US Equity Research
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Tony Dwyer | Analyst | Canaccord Genuity Inc. (US) | TDwyer@canaccordgenuity.com | 212.389.8216
Michael Welch | Analyst | Canaccord Genuity Inc. (US) | MWelch@canaccordgenuity.com | 212.389.8217

Evidence over emotion

Use evidence over emotion. While visiting with friends over the weekend, the consistent theme of conversation was the expectation that the volatility in the current administration would end up roiling the markets and causing folks to back away from equities. On the surface, this fear seems very rational given all the problems thus far with the president's agenda, culminating around the Comey firing last week. The only problem with the thought process is that it isn't working. If we gave you the political headlines that have taken place thus far during the Trump Administration, many would have expected extreme volatility in the markets. While the volatility around Washington has made for great headlines and influenced how investors "think," it hasn't mattered one bit to how investors "act." The evidence is very clear – market volatility remains near a record low.

Why is market volatility so low? The reason for this is clear – the market correlates most closely to the direction of earnings, and that direction remains positive with no sign of recession for the foreseeable future. If any cycle has proven you need a recession for a significant and sustainable drop in equities, it is this one. We have seen multiple levels of a European debt crisis, a commodity-driven emerging currency crisis, a global populist movement in Brexit and Trump, a near hard landing in China, and increasing tensions on the Korean peninsula. All of these seemingly huge events provide evidence that investors should use every correction as an opportunity to become more offensively positioned absent a sign of a recession that causes a significant and sustainable drop in EPS.

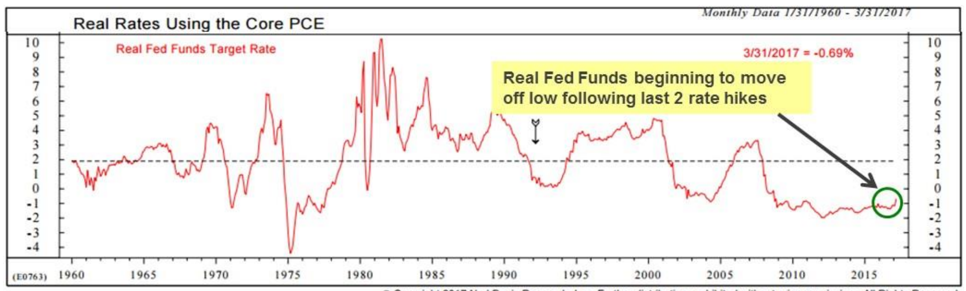
MOACs drive recession timing – and it still isn't close. By now, everyone has heard of the MOAB dropped in Afghanistan, and today we highlight the market version – "the Mother Of All Charts (MOAC) in determining the timing of a recession:

- **Historically low Real Fed Funds rate.** Over the past 60 years, there has not been a recession without the Real Fed Funds Rate using the Core PCE being at 3% or above (Figure 1), yet the current level remains in negative territory at -0.69%. That said, over the last 30 years, the increased leverage in the U.S. economy has caused the level it takes to generate a recession to be lower each cycle, and in this cycle should be no different. It may be lower than 3%, but a recession remains HIGHLY UNLIKELY while the Real Fed Funds Rate remains in negative territory.
- **Positive yield curve.** While many try to figure out the absolute level of rates that would be high enough to generate a recession, history has shown that isn't the most important determinant to recession. The key determinant of recession is the level of short-term rates that cause long-term interest rates to reflect recession fears, as reflected by an inversion of the yield curve. Using the current Fed dot plot and assuming a 2.5% U.S. Treasury 10-year Note yield, the curve doesn't invert until the second half of 2018, and the mean inversion lasts 15 months, which suggests no recession until 2020.

For important information, please see the Important Disclosures beginning on page 5 of this document.

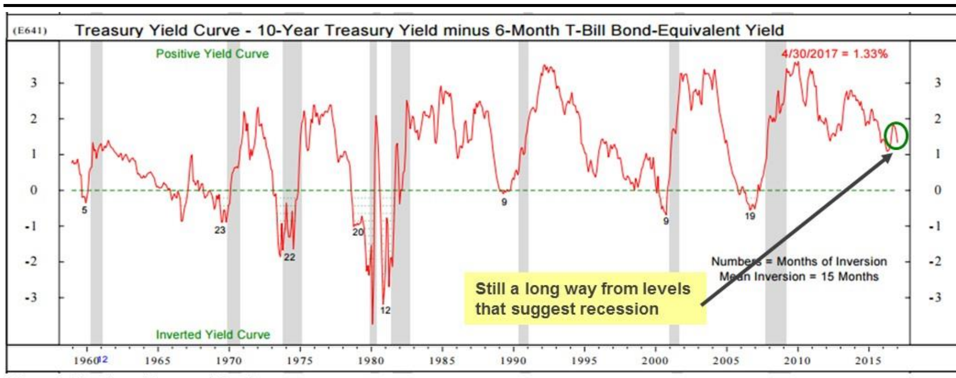
- Chicago Fed National Financial Conditions sub-indices. This is our "checks and balances" MOAC. The Chicago Fed publishes these sub-indices weekly, and uses 105 indicators to measure risk in the credit markets, banking system, and shadow banking system (Figure 3). If you surmise the Fed has lost control of managing rates and the Fed's manipulation of rates via QE has rendered the yield curve useless, then surely somewhere in the 105 indicators, there would be signs of stress. All three sub-indices spike as a recession nears, yet in the current environment, despite all the aforementioned issues, there have been no real signs of stress in any broad category of credit.

Figure 1: Real fed funds rate MOAC



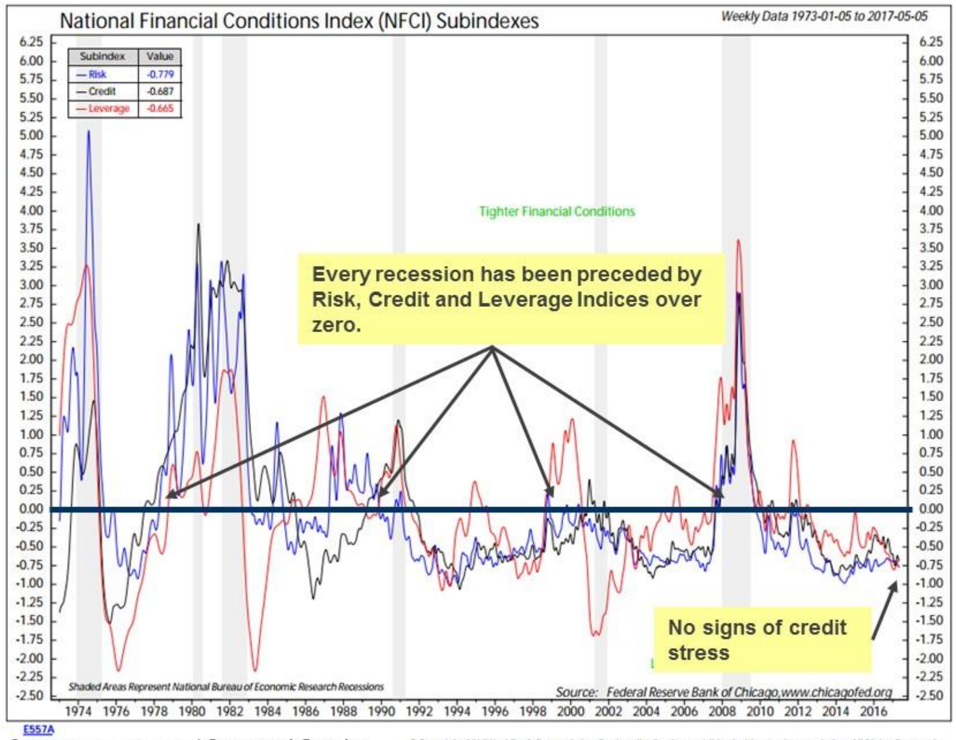
Source: www.ndr.com / Canaccord Genuity

Figure 2: Yield curve MOAC



Source: Bloomberg / Canaccord Genuity

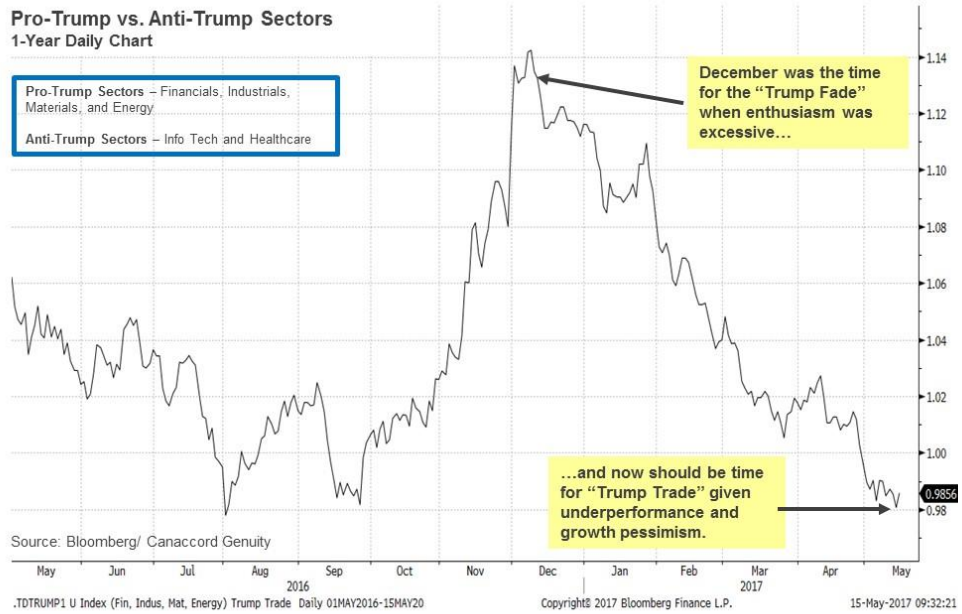
Figure 3: Chicago Fed Financial Conditions MOAC



Source: www.ndr.com / Canaccord Genuity

The MOACs dictate positive stance until at least 2019. The market peaks on average eight months prior to recession, and all three MOACs suggest a recession is at least two years away. This means any pullback in the market should be used as an opportunity to become more offensive. Although the S&P 500 (SPX) remains near record territory, outside of Info Tech the most economically sensitive areas have seen a period of significant underperformance since early December (Figure 4). As we first highlighted in Please leave your Kevlar vest at home, the pro-Trump sectors of Financial, Industrial, Energy and Materials have significantly underperformed the anti-Trump sectors of Info Tech and Health Care. In our view, the time to fade the pro-Trump sectors was in December when economic expectations were high, the global Citigroup Economic Surprise Indices (CESI) were ramping, and everyone expected the Trump agenda to get passed easily with a Republican Congress. The opposite now seems true with economic expectations being depressed, the global CESIs declining, and talk of impeachment and obstruction vs. optimism toward agenda. The evidence supported neutralizing offensive sector bets on good news, so we in turn want to buy them on seemingly less optimistic news.

Figure 4: Time to put on the "Trump Trade" that has underperformed since December



Past performance does not predict future results.

The only evidence that matters is EPS – and they look strong. The political headlines continue to trump the EPS headlines (pun intended). Ultimately, until proven otherwise, we will always fall back to the basis of our fundamental core thesis that states the market correlates most directly to the direction of EPS, and that direction remains positive. With 90% of EPS having been reported, it now appears 1Q/17 S&P 500 (SPX) operating EPS have been terrific (Source: Thomson Reuters I/B/E/S):

- Q1/17 EPS growth currently is expected to be 14.72%, led by double-digit growth in Financials and Technology, coupled with a strong rebound in Energy and Materials. Even if you exclude the Energy sector sharp rebound, EPS were still up 10.5%
- 75% of companies that have reported beat expectations by 6.1%. This is double the long-term average of 3% since 1994, and 4% surprise factor over the past four quarters. While weak 1Q/17 GDP and politics took the headlines, the evidence is something much better.
- 1Q/17 revenues in aggregate should end up 7.3%, and even when excluding the sharp jump in the Energy sector, top line revenues should be up 5.3% with 63.1% beating expectations.

Summary – We remain focused on intermediate-term potential and reiterate offensive sector position. While our key tactical indicators never reached a level that typically pulls us off the sidelines, the combination of (1) our positive fundamental core thesis remains in place, (2) the synchronized global recovery and improvement in the domestic economic data and EPS, (3) history following long-duration, low-volatility periods, and (4) increased probability of corporate tax cuts does cause us to turn our attention to the intermediate-term opportunity rather than the near-term risk. We believe our SPX 2017 and 2018 targets of 2,470 and 2,720, respectively, may prove to be conservative and would add to positions in the Financial, Industrial, Energy and Materials sectors, especially on further weakness.

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Date and time of first dissemination: May 15, 2017, 10:27 ET

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Distribution of Ratings:

Global Stock Ratings (as of 05/15/17)

Rating	Coverage Universe		IB Clients
	#	%	%
Buy	574	60.42%	39.20%
Hold	277	29.16%	19.13%
Sell	27	2.84%	14.81%
Speculative Buy	72	7.58%	68.06%
	950*	100.0%	

*Total includes stocks that are Under Review

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