’s light-truck mix in May was 59%, quite a move from the mid-40s in 2008–09. Internationally, the U.K. vote to leave the EU raises economic uncertainty, possibly resulting in declining light vehicle sales, but the mechanics of exiting will take several months. In the meantime, given the recent strength in EU auto demand, we continue to expect EU full-year 2016 light vehicle sales to increase by 5%–7%. We expect Brazilian volume to trough this year on the expectation that a new administration, with the impeachment of President Rousseff, will immediately seek economic stimulus to quickly turn around the country’s faltering economy. As the middle-class population in these regions expands, emerging
markets offer tremendous long-term growth potential for automakers, with entry-level vehicle segments averaging 25% of global auto production.

Though the U.S. defense budget fell 25% between 2008 and 2015, we expect it to return to annual growth of 1%-2%. The threat environment, fiscal deficits, defense budget cycles, and politics all point toward a modest but sustained upturn in U.S. defense spending that will last through the next decade.

Sluggish freight demand has loosened truckload industry capacity and begun to pressure underlying rates. Most of the truckload carriers on our coverage list expect core pricing conditions to remain weak in the second quarter, as capacity remains somewhat slack across the industry. On the positive side, many industry participants still anticipate better pricing conditions in the first half of 2017, with help from easing comparisons and the prospect of some supply (small carriers) exiting the market. While not a certainty, we think this is a reasonable assumption, given how far spot rates have fallen, coupled with the high-fixed-cost nature of trucking and recent regulatory changes (particularly new electronic logging device rules).

Rail continues to face serious volume challenges because of low commodity prices (in particular, natural gas that is sufficiently cheap to make coal relatively unattractive), lower commodity demand from China, and reduced oil and gas investment. We do not expect the trends creating these headwinds to change significantly in 2016, and weak rail carload data through the first five months of 2016 aligns with this view. As of the week ended June 4, year-to-date North American total carloads are down 13%, with coal carloads down a staggering 33%. Total intermodal units are down 2% for the year to date.

**Top Picks**

**BorgWarner BWA**

Star Rating: ★★★★★

Economic Moat: Narrow

Fair Value Estimate: $52

Fair Value Uncertainty: High

Consider Buying: $31.20

The global trend toward cleaner, more fuel-efficient vehicles is good news for BorgWarner. We expect this trend will drive increased demand for the auto-parts supplier’s engine and drivetrain technologies, resulting in 10% annualized sales growth over the next five years. BorgWarner’s valuable intangible assets, high customer switching costs, and cost advantages earn the company a narrow moat rating. The company benefits from a substantial global manufacturing presence, highly integrated and long-term customer ties, and moderate pricing power on new technologies. BorgWarner’s ability to consistently innovate provides long-term pricing opportunities that, in conjunction with cost advantages derived from low-cost country locations, should enhance margins and returns on invested capital. At current prices, we believe BorgWarner is attractive for investors seeking to add auto exposure to their portfolio.
**Embraer** ERJ

Star Rating: ★★★★

Economic Moat: Narrow

Fair Value Estimate: $34

Fair Value Uncertainty: High

Consider Buying: $20.40

Embraer boasts leading market share of aircraft between 70 seats and 130 seats. We see global urbanization, aircraft replacement demands, and a potential for U.S. scope clause changes as tailwinds for the regional aircraft manufacturer. We expect Embraer’s leading position in regional jets, a more comprehensive lineup of business aircraft, and a growing defense business to drive sales and profit growth. We believe Embraer’s intangible assets and high switching costs have allowed the company to maintain a market leadership position and earn the company a narrow moat rating. Historically, Embraer’s returns on invested capital have been strong, thanks to solid margins combined with limited working capital demands. Embraer’s ADRs look undervalued in our opinion, and we see nearly 70% upside.

**Stericycle** SRCL

Star Rating: ★★★★

Economic Moat: Wide

Fair Value Estimate: $127

Fair Value Uncertainty: Medium

Consider Buying: $88.90

We see opportunity in wide-moat Stericycle’s shares at present, as operational issues have plagued the firm since the completion of the PSC Environmental and Shred-It acquisitions in 2014 and 2015, respectively. As the largest provider of regulated medical waste management, the company enjoys superior positioning in a niche market protected by strong barriers to entry. We believe that rising costs support an increased appetite for healthcare providers and pharmaceutical companies to outsource waste disposal, a dynamic that will preserve stability in Stericycle’s core business. However, the company’s growth trajectory has evolved toward offering customers additional services, such as compliance training, patient appointment reminders, and hazardous waste collection. The $2.3 billion Shred-It deal, the largest in the company’s history, brought paper-shredding into the mix; however, synergy delays, along with sluggish waste volumes at the industrially focused PSC Environmental, have contributed to weaker-than-expected earnings growth over the past several quarters, rattling a market that historically awarded Stericycle’s acquisitive growth strategy with a premium multiple. At 4 stars, we believe the risk-reward relationship is now more compelling, and while we acknowledge that Stericycle’s earnings may still experience near-term volatility, in the longer term, the company has ample opportunity to weave itself even deeper into the operational fabric of its customers as it adds new services to its portfolio of offerings, strengthening switching costs over time.

*Brian Bernard, CFA, CPA does not own shares in any of the securities mentioned above.*
Real Estate: ‘Safety’ Becomes More Expensive

Attractive investment opportunities still exist but are much harder to come by, as wary investors flock to “safer” REIT names.

By Edward Mui, Equity Analyst

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

- In the U.S., healthcare remains our preferred property sector, and our favorite firm in the sector is Welltower HCN, while real estate service firms CBRE Group CBG and Jones Lang LaSalle JLL represent attractively priced long-term opportunities.

- We continue to view themes in commercial real estate as generally defensive in nature. REITs have been net sellers of real estate and are focused on repositioning and strengthening their portfolios, deleveraging, and capital recycling, while being opportunistic about capital deployment. Development of new supply continues, however, as firms look for higher returns.

- After a soft start to the year, property stocks have surged in both Australia and New Zealand, with most stocks now at all-time highs. Corresponding with this, we see little value in the sector, which is trading on a forward PE (interest-rate normalized) roughly 50% above the long-term average. A lurking headwind is the reduced cost of capital having driven an escalation in developments, which points to lower rent growth in outer years. One firm we see as offering an attractive risk/return dynamic is Goodman Group GMG.

Morningstar’s real estate coverage looks reasonably priced; the sector trades at a 3% aggregate discount to our fair value estimates. We believe investors should continue to be selective in the sector, as we expect increasingly uncertain economic conditions to continue to affect capital access and activity, asset pricing, and operating fundamentals throughout the year.

The market is still attempting to reconcile the implications of interest-rate expectations for real estate valuations. Higher interest rates could put pressure on growth rates, cap rates, and return expectations. Also, to the extent that low interest rates have diverted investor funds to REITs searching for higher yield, the same funds could flow out of REITs if interest rates rise, further pressuring commercial real estate and REIT valuations.

However, we still expect U.S. interest rates to remain historically low for an extended period. Investors see the U.S. as a relative safe haven for investment capital, and 10-Year U.S. Treasury yields continue to compress, at historically low rates of roughly 1.6% today, even
compared with 1.8% in our previous quarterly update, amid global yields coming down overall. Additionally, the U.S. economy seems more and more vulnerable to a slowdown, highlighted by weakness in recent jobs reports. Altogether, this has prompted policymakers to revisit where they want rates to go and how quickly they want them to get there.

That said, most REITs are in a good position to weather potential broader economic volatility. Many are well capitalized and benefit from in-place long-term leases that can potentially still be released at higher current market rents, giving these firms embedded cash flow growth, if not a safety cushion for future economic weakness. REITs have also been net sellers of assets, trading out of weaker, more vulnerable assets into moatier assets with better long-term growth prospects. And as the operating performance, demand outlook, and ultimately cash flows for many REITs remain solid, albeit decelerating, for the time being, asset values have largely stayed intact and mostly in line with Treasury yields.

Eventually, rising interest rates will be viewed as a sign of a strengthening economy, which could benefit real estate fundamentals, although we see that scenario as being unlikely in the near term. If effective debt yields ultimately rise relative to overall performance, we would expect asset values to be increasingly challenged.

Nonetheless, as investors and businesses become wary and return expectations decrease, a reduction in investment will help slow demand and reinforce negative outlooks. Logically, this has caused capital to flock to “safer” REIT names and assets. We generally categorize these as firms with reasonable leverage, moaty assets or businesses, demonstrated historical success across economic cycles, identifiable internal and external growth drivers, and reasonable margins of safety to our estimates of value. While these are our preferred investment vehicles, we think it makes sense to focus not only on firms with these attributes, but also on those that also have well-covered dividends with strong prospects for growth over time.

Attractive investment opportunities are much harder to come by, though, as safety becomes more expensive. Furthermore, aggressive transaction pricing for existing institutional real estate assets are progressively railroading many capable U.S. REITs into allocating more capital toward value-creating opportunities, such as the redevelopment of existing assets or the development of new properties in order to further grow and achieve required returns. While we generally acknowledge the opportunity for prudent capital allocation to achieve excess returns, we remain wary of firms overextending themselves into riskier investments, especially as concerns rise about oversupply or slowing demand.

That said, we believe there are still strategic investment opportunities in the U.S. market. In particular, healthcare REITs—including Welltower—remain preferred, owing to a robust demand outlook and positive industry trends that should help maintain strong cash flow generation and insulate these firms from economic cyclicality. On the other hand, particularly moaty real estate service firms such as CBRE and Jones Lang LaSalle represent an attractively priced long-term opportunity for companies that, in our view, enjoy strong and enduring competitive advantages.
As with other major markets, Asia-Pacific property appears undervalued and offers attractive yields relative to conventional income products, such as bonds. A pullback in the equity markets in the region has provided new opportunities in the property space. We prefer developers such as CapitaLand C31 with geographical diversification across greater China and Asia and steady earnings underpinned by recurring investment income.

The shares of Hong Kong developers and landlords have remained subdued in recent months, owing to a continued pessimistic outlook in the residential sector and a poor retail environment, particularly in the tourism-driven luxury sector.

Singapore REITs have tracked sideways since the sector’s recovery in the first quarter of 2016, performing largely in line with the Strait Times index. There is no change to our preference on defensive retail REITs as opposed to office property in the near term, given increased office supply in the near term. Completion of office construction in 2016 will add 4.3 million square feet of new supply in 2016. With limited new supply of 0.4 million and 0.6 million square feet in 2017 and 2018, respectively, and no planned supply thereafter, we expect the large addition to be slowly absorbed. The above new supply averages to 1.06 million square feet per year over the next five years, in line with historical annual net office demand of 1.1 million square feet. Singapore’s steady political and transparent regulatory regime underpins the city-state as a premier destination for global multinational corporations in setting up or moving their regional headquarters. However, we expect the new supply to pressure office rental growth in the near term.

**Top Picks**

**Sun Hung Kai Properties 00016**
Star Rating: ★★★★★
Economic Moat: Narrow
Fair Value Estimate: HKD 141
Fair Value Uncertainty: Medium
Consider Buying: HKD 98.70

**Cheung Kong Property Holdings 1113**
Star Rating: ★★★★★
Economic Moat: Narrow
Fair Value Estimate: HKD 70
Fair Value Uncertainty: Medium
Consider Buying: HKD 49

The shares of Hong Kong developers and landlords have remained subdued in recent months, owing to a continued pessimistic outlook in the residential sector and a poor retail environment, particularly in the tourism-driven luxury sector. As the bellwethers and pure plays of the Hong Kong real estate sector, Sun Hung Kai Properties and Cheung Kong Property retreated 13% and 20%, respectively, since late 2015, when residential prices peaked. The Hang Seng
Index registered a 7% decline over the same time period. As the leading developers in Hong Kong, these companies are mainly exposed to development risks related to large-scale residential projects. While a weak physical market certainly means lower selling prices, the companies can benefit from a less competitive land auction market, leading to lower input costs. Further, as holders of large agricultural land banks, the companies have the opportunities to negotiate favorable conversion premiums with the government.

Sun Hung Kai Properties holds a large portfolio of retail assets focusing on nondiscretionary spending, shielding the company from the current headwind in the luxury- and tourism-driven retail sector. Its large holding of office assets has performed very well in recent months. Cheung Kong Property employs a flexible pricing strategy and full cycle view, allowing it to achieve good sell-through regardless of the physical market conditions. It focuses on quick asset turns and maintains a strong balance sheet, leaving ample opportunities for countercyclical land acquisitions. As of its reorganization in early 2015, the company is not overly exposed to residential trading, as 45% of its income now comes from rentals, hotels, and REITs.

**CapitaLand Mall Trust** C38U

- Star Rating: ★★★★
- Economic Moat: Narrow
- Fair Value Estimate: SGD 1.80
- Fair Value Uncertainty: Medium
- Consider Buying: SGD 1.26

CapitaLand Mall Trust owns a portfolio of high-quality malls around Singapore and boasts the city-state’s greatest market share. Its malls are well managed, situated in densely populated areas, and close to mass transport hubs with high levels of foot traffic. These attributes are attractive for its diverse tenant base, resulting in high retention rates and near-full occupancy across its properties. Nondiscretionary products and services, such as food and beverages, drive repeat customer visits and account for 30% of gross income. This high occupancy and staggered lease expiry profile helps reduce rental cyclicality and is conducive to stable distributions to unitholders.

*Edward Mui does not own shares in any of the securities mentioned above.*
Tech & Telecom: We See Opportunities in Apple and Microsoft

While the tech sector looks fairly valued to us, we see opportunities in smartphone- and cloud software-related vendors.

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

- Overall, we view the tech and telecom sectors as fairly valued, with market-cap weighted price/fair values right around 1.00.
- We continue to see opportunities in smartphone-related vendors.
- Microsoft’s evolution will yield long-term success.
- When the chips are down, bet on capital equipment firms.

We Continue to See Opportunities in Smartphone-Related Vendors
Firms with exposure to the smartphone market have faced some tough times in recent quarters, as Apple AAPL iPhone demand has not lived up to prior expectations and the company reported its first year-over-year quarterly revenue decline since 2003. Meanwhile, the rest of the smartphone market hasn’t fared much better; we’ve seen some company-specific market share shifts across the Android ecosystem, but in total, smartphone unit sales will fail to achieve double-digit growth in 2016 for the first time this decade. In turn, a host of components suppliers have sold off accordingly.

Despite this near-term sluggishness, we remain confident that the strong secular shift away from feature phones and toward more advanced smartphones is still intact. While we no longer foresee exponential iPhone growth for Apple, we think that customer switching costs will drive most iPhone customers today to buy future iPhones tomorrow, thus supporting the company’s unmatched free cash flow generation.

Microsoft’s Evolution Will Yield Long-Term Success
In the software space in particular, we have seen several firms navigate the challenges of moving from a legacy, on-premise world to the new world of cloud computing. Adobe has been especially adept at this transformation, while Oracle’s ORCL shift remains to be seen. We now view Microsoft MSFT on the more favorable end of this spectrum and showcase the company’s transformation from a dominant legacy software vendor to a more nimble and user-friendly business.

Following the lead of new CEO Satya Nadella, Microsoft has embraced changes that we think will leave the firm better positioned for long-term, sustained success. Microsoft has quickly
emerged as one of the most important cloud computing firms in the world. Azure, the firm’s public cloud service, has established itself as the number-two player in the space behind Amazon, and the platform should continue to garner significant user growth as Microsoft leverages Azure-hosted software such as Office 365 and Dynamics. Public cloud represents a monumental opportunity for Microsoft as new workloads increasingly shift to the cloud, and the firm has curated a rich set of software and tools that will help keep developers in the ecosystem. The rise of Azure should help make up for the Windows Server OS, which is flagging against the continued meteoric rise of Linux, and it should also offset declines in other segments.

When the Chips Are Down, Bet on Capital Equipment Firms
The $30 billion-plus wafer fabrication equipment, or WFE, industry is dominated by five players that account for roughly two thirds of the market. We believe equipment providers play an integral, yet often unappreciated, role in today’s advanced electronic devices. These firms enable the continuation of Moore’s Law via their involvement in creating faster and more energy efficient chips. Based on the intangible assets around design expertise and research and development cost advantages required to compete for the business of leading-edge manufacturers, barriers to entry are high. Most important, in our view, is the fact that the top five are relatively indifferent with respect to which chipmakers manage to survive and/or thrive after making hefty up-front R&D investments, as WFE firms boast all major chip manufacturers as customers.

Top Picks

Apple AAPL
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: $133.00
Fair Value Uncertainty: High
Consider Buying: $79.80

We believe that near-term weakness and a broadly sluggish smartphone market has provided investors with an attractive margin of safety in narrow-moat Apple as compared with our $133 fair value estimate. By our calculations, Apple appears to be priced as if iPhone sales have peaked and will face a long, secular decline from here on out. While we no longer foresee exponential growth for the iPhone, we think that future sales will be more resilient than what the market has priced into the stock. Ultimately, we think that, for a host of reasons (such as software and services like iCloud, FaceTime, and iMessage, as well as the need to repurchase apps and subscriptions, and a loss of compatibility with other Apple products), iPhone users today will continue to buy future iPhones well into the future. Meanwhile, we think the market is giving Apple little credit on the innovation front, either in new software, native applications, new services (perhaps a streaming TV service) or new products (potentially Apple Car).
Microsoft MSFT
Star Rating: ★★★★
Economic Moat: Wide
Fair Value Estimate: $61.00
Fair Value Uncertainty: Medium
Consider Buying: $42.70

Microsoft has emerged as one of the most important cloud computing firms in the world, and we believe the market is undervaluing its long-term opportunities as a cloud leader. Azure, the firm’s public cloud service, has established itself as the number-two player in the space behind Amazon, and the platform should continue to garner significant user growth as Microsoft leverages Azure-hosted software such as Office 365 and Dynamics. Public cloud represents a monumental opportunity for Microsoft as new workloads increasingly shift to the cloud, and the firm has curated a rich set of software and developer tools that will help keep developers in the ecosystem. We believe Azure will help offset declines in some of Microsoft’s legacy businesses, solidifying the firm’s wide moat and stabilizing the moat trend. Although we think Microsoft will be subject to some lumpiness over the next several quarters as the revenue mix continues to shift toward cloud-based services, we are confident that management can guide the company into its next era of widespread success as a dominant cloud vendor spanning Internet as a service, platform as a service, and software as a service.

Skyworks Solutions SWKS
Star Rating: ★★★★
Economic Moat: Narrow
Fair Value Estimate: $92.00
Fair Value Uncertainty: High
Consider Buying: $55.20

We foresee growth at a reasonable price and an adequate margin of safety in narrow-moat radio frequency chipmaker Skyworks Solutions SWKS. Given the need for far higher RF chip content per 4G LTE smartphone, the ongoing complexity around LTE networks, and the rapid expansion of these networks in developed and emerging markets over the next few years, we still foresee tailwinds for RF chip suppliers like Skyworks over the next couple of years. We do have some concerns about long-term RF pricing trends, but we believe these are accounted for in our $92 fair value estimate as we model Skyworks’ long-term growth at a slower pace than the firm’s forecast.

*Brian Colello, CPA does not own shares in any of the securities mentioned above.*
Utilities: A Sector-Shaking Pile-up Could Be Coming

Nothing has been able to halt a historic utilities sector rally since mid-2015, but when will the music stop?

By Travis Miller, Director of Utilities Equity Research

- The utilities sector kept its foot on the gas during the second quarter, speeding past the peak that the Morningstar U.S. Utilities Index hit in February. Morningstar’s worldwide utilities sector coverage traded at a 1.07 market-cap-weighted price/fair value as of the end of May, but the median price/fair value for U.S. utilities is 1.14, near an all-time peak.

- The 200-basis-point spread between U.S. utilities’ 3.6% average dividend yield and 1.6% 10-year U.S. Treasuries suggests utilities have a long way to run, based on historical averages. Even with historically high valuations, utilities’ yield properties remain attractive.

- European energy market policy is splintering. The biggest markets—Germany, U.K. and France—are pursuing three different ways of addressing carbon emissions reduction that an EU-wide carbon credit trading scheme has not achieved. Brexit offers a buying opportunity.

- Deal-making could continue unabated as long as interest rates stay low. Great Plains’ implicit leveraged buyout of Westar Energy in May at a 50% premium to our fair value estimate is a template for further industry consolidation among small- and mid-cap utilities.

U.S. utilities are up 18% year-to-date through mid-June, far exceeding the returns for any other sector. Another jump in early June leaves the sector up 26% since last June, among the best trailing 12-month returns for the sector in at least the past 25 years. And with the U.S. Federal Reserve seemingly content to maintain a near-zero interest rate policy, the rally might continue. Utilities’ dividend yields are exceedingly attractive relative to long-term bond yields.

We think deal activity in the sector is both a product of and a cause of the high valuations in a low-interest-rate world. In the sector’s latest deal, Great Plains GXP proposed buying Westar WR for mostly cash at a 50% premium to our fair value and an implied 25 times our projected 2017 earnings. Five of the seven largest U.S.-based utilities have a pending acquisition or recently closed one. Six utilities we cover have agreed to an acquisition proposal that could close in the next 12 months. Other utilities are adjusting their portfolios with cash-fueled asset sales and purchases.

Mid-cap utilities in constructive and fundamentally attractive markets are prime targets. We wouldn’t be surprised to see firms like Alliant Energy LNT, CMS Energy CMS, New Jersey Resources NJR or Portland General POR entertain suitors. All of them already appear to enjoy
an M&A premium, trading at valuation multiples above their peers, dividend yields below their peers and 20%–30% above our fair value estimates. However, the sector is running out of big fish and European utilities aren’t likely to look West like they did a decade ago given their own cash constraints at home.

So when will the music stop? A sudden and unexpected rise in interest rates could bring a sharp near-term correction. However, history shows that utilities produce fairly steady total returns over three to five-year periods regardless of how interest rates move. A long-term concern always is capricious regulation. We think electricity demand will slow to just half of the U.S. real GDP rate during the next decade. As utilities invest in renewable energy, distributed generation and new technology, they will have to rely more heavily on regulators to increase customer rates. That is never popular.

European utilities continue to struggle managing nationalist policies primarily focused on reducing carbon emissions and figuring out a place for nuclear. We think the market is overly punishing Electricite de France EDF for uncertainty related to its huge nuclear fleet and plans for uneconomic new nuclear construction. RWE RWE and E.ON EONGY continue to struggle with the market’s concerns about their corporate splits, government oversight of nuclear decommissioning funding, and potential forced coal plant shutdowns. Dividend cuts worry the market even more. But for investors willing to wait for the market overreaction to fade, we think these three have attractive upside. The Brexit market sell-off offers another opportunity to pick up European utilities cheaply since we don’t expect utilities businesses in the U.K. to feel any long-term effects from the move out of the EU.

**Top Picks**

**Electricite de France** EDF  
Star Rating: ★★★★★  
Economic Moat: None  
Fair Value Estimate: EUR 17  
Fair Value Uncertainty: High  
Consider Buying: EUR 10.20

With EDF trading near EUR 10 per share, we think the downside is priced in and a likely rally is ahead if EDF announces it will abandon the Hinkley Point C new nuclear project. The project has become a head-scratching nightmare of delays, design issues, wildly out-of-market economics, and a scramble for funding, including a dividend cut this year and we think a likely dividend cut next year. Brexit adds more uncertainty. We now believe the project will be a EUR 1–2 per share value drag if it goes forward, and we think the market is pricing in even more downside. EDF is more attractive without Hinkley, and a new carbon mechanism in France will help unlock that value.
Germany’s RWE is one of the largest electricity and gas suppliers and power generators in Europe but has plans to split the business in 2016. RWE will hold the suffering conventional generation and commodities businesses while spinning off its stable, growing renewable energy, retail supply, and distribution grid businesses. We expect weak energy markets to persist at least through 2017. Our sum-of-the-parts analysis values legacy RWE at EUR 3 per share and the spin-off at EUR 15 per share. On a consolidated basis, we expect trough EUR 5.1 billion EBITDA in 2017, primarily due to the drop in conventional generation earnings from renewable energy growth, high gas prices and capacity overbuild. Management has cut back investment in renewable energy, but we still expect that segment to grow modestly, especially if RWE International can raise cheap equity capital following the spin-off. We continue to watch how RWE and the German government resolve concerns about funding some EUR 10 billion of present-value nuclear decommissioning liabilities.

Calpine is uniquely positioned among independent power producers as the industry’s predominant natural gas generator, with the most efficient fleet in the U.S. This allows Calpine to benefit from tightening supply-demand conditions in the power markets and low gas prices across Texas, California, and the Mid-Atlantic. All of Calpine’s operating regions are struggling to provide market incentives for newbuild expansion and pending emissions regulations that will take significant coal plant capacity off line throughout the U.S. We expect this to create supply constraints across Calpine’s core operating regions, allowing it to capture significant margin expansion independent of natural gas prices. We forecast $840 million free cash flow before growth in 2016, an effective 16% yield.

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