Global Research

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US Equity and Derivatives Strategy

US Outlook 2016: Into the Late Innings

Equity Strategy

Americas

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2,275

81 months and 200% higher, this Bull is the third longest since 1932 and surpasses the average of 138%. While age or return alone does not signal The End, increasing volatility, Fed rate hikes, and an M&A boom in its third year have all preceded past tops. Importantly, neither valuation or sentiment excesses nor signs of a recession, usually evident at peaks, are apparent – yet. 2016 will likely see balance sheet strength, modest earnings growth and a subdued but rising interest rate backdrop. We forecast a year-end S&P 500 price of 2,275 and earnings of $126 in 2016 and $132.50 in 2017.

Upside Potential: 2,500 – Suspension of Disbelief?

Higher volatility expands potential downside and upside outcomes. Upside to a multiple near prior peaks is catalyzed by positive Fed reaction, a China "soft landing" and a long awaited return of the Public as buyers (Figure 1). Stocks are historically strong in the October to April period; an overshoot is likely in 1H2016 prior to a focus on the November 8 US Elections. We recommend going long the SPX June 2,175 Call/1,850 Put Risk Reversal for a potential 1H "Suspension of Disbelief" rally; pgs. 25-26.

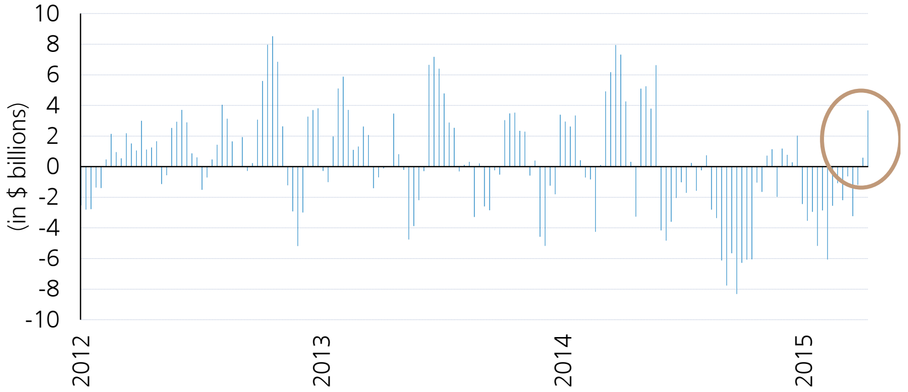
Downside Risk: 1,750 – The End

Anemic earnings whether a result of a sluggish US economy, margin pressures or foreign weakness ends the Bull. Absent soft earnings, liquidity concerns resulting from deviations in "global central bankers' scripts" – episodically evident over the past year – could prompt margin liquidation and market gridlock. In no ongoing bull market since the 1970's has the next year traded below the preceding year's low price. The 2015 low is 1,867.01; a breach would likely result in volatility exceeding August 2015 peaks.

Sector Preferences – Overweight Financials, Technology and Healthcare

Sector preferences are driven by cash – more valuable with rising volatility and rising rates. Cash is augmented by valuations, earnings consistency and the potential for more M&A. We underweight Consumer Staples, Utilities and Telecom given growth and regulatory headwinds as well as sensitivity to rising rates. Selectivity is critical as the Bull enters its seventh year; we prefer UBS Buy rated stocks which have grown revenues YoY over the past five years and (ex-Financials) which have 15% or more of total assets in cash – "Late Innings Leaders"; details pgs. 42 – 43.

Figure 1: Return of the Public? (Domestic Equity Flows, 4 wk. MA)



Source: Lipper, UBS

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UBS Research THESIS MAP **2016 Outlook: Into the late Innings**

PIVOTAL QUESTIONS

Q: Can US Earnings grow again?

Yes: Greater stability in commodity prices and FX markets as 2015 comparisons become easier should underpin a modest earnings recovery – around 5% YoY growth. 2.8% US GDP growth in 2016 supports expanding top line also set to benefit from macro stabilization.

Q: Will the Fed finally hike? Does it Matter?

Yes and Yes: UBS believes the first Fed hike will occur on December 16, 2015. As important as the actual hike is the Fed's ability to "sell" markets on its' confidence with regard to economic conditions at home and abroad. Another Q1 soft patch (2014 and 2015) or a relapse of China financial turmoil stokes perceptions of a "policy error" which could impair market liquidity, compressing multiples. Conversely, economic strength above expectations will reinforce the Fed's message and hiking intent.

Q: What are the biggest risks?

Upside: A positive reaction to the beginning of Fed rate hikes (as the ECB, BOJ and PBOC remain easy), resulting in an economic and equity market acceleration common in past hiking cycles and catalyzing a renewed public participation in equites. **Downside:** Little to no earnings growth and a continuation of International instability post the start of Fed Normalization, which results in market dislocation and volatility in excess of August 2015 peaks.

WHAT'S PRICED IN?

Equity markets are pricing in single-digit earnings growth. Market multiples are not taxing at around 16.5x NTM particularly when compared with a 10 year treasury yield of 2.3%. Expectations are for earnings normalization due to modest GDP growth and greater oil and FX price stability.

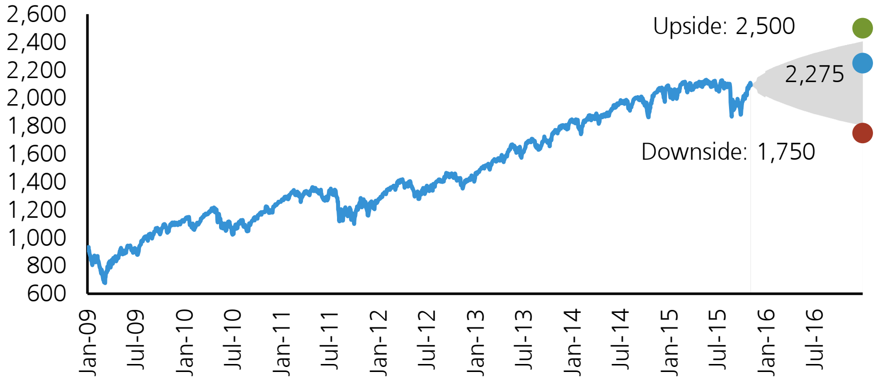
UBS VIEW

Modest earnings growth will likely be sufficient. As volatility of earnings expectations subsides and Fed lift-off ratifying US economic strength is absorbed by investors, stocks continue to advance supported by M&A and balance sheet strength. The prospective return of the investing public as buyers after being absent during 2015 could support 1H 2016 multiple expansion/market overshoot.

EVIDENCE

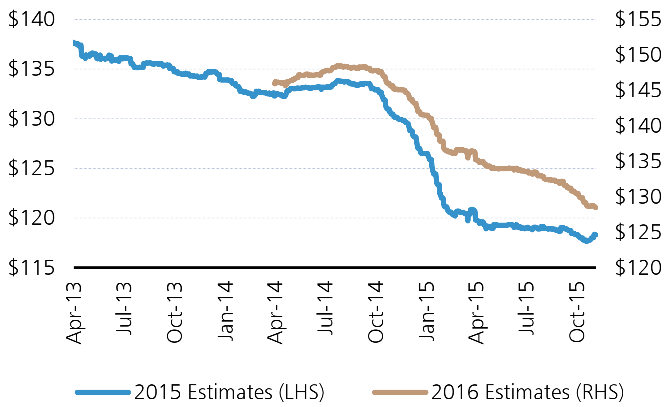
While market volatility was evident in late Summer, Consensus downward EPS revisions eased and are troughing during Q3 reporting season. M&A activity remains on record pace, jobs growth and wage trends are robust supporting consumption and further equity market upside.

Figure 2: 2016 – Market Implied Outcomes and UBS Base, Upside, Downside



Source: Bloomberg, UBS

OUR THESIS IN PICTURES



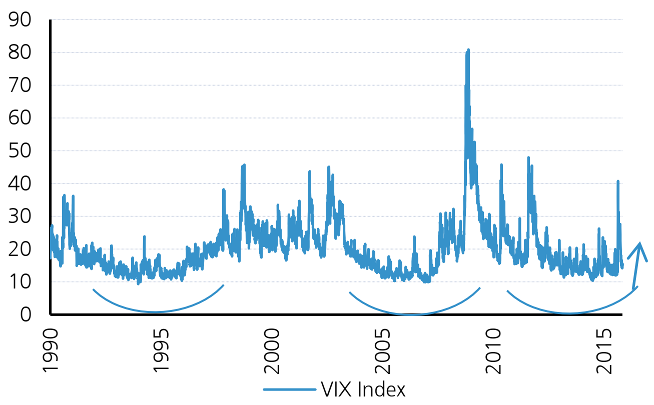
Sources: FactSet, UBS

The speed of earnings estimates downgrades has troughed in recent months. Modest 2016 growth should come from 2.8% US GDP and greater oil/fx stability – UBS 2016 Earnings Estimate is $126.

Date of 1st Rate Hike	S&P 500 Advance from First Hike (%)	Time to Market Top (# months)	Fed Funds Rate Range (Tightening)
8/14/1977	41.1%	41	6.00 - 20.00%
12/16/1986	34.7%	8	6.00 - 7.25%
3/29/1988	41.9%	28	6.50 - 9.75%
6/30/1999	11.3%	9	4.75 - 6.50%
6/30/2004	37.2%	40	1.00 - 5.25%
2015?	?	?	0.25 - ?.??%
Avg (ex current)	33.2%	25	

Source: FOMC, Bloomberg, UBS

The Fed is expected to begin hiking on 12/16/15. Past hiking cycles have signalled an eventual end to the Bull Market, but not before a rally extension of both duration and total returns.



Source: UBS

The 3-5 year cyclical volatility regime shifted from low to high with August's China FX devaluation. Higher volatility often occurs in the "Late Innings" of rallies, as markets discount a greater likelihood of both upside and downside scenarios.

Supports Still in Place

The late Hall of Fame Yankees catcher Yogi Berra once said, "It's like déjà vu all over again." In this regard, much of what we wrote in our 2015 Outlook is still applicable in the current economic environment. For example, in November of last year, we wrote:

> *The S&P 500 has risen 200% since the bull market began in March 2009 - not unprecedented by historical standards. Buoyed by strong corporate balance sheets positioned to drive further M&A, the prospect of solid GDP anchoring steady earnings growth, and a Fed set to raise interest rates while mindful of incoming data, we expect the advancing tide to continue rolling.*[1]

One year later, our view of the US equity landscape remains quite similar. While the bull market – which has now advanced approx. 210% since the low in March 2009 – is now nearly 7 years old, US equities continue to be buoyed by the broad health of corporate balances sheets, a flurry of M&A activity and the prospect for solid economic growth driving an improvement in corporate earnings.

Coming into 2015, we expected the start of a Fed rate hiking campaign to be a catalyst for higher volatility and although the Fed did not raise rates as we originally expected (UBS now expects the Fed to hike in December 2015[2]), we witnessed a noticeable increase in volatility, particularly during the third quarter; catalysed by China's surprise CNY devaluation and following the narrowest six-month S&P 500 trading range in decades. We believe the volatility regime has shifted higher, consistent with prior aging bull markets, and higher volatility is likely to continue to provide investors with greater opportunities to generate alpha.

In short, we believe the requisite supports are still in place for the bull market to continue to run, albeit with incrementally increasing caution. Below, we present a summary of our year end 2016 S&P 500 Price Target and EPS estimate.

Figure 3: UBS Forecasts

	2014	2015E	2016E	2017E
Economic				
US Real GDP Growth (%)	2.4%	2.5%	2.8%	2.5%
10yr Treasury Yield (%)	2.5%	2.4%	2.5%	3.0%
S&P 500				
Price Level ($)	2,058	2,125	2,275	-
% growth	*11.4%*	*3.2%*	*7.1%*	-
Earnings per Share ($)	118.68	120.00	126.00	132.50
% growth	*8.3%*	*1.0%*	*5.0%*	*5.2%*
Forward P/E Multiple	17.2x	16.9x	17.2x	-
Trailing P/E Multiple	17.3x	17.7x	18.1x	-
Earnings Yield (trailing)	5.8%	5.6%	5.5%	-
Dividend Yield	1.9%	2.0%	2.1%	-

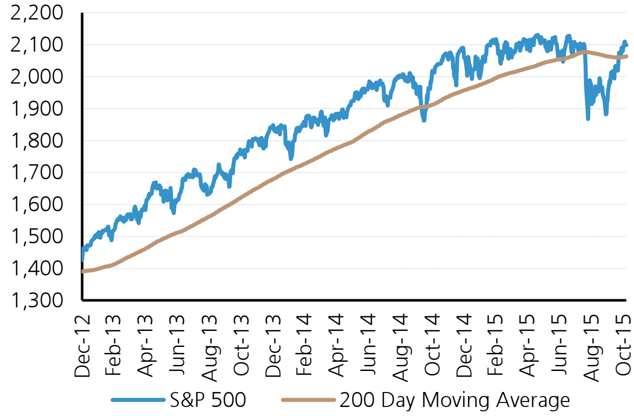
Source: FactSet, Bloomberg, UBS

[1] See 11/10/2014, US Equity & Derivatives Strategy – US Outlook 2015: Roll Tide, Roll…
[2] See 10/28/2015, US Economic Comment – FOMC: Waiting for Go or Godot?

The Bull: Aging and More Volatile

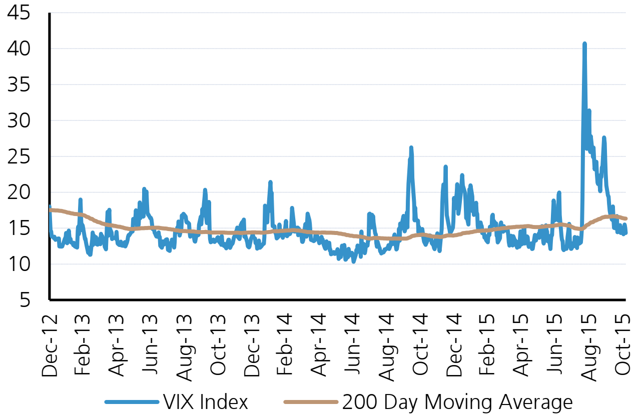
Despite the market's abrupt selloff at the end of the summer, following what was a historically narrow trading range in the S&P 500 during the preceding six months, the bull market trend remains intact, albeit in an environment where perceptions of risk have risen.

Figure 4: S&P 500, 2013-Present



Source: Bloomberg, UBS

Figure 5: CBOE SPX Volatility Index, 2013-Present



Source: Bloomberg, UBS

The volatility regime has shifted higher as rising risk is quite normal at this point in the market cycle where the rally is maturing (Figure 5) and the Fed is poised to begin raising interest rates – UBS now forecasts the rate hike cycle to begin at the December 16th FOMC meeting.

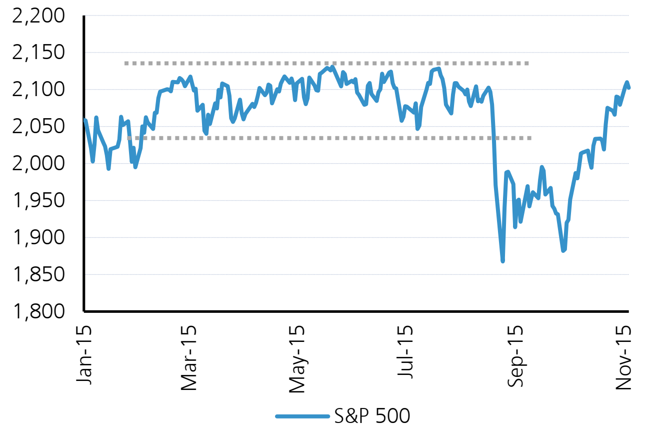
Figure 6: Mature Bulls – Often a Bumpy Ride

		Average 1yr Volatility	
Start	End/ Current	1yr Prior to Market Top	2yrs Prior to Market Top
6/1/1932	3/10/1937	17.5	18.2
3/31/1938	11/9/1938	35.3	22.4
4/11/1939	10/25/1939	26.7	36.2
4/28/1942	5/29/1946	14.8	10.4
6/13/1949	8/2/1956	13.2	11.6
10/22/1957	12/12/1961	8.1	9.8
6/26/1962	2/9/1966	6.3	5.2
10/7/1966	11/29/1968	9.8	8.4
5/26/1970	1/11/1973	8.0	9.6
10/3/1974	9/21/1976	12.2	19.5
3/6/1978	1/6/1981	16.1	11.1
8/12/1982	8/25/1987	15.2	12.8
12/4/1987	7/16/1990	13.6	12.3
10/11/1990	3/24/2000	18.9	20.0
10/9/2002	10/9/2007	12.1	10.7
	Average:	15.2	14.6

Source: Bloomberg, UBS

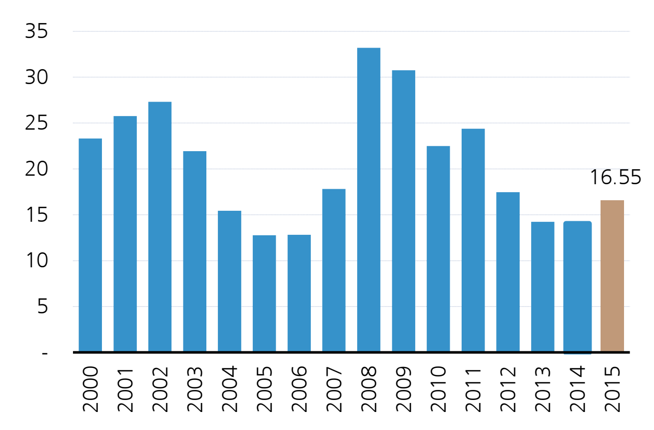
Prior to the summer selloff, markets were coming off a period of lower than normal volatility and a historically tight 6-month trading range in the S&P 500 index.

Figure 7: A Historically Tight S&P 500 Trading Range



Source: Bloomberg, UBS

Figure 8: Average VIX Levels



Source: Bloomberg, UBS

Though sceptics could point to the extent of gains, as well as the length of the rally since 2009, as sufficient rationale to believe a bear market is "due," we highlight that although the current rally is extended in both time and price, it is only the third longest and fifth largest rally since the Great Depression.

Figure 9: From FDR to Obama – A History of the Bulls

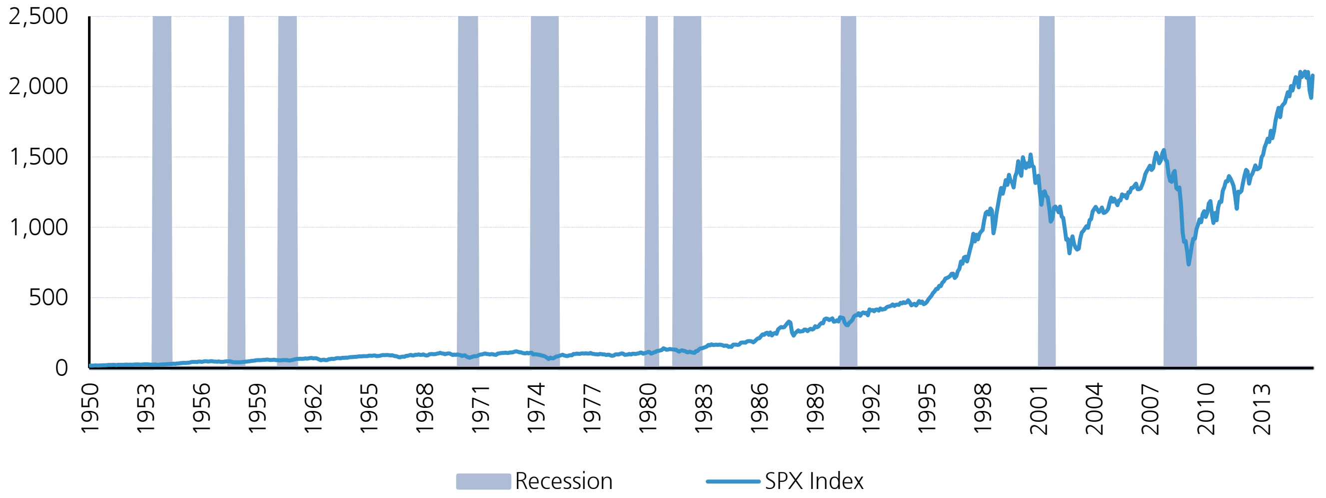
Start	End/ Current	Length (months)	Return	CAGR
6/1/1932	3/10/1937	58	324%	35%
3/31/1938	11/9/1938	7	62%	121%
4/11/1939	10/25/1939	7	27%	55%
4/28/1942	5/29/1946	50	158%	26%
6/13/1949	8/2/1956	87	267%	20%
10/22/1957	12/12/1961	50	86%	16%
6/26/1962	2/9/1966	44	80%	18%
10/7/1966	11/29/1968	26	48%	20%
5/26/1970	1/11/1973	32	74%	23%
10/3/1974	9/21/1976	24	73%	32%
3/6/1978	1/6/1981	35	59%	18%
8/12/1982	8/25/1987	61	229%	27%
12/4/1987	7/16/1990	32	65%	21%
10/11/1990	3/24/2000	115	417%	19%
10/9/2002	10/9/2007	61	101%	15%
3/9/2009	11/6/2015	80	210%	
	Avg (ex. current):	46	138%	31%

Source: Bloomberg, UBS

Nonetheless, at 81 months and counting, the current bull market is one of the longest on record. That said, **no bull market since before the 1970's has ended without a recession** and both our US Economics team or our US Credit

Strategy team do not forecast a near term recession. Simply put, barring an unforeseen external shock or a recession, if earnings continue to improve, 2016 should be a positive year for US equities. Regardless, we continue to expect further volatility – which in essence means higher risk, both **upside** and **downside**.

Figure 10: S&P 500 Historical Performance



Source: Bloomberg, UBS

Growth Drivers: The Economy & the Fed

Much like last year, we believe the underlying fundamentals support higher stock prices into 2016, particularly when viewed through the lens of the economy and the Fed. Low inflation persists and our UBS Economics team notes that relatively low inflation has tended to be associated with longer economic recoveries. In fact, the longest recoveries have been during times of comparatively modest inflation that did not generate exceptionally tight monetary policy and unsustainable demand imbalances.[3]

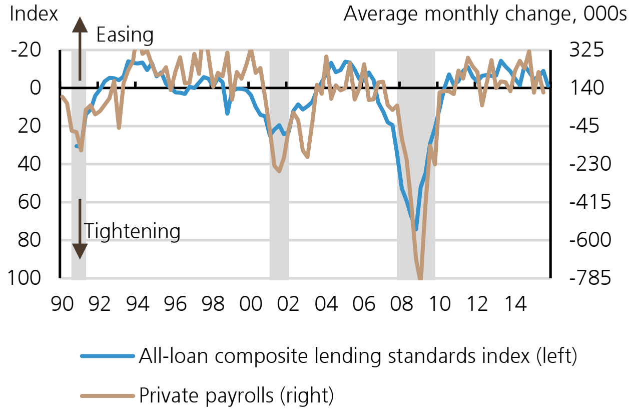
Our US Economists' forecast of 2.8% real GDP growth in 2016 is largely driven by credit and wages. Credit in most sectors is still largely available and the fraction of small businesses (that are pivotal for economic expansion) unable to obtain credit remains very low. Furthermore, our UBS all-loan composite bank lending standards index continues to signal relatively abundant bank credit and healthy private sector job formation.

[3] See 11/2/2015, US Economic Perspectives – US Economic Outlook 2016-17

Figure 11: Credit Remains Available for Small Firms

Source: National Federation of Independent Business, UBS

Figure 12: Bank Lending Conditions are Key for Jobs



Source: Federal Reserve Board, Bureau of Labor Statistics, UBS. (Note: Shaded areas mark recessions. The all-loan composite lending standards index is composed of lending standards responses for C&I loans, real estate loans, and banks' willingness to make consumer loans, weighted by outstanding commercial bank loans)

Along with the jobs facilitated by credit conditions, wages are critical for household purchasing power, and continued consumer optimism. With the unemployment rate expected to fall to calendar averages of 4.8% in 2016 and 4.2% in 2017, hourly wage and salary gains are expected to accelerate to 3.0% in 2016 and 3.3% in 2017.

Figure 13: Wage Gains at 5% Unemployment

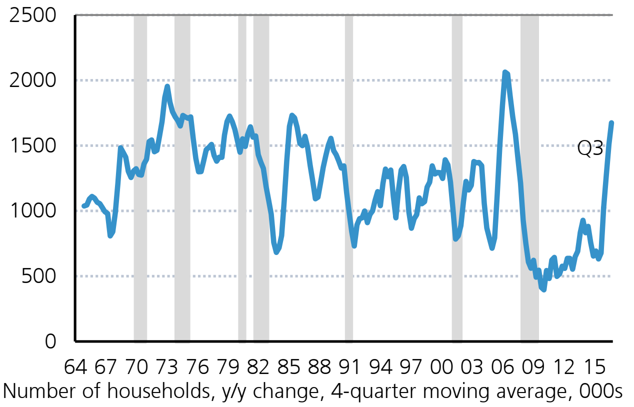
Source: Bureau of Labor Statistics, UBS

Figure 14: Consumer Confidence Remains High

Source: Bloomberg, UBS (Ticker: CONCCONF)

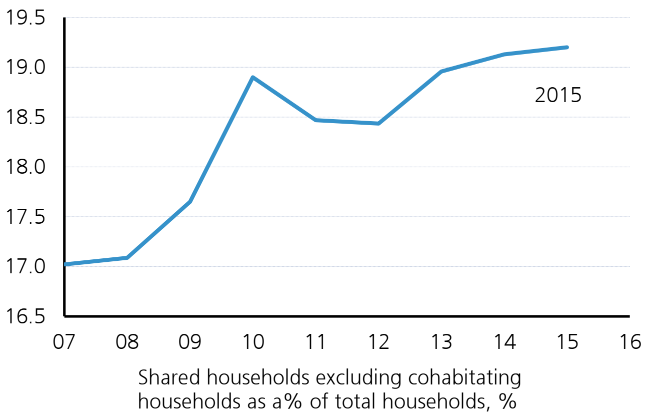
Growth could be better than expected if the US continues to experience relatively fast household formation. Following years of below normal household formation and an unusually high level of "doubled up" living arrangements, household formation has picked up to an around 1½ million annual pace.

Figure 15: Household Formation Improving



Source: Census Bureau, UBS. (Note: Shaded areas mark recessions)

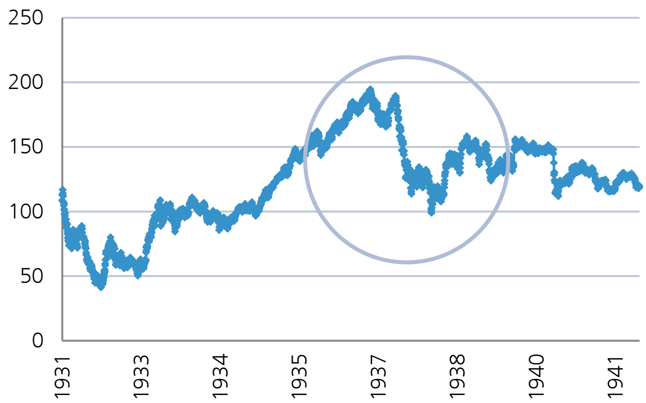
Figure 16: Yet Shared Households Still Remain High



Source: U.S. Census Bureau Current Population Survey Annual Social and Economic Supplement, 2007-2014

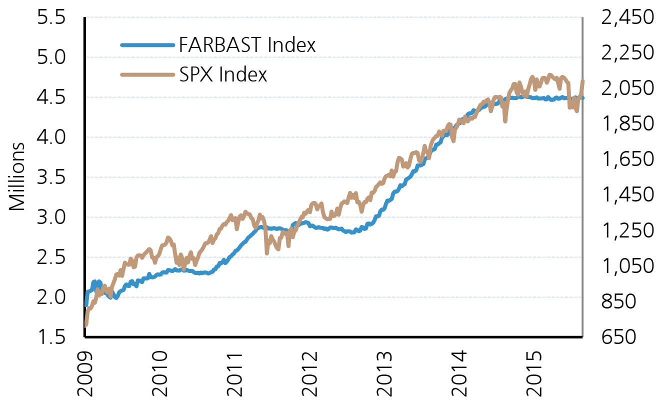
Turning to monetary policy, we believe the Fed continues to be "mindful" to not repeat the mistakes made by premature monetary tightening during the recovery phase of the 1930's, particularly given the close correlation of stocks to the Fed balance sheet. Despite the anticipated 12/16 "lift-off" date for Fed Normalization, the pace is likely to be slow and measured, subject to incoming economic data and changing conditions. And in this cycle, perhaps more than other hiking cycles, such subjectivity will include the health of International economies (particularly China and Europe) and the value of the US Dollar.

Figure 17: Premature Fed Tightening = a "Lost Decade"



Source: Bloomberg, UBS (Ticker: INDU)

Figure 18: Federal Reserve Banks Total Assets vs. S&P 500



Source: Bloomberg, UBS

With respect to market cycles and Fed hiking cycles, it is important to remember that equity peaks have occurred, on average, two years and a full 33% higher than when the Fed first began to raise interest rates, though by all rights, the first hike should indeed "start the countdown to the Bull market finale."

Figure 19: Fed Rate Hikes – Start is not the End for Stocks, For Awhile

Date of 1st Rate Hike	S&P 500 Advance from First Hike (%)	Time to Market Top (# months)	Fed Funds Rate Range (Tightening)
8/14/1977	41.1%	41	6.00 - 20.00%
12/16/1986	34.7%	8	6.00 - 7.25%
3/29/1988	41.9%	28	6.50 - 9.75%
6/30/1999	11.3%	9	4.75 - 6.50%
6/30/2004	37.2%	40	1.00 - 5.25%
2015?	?	?	0.25 - ?.??%
Avg (ex current)	33.2%	25	

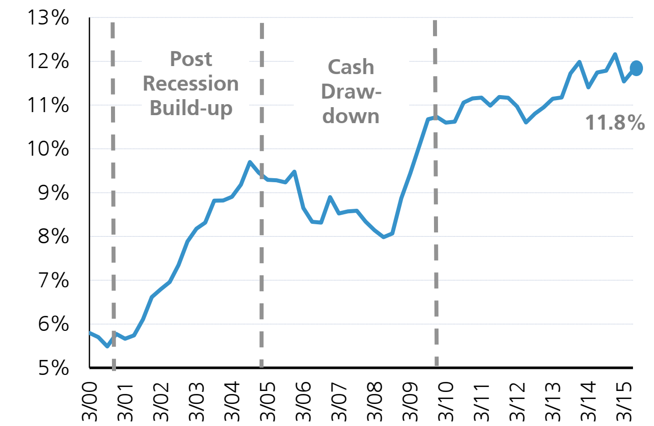
Source: FOMC, Bloomberg, UBS

Flexibility: Corporate Balance Sheets

When we combine a solid economy with a still "mindful" Fed and adequate balance sheet flexibility in corporate America, it seems reasonable to expect a further rally in the S&P 500 in 2016.

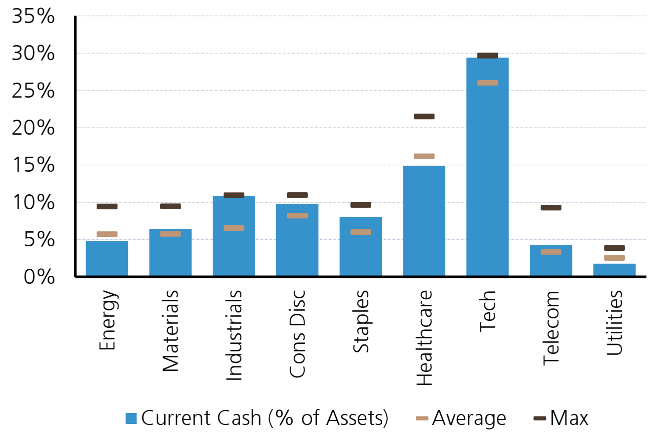
While companies have re-levered, particularly through the bond markets, the overall health of balance sheets remains a clear positive – in a higher volatility environment, cash is more valuable. S&P 500 cash balances (as a % of total assets) remain near all-time highs…

Figure 20: Cash (% of Total Assets) Near Peak



Source: Compustat, FactSet, UBS (Note: Data is representative of the S&P 500 ex financials)

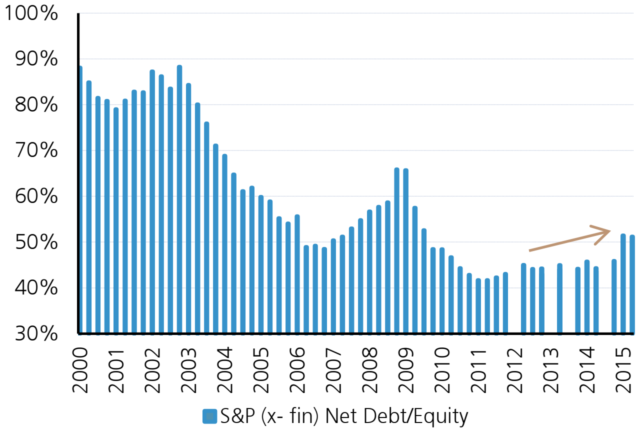
Figure 21: Positive Picture Across all Sectors



Source: Dealogic, UBS (Note: Volumes as of announced date)

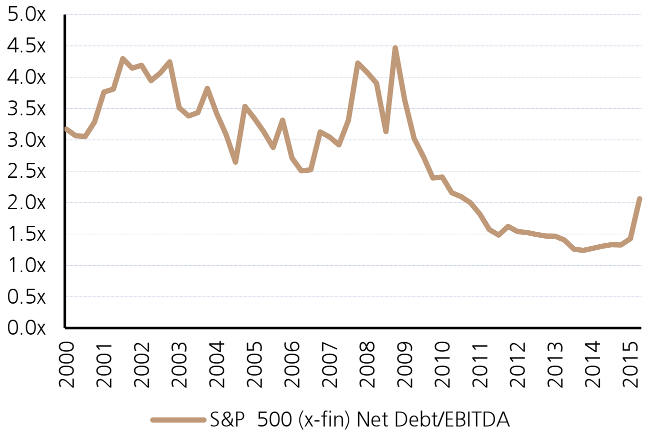
…and overall leverage levels, while increasing recently, remain well below peak levels. As bond market participants become more selective, growth in overall debt levels is likely to slow. However, debt remains cheap and available, particularly for those companies with sufficient flexibility and resources.

Figure 22: S&P 500 (ex Fin) Net Debt to Equity



Source: Compustat, FactSet, UBS

Figure 23: S&P 500 (ex Fin) Net Debt to EBITDA

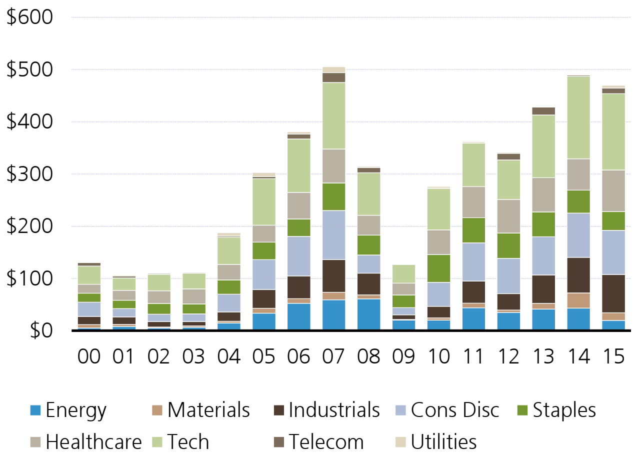


Source: Compustat, FactSet, UBS

Why do we like balance sheet flexibility and how is it a driver for US equities into 2016? The answer is fairly straight forward – in times of volatility, excess cash and, more broadly, balance sheet flexibility becomes more valuable as it provides corporate management teams with the ability to undertake value enhancing initiatives.

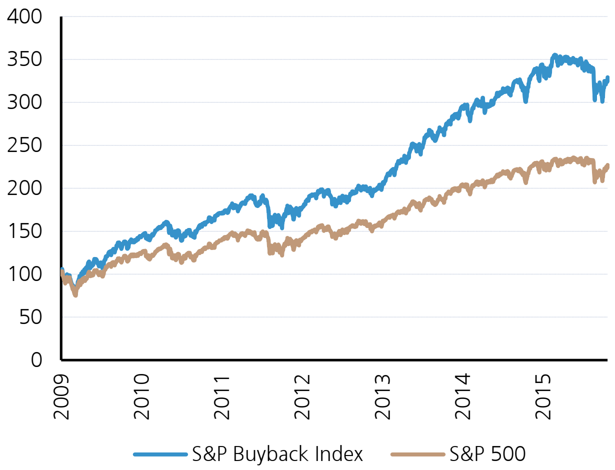
With ample flexibility, a company is capable of investing in future growth via capex as top line growth slows. Perhaps more relevant for the current environment, cash and balance sheet capacity allows companies to increase their capital returns to shareholders via larger dividends and, more recently, increasingly large share repurchase programs. In fact, until very recently, the S&P 500 Buyback Index has largely outperformed the broader market (Figure 25).

Figure 24: S&P 500 (ex. Fin) Buybacks by Sector, $bn



Source: FactSet, UBS (Note: Data is of S&P 500 companies ex financials)

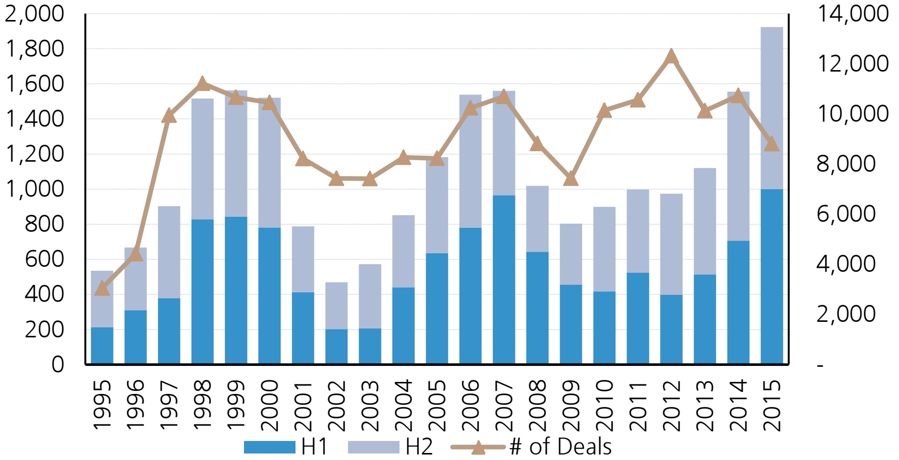
Figure 25: S&P 500 vs. S&P 500 Buyback Index



Source: Bloomberg, UBS

However, the Buyback Index has begun to underperform since Q2 of this year as the focus has increasingly shifted to M&A – another benefit to ample balance sheet resources. In a slower growth environment, corporate managers have focused on identifying growth through M&A.

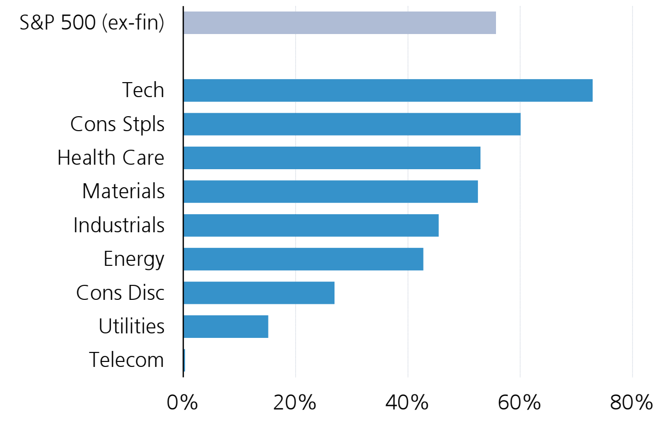
Figure 26: US Annual M&A Volumes – Three Year Peaks?



Source: Dealogic, UBS

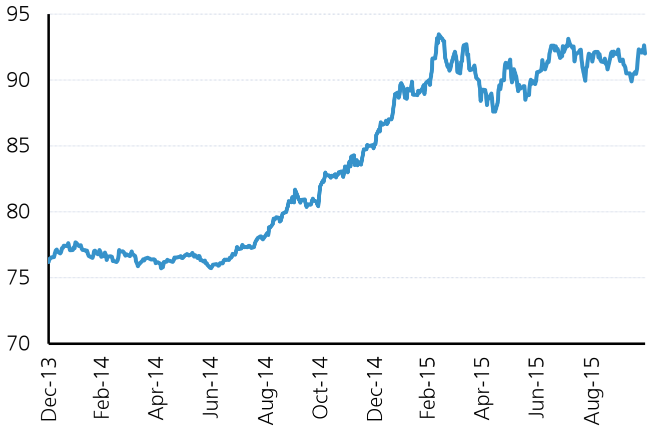
If we look at the past two M&A cycles, it seems as though M&A waves come in bunches of three years. We believe 2016 is likely to be year 3 of the current M&A cycle but signs for continued activity remain healthy. Companies have ample cash reserves and have access to fairly cheap credit. Furthermore, the large amount of offshore cash (given reduced likelihood of a repatriation holiday in the US) on S&P 500 corporate balance sheets – which we estimate to be over $900bn ex financials – and the continued strength of the US dollar could drive further M&A abroad (by US companies).

Figure 27: Offshore Cash (% of Total) by Sector



Source: FactSet, UBS

Figure 28: US Trade-Weighted Dollar Index



Source: Bloomberg, UBS

S&P 500 Outlook

Steady economic growth is central to the positive outlook for US equities in 2016. As the bull market enters into the late innings, we expect earnings growth to play an increasingly important role in overall equity market returns. However, a combination of low interest rates and an acceleration of equity inflows could contribute to further multiple expansion – typical of maturing bull markets.

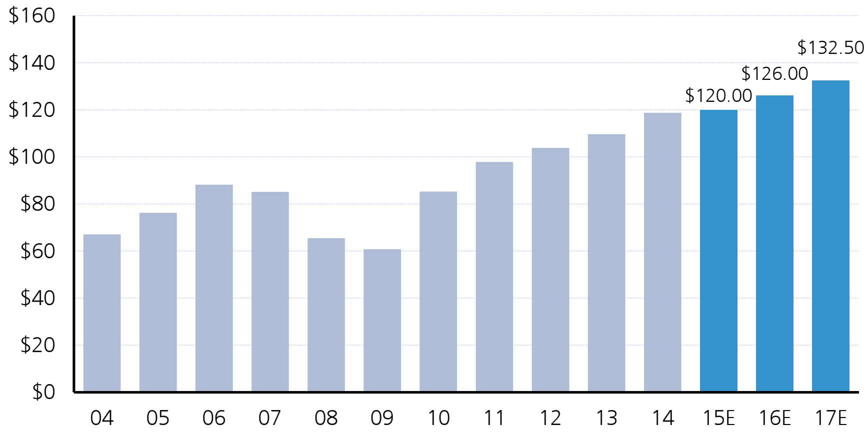
Figure 29: S&P 500 Performance, 2009-Present (Annual Returns*)

Source: Bloomberg, UBS (2015 & 2016 returns based off UBS price targets)

Earnings per Share

On the back of stronger GDP growth driven by an increase in consumer (wages) and corporate (access to credit) spending, we anticipate EPS to grow 5.0% in 2016 and 5.2% in 2017. As we enter the later innings of the current market cycle, we anticipate top-line growth to increasingly represent a larger share of earnings growth – as opposed to cost cutting and further margin expansion.

Figure 30: S&P 500 EPS ($, Annual)



Source: Compustat, First Call, IBES, FactSet, Bloomberg, UBS

Our top-down earnings model for S&P earnings uses a series of regressions to forecast key elements of the S&P income statement, thus leveraging the breadth of the UBS platform when incorporating forward views from our economists, strategists and analysts.

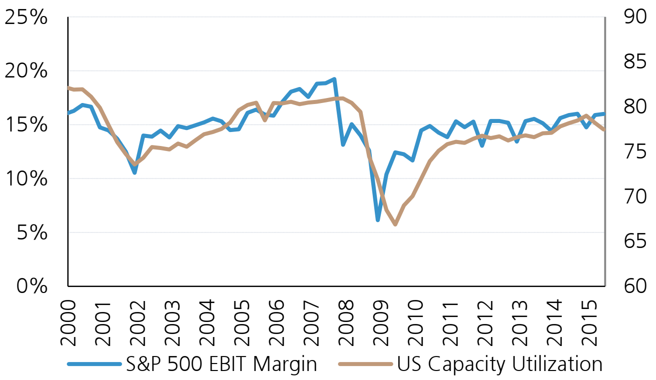
For sales, we focus on what we believe are key demand drivers such as personal consumption expenditures, private non-residential investment, oil prices and dollar strength. Operating margins are forecasted incorporating US capacity utilization and oil prices, while interest rates consider the spread between 2 and 10 year treasury yields (to estimate the incremental cost of debt funding for corporates). Lastly, we look to recent history to estimate divisor growth (slight reductions in-line with recent trends) and tax rate (average tax rate in recent years).

Figure 31: Key Drivers

	2015E	2016E	2017E
Sales Growth			
PCE – Durable Goods (%, y/y)	3.8%	3.9%	3.4%
Private NonRes Fixed Invest (%, y/y)	3.2%	5.0%	5.7%
Brent Crude Oil (%, y/y)	2.4%	2.5%	3.0%
EBIT Margin			
US Capacity Utilization Rate (%)	77.9	78.1	78.0

Source: Haver, UBS

Figure 32: S&P 500 Margins vs. Capacity Utilization

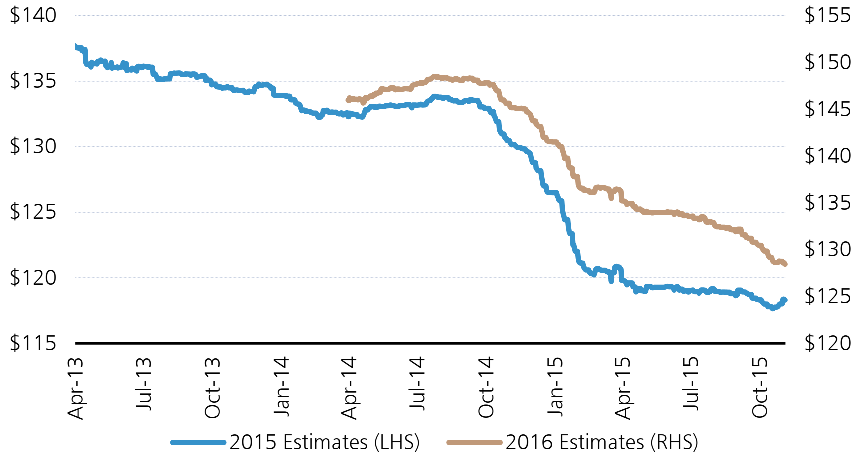


Source: Haver, UBS

Hence, the key risk to our top-down S&P earnings growth forecast is the pace of US economic growth – specifically, consumer and corporate spending. Oil represents a significant wildcard as any material bounce (or further weakness) could have significant upside (downside) risk to our estimates. The US dollar is also a factor into our model, with further material appreciation in the US dollar likely to impact earnings. Finally, although international growth forecasts, specifically for China and Europe are not direct inputs into our earnings model, a substantial slowdown in global growth will likely impact the pace of US economic growth. In the case of China, despite fairly limited direct revenue exposure for S&P 500 companies (~1-2% of sales), a hard landing would also add downside pressure on commodity prices (i.e. oil) – a direct input into our model.

Relative to bottom-up consensus expectations of $128.45 and $144.48 in 2016 and 2017 respectively, our Strategy estimates of $126 and $132.50 appear somewhat conservative.

Figure 33: Bottom-up Consensus Estimates, 2015 & 2016



Source: First Call, FactSet, UBS

While bottom-up consensus estimates are typically more optimistic at first and begin to adjust downward as additional information is incorporated into analyst thinking, oil prices and the US dollar (as evidenced by the consensus growth forecasts by sector) represent obvious wildcards. Easier comps in oil prices and the US dollar will likely provide a tailwind to earnings in 2016 although clearly there could be incremental further downside risk – particularly to consensus forecasts for the Energy and Materials sectors heading into next year.

Figure 34: Actual and Consensus EPS Growth

	Growth (%, YoY)					
Sector	Q1'15	Q2'15	Q3'15E	Q4'15E	2015E	2016E
Cons Disc	7.4%	8.7%	16.9%	9.8%	11.8%	15.0%
Cons Stpls	4.4%	1.5%	-1.1%	-2.5%	0.3%	6.6%
Technology	8.7%	7.3%	6.3%	-3.0%	6.7%	8.3%
Healthcare	21.7%	15.1%	15.1%	5.4%	12.4%	9.7%
Telecom	-0.8%	7.4%	15.7%	18.9%	11.9%	3.1%
Utilities	1.9%	8.0%	0.5%	0.0%	3.3%	3.5%
Energy	-56.6%	-56.2%	-57.8%	-66.4%	-59.4%	0.8%
Materials	-0.4%	9.3%	-15.4%	-18.5%	-5.0%	12.3%
Industrials	9.3%	1.3%	4.6%	2.4%	4.5%	4.9%
Financials	14.7%	7.2%	6.8%	13.1%	14.0%	8.5%
S&P 500	1.8%	0.3%	0.0%	-2.4%	-0.4%	8.6%

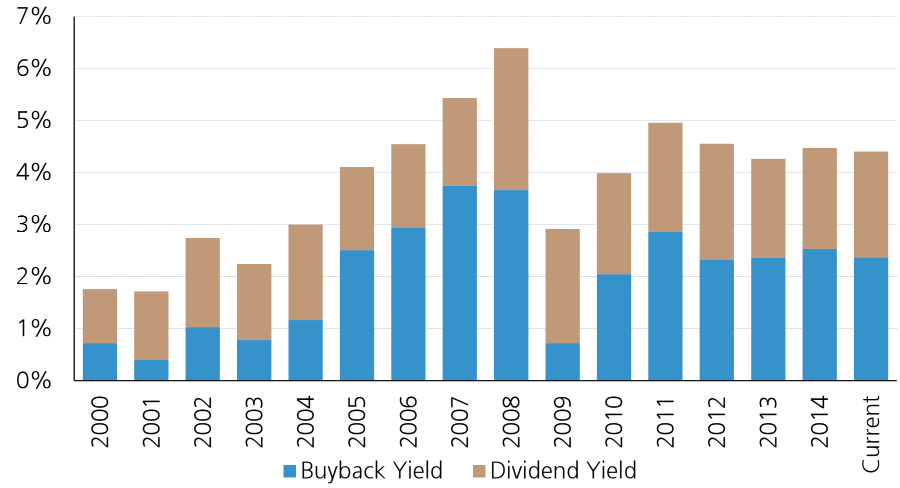
Source: FactSet, Bloomberg, UBS

Valuation

Using our top-down estimate for S&P 500 EPS, we apply a forward P/E multiple of 17.2x to arrive at our S&P 500 price target of 2,275. We believe our forecast for the slight increase in the forward P/E multiple from current levels is justified given the prospective growth profile for US companies, the health of corporate balance

sheets, a continued low interest rate environment and the potential for upside to our EPS forecasts. Given the combination of low long term yields (i.e. a 10yr treasury yield of 2.3%), a healthy yield on equities when taking into account dividends and buybacks, and relatively attractive growth prospects, we believe US equities look attractive in the current environment (Figure 35).

Figure 35: S&P 500 Total Yield

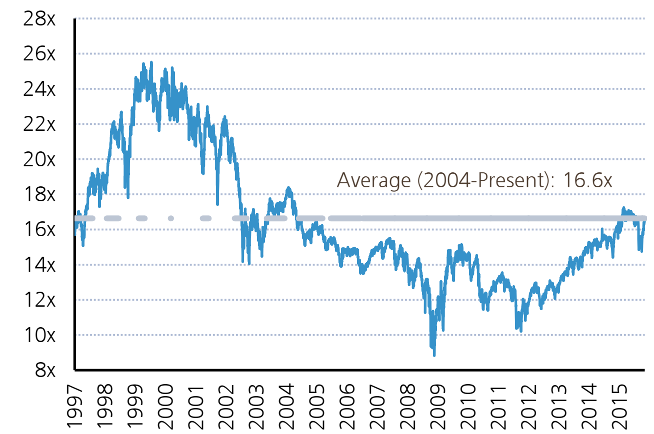


Source: Compustat, FactSet, UBS

What Does History Tell Us?

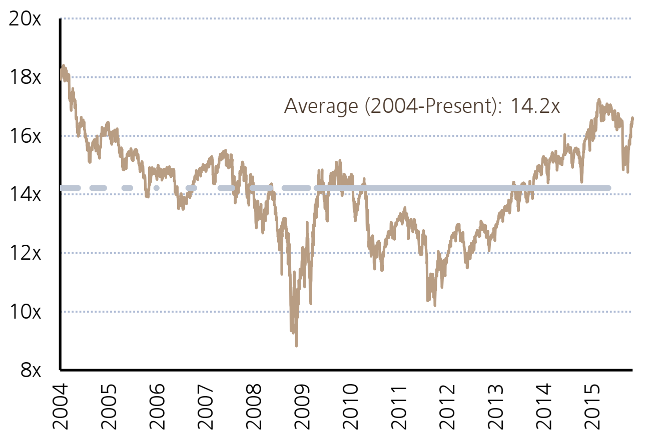
Is 17.2x NTM earnings too high for the S&P 500? Depending on the length of historical data, our projected multiple is roughly in-line to slightly elevated. However, the combination of low interest rates, healthy corporate balance sheets, and the maturity of the bull market justify, in an historical context, our projection for a slight degree of multiple expansion in 2016.

Figure 36: S&P 500 NTM P/E, 1997-Present



Source: First Call, IBES, FactSet, UBS

Figure 37: S&P 500 NTM P/E, 2004-Present



Source: First Call, IBES, FactSet, UBS

On a trailing basis, our 19x trailing multiple is still below the peaks reached in prior bull markets. In fact, the average peak multiple for all post World War II bull markets is approximately 20x trailing S&P earnings (Figure 38).

Figure 38: Peak P/E Multiples in Prior Bull Markets

Start Date	End Date	Max/Current P/E Ratio
10/22/1957	12/12/1961	22.4x
6/26/1962	2/9/1966	20.0x
10/7/1966	11/29/1968	19.0x
5/26/1970	1/11/1973	20.2x
10/3/1974	9/21/1976	13.7x
3/6/1978	1/6/1981	9.9x
8/12/1982	8/25/1987	22.7x
12/4/1987	7/16/1990	16.6x
10/11/1990	3/24/2000	30.7x
10/9/2002	10/9/2007	21.7x
3/9/2009	?	
	Average (ex. current):	19.7x

Source: Bloomberg, UBS

Sector comparison

While our forecast calls for slight multiple expansion, we think certain sectors are better-positioned to provide upside – at least relative to historical valuations within each sector. In particular (see sector preferences), we believe technology and financials are best-positioned sectors to see continued multiple expansion.

Figure 39: Valuation Heat Map

	S&P 500	Tech	HealthCare	Industrials	Cons Disc	Staples	Financials*	Energy	Utilities	Telecom	Materials
1990	11.3	10.7	15.1	11.2	11.0	13.3	1.4	13.4	10.4	12.7	9.2
1991	13.6	12.4	17.9	12.9	16.5	15.3	1.5	13.4	11.1	13.1	13.3
1992	14.3	13.8	16.8	13.2	17.2	16.1	1.6	15.9	12.0	13.6	14.9
1993	14.6	16.8	13.5	14.5	16.0	14.8	1.8	16.7	13.7	16.1	16.3
1994	13.1	15.1	13.7	13.7	12.7	14.4	1.6	16.5	11.2	14.7	15.7
1995	13.2	14.4	16.7	13.8	12.2	16.0	1.8	15.7	11.8	14.7	10.2
1996	15.0	16.5	19.3	16.1	14.2	18.2	2.0	16.4	12.2	14.6	13.7
1997	17.5	20.5	23.0	18.1	15.0	21.5	2.7	18.3	12.4	16.7	16.0
1998	20.6	26.9	29.2	19.2	19.7	23.9	3.1	20.4	15.1	20.8	16.6
1999	23.3	37.6	28.7	21.7	22.8	22.6	3.4	26.0	14.6	23.5	18.4
2000	22.1	39.1	27.8	21.4	20.2	18.5	3.5	18.9	15.2	18.8	11.5
2001	20.2	31.8	25.7	20.3	23.2	19.3	3.0	15.9	13.8	19.3	17.2
2002	17.5	27.0	20.6	17.1	20.9	17.8	2.5	18.4	10.6	14.4	18.1
2003	16.5	25.3	18.0	17.2	19.1	17.1	2.1	15.4	12.1	14.1	18.0
2004	16.5	22.5	17.6	18.2	18.4	18.1	2.2	14.9	13.8	17.0	15.3
2005	15.1	19.6	17.3	16.5	17.7	17.4	2.0	11.9	15.0	14.6	13.1
2006	14.5	18.9	16.7	15.7	16.5	17.4	2.1	10.2	14.4	14.3	13.0
2007	14.7	19.4	16.0	15.8	16.8	17.4	1.9	11.8	16.0	15.4	14.7
2008	12.3	14.5	12.6	12.7	13.5	15.1	1.3	9.6	13.6	11.9	12.9
2009	13.0	14.9	10.9	13.5	14.2	13.1	1.0	13.0	11.2	12.1	16.8
2010	12.7	13.3	11.0	14.7	14.4	13.7	1.1	11.4	11.9	12.6	13.9
2011	12.2	12.3	11.4	13.4	14.1	14.2	1.0	11.0	13.5	14.0	12.0
2012	12.5	12.1	12.3	12.6	14.7	15.3	1.0	10.7	14.6	15.0	12.4
2013	14.1	13.0	15.0	14.7	16.8	16.5	1.2	12.2	15.3	15.1	14.4
2014	15.5	15.2	16.6	16.1	17.6	17.7	1.4	13.9	16.2	13.5	16.4
2015	16.3	15.6	16.9	15.5	18.3	19.2	1.4	21.9	16.1	13.0	15.9
Current	16.4	16.5	15.8	15.9	18.5	19.2	1.4	23.5	15.0	11.8	15.8

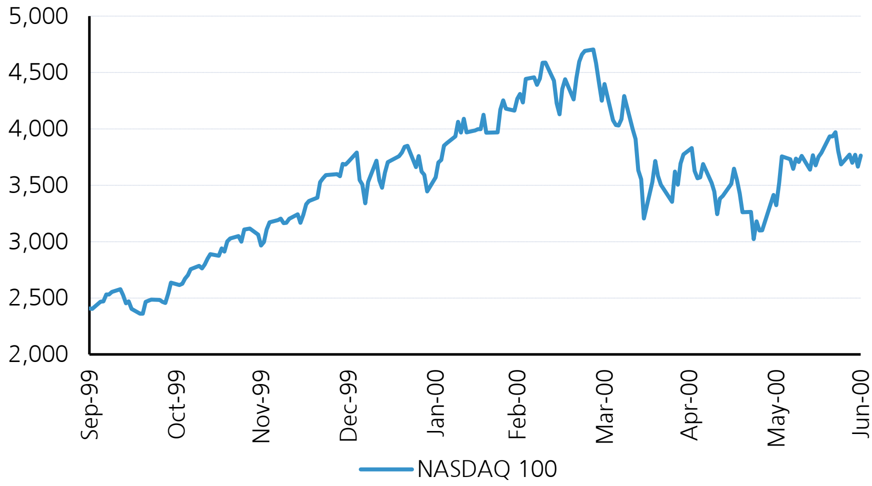
Source: IBES, First Call, FactSet, UBS (Note: Financials data is Price-to-Book, whereas all other sector data is Forward 12m Price-to-Earnings)

Upside Potential: 2,500 – Suspension of Disbelief

"Suspension of Disbelief" is a term coined in 1817 by poet Samuel Taylor Coleridge normally applicable to works of literary fiction that suggests that if the writer could infuse a "human interest and a semblance of truth" into a fantastic tale, the reader would suspend judgment concerning the implausibility of the narrative.

Almost seven years into an historical bull market largely devoid of public participation and enthusiasm, we have begun to see the first signs (see 10/30/15, Macro Keys – US Equities: Signs of The Top?) – higher volatility, torrid M&A activity, and a trickle of retail inflows – that normally accompany the final, sometimes remarkably higher, rally in a bull market. The conditions for "Suspension of Disbelief", a classic Sign of the Top epitomized by the NASDAQ in 1999-2000 (Figure 40), are building.

Figure 40: Suspension of Disbelief – Tech Bubble Top, 1999-2000



Source: Bloomberg, UBS

Is a move to S&P 500 2,500 at some point in 2016 truly plausible in the event that the "Suspension of Disbelief" accelerates? From a valuation perspective, we believe it is. As we illustrate in Figure 38, the average bull market multiple peak on trailing earnings is 19.7x. 2,500 on flat earnings of approx. $120 in 2016 equates to 20.8x, while on UBSe for 2016 of $126 is 19.8x and on current bottoms up consensus of $128.45 is 19.5x.

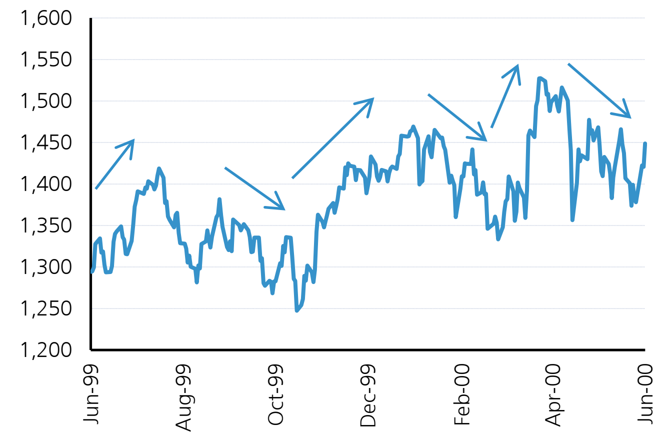
Volatility Cuts Both Ways

As we illustrated in Figure 6 earlier, the latter stages of a number of historic bull markets have become noticeably more volatile (see 1/20/15, Monetizing Manic Movement).

Two of the most important examples of the idea that stocks can rise (and, perhaps eventually, fall) in an environment of higher volatility are the 1999-2000 end of the Tech bubble (Figure 41) and the 2007-2008 onset of the Great Financial Crisis

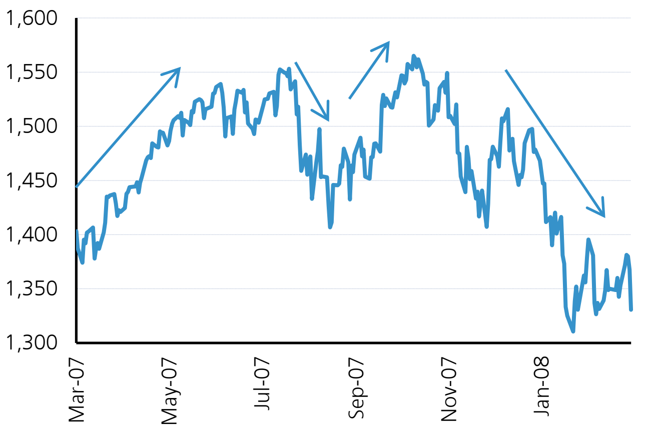
(Figure 42) – both of which saw surges and plunges on the way to their ultimate Bull market peaks.

Figure 41: Tech Bubble Zig-Zag (S&P 500, 1999-00)



Source: Bloomberg, UBS

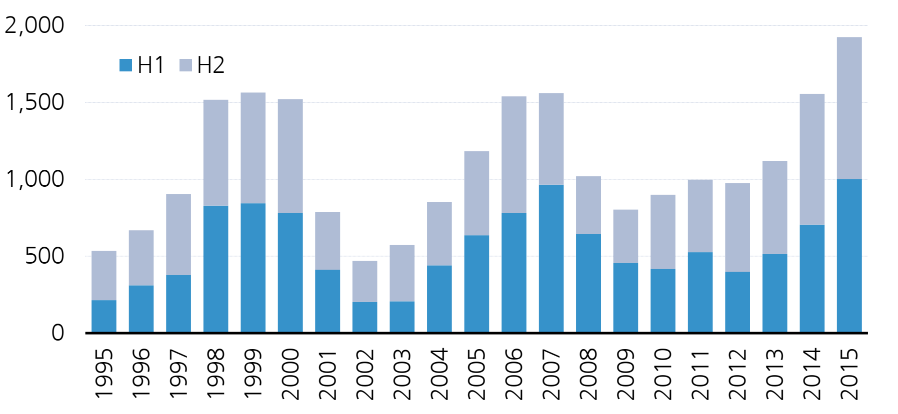
Figure 42: Manic Recession (S&P 500, 2007-08)



Source: Bloomberg, UBS

We use 1999-2000 and 2007-08 as prime examples of higher volatility Bull market finales because there is one other notable similarity with the market of 2015-16; a dramatic spike in M&A activity that, in the third year, peaked (Figure 43), but not before catalyzing the upside that ultimately proved unsustainable.

Figure 43: Historical US M&A Announced Deal Volume ($bn)



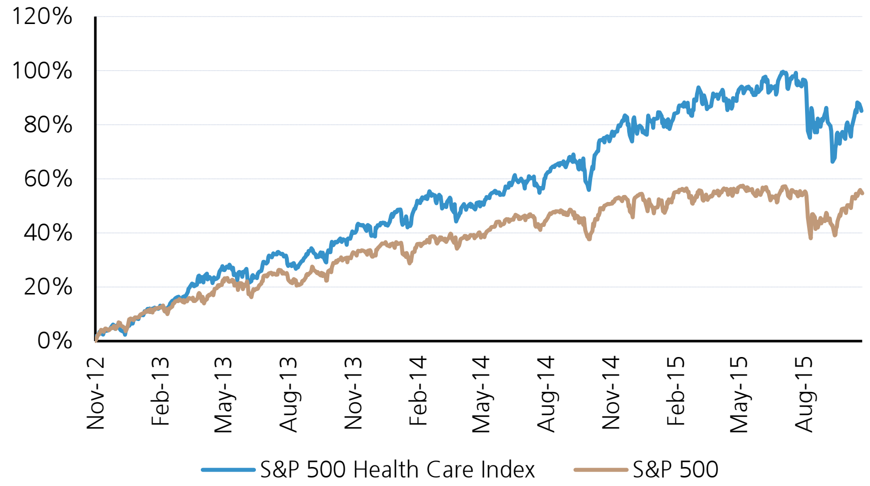
Source: Dealogic, UBS

Of particular note were "blockbuster" M&A transactions in sectors and stocks which were perceived market leaders at the time (Tech in 2000, Financials in 2007) that gave rise to the notion that anything was possible in the world of M&A; AOL/Time Warner ($182B deal) in January 2001 and RBS/ABN AMRO ($98B deal) in 4/2007.

Alas, the "sky" turned out not to be "the limit". Such deals were ultimately recognized as "bell ringing" transactions, however not before the broader S&P 500 index continued its robust advance – In 2000, SPX peaked 5% above and 2 months after AOL/TWX was announced, and in 2007, stocks peaked 8% and 6 months later.

Fast forward to 2015-16: M&A volumes in the US have swelled to all-time highs; led in large part by the Health Care sector, flush with cash, driven by demographic and demand tailwinds, a sector widely acknowledged as one of the market leaders in the last few years (Figure 44).

Figure 44: Health Care – Bull Market Medicine

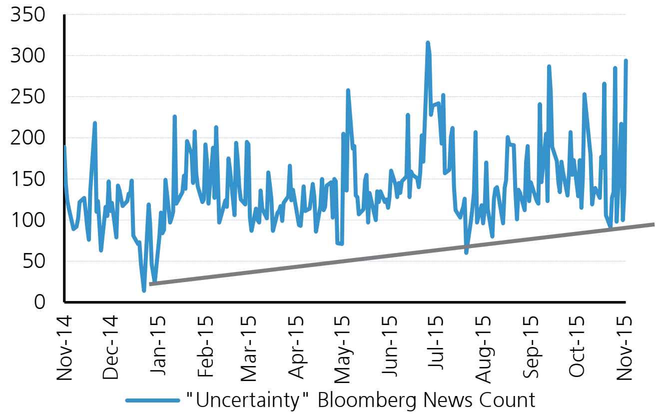


Source: Bloomberg, UBS

Paradoxically, the volatility in the market since August, and particularly since Presidential Candidate Hillary Clinton tweeted her intent to propose a plan to combat the high cost of prescription drugs on September 21st, has, if anything, intensified the M&A activity, whose recent prominent feature was the proposed combination of Pharmaceutical behemoths Pfizer (PFE) and Allergan (AGN), a deal that currently values AGN at $120B. We think the proposed PFE/AGN combination, if consummated, could go down as one of the landmark transactions of this current M&A wave, perhaps similar to other notable large scale "headline" deals which occurred near past M&A activity peaks in 2000 and 2007.

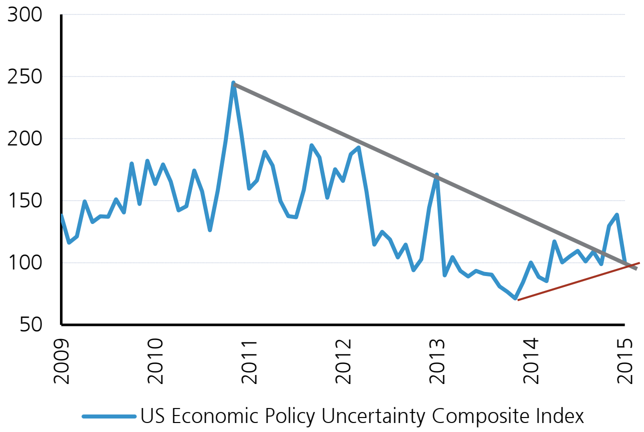
So rather than be deterred by the recent volatility and uncertainty in markets, which, in a political season where the November 8 elections promise that the only certainty is change and greater uncertainty (Figure 45 and Figure 46), managements have become bolder at attempting to strike deals prior to the onset of both a new political regime in Washington as well as the start of "more expensive money" courtesy of the Fed.

Figure 45: Word Count - A Quiet Uptrend in Uncertainty



Source: Bloomberg, UBS

Figure 46: US Economic Policy Uncertainty – Breakout?



Source: Bloomberg, UBS

The uncertainty observed in and around Washington DC is by no means the only area where "uncertainty bull markets" - hence elevated volatility - are in full bloom. Positive resolution to these other uncertainties could further stoke the "animal spirits" that have seemingly been missing from what many pundits call the "most hated Bull market in history". We pinpoint three uncertainties which, under the right set of circumstances, could propel markets higher, perhaps significantly enough to inflate valuations, in the coming months.

The Fed – While UBS expects the Fed to begin raising rates at the 12/16/15 FOMC meeting, the question is, with this being one of the most watched and widely anticipated Central Bank events in history, how do equity markets react? UBS Economist Drew Matus in his 4/10/15 Macro Keys – Why Zero Rates are Bad for the US Economy posits the idea that the first few rate hikes may cause an acceleration in economic activity rather than acting as a restraint. If this were to be the case, investors could quickly become emboldened buyers, further interpreting the Fed's actions as a sign that not only would the US be deemed to be on solid economic footing, so too would China, a focus for the Fed and the markets for a number of months.

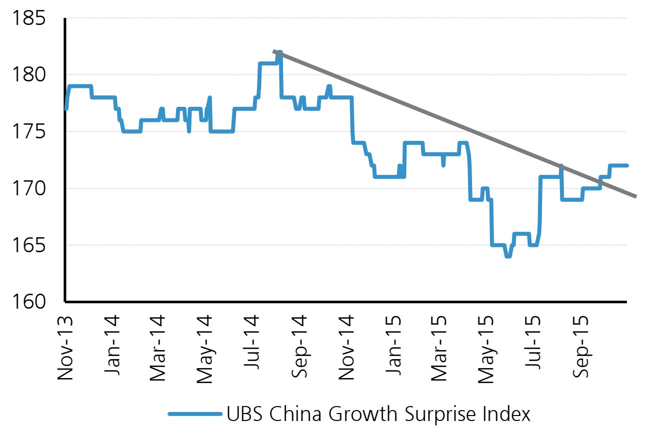
China – China is admittedly a great unknown where uncertainty has remained elevated (Figure 47), even in the wake of the surprise CNY devaluation on 8/11 – but perhaps finally showing signs of a peak?

Figure 47: China Uncertainty – Has It Peaked?

Source: Bloomberg, UBS

Signs are beginning to accumulate that both economists (Figure 48) and investors (figure 49) are discounting the moderating of China uncertainty as well.

Figure 48: China Slowdown fully Priced in?



Source: Bloomberg, UBS

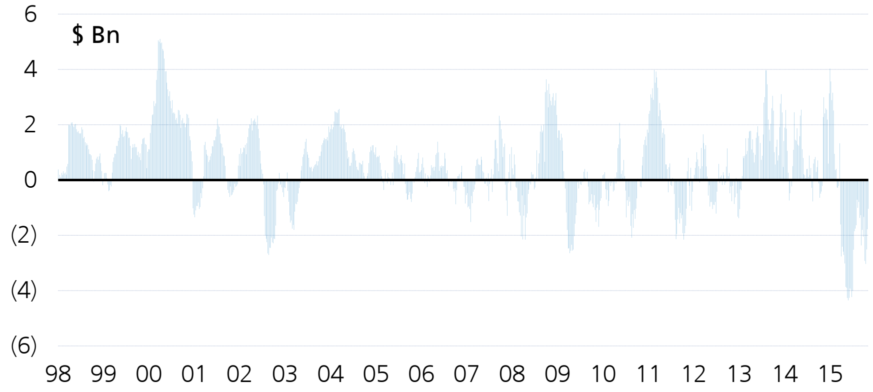
Figure 49: SHASHR – Investors Feeling Relieved, Too?

Source: Bloomberg, UBS

Greater belief in China's ability to "soft land" in the coming months – China economist Tao Wang forecasts 6.2% GDP growth in 2016, 5.8% in 2017 – could prove to be a major boost to US equities, which suffered in August when China's authorities surprised markets, dropping over 10% in a matter of days while no material adverse effects to the US economy were apparent (see 9/11 Macro Keys – Dark Skies Over China and the Impact on US Equities).

The Investing Public – The Public has long been absent as a buyer of US equities; in fact retail investors have been heavy net sellers of US equities in 2015; this is contrary to the normal trend in bull markets, where "the late innings" are marked by greater public enthusiasm for stocks, where the desire to own equities often takes on a climactic dimension as occurred in 1999-2000 (Figure 50) often inflating valuations (Figure 39, page 18, Valuation Heat Map) beyond reasonable fundamentals.

Figure 50: Domestic Equity Flows (13 wk. MA): Like 1999-00 or Like 2015?

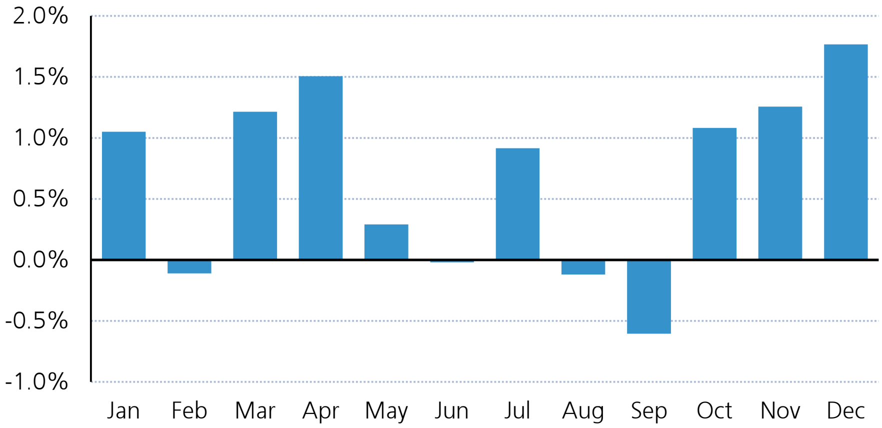


Source: Lipper, UBS

Tellingly, as the market has staged its October recovery from the prior months' maelstroms, the public has been a net buyer of US equities for four consecutive weeks, the first such occurrence in a year. Four weeks does not a trend make, but it is the first concrete signs after months of constant selling, that a strong economy, a decisive Fed, and a China stabilizing – all against the backdrop of an M&A boom – could be sufficient to entice the Public into stocks. We will be watching the weekly flow data with special interest in the months ahead.

So clearly, the "positive pressure" is building in the equity market which could take stocks materially higher in the months directly ahead, particularly in light of the fact that the best return months for the market tend to be October - May (Figure 51)....

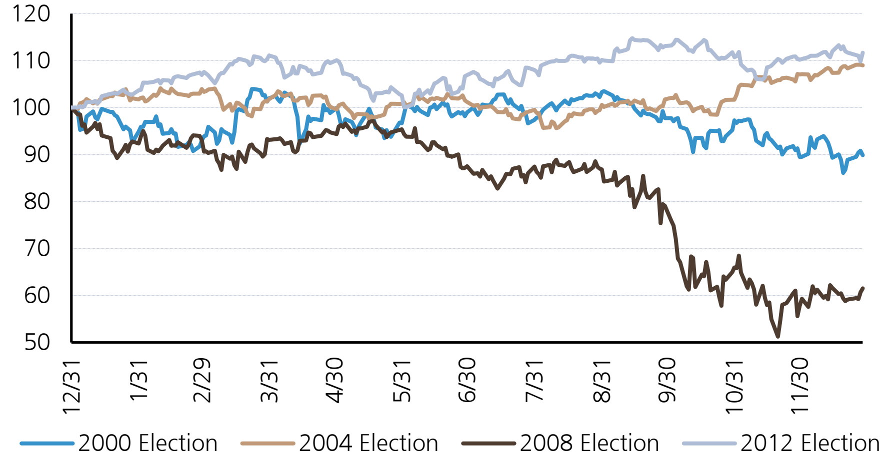
Figure 51: Returns By Month – History on the Side of the Bulls into 2016



Source: Bloomberg, UBS

...months where the focus will not be as squarely on politics, which can often serve as a distraction to markets during the Summer and Fall campaigning season (Figure 52).

Figure 52: Presidential Election Season – Sell in May?



Source: Bloomberg, UBS (Note: S&P 500 Indexed to 100 on 12/31)

Option Option: Go Long the June 2,175 Call/1,850 Put Risk Reversal

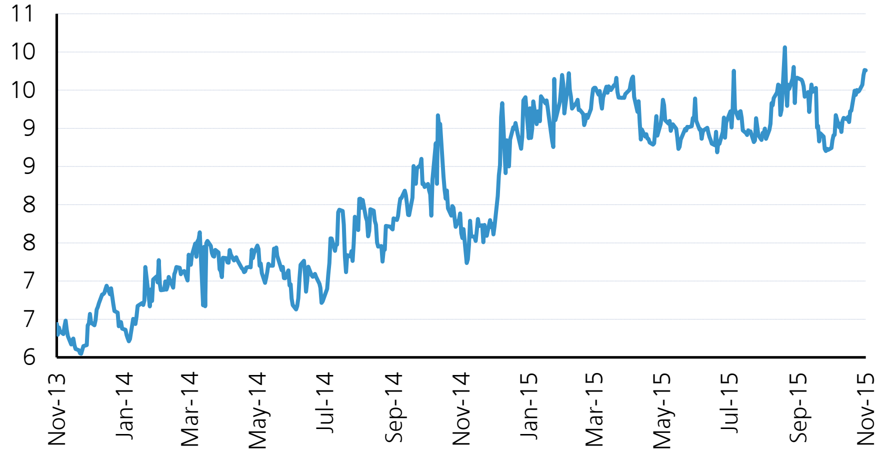
What does the options market think of the possibility of SPX 2,500 in 1H2016?

Current prices, using 16% volatility, in line with 200 day S&P 500 realized volatility and June 2016 At The Money (ATM) option volatility, assign the probability of 2,500 being touched prior to June 30 at approximately 18%; and while on $120 in 2015 earnings, such an Index level would represent a trailing multiple of 20.8x, above the 19.7x average peak multiple experienced in prior bull markets (Figure 38, pg. 18), the valuation "competition" from a 10 year US treasury yield remaining near generational lows around 2.3% in our view makes the likelihood greater, on the order of 25 – 30%. This higher probability is in line with the long run average VIX level of 20%, a reading we expect to see with far greater frequency in 2016's forecast higher volatility environment.

In order to position for the potential of stock prices to "overshoot" to the upside in 1H2016, we recommend investors go long an S&P 500 June 2016 expiry "Risk Reversal", buying the June 2,175 Call for $47.30 and selling the June 1,850 Put for $48.60; the position can be initiated for a credit of $1.30 ex fees and commission based on the closing SPX level of 2078.58 on 11/9.

We believe this type of risk reversal structure is appealing because out of the money puts continue to trade expensive relative to out of the money calls (steep skew – Figure 53). We especially like these strike prices, with 2,175 below our year end 2016 price target of 2,275 and 1,850 representing a level below the 2015 Index low of 1,867.01; in no ongoing bull market since the 1970's has the next year (2016) traded below the preceding year's low price.

Figure 53: Skew SPX 6 month 90% Put/110% Call Skew, % Vol – Elevated

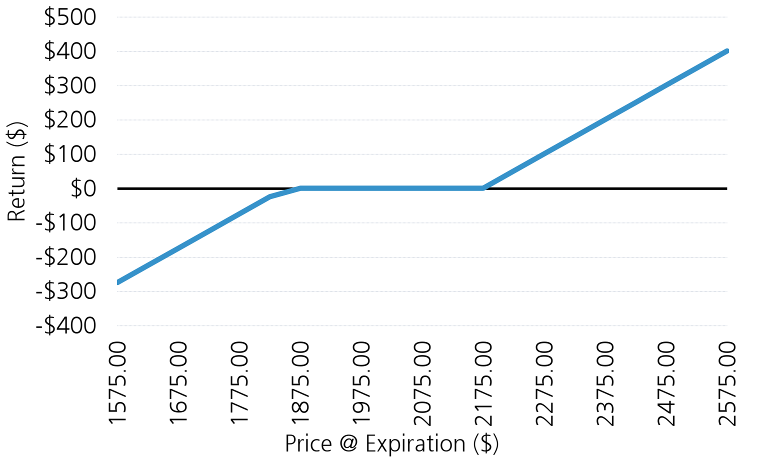


Source: Bloomberg, UBS

At expiration, the position remains profitable above 1,850 (with near unlimited loss potential below 1,850) and while the investor does not participate in market gains at expiration until price exceeds 2,175, the gains are theoretically unlimited, particularly attractive in the event that our upside risk level of 2,500 comes into focus.

The payoff profile at expiration for the S&P 500 June 2,175 Call/1,850 Put Risk Reversal is as below.

Figure 54: SPX Risk Reversal Payoff



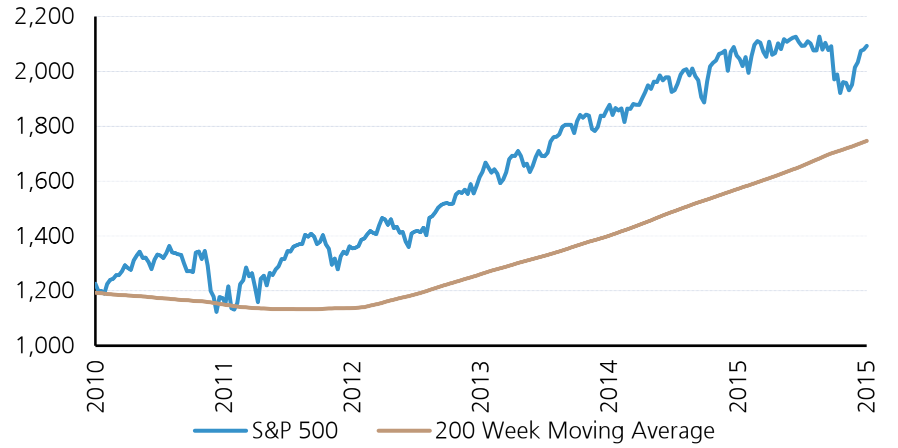
Source: Bloomberg, UBS

Downside Risk: 1,750 – The End

Seven Years Gone

In an environment of high volatility, even a trade down to 1,750 at some point before year end 2016, ending the seven year Bull market, would appear to be quite improbable – it has been almost 2 years – February 2014 – since 1,750, and the 200 week moving average, which tends to act as support for most major market setbacks, is priced at 1,750, rising by four points per week (Figure 55).

Figure 55: A Bull in Full

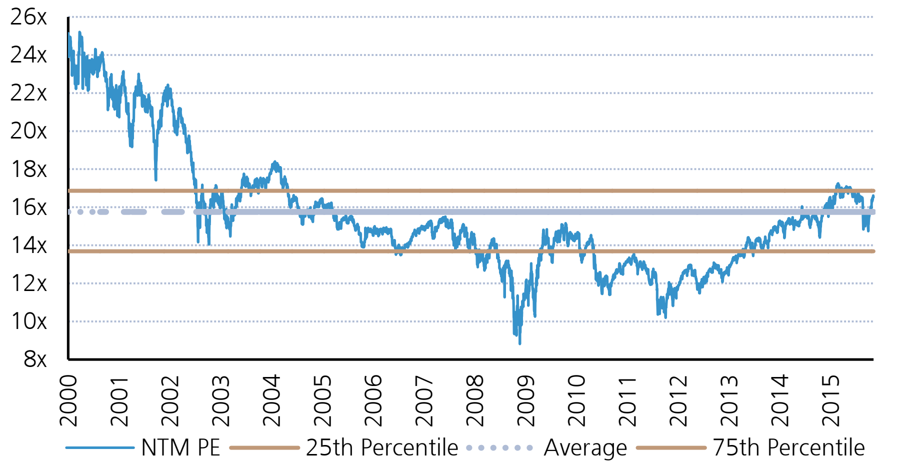


Source: Bloomberg, UBS

And yet, in a regulatory driven world where reduced capital allocated to sell side market making operations has kept option skew very elevated, such an occurrence is currently being priced in option markets as having a 44% probability of happening at some point between now and 12/31/2016. For reference, in a world without option skew (which, to the uninitiated, was the norm prior to stock market Crash of 1987 – see 8/23/12 Option Strategy: Thinking About Risk – Seems Like Only Yesterday) that probability drops to 28%, still material.

S&P 500 1,750 represents another year of zero earnings growth - $120 for 2016, and thus a multiple of 14.6x, a full turn below the average, in an environment where the 10 year yield currently resides at 2.3% (Figure 56).

Figure 56: NTM PE 2000 – 2015



Source: FactSet, UBS

What are the catalysts that could move the S&P 500 to 1,750 – The End of the Bull?

There are two main catalysts, Earnings weakness and Liquidity concerns.

Earnings

That earnings have been decidedly lackluster in 2015 has been a very poorly kept secret.

Figure 57: Actual and Consensus EPS (2015e, 2016e)

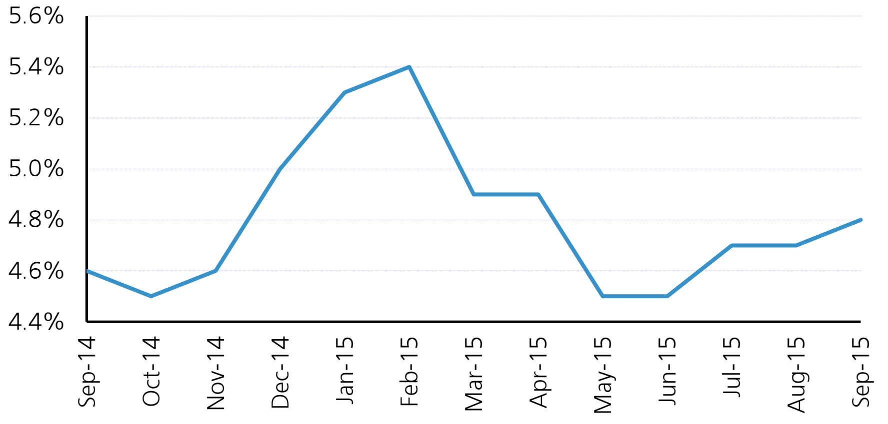
	2014	2015	2016
S&P 500	118.78	118.3	128.45
% y/y	*8.3%*	*-0.4%*	*8.6%*
Consumer Discretionary	26.92	30.09	34.61
% y/y	*6.6%*	*11.8%*	*15.0%*
Consumer Staples	24.55	24.63	26.25
% y/y	*4.4%*	*0.3%*	*6.6%*
Financials	20.67	23.56	25.56
% y/y	*0.3%*	*14.0%*	*8.5%*
Information Technology	39.51	42.16	45.67
% y/y	*14.5%*	*6.7%*	*8.3%*
Health Care	42.42	47.68	52.32
% y/y	*18.3%*	*12.4%*	*9.7%*
Materials	16.94	16.09	18.07
% y/y	*6.4%*	*-5.0%*	*12.3%*
Industrials	27.45	28.67	30.08
% y/y	*10.3%*	*4.5%*	*4.9%*
Energy	43.23	17.56	17.70
% y/y	*-0.7%*	*-59.4%*	*0.8%*
Telecom	10.61	11.87	12.24
% y/y	*7.4%*	*11.9%*	*3.1%*
Utilities	13.42	13.86	14.35
% y/y	*3.7%*	*3.3%*	*3.5%*

Source: FactSet, UBS

In the (almost) final analysis, the culprit has clearly been the Energy sector, with YoY earnings declines of nearly 60% in 2015. Though growth has been reasonable in the Consumer Discretionary sector (est. +15%), the anticipated benefits from the fall in energy prices haven't been fully realized.

Why? Because the Consumer's first reaction to cheap oil was to increase his/her savings rate (Figure 58). And while the purse strings loosened in the Spring, the savings rate has begun to creep higher once again, perhaps in response to the equity market dislocations in August and September.

Figure 58: Personal Savings Rate, % of Disposable Income



Source: Bloomberg, UBS

In an environment where the downside risks to the economy are largely a function of export and capex uncertainties, ongoing consumer strength will be critical and is a core of economist Maury Harris' 2.8% GDP growth forecast for 2016, aided by a pickup in household formation (see 11/2 US Economic Perspectives: US Economic Outlook 2016-17).

If the economy were to disappoint to the downside in 2016, the bullish thesis of the salutary benefits of cheap energy – a thesis that has been very effective in past "supply driven" oil price crash/solid economy periods such as 1985-87 and 1997-99 (Figures 59 and 60), which both saw earnings recoveries off the "oil trough", could be discarded, damaging equity markets in 2016.

Figure 59: GDP, EPS, S&P 500 Valuation, 1985-7

		S&P 500		
	GDP Growth (%)	EPS Growth (%)	Price Change (%)	P/E @ YE
1985	4.30%	-12.20%	26.30%	14.5x
1986	2.90%	-0.90%	14.60%	16.7x
1987	4.40%	20.90%	2.00%	14.1x

Source: Bloomberg, UBS

Figure 60: GDP, EPS, S&P 500 Valuation, 1997-9

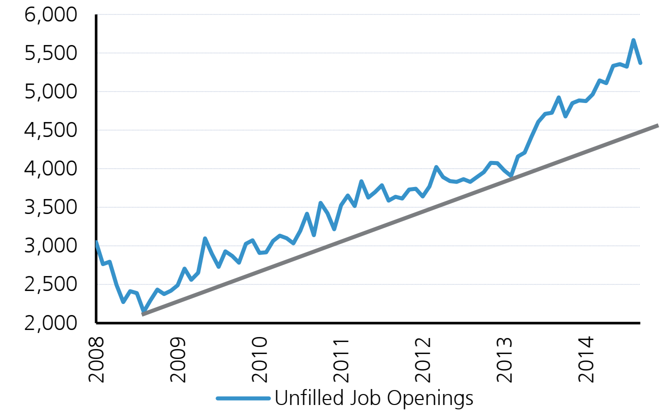
		S&P 500		
	GDP Growth (%)	EPS Growth (%)	Price Change (%)	P/E @ YE
1997	4.40%	2.60%	31.00%	24.4x
1998	5.00%	-5.10%	26.70%	32.6x
1999	4.70%	27.70%	19.50%	30.5x

Source: Bloomberg, UBS

Earnings could also disappoint due to margin pressures or continued International economic weakness.

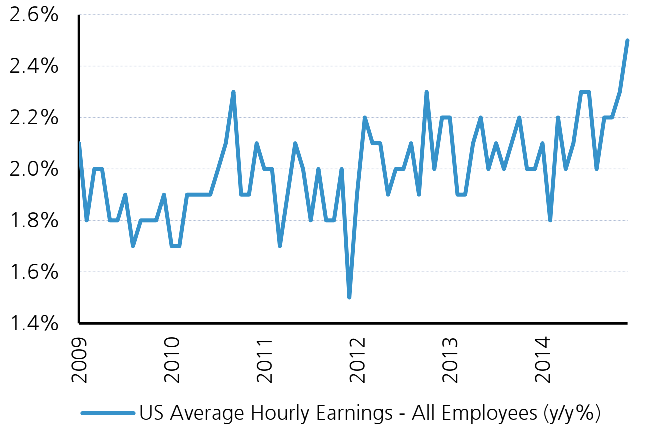
On margins, the story has been building, slowly, in 2015. Jobs are hard to fill (Figure 61) and that is a substantive part of the reason that wages have begun to accelerate (Figure 62).

Figure 61: JOLTed



Source: Bloomberg, UBS

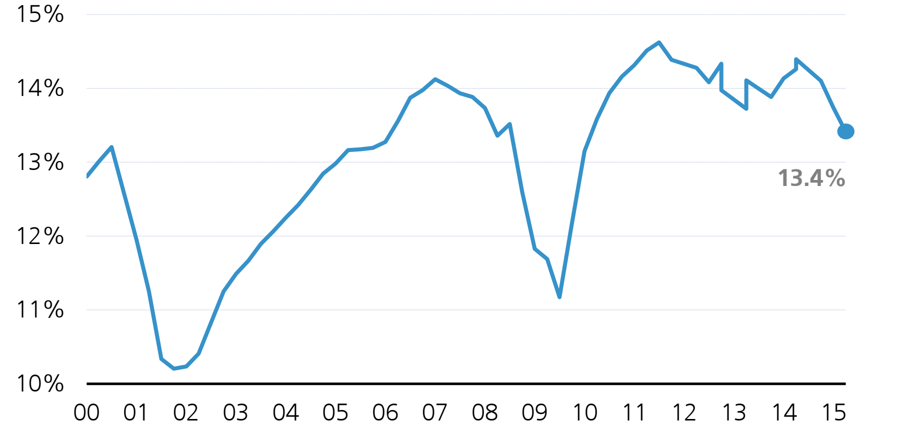
Figure 62: Wage Gains – Bullish Breakout



Source: Bloomberg, UBS

And while margins have begun to erode to a small degree, they remain near prior peaks (Figure 63).

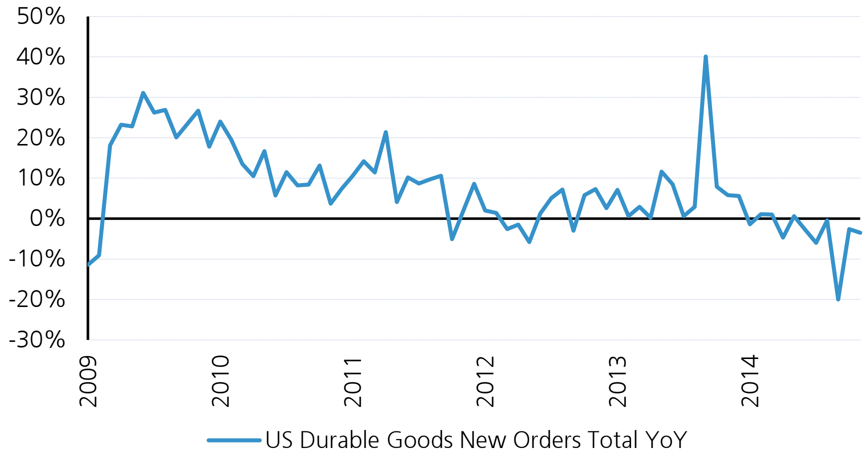
Figure 63: S&P 500 EBIT Margins (ex Fin) - LTM



Source: FactSet, UBS

While a pickup in wages could spur increased productivity (in the form of capex and or revenue growth – see 5/1 Macro Keys – Can US Equities Handle the (Wage) Pressure) – signs of such potential revenue growth have yet to crystallize, as the industrial sector stays challenged (Figure 64).

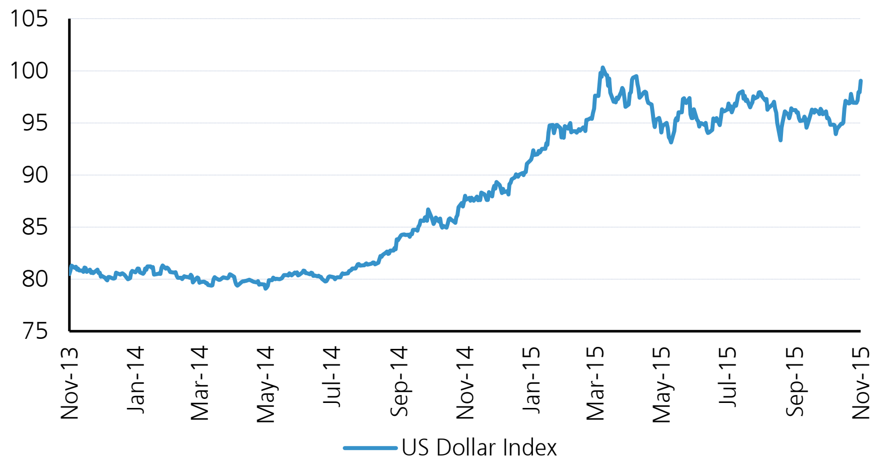
Figure 64: Durable Goods – Still Struggling



Source: Bloomberg, UBS

Lastly, while there have been some encouraging signs that International markets are stabilizing, the 30% of S&P 500 revenues that are attributable to International sales remain challenged, particularly in an environment of ongoing US Dollar strength (Figure 65).

Figure 65: The Dollar Bull – An Earnings Headwind

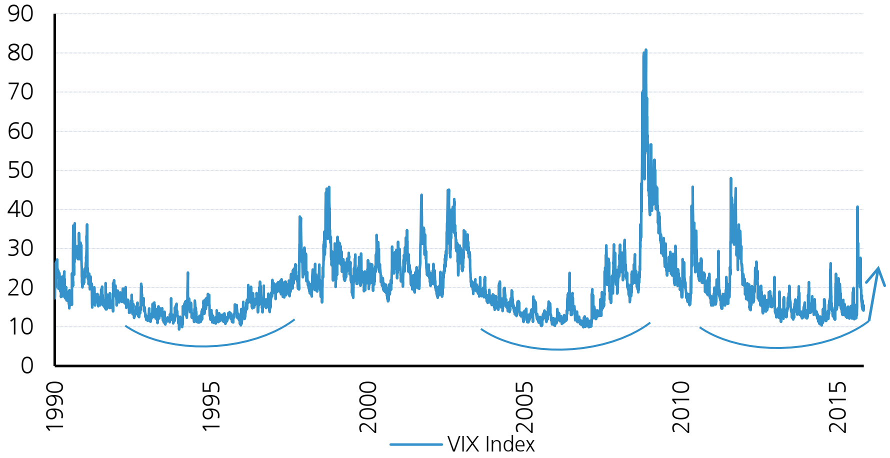


Source: Bloomberg, UBS

Liquidity

As markets move closer to the inevitable start of the Fed's rate hike regime, concerns with respect to the impact on market liquidity of such a momentous change in policy – 9 years in the making – are natural, particularly now that equity markets themselves have recognized the shift to a higher volatility regime (Figure 66). This is all the more true since, as economist Drew Matus points out in his 8/18 Fed Exit Mechanics: Answers to FAQs, there are numerous complications to Normalization, chief among them the Fed's $4 trillion balance sheet.

Figure 66: Volatility Cycles: Storm then Calm, Now Storm Again



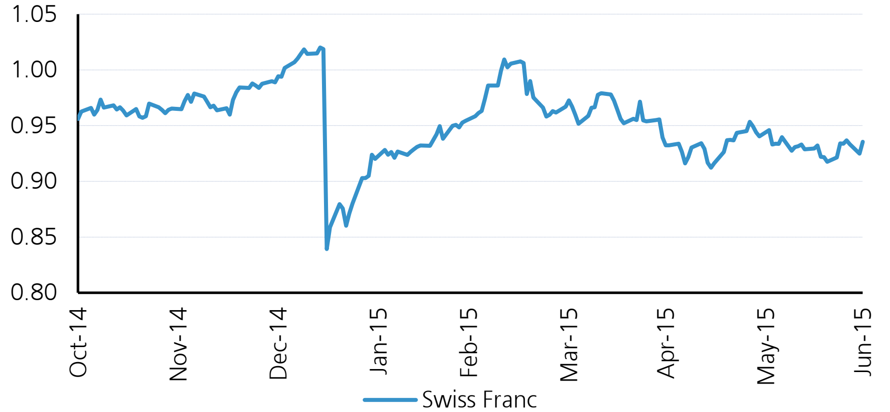
Source: Bloomberg, UBS

In reality, ripples in the fabric of market liquidity have become evident over the past year. What has occurred is a series of shorter term "seizures" in markets. There are a number of examples, the most extreme of which occurred as a result of "surprise" Central Bank moves - "deviations from the Bankers' script":

10/15/2014 - US treasury market freezes as 10 year yields moved back and forth in a 30 basis point vacuum in a matter of a few hours in response to a minor economic report.

1/15/2015 – The Swiss National Bank removes the EUR/CHF trading floor.

Figure 67: SNB Walks Away (CHF/$)



Source: Bloomberg, UBS

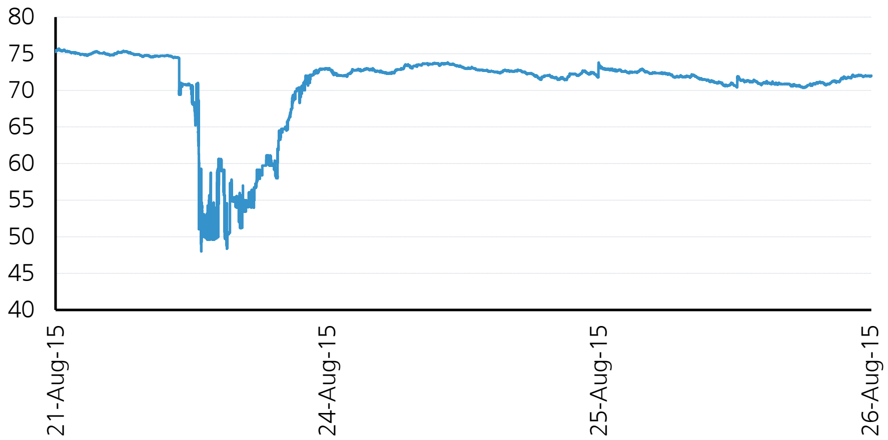
April/May – In anticipation of ECB QE, German Bund yields plunge to near zero and quickly boomerang higher.

Figure 68: ECB and the Bund: The Days of Awe

Source: Bloomberg, UBS

and when the Chinese authorities "deviated from the script" by devaluing the CNY on August 11, the S&P 500 promptly dropped over 10% in a matter of days, ending in the 1000 point plunge in the Dow Jones Industrial Average early on August 24, where a number of ETF's traded prices deviated significantly from their underlying asset prices (Figure 69).

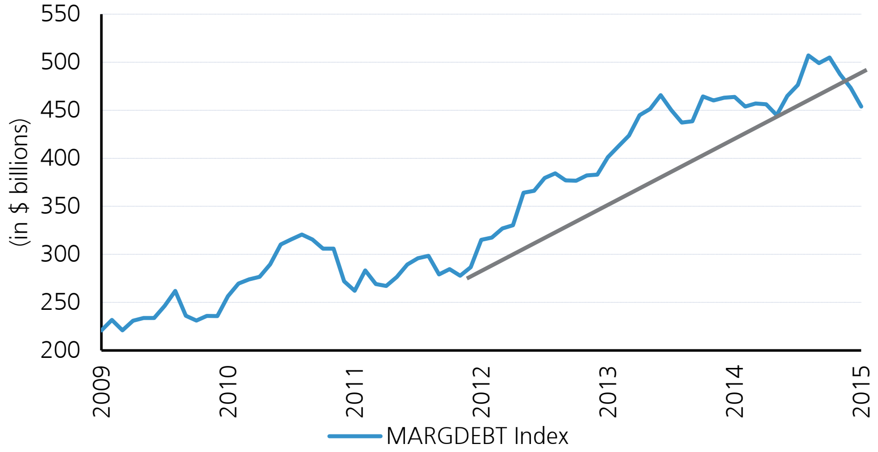
Figure 69: DVY ETF, August's Intraday Pricing Dislocation



Source: Bloomberg, UBS

One of the consequences of the Summer volatility in the US has been the beginnings of an unwind to trading on margin (Figure 70).

Figure 70: US Margin Debt – Sign of The Top?



Source: Bloomberg, UBS

And as was so clearly evident in China in 2015, a rapid unwind of margin trading (Figure 71) can cause severe market dislocations (Figure 72).

Figure 71: As Margin Balances Go (100 MM RMB)…

Source: Bloomberg, UBS

Figure 72: …So Goes Chinese Share Prices

Source: Bloomberg, UBS

In the event that the ECB or PBOC decide to deviate from their well telegraphed easing path, or the BOJ decides that there are sufficient "arrows" to move the economy forward without more easing, or either the Fed or perhaps the Bank of England increase interest rates in an unexpectedly aggressive manner, equity markets could become vulnerable. Simply put, markets do not like surprises.

In an environment where subtle shifts in liquidity are already evident, surprises have the potential to cause volatility which could easily exceed that seen in August 2015 (a move with no shift in US fundamentals evident) are possible. The potential is for rapid compression below the 2015 low at 1,867.01 toward 1,750, ending the Bull Market - since in no ongoing bull market since the 1970's has the next year traded below the preceding year's low price. Markets could, in our view, become disorderly in such a situation.

Sector Preferences

Given lower economic growth than initially anticipated and the Fed's inaction during 2015, our tactical 2016 sector outlook remains largely unchanged. We've already seen a shift to a higher volatility regime since the summer selloff in August, yet still believe in the prospect for higher stock prices and higher interest rates in 2016. This not-altogether-unique combination of factors, observed in the latter stages of both the 1990-2000 and the 1982-1987 advances, leads us to prefer sectors with the following characteristics:

- Limited Sensitivity to Rising Rates – With the expectation that rates are likely to rise in 2016 as an expression of economic health and the beginning of a Fed rate hike regime, we prefer sectors where rising rates are not necessarily a headwind.
- Balance Sheet Flexibility – The ability to create long term shareholder value through capital return to investors, M&A or thoughtful capex projects is attractive when higher volatility and higher interest rates increase the value of cash for both strategic and opportunistic deployment, all else equal.

Relative Valuation – Particularly when considering growth prospects and demand drivers, we focus on sectors which we believe are relatively more attractive – either to historical valuations or when compared to other sectors.

Figure 73: US Equity Strategy Sector Preferences

Overweight	Neutral	Underweight
• Financials	• Energy	• Utilities
• Healthcare	• Industrials	• Telecom
• Technology	• Materials	• Consumer Staples
	• Consumer Discretionary	

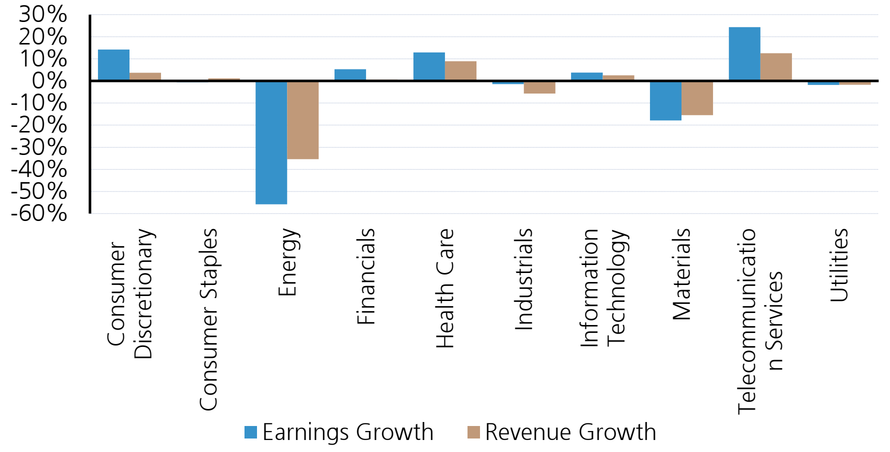
Source: UBS

Overweight

Financials

With companies focused on M&A, capex and share repurchases, we believe Financials stand to benefit from the increased lending activity, advisory fees and interest income. Continued asset price volatility should drive additional interest in the space, as some of the larger banks/brokers should see an increase in trading volumes, and hence commissions. In what has otherwise been a weak year for S&P 500 earnings, the Financials sector has been one of the few bright spots given the relative strength in revenue and earnings growth. Q3 is yet another example of the sector's relative strength compared with the broader group.

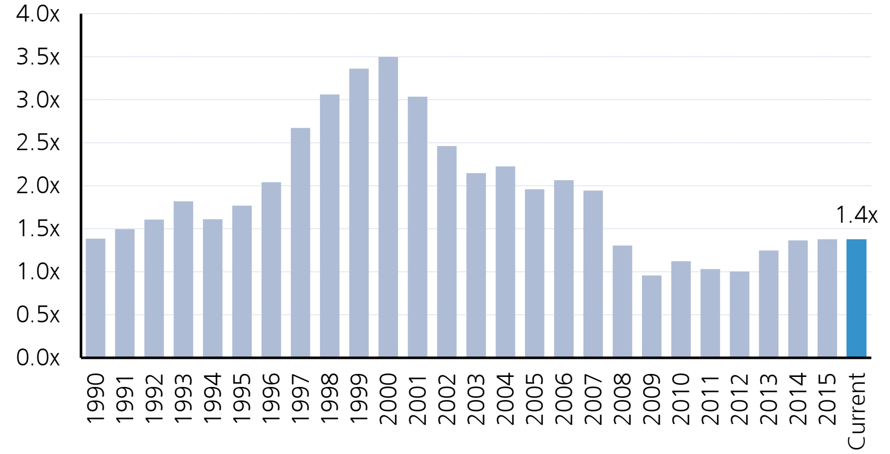
Figure 74: Q3 Earnings Growth



Source: IBES, First Call, FactSet, UBS

As interest rates rise once the Fed begins its hiking regime, Financials are among the potential beneficiaries operationally. Furthermore, the Financials sector remains one of the most attractively valued sectors in our opinion, particularly on a relative basis to historical averages (Figure 75).

Figure 75: Historical P/B, Financials

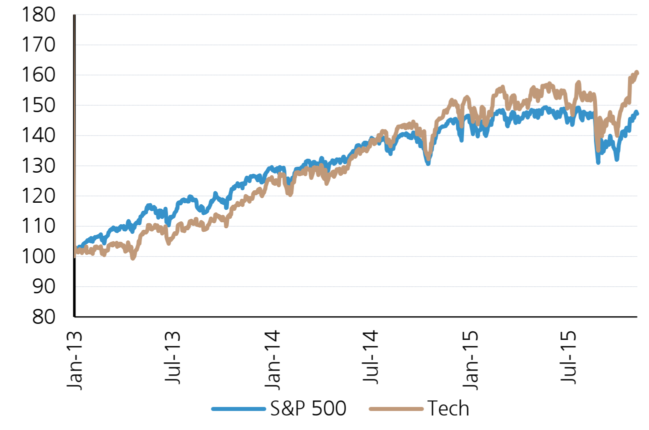


Source: FactSet, UBS

Technology

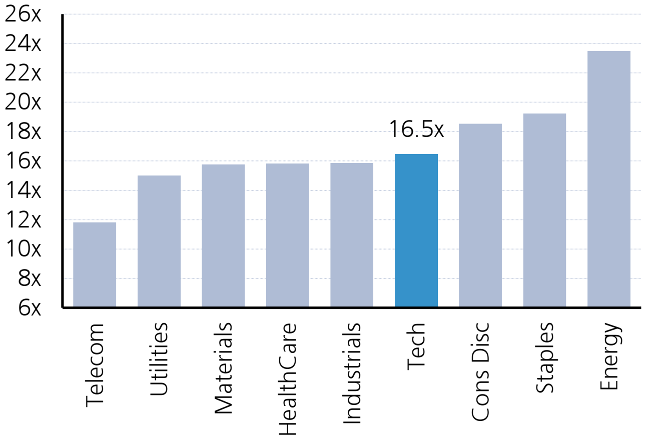
Despite the recent rally, the technology sector is not yet overvalued in our opinion, particularly given the potential earnings growth and M&A activity. Although the sector is currently trading at 16.4x NTM earnings, we believe Tech benefits from an attractive growth profile and substantial balance sheet flexibility that is likely to continue to be used for M&A and share buybacks.

Figure 76: Recent Outperformance To Continue



Source: Bloomberg, UBS

Figure 77: Tech Not Yet Expensive



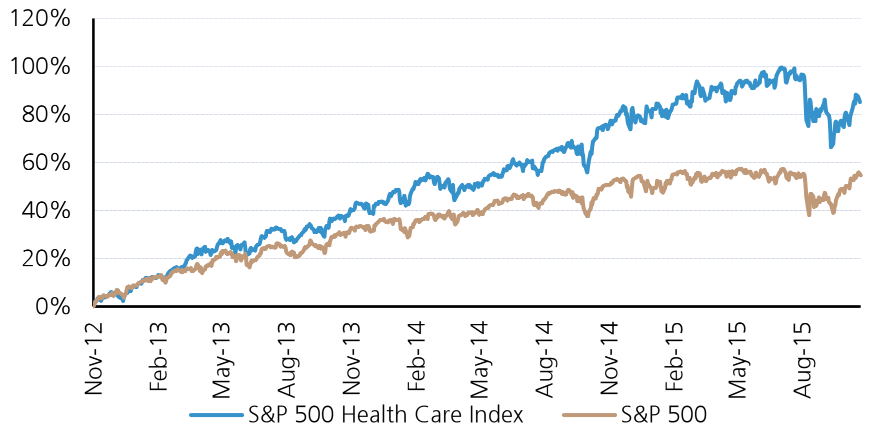
Source: FactSet, UBS

The sector, as a whole, benefits from a relatively high degree of operational leverage, low financial leverage, and is likely to be a clear beneficiary of incrementally higher capital expenditures as companies look to improve productivity.

Healthcare

For most of the year, the healthcare sector was among the strongest performers. However, an increase in political attention on pharma pricing followed by reports of potential accounting issues at a large pharmaceutical company sent the entire biotech/spec pharma and broader healthcare sector plummeting. Nonetheless, the healthcare sector is up 5% YTD.

Figure 78: Healthcare vs. S&P 500

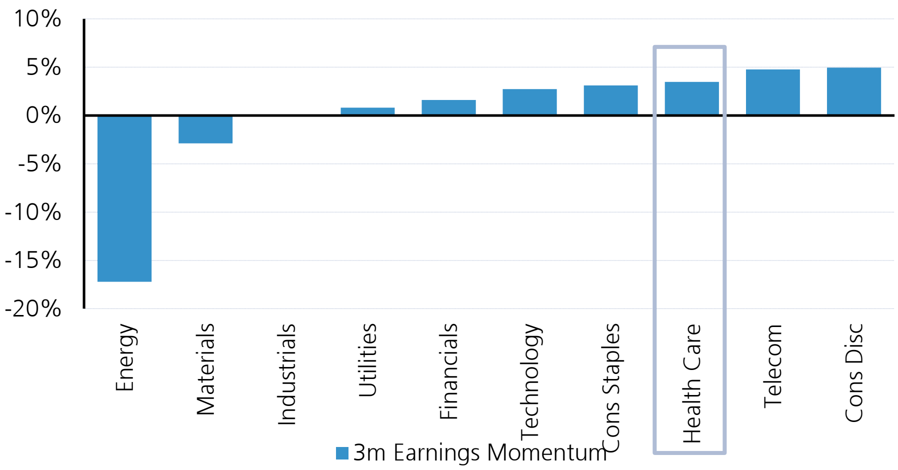


Source: Bloomberg, UBS

The defensive characteristics (i.e. earnings stability and high barriers to entry) of the sector remain quite attractive despite the ongoing economic recovery. In an environment in which top-line growth is hard to come by, the healthcare sector is one of the only sectors that has managed to grow revenues. While not the

cheapest on a relative basis, the sector's earnings momentum, strong top-line growth, attractive dividend yield and potential for further share buybacks, given the health of balance sheets and high cash balances, should provide an additional tailwind into 2016 in our opinion.

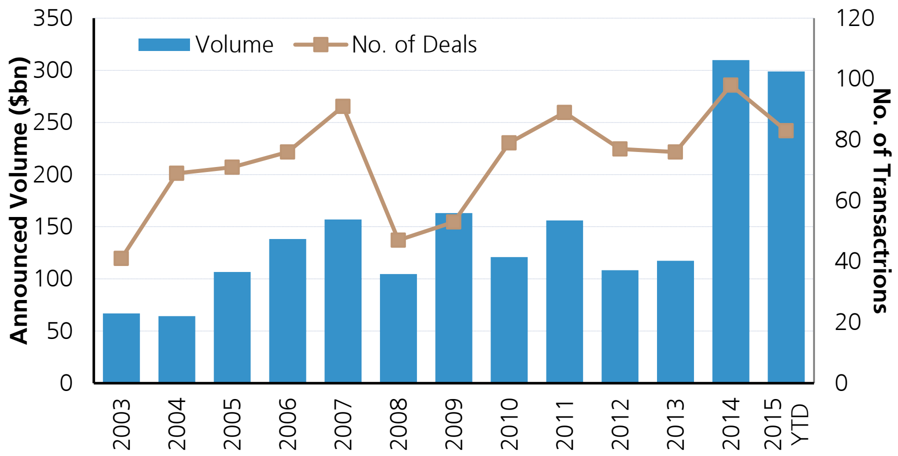
Figure 79: Earnings Momentum



Source: FactSet, UBS

In the longer term, the sector is likely to benefit from the demand tailwinds of an aging baby-boomer generation. In the immediate term, a continuation of the current consolidation trend – an abundance of cash and corporate boards in search of opportunities for incremental operational efficiencies/synergies – should drive further upside in the sector.

Figure 80: Strength in M&A Volumes



Source: Bloomberg, UBS

Neutral

Energy & Materials

Materials have already underperformed in 2015 but the group will continue to face the headwinds of large exposure to non-dollar denominated sources of revenue.

Energy continues to be challenged by weak earnings EPS and reduced revenue expectations following the plunge in oil prices. As year-over-year comps in oil and the US dollar ease, some of the earnings-related pressure is likely to alleviate. However, absent a sharp rebound in oil prices, we think the demand and supply dynamics of the industry remain challenged. The sector itself continues to command a premium valuation in anticipation of an earnings recovery (Figure 39, p. 18)

Figure 81: Brent Actual and UBS Forecast Prices

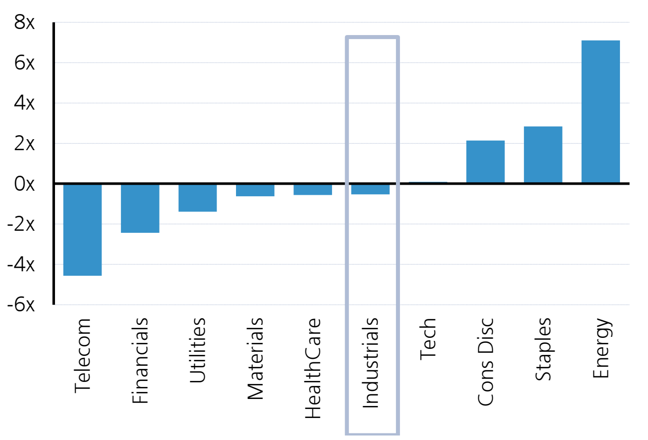
Quarter	Brent Oil
1Q15A	$55.17
2Q15A	$63.37
3Q15A	$51.30
4Q15E	$50.50
1Q16E	$55.00
2Q16E	$55.00
3Q16E	$60.00
4Q16E	$60.00

Source: Bloomberg, UBS

Industrials

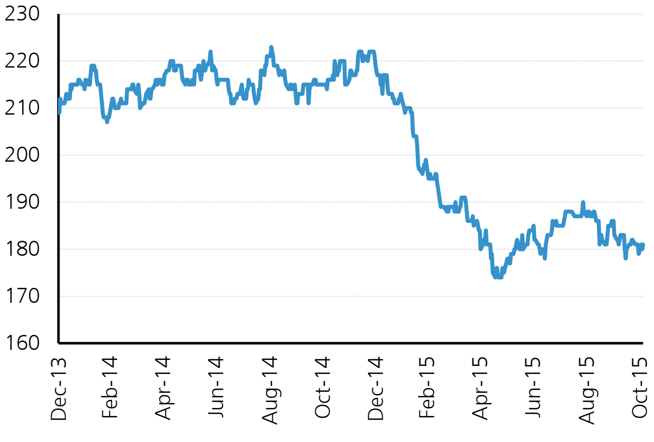
Industrials continue to seek the "sweet spot" of capex acceleration, likely to occur closer to the start of the Fed rate hike cycle. As a result, we will continue to keep our eye on the sector given the attractive valuation of the sector. However, the lack of a sharp rebound in economic activity, as evidenced by our UBS US growth surprise index (Figure 83), leads us not to envision material outperformance.

Figure 82: Middle of the Road Relative P/E



Source: FactSet, UBS

Figure 83: UBS US Growth Surprise Index

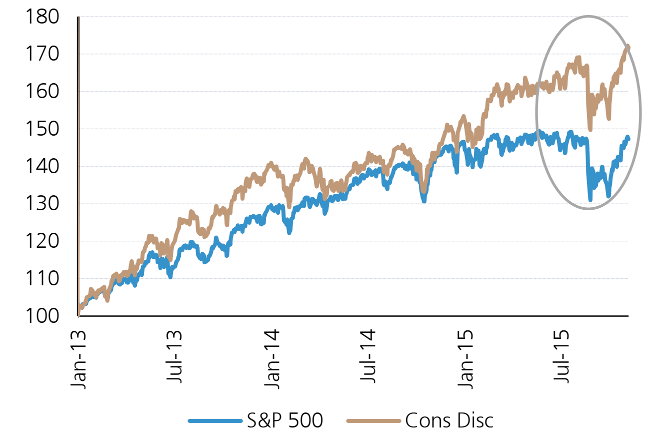


Source: Bloomberg, UBS

Consumer Discretionary

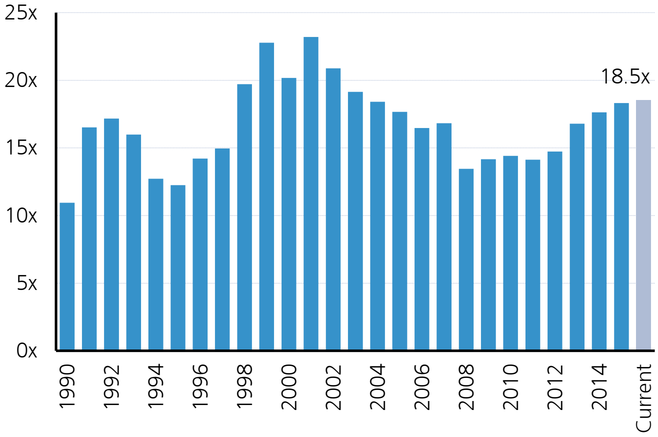
Consumer Discretionary was a sector we characterized as "very controversial" last year and we continue to feel the same way now. The sector has been the best performing sector YTD, returning 12.8% (vs 2.0% for the S&P 500). As a result, despite the prospects for stronger consumer engagement given the fall in oil prices and a potential acceleration in wage growth, we remain neutral on the sector given the recent outperformance. This, coupled with a somewhat high relative valuation, warrants caution in our eyes in spite of the upside risk coming from a prospective increase in consumer spending.

Figure 84: Discretionary's Recent Outperformance



Source: Bloomberg, UBS

Figure 85: Historical P/E, Consumer Discretionary



Source: FactSet, UBS (Note: PE Values are Yearly Averages)

Underweight

While Utilities, Consumer Staples, and Telecom all have their own idiosyncratic reasons supporting our underweight view, the idea that US interest rates will rise in 2016 as the Fed gets ready to hike, is a significant driver.

Investors' love affair with yield was evident in 2014 as 10 year rates remained far lower than most expert prognostications. The passion manifested itself to flows into REITs, High Yield Bonds, MLPs and of course Utilities. 2015 has unfolded entirely differently, as yield plays have been underperformers. We think this trend continues in 2016.

Utilities

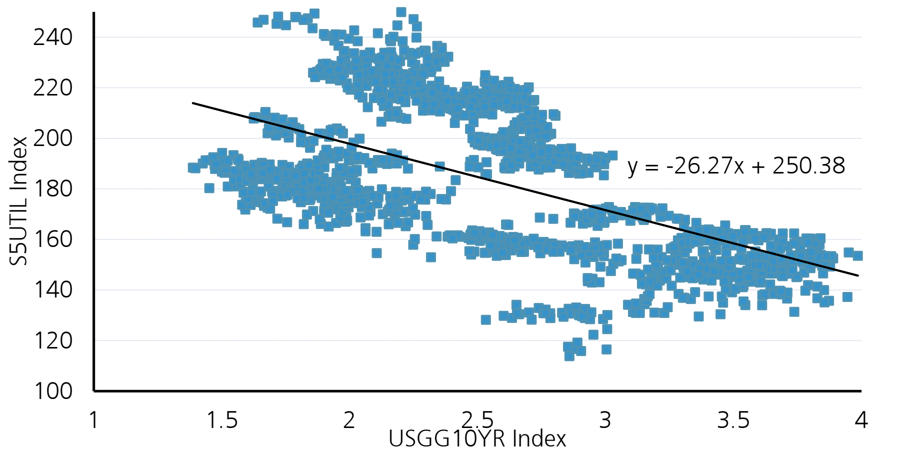
2015 has been the year in which investors finally embraced the idea that interest rates will rise, despite the fact that they have actually yet to do so. In this context, Utilities have been noticeable underperformers, lagging the S&P 500 Index by 12%. We expect the trend to intensify once the Fed moves.

Referencing the "Valuation Heatmap" in Figure 39 on page 18, Utilities remain at the upper end of their valuation on both an absolute and a relative basis, despite the YTD underperformance.

Utilities' EPS and revenue growth prospects are perennially challenged given the regulatory environment with which they operate. It is unlikely that in the final year of the Obama administration much regulatory relief will be in sight.

Utilities have been negatively correlated (-.55) to the 10 year US Treasury since the bull market began (Figure 86). Still elevated valuations and a rising interest rate cycle that has yet to begin in earnest – but likely will – reinforce our underweight view on Utilities.

Figure 86: Utilities Dislike Rising Rates

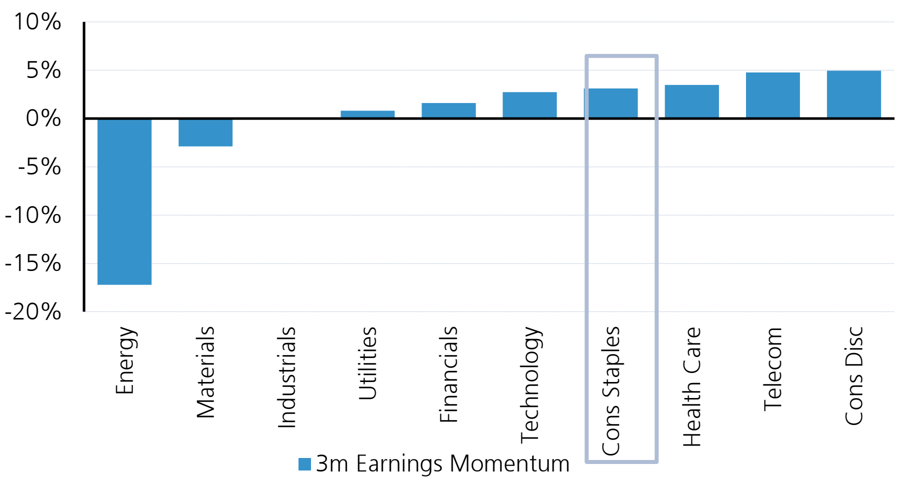


Source: Bloomberg, UBS

Consumer Staples

At 19.5x forward, Consumer Staples continues to be relatively expensive (Figure 39 p.18). And, despite the potential tailwinds of lower commodity input costs, earnings momentum continues to be lackluster (Figure 87). Given a perennially lower revenue growth profile and exposure to overseas markets – particularly Emerging Market economies, Staples relative performance looks to remain challenged.

Figure 87: Earnings Momentum (3-month)

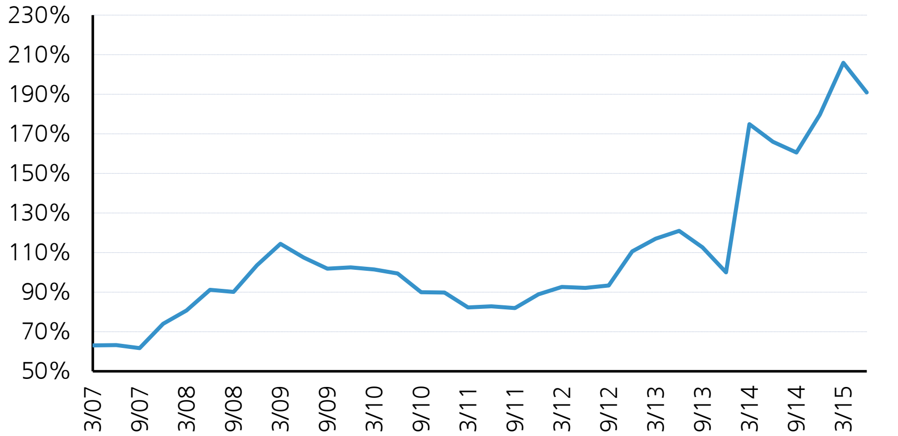


Source: IBES, First Call, FactSet, UBS

Telecom

Telecoms are especially challenged in the rising interest rate environment, to which the group is historically inversely correlated. The challenge in particular lies in the fact that telecom net debt to equity has been rising, exceeding the levels of the Financial Crisis peaks (Figure 88).

Figure 88: Net Debt to Equity, Telecom



Source: FactSet, UBS

Late Innings Leaders

Earlier in our report we wrote about the need for greater selectivity as the Bull Market enters "the Late Innings". As the Bull ages, selectivity is critical as not all stocks could be expected to participate in the late stage rally we expect. In a rising rate, rising volatility and slow growth environment, we prefer stocks with large cash balances (15% or more of total assets) and which have a proven ability to grow revenues YoY over the ups and downs of the past five years.

Below we present an updated list of UBS Buy Rated stocks (first appearing on 10/30 in Macro Keys US Equities: Signs of The Top?) across the S&P 500 with greater than 5% upside to analysts' Price Targets which have 15% or more of their assets in cash and marketable securities and have grown revenue YoY each year for the past 5 years. Also included in this updated list is UBS Buy Rated Financial stocks with positive Revenue growth each year for the past 5 years.

In our view, these "Late Innings Leaders" could be expected to outperform in the event growth remains challenged (even as the consumer remains robust) in 2016; they are for the most part, convex to rising interest rates. And lastly, if public flows into equities crystallize, we would look for outperformance of themes the public is familiar with – Technology, which now permeates all aspects of the average investor's everyday life; Health Care, prominent in the headlines for leading the M&A boom, and Financials, easily understood for its outperformance potential in a rising rate environment and domestic revenue focus in a strong dollar environment, and still "underloved and underowned" by institutions.

Figure 89: "Late Innings Leaders"

Ticker	Name	Sector	Analyst	Last Price ($)	Cash % Assets
AAPL	Apple Inc	Information Technology	Steven M Milunovich	120.57	70.8%
ABBV	AbbVie Inc	Health Care	Marc Goodman	63.23	30.4%
AKAM	Akamai Technologies Inc	Information Technology	Steven M Milunovich	61.83	40.7%
ALXN	Alexion Pharmaceuticals Inc	Health Care	Matthew Roden	172.64	46.7%
AMGN	Amgen Inc	Health Care	Matthew Roden	159.63	39.2%
AMZN	Amazon.com Inc	Consumer Discretionary	Eric J Sheridan	655.49	32.0%
AVGO	Avago Technologies Ltd	Information Technology	Stephen Chin	126.50	15.3%
BLK	BlackRock Inc	Financials	Brennan Hawken	349.57	2.4%
CELG	Celgene Corp	Health Care	Matthew Roden	114.08	43.5%
CERN	Cerner Corp	Health Care	Steven Valiquette	59.38	31.4%
CRM	salesforce.com inc	Information Technology	Brent Thill	78.22	17.7%
DLTR	Dollar Tree Inc	Consumer Discretionary	Michael Lasser	67.61	24.2%
EL	Estee Lauder Cos Inc	Consumer Staples	Stephen Powers	84.65	23.6%
EMC	EMC Corp/MA	Information Technology	Steven M Milunovich	25.83	18.1%
EW	Edwards Lifesciences Corp	Health Care	Matt Miksic	157.18	40.8%
EXPE	Expedia Inc	Consumer Discretionary	Eric J Sheridan	129.48	19.5%
FB	Facebook Inc	Information Technology	Eric J Sheridan	106.49	27.9%
GILD	Gilead Sciences Inc	Health Care	Matthew Roden	108.11	33.8%
GOOG	Alphabet Inc	Information Technology	Eric J Sheridan	724.89	51.5%
MDT	Medtronic PLC	Health Care	Matt Miksic	75.87	18.3%
MMC	Marsh & McLennan Cos Inc	Financials	Brian Meredith	55.63	11.0%
MNST	Monster Beverage Corp	Consumer Staples	Stephen Powers	149.05	59.4%
NFLX	Netflix Inc	Consumer Discretionary	Douglas D Mitchelson	109.86	22.8%
NKE	NIKE Inc	Consumer Discretionary	Michael Binetti	130.48	27.4%
PCLN	Priceline Group Inc	Consumer Discretionary	Eric J Sheridan	1311.15	28.7%
PGR	Progressive Corp	Financials	Brian Meredith	31.47	0.4%
RHT	Red Hat Inc	Information Technology	Brent Thill	80.29	47.6%
SCHW	Charles Schwab Corp	Financials	Alex Kramm	33.49	7.3%
TJX	TJX Cos Inc	Consumer Discretionary	Michael Binetti	71.07	24.9%

Source: FactSet, Bloomberg, UBS

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12-Month Rating	**Definition**	**Coverage**[1]	**IB Services**[2]
Buy	FSR is > 6% above the MRA.	49%	33%
Neutral	FSR is between -6% and 6% of the MRA.	40%	26%
Sell	FSR is > 6% below the MRA.	12%	18%
Short-Term Rating	**Definition**	**Coverage**[3]	**IB Services**[4]
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 30 September 2015.
1:Percentage of companies under coverage globally within the 12-month rating category. 2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category. 4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

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UBS Securities LLC: Julian Emanuel; Omar Elangbawy; Sibi Gnanasundaram.

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Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
AbbVie[6c, 7, 16]	ABBV.N	Buy	N/A	US$63.23	09 Nov 2015
Akamai Technologies Inc[6c, 7, 16, 18a]	AKAM.O	Buy	N/A	US$61.83	09 Nov 2015
Alexion Pharmaceuticals, Inc.[16]	ALXN.O	Buy	N/A	US$172.64	09 Nov 2015
Alphabet Inc.[6b, 6c, 7, 16]	GOOG.O	Buy	N/A	US$724.89	09 Nov 2015
Amazon.com[16, 18b]	AMZN.O	Buy	N/A	US$655.49	09 Nov 2015
Amgen Inc.[2, 4, 6a, 6c, 7, 16]	AMGN.O	Buy	N/A	US$159.63	09 Nov 2015
Apple Inc.[6c, 7, 16, 18c]	AAPL.O	Buy	N/A	US$120.57	09 Nov 2015
Avago Technologies[16]	AVGO.O	Buy	N/A	US$126.50	09 Nov 2015
BlackRock, Inc.[2, 4, 5, 6a, 6b, 6c, 7, 16]	BLK.N	Buy	N/A	US$349.57	09 Nov 2015
Celgene Corporation[5, 6b, 6c, 7, 16]	CELG.O	Buy	N/A	US$114.08	09 Nov 2015
Cerner Corp.[16]	CERN.O	Buy	N/A	US$59.38	09 Nov 2015
Charles Schwab Corp[2, 4, 6a, 6b, 6c, 7, 16]	SCHW.N	Buy	N/A	US$33.49	09 Nov 2015
Dollar Tree[16]	DLTR.O	Buy	N/A	US$67.61	09 Nov 2015
Edwards Lifesciences Corp[16]	EW.N	Buy	N/A	US$157.18	09 Nov 2015
EMC Corporation[4, 6a, 6b, 6c, 7, 16]	EMC.N	Buy	N/A	US$25.83	09 Nov 2015
Estée Lauder[16]	EL.N	Buy	N/A	US$84.65	09 Nov 2015
Expedia[4, 16]	EXPE.O	Buy	N/A	US$129.48	09 Nov 2015
Facebook[16]	FB.O	Buy	N/A	US$106.49	09 Nov 2015
Gilead Sciences[16, 18d]	GILD.O	Buy	N/A	US$108.11	09 Nov 2015
Marsh & McLennan Companies, Inc.[16]	MMC.N	Buy	N/A	US$55.63	09 Nov 2015
Medtronic PLC[4, 6a, 6b, 6c, 7, 16, 18e]	MDT.N	Buy	N/A	US$75.87	09 Nov 2015
Monster Beverage[16]	MNST.O	Buy	N/A	US$149.05	09 Nov 2015
Netflix Inc[16]	NFLX.O	Buy	N/A	US$109.86	09 Nov 2015
Nike Inc.[16]	NKE.N	Buy	N/A	US$130.48	09 Nov 2015
Progressive Corporation[6b, 7, 16]	PGR.N	Buy	N/A	US$31.47	09 Nov 2015
Red Hat Inc.[4, 6a, 6b, 7, 16]	RHT.N	Buy	N/A	US$80.29	09 Nov 2015
Salesforce.com[16]	CRM.N	Buy	N/A	US$78.22	09 Nov 2015
The Priceline Group Inc.[16]	PCLN.O	Buy	N/A	US$1,311.15	09 Nov 2015
The TJX Companies, Inc.[16]	TJX.N	Buy	N/A	US$71.07	09 Nov 2015

Source: UBS. All prices as of local market close.
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