MORNINGSTAR®

Market Outlook Q1 2016

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Stock Market Outlook: Late-Cycle Behavior?

We're unenthusiastic about the valuation of the broader market, but opportunities can be found in a few out-of-favor sectors.

By Matthew Coffina, CFA, Equities Strategist and Editor of *Morningstar StockInvestor*

- The S&P 500 has made up most of the ground it lost in the August correction, but it once again looks fully valued. Investors should be prepared for modest returns over the next five years.

- The market is increasingly driven by a handful of high-flying growth stocks like Amazon.com AMZN and Netflix NFLX, leaving more opportunities in out-of-favor cyclicals and value stocks. We believe investors are too pessimistic about certain apparel, energy, and industrial companies, among others.

- Depending on the metric used, the S&P has been cheaper on a normalized price/earnings basis two thirds to three fourths of the time over the past 25 years.

Late-Cycle Behavior?

While the S&P 500 is on track to end 2015 almost exactly where it started, earnings have deteriorated, pushing up valuation multiples. Earnings per share for the index are on track to decline at least 5% this year because of the strong U.S. dollar, weak commodity prices, slowing emerging-market growth, and recession-like conditions in several industrial areas of the economy. Market timing has never been our game, but we can't help but notice signs that this bull market may be getting long in the tooth: the Federal Reserve's first interest-rate hike in a decade, a lack of market breadth, investors' willingness to pay almost any price for fast-growing but unprofitable "story stocks," signs of trouble in the junk-bond market, and records or near-records in share repurchase activity and mergers and acquisitions. Even if current profit margins and price/earnings ratios are sustainable, it seems unlikely that dividends and earnings growth can support total returns above 6%–8% per year over the long run. Investors should set their expectations accordingly.

Where Our Analysts Are Finding Value

The valuation of the overall market may not leave much margin for error, but diverging returns between industries have created a few areas of opportunity. For example, although the consumer cyclical sector has posted the best year-to-date total returns, apparel firms and lower-ticket discretionary retailers have fallen out of favor. Some of the issues facing these firms are likely to prove temporary, including unseasonably warm weather, excess inventory, and a lack of new fashion trends. Other challenges are more secular in nature, such as rising labor costs and consumers' shift to online shopping. Our analysts see value in firms like VF Corp. VFC, Nordstrom JWN, and Gap GPS. In the consumer defensive arena, we believe Wal-Mart's

WMT valuation already incorporates the growth and margin pressures confronting the world's largest retailer.

Falling commodity prices continue to buffet the energy and basic materials sectors. While both will face serious financial challenges in the near term, we're more optimistic about an intermediate-term turnaround in the former than the latter. Energy markets are significantly oversupplied—a situation made worse by OPEC's refusal to scale back production, improving drilling efficiency in U.S. shale plays, and storage facilities that are being filled to capacity. However, current oil and gas prices can't support the investment needed to meet long-term energy demand, and sooner or later natural decline curves will catch up to producers that are sharply cutting back on drilling activity. Our analysts favor energy firms with low costs and relatively strong balance sheets, including Exxon Mobil XOM, Continental Resources CLR, and Cabot Oil & Gas COG. It's a different story in the basic materials sector: We see China's move away from infrastructure investment as a permanent change, and new low-cost mining capacity is coming on line that could produce at peak levels for decades. We would avoid most industrial commodity miners, but are relatively more bullish on commodities linked to Chinese consumer spending, such as gold and fertilizer.

Low energy prices, the strong U.S. dollar (which hurts export demand), and global macroeconomic worries have also weighed on the industrials sector. Our analysts' picks include conglomerate Emerson Electric EMR, mining equipment manufacturer Joy Global JOY, and a number of railroads, such as Canadian Pacific CP, Kansas City Southern KSU, and CSX CSX. The auto industry has been a rare bright spot, and we find General Motors GM and Ford F to be undervalued. Elsewhere, our analysts are finding discounted valuations for industry- and company-specific reasons in media, healthcare REITs, biotech, and Canadian banks.

Market Valuation

As of mid-December, the median stock covered by Morningstar trades with a price/fair value ratio of 0.95, roughly unchanged since last quarter. The S&P 500 stands at 2,073, implying a price/earnings ratio of 19.5 using trailing 12-month operating earnings, 26.2 using a 10-year average of inflation-adjusted earnings (the Shiller P/E), or 18.1 using trailing peak operating earnings. Those measures have been lower 67%, 67%, and 74% of the time since 1989, respectively. Valuation multiples have deteriorated since last quarter due to the combination of rising stock prices and falling earnings.

Matthew Coffina, CFA, has a position in the following securities mentioned above: XOM WMT.

Economic Outlook: Escape Velocity Not in the Cards for U.S. Growth

Slowing population growth rates and an aging population make it unlikely that the U.S. or any developed market can ever again reach sustained 3%-plus growth rates.

By Robert Johnson, CFA, Director of Economic Analysis, and Roland Czerniawski, Markets Research Analyst

- We are forecasting 2.0%–2.5% GDP growth for 2016, lower than most other economists predict, mostly driven by the consumer with little help from other areas of the economy.
- As we lap some of the biggest energy price declines, we suspect headline inflation could easily approach 2.5% by the end of 2016.
- We think analysts are overestimating starts and underestimating home-price appreciation again for 2016.
- U.S. population growth has collapsed from 1.8% in the 1950s and 1960s to 0.7% currently, which is closely correlated with slower GDP growth rates.
- At just over 3.4% year-over-year, slow credit growth is continuing to hold the economy back.

Our economic forecast for the year ahead isn't much different than our forecasts for the prior three years, namely 2.0% to 2.5% real GDP growth for the U.S. economy. That growth will again be driven by the consumer, with not a lot of help from the other major components of GDP. Government spending will be limited by extreme pressures not to raise taxes and being forced to spend more money on transfer payments and less on goods and services that more directly benefit growth.

Shifts away from brick-and-mortar stores and the rethinking of office space, as well ongoing issues in oil drilling, mean business investment spending won't provide much help, either. Net exports will likely remain a small negative as slow world growth, ongoing issues in the commodity complex, and a strong dollar will all hurt exports, while consumers are likely to snap up ever-cheaper imported goods. Residential spending should continue to add a few tenths of a percent to GDP growth, but our belief is housing growth will not accelerate from current levels.

All in, our 2.0%–2.5% growth rate is lower than the 2.5%–3.0% growth that the Fed and most economists are estimating. Over the past few years, most forecasters have believed that growth would accelerate in the year ahead, with the economy reaching some type of escape velocity and eventually a 3.0%–3.5% growth rate, if not more. However, both slowing population growth rates and an aging population make it extremely unlikely that the U.S. or any developed market can ever reach those types of growth rates on anything but a very short-term basis. That is part of the reason that economists have had to scale back their cheery December forecasts, often as soon as the following March.

U.S. Economic Forecast

	2012	2013	2014	2015 Dec. Estimate	2016 Dec. Estimate
Real GDP Growth (%) (Full Year)	2.3	1.5	2.4	2.4–2.6	2.0–2.5
Real GDP Growth (%) (Q4 over Q4)	1.3	2.5	2.5	2.0–2.4	2.0–2.5
Core Inflation (%) (Q4 over Q4)	1.9	1.7	1.7	2.0	2.2–2.4
Emp. Growth (Avg. Jobs Per Month)	188,000	199,000	260,000	220,000	220,000
Unemployment Rate (%) (Dec)	7.9	6.7	5.6	4.9	4.7
10-Year Treasury (%) (Dec)	1.80	3.04	2.17	2.2	3.0–3.5
Home Prices (%) (FHFA Q4 to Q4)	5.6	7.2	5.0	5.5–6.0	5.8–6.2

Source: Morningstar Estimates

Most of our other forecasts fall out of our low GDP growth predictions and the aging population dynamic. For example, employment growth generally trails GDP growth as office and factory workers become more productive. Looking ahead to 2016, we expect employment to grow at 1.9%, which is slower than our 2.25% central tendency GDP forecast for 2016, because of that productivity factor. We are forecasting both employment and GDP growth rates in 2016 to be similar to 2015. That percentage converts to the more commonly reported 220,000 jobs per month, or 2.6 million per year. That growth is likely to favor services jobs over manufacturing and government in the year ahead.

Interestingly, because of the dynamics of a shrinking working-age population, the rate of unemployment fell much faster than expected in 2015 to 4.9%, even though most forecasters overestimated the number of jobs per month that would be added. A combination of retiring baby boomers, teens staying in school longer, and skills or wage mismatches have caused some potential workers to drop out of the job market. Those same phenomena are likely to drive unemployment even lower in 2016, even though overall economic and employment growth rates are unlikely to get much better next year.

Core inflation has been relatively tame over the past three years (excluding food and energy), at just under 1.7%, with some pick-up in 2015 to 2.0%, due to rising rents and increased healthcare costs. Those same dynamics, plus increased shortages of workers, could push core inflation even higher in 2016, to the 2.2%–2.4% range.

Falling oil prices have largely masked the steady increases in services inflation in 2015. However, as we lap some of the biggest energy price declines, we suspect headline inflation (food, energy, and everything else) could easily approach 2.5% by the end of 2016. A geopolitical event or OPEC clamping down on production could push overall inflation closer to 3%.

The demographics of spenders and slow growth overall should keep inflation from getting out of hand. Still, 3% inflation could be a bit of shock to some. All in, 4% inflation is usually when big economic problems set it in. Hopefully, things won't get that bad in the short term. The housing market, though improved, was a disappointment in 2015, with housing starts falling almost 100,000 below the consensus forecasts of 1.2 million units. Weather, worker shortages, and a lack of available land all weighed heavily on housing starts. Lower-than-expected housing starts are why most GDP forecasts were too aggressive for 2015.

The shortage of new homes caused the prices of existing homes to go up almost 6% in 2015, handily outpacing the consensus forecast of under 4% price appreciation. We think analysts are overestimating starts and underestimating home-price appreciation again for 2016. Ramping up housing production is not easy. And where housing demand is high, there are few available lots to build on. That problem is particularly visible in California and New York City.

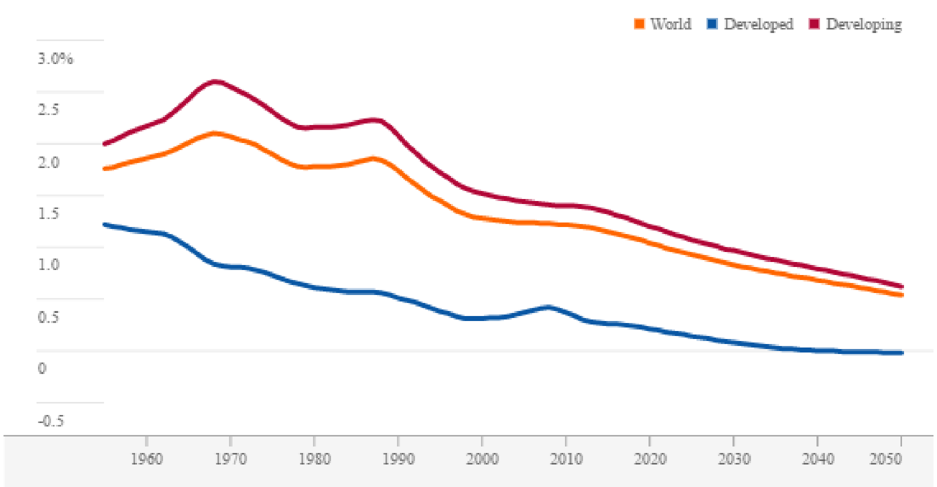
Although we've had three years of good GDP forecasts, our calls on interest rates have not been as accurate. We have always believed bond yields would be some type of spread above inflation. For example, we believe that the 10-year U.S. Treasury rate should be about 2% above inflation. We thought inflation would be about 1.5% in 2015, for a total forecast of 3.5%. Instead, headline inflation for 2015 will be well under 1%, due to falling energy prices. And the Fed delayed starting interest rate normalization until the very end of the year (versus March or June expectations) because of an economic slowdown in China and other commodity-related emerging markets. Easy monetary policies in other world economies also kept U.S. rates lower than they would have been otherwise. With the normalization now started (and we expect several more Fed rate increases in 2016), and inflation moving modestly higher, we continue to expect the 10-year Treasury rate to be at 3.0%–3.5% by the end of 2016.

Population Growth Slowing Not Just in the U.S. But Around the World (by Roland Czerniawski)

We have previously produced a lot of charts showing how dramatically population growth has slowed in the U.S. through a combination of slower immigration rates and lower fertility rates. U.S. population growth has collapsed from 1.8% in the 1950s and 1960s to 0.7% currently. That diminishing population growth is closely correlated with slower GDP growth rates. Unfortunately, the U.S. is not alone. Population growth globally has slowed just as dramatically.

Going back to 1955, developing economies (also known as emerging markets) were in the midst of a population boom that culminated in a peak population growth rate of around 2.5% in the late 1960s. At the same time, developed economies were already experiencing a decline from a modest 1.2% rate. It is worth mentioning that in the 1950s, developed economies accounted for about 30% of the world population, while emerging markets comprised the remaining 70%.

The following decades have seen a gradual decline in population growth rates in both developed and emerging economies, caused by gradually declining fertility rates. The average number of children per woman declined from a world average of 5 in the 1950s to 2.5 in 2015. As a result, Population Growth, Year-Over-Year



Source: United Nations

today's world population growth rate stands at around 1.2%. Current population growth for developed economies is even lower, as fertility rates in many European countries and Japan have declined dramatically.

Developed economies make up only 16% of today's world population, no longer the 30% of the 1950s. The United States accounts for about a quarter of the developed-world population, and among those nations, it has above-average population growth, which today stands at around 0.7%. This makes the U.S. long-term economic outlook more favorable compared with most developed economies.

Going forward, fertility rates are expected to decline further, and world population growth is expected to fall to 0.5%, while population growth for the developed economies is expected to dip into negative territory in the late 2040s. This already has and will continue to be a long-term headwind to global growth. Without much help from population growth, the world will have to rely on increased productivity in order to maintain current growth rates.

Slow Credit Growth Is Continuing to Hold the Economy Back

While one can argue about the virtues of debt, without debt to amplify incomes, overall economic growth is considerably lower than it would be if debt were growing at a sensible level. Although debt levels that get out of hand are damaging, shrinking debt levels aren't all they are cracked up to be, either, because that means the economy will generally grow more slowly than incomes if debt is falling.

The Federal Reserve provides aggregate debt data that includes household debt, business debt, and even government debt. Business, federal government, and consumer debt levels are approximately equal, and the state and local government sector is 80% lower than the other three sectors.

Total Domestic Nonfinancial Debt, Year-Over-Year Growth

Source: Federal Reserve

2015 Uses Q3 Over Q3

Clearly the 9% debt growth recorded in the early 2000s was not sustainable or healthy. Those high debt growth rates at least partially explain why overall GDP and consumption growth looked relatively healthy, despite very poor wage gains. Now things have swung in the other direction, with recent debt growth at just 3.4% year over year.

Of the four major segments, only business debt is growing at its long-term average rate (about 7%). Combined, governments (federal, state, and local) are growing at under 2%, below long-term averages that are closer to 6%. Even household debt growth is running at only 2.1% currently, as the mortgage debt growth portion remains nonexistent. (Some other consumer debt is beginning to increase at more normal levels.) Even some of the business debt growth is suspect, because many of the proceeds from bond offerings, made opportunistically to take advantage of favorable exchange rates and interest rates, are still sitting on corporate balance sheets doing little to support economic growth.

Again, we are cognizant that too much credit and debt is not a good thing, but nonetheless it looks as if slow credit growth is continuing to hold the economy back. The annual 3.4% credit growth appears to be below the combined total of real GDP growth of 2.5% and inflation of 2% for a total of 4.5%, which seems to be a fair approximation of how fast debt should grow if it were at optimal levels.

Anecdotally, some areas of the economy have had easy access to credit and are returning to normal (autos), while tight credit has kept the housing industry running at only half of its all-time high. A modest easing of credit terms could prove to be a big help for the economy, if not taken to extremes.

Sector Reports Highlight Commodity Complex Issues, Extreme M&A Activity, Emerging Markets

Many of our quarter-end sector reports highlight the effects of a slowing commodity complex—much of that stemming from a slower-growing China. Unfortunately many countries and companies are seeing the unexpected side effects of cheaper oil and cheaper goods in the form of fewer exports and a softer manufacturing sector. Consumer savings haven't yet fully offset some of these negative effects.

Many of the sector reports indicate that emerging markets and commodities could get a little worse before they get better, but dirt-cheap commodities can't last indefinitely. China is still a land with a lot of growth potential. In addition, while a lot of commodity-oriented emerging markets are doing poorly, many others are net commodity importers and could potentially do better going forward, including India. One label for all emerging markets doesn't help investors very much anymore.

Our analysts also continue to discuss all the mergers and acquisitions as well as stock buybacks. Corporations continue to generate a lot of cash and have ample borrowing facilities. Unfortunately, low growth rates and more interest in services than manufacturing are causing businesses to limit (or not need to make) capital expenditures. Instead they are deploying that cash buying competitors or their own stock. With such low interest rates, those activities can quickly enhance short-term earnings without all the risks of a new greenfield plant. However, that doesn't do much for GDP and employment growth.

Credit Markets: Volatility and Spreads to Remain Elevated

Headwinds including M&A, weak commodity prices, and Fed tightening should keep spreads at elevated levels.

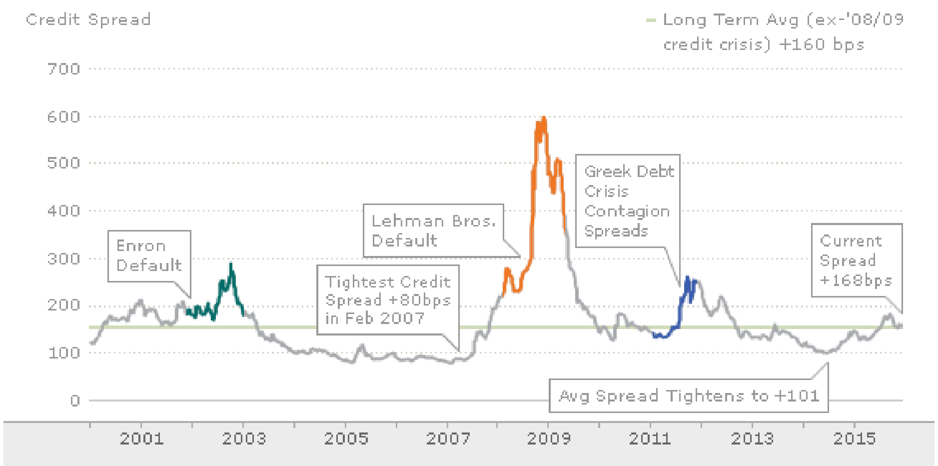
By Rick Tauber, Director of Corporate Bond Research

- Spreads in investment grade and high yield remain near year-to-date wides.
- Weak commodities prices are pushing some high-yield credits toward default.
- The first Fed tightening cycle in almost a decade is upon us.
- Steady but low GDP and a strong consumer provide support to credit.

We expect volatility to remain elevated in the first quarter, with spreads staying range-bound at or near year-to-date wides. We expect the ongoing headwinds of weak commodity prices and debt-funded mergers and acquisitions to continue. Pressure on the energy and metals and mining sectors, which got hit hard in the fourth quarter, does not look likely to abate, per our sector analysts. Still, we expect mild economic growth to continue domestically, which along with spreads at above-average levels should provide support to valuations.

We view the investment-grade market as fair to slightly expensive, even at levels slightly wider than long-term averages, given weaker credit quality and poor technicals. Investment grade has been whipped around this year by a number of factors including record M&A activity, and spreads of +168 basis points as of Dec. 16 on the Morningstar Corporate Bond Index are +28 bps wider on the year and wide of the +160 bps long-term average (excluding the financial crisis). Spreads are also well wide of the recent tights of +101 bps in July 2014. With negative top-line growth and operating margin pressure, companies have looked to other sources to boost growth and value, including massive share repurchases. This has led to record new bond issuance, which has also contributed to spread widening over the course of the year. However, the index is trading about +20 bps inside of its wide level for the year of +188 bps reached on Sept. 30, whereas the high-yield market is about +30 bps wider since then. This is partially due to the composition of the investment-grade index, which has fewer energy or metals and mining names and many more financials. The latter performed very well in November. We expect M&A to taper off from record levels in 2016, which could eventually ease the burden on the investment-grade market. However, new issue supply from deals announced but not yet funded remains substantial and could put pressure on spreads in the first quarter. We also expect fourth-quarter earnings results to largely be mixed, given the confluence of global economic weakness and pressure from declining prices in the commodity sectors. Management guidance for 2016 revenue and earnings has the potential to disappoint, in our view. Finally, our list of ratings under review with negative implications (UR—) far exceeds our list of ratings under review

Morningstar Corporate Bond Index Average Credit Spread

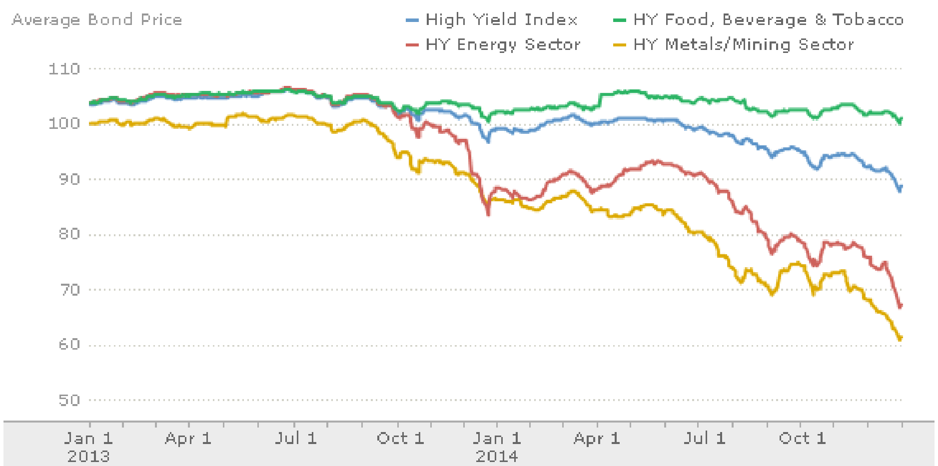


Source: Morningstar
Data as of 12/16/2015

with positive implications (UR+), and our downgrade/upgrade ratio remains heavily slanted to recent downgrades, suggesting that credit quality is weakening. As such, we see spreads as most likely to be range-bound, with widening out to the year-to-date wides as possible.

We view high yield as fairly valued to slightly expensive near year-to-date wide levels as we see the market pricing in a substantial ramp in defaults from the energy and metals and mining sectors. High-yield spreads, as measured by the BofA Merrill Lynch High Yield Master II Index, reached new year-to-date wides of +683 basis points on Oct. 2, tightened over 100 bps a month later, and then rose to a new high of +733 bps as of Dec. 14 before settling back to +698 bps on Dec. 16. Yields are also near year-to-date wides at 8.79%, driven by ongoing weakness in the energy and metals and mining sectors. We see the high-yield market as remaining bifurcated, with some of the more consumer-oriented sectors trading at tight but sustainable yields and some of the commodity or industrial sectors trading at yields well wide of the index. For example, the food, beverage, and tobacco sector of the index yields just over 6% despite an average rating of high B. The energy sector yields almost 15% despite a similar high B average rating.

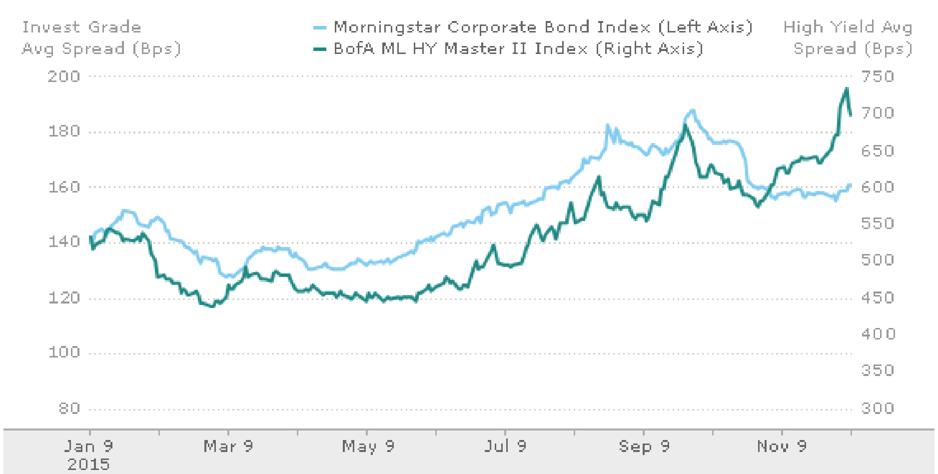
Bank of America Merril Lynch High Yield Index



Source: BofA Merrill Lynch Global Indexes Data as of 12/16/2015

The latter will also eventually suffer elevated defaults, and we expect overall market default rates to increase well above the 2%–3% range we have seen, although probably not in the first quarter. As such, high-yield performance will continue to be driven by sector selection, and we lean toward more conservative sectors. The bulk of our best ideas have been higher-rated credits throughout the year. We also worry about the recent trends of sharp fund outflows combined with poor liquidity leading to gap-downs in bond pricing. This has mostly permeated the weaker sectors, but if fund managers are forced to look to higher-quality names to raise cash, this could add pressure to the whole market.

Corporate Credit Spreads



Source: Morningstar, BofA Merrill Lynch Global Indexes Data as of 12/16/2015

Supportive of credit is the economic outlook provided by Robert Johnson, Morningstar's director of economic analysis. He continues to forecast that real GDP will expand 2%–2.5% in 2016, similar to the level that he accurately predicted over the past several quarters. Positive slow economic growth despite global headwinds, a gradually improving jobs story, and a boost to consumers from lower commodity prices can all support corporate credit.

Potentially complicating the outlook is the fact that we are at the front end of the first Federal Reserve tightening schedule since 2006. With much of the rest of the world easing or providing artificial support to markets, this could result in ongoing support to the dollar but stunt revenue and operating income at global U.S. companies. Still, we see the Fed's approach as likely to be very methodical, with strategic rate hikes over an extended period, assuming the economy holds up. Initially, we don't believe this will have a meaningful impact on the important two thirds of the economy that remains in growth mode, the consumer. We don't expect any Fed moves to substantially drive intermediate-or long-term interest rates higher, although that remains a risk as investors could move to the sidelines on corporate bonds similar to when the taper tantrum occurred in 2013.

Fed Expected to Take a Go-Slow Approach on Tightening

After seven years of a near-zero interest rate policy, the U.S. Federal Reserve raised the short-term federal-funds rate above 0% with its recent 25-basis-point increase, which was widely anticipated. The rise in the fed-funds rate is the first in nine years and is the beginning of what the Fed hopes to be an interest rate normalization process after years of emergency monetary measures. However, even the Fed acknowledges the process will probably be slow and gradual, with the U.S. economy grinding out expected growth in the 2%–2.5% range when measured by GDP. This begins the sixth tightening cycle since 1979; traders are currently expecting another two or three rate increases in 2016.

The latest U.S. core CPI (year over year) was measured at 2.0%. This statistic has averaged 1.7% over the past seven years and, after considering hedonic adjustments for quality changes and substitution effects by the Bureau of Labor Statistics in calculating, it is effectively at the Fed's goal of 2%. In other words, the real money interest rate has been at negative 2% for seven years. Moreover, the Taylor rule model, a monetary-policy rule that stipulates how much a central bank should change the nominal interest rate in response to changes in inflation, output, or other economic conditions, states that the fed-funds rate should already be at 2.5%. The move at this point to normalization is very much desired by the members of the Fed; however, it is in uncharted waters after the unprecedented monetary measures of the past seven years, which among other things added an extra $3 trillion to the Fed's monetary base.

Some believe that this rate increase may be limited with the economy less than robust and high-yield credit markets signaling some distress in the economy. Additionally, there is a developed-market central bank divergence in monetary policy, with the European Central Bank and Bank of Japan loosening monetary policy and the Fed strengthening. Continued rising fed-funds rates would increase this divergence and further strengthen an already-strong U.S. dollar, which would further pressure U.S. multinational profits and emerging-market economies, 10-Year U.S. Treasury Less 2-Year U.S. Treasury Spread

Source: St. Louis Federal Reserve
Data as of 12/16/2015

depending on export of commodities. Finally, 2016 is a presidential election year, and while there exists precedent for rising rates (fed funds) in such years, it is usually occurs when the U.S. economy is much stronger.

One thing, among many, that the data-dependent Fed will be monitoring is the 2-year–10-year U.S. Treasury spread. Generally speaking, when this spread goes to zero or negative, the economy typically enters into recession. Four of the past five tightening cycles since 1979 eventually produced a zero or negative spread and a subsequent recession.

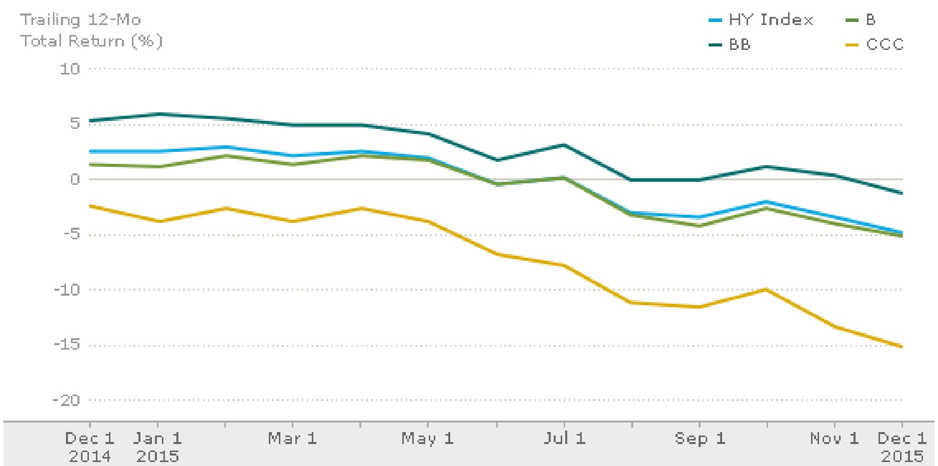
We believe the Fed will be tentative and slow with its rate rises, observing how they affect longer Treasury rates as well as general economic and credit conditions. In particular, the Fed will closely monitor how rising short-term rates affect overall credit growth trends in the United States. Also, we believe the Fed would be quite tolerant of inflation above 2% for a while as a trade-off for a strengthening economy.

Contributed by Sean Sexton, CFA

High-Yield Outlook

Spurred by renewed weakness in energy and commodity prices, credit spreads on high-yield corporate bonds resumed a widening trend over the past few weeks, reversing a spread recovery throughout early November. For the quarter through Dec. 16, the BofA Merrill Lynch High Yield Index has returned negative 2.4% and is on track to suffer its first losing year since 2008. For the year to date, the return on the BofA Merrill Lynch High Yield Index is now down 4.9%. For comparison, the S&P 500 is still up 3.0% year to date including dividends, and investment-grade corporates are down 0.7% on a total return basis.

High Yield Total Returns by Rating Category

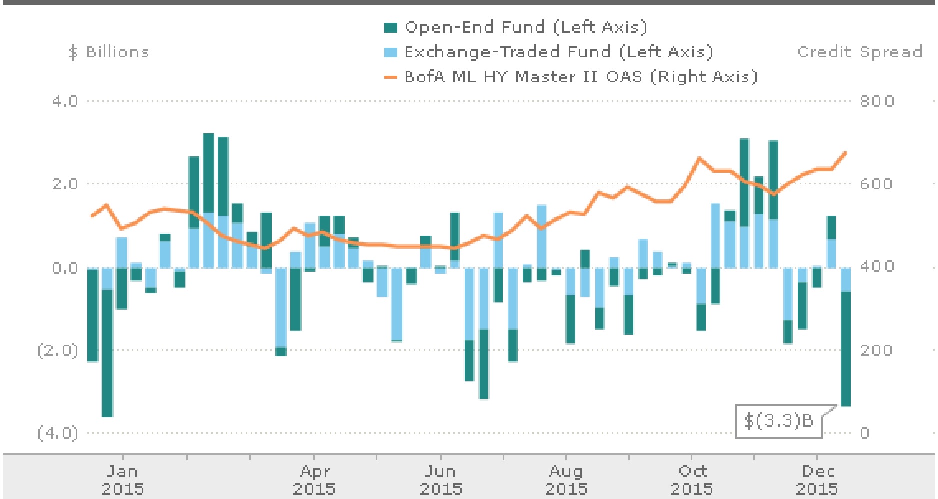


Source: Morningstar, BofA Merrill Lynch Global Indexes Data as of 12/16/2015

Weakness in high-yield spreads has had a material impact on several recent new issue transactions over the past few months. For example, Frontier Communications' $6.6 billion issuance of senior notes in late September met with a very lukewarm reception, pushing 10-year pricing to 11% at issue. In secondary market trading during October, the price on the new Frontier 10-year senior notes declined, with the corresponding yield widening out to as much as 12% before finding support. However, after subsequently tightening into around 10%, it has since traded back out toward the wides. Also affected was a planned senior note financing to fund Carlyle Group's pending acquisition of Symantec's Veritas information management business, which has been delayed by weak high-yield market conditions. As a result, the banks that committed to short-term bridge financing are unable to reduce their exposure. This in turn has negatively affected leveraged loan pricing, particularly for highly speculative credits. Over the past three months, the average bid price on large corporate loans has slid 2 points to an average of $95 according to data from S&P Capital IQ. The S&P/LSTA Top 100 Loan Index lost 0.88% during November, and year to date it is up just 0.4% compared with the BofA Merrill Lynch High Yield Index, which is down 4.9%. We also attribute the weak recent performance in loans to a technical squeeze as a result of the convergence of a higher supply of new loans last month, concurrent with a slowdown in demand for paper, particularly in the lower rating categories.

As the year has progressed, higher spreads have dramatically slowed the pace of high-yield new issuance, which is now down 11% compared with a year ago. This is a marked slowdown from earlier this year as issuance volume in the first quarter of 2015 was up 44% above the prior year. Year to date, CCC rated corporate debt delivered the worst performance, with a negative return of over 15% as demand for the most speculative credit has dried up. This effect has been exacerbated by migration into the category from ratings downgrades. Meanwhile, operating pressures continue to mount for many high-yield names, particularly those in the energy and basic materials sectors.

Estimated Weekly High-Yield Bond Fund Flows and High Yield Credit Spreads



Source: Morningstar, BofA Merrill Lynch Global Indexes Data as of 12/16/2015

High-yield outflows have risen sharply as investors have fled the high-yield market. High-yield mutual funds and exchange-traded funds registered a $3.3 billion outflow the first week of December, the second-greatest outflow over the past 52 weeks, dominated by open-end fund redemptions. In recent weeks, two high-yield funds, Third Avenue's $2.4 billion Focused Credit Fund and a $400 million distressed credit fund managed by Stone Lion Capital Partners, were reported to have suspended redemptions as asset liquidity has deteriorated.

In 2016, we expect default rates to increase, and we also expect additional downward rating migration. As we head into the first quarter, we believe investor sentiment is more likely to remain risk averse. We expect higher-quality to continue to outperform low-quality paper, assuming energy and commodity prices remain weak. However, the desire to reduce exposure and access liquidity across the asset class is likely to suppress returns for even the strongest names. In this context, we currently view high-yield valuations to be fair to slightly overvalued.

Looking ahead to 2016, the 800-pound gorilla in the room is Dell's proposed leveraged buyout of EMC for $67 billion. The transaction, if consummated, will involve $59 billion of debt, currently in the form of committed and syndicated bridge loan financing. For comparison, the largest high-yield bond deal so far this year was Charter Communications' $15.5 billion to finance its acquisition of Time Warner Cable. The Dell transaction is targeted to close in mid-2016 but could face challenging financial market conditions if current trends persist. However, even if market conditions improve, the sheer size of any public refinancing of this debt package could quickly overwhelm available market demand for paper, crowding out other potential issuance and keeping pressure on secondary yields.

Contributed by Michael Dimler, CFA

Rick Tauber does not own shares in any of the securities mentioned above.

CMBS Outlook: Market at a Crossroads

While issuance volume of U.S. commercial mortgage-backed securities should increase, uncertainty abounds.

By Ken Cheng, Managing Director CMBS New Issue and Valuation Services

- The U.S. commercial real estate sector continued to grow in 2015, driven primarily by the domestic economic recovery.

- Prospects for CMBS market growth in 2016 are bolstered by a spike in the CMBS loan maturity pipeline over the next two years, but recent spread widening and volatility, along with pending regulatory requirements, threaten the ability of originators to take full advantage of this massive volume.

- Originator underwriting standards continued to decline. Less amortization, more aggressive cash flow projections, and greater exposure to tertiary markets raised investor concern and pushback. Rating agencies responded likewise by increasing credit-support levels.

Heading into 2016, while we expect issuance volume of U.S. commercial mortgage-backed securities to increase, uncertainty abounds, as factors such as spread volatility and the resultant higher funding costs weaken the ability of CMBS lenders to take full advantage of the expanded financing opportunities presented by an influx of maturing CMBS loans.

The U.S. CMBS market jumped out of the gates in 2015 with $54.49 billion of private-label issuance during the first half of the year, up 33.4% from a year earlier, but met headwinds in the second half of the year, as investors pushed back on declining loan quality and deal fatigue. The $99.8 billion of U.S. issuance as of December 11 exceeds the $94.08 billion of issuance in all of 2014 but falls well short of the $124 billion average prediction by a panel of CMBS specialists at the beginning of the year in a survey by the industry publication, *Commercial Mortgage Alert*.

CMBS Market at a Crossroads

Spurred by continued improvements in the commercial real estate sector, 2015 marked the sixth year of steady growth for the CMBS market since it effectively shut down in 2008. With a few more transactions scheduled to go to market by the end of the year, U.S. CMBS issuance for 2015 is within reach of the $100 billion milestone for the first time since 2007. Conduit transactions remain the largest segment of the CMBS market, accounting for 60.5% of the $77.61 billion issuance as of the end of the third quarter, according to Commercial Mortgage Alert. Conduit transactions comprise diverse portfolios of mortgage loans secured by properties such as office buildings, retail centers, hotels, and warehouses, as well as multifamily properties.

With a massive CMBS loan maturity pipeline totaling $181.80 billion over the next two years and prospects for continued growth in both the national economy and commercial real estate sector, conditions are ripe for significant growth in the CMBS market. Though the majority of the maturing loans were originated with higher leverage during the peak of the past commercial real estate cycle in 2006 and 2007, and prospects for refinancing were thought to be challenging just a few years ago, the growth in rents and occupancy levels afforded by a recovering economy, along with relatively low new construction and favorable financing conditions (low interest rates) have substantially increased the number of loans that are likely to refinance.

Based on Morningstar Credit Rating's experience covering most of the domestic CMBS universe, our historical analysis indicates that an 80% loan-to-value threshold is a reliable barometer of a loan's likelihood to successfully payoff on time. Applying this metric, we expect 60% to 70% of the $76.77 billion in the 2016 loan maturity pipeline to be able to obtain refinancing. That said, we have also observed an increase in the market's appetite to provide take-out financing on loans backed by properties with higher LTVs, as property fundamentals continue to improve, capital becomes more abundant and competition among CRE lenders heats up. All this could lead to refinancing opportunities beyond our expectation.

Several factors may limit the growth in CMBS issuance. As the number of loan originators expanded to 50 from 36 at the start of the year, increased competition for loans led to further deterioration of originator underwriting standards. While loan leverage increased slightly, the combination of more aggressive cash flow projections, increased use of interest-only payment terms, and greater exposure to tertiary markets heightened investor concern. Paired with volatility in the credit markets, investor pullback caused CMBS conduit spreads over swaps to widen significantly in the second half of 2015 with lingering effects heading into the new year. Benchmark 10-year AAA spreads that were in the mid-80s basis-point range for transactions originated in April were as wide as 140 basis points as of early December.

The increased funding cost has further eroded the ability of CMBS conduit lenders to compete against other CRE lenders such as life insurance companies, banks, and specialty lenders. The spread volatility has made many arrangers more reluctant to lock in lending rates early and, in turn, decreased the certainty of execution for borrowers. This further weakened the competitive standing of the CMBS lenders.

Transaction size is another factor limiting conduit market growth. General investor reluctance to take on large positions constricted the size of offerings, with average deal size dropping to $1.1 billion from $1.2 billion a year ago, per a Deutsche Bank market research report. The final quarter of this year saw a number of transactions issued with balances below $800 million, though this might be partially attributed to deal fatigue. These deal sizes are a far cry from the $3 billion conduit deals issued precrisis.

Heading into 2016, amid a rising interest-rate environment, Morningstar expects borrowing costs to increase, but this would affect all commercial real estate lenders and not necessarily put CMBS originators at a competitive disadvantage. More than the interest-rate environment, regulatory changes will have a bigger impact on the CMBS market. Risk-retention rules are set to take effect on Christmas Eve in 2016. As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, this rule requires the arranger of asset-backed securities, including CMBS, to retain at least 5% of the credit risk of the assets collateralizing the securitization. Once in place, risk retention will increase the funding cost of CMBS loans, thereby further eroding the ability for CMBS lenders to compete against other sources of financing. With this rule looming, CMBS lenders and arrangers are incentivized to maximize production in 2016.

CRE Fundamentals Continue to Improve

In spite of these factors, the CRE market is expected to continue to improve in the foreseeable future. The CRE market has historically been highly correlated with the general economy, and there is little reason to believe this link will be broken. Demand for office space rises as the economy grows and more white-collar jobs are created. Demand for retail space increases as household income and consumer confidence improve and discretionary spending grows. Occupancy rates at hotels jump as work-related travel increases, and families take more vacations. In the absence of excessive new construction, the unmet demand leads to higher rental rates and occupancy rates.

National economic conditions continue to improve. According to the U.S. Bureau of Labor Statistics, the unemployment rate stood at 5.0% as of November, down 0.8% over the past 12 months. This rate of unemployment is the same as that at the beginning of the Great Recession and well below the peak of 10.2% recorded in October 2009. Among the unemployed, 25.7% fell into the long-term unemployed category (defined as jobless for 27 weeks or more). This is well below the same statistic of 46.0% recorded in the May 2010.

The improvement in the CRE sector is borne out in U.S. national level statistics provided by CoStar Group Inc., a provider of commercial real estate information, in a series of third-quarter 2015 reports.

- Office properties: The office market in most geographic regions across the country continued to strengthen. At 11%, the vacancy rate is at a real estate cycle low and is below the rate during the 2006–07 market peak in more than half of the major metropolitan areas. Year-over-year rental growth of 4.3% exceeds the 3.8% growth rate in the year-earlier quarter; net absorption, which measures the rate at which space is rented, was 14% higher than the same period last year. There are some local exceptions to this picture of growth such as Houston, which is feeling the effects of depressed energy prices.

- Retail: Retail real estate fundamentals continue to strengthen, with the vacancy rate down to 5.9% from 6.4% in the year-earlier quarter and year-over-year rent growth at a moderate 2.7%. Rents, however, remain depressed at 7% below the prerecession peak; net absorption, while positive, is 28% below the historical average. The drop in vacancies is mostly attributed to a slow pace of new development during the recovery. Performance in this sector is bifurcated, with functional centers generally able to maintain near full tenancy, while noncompetitive centers, such as dead malls, languish.

- Warehouse and Distribution Centers: At 8.1%, the vacancy rate is below the all-time high of 13.3% in mid-2010, but supply may be catching up with demand because the third quarter is the first since the beginning of the recovery that the national vacancy rate did not decline. Rent growth remains healthy at 5.4% on the heels of the year-earlier quarterly rate of 4.7%. Net absorption is positive and is 70% above the historical average.

- Multifamily: The vacancy rate remained flat at a historical low of 3.7%, and net absorption remained positive despite new construction. While year-over-year rental growth was a solid 4.3%, the vacancy level is well below the historical average of 5.5% as market specialists ponder whether multifamily market fundamentals changed after the recession. With the pace of new construction accelerating, future multifamily property performance will rest upon the continuation of recently observed behaviors such as the preference of young renters to rent an apartment rather than own a home.

- The hotel sector performance continued to improve, with revenue per available room, commonly referred in the industry as RevPAR, increasing by 6.7% year-over-year as of the third quarter, according to Jones Lang LaSalle Inc., a commercial real estate services firm. Benefitting from robust demand and restrained new construction, RevPAR has now increased for six consecutive years, and occupancy rates are approaching historical highs. Notable exceptions are New York, where year-over-year RevPAR fell because of new supply, and Houston, where RevPAR declined amid slumping energy prices.

Credit-Enhancement Levels Increasing

As loans are originated with more aggressive cash flow projections, less amortization, and more exposure to tertiary markets, credit-support levels have generally increased to address the additional risk. To illustrate this observation, we compare credit-enhancement levels for the natural AAA securities in conduit deals, issued during the final quarters of this year and 2014. Typical credit-enhancement levels for these securities were mostly between 23.0% and 24.25% during the current fourth quarter, up from levels mostly in the 22.375% to 23.625% range a year earlier. A couple of deals were issued during this current quarter with credit-enhancement levels of 25.0% and 25.5%. The highest credit-enhancement level issued a year prior was 24.625%. The rise in credit-support levels places CMBS lenders at a disadvantage to other CRE lenders as more subordinated classes of certificates bearing higher interest rates are issued.

The correlation between loan quality and credit-enhancement levels provides some comfort that rating agencies such as Morningstar Credit Ratings continue to maintain their underwriting standards and portfolio risk assessment. The difference in credit levels across deals also reflects differentiation between the risk profile of transactions.

To recap, heading into 2016, we expect the national economy to continue to expand, and because a rising tide lifts all boats, for the CRE market to continue its upward trajectory. Likewise, the CMBS market should remain robust, yet restrained by the combination of rating agency diligence and investor pushback serving as brakes against deteriorating loan underwriting standards. While the size of the CMBS market may never return to the heights of precrisis issuance, these restraints, which were missing during the boom years of 2005–07, enhance the prospect for the sustained, long-term viability of CMBS as a CRE funding vehicle. After all, history has taught us that the economy is cyclical, and the growth we've enjoyed these past few years, and perhaps for a few more years, will eventually reverse course.

Basic Materials: Faltering China Continues to Define the Outlook for Most Commodities

Despite significant share price declines in recent months, the materials sector is not a land of investment opportunity.

By Daniel Rohr, CFA, Director of Basic Materials Equity Research

- Despite significant share price declines in recent months, the materials sector is not a land of investment opportunity. The average stock under our coverage trades at a 6% premium to our assessment of intrinsic value. However, the mean masks significant dispersion of valuation assessments.
- We continue to forecast weak Chinese fixed asset investment and commensurately tepid demand growth for related commodities such as copper and iron ore.
- We remain relatively bullish on commodities oriented to the Chinese consumer but nonetheless expect Chinese household consumption growth to decelerate from the trailing 10-year average.
- Companies are responding to tectonic shifts in the macroeconomic environment by reorganizing their portfolios. Miners coping with poor Chinese demand and weak commodity prices are looking to sell assets and shrink. Agricultural chemical companies have taken a different approach. Faltering crop prices have prompted many to seek mergers in a bid to cut overhead and grab synergies.

We remain negative on the outlook for Chinese fixed asset investment, a view we've held since 2011. Overcapacity abounds across the Chinese economy, from real estate to manufacturing to infrastructure. Excess investment has manifest in a worryingly high debt-to-GDP at the macroeconomic level and struggling manufacturers at the company level. The recent slowdown in FAI is therefore more of a structural than a cyclical phenomenon. We expect, at best, 1.5% growth in Chinese FAI in the next five to 10 years.

This will have profound implications for most mined commodities, since China's investment-led growth model underwrote nearly all demand growth in the last decade. For example, we believe China's copper demand has peaked and should shrink as real estate activity fades to a level more commensurate with underlying urbanization trends and power infrastructure spending pivots from copper-hungry distribution outlays to copper-light transmission outlays. We expect copper prices to slip below $2 per pound in 2017 and, in contrast to most forecasters, do not expect a sustained recovery to the $2.50–$3.00 range in subsequent years.

We remain relatively more bullish on commodities oriented to the Chinese consumer, as well as the stocks of companies that produce those commodities. Although we expect Chinese household consumption growth to decelerate, it should nonetheless perform much more strongly than the investment side of the economy. Our positive long-term gold outlook reflects this thesis. Although we expect gold prices to slip below $1,000 per ounce in 2016 as faltering investor interest in the yellow metals weighs on total demand, we believe sustained jewelry demand growth in China and India will lead gold prices on a sustained recovery thereafter, touching $1,300 per ounce by 2020.

Consolidation activity in the chemicals space has picked up, highlighted by the mega-deal between Dow Chemical DOW and DuPont DD. With crop prices under pressure and agricultural chemical profits somewhat lagging, companies have been looking to cut costs to weather the storm. Add in activist pressure and management shakeups at a number of big industry players and you get an environment ripe for M&A activity centered around cost synergies. We think the Dow and DuPont merger of equals will be value accretive for shareholders of both companies. Interestingly, and contrary to the broader trend in the materials space over the last decade, the Dow and DuPont plan is to eventually split the merged company into three separate publicly traded companies focusing on agriculture, material science, and specialty products. Although this reduces the ability to generate corporate costs synergies, we like the fact that it gives investors more choice. Prospective cost synergies will likely be the big selling point for any additional consolidation in the space. We wouldn't be surprised to see Monsanto MON take another run at Syngenta SYT, after being rebuffed in 2015.

Top Basic Materials Sector Picks

	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Consider Buying
Allegheny Technologies	★★★★★	$27.00	Narrow	High	$16.20
Potash Corp	★★★★★	$32.00	Wide	High	$19.20
Goldcorp	★★★★★	$24.00	None	Very High	$12.00

Data as of December 18, 2015

Allegheny Technologies ATI

Allegheny Technologies supplies specialty metals to a variety of end markets, including aerospace, energy, medical, and automotive. Some of the firm's major products include titanium and nickel-based alloys. Additionally, Allegheny manufactures flat-rolled stainless steel products. The company's product lines are frequently used in applications that require stress tolerance as well as corrosion and heat resistance.

Misplaced concern about the impact of lower oil prices provides investors with an opportunity to purchase Allegheny at an attractive price. Allegheny has a high degree of exposure to the production of next-generation commercial aircraft, which underpins attractive long-term growth prospects. Lower share prices since mid-2014 reflect the expectation that low oil prices will diminish commercial aircraft deliveries as well as sales to customers in the oil and gas space. We assert that the impact of these headwinds is overstated.

Potash Corp **POT**
PotashCorp is the world's largest fertilizer company measured by capacity. The company's main focus is potash, where it is the global leader in installed capacity with a roughly 20% share. PotashCorp is also a player in the nitrogen and phosphate industries. The company is focused on growing its potash business, and brownfield expansions coming on line over the next couple of years will increase capacity.

We think the market is missing PotashCorp's long-term production potential and ability to grow free cash flow as it eventually fills its already-completed expansions. The market seems concerned about the long-term supply/demand outlook for potash, competitive dynamics, and recent price pressure. Our long-term view of the potash market gives us confidence that near-term headwinds will fade and strong fundamentals will eventually take hold. Following a temporary step back in demand in 2015, we expect normal growth to return in years to come. Capacity is expected to grow at a faster clip, but we're not expecting enormous pressure on prices, as current producers add supply judiciously.

Goldcorp **GG**
Goldcorp is a large gold-mining company with operations in Canada, the United States, Mexico, and Latin America. It produced roughly 2.9 million ounces of gold in 2014. Goldcorp has historically focused on stable mining jurisdictions in North and South America while targeting rapid production growth through internal development and acquisitions. As of Dec. 31, 2014, Goldcorp had 50 million ounces of gold reserves.

Gold prices have fallen 10% year to date (Dec. 16), with shares of miner Goldcorp falling 36%. Fears of rising U.S. interest rates and operational challenges at Goldcorp's new mines have created an attractive opportunity to buy the growing low-cost gold miner at a discount. The market is concerned that higher interest rates will greatly diminish investment demand for gold. We agree and think near-term gold prices will weaken because of it. But we think the market is overlooking still-growing jewelry demand from China and India.

Daniel Rohr, CFA has a position in the following securities mentioned above: MON.

Consumer Cyclical: Consumer Volatility Creates Investment Opportunities

The market now appears to be pricing in more conservative long-term cash flow assumptions than baked into our longer-term consumer cyclical valuation assumptions.

By Bridget Weishaar, Senior Equity Analyst

- Our consumer cyclical universe trades at a median price/fair value of 0.99 after spending much of the year modestly overvalued. Although we acknowledge the possibility of more-volatile consumer spending trends than we've become accustomed to across the globe as well as supply/demand inventory imbalances throughout the remainder of 2015 and into 2016, we believe the market now appears to be pricing in more conservative long-term cash flow assumptions than baked into our longer-term consumer cyclical valuation assumptions.

- The apparel sector has been very challenged, and we continue to see headwinds into 2016. We think that warm weather, poor inventory management, a lack of new fashion trends, and shifts to other distribution channels and product lines has contributed to the weakness.

- We continue to see China as a key driver of investor concern, especially in the luxury goods space. However, despite China's risks and macroeconomic issues, we believe even small rates of growth will yield significant opportunities for luxury firms. With Chinese consumers already responsible for 30% of global luxury goods purchases, the continued growth of wealthy and upper-middle-class consumers appears to offer great potential.

After trading at a median price/fair value above 1.0 for the better part of the year, Morningstar's consumer cyclical universe has pulled back in recent weeks and now trades at a median price/fair value estimate of 0.99. We attribute much of the recent weakness to concerns about slowing economies across the globe and foreign currency headwinds, which we believe have triggered a rotation into less discretionary categories.

Mainstream apparel retailers reported slowing traffic to stores in the third quarter and an excess of inventory in the market heading into the holidays. We think this is due to a couple factors. First, unseasonably warm weather has pressured sales of cold weather merchandise including boots and jackets. Second, many retailers had expected demand to increase into the back half of the year on the heels of strong employment numbers and improving wages. However, this theory did not pan out. We think that increases in rents and health care costs have offset some of the upside. Now retailers have too much inventory, and we think the holidays will be highly promotional. Third, there is a lack of newness in fashion and, with closets overflowing with skinny bottoms and loose tops, the consumer is bored with the offering and doesn't need any more. We note that big ticket items, like home goods, and autos have been strong. Finally, we think that the shift to shopping online is accelerating with poor retail Black Friday performance offset by online gains throughout the weekend.

That being said, there are some standouts in the apparel retail space. We note that off-price retailers (such as TJX TJX and Ross Stores ROST) have benefited from both a multitude of buying opportunities given excess inventory and demand increases as consumers have remained price sensitive. Athletic apparel is also still outperforming the general apparel industry.

Macroeconomic worries in China have become top of mind for investors. Many of the luxury stocks we cover have experienced volatility and have traded at discounts to our fair value estimates this year. Negative data points ranging from the greater than 40% drop in the Shanghai composite stock index this past summer to the sudden devaluation of the yuan have added to investor worries over companies' prospects for selling goods to China. Luxury goods companies have seen further headwinds from Hong Kong and Macau traffic declines. Investors accustomed to double-digit or higher growth rates are adjusting expectations, and some rightfully harbor concerns that issues will persist or worsen.

However, the stock market fall taken against the relative gains of the prior years means that investors are still better off unless they bought in the spring of 2015, late in the rally. The market is still net higher than in 2013 and 2014, and it is relatively small compared with the bank loan market and consumers' total savings (Chinese consumers hold $9 trillion in savings, according to JPMorgan; Bloomberg cites the People's Bank of China with a similar figure of CNY 50 trillion in 2014). Stock ownership is also less widespread then in developed economies, with various forms of banks loans and bank deposits making up the largest portion of financing in the economy.

Using Morningstar's forecast for Chinese consumption growth of 7% as a basis, we make the assumption that middle- and upper-income consumers can outpace the whole economy for the long run. We believe factors such as increased investment in private businesses, saving rates and increased access to credit, increased government share of social welfare and healthcare costs, better investment returns for the middle class, and further returns for the upper class can all contribute to the high end of consumption outpacing the whole.

With the apparel sector facing near-term headwinds and many luxury stocks trading at a discount given perceived China exposure, we think that there is an attractive entry point for long-term investors.

Top Consumer Cyclical Sector Picks

	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Consider Buying
Gap Inc	★★★★★	$45.00	Narrow	Medium	$31.50
Wynn Resorts	★★★★★	$136.00	Narrow	High	$81.60
Arctic Cat	★★★★★	$33.00	Narrow	High	$19.80

Data as of December 18, 2015

Gap GPS
With investor attention focused on what we perceive to be near-term, fixable product issues within the core Gap brand, we think that Gap's larger and more important margin expansion story is being overlooked. Having invested heavily in a seamless inventory model (expected to be fully integrated by 2016); omnichannel capabilities including ship-from-store, find-in-store, reserve-in-store, and order-in-store; and responsive supply chain initiatives including fabric platforming, vendor-managed inventory, rapid response, and test and respond, we think Gap is poised to close the disparity between its low-double-digit operating margin and the high-teens margins of fast-fashion competitors.

All these initiatives reduce lead times and allow the company to read demand and react to color, size, or silhouette that customers are purchasing. In total, these initiatives should reduce volatility in performance, increase full-price sell-through, and fulfill previously missed sales, putting Gap well on track to matching fast-fashion core competencies. The company expects to increase the percentage of assortment on the responsive model to 50% by the end of 2016. If successful, we see no reason Gap could not reduce the operating margin gap between itself and other fast-fashion retailers and further distance itself from other no-moat companies.

We continue to view near-term product misses at the Gap and Banana Republic brands as fixable and think the brands are on track to post positive comparable sales growth in 2016. Although we do not think new products will hit the shelves until the end of the fourth quarter or early 2016 given current lead times, we think the company is on track with its turnaround efforts. In our opinion, management and brand teams have correctly identified the source of prior product misses—namely fit, quality, and design—and new products will resonate better.

As the stock is currently trading at a discount to our fair value estimate, given product challenges and an underappreciation of the margin expansion opportunity, we think that this is an attractive entry point for investment.

Wynn Resorts WYNN
We view Wynn Resorts as a well-established high-end iconic brand that is well positioned to participate in the attractive long-term growth opportunity of Macau (70% of EBITDA), as the company expands its room share to 9% from 6% through the Cotai Palace opening in 2016. The offset to this expanded room presence is the continued shift away from VIP and gaming revenue (where Wynn has an outsized exposure) toward nongaming and mass play, as well as its existing Macau property being located on the peninsula, where traffic has lagged Cotai.

It is not unreasonable to expect Macau visitation and revenue to reaccelerate to above a mid-single-digit pace in a few years, as new casinos open in 2015–17 (increasing Macau room supply toward 43,000 from 28,000 currently), infrastructure is built out in 2017 and beyond (easing overcrowding and accessibility issues), and nearby Hengqin Island is developed over the next decade (three times the development area of Macau). This increased supply should easily be matched with demand, as the population within a few hours of Macau is seven times that of Las Vegas, yet the number of Macau rooms and visitors were only one-fifth and three-fourths that of Las Vegas in 2014. With Wynn holding one of only six gaming licenses, it stands to benefit from this growth. That said, the Macau market is highly regulated, and as a result the pace and timing of growth is at the discretion of the government.

In Las Vegas, Wynn's casino properties generate industry-leading EBITDA (around 30% higher than the next-largest property, Bellagio). Las Vegas doesn't offer the long-term growth potential or regulatory barriers of Macau, so we do not believe the region contributes to Wynn's moat. But there have been very minimal industry supply additions this decade, which is expected to continue over the next few years, supporting solid industry Strip occupancy (93% in 2014).

Arctic Cat ACAT
Arctic Cat is one of the longest-operating powersports manufacturers. Unlike its closest peers, the firm is at a critical juncture in its life cycle, making an aggressive attempt to rebuild its revenue and earnings results after clearing bloated inventory levels in the retail channel. The firm has sacrificed price, running promotions to move older units rapidly out of dealer inventory, but has been able to gain share thanks to faster unit sales. While discounts continue to prevail, which we believe will persist through the end of fiscal 2016, Arctic Cat should restore operating profit growth beginning in 2017. Despite no switching costs, we think the company's long-standing brand intangible asset and leading market share position garner competitive returns on invested capital and a narrow economic moat.

We expect unit demand to stem from the delivery of new, innovative products after retail inventory levels are restored to normal, which should help improve the firm's gross margin profile. Management has also articulated its willingness to expand in new channels, both through bolt-on acquisitions and partnerships. We liken this updated strategy to the one Polaris has implemented in recent years and see acquisitions like Motorfist (in parts, garments, and accessories) and partnerships with Toro and Yamaha as integral to scaling faster and becoming more operationally efficient and better diversified. With no debt on the balance sheet and the likelihood for rising free cash flow, Arctic Cat should be able to capitalize on appropriate acquisition opportunities at will.

However, the firm has robust 2020 goals that include an 11% sales CAGR ($1 billion), operating margins that grow more than twentyfold, and gross profit margins that rise more than 1,000 basis points—these would represent never-before highs in both the gross and operating margin ratios, above prerecession levels. Though our model incorporates significant traction in these metrics, our forecast includes lower 2020 results ($804 million in sales, gross profit margins of 25%, and EBIT margins of 10%), since much of this expansion depends on precise operational execution and a stable economic environment.

Bridget Weishaar does not own shares in any of the securities mentioned above.

Consumer Defensive: Cost-Cutting and M&A Should Drive Continued Earnings Growth

After another strong year for consumer defensive stocks, the sector remains relatively less attractive than our overall universe.

By Philip Gorham, CFA, FRM, Consumer Strategist

- The consumer defensive sector is currently slightly overvalued, in our opinion, trading at around 2% above our fair value estimate, versus a 2% market discount in the global universe.
- The emerging market slowdown is showing up in consumer product manufacturers' earnings reports, with broad weakness in Asia a new headwind for many companies. Generally, we regard this as a cyclical impact, and we still believe emerging markets will drive long-term volume growth for the consumer staples firms with strong exposure and an appropriate product portfolio. Europe, on the other hand, appears to be stabilizing.
- The confirmation arrived this quarter that Anheuser-Busch InBev is focusing investors' attention on the potential for ongoing transactions in the sector. Companies in the household and personal products category, in particular, appear to have capacity for financing deals.
- With organic growth fairly limited, cost-cutting remains an important driver of earnings growth.

After another strong year for consumer defensive stocks, the sector remains relatively less attractive than our overall universe, with our sector coverage trading at 2% above our fair value estimate. Although the consumer staples space is often fairly defensive in a market downturn, we remain cautious of global consumer spending, particularly in emerging and developing markets. Earnings reports this quarter began to show the emerging market slowdown impacting consumer firms' financial results. We generally recommend focusing on companies in the sector with narrow or wide moats that enjoy strong intangible assets and/or sustainable cost advantages.

Third-quarter earnings was the usual mixed bag, with performance largely driven by geographic exposure. Europe appears to be incrementally more positive from a consumer demand standpoint, with several companies reporting that the troubled markets in southern Europe are stabilizing. The CIS region, however, remains weak. New headwinds have appeared in the emerging markets in recent months, with volume growth in Asia and Latin America slowing. China is particularly concerning, with beer volumes in decline. High rates of inflation in some Latin American countries are boosting local currency cash flows, but the underlying health of the consumer remains poor. We acknowledge that the downturn may be prolonged, particularly for commodity-linked economies, but we believe emerging markets will be an important driver of growth in the consumer defensive sector in the long term. Going forward, currencies will again have a heavy influence on reported results and cash flows. The weak euro is likely to remain a tailwind next year for companies reporting in euros, while companies reporting in dollars will likely face a currency headwind, albeit less strong than that in 2015.

In October, the boards of Anheuser-Busch Inbev SA BUD and SABMiller confirmed that they had reached an agreement under which AB InBev will acquire the London-based brewer for around $108 billion in a stock and cash deal. We think the deal will be value-accretive for AB InBev shareholders and enhancing to both the firm's economic moat and its ROIC generation. Beer is a business in which scale matters. The majority of raw materials are commodities and common across beer categories and brands. This gives brewers with scale pricing power in their input procurement. The combination of AB InBev and SABMiller will create a brewing behemoth, controlling almost one-third of global volumes. Its procurement scale will be unmatched, and this is likely to create a cost advantage that no competitor can come close to matching. We think the deal has been struck at a price that will create value for AB InBev shareholders, but the transaction is complex and moving parts remain. Beyond MillerCoors, Peroni, and Grolsch, we expect further asset disposals to be announced soon.

The transformative deal in the beer industry is sharpening investors' focus on other potential deals in the consumer defensive industry. With the window of record-low interest rates beginning to close in the U.S., there may be an acceleration of merger activity in the coming quarters. We expect this activity to be centered around the more fragmented categories and around companies with the most balance sheet optionality. Household and personal care appears to be a clear area for mergers and acquisitions in the near term. Fairly low market shares allow for a great deal of consolidation, while several companies are either underleveraged relative to consumer defensive peers or have large cash balances. We regard M&A in household and personal care categories as being slightly less enhancing to cost advantages, however, because economies of scale are limited by the vast array of raw material inputs.

With the emerging markets slowdown putting pressure on global organic growth, and the emergence of the AB InBev/3G model of rigid cost discipline, consumer defensive companies are paying closer attention to profitability as a driver of earnings growth. Several companies have implemented zero-based budgeting strategies, and many have adopted multi-year strategies to improve margins.

Top Consumer Defensive Sector Picks

	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Consider Buying
Symrise AG	★★★★★	EUR 77.00	Narrow	Low	EUR 61.60
Tesco PLC	★★★★★	GBX 270.00	None	High	GBX 162.00
Wal-Mart	★★★★★	$75.00	Wide	Low	$60.00

Data as of December 18, 2015

Symrise AG SY1
Symrise is the world's third largest supplier of flavors and fragrances, with a market share of 12%. Its narrow-moat rating is based on customer switching costs, which makes the business stable and predictable as clients don't change ingredients providers easily due to the risk that they might suffer production disruption as a result or impair brand values. Symrise has exhibited among the most consistent operating metrics of the major ingredients companies, with the highest organic sales growth, a stable operating margin, and strong free cash flow generation. There is upside potential to ROIC once its two recent acquisitions have been successfully integrated. Symrise has exposure to the high margin fragrance business, strong market shares in oral care ingredients, and high exposure to strong growth in emerging markets that account for 47% of sales. Valuation looks appealing as P/FVE of 0.78 makes it among the most modestly valued of the ingredients stocks.

Tesco PLC TSCO
Trading at a near-50% discount to our fair value estimate, Tesco is one of the most undervalued stocks in our coverage universe, and we think risk-tolerant investors looking for exposure to U.K. retail should consider the stock. However, Tesco is in the early innings of its turnaround, and competition remains very intense from discounters Aldi and Lidl and other traditional grocers looking to stem market share losses.

U.K. and Ireland like-for-like sales declined around 1.3% in the first half, versus a decline of 4.8% in the first half of last year. More encouragingly, transactions and total volume are increasing 1.5% and 1.4%, respectively, in the United Kingdom, implying that basket sizes shrank slightly but deflationary pressures and Tesco's price cuts are the main drag on like-for-like performance. We expect additional price cuts to affect U.K. profit margins (0.8% in the quarter, but guided to about 2.0% for the year), but given that Tesco has considerable scale and operating leverage, we believe it can drive its U.K. margin to around 3% over the long term.

We still do not assign Tesco an economic moat, as we do not believe that its operating scale gives the firm a sufficient cost advantage to generate returns on invested capital that are materially above its cost of capital. However, we do believe Tesco will remain a strong competitor. Its U.K. convenience store like-for-like sales continue to increase around 4%, while its online grocery sales are increasing at a midteens rate; Tesco maintains about 50% market share in online grocery. The firm faces stiff competition from discounters, but with improved pricing and investments in service, it should be able to defend its turf.

Wal-Mart WMT
Shares of Wal-Mart have increased after the company reported third-quarter results, but they still trade at a 20% discount to our $75 fair value estimate. Investors remain concerned that Wal-Mart will need to continue investing larger and larger sums of money to generate the same level of sales growth. However, we believe Wal-Mart's earnings power has been underappreciated, especially as investments moderate over the medium and long term.

We think the discrepancy between the current share price and our fair value estimate stems from investors overemphasizing the fact that e-commerce firms are not burdened by store operating costs while underemphasizing the very costly last-mile shipping costs that e-retailers must overcome. High throughput, proximity to consumers, and store/shipment density are vital to winning the logistics game, but we believe Wal-Mart's capabilities in these regards have been overlooked.

We do believe Amazon.com AMZN is well ahead of Wal-Mart in the online channel, but we also think Wal-Mart has a proximity advantage with its store and distribution network that it can leverage to sell online and in stores, especially if it uses groceries and gas to drive traffic; relative to other brick-and-mortar firms, Wal-Mart is the closest to being able to compete with Amazon in the online channel. Thus, while investments in e-commerce and wages will pressure earnings over the next 12–18 months, we continue to believe that wide-moat Wal-Mart can leverage its cost advantage and a brand intangible asset (due to its reputation for low prices) to leverage modest sales growth once investments moderate.

At 14.5 times trough earnings in fiscal 2017 (calendar 2016), Wal-Mart shares have a lot of pessimism baked in, presenting an opportunity for investors with a three- to five-year time horizon to generate solid risk-adjusted returns. We think many investors are underestimating Wal-Mart's ability to compete in multiple channels. Wal-Mart still generates about $12 billion in free cash flow, and it expects to buy back around $20 billion (10% of shares outstanding) over the next five years.

Philip Gorham, CFA, FRM, does not own shares in any of the securities mentioned above.

Energy: Pain Continues as OPEC Refuses to Play White Knight

The current glut in crude supply continues to weigh on prices and will take several quarters more to work through.

By David Meats, Senior Equity Analyst

- We continue to believe that crude oil prices are well below the levels required to encourage sufficient investment to meet demand beyond 2017, and our long-term per-barrel price outlook remains at $70 Brent and $64 West Texas Intermediate.

- Near-term prices could be ugly, though. OPEC spooked markets yet again in December by failing to signal any willingness to cut production and defend prices, even though weaker member states (like Venezuela) are hurting because of lower oil revenue.

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

- Sharp curtailments in oil-directed drilling activity could also reduce U.S. natural gas production growth in the near term. But the wealth of low-cost inventory in areas like the Marcellus and Utica ultimately points to continued growth through the end of this decade and beyond.

- Abundant supply is holding current natural gas prices low, but in the long run we still anticipate relief from incremental demand from liquefied natural gas exports as well as industry. Our midcycle U.S. natural gas price estimate is unchanged at $4 per thousand cubic feet.

The most pressing question on the minds of energy investors: How long will it take for the industry to work through the current period of oversupply and rebalance itself? The answer: Not anytime soon. Current supply imbalances are such that oil production as of today is effectively running two years ahead of demand. Declining U.S. oil production over the next several quarters will help reduce global oversupply, but in our opinion, that alone cannot quickly fix the current global imbalances.

For the market to approach any semblance of normalcy before 2017—and likely for prices to respond accordingly—requires one or more of the following: Saudi Arabia reverses course from its "maintain market share at all costs" approach and cuts production; global demand surprises to the upside from current expectations of 95 million barrels a day in 2016 and 96 mmb/d in 2017; or a geopolitical event occurs (for example, political upheaval in Venezuela or another oil-exporting nation). Without one or more of these occurring, “lower for longer” looks to be the unavoidable near-term course for the industry.

Top Energy Sector Picks

	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Consider Buying
Continental Resources	★★★★★	$36.00	Narrow	High	$21.60
ExxonMobil	★★★★	$87.00	Wide	Low	$69.90
Cabot Oil & Gas	★★★★★	$40.00	Narrow	High	$24.00

Data as of December 18, 2015

Continental Resources CLR

Continental is our top pick in the U.S. oil-focused exploration and production group. Continental played a key role in the early development of the Bakken Shale and now holds 1.2 million net acres prospective in this prolific oil play. The company has added a second string to its bow with the ongoing delineation of the South Central Oklahoma Oil Play. Even at today’s prices, wells drilled in these areas offer attractive returns, and Continental’s positions will take at least 20 years to work through. The firm has a strong liquidity reserve and will be free cash flow neutral in 2016.

ExxonMobil XOM

We view ExxonMobil as offering the best combination of value, quality, and defensiveness. Exxon will see its portfolio mix shift to liquids pricing as gas volumes decline and as new oil and liquefied natural gas projects start production. The company historically set itself apart from the other majors as a superior capital allocator and operator, delivering higher returns on capital than its peers as a result.

Cabot Oil & Gas COG

On the gas side, Cabot controls more than a decade of highly productive, low-cost drilling inventory targeting the dry gas Marcellus Shale in Pennsylvania. Fully loaded cash break-even costs are less than $2.50 per mcf, based on 2015 cost structure and current, historically low oil prices.

David Meats does not own shares in any of the securities mentioned above.

Financial Services and Real Estate: The Department of Labor's Fiduciary Standard Rule Could Have a Major Impact

Investors see banking crises as the result of extraordinary circumstances—chiefly, unforeseeable economic shocks. We disagree.

By Stephen Ellis, Director of Financial Services Equity Research

- Our overall financial services sector valuation remains attractive at a price/fair value ratio of 0.90. Similarly, the real estate sector remains equally attractive at a price/fair value ratio of 0.97.
- We assess that the U.S. Department of Labor's proposed conflict-of-interest, or fiduciary standard, rule could drastically alter the profits and business models of investment product manufacturers like BlackRock and wealth management firms like Morgan Stanley serving retirement accounts.
- In Australia, against the backdrop of a slowing Australian economy, we have been surprised by recent strength in specialty retail sales performance.
- We expect REIT prices generally to move inversely with changes in long-term government bond yields. Higher interest rates would take some time to show up in REIT financial metrics. But eventually, higher rates could cause higher debt financing costs, put pressure on traditional after-interest expense measures of REIT cash flow (such as funds from operations, adjusted funds from operations, and funds available for distribution), and lead to higher cap rates, which could pressure investment spreads.

We assess that the U.S. Department of Labor's proposed conflict-of-interest, or fiduciary standard, rule could drastically alter the profits and business models of investment product manufacturers like BlackRock and wealth management firms like Morgan Stanley that serve retirement accounts. Based on our proprietary estimates, we believe that the rule will affect around $3 trillion of client assets and $19 billion of revenue at full-service wealth management firms. Additionally, we think that investors and business analysts looking only at the more studied implementation costs of the rule are vastly underestimating the rule's potential impact on the financial sector. Current government and financial industry reports have a high-end annual cost estimate of $1.1 billion, but even our low-end prohibited transaction revenue estimate, arrived at using Morningstar Direct data, is more than double that at $2.4 billion. The rule's financial repercussions also extend far beyond wealth management firms.

Full-service wealth managers may convert commission-based IRAs to fee-based IRAs to avoid the additional compliance costs of the Department of Labor rule. As fee-based accounts can have a revenue yield upwards of 60% higher than commission-based, this could translate to as much as an additional $13 billion of revenue for the industry.

Robo-advisors stand to benefit from the Department of Labor rule, as they pick up a portion of our estimated $250 billion to $600 billion of low-account-balance IRA assets from clients let go by the full-service wealth management firms. Capturing a fraction of these loose assets will bring stand-alone robo-advisors much closer to the $16 billion to $40 billion of client assets that we believe they need to become profitable.

We believe that over $1 trillion of assets could flow into passive investment products from the Department of Labor rule. The increase would be from higher adoption of robo-advisors, increased usage of passive investment products from financial advisors that formerly may have been swayed by distribution payments, the proposed "high-quality, low-cost" exemption, and the effect of advisors trying to balance out higher explicit financial planning charges.

We believe beneficiaries will be discount brokerages, like Charles Schwab; companies tied to passive investment management, like State Street; and robo-advisors. Conversely, some life insurance companies, like Prudential Financial, will probably be challenged. Companies with economic moats will be the winners of the disruption to the investment product distribution landscape.

Real Estate
In Australia, against a backdrop of a slowing Australian economy, we have been surprised by recent strength in specialty retail sales performance. We don't think domestic economic fundamentals support a continuation of this trend as household income has been buoyed by one-offs of lower borrowing costs and falling fuel prices. We forecast a moderating rate of rent growth, but growth nonetheless. Our outlook for tepid long-term growth reflects a rising proportion of sales occurring online and rising Federal government budget deficits, which increase the likelihood of further rationing of handouts.

We expect REIT prices generally to move inversely with changes in long-term government bond yields. Higher interest rates would take some time to show up in REIT financial metrics. But eventually, higher rates could cause higher debt financing costs, put pressure on traditional after-interest expense measures of REIT cash flow (such as funds from operations, adjusted funds from operations, and funds available for distribution), and lead to higher cap rates, which could pressure investment spreads. Also, to the extent that low interest rates have diverted investor funds to REITs searching for higher yield, funds could flow out of REITs if interest rates rise, pressuring commercial real estate and REIT valuations. Although rising interest rates might signal a strengthening economy, which could benefit real estate fundamentals, we do not expect the macro environment to improve enough to offset what could be another 200-basis-point rise in U.S. government bond yields to levels nearer historical norms.

Although the potential negative impact of rising interest rates remains a key concern for REIT investors, U.S. REIT management teams seem less concerned. The majority of U.S. REITs have improved their balance sheets since the last downturn and appear as a group to remain more conservatively leveraged than the last boom in the mid-2000s. Moreover, upcoming maturities for many U.S. REITs over the next few years still carry interest rates that far exceed current borrowing costs, so even a 100-basis-point rise in rates from here would have a negligible impact on cash flow, at least over the medium term.

Nonetheless, recent trading activity suggests that investor expectations about actual or expected future interest rates can have an immediate impact on U.S. REIT stock prices. Although we still view the potential for higher interest rates as a valuation risk for U.S. REITs, we would expect higher interest rates to have a negligible impact on our estimates of value. We already embed a mid-4s yield on the 10-year Treasury into our weighted average costs of capital, relative to the low-2s level recently observed in the Treasury market.

Top Financial Services Sector Picks

	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Consider Buying
TD Ameritrade	★★★★	$43.00	Narrow	High	$28.50
Toronto-Dominion Bank	★★★★	$50.00	Wide	High	$30.00
Ventas	★★★★	$81.00	Narrow	High	$48.60

Data as of December 18, 2015

TD Ameritrade AMTD

Over the next five years, we're projecting pre-tax operating income at TD Ameritrade to more than double, due to both revenue growth and operating margin expansion. Interest rate-related revenue remains the key driver of medium-term earnings. Some 40% to 50% of the company's interest-rate-sensitive balances are more leveraged to short-term rates than long-term rates, so there will be an almost immediate benefit once the Fed Funds Rate increases. Due to TD Ameritrade's unique relationship with Toronto-Dominion, it won't have to retain capital to grow its interest rate-related income, so can increase its dividend or share repurchase activity along with earnings. We believe that there are three concerns on investors' minds that are overblown. The first is a market correction. While this will have a direct impact on the company's assets under management revenue streams, stock market volatility will increase trading volumes, and the benefit from rising interest rates is more important. The second is that an increase in interest rates will lead to a trading commission pricing war. Commission pricing wars are a zero-sum game, so we don't think any rational player will start one. While historically there may be some correlation between rising interest rates and lower commission pricing, the last 15 years can be characterized as having more players and room for material differences in trade pricing. Now, client assets are concentrated in the hands of fewer, larger players and commission pricing is low in absolute terms with changes in pricing less likely to cause client switching. The last major concern is over how much TD Ameritrade may share the benefit of rising interest rates with clients. It's important to note that the "trading cash" awaiting investment by TD Ameritrade's customers is largely rate insensitive. They are traders hoping to put the cash to use, instead of people shopping around for the highest certificate of deposit rate. While the company may have to slightly revise its guidance for how much it will benefit from rising rates, the market has more than already priced this in.

Toronto-Dominion Bank **TD**

With its strong retail network in both Canada and the U.S., Toronto-Dominion Bank continues to deliver excess returns during this low rate environment. We take comfort in TD Bank's relatively low exposure to the oil patch, which, compared with other Canadian peers, will not have a significant impact upon those returns should energy pricing remain subdued. Also with a high percentage of residential loans either government insured or currently at low loan/value ratios, we take comfort that any impact upon the bank due to a housing bubble burst will not erode TD Bank's capital base. With the expectation that mortgage rates will rise very slowly in the medium term, we think any impact upon the bank due to delinquencies caused by higher rates will be stretched out over several years, also minimizing the impact to TD Bank's capital. Trading at a significant discount to our fair value estimate and 10.8 times 2016 estimated earnings, along with healthy 3.9% dividend yield, we think this is an attractive opportunity for investors.

Ventas **VTR**

Healthcare REITs in general are one of the most attractive property sectors in our U.S. real estate coverage on a relative valuation basis, and Ventas—with its narrow moat and exemplary stewardship—is currently our favorite among the bunch. In general, U.S.-based healthcare REITs should benefit from some favorable tailwinds, including an expanding and aging population and potentially tens of millions of people added to the ranks of the insured because of the Affordable Care Act—all of which should drive incremental demand for healthcare real estate relative to historic levels. Plus, healthcare is a property sector in which the vast majority of assets remain in private hands, so Ventas should have opportunities to further consolidate ownership. We think the combination of Ventas' 7%-plus cash flow yield (using our 2016 normalized AFFO estimate) with growth prospects in the low- to mid-single-digit range (if not higher, depending on external growth opportunities) provides investors with a compelling total-return prospect in the current environment.

Stephen Ellis does not own shares in any of the securities mentioned above.

Healthcare: Positive Stock Price Movement Brings Valuations Closer to Fair Values

While valuations in healthcare stocks have improved, we still see opportunities in undervalued companies.

By Damien Conover, CFA, Director of Health-Care Equity Research

- The recent market uptick in healthcare has pushed the valuation of the sector to slightly undervalued, with the group trading close to 4% below our fair value estimates in aggregate. However, some stocks still look significantly undervalued, including Amgen AMGN, Biogen BIIB, and BioMarin Pharmaceutical BMRN.
- Despite increasing political rhetoric coming out of Washington, we expect pricing power for drug and biotech companies to remain strong.
- Adding to some healthcare valuations (especially smaller potential healthcare targets), mergers and acquisitions continue at a rapid pace as large conglomerates look for growth avenues and opportunities to cut costs, partly through lowering taxes.
- Strong drug launches and excellent clinical data in specialty-care areas, such as oncology, are increasing the productivity of drug and biotech companies.

As the U.S. presidential campaigns pick up full steam in early January, the political rhetoric on lowering drug prices will probably continue, but we don't see any major shifts in U.S. drug prices over the next several years. Nevertheless, we expect drug pricing concerns to cause increased volatility in pharmaceutical and biotechnology stocks. However, without a major structural reform and a willingness by the patients and doctors to limit treatment options, we don't see any major changes in U.S. drug prices.

On the investment banking front, companies continue to acquire and merge to increase their growth potential through creating scale, cutting costs, and focusing on key strategic areas. Further, the persistent low interest rates are also fueling merger and acquisition trends, because cheap capital is available to fund acquisitions. Beyond the heavy prevalence of M&A in the drug space, with large drug firms acquiring Allergan and Pharmacyclics, we are seeing further consolidation in healthcare services. UnitedHealth's UNH acquisition of Catamaran and Aetna's AET acquisition of Humana show the increasing importance of gaining scale advantages.

Turning to a core element of moats with innovation in healthcare, drug companies continue to shift their focus toward specialty-care areas such as oncology and immunology. We expect the shift to increase drug-development productivity and strengthen the moats for drug companies, since these areas of development carry strong drug pricing, a more accommodating stance from regulatory agencies, and steep launch trajectories. Although some of these specialty indications have smaller patient populations than primary care areas, the strong pricing power can easily turn the drugs into blockbusters. In oncology, recent approvals carry price tags over $100,000 per year, opening the door to major market opportunities even in the less prevalent cancers.

Top Health-Care Sector Picks

	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Consider Buying
Biogen	★★★★	$400.00	Wide	Medium	$280.00
BioMarin	★★★★	$132.00	Narrow	Medium	$92.40
Amgen	★★★★	$194.00	Wide	Low	$155.20

Data as of September 24, 2015

Biogen BIIB

Biogen is the leader in the multiple sclerosis market, with a range of options for patients seeking injectables (Avonex and Plegridy), orals (Tecfidera), or high-efficacy treatments (Tysabri). Competition in MS is heating up, but we still think Biogen has a dominant portfolio that can withstand this pressure, and we assign the firm a stable wide moat rating. We remain optimistic on upcoming clinical data over a longer time horizon (2016–18) and think the firm has a promising collection of neurology-focused pipeline candidates. Recent prices appear to be giving the firm little credit for two key pipeline programs, Alzheimer's drug aducanumab and a novel MS therapy targeting Lingo. Also, the spinal muscular atrophy program (partnered with Isis) should generate phase 3 data in late 2016 or early 2017, and we're bullish on its potential in this rare pediatric indication.

BioMarin BMRN

BioMarin focuses on the ultra-rare-disease space, and its products have strong global pricing power because of the severe and rare nature of the genetic diseases they target. While Kuvan, Naglazyme, and Aldurazyme are more mature, the ongoing Vimizim launch is poised to make it BioMarin's biggest product. A very productive pipeline has kept research and development expenses high and prevented profitability, but we think the firm should be able to leap from four key marketed products to eight by the end of 2017, securing sustainable profitability at that time. While there is risk around the timing of drisapersen's approval in Duchenne muscular dystrophy, BioMarin's shares trade at enough of a discount to our fair value estimate to make the stock look undervalued regardless of our view on this regulatory outcome. Three other pipeline programs in PKU, Batten disease, and achondroplasia could reach the market by the end of 2017, and outside of DMD, BioMarin lacks competition.

Amgen **AMGN**

Amgen has several innovative biologic therapies that have turned into blockbuster products and generated consistently high returns on invested capital, and we think Amgen's pipeline turnaround will continue to support the firm's wide moat. Although Amgen has heavy exposure to biosimilars—close to 40% of total sales are at risk to biosimilars over the next five years—we think the firm is well-positioned to grow throughout upcoming U.S. biosimilar launches. In the near term, fast-growing approved drugs like Prolia/Xgeva and Kyprolis, as well as Amgen's emerging cardiovascular drug Repatha, will counter biosimilar pressure. In the long term, we expect better pipeline productivity (via the deCode human genetics database) and an internal biosimilar pipeline will drive stronger growth. We expect the firm's reputation for quality biologics manufacturing and large biosimilar pipeline will allow it to gain a more than 10% share of the global biosimilar market.

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

Industrials: An Unsettled Global Economy Serves Up Individual Stock Bargains

Valuations look more attractive as the market reacts to persistent near-term headwinds affecting several industrial subsectors.

Kurt Funderburg, Senior Equity Analyst

- Our industrials coverage currently trades 1% above our fair value estimates, despite broader market declines. Select stocks within the group are trading at steep discounts to our fair value estimates, providing attractive opportunities for investors.

- Industrials have been buffeted by strong global economic crosscurrents. Oil and many commodity prices have continued their downward spiral, while growth in China remains relatively weak, and worries are mounting over whether the Chinese government can effectively manage the economy to avoid a hard landing. The strength of the U.S. dollar against most other currencies continues to hamper firms that generate significant portions of their sales outside of the United States. The Federal Reserve appears poised to begin tightening monetary policy and lifting the discount rate in the U.S., even as the European Central Bank continues its program of quantitative easing and several European markets currently have negative-interest-rate environments.

- Despite the global turmoil, the U.S. economy remains relatively strong, with third-quarter GDP rising 2.1% and the headline unemployment rate declining to 5%. Demand for automobiles remains healthy, and both residential and nonresidential construction continue to expand. We believe that continued strength in the U.S. will buoy many of our companies as they continue to improve cost efficiency, preparing for more-stable commodity prices and a return to stronger growth in emerging markets. Merger and acquisition activity, which has been somewhat muted in the industrials space relative to healthcare and some other sectors, could also begin to play a bigger role for industrials.

Since our last update, the global economy has continued to convulse from the effects of dropping commodity prices and slower growth, especially in many emerging markets.
At the time of writing, our industrials coverage list is trading at a 1% premium to our fair value estimates. We believe that declines in select industrials stock prices has provided long-term investors with several attractive opportunities. Below, we highlight multisector industrial Emerson Electric EMR, mining equipment maker Joy Global JOY, and railroad operator Union Pacific UNP.

Prices in the energy and many commodity markets continued to slide this quarter, in keeping with the trend that has been in place since last year. West Texas Intermediate crude oil prices recently touched $36 per barrel, breaking lows seen during the financial crisis in 2009. Other commodities, such as coal, copper, and iron ore, have seen steady price declines as emerging-market demand, especially in China, has stagnated while production has expanded or held stable. The ongoing pressure on energy and commodity prices has led to sharp reductions in capital spending plans among oil producers, miners, and farmers, resulting in decidedly lower order books for many machinery and equipment makers in the industrials sector. Eventually, commodity markets will balance as prices move toward levels needed to incentivize exploration and production to meet future demand.

Energy and commodity weakness, as well as sluggish world trade growth, has negatively affected the transportation-related names in the industrials group. Global trade has been somewhat volatile, with the CPB World Trade Monitor index rising 0.5% in September, following a 0.6% decline in August. Total carloads for North America's six major railroads have declined by between 2% and 8% during the past 13 weeks, according to AAR data. Coal has seen the largest volume declines, but intermodal and merchandise volumes have been generally weak as well. Trucking tonnage has held up somewhat better with the ATA Truck Tonnage Index, rising 1.9% in October, versus September's 0.7% drop. Even here, however, there are concerns, as supply-chain inventories have risen relative to sales.

Global automobile demand remains a clear bright spot in the industrials sector. U.S. auto SAAR reached 18.1 million in November, a number not achieved since before the financial crisis and up nearly 8% from year-ago levels. Auto demand remains similarly strong in Europe, with European automobile registrations hitting 1.1 million in October, 16% above the year-ago period. At Morningstar, our outlook calls for continued growth in auto sales in 2016 for both the U.S. and Europe.

The U.S. construction market is another positive area and continues to generate gradual but steady growth. Both residential and nonresidential construction spending continue to expand. New home starts, including multifamily units, were 1.06 million in October, down from September's level of 1.2 million and roughly even with last October's 1.1 million figure. Job growth should encourage more first-time home purchases, but builders are currently struggling with shortages of construction labor in many markets, which limits what might otherwise be a stronger housing recovery. Nonresidential construction continues on a similar path, with the architectural billing index declining moderately to 53.1 in October, from 53.7 in September. Any reading above 50 indicates an expanding market.

Global merger and acquisition activity remains strong as companies look for new growth and cost-reduction opportunities, while taking advantage of very low interest rates. While healthcare and energy have been leading sectors for consolidation, the industrials sector has also seen M&A activity. Within the past quarter, French industrial gas giant Air Liquide AI announced the acquisition of U.S.-based Airgas ARG at a 51% premium to Airgas' last closing price before the deal announcement. Additionally, consolidation has picked up in the freight transportation sector, where recently announced tie-ups include FedEx FDX and TNT Express TNTE, DSV DSV and UTi Worldwide UTIW, and XPO Logistics XPO and Con-way. Perhaps in a partial reflection of this M&A activity, the trucking sector currently trades at a 6% premium to our fair value estimates. Last but not least is Canadian Pacific Railway CP's ongoing effort to acquire Norfolk Southern NSC. We expect that demand dislocation and low interest rates will drive further M&A activity in industrials.

Top Industrial Sector Picks

	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Consider Buying
Emerson Electric	★★★★	$62.00	Wide	Medium	$43.40
Joy Global	★★★★★	$26.00	Narrow	High	$15.60
Union Pacific	★★★★★	$110.00	Wide	Medium	$77.00

Data as of December 18, 2015

Emerson Electric EMR

Shares of Emerson Electric currently trade in the 4-star range and offer a nearly 20% discount to our fair value estimate of $62 per share, as negative sentiment surrounding the company's oil and gas and emerging-market exposure continues to pressure the name. Nearly 80% of the sales in Emerson's process management segment touch the oil and gas supply chain from upstream to downstream, and fears of an extended downturn in the sector have weighed heavily on the company's share price for the majority of 2015. That said, we continue to believe that Emerson's entrenchment in process automation helps to mitigate cyclicality, and the company has historically been a consistent producer of healthy returns on invested capital, even as its segments experienced boom and bust cycles. In addition, Emerson announced the intent to spin off or sell its lagging network power segment in 2016, an event we believe will ultimately serve as a catalyst for the depressed shares for two main reasons. First, letting go of the segment will ultimately free time, talent, and capital resources to be more productive in Emerson's remaining segments, which include the moaty, high-return process management, climate technologies, and commercial and residential solutions segments. Second, we expect that any proceeds realized in the transaction may be deployed toward tuck-in acquisitions that increase end-market diversification in process management, which suffers from overexposure to the beleaguered oil and gas segment. We stress that this investment idea requires a long time horizon: Share gains in automation often occur at a glacial place, and acquiring new end markets in process management requires finding acquisition targets at reasonable valuations in an M&A environment that has recently felt rich. Nevertheless, we believe the foundation of Emerson's wide economic moat remains strong, and we expect stronger returns on invested capital to emerge as the company works through its portfolio repositioning.

Joy Global JOY

We believe that the market is undervaluing mining equipment manufacturer Joy Global. While we do not think the mining equipment industry is on the cusp of a dramatic recovery, we do believe that Joy, which is trading under 7 times our 2015 free cash flow estimate and in the 5-star range, is inexpensive for a business where conditions are close to a trough. Joy Global is unique among its peer group in that roughly 70% of sales come from aftermarket parts and service. Most competitors have given this business to their dealers. While mining capital expenditures are under pressure in 2015–16, mining customers have reached a point where they have to begin rehabilitating their existing fleet of equipment, and this should benefit Joy Global. Joy also stands apart because roughly 60% of its business is exposed to coal (predominantly in the United States). While the near-term outlook for U.S. coal consumption is not one of growth, our basic materials team sees upside in Powder River Basin coal prices and stability in Illinois Basin coal prices beyond 2015, which should spur more spending from mining customers. We think these conditions mean that Joy Global is inexpensive relative to near-term earnings, with share-price upside to a future recovery in new equipment sales. Finally, Joy is not solely captive to the environment. Over 2014, management pulled $80 million of costs out of the business, with plans to remove another $50 million of expenses in 2015. The company's attractive free cash flow has been used to buy $483 million of stock during the past 24 months, and it has the authorization to buy back another $517 million of stock through August. We believe this cash flow deployment is particularly attractive relative to Joy's $1.5 billion market cap.

Union Pacific UNP

Trading at a 23% discount to our $110 fair value estimate and in the 5-star range, wide-moat Union Pacific is the largest North American railroad and our top pick among transportation names. At 13.6 times forward price/earnings (2016) and 7.8 times forward enterprise value/EBITDA, Union Pacific trades cheaper than all but the lagging Eastern railroads, which continue to struggle with cost-disadvantaged Appalachian coal. We think it should trade closer to Canadian Pacific and Canadian National Railway CNI, the other high-return long-haul railroads. Coal constituted 18% of Union Pacific's sales last year, and year-to-date coal carloads have declined 15.8% versus the year-ago period, as still-low natural gas prices, mild weather, and high utility coal inventories have suppressed demand. We incorporate a 17% full-year coal decline and maintain our expectations of coal declines this year and next, offset somewhat by growth in intermodal units going forward. Managing headcount is complex, but matching labor to work is key to operating ratio performance, as this is the rails' greatest expense line. After a half year of mismatches, Union Pacific dialed in labor in the third quarter to better meet demand and delivered a record 60.3% operating ratio—a 200-basis-point improvement year over year despite the coal drag and a 6.3% overall volume decline in the period. We still model a 63% operating ratio for 2015, but recently tempered our projected progress in 2016 to 61%, up from our previous projection of 60%. However, we think the firm will continue beyond this into the 59% range by 2018. We like Union Pacific for its diverse portfolio (Powder River Basin coal, intermodal franchise at Los Angeles/Long Beach, California, Mexican trade, and fast-growing domestic, high auto exposure, and frac sand), room to slightly improve the operating ratio, conservative management, and 2.4% dividend yield. We think the market is focused excessively on the near term, and with a larger decline than expected in coal volume this year, earnings are down (1.7% decline in the third quarter) and shares are trading off. We maintain our wide moat rating, founded on a duopoly of efficient market structure and low cost compared with competing modes.

Kurt Funderburg does not own shares in any of the securities mentioned above.

Tech & Telecom: Cord-Cutting and Programmatic Advertising Trends Continuing

The sector looks fairly valued overall, but there are still opportunities for selective investors.

Peter Wahlstrom, CFA, Director of Technology, Media, and Telecom Equity Research

- Secular growth drivers abound across the tech media and telecom industries, but even despite growing tech spending, some legacy firms are stuck in neutral. The sector looks fairly valued, and we'd be selective.
- Even with the evolution of the television bundle, there's still plenty of profit in couch potatoes for wide-moat media firms.
- The programmatic advertising wave is still surging.
- Telecom merger rumors continue to swirl in Europe, but don't get excited.

The S&P 500 is down a few percentage points for the year to date, though it is still up from the late-summer sell-off. The performance of the technology sector in aggregate has been slightly stronger, but there are notable areas of strength and weakness. Despite some choppiness across the global macroeconomic landscape, many management teams have remained upbeat and relatively optimistic about their operations and opportunities heading into 2016, but we still embrace a view of bifurcation between legacy and emerging tech companies. Many large tech firms are struggling to reinvent themselves and drive organic growth from new avenues (funded through existing cash flow), while other fast-growing niche players are hoping to disrupt the hierarchy by taking advantage of adoption in analytics, cloud, and engagement (social-media advertising). We continue to believe that persistent foreign exchange headwinds may result in another year of challenging growth and profitability at some firms; however, the underlying tech spend is still projected to grow. In aggregate, we view the tech sector as fairly valued and remain selective in our picks.

In the table below, we highlight a few companies in technology, media, and telecom that appear to be fundamentally undervalued. All three have significant international exposure in some form or another; because we don't explicitly offer currency forecasts (although we do bake them into our uncertainty ratings), this is a factor that investors will want to keep a close eye on.

Taking a step back, although the media and telecom subsectors trade just below our respective fair value estimates, we would still seek a wider margin of safety in many cases. We are quick to gravitate toward firms with established economic moats, those with strategic assets, and those that are well positioned in key growth areas. We believe firms with this combination should be in a better relative position to withstand near-term revenue and operating-margin volatility, while offering long-term free cash flow growth potential.

The Evolution of the Television Bundle: There's Still Plenty of Profit in Couch Potatoes for Wide-Moat Media Firms

The television ecosystem is constantly evolving and the traditional bundle model has come under pressure recently, but we believe investors have overreacted to fears that a sudden shift in consumer behavior is about to occur. In our view, the changes taking place today are a continuation of the fragmentation that has been occurring over the past several decades. Penetration of traditional television service has steadily eroded, following a peak somewhere around the end of the last decade. Perhaps counterintuitively, the industry's growth accelerated sharply during the worst of the financial crisis and has steadily deteriorated since. We ascribe this blip to the limited video alternatives available at the time, aggressive price promotion among several providers aiming to protect their customer bases (especially the phone and satellite companies), and the fact that television service is inexpensive relative to other forms of entertainment.

But the market is different today than it was just a few years ago. We find that younger age cohorts are driving the majority of the decline in traditional television penetration. Younger consumers are increasingly viewing traditional content in nontraditional ways, but we still believe younger consumers simply don't value the traditional television bundle as much as prior generations have.

So looking ahead, the key question is how the media industry can evolve to combat the challenges currently facing the traditional television business. We expect consumer purchase decisions will fragment into network choices, where cable companies like Comcast CCZ are positioned to dominate, and content selection. We also believe content owners should work aggressively to accelerate this shift, encouraging new entrants to innovate the manner in which consumers interact with content and compete away excess profits that exist in the content distribution business today to make content more affordable to consumers. In so doing, we see a clear path to maintaining and enhancing the broad appeal that the traditional bundle has enjoyed for most of the past couple of decades.

As new firms continue to come into the television market, we expect that video on demand and subscription video on demand will steadily grow in importance as these entrants innovate around television distribution. We have introduced a new four-pillar framework through which we evaluate each company's positioning amid the changing media landscape. The four criteria include; 1) Known brands and studios; 2) Access to a strong library of content; 3) Lower dependence on traditional advertising; and 4) Higher international exposure.

We prefer media firms with strong production studios in both film and television, along with a deep content library. As the bundle evolves, we expect the most watched networks to survive and even flourish. Their content and sports rights provide a leg up in discovery, as consumers already watch and monitor their channels. In addition, we are looking for companies with lower exposure to one of the traditional sources of revenue: advertising. We expect that new television platforms will prioritize the customer experience over ad loads, putting pressure on traditional ad revenue. Also, advertisers are steadily shifting budgets to digital formats that are more easily measured. Finally, strong companies should have exposure to the faster-growing international markets where high-quality Internet access is less pervasive, providing a longer runway for traditional distribution models.

We believe five companies—Comcast, Walt Disney DIS, CBS CBS, Twenty-First Century Fox FOXA and Time Warner TWX—have the networks necessary to remain in any relevant bundle. From a content production and library standpoint, Disney, Fox, Time Warner, and Comcast are best situated to anticipate and react to potential outcomes from the transition away from traditional distribution channels. Three companies pass all four pillars of our wide-moat framework for media firms: Walt Disney, Time Warner, and Twenty-First Century Fox. These firms stand out as possessing both a wide moat and the ability to sustain their moat in the face of the ongoing changes across the pay-television landscape. We believe the investor reaction to fears surrounding the pay-television business has created an opportunity to buy all three at attractive prices.

Programmatic Advertising Wave Still Surging

Investors should pay attention to a massive shift in the digital advertising industry toward programmatic advertising (the automated buying and selling of advertising inventory), a trend that we believe highlights the distinct competitive advantages of Alphabet GOOG and Facebook FB, while underscoring the wasting assets at traditional web media properties such as Yahoo YHOO. This algorithmic placing of ads represents nearly half of the $30 billion display market in the United States. These new technologies are detrimental to companies like Yahoo because marketers now have the ability to target audiences in a more precise, identifiable, and efficient way across multiple web properties. Quite simply, technology has leveled the playing field by providing marketers with reach, obviating the value of Yahoo's generic traffic, where little is known about the users. In our view, the rich customer data that Google and Facebook possess is even more valuable in a programmatic world, particularly as these companies seem to be operating walled gardens. We also believe that wide-moat firms such as Oracle ORCL, Salesforce CRM, and Adobe Systems ADBE are sell-rich marketing technology products that will help marketers maximize their data assets and adapt to a world where they are marketing across multiple devices and multiple channels. These products will have switching costs similar to their broader software offerings, in our view.

Telecom Merger Rumors Continue to Swirl in Europe, but Don't Get Excited

Telecom merger rumors continue to swirl in Europe, but we don't place much credence in many of them. For example, it seems a regular occurrence that Orange ORAN will supposedly buy another player. We think rumors of it acquiring another operator in France are unfounded, and currently think there is a 0% chance that regulators would approve Orange acquiring any of the other three France-based operators. On the other hand, we do think Orange may be willing to buy some assets or subscribers if two of the other domestic players were to merge and regulators wanted some divestitures. A more likely longer-term scenario includes the possibility of Orange acquiring an operator in another country. But this isn't without its challenges, as we think KPN KPN in the Netherlands and Proximus PROX in the Belgium area would be too small, and neither has any interest in selling. Similarly, we think Telecom Italia TI shares are overvalued, and Orange shareholders would rebel at an offer for this company. We expect the rumor mill to continue to churn, but we'd encourage investors to maintain an eye on underlying fundamentals and not get caught up in market speculation.

Elsewhere, we think all eyes remain on the EU regulator's rulings for the proposed acquisition of Telefonica TEF's O2 division in the United Kingdom by CK Hutchison Holdings 00001's 3 unit and its Italian unit's proposed merger with VimpelCom VIP's Wind unit. Until those rulings are out, we don't expect any more in-country merger proposals. We anticipate that the EU will likely rule during the second quarter of 2016. While we expect more rumors between now and then, we believe the likelihood of any official merger announcements in Europe before then to be quite low. In general, anticipation surrounding global mergers and acquisitions across the telecom industry is reflected in higher stock prices in many cases. There are still pockets of value across the global telecom space, but most come with baggage in the form of lagging sales growth, higher legacy costs, or poor macroeconomic conditions, so we encourage investors to be highly selective.

Top Tech & Telecom Sector Picks

	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Consider Buying
Twenty-First Century Fox	★★★★	$38.00	Wide	Medium	$26.60
Time Warner	★★★★★	$94.00	Wide	Medium	$65.80
Grupo Televisa	★★★★	$36.00	Wide	Medium	$25.20

Data as of December 18, 2015

Twenty-First Century Fox FOXA

Twenty-First Century Fox is a media conglomerate with a wide range of assets: a film studio, which creates television programs and movies; broadcast television, including the Fox broadcast network and local TV stations in the U.S.; cable networks, which comprise over 300 channels around the world; and direct-broadcast satellite TV in the form of SKY, a satellite pay-TV provider in Europe. We acknowledge that the streaming service and skinny bundles will disturb the traditional pay-TV bundle in the near future. However, the timing and magnitude of the disruption remains unclear, and too much pessimism appears baked into the share price at current levels.

Time Warner TWX

Time Warner is a pure-play entertainment company that owns several television networks, including HBO, CNN, TNT, and the CW. The filmed entertainment segment creates and distributes movies and television programming for both internal and external distribution outlets. Warner Bros. and New Line Cinema combine to form the largest filmmaker in the world. The company owns a deep and valuable content library that includes popular movie franchises such as DC Comics and Harry Potter and television programs such as Friends and The Big Bang Theory. We acknowledge that the streaming service and skinny bundles will disturb the traditional pay-TV bundle in the near future. However, the timing and magnitude of the disruption remains unclear, and too much pessimism appears baked into the share price at current levels.

Grupo Televisa TV

Grupo Televisa is the largest media company in the Spanish-speaking world. Besides operating broadcast channels in Mexico, the company produces pay-television channels whose content reaches subscribers in North America, Asia, Europe, and Latin America. Televisa also owns interests in satellite television, cable TV, terrestrial radio, magazine publishing, Mexican bingo parlors, and three of Mexico's professional soccer teams. We remain focused on the regulatory front, but management appears focused on strengthening its core businesses. The firm continues to seek out balance between growth, investment (margin preservation), and navigating the regulatory environment.

Peter Wahlstrom, CFA, does not own shares in any of the securities mentioned above.

Utilities: Don't Fear the Fed; Yield and Growth Still Look Good After 2015 Slump

It's time for investors to focus on utilities' fundamental earnings-growth prospects and dividend yields, with the aim of attaining the consistent shareholder returns that they expect from the sector.

By Travis Miller, Director of Utilities Equity Research

- The global utilities sector is trading at a 0.97 market-cap-weighted price/fair value ratio at the end of November. We think the most value is among regulated utilities with dividend yields above 4% and power producers that can benefit from a rebound in historically low power and natural gas prices.
- U.S. utilities' 3.7% median dividend yield represents a historically attractive 140-basis-point premium to the 10-year U.S. Treasury yield. Some high-quality utilities are trading with dividend yields that are double those of 10-year U.S. Treasury yields.
- Merger and acquisition activity picked up in the second half of 2015, featuring some eye-watering valuations. Electric utilities have shown a willingness to pay top dollar for faster-growing natural gas utilities.
- Global energy markets are convulsing as renewable energy, weak electricity demand, and low worldwide commodity prices bring down margins for fossil-fuel power generators worldwide. Although we think we've reached a bottom, it could be several years before a rebound.

After a glorious 2014 and a dreadful 2015, utilities are back where they started two years ago—fairly valued. The market's myopic focus on interest rates during the past two years has finally subsided as the U.S. Federal Reserve raised its target rate in December for the first time in nearly a decade. Now, we think it is time for investors to focus on utilities' fundamental earnings-growth prospects and dividend yields, with the aim of attaining the consistent shareholder returns that they expect from the sector.

U.S. utilities are on their way to finishing 2015 down nearly 10%, the first time since 2008 that utilities have posted a negative return in a calendar year. Most of that downdraft came during the first half of the year, when rising interest-rate expectations and overheated valuations contributed to a 14% drop in the Morningstar Utilities sector index between late January and mid-summer.

But with higher interest rates mostly priced into utilities' valuations, some pockets of value have developed during the second half of 2015. Most utilities' dividends, balance sheets, and growth outlooks are as strong as they have been through this cycle. Utilities continue to enjoy low-cost financing that is turbocharging earnings growth and shows no sign of abating.

Spreads between regulatory allowed returns, which drive revenue, and financing costs are as wide as they have been in at least three decades.

This attractive financing dynamic has led to a half-dozen substantial acquisition bids during the last year, all at eyewatering valuations. Deals such as Duke Energy's bid for Piedmont Natural Gas at 30 times earnings and Southern Company's bid for AGL Resources at 22 times earnings demonstrate the benefits of low-cost financing to boost long-term earnings growth. We expect more sector consolidation as long as interest rates stay low.

Offsetting these tailwinds, we expect weak electricity demand and regulatory risk to remain a concern for some utilities in the U.S. and globally. Diversified utilities and independent power producers with coal and nuclear generation around the globe are struggling as natural gas becomes a cheaper, more environmentally friendly fuel source for power generation.

Given these concerns, we encourage investors to seek utilities with premium dividend yields, consistent and transparent long-term growth opportunities, and stable regulatory frameworks. We think these utilities will produce solid long-term shareholder returns regardless of interest-rate movements.

Top Utilities Sector Picks

	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Consider Buying
Duke Energy	★★★★	$82.00	Narrow	Low	$65.60
ITC Holdings	★★★★	$42.00	Wide	Low	$33.60
Electricite de France	★★★★★	EUR 21.00	Narrow	Medium	EUR 14.70

Data as of December 18, 2015

Duke Energy DUK

Duke Energy became the largest U.S. utility after it merged with Progress Energy in 2013. Duke's regulated utilities in the Carolinas, Indiana, Florida, Ohio, and Kentucky contribute about 90% of earnings. Duke also owns and operates renewable wind and solar assets and Latin American hydroelectric generation assets. In 2015–19, we expect Duke to invest $41.8 billion, of which nearly $30 billion is growth capital. That growth investment and management's ability to achieve cost savings support our 6% earnings growth estimate. Investors' worries about the international segment are far out of line, resulting in a dividend yield and valuation multiples that haven't been this attractive since the financial crisis.

ITC Holdings ITC

ITC Holdings is the only publicly traded pure-play independent electric transmission company in the United States. ITC has been one of the fastest-growing utilities during the past decade and now has more than 15,600 miles of high-voltage transmission lines and supporting facilities in seven U.S. states. ITC's wide moat and the financial incentives federal regulators offer to enhance transmission grid reliability, renewable energy interconnection and low-cost natural gas power generation should continue to support industry-leading returns on capital and earnings growth. We expect ITC's capital investments to support close to 8% average annual earnings growth and 13% annual dividend growth during the next five years, even as regulated rates of return come down. We think any downside from lower allowed revenues is more than priced into the stock.

Electricite de France EDF

EDF is one of the world's largest energy companies, controlling the French power grid along with a massive global generation fleet. Its French nuclear fleet comprises 58 plants, and it operates the largest power supply business in France. Investments in France's regulated electricity grid and renewable energy, along with new capacity-market revenue, should drive 2% annual EBITDA growth through 2019. This, in turn, should support a healthy dividend, most of which goes to the French state, owner of nearly 85% of shares. EDF's performance is heavily influenced by French regulation and structural reforms to European power markets, both of which are subject to political meddling. Even with our expectations for a modest rise in French tariffs and substantial lost customers as France moves toward a different pricing scheme, we still think the market is overly pessimistic. EDF also has upside from newbuild nuclear in the United Kingdom and possibly China.

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