March 12, 2020

US Strategy Comment

Our Conviction Is Resolute, Template Notwithstanding

This Too Shall Pass- Control What You Can Control

"Worst birthday ever." Such were the words uttered by the secular bull market as it turned 11 this week, all while it was unceremoniously being smacked into a cyclical bear (by definition down more than 20% from the peak). Panic, fear, and ambiguity remain firmly entrenched as the only drivers of investment strategy, as perspective, poise, and process continue to be ignored. Unfortunately, there is no magic bullet, support level, fiscal or government response let alone containment protocol that would release the gripping anxiety that has paralyzed the world. As such, those seeking academic templates and traditional signals to diagnose the ultimate bottoming mechanism of US stocks will continue their befuddlement, in our view.

However, the same holds true for the recovery – which WILL occur. Why? We are choosing to default to the principles of the founding fathers. They were incredible people of faith and fortitude, helping to create one of the greatest countries in the world with a mindset and culture of optimism. As a result, that template and mindset has spawned companies whose innovation, services, and products have shaped and the led the world.

Coronavirus (COVID-19 virus) is a human tragedy - there is no way around that. But our experience tells us that it cannot and will not wipe out every fabric of investing. As such, we continue to believe US companies will ultimately provide, define, and lead the recovery – when and only when the fear abates. The collateral damage is what it is. As a strategist who is defined by perspective, poise, and process – these are unprecedented times which require unwavering courage, conviction, and resolution.

Therefore, we must control what we can control - realizing that earnings will be impacted and the internal parts of our models and sector positioning need to be adjusted accordingly. While the secular bull market's birthday party was literally crashed this week, the depth and duration of any cyclical bear simply cannot and should not be foretold. Faith defines our perspective that this too shall pass; poise fuels our courage to not react; and process exemplifies our discipline.

Main Points:

- **Lowering Our S&P 500 2020 EPS Target to $160 From $176**
- **Real Estate: Upgrade to Overweight From Market Weight**
- **Financials: Downgrade to Market Weight From Overweight**
- **Energy: Remain Market Weight**
- **Rebalancing Target Weights to Reflect Recent Market Action**

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US Strategy –S&P 500 Targets

Model	2020E
S&P 500 Price Target	
DDM	3,400
Fair Value P/E	3,675
Macro Regression	3,125
Price Target	**3,400**
S&P 500 EPS Target	
Macro Regression	$163
Bottom Up Consensus	$173
Normalized EPS	$157
EPS Target	**$160**
Implied P/E	**21.3x**

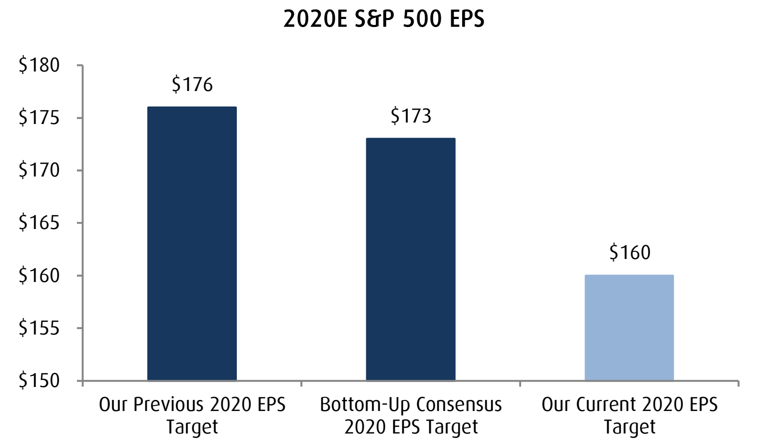
Source: BMO Capital Markets Investment Strategy.

US Strategy – Recommended S&P 500 Sector Weightings

Sector	Opinion	Tgt. Wgt.
Communication Services	OW	12.5%
Consumer Discretionary	OW	10.5%
Consumer Staples	UW	6%
Energy	MW	3%
Financials	MW	11.5%
Health Care	MW	14%
Industrials	MW	8.5%
Information Technology	OW	25.5%
Materials	MW	2.5%
Real Estate	OW	4%
Utilities	UW	2%

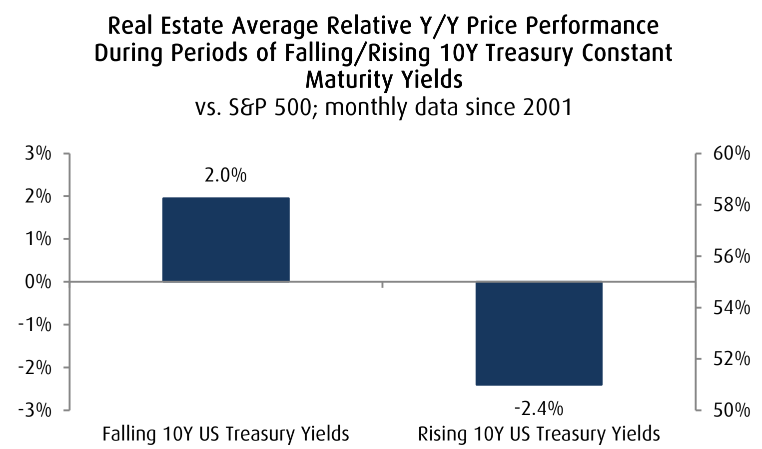
Source: BMO Capital Markets Investment Strategy.
OW: Overweight
MW: Market Weight
UW: Underweight

Exhibit 1: Lowering Our 2020 EPS Target



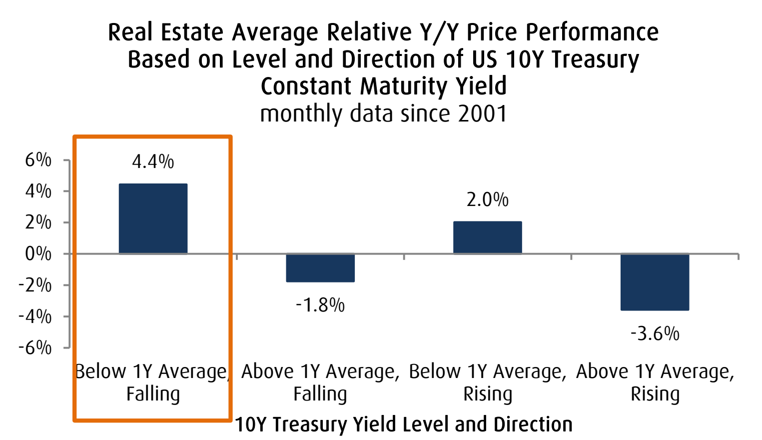
Source: BMO Capital Markets Investment Strategy Group, FactSet, IBES.

Exhibit 2: Real Estate Usually Outperforms When Yields Are Falling



Source: BMO Capital Markets Investment Strategy Group, FactSet.

Exhibit 3: Level & Direction of Yields Matter for Real Estate Performance



Source: BMO Capital Markets Investment Strategy Group, FactSet.

Decreasing Our S&P 500 2020 EPS Target to $160 Amid Lower US GDP Growth Expectations

Although it will likely take many months to understand the full economic fallout from the pandemic, we believe it is appropriate to adjust our EPS target at a minimum.

- EPS and GDP growth trends have historically tracked each other quite well, so we believe lower GDP will translate into lower EPS growth.
- Our new target implies ~2% of EPS declines, which we believe should adequately represent any expected damage resulting from the pandemic.
- Also, analysts have been slow to react to fast moving markets, so we expect bottom-up numbers to decrease closer to our new EPS target eventually.

Falling Yields Should Benefit Real Estate Relative Performance

Treasury yields have plummeted in response to the global panic regarding COVID-19 virus. And this has important investment implications for US stock investors.

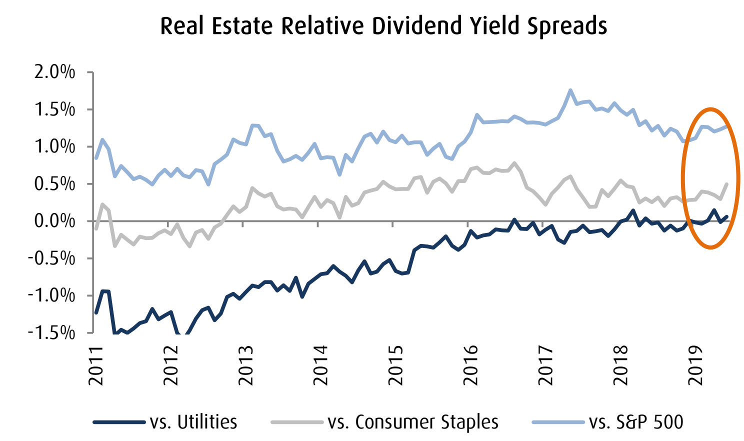
- Real Estate is one area we believe will benefit from the new lower yield levels.
- Historically, the group has outperformed by relatively wide margins when yields are falling and is the main reason we decided to upgrade the sector to Overweight.

Price Performance for Real Estate Is Best When US 10Y Treasury Yield Is Below Average and Dropping

The direction and level of Treasury yields are also an important consideration.

- Given historically low levels of Treasury yields, it is unlikely for them to fall significantly from current levels for an extended period. But if they do, this would be an optimal scenario for Real Estate from a relative performance perspective.
- However, if yields do rise, they are likely to remain well below average according to updated forecasts, and we found that this also is beneficial for Real Estate relative performance.

Exhibit 4: Real Estate Dividend Yield Spreads vs. Utilities, Staples, and S&P 500 All Above 0%



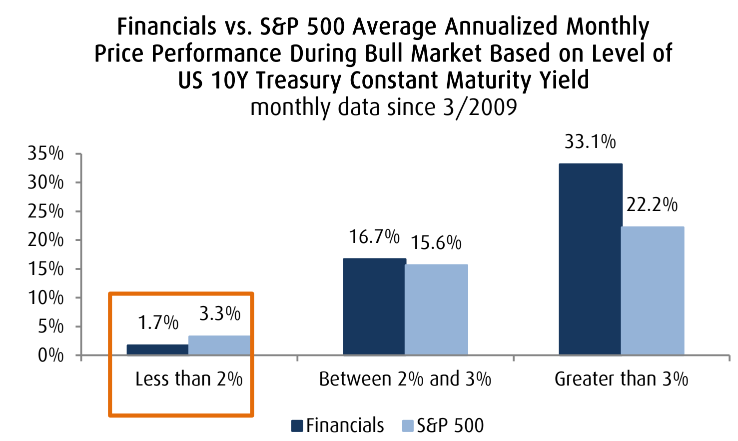
Source: BMO Capital Markets Investment Strategy Group, FactSet.

Dividend Yield Spreads for Real Estate Look Attractive

Historically low Treasury yields have also brought dividend strategies back to the forefront.

- Real Estate has always been an area where investors have searched for yield, but recent trends have made the sector more appealing compared to other "dividend plays."
- For instance, the dividend yield spread vs. the S&P 500 has increased lately and its current level remains near recent highs.
- More important, Utilities have been the typical "go-to" dividend play but the sector's yield advantage relative to Real Estate has been eliminated.

Exhibit 5: Financials Struggle When 10Y Yield Is Below 2%



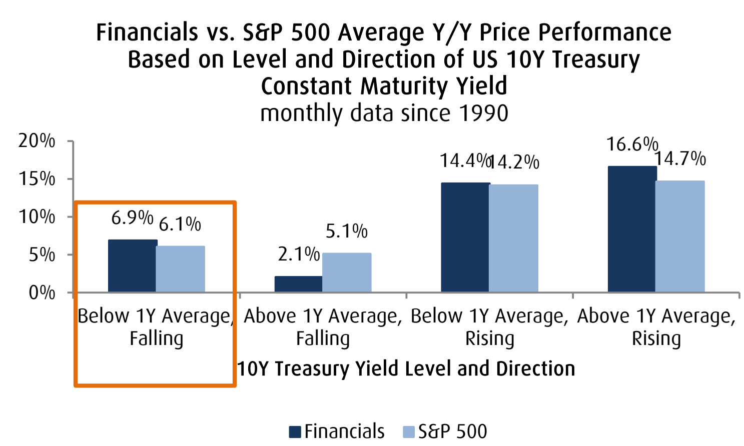
Source: BMO Capital Markets Investment Strategy Group, FactSet.

Low Yields Tend to Be Obstacles for Financials Outperformance

We decided to downgrade Financials to Market Weight from our longstanding Overweight recommendation.

- From our perspective, historically low interest rates are a major impediment from a relative performance standpoint.
- We found that Financials significantly underperform during periods where 10Yr Treasury yields are below 2%.
- And given current levels (below 1%), we do not anticipate yields exceeding 2% anytime soon.

Exhibit 6: Historically, Financials Have Essentially Been Market Performers When US 10Y Treasury Yield Is Below Average + Falling



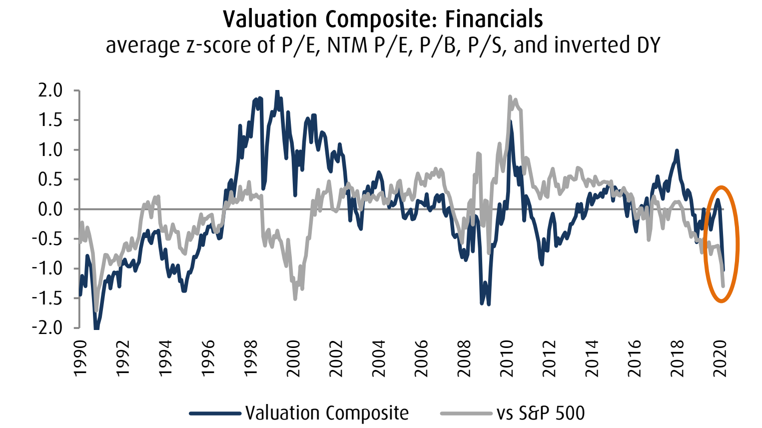
Source: BMO Capital Markets Investment Strategy Group, FactSet.

Over Longer Periods, Financials Can Match Market Performance Despite Low Yields

Notwithstanding the near term obstacle of historically low yields, we found that Financials have essentially performed in line with the market at below average yield levels irrespective of yield trajectory.

- It is for this reason we are not as pessimistic as some others when it comes to Financials and the interest rate outlook.

Exhibit 7: Financials Valuation Fall to Lowest Level Since 2011



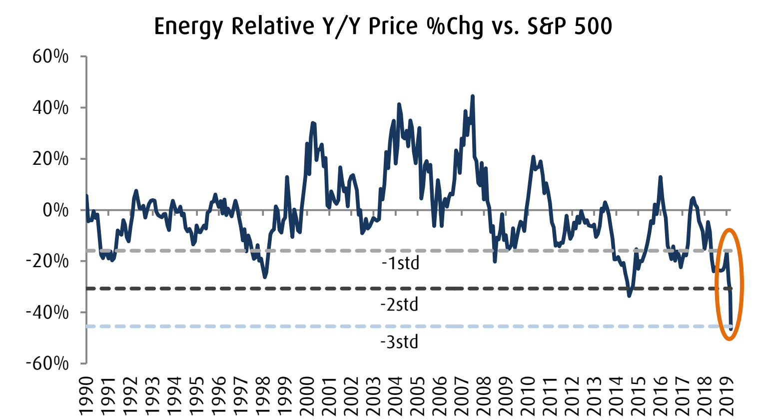
Source: BMO Capital Markets Investment Strategy Group, FactSet, IBES.

Financials Valuation Suggest Much of the Bad News Is Already Priced In

Financials have been one of the hardest hit areas of the market since the COVID-19 virus panic started. As a result, absolute valuations for the sector have plummeted to levels last seen in late 2011 according to our valuation composite model.

- Relative to the S&P 500, valuations for Financials have fallen to the lowest levels since 2000.
- From our perspective, this valuation reset has already accounted for any upcoming "bad news" on the earnings front and should help to support stock prices in the coming months – another reason we do not share the market's pessimism for financial stocks.

Exhibit 8: Energy Y/Y Price %Chg vs. S&P 500 Has Plunged to Three Standard Deviations Below Average



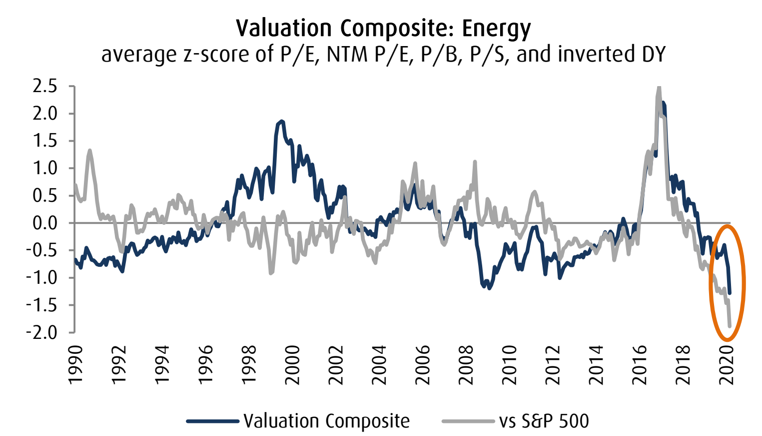
Source: BMO Capital Markets Investment Strategy Group, FactSet.

Energy Relative Y/Y Performance Has Hit Extreme Negative Levels Never Exhibited Before

Energy stocks have plunged more than 30% in March amid concerns over an oil price war and growing coronavirus fears, and are currently down ~50% for the year.

- Relative y/y price performance for Energy has plummeted to extreme negative levels never exhibited before – three standard deviations below its historical average.

Exhibit 9: Relative Valuations for Energy at All-Time Low



Source: BMO Capital Markets Investment Strategy Group, FactSet, IBES.

Energy Stocks Are Already Priced for Disaster

While Energy stocks certainly have a long road ahead on both a price performance and fundamental basis, the sector, at the moment, looks to be already priced for disaster. Additionally, recent price weakness has pushed the weight of the sector in the S&P 500 to a mere 2.8%, its lowest weight on record. As such, we are maintaining our Market Weight recommendation on the S&P 500 Energy group.

- Energy valuations have dropped to all-time low valuations relative to the S&P 500 according to our valuation composite model, while absolute valuations are right at cycle lows.

Recent US Strategy Research Reports

Date	Title
	Comments, Snapshots, and Perspectives
2/27/2020	US Strategy Snapshot: Epidemic of Fear
2/27/2020	US Strategy Comment: Panic Is Not a Winning Investment Strategy
2/24/2020	US Strategy Snapshot: Coronavirus Impact on US Stock Performance and Earnings
2/10/2020	US Strategy Comment: Thematic Report – The Shifting Consumer
1/22/2020	US Strategy Comment: The Doubted Bull Returns Yet Again
1/17/2020	US Strategy Comment: Making the Case to Overweight Comm Svcs and Discretionary
1/15/2020	US Strategy Comment: Staying Selective Within Industrials
12/11/2019	US Strategy Comment: 2020 US Sector Positioning
10/30/2019	US Strategy Snapshot: Pictures to Ponder With Stocks Hitting New Records
10/17/2019	US Strategy Snapshot: Sector Expectations From the Lens of Analysts
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9/12/2019	US Strategy Comment: Leveraging Low Risk Factors to Manage Uncertainty
8/15/2019	US Strategy Perspective: Yield Curve FACTS
	Monthly Reports
3/5/2020	US Strategy: US Chartbook – March 2020
3/5/2020	US Strategy: US Factor Profiles – March 2020
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11/21/2019	Investment Strategy: 2020 Market Outlook
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Hold	Market Perform	52.0 %	18.4 %	43.6 %	50.0 %	43.7 %	37.5%
Sell	Underperform	3.7 %	15.0 %	2.6 %	3.0 %	1.1 %	4.8%

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