US Equity and Derivatives Strategy
US Outlook 2015: Roll Tide, Roll…

Equity Strategy

Americas

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2,225

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. We forecast a 2015 year-end S&P 500 price of 2,225 on the back of earnings growth and modest multiple expansion, typical in a maturing rally. We forecast S&P 500 earnings of $126 in 2015 and $134 in 2016.

Known Unknowns = Opportunity

The market's manic plunge followed by a furious rally in October has awakened investors to the idea that risk perceptions now change more quickly. At one moment, a strong dollar, depressed bond yields, weakening energy prices, Europe pondering reflation as opposed to a less accommodative Fed are equity positives, while at the next they are symptomatic of a global growth scare. Bull markets tend to become more volatile as they age – we expect frequent volatility spikes in 2015 to provide investors with added opportunities to generate alpha.

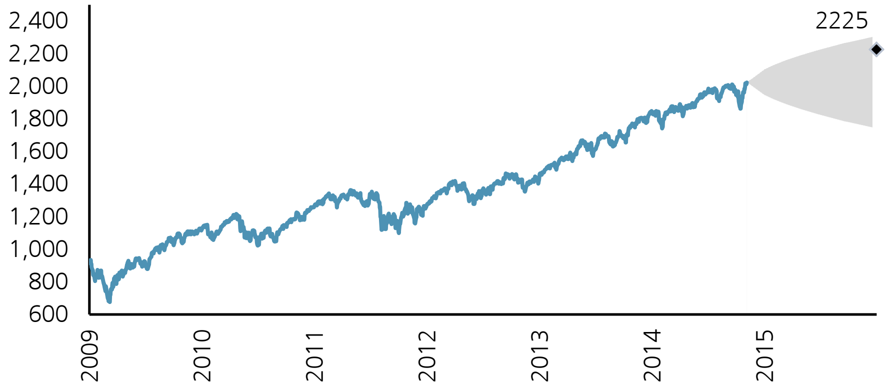
Risks: Upside = 2,400, Downside = 1,750 – Love Once More?

Doubts linger but may dissipate – the public has only grudgingly participated in the 5 ½ year rally as most measures of inflows and confidence, while rising, have not approached levels seen in 2000 or 2007, whereas favorable household debt and net worth provide ample "dry powder" for individual investors. On the downside, European and Chinese growth concerns predominate, yet in no ongoing bull market since the 1970's has the next year traded below the preceding year's low price.

Sector Preferences – Overweight Financials, Technology and Healthcare

We prefer Financials for leverage to robust capital markets activity and attractive valuations, Technology on strong growth and Healthcare for strong earnings momentum and demand tailwinds. All three sectors share the appeal of having substantial cash positions. We remain underweight Consumer Staples, Utilities and Telecom given growth and regulatory headwinds, as well as sensitivity to rising rates.

Figure 1: The Year Ahead – 2,225 vs. Market Implied Range of Outcomes



Source: FactSet, Bloomberg, UBS (Note: Graph represents the S&P 500 price.)

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2015 Playbook: Tide Continues to Roll

We present below a summary of our year-end 2015 S&P 500 Price Target, Valuation and EPS estimates.

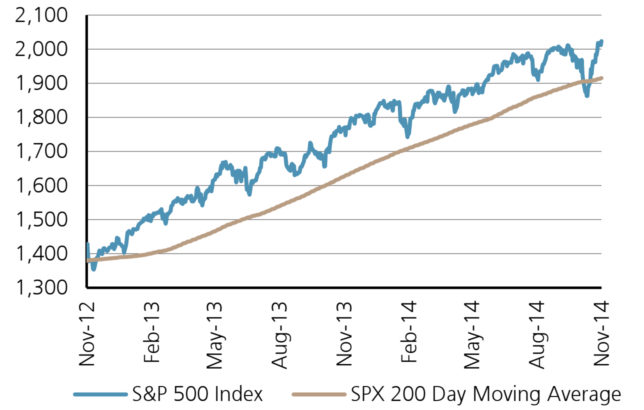
Figure 2: UBS Forecasts

	2013	2014E	2015E	2016E
Economic				
US Real GDP Growth (%)	2.2%	2.2%	2.9%	2.8%
10yr Treasury Yield (%)	3.0%	2.6%	3.5%	3.5%
S&P 500				
Price Level ($)	1,848	1,950	2,225	-
% growth	*29.6%*	*5.5%*	*14.1%*	-
Earnings per Share ($)	109.68	117.50	126.00	134.00
% growth	*5.7%*	*7.1%*	*7.2%*	*6.3%*
Forward P/E Multiple	15.7x	15.5x	16.6x	-
Trailing P/E Multiple	16.9x	16.6x	17.7x	-
Earnings Yield	5.9%	6.0%	5.7%	-
Dividend Yield	1.9%	2.0%	2.2%	-

Source: Bloomberg, FactSet, UBS

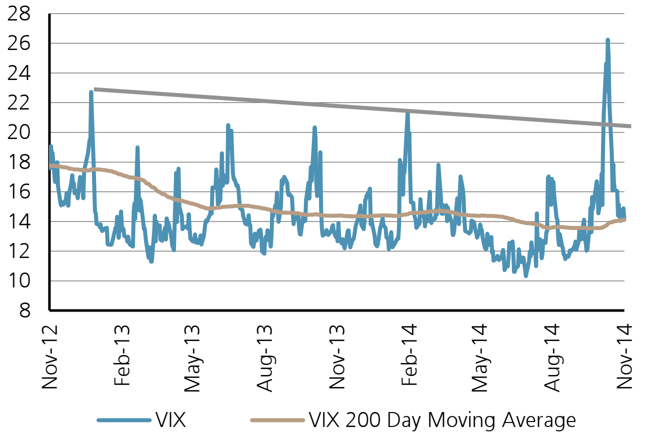
Although 2014 saw the S&P 500 trade below its 200-Day Moving Average for the first time since the 2012 Election, the bull market trend remains intact (Figure 3), albeit in an environment where risk measures have begun to rise, appropriately (Figure 4).

Figure 3: S&P 500, 11/2012 - Current



Source: Bloomberg, UBS

Figure 4: More VIX, more Value at Risk (VaR)



Source: Bloomberg, UBS

Rising risk is perfectly 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 forecasts the rate hike cycle to begin in mid-2015.

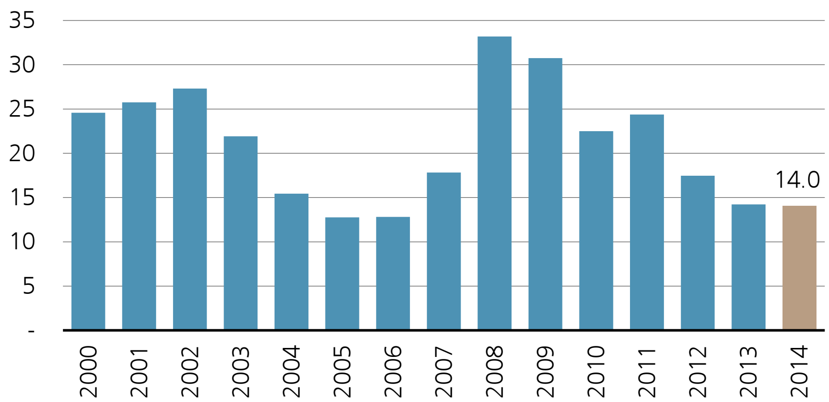
Figure 5: Mature Bulls – Often a Bumpy Ride

		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

And, what's more, markets are coming off of a period of lower than normal volatility (Figure 6).

Figure 6: Average VIX Levels



Source: Bloomberg, UBS

Nonetheless, higher volatility might be another reason for sceptics to point to the gains and the length of the rally since 2009 as sufficient rationale to believe a bear market is "due". However, we would note 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 7).

Figure 7: 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	11/6/2014	69	200%	21%
	Avg (ex. current):	46	138%	31%

Source: Bloomberg, UBS

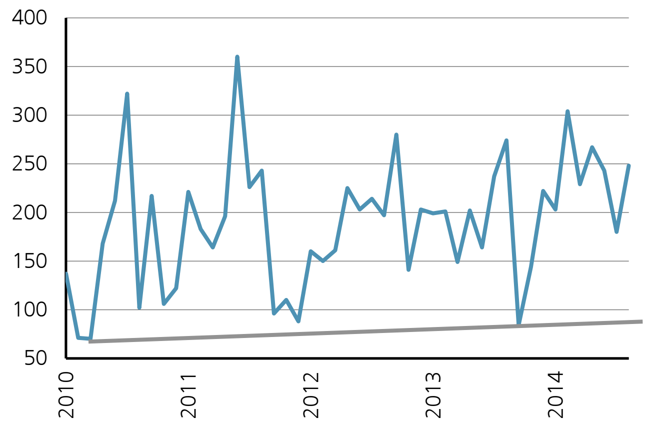
Growth drivers

At the current juncture, both underlying fundamentals and history are on the side of higher stock prices in 2015, particularly when viewed through the lens of the economy and the Fed.

While economic progress has occurred at an uneven pace in 2014, dramatized by Q1's "polar vortex" induced -2.1% contraction followed by Q2's 4.6% rebound, UBS Chief US Economist Maury Harris is calling for an acceleration to 2.9% growth for full year 2015 GDP, followed by 2.8% growth in 2016.

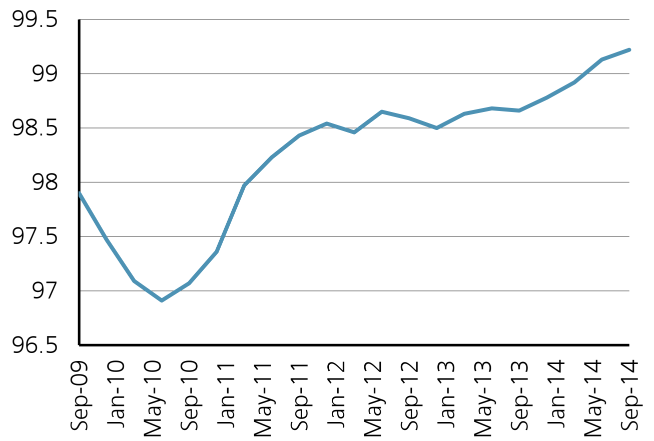
The solid growth forecast is driven by a steady pace of jobs creation (Figure 8), which has served to underpin wages (Figure 9).

Figure 8: Nonfarm Payroll Gains by Month, 000's



Source: Dept of Labor, Bloomberg, UBS (Ticker: NFPTCH)

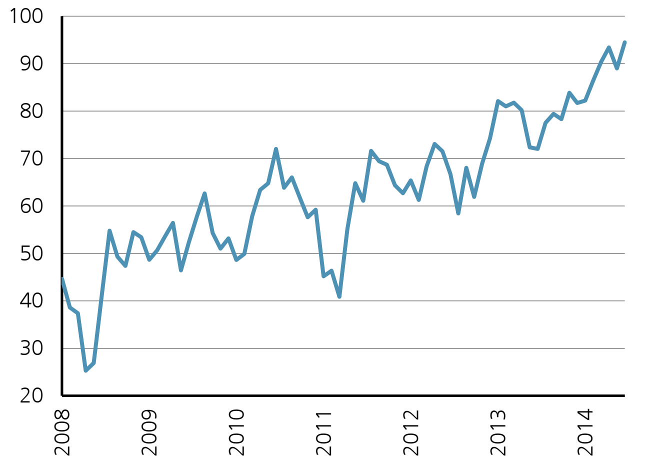
Figure 9: Bureau of National Affairs Wage Trend Index



Source: Bureau of National Affairs, Bloomberg, UBS (Ticker: WAGETRND)

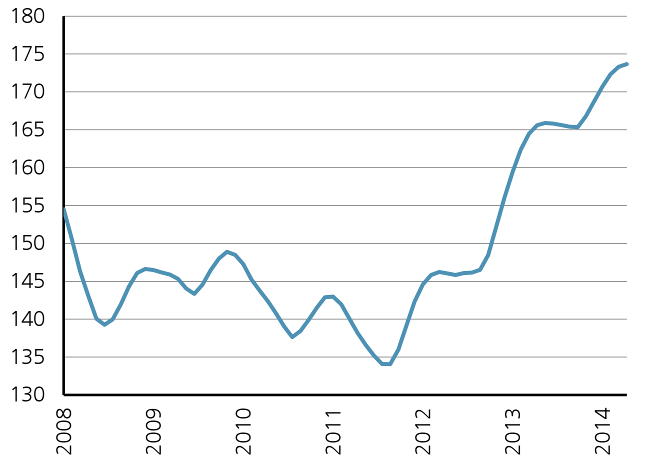
This, in turn, has helped to keep consumers confident (Figure 10) and bolster one of the most important stores of value to Americans, their home (Figure 11).

Figure 10: Consumer Confidence Index



Source: Bloomberg, UBS (Ticker: CONCCONF)

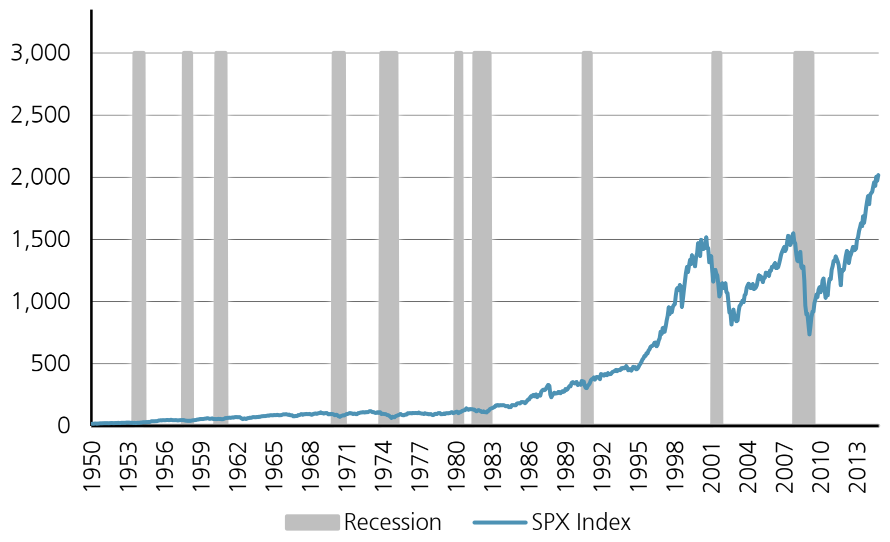
Figure 11: Home is Where the Heart (and Wallet) Is



Source: Bloomberg, UBS (Ticker: SPCS20)

Simply put, barring an unforeseen external shock – which, given 2014's geopolitical incursions in the Middle East and Ukraine, incipient European weakness, as well as the recent public health concerns, cannot be ruled out entirely – or a recession, traditionally one of the two primary threats to a bull market (Figure 12) is not on the horizon.

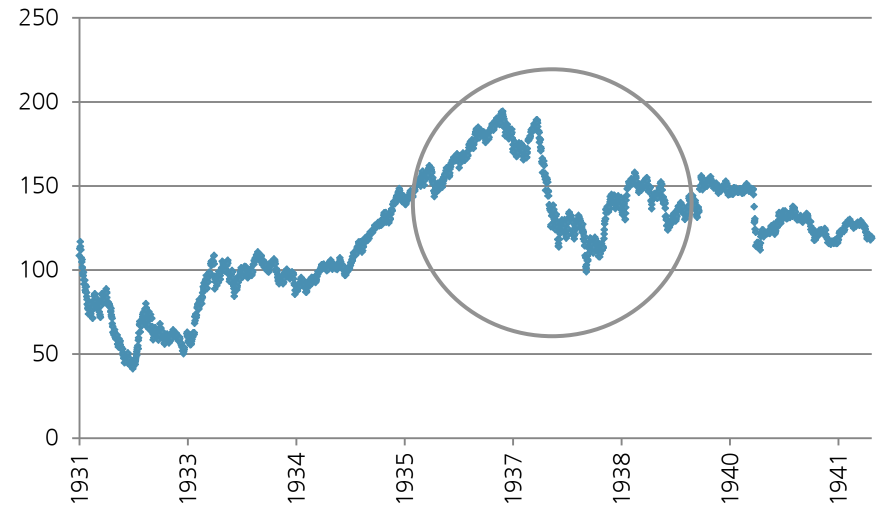
Figure 12: S&P 500 Historical Performance



Source: Bloomberg, UBS

The Fed, while having ended the latest round of QE on October 29th, continues to be flexible in its thinking – mindful of not repeating the mistakes made by premature monetary tightening during the recovery phase of the 1930's (Figure 13);

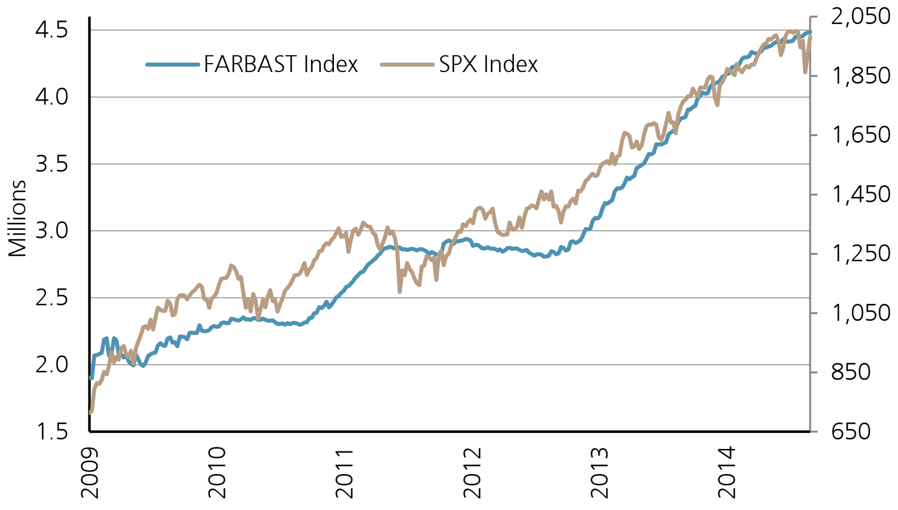
Figure 13: Premature Fed Tightening Prolongs a "Lost Decade"



Source: Bloomberg, UBS (Ticker: INDU)

Particularly since the equity market has such a close correlation (0.97) to the unprecedented level of the now bloated Fed balance sheet (Figure 14)…

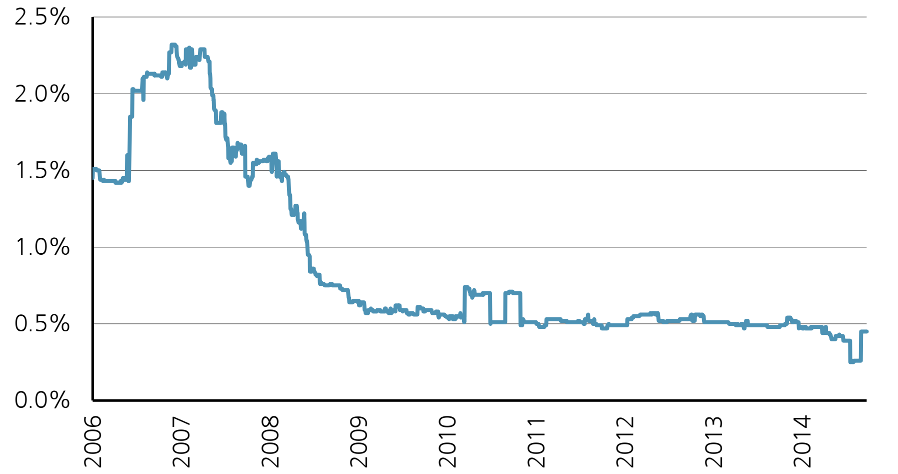
Figure 14: Federal Reserve Banks Total Assets ($m) and S&P 500



Source: Bloomberg, UBS

…With the challenge being an economy that in some respects has become accustomed to super low interest rates on "risk free" instruments such as checking and savings accounts (Figure 15).

Figure 15: Bankrate.com US Interest Checking National Average



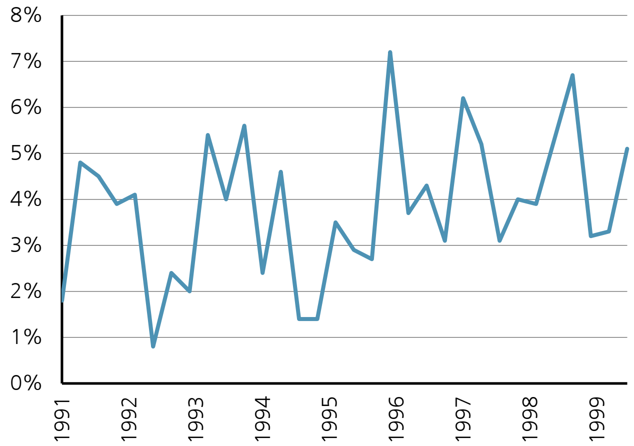
Source: Bloomberg, UBS (Ticker: ILSINAVG)

But more than having to tackle reducing the enormous balance sheet and raising the Fed Funds rate off the non-zero bound in coming months and years, the Fed has in recent weeks acknowledged sensitivity to the fact that the US may not be immune to the problems outside its' borders, particularly with respect to European economic fragility (UBSe Eurozone growth of 1.2% for 2015) or China's vulnerability to a property-led, harder-than-expected landing (UBSe China growth of 6.8% in 2015 and 6.5% in 2016).

While international revenues only account for 30% of S&P 500 companies' exposures, what the Fed cannot completely assess is the degree to which global economic and technological interconnectedness – which has so clearly mushroomed since even the end of the Financial Crisis in 2009 – could incrementally impact economic and market psychology.

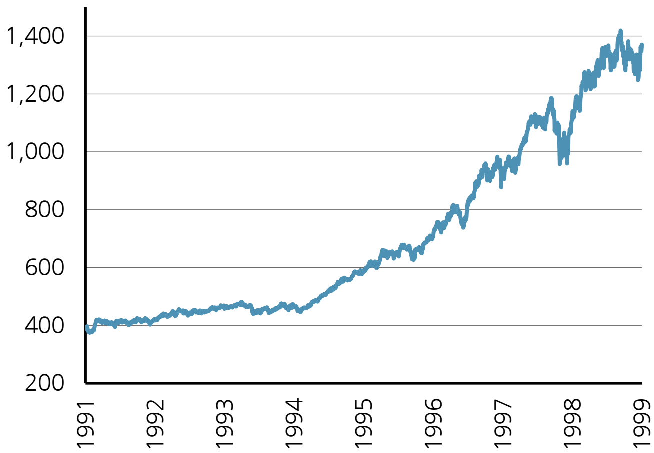
It may be possible for the US to continue to decouple from the rest of the world, both in terms of economy (Figure 16) and as far as equities markets (Figure 17) are concerned, as it did in the wake of Japan's lost economic decade of the 1990's (much of which was spent in recession), the Asian Tiger Crisis in 1997-98 (where YoY growth for Asia dipped below 2% in 1998) and the Russian meltdown in 1998, but the Fed seems less willing to assume perpetual decoupling in the current environment.

Figure 16: US GDP, Q on Q changes, 1991-1999



Source: Bloomberg, UBS (Ticker: GDP CQOQ)

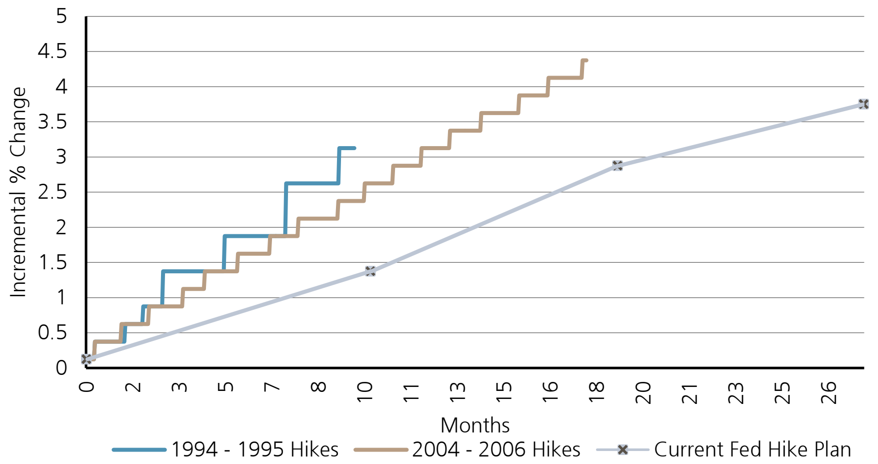
Figure 17: S&P 500, 11/1991 – 11/1999



Source: Bloomberg, UBS

How much less willing than "normal" might the Fed be to raise rates? Considerably so given the pace of past rate hiking cycle trajectories (Figure 18).

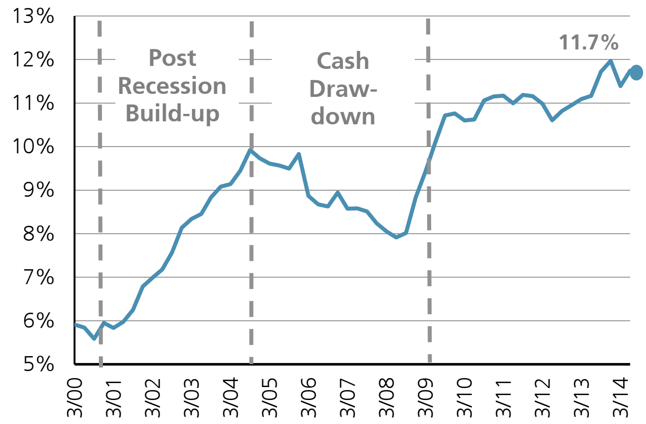
Figure 18: That was Then, This is Now for the Fed (Dot Plot)



Source: Federal Reserve, Bloomberg, UBS

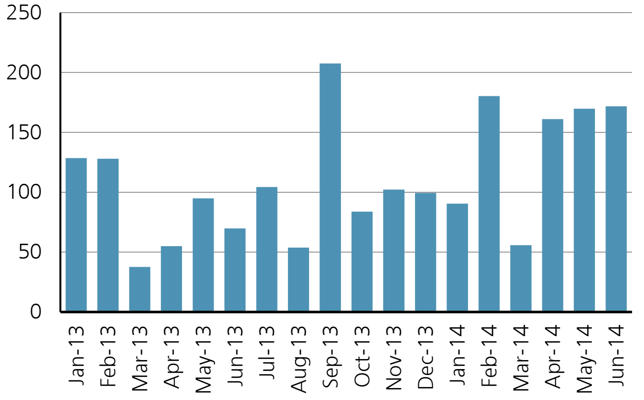
When we combine a solid economy with a still "mindful" Fed and a corporate America that has sufficient cash on hand (Figure 19) to help continue an M&A consolidation trend whose volumes in late 2013 and 2014 YTD are reminiscent of multi-year booms such as those begun in 1998 and 2005 (Figure 20), it becomes reasonable to expect a further rally in the S&P 500 in 2015.

Figure 19: Cash as a % of Total Assets (S&P 500 ex Fin)



Source: Compustat, FactSet, UBS

Figure 20: Monthly US M&A Volumes, $bn



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

We take comfort in the knowledge that when examining past bull markets, the peaks have occurred on average two years and a full 33% higher than when the Fed first began to raise interest rates (Figure 21).

Figure 21: Fed Rate Hikes – The Start is not the End for Stocks

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	

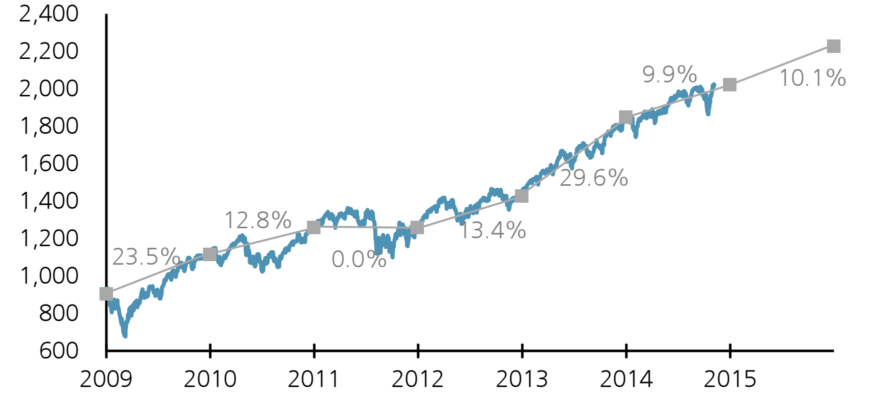
Source: FOMC, Bloomberg, UBS

So in many ways – an expectation of higher interest rates, higher volatility, and higher stock prices – 2015's Playbook is shaping up to be in the way that 2014's X's and O's were diagrammed on the "whiteboard" by economists and strategists.

S&P 500 Outlook

As discussed above, our conviction in the strength of the ongoing US economic recovery is central to our positive outlook for US equities in 2015. As the bull market continues to mature, we expect earnings growth to play an increasingly important role in overall equity market returns. Nonetheless, a combination of low, but rising interest rates and continued (and potentially accelerating) flows into equities will likely contribute to modest multiple expansion.

Figure 22: S&P 500 Performance, 2009-Present (Annual Returns*)

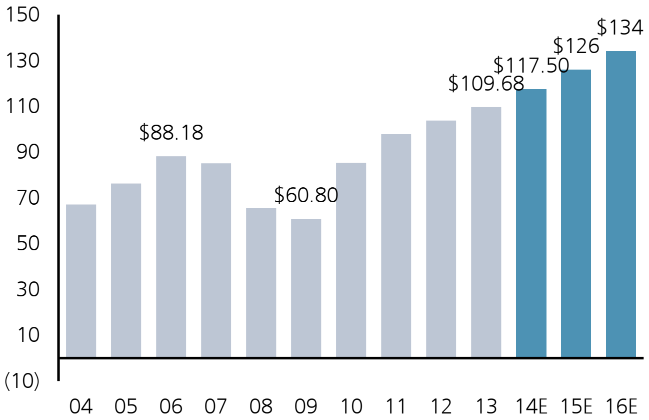


Source: Bloomberg, UBS (*2014 = YTD price return for the S&P 500; 2015E returns based off UBS price target.)

Earnings per Share

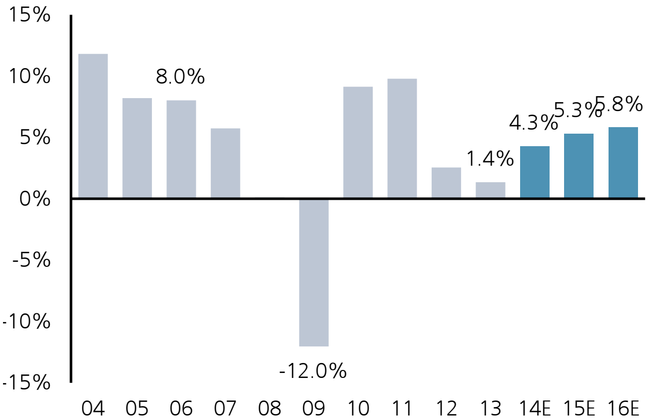
On the back of stronger GDP growth – driven primarily by consumer and corporate spending – and rising interest rates, we anticipate EPS to grow 7.2% in 2015 and 6.3% in 2016. Unsurprisingly, as the bull market continues to mature, we expect top-line growth to increasingly represent a larger share of EPS growth.

Figure 23: S&P 500 EPS ($, Annual)



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

Figure 24: S&P 500 Sales Growth (%, Annual)



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

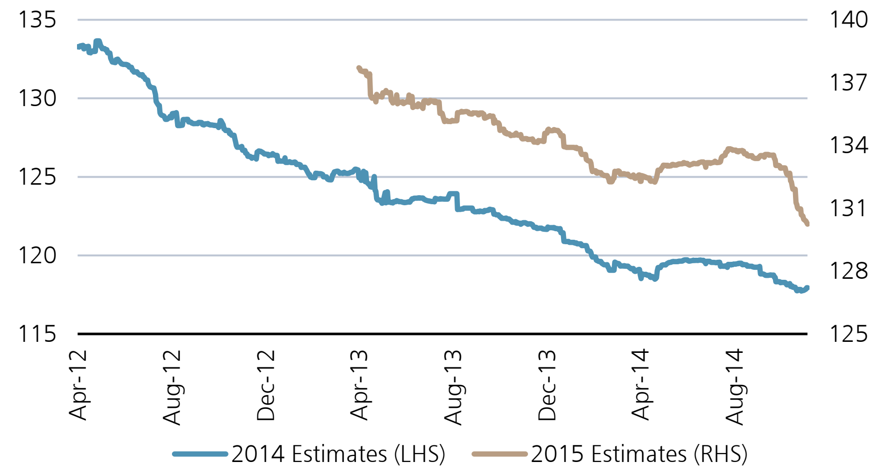
Note: We are adjusting our 2014 S&P 500 EPS estimate to $117.50 (up from $116). While our initial estimate erred on the side of conservatism, better than expected growth and improved margins in Q2 and Q3 drove our upward revision.

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-res 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).

Relative to bottom-up consensus expectations of $130.24 and $145.18 in 2015 and 2016, respectively, our estimates of $126 and $134 seem rather conservative. However, we've found that bottom-up consensus estimates are typically more optimistic at first and begin to be adjusted downward as additional information is incorporated into analyst thinking. For example, since January 1st of 2013, consensus 2014 estimates have declined nearly 7% going from $125.97 to the current estimate of $117.94 (Figure 25). Nonetheless, much like this year, we think the risk to our EPS forecast is likely skewed to the upside.

Figure 25: Bottom-up Consensus Estimates, 2014 & 2015



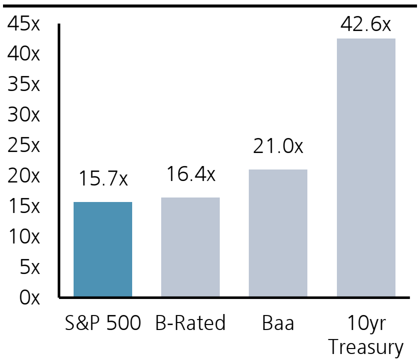
Source: First Call, FactSet, UBS

Valuation

Using our top-down estimate for S&P 500 EPS, we apply a forward P/E multiple of 16.6x (17.7x trailing) to arrive at our S&P 500 price target of 2,225. We believe our forecasted increase in the forward P/E multiple from its current level of 15.7x is justified given a the attractive growth profile for US companies, the health of corporate balance sheets, a continued low interest rate environment and the potential for upside in our EPS forecasts.

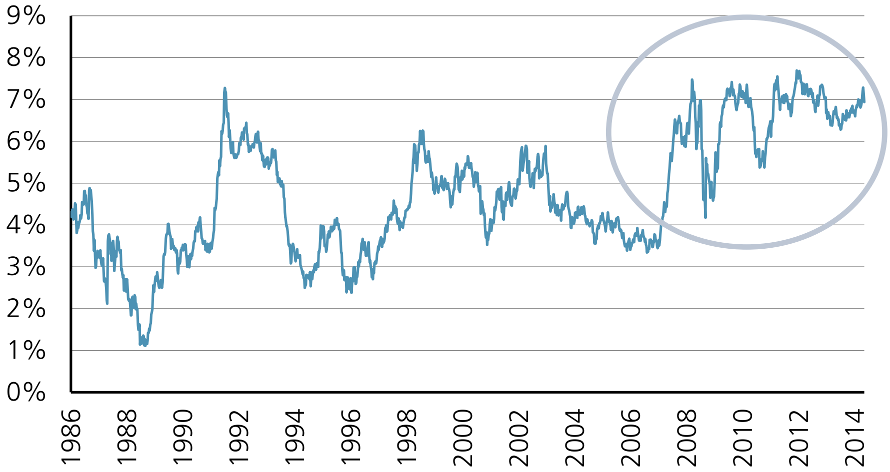
Furthermore, the current implied equity risk premium in the US, given the combination of low long-term yields and attractive growth prospects, makes US equities look particularly compelling in the current environment (Figure 27).

Figure 26: S&P 500 vs. FI "P/E"



Source: IBES, First Call, Bloomberg, UBS

Figure 27: US Implied Equity Risk Premium

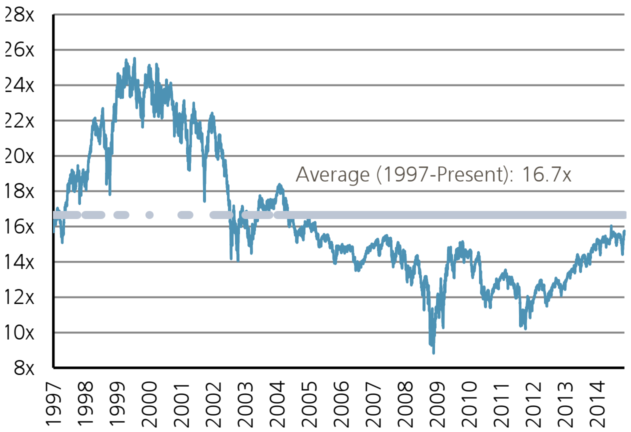


Source: Bloomberg, UBS Global Asset Allocation

What Does History Tell Us?

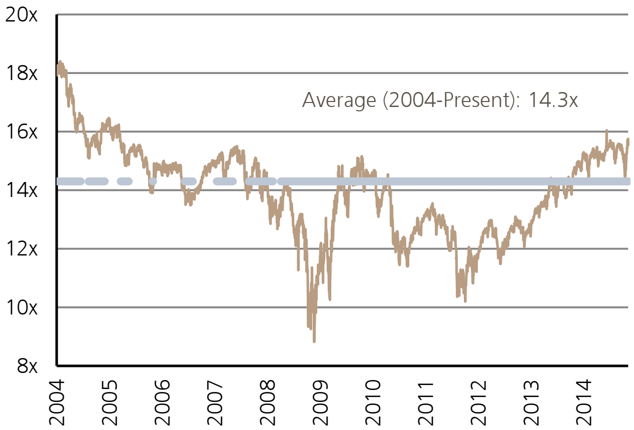
Is 16.6x NTM earnings too high for the S&P 500? Depending on the length of historical data, our projected multiple is roughly in-line to slightly elevated. However, the combination of low interest rates, healthy corporate balance sheets, and the maturity of the bull market justify, in an historical context, our projection for a degree of multiple expansion in 2015.

Figure 28: S&P 500 NTM P/E, 1997-Present



Source: First Call, IBES, FactSet, UBS

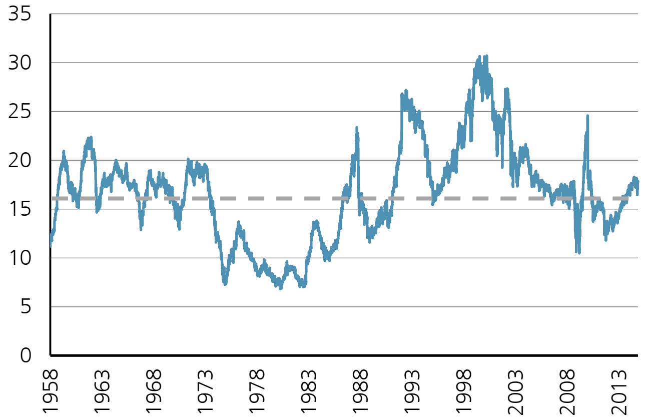
Figure 29: S&P 500 NTM P/E, 1997-Present



Source: First Call, IBES, FactSet, UBS

On a trailing basis, our 17.7x trailing multiple, while slightly above the long-term average of 16.6x, is still well 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 31).

Figure 30: S&P 500 Trailing P/E, 1958-Present



Source: Bloomberg, UBS

Figure 31: 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	?	17.8x
	Average (ex. current):	19.7x

Source: Bloomberg, UBS

Many market observers will point to an elevated Shiller P/E or a cyclically adjusted P/E multiple. However at around 26x, that too is in-line with the historical average of approximately 25.3x going back to 1990. Furthermore, it remains below the peak level reached in the prior bull market that ended with the financial crisis.

Sector comparison

While our forecast calls for some multiple expansion, we think certain sectors are better-positioned to provide the 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 32: Valuation Heat Map – Forward P/E Multiples (P/B for Financials)

	Tech	HealthCare	Industrials	Cons Disc	Staples	Financials*	Energy	Utilities	Telecom	Materials
1990	10.7	15.1	11.2	11.0	13.3	1.4	13.4	10.4	12.7	9.2
1991	12.4	17.9	12.9	16.5	15.3	1.5	13.4	11.1	13.1	13.3
1992	13.8	16.8	13.2	17.2	16.1	1.6	15.9	12.0	13.6	14.9
1993	16.8	13.5	14.5	16.0	14.8	1.8	16.7	13.7	16.1	16.3
1994	15.1	13.7	13.7	12.7	14.4	1.6	16.5	11.2	14.7	15.7
1995	14.4	16.7	13.8	12.2	16.0	1.8	15.7	11.8	14.7	10.2
1996	16.5	19.3	16.1	14.2	18.2	2.0	16.4	12.2	14.6	13.7
1997	20.5	23.0	18.1	15.0	21.5	2.7	18.3	12.4	16.7	16.0
1998	26.9	29.2	19.2	19.7	23.9	3.1	20.4	15.1	20.8	16.6
1999	37.6	28.7	21.7	22.8	22.6	3.4	26.0	14.6	23.5	18.4
2000	39.1	27.8	21.4	20.2	18.5	3.5	18.9	15.2	18.8	11.5
2001	31.8	25.7	20.3	23.2	19.3	3.0	15.9	13.8	19.3	17.2
2002	27.0	20.6	17.1	20.9	17.8	2.5	18.4	10.6	14.4	18.1
2003	25.3	18.0	17.2	19.1	17.1	2.1	15.4	12.1	14.1	18.0
2004	22.5	17.6	18.2	18.4	18.1	2.2	14.9	13.8	17.0	15.3
2005	19.6	17.3	16.5	17.7	17.4	2.0	11.9	15.0	14.6	13.1
2006	18.9	16.7	15.7	16.5	17.4	2.1	10.2	14.4	14.3	13.0
2007	19.4	16.0	15.8	16.8	17.4	1.9	11.8	16.0	15.4	14.7
2008	14.5	12.6	12.7	13.5	15.1	1.3	9.6	13.6	11.9	12.9
2009	14.9	10.9	13.5	14.2	13.1	1.0	13.0	11.2	12.1	16.8
2010	13.3	11.0	14.7	14.4	13.7	1.1	11.4	11.9	12.6	13.9
2011	12.3	11.4	13.4	14.1	14.2	1.0	11.0	13.5	14.0	12.0
2012	12.1	12.3	12.6	14.7	15.3	1.0	10.7	14.6	15.0	12.4
2013	14.1	15.5	15.3	16.6	16.9	1.3	12.8	15.9	14.5	15.3
2014	15.2	16.6	15.8	17.1	18.0	1.4	13.6	16.5	13.7	15.5
Current	**15.6**	**16.8**	**15.9**	**17.3**	**18.4**	**1.4**	**14.0**	**16.8**	**13.7**	**15.7**

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

2015 "Role Players"

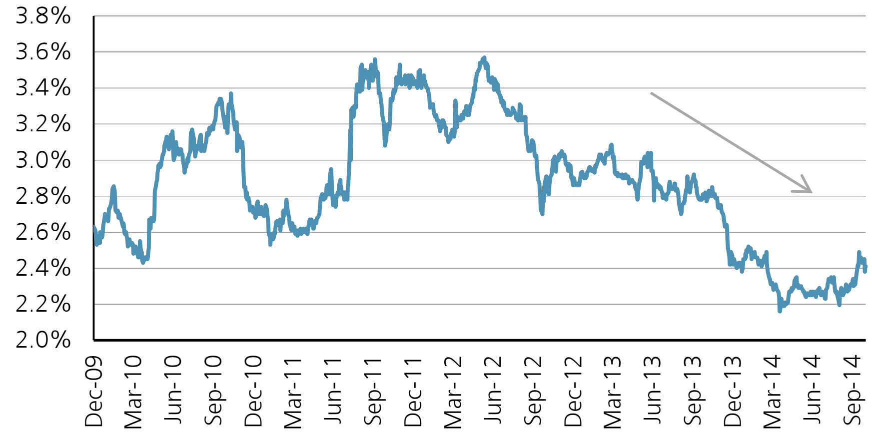
In the context of the ongoing economic recovery, we identify a few key "role players" in our 2015 playbook – namely US consumer spending, corporate spending, US policymakers and investors.

Consumer & Corporate Spending

As discussed in "Growth Drivers," we expect increased consumer spending to be driven by further jobs creation, wage growth, the ongoing housing recovery and continued consumer confidence in the US economy.

For US companies, the story is centered on a willingness to spend via capex, more M&A, and continued dividends and share-repurchases. Underpinning this willingness to spend has been, and will continue to be, the health of corporate balance sheets and the availability of cheap financing (Figure 33).

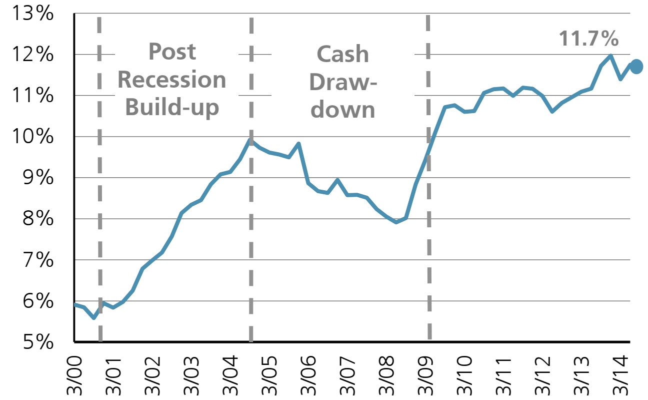
Figure 33: Spread Between IG Bonds (Baa) and US 10-year Treasury Yields



Source: Haver, UBS

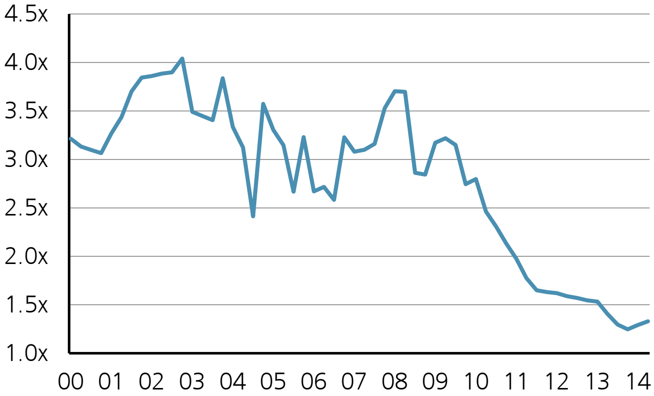
By most measures, corporate America remains as healthy as it has been in years. Unlike the debt-fueled bull market prior to the Financial Crisis, management teams continue to exhibit discipline that was absent pre-Crisis – cash balances are near all-time highs while debt levels remain well below the levels seen in 2006-7.

Figure 34: S&P 500 Cash Balances, % of Total Assets



Source: Compustat, FactSet, UBS

Figure 35: S&P 500 Debt/EBITDA Multiple

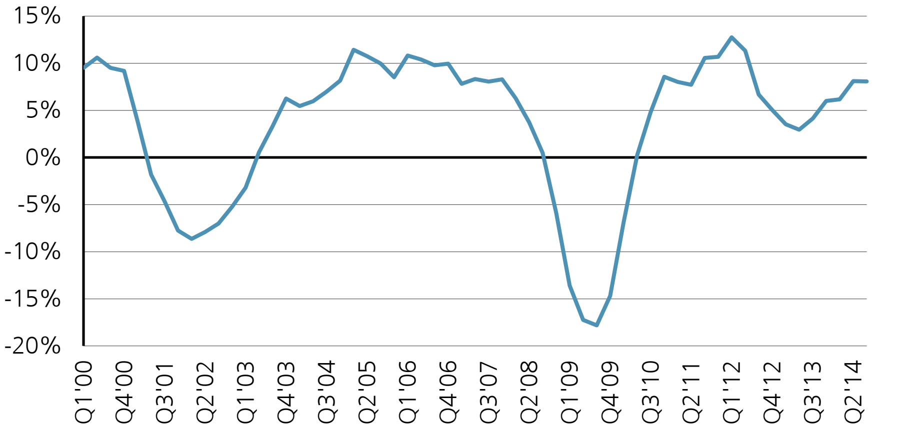


Source: Compustat, FactSet, UBS

Capital Expenditures

Despite the expectation for higher rates and volatility, we expect capex to increase in 2015 given the reduced impetus for management teams to make capital investments in a low volatility, zero interest rate environment. In effect, the expectation for rising rates may lower the effective returns to buybacks and dividends in favor of capital expenditures that drive revenue growth or increase operational efficiencies (i.e. cost reductions).

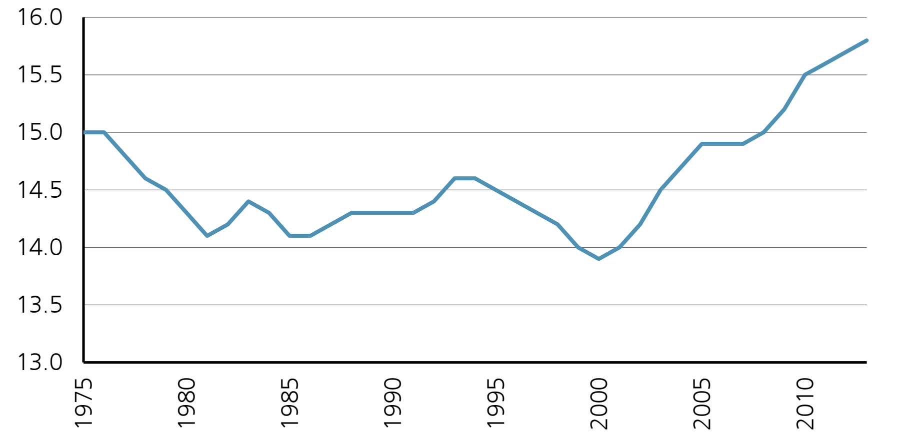
Figure 36: US Business Fixed Investment, % YoY



Source: BEA/Haver, UBS

In addition, at some point, the realities of the corporate replacement cycle should begin to impact management spending decisions leading to an increase in capex (Figure 37).

Figure 37: Age of US Capital Stock



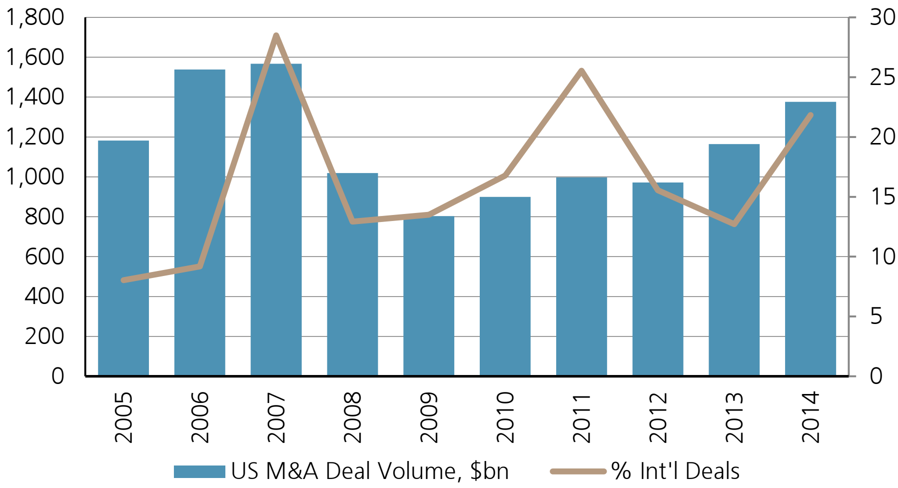
Source: BEA/Haver, UBS

M&A

Much like 2014, we expect M&A activity to play a major role in 2015. The major drivers of significant cash reserves, low funding costs, available leverage and continued business confidence remain in place. At the same time, a stronger dollar should only fuel additional activity as US management teams, flush with overseas

cash, are likely to become more willing to deploy capital overseas in search of high growth companies/divisions and opportunities to expand product offerings or gain market share.

Figure 38: International M&A to Play a Larger Role

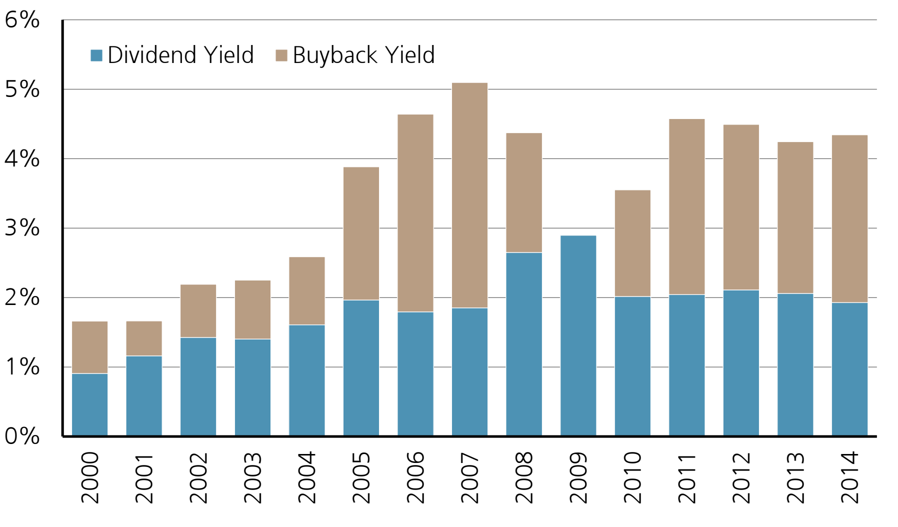


Source: Dealogic, Bloomberg, UBS

Dividends & Buybacks

In spite of our view for increased capex and M&A, dividends and share-buybacks are likely to remain a focal point for corporate boards, especially given the ongoing search for yield from investors.

Figure 39: S&P Total Yield, Annual Average



Source: Compustat, FactSet, UBS

Year-to-date, approximately 169 companies in the S&P 500 announced share buyback programs/authorizations with the intent to repurchase over $380bn in stock. This trend is likely to continue.

US Policymakers

We've discussed the benefit of a "mindful" Fed and its supportive interest rate trajectory for the US equity markets at length above. However, policymakers outside of the Fed will continue to play an important role in 2015.

The combination of a Republican House and Senate, and a lame-duck President could create additional uncertainty/volatility in equity markets. In addition, a continued regulatory focus on topics such as tax inversions, could impact overall M&A activity – a driver to our base case for 2015.

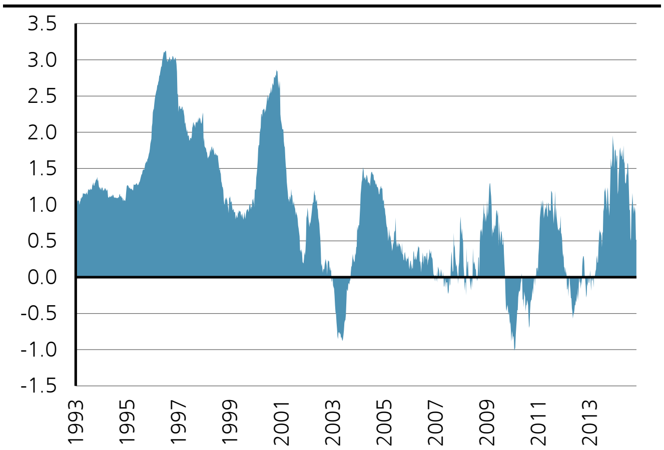
Positively, the "base case" appears to be a "standoffish inertia" between Congress and the White House, so any signs of legislative progress or even incremental bipartisan cooperation are likely to be a source of upside volatility.

Investors

The last key "role player" is the US equity investor, including both households and institutional investors. Although the Fed is expected to raise rates beginning next year, the underlying growth prospects of US equities (given the ongoing US economic expansion) will drive investor demand.

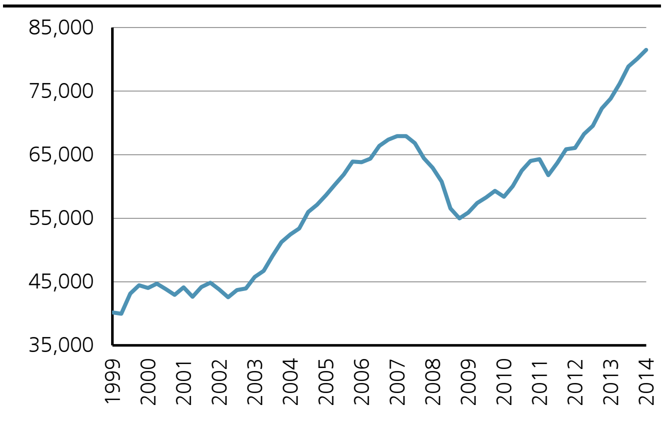
Over the last couple of years, flows have continued to pick up, yet remain below the peaks reached in the dot-com bubble. That tells us that public investors, while active, have not become as active as prior bull markets (Figure 40) despite the increase in household net worth (Figure 41).

Figure 40: Domestic Equity Flows, 52-wk Avg ($bn)



Source: AMG Lipper, UBS

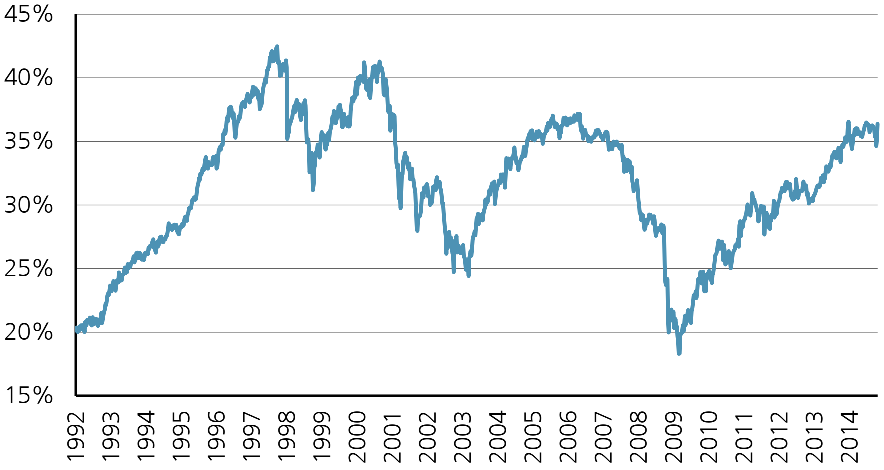
Figure 41: Households & NPO Net Worth ($bn)



Source: Federal Reserve, Bloomberg, UBS (Ticker: NWORVALU)

As a percentage of total assets invested (in mutual funds and ETFs), the proportion versus total invested assets has continued to increase as the current bull market has matured. As it approaches the peak reached in the previous bull market, it remains well below the peaks in the late 90's and early 2000's (Figure 42).

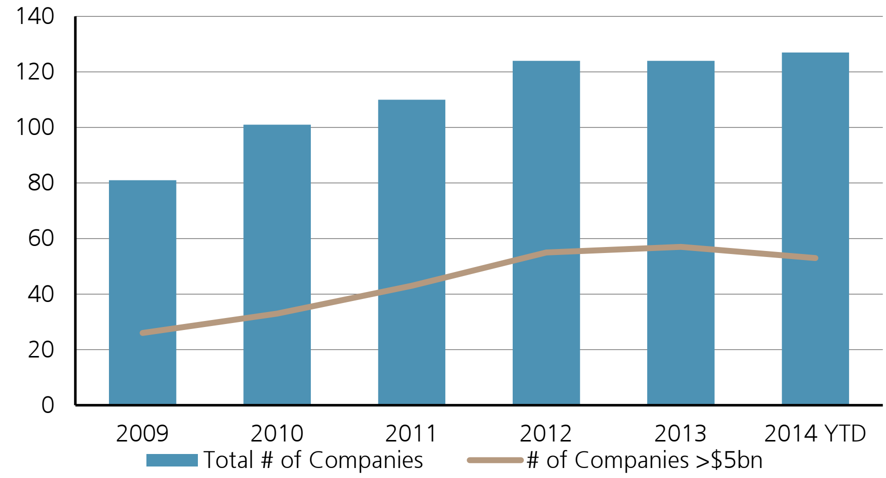
Figure 42: Allocation to US Equities Still Climbing



Source: AMG Lipper, UBS

On the institutional side, we've seen an increased role in investor activism with a greater emphasis on large cap companies (Figure 43). Given the large cash reserves on corporate balance sheets, activists will remain actively involved in trying to unlock value for shareholders – either through further share buybacks, M&A or operational efficiencies.

Figure 43: Greater Focus on Activist Campaigns, # of Targets



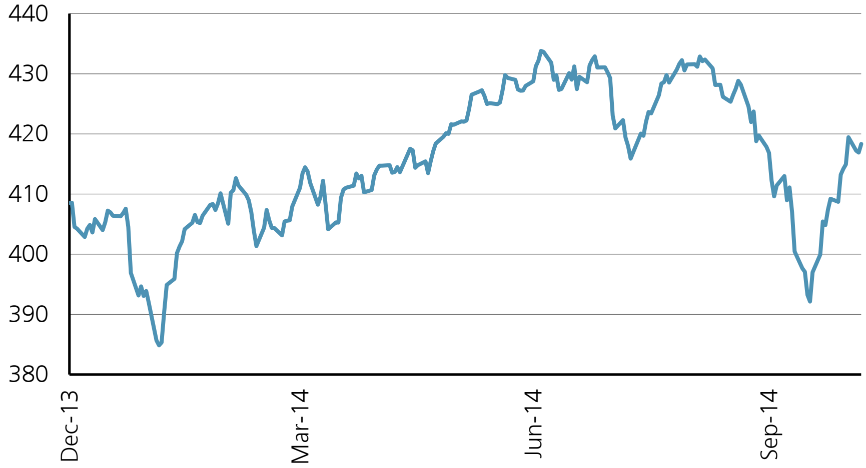
Source: FactSet, UBS (Note: Data through 9/2014.)

2015 "Wildcards"

Assessing the Risks – What if We're Wrong?

Financial markets have exhibited a remarkable resilience in 2014 to events best characterized as both "bolts from the blue" as well as "known unknowns"; the MSCI World Index (MXWD) is up around 2.5% year to date (Figure 44).

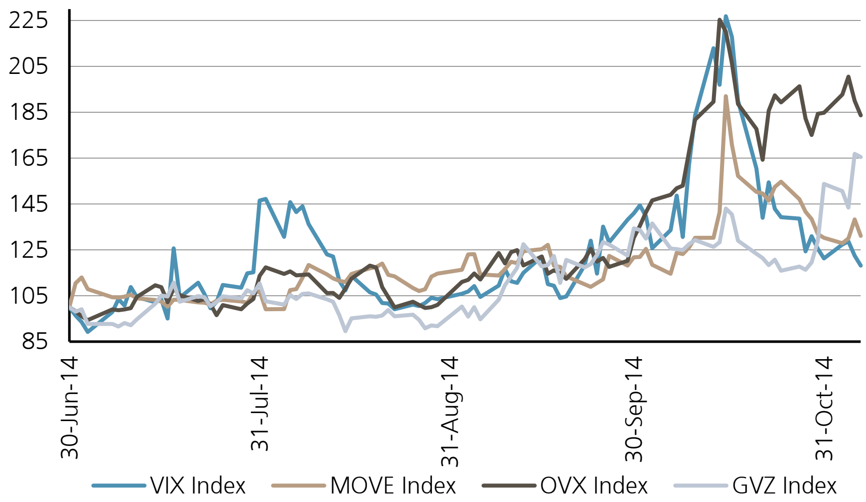
Figure 44: World Equities – 2014's Long, Strange Trip



Source: Bloomberg, UBS (Ticker: MXWD)

The surprises have included the "polar vortex" Q1 US GDP contraction, annexation of Crimea by Russia, a rise in Middle East tensions, and an escalating concern in September and October about public health issues. As a result of these unexpected surprises, risks as measured by volatility, whether assessing stocks (VIX), oil (OVX), gold (GVZ), or bond markets (MOVE) have risen dramatically (Figure 45).

Figure 45: Volatility Rising: Stocks, Bonds, Oil, Gold (Indexed to 100 at 6/30)



Source: Bloomberg, UBS

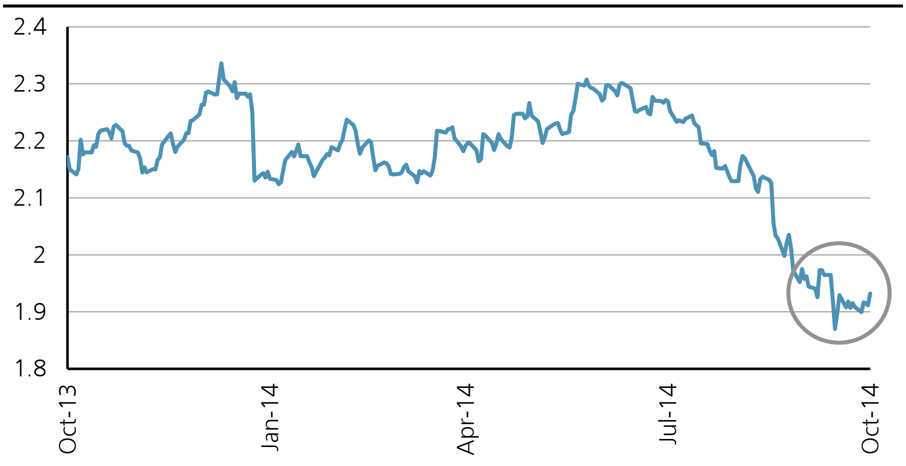
As we've said earlier, higher volatility is normal for this part of the cycle in the US, and all the more so given that Europe, Japan and China are not synchronized to the US, being in an earlier part of their cycle (slowing and/or trying to find growth avenues).

What is perhaps most surprising about the outcome of the "bolt from the blue" surprises is the decline in oil prices and coincident strength in the US Dollar; particularly in light of the geopolitical aggressions.

While European economic weakness and the removal of the Fed's QE have been the "known unknowns" that in hindsight explain a great deal of the moves, the rapidity of the change in perceptions – where for one moment a strong dollar, depressed bond yields, weakening energy prices, Europe pondering reflation as opposed to a less accommodative Fed were viewed as equity positives, while at the next they are symptomatic of a global growth scare – has been extreme in Q3 and Q4.

The abrupt change in the markets' mentality with regard to the reward/risk/reward path of a US delinked from Europe's growth trajectory is captured by the abrupt swing down, then recent stabilization, in inflation expectations; inflation having been a very close proxy for growth in the post Financial Crisis environment (Figure 46).

Figure 46: 10-year US Inflation expectations, %



Source: Bloomberg, UBS

In fact, these types of Growth Scares have been commonplace since 2010, and the moments of higher volatility have proven to be a boon to opportunistic capital allocators (Figure 47).

Figure 47: Previous Growth Scares (SPX Highs and Lows)

Time Period	High Date	Index High	Low Date	Index Low	Decline
QE1 End	4/23/2010	1,217	6/30/2010	1,031	-15.3%
QE2 End	4/29/2011	1,364	8/8/2011	1,119	-17.9%
European Sovereign Crisis	4/2/2012	1,412	6/1/2012	1,278	-9.5%
Taper Tantrum	5/21/2013	1,669	6/24/2013	1,573	-5.8%
				Average Decline	-12.1%

Source: Bloomberg, UBS

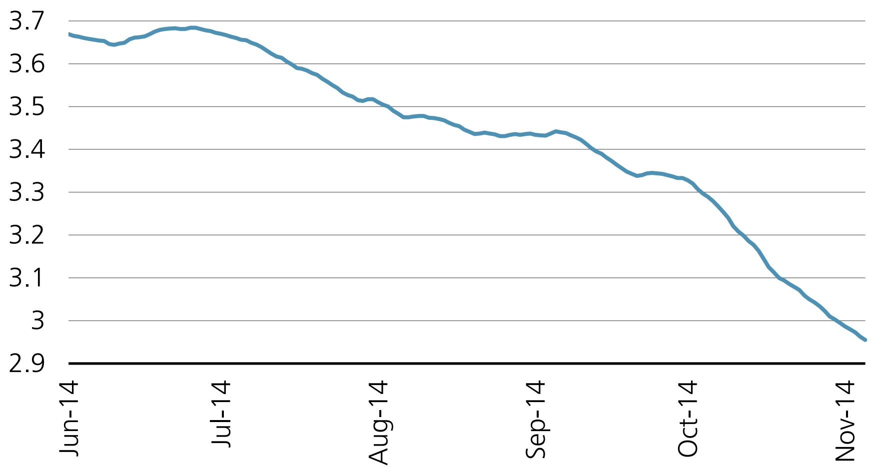
With the specter of a dollar forecast by UBS to strengthen through 2015 into 2016 (Euro 1.15, Yen 120) coupled with the knowledge that bottom-up consensus estimates for 2015 EPS remain too high (+11% YoY) and will get walked down partly as a consequence of FX, given 30% of S&P 500 revenue is international, we expect more frequent "mood swings" in the markets on the Road to 2,225.

In terms of the impact on US equities from lower oil prices, the message is less clear. Anecdotally, there has yet to be a significant supply response from the US "oil patch".

Doubtless, though, energy companies will be adversely impacted; Q3 EPS Growth for Energy, while robust at 7.1%, is accompanied by revenue growth of -2.5%, as opposed to S&P 500 revenue growth of 4.0%. Current bottom-up consensus estimates over the next four quarters have energy EPS declining approximately 4.5% on revenue declines of approximately 8%.

What we do expect is some of the cost savings from cheaper gasoline prices – UBS' US economics team estimates that the decline in recent months (Figure 48) has freed up in excess of $56B (annualized), which could find its way into increased consumer discretionary spending coming into the Holiday shopping season. Current consensus estimates over the next four quarters have Consumer Discretionary EPS increasing around 14% with revenue projected to gain 6%.

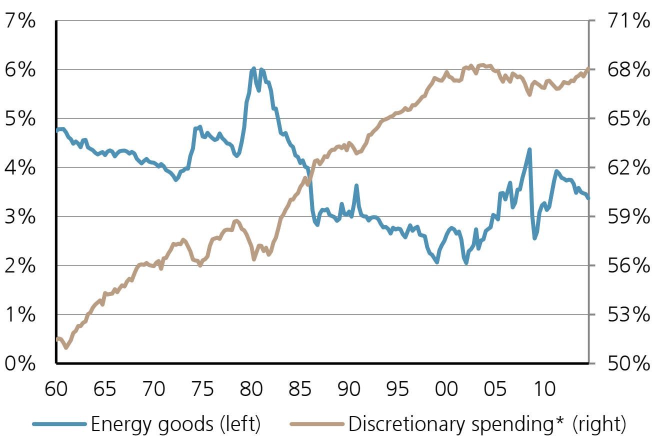
Figure 48: Daily National Average Gasoline Prices, $/Gallon



Source: Bloomberg, UBS (Ticker: 3AGSREG)

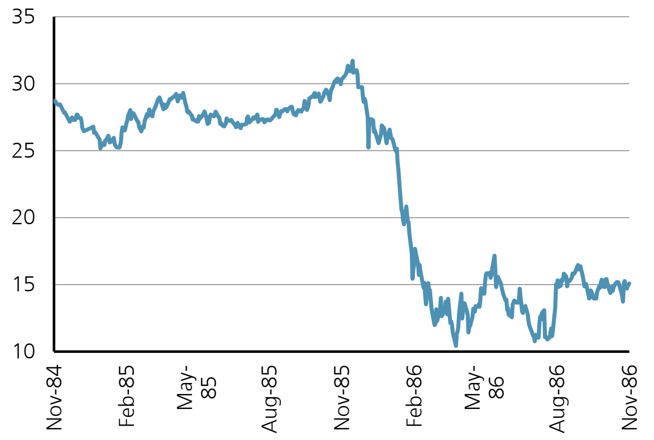
To the extent that lower energy prices are perceived as longer lasting within the context of a still strengthening US economy (unlike the experience during the heart of the Financial Crisis in 2008), the tailwind for incremental consumption spending could be of an extended nature (Figure 49) as was the case in 1985-86 when oil moved from a range of $25 – 30/bbl. to $10 – 20/bbl (Figure 50).

Figure 49: Share of Consumer Spending, %



Source: Haver, Bloomberg, UBS

Figure 50: The 1980's Oil Bust



Source: Bloomberg, UBS (Ticker: CL1 Comb Comdty)

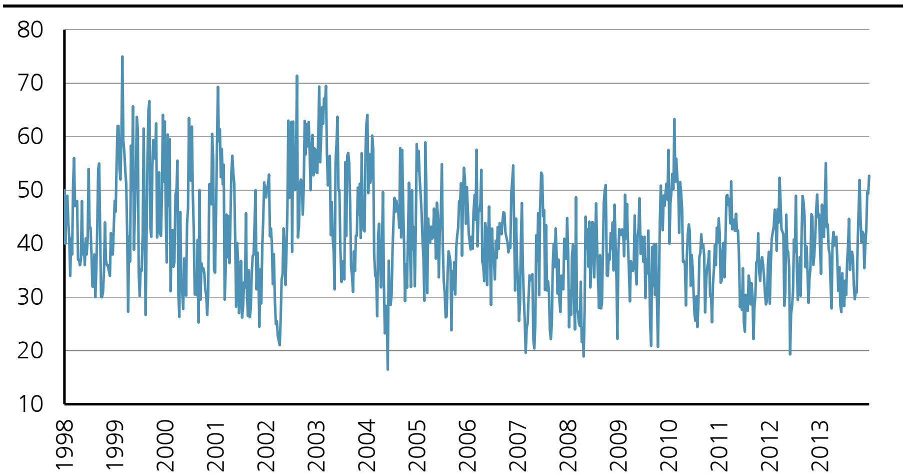
Looking at the balance of risks, both knowns (Europe, the Fed) and unknowns (geopolitics and other exogenous shocks), we want to identify exactly how our YE price target of SPX 2,225 could be "off the mark" – What if We are Wrong?

Upside: 2,400 – Love Once More?

One of the hallmarks of past bull markets toward their latter stages is public acceptance of equities – perhaps even an element of "irrational exuberance".

Bullish sentiment has not gotten to the extremes witnessed at the top of the 1991 – 2000 bull market (Figure 51).

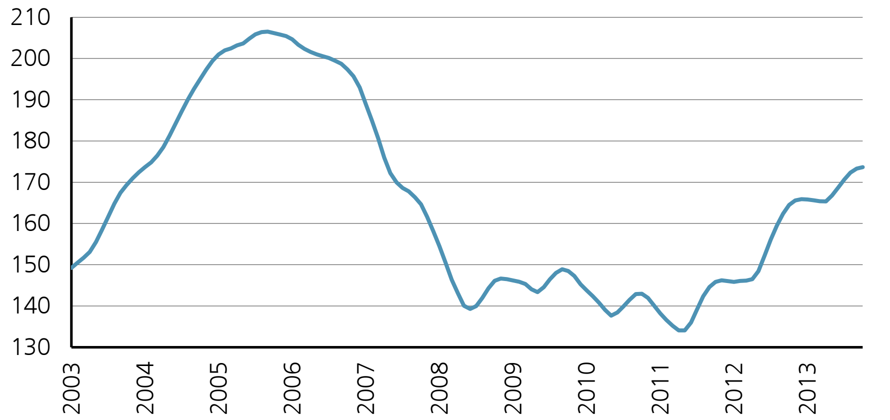
Figure 51: Love and the Tech Bubble



Source: Bloomberg, UBS (Ticker AAIIBULL)

And while investors' passions were less evident in equity markets near the peaks in 2007, their ardour was most evident in the housing market (Figure 52).

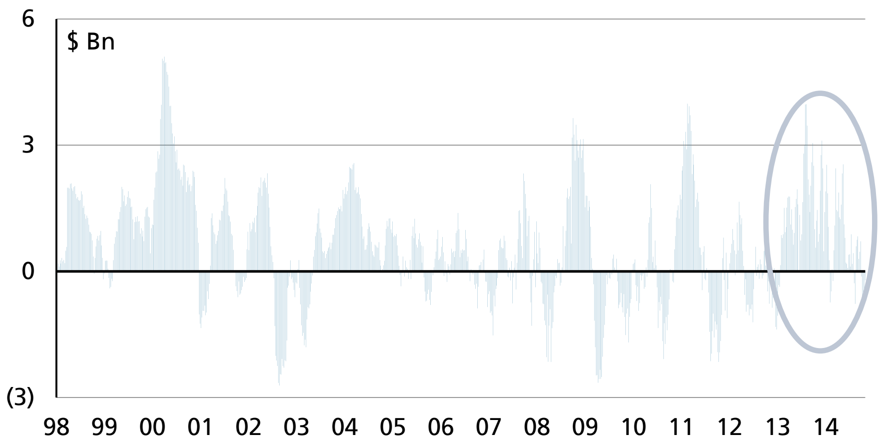
Figure 52: Love and the Housing Bubble



Source: Bloomberg, UBS (Ticker: SPCS20)

Looking at inflows into equities since the late 1990's, while there have been periods of great strength over the last couple of years, the numbers have not approached the levels seen at the 2000 top either on an annualized basis (Figure 40, page 18) or looking at a shorter-term time frame (Figure 53).

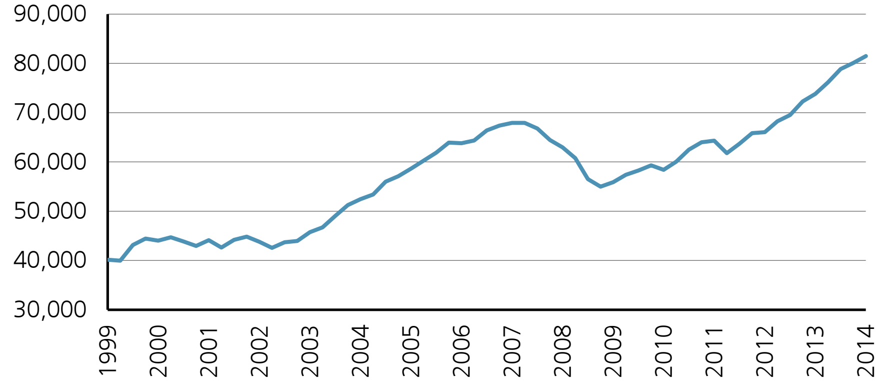
Figure 53: Equity Inflows, 13-week Moving Average



Source: AMG Lipper, UBS

More dramatic is to think about these flows as a percentage of the aforementioned household net worth, which has nearly doubled since the end of 1999 (Figure 54).

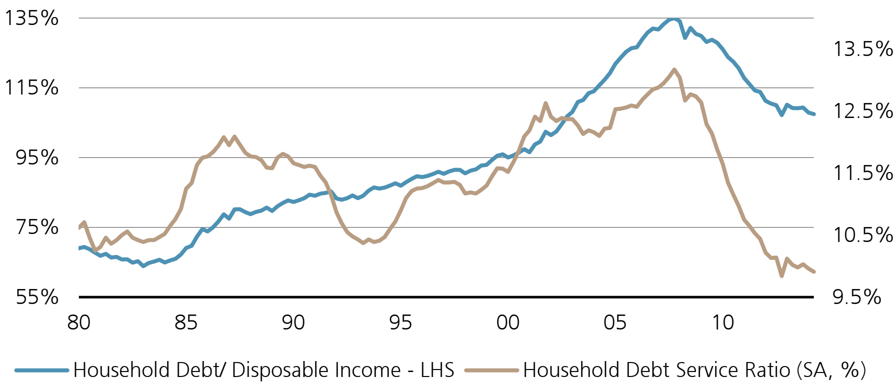
Figure 54: Household Net Worth – The Mojo Keeps Risin'



Source: Federal Reserve, Bloomberg, UBS (Ticker: NWORVALU)

When factoring in the "cleanliness" of household balance sheets (Figure 55) it would appear that the investing public has ample "dry powder" to pour money into stocks in 2015, driving up multiples closer to the typical bull market peak of 19.7x trailing earnings, which at year-end 2015 on UBSe EPS of $126 yields an S&P 500 price of 2,482.

Figure 55: Household Debt Service to Disposable Income



Source: Federal Reserve, Haver, UBS

But what moves the investing psychology toward less-restrained participation?

We cite two specific catalysts, starting with M&A. The M&A boom, which we believe will continue in 2015 based on available corporate cash, CEO confidence and a rising rate environment, could capture the public's imagination as it did during 1999, the middle of the first great M&A boom. While we are not believers in the "Great Rotation" trade per se, a rising rate environment, particularly if the Fed moves the short end and the long end responds accordingly, could cause incremental shifts from fixed income into equities.

Politics could also drive investors toward equities. While it is unlikely that substantive tax reform will be achieved in 2015, even a dialogue that occurs in concert with an orderly disposition of the next Debt Ceiling showdown (coming to

a theater near you in March 2015), could sway the public's abysmal perception of Washington positively, with the improved mood spilling into stocks.

In this regard, the parallels to 1999 are interesting. The GOP held Congress, Democrat Bill Clinton was a lame duck president, the M&A boom was full on in a rising US Dollar environment accompanied by weak oil prices, declining inflation expectations and higher equity market volatility. Stocks rose 19.5% in 1999. Sound familiar – echoes of 1998-99 into 2014-15? (Figure 56)

Figure 56: Bull Market Checklist – Party Like It's 1999?

Development	1998-99	2014-15
Middle of Multi Year Uptrend	✓	✓
Strong M&A Activity	✓	✓
Dollar Rally	✓	✓
Weak Oil	✓	✓
Asian Tiger Distress	✓	
Japanese Distress	✓	✓
Europe Distress		✓
Russian Currency Implosion	✓	✓
V Shaped Volatility Episode	✓	✓
Second Term Democrat President	✓	✓
GOP Congress	✓	✓
Near 20% Equity Market Gains	✓	???

Source: UBS

Downside – 1,750

Perhaps of greater consequence to those individuals who have managed to capture the bulk of the gains from the Bull Market which began in March 2009 – what are the downside risks?

In our view, the main downside risk is that of European or Chinese weakness denting the psychology of the US equity investor, much in the way prior Growth Scares have unfolded over the past 5 years, including the September-October 2014 peak to trough decline in the S&P 500 of almost 10% (Figure 47, page 22).

While it is possible that Europe (or China) could fall into a growth trajectory that puts strain on the international system, as was the case in the European Peripheral Crisis in 2011-12, we are encouraged by the ECB's Draghi "talking tough" on the need for stoking growth and note that Draghi naysayers over the last several years have been disappointed. We think the Chinese government will also take sufficient measures to stave off a damaging hard landing and note that our China economist Tao Wang is calling for 6.8% growth in 2015 and 6.5% in 2016.

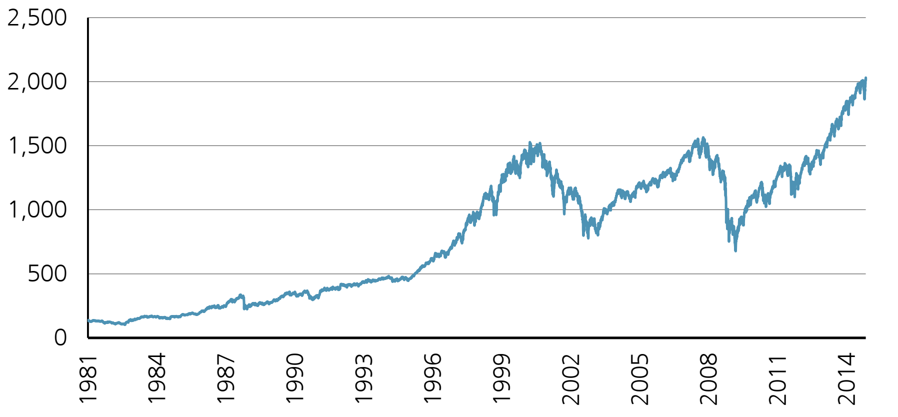
The Fed could move to tighten much more rapidly than markets are comfortable with. While we do not dismiss this entirely out of hand given that the market's estimation of Fed Funds in December 2016, at around 1.6%, is well below the median Fed "Dot Plot" value of 2.875%, we believe that the convergence of these figures toward the Fed's values would be a validation of the strength of the US economy and an acknowledgement that risks have diminished abroad rather than a reaction to budding inflation.

Politics could also be a downside risk, though given the negative sentiment surrounding both Congress and the President, it is a less likely risk factor. Nevertheless, the Tea Party could perhaps somehow become emboldened to challenge an unyielding Democratic Party who may perceive by next spring/summer that they have little to lose by standing firm against the GOP.

Why do we see downside in 2015 limited to 1,750, which is around 14% lower than current levels?

We believe that the combination of valuations and economic and earnings fundamentals are sufficient to keep the bull market, which began in 2009, intact. In that regard, we note that in no year in each bull market cycles of the past 30 years – 1982-87, 1991-2000, 2002-07 and 2009-present – has the following year made a low lower than the previous year (Figure 57). 2014's YTD low is 1,737.92. We expect this level to hold any declines in 2015.

Figure 57: Past Bulls – Always Higher Lows (S&P 500, 1981-Present)

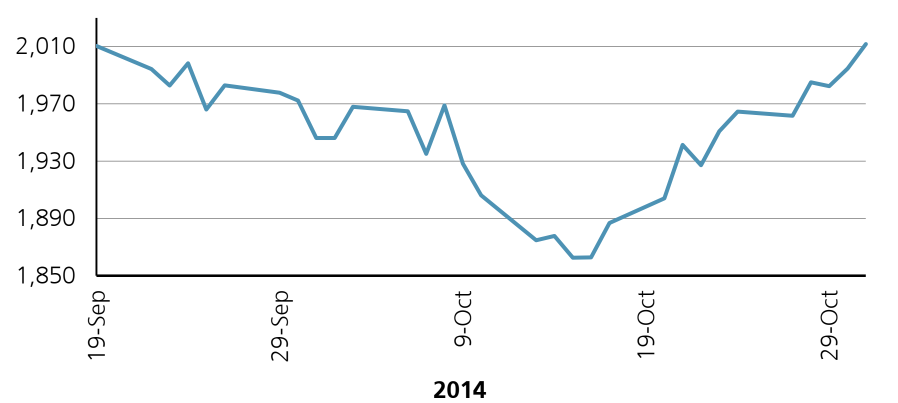


Source: Bloomberg, UBS

Options Options

Given that the US equity market is currently trading at an all-time high, many investors might well be reticent to commit to new long positions in stocks at present, particularly in light of the sharp V-bottom and strong rally of the past month (Figure 58).

Figure 58: S&P 500 – "V" is for Victory



Source: Bloomberg, UBS

In this regard, longer dated S&P 500 options provide a very attractive risk/reward alternative, in our view. Looking out to December 2015, at the current S&P 500 level of 2,031.92, an investor could go long the December 2015 1,725 put/2,175 call risk reversal.

The 1,725 put could be sold for $57.60, 20.2% volatility, 21 delta and the 2,175 call bought for $55.40, 14.1% volatility, 30 delta; the entire structure could be initiated for a credit of $2.20, excluding fees and commissions.

This structure is priced attractively because there continues to be strong demand for downside protection relative to upside exposure – steep skew (Figure 59).

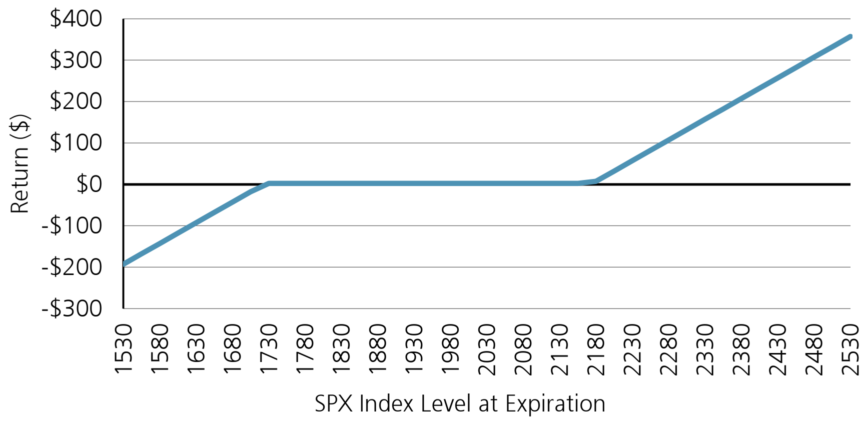
Figure 59: 1-year S&P 500 90%/110% Skew

Source: Bloomberg, UBS

In addition, the position inception delta is only .51, so the p&l will fluctuate at half the rate of a pure cash position in the Index in the near term. At expiration, the position remains profitable above 1,725 (with near unlimited loss potential below 1,725) 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 2,400 comes into focus.

Payout profile of the SPX December 1,750p/2,175c risk reversal is as below:

Figure 60: Payout Profile



Source: Bloomberg, UBS

Sector Preferences

In many ways, the 2015 "playbook" is similar to what we had originally anticipated for 2014. Thus, our sector weightings remain unchanged, driven in large part by our call for higher stock prices, higher volatility and the likelihood of higher interest rates. 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 2015 as an expression of economic health, we prefer sectors where rising rates are not necessarily a headwind.
- Balance Sheet Flexibility – The ability to create long-term shareholder value through return of cash 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 61: Sector Preferences

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

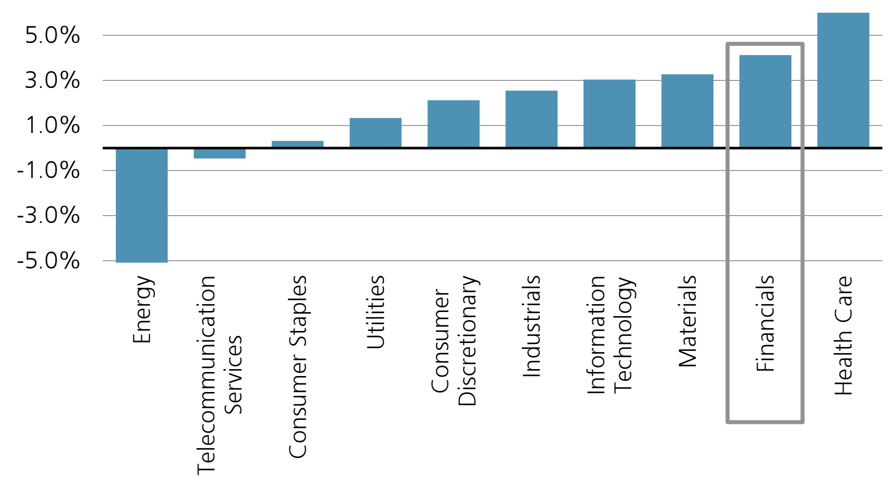
Source: UBS

Overweight

Financials

As the economy continues to recover post the 2007-09 Financial Crisis, financials are one of the better-positioned sectors. With companies focused on M&A, capex and share repurchases, financials stand to benefit from the increased lending activity, advisory fees and interest income. Any increase in volatility will only drive additional interest in the space, as some of the larger banks/brokers will see an increase in trading volumes, and hence commissions. The positive earnings momentum is proof of some of the gains likely to come from a new, higher volatility regime (Figure 57).

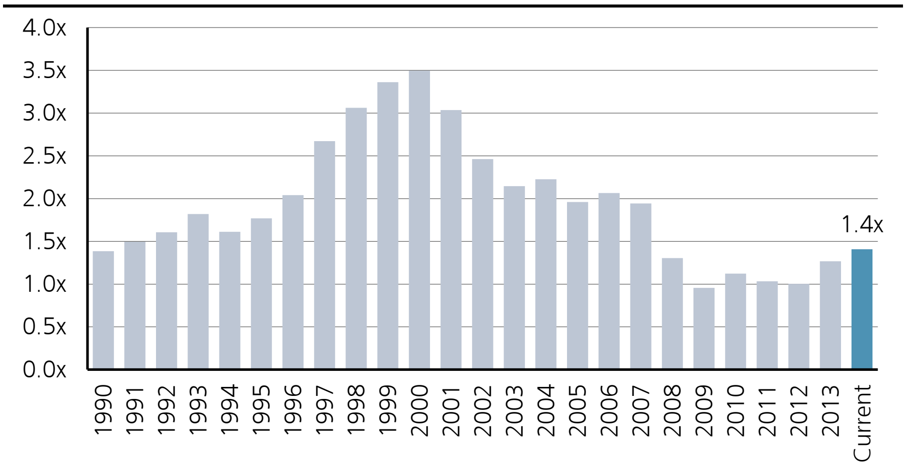
Figure 57: Earnings Momentum



Source: IBES, First Call, FactSet, UBS

As interest rates rise, financials, especially insurers and regional banks, are among the clear beneficiaries operationally. Although a rise in interest rates was the base case for 2014, we've seen strong performance in the financials sector – largely due to improved earnings potential and an attractive valuation. In our opinion, the financials sector remains one of the most attractively valued sectors, particularly on a relative basis to historical averages (Figure 58).

Figure 58: Historical P/B, Financials

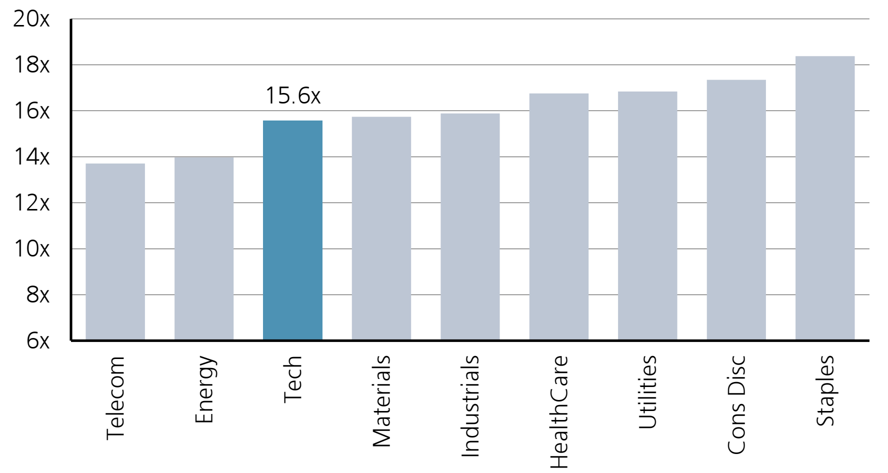


Source: FactSet, UBS

Technology

Technology remains among the most attractively valued sectors (Figure 59) given its compelling growth profile. 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.

Figure 59: Historical P/E Multiple, Technology



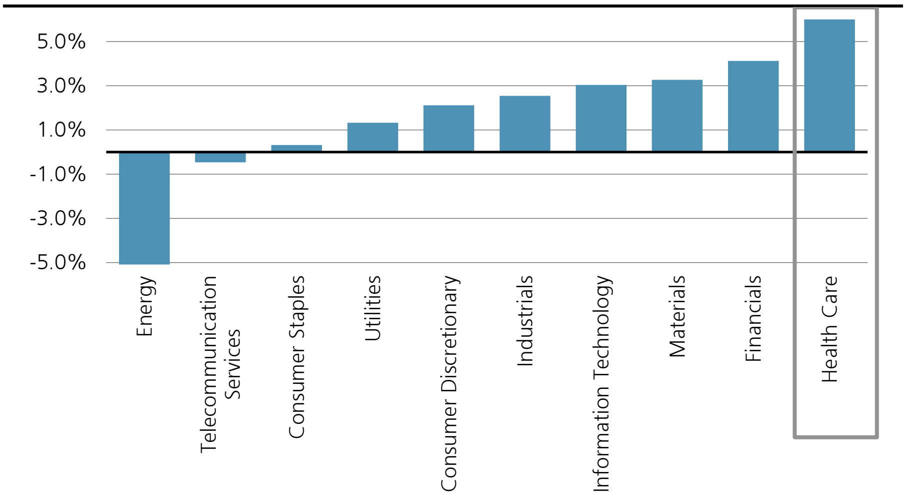
Source: FactSet, UBS

In addition to an attractive growth profile, the health of balance sheets will likely continue to drive M&A activity (as companies search for new growth opportunities), particularly overseas, as well as share buybacks.

Healthcare

The healthcare sector, thus far, has been one of the strongest performing sectors in 2014. Yet we remain positive on the outlook for the sector going into 2015. The defensive characteristics (i.e. earnings stability and high barriers to entry) of the sector remain quite attractive despite the ongoing economic recovery. While not the cheapest on a relative basis, we believe the sector's earnings momentum (Figure 60), 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 2015.

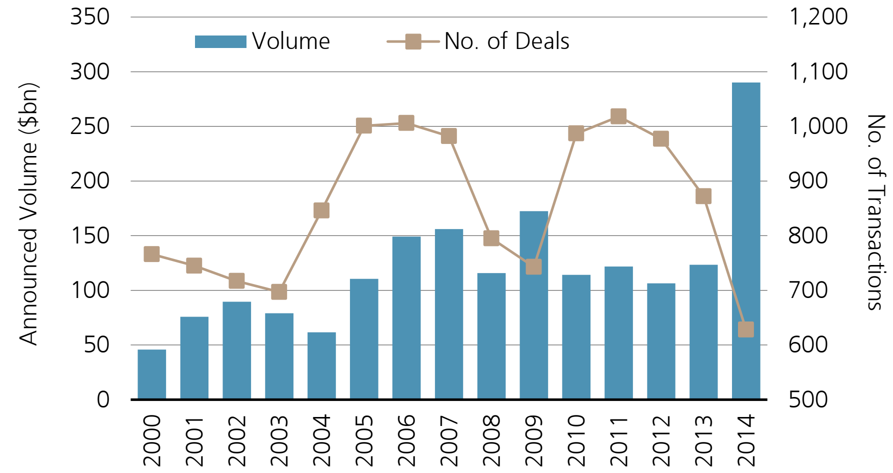
Figure 60: Earnings Momentum (3-month)



Source: IBES, First Call, FactSet, UBS

In the longer term, the sector is likely to benefit from the demand tailwinds of an aging baby-boomer generation. In the more 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 (despite recent regulation against inversions).

Figure 61: Strength in M&A Volumes



Source: FactSet, UBS

Neutral

Materials, Energy, Industrials, Consumer Discretionary

Materials have already underperformed in 2014 but the group will continue to face the headwinds of large exposure to non-dollar denominated sources of revenue. **Energy** will be challenged in the quarters ahead by declining EPS and revenue expectations due to the plunge in oil prices; given the degree of underperformance vs. SPX is greater than in the 2008 "oil crash", we will be alert to signs of oil price stabilization as positive "green shoots". **Industrials** continue to seek the "sweet spot" of capex acceleration, likely to occur closer to the start of the Fed rate hike cycle. **Consumer Discretionary** is very controversial. Despite the prospects for stronger consumer engagement given the fall in oil prices and the favorable wage and jobs trends, CD has underperformed in 2014, a victim of its own vast outperformance in 2009-13. CD's relative valuation continues to remain high, a headwind despite the likelihood of strong YoY EPS and revenue growth over the next several quarters.

Underweight

While Utilities, Consumer Staples, and Telecom all have their own idiosyncratic reasons supporting our underweight view, the idea that interest rates will rise in 2015 post QE and prior to and throughout the Fed's rate hike cycle campaign, is a significant driver.

Investors' love affair with yield continued in 2014 as 10-year rates remained far lower than most expert prognostications (US 10-year is currently 2.3%). The passion manifested itself into flow into REITs, High Yield Bonds, MLPs and of course Utilities.

Utilities

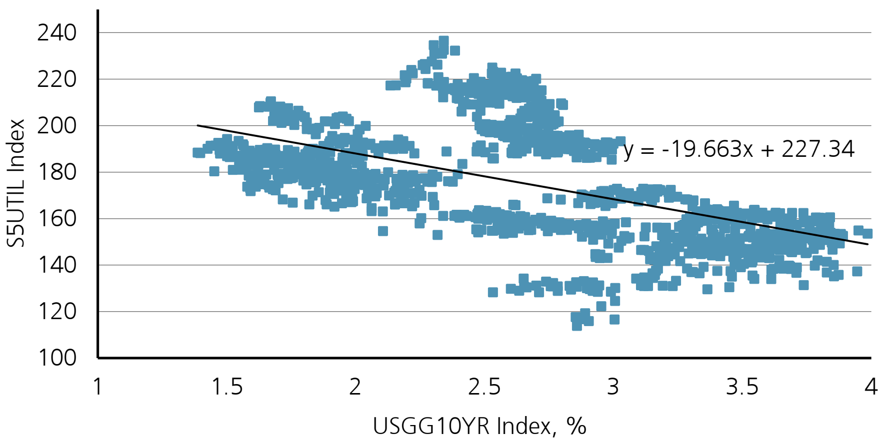
Yes, this group is among the top performers in 2014. Yes, the "halo" effect from the weather induced "earnings extravaganza" in Q1 seems not to have dissipated. Yes, the space is part of corporate America's restructuring gameplan. Yes, global interest rates remaining preternaturally depressed have been a significant tailwind for Utilities.

Assessing the next 14 months' prospects we ask ourselves whether we would wish to underweight the Group starting without any prior viewpoint. The answer is Yes.

Utilities' EPS and revenue growth prospects are exceptionally challenged in the quarters to come given the Q42013 and Q12014 compares, and yet the group trades at 16.8x forward, the highest level of the last 25 years (Figure 32, page 14), a valuation exceeded only by the Consumer Discretionary and Staples sectors. In addition, the Obama administration is widely seen as redoubling a variety of regulatory initiatives in its final two years; this is likely to be a headwind for Utilities, already a highly regulated sector to begin with.

Though Sir Isaac Newton did not believe in "That which goes down must inevitably rise", UBS forecasts interest rates to rise in 2015, with a 2015 year-end 10-year yield forecast of 3.5%. Utilities have been negatively correlated (-.55) to the 10-year US Treasury since the bull market began (Figure 62).

Figure 62: Utilities Dislike Rising Rates

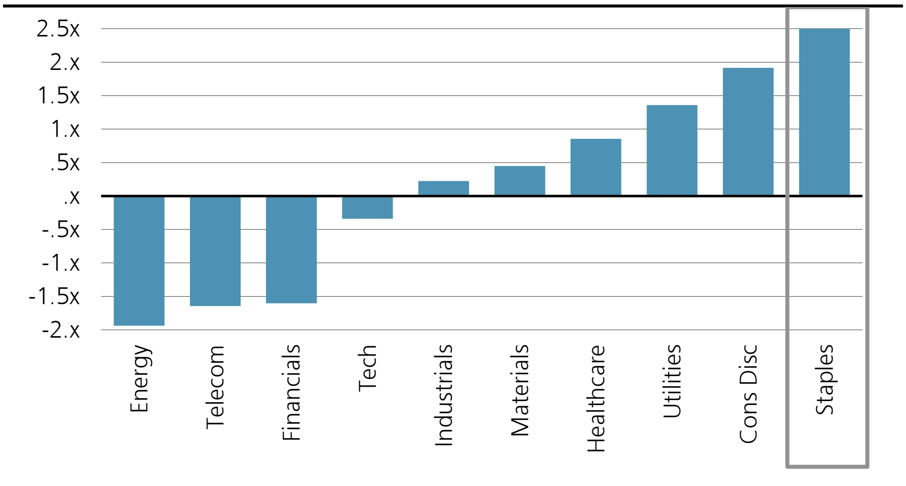


Source: Bloomberg, UBS

Consumer Staples

No group is more expensive, at 18.4x forward P/E, than the Consumer Staples sector (Figure 63).

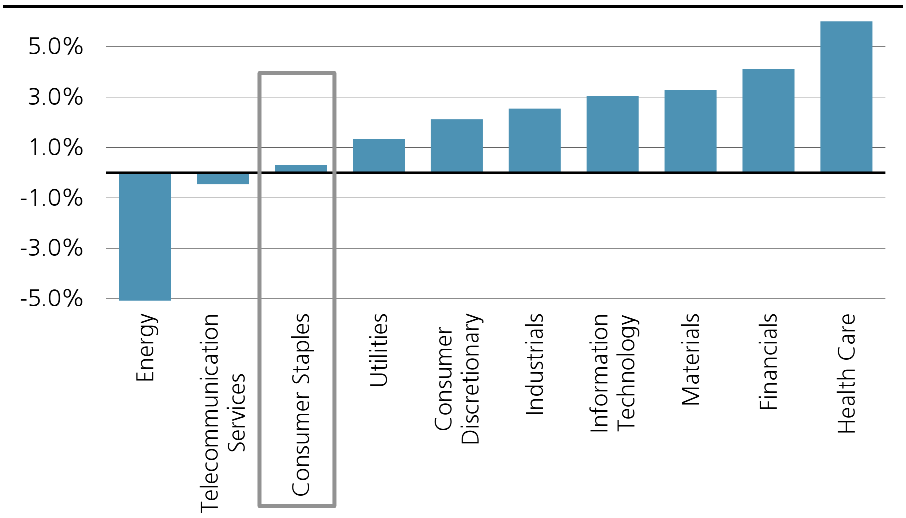
Figure 63: S&P 500 Sector Relative P/E



Source: FactSet, UBS

And, despite the potential tailwinds of lower commodity input costs, earnings momentum continues to be lackluster (Figure 64).

Figure 64: Earnings Momentum (3-month)

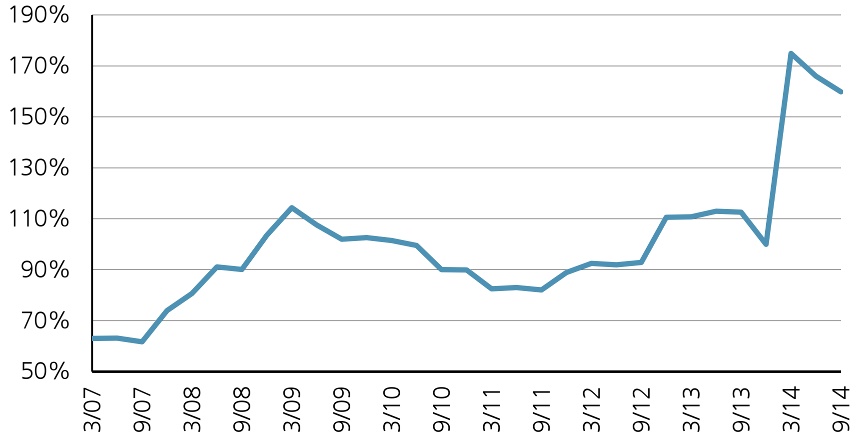


Source: IBES, First Call, FactSet, UBS

Telecom

Telecoms are especially challenged in the rising interest rate environment, to which the group is historically inversely correlated. The challenge lies in the fact that telecom net debt to equity has been rising, exceeding the levels of the Financial Crisis peaks (Figure 65).

Figure 65: Net Debt to Equity, Telecom



Source: FactSet, UBS

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Investing in options involves numerous risks. Such risks include, but are not limited to, the following: a long option position is negatively impacted by a decrease in implied volatility, lack of movement in the underlying stock or Index and the passage of time. A short option investor is negatively impacted by an increase in implied volatility, a large directional movement in the underlying stock or Index and the lack of the passage of time. For options purchased the maximum loss is the premium. For an uncovered call sold the maximum loss is unlimited, while for an uncovered put sold the maximum loss is put strike minus premium. For uncovered options margin must be posted. Because uncovered option selling involves significant risks this strategy should be under taken only by sophisticated investors.

Complex option strategies involve either the simultaneous purchase or sale of multiple options or the simultaneous purchase and sale of numerous options, such as spreads or collars. Their pay off profile and risks can be complicated, and should only be undertaken by sophisticated investors. Complex option strategies can often be broken down into individual component options, and their risks can be identified and analyzed. Complex strategies may have limited or unlimited loss potential, and in cases where uncovered options are sold margin is required to be posted.

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Neutral	FSR is between -6% and 6% of the MRA.	42%	28%
Sell	FSR is > 6% below the MRA.	11%	21%
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 2014.
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.
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