

Global Market Strategy Research

Regional and Sector Strategy: Monthly Update

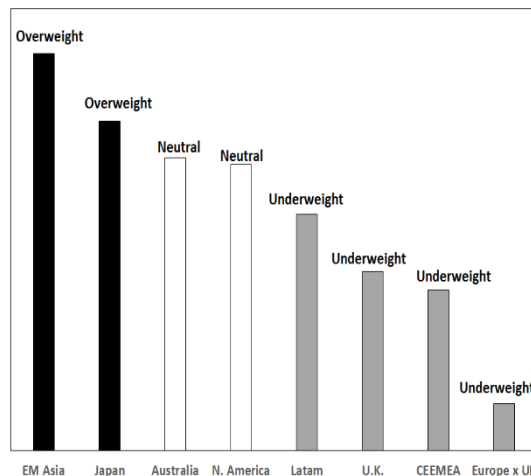


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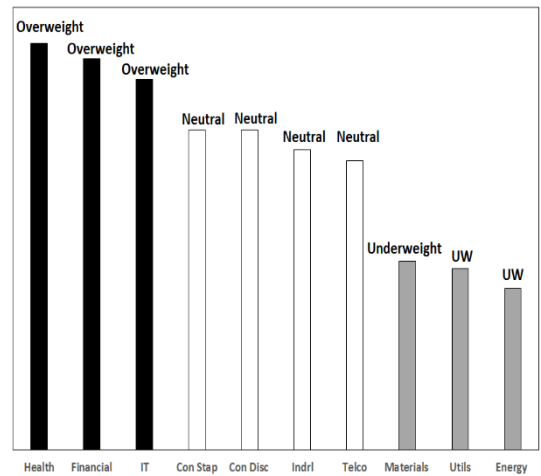
- **Regional Strategy** — Our regional strategy is unchanged, even with a heightened focus on monetary policies and exchange rates in the past month driven, in part, by fears of deflation. We continue to have a defensive tilt in our regional recommendations, and are Underweight the commodity-rich regions of CEEMEA and Latin America.
- **Sector Strategy** — Our sector strategy is also unchanged and remains “less cyclical, more defensive.” We maintain our relatively defensive posture given pockets of economic weakness globally. We are Overweight Health Care in North America, the U.K. and Europe ex U.K. We are Underweight or Neutral Energy in the majority of regions.
- **Food for Thought** — Is deflation always “bad” for equities? History suggests not.

Figure 1: Regional Rankings
Arrows Indicate Change vs. Last Month



Source: Cornerstone Capital Inc.

Figure 2: Sector Rankings
Arrows Indicate Change vs. Last Month



Source: Cornerstone Capital Inc.

Regional and Sector Strategy: Monthly Update

This month there are no changes to the recommendations in our regional and sector strategy models. Our previous regional and sector recommendations were published in the January 2015 edition of the Cornerstone Capital [Regional and Sector Strategy: Monthly Update](#).

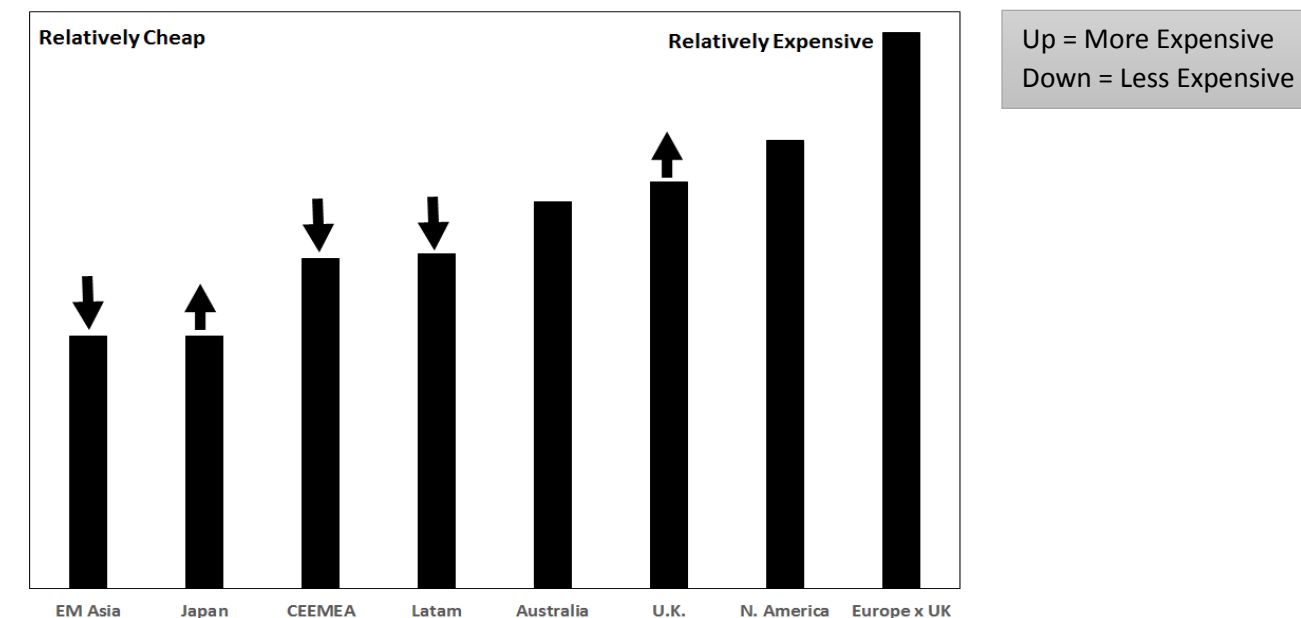
Even with a heightened focus on monetary policies and exchange rates in the past month, our regional strategy is unchanged. We continue to have a defensive tilt in our regional recommendations, and are Underweight the commodity-rich regions of Central and Eastern Europe, Middle East and Africa (CEEMEA) and Latin America.

Our sector strategy is also unchanged and remains “less cyclical, more defensive.” We maintain our relatively defensive posture given pockets of economic weakness globally. We are Overweight Health Care in North America, the U.K. and Europe ex U.K. We are Underweight or Neutral Energy in the majority of regions.

Regional Strategy Update

We have updated the inputs to the Cornerstone Capital Regional Strategy Model in which we rank eight regions/major economies that are included in the MSCI All Country World Index (ACWI). In terms of valuations, Figure 3 illustrates that the valuation of Emerging Asia, which we are Overweight, has become even more attractive. Our other Overweight — Japan — continues to look attractive on a relative valuation basis, even though the country has become a little more expensive.

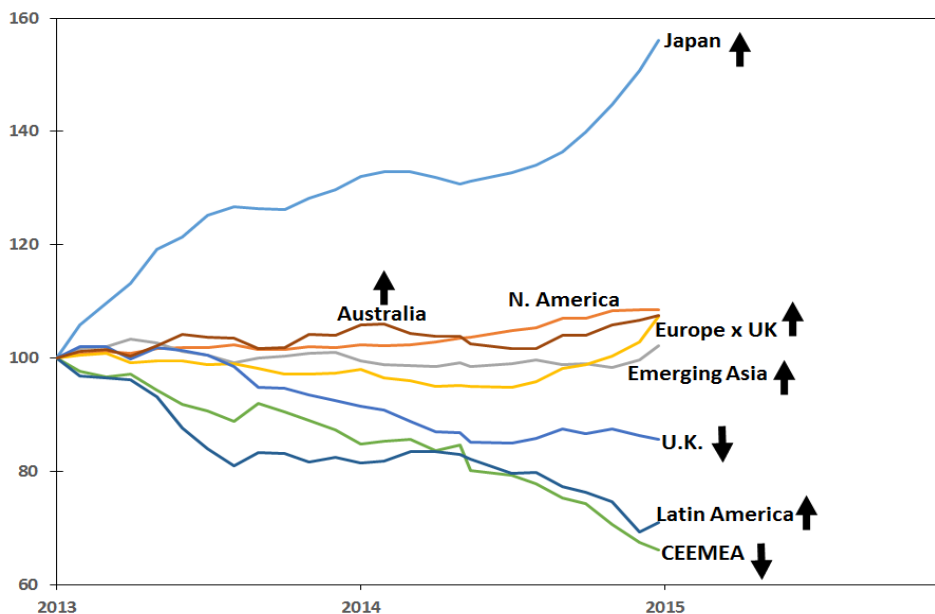
Figure 3: Regional Valuations (50% of Aggregate Weight)
Arrows Indicate Change vs. Last Month



Source: Cornerstone Capital Inc.

Figure 4 illustrates that earnings momentum in Japan and Emerging Asia continues to improve, while earnings momentum in the U.K. (downgraded to Underweight last month) has weakened further.

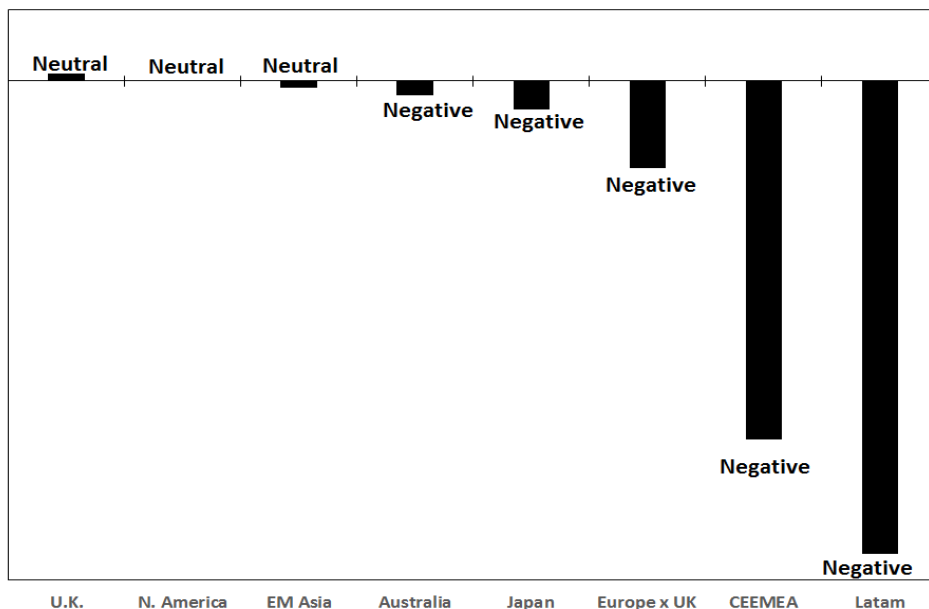
Figure 4: Earnings Momentum (33% of Earnings Weight)
Arrows Indicate Change vs. Last Month



Source: Cornerstone Capital Inc.

Figure 5 illustrates that the earnings revisions trends in three of our Underweight regions — Latin America, CEEMEA and Europe ex. the U.K. — remain extremely negative i.e., downgrades by far exceed upgrades.

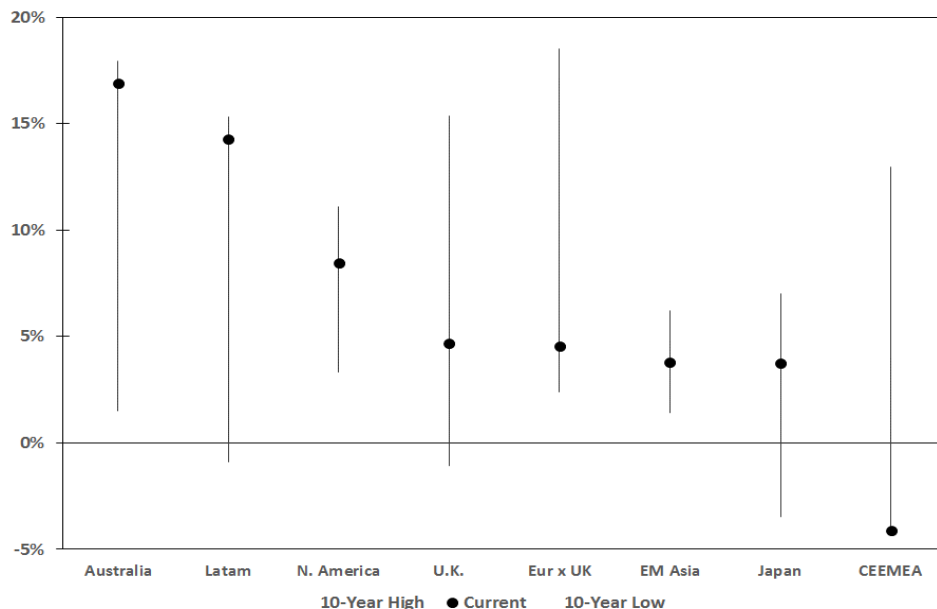
Figure 5: Earnings Revisions (33% of Earnings Weight)



Source: Cornerstone Capital Inc.

Figure 6 illustrates that free cash flow margins in the Underweight CEEMEA region are currently at ten year lows.

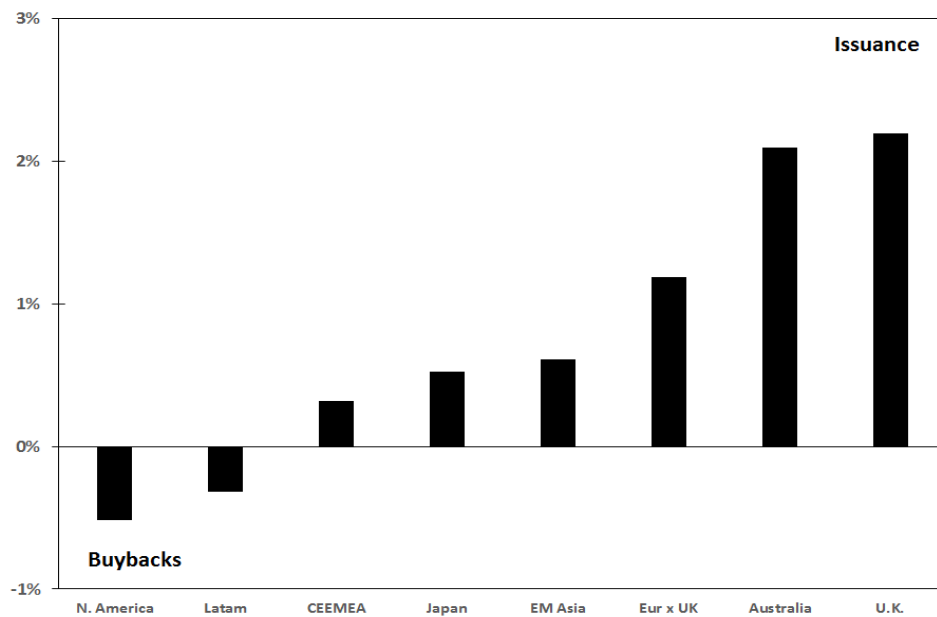
Figure 6: Free Cash Flow Margins (15-20% of Earnings Weight)



Source: Cornerstone Capital Inc.

Figure 7 illustrates that share issuance is relatively high in the U.K., an Underweight region.

Figure 7: Net Share Issuance (15-20% of Earnings Weight)



Source: Cornerstone Capital Inc.

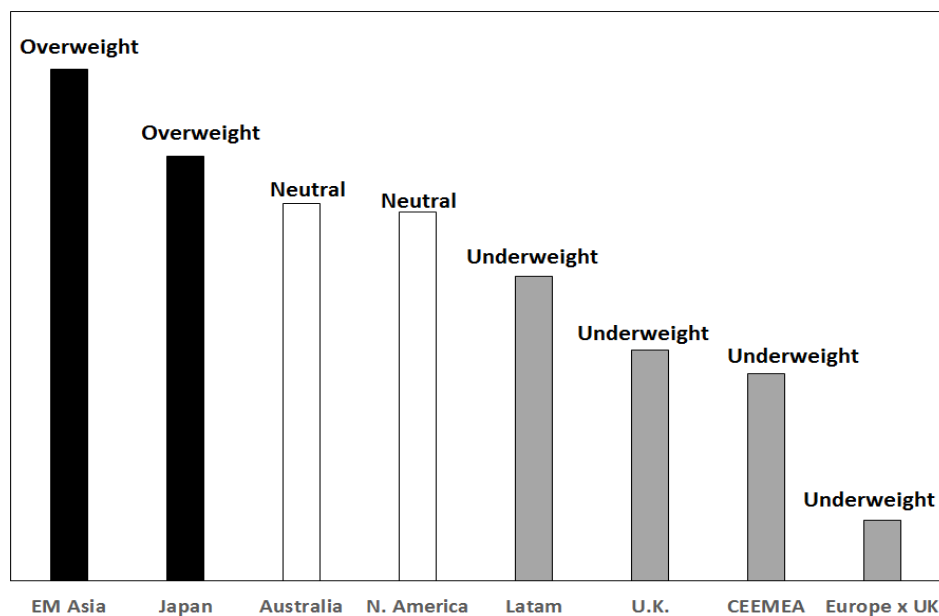
Figure 8 summarizes the current regional recommendations and Figure 9 illustrates the dispersion of the regional scores.

Figure 8: Regional Recommendations

Region / Major Economy	Recommendation	Valuation (Relative)	Governance (Relative)	Earnings Momentum	Earnings Revisions	Margins (Relative)	Share Buybacks
EM Asia	Overweight	Positive	Negative	Positive	Neutral	Negative	Negative
Japan	Overweight	Positive	Neutral	Positive	Negative	Negative	Negative
Australia	Neutral	Neutral	Positive	Positive	Negative	Positive	Negative
North America	Neutral	Negative	Positive	Neutral	Neutral	Positive	Positive
Latin America	Underweight	Neutral	Negative	Negative	Negative	Positive	Positive
U.K.	Underweight	Negative	Positive	Neutral	Neutral	Negative	Negative
CEEMEA	Underweight	Positive	Negative	Negative	Negative	Neutral	Negative
Europe x U.K.	Underweight	Negative	Neutral	Positive	Negative	Neutral	Negative

Source: Cornerstone Capital Inc.

Figure 9: Ranking Regions by Weighting Valuation, Earnings and Governance Scores



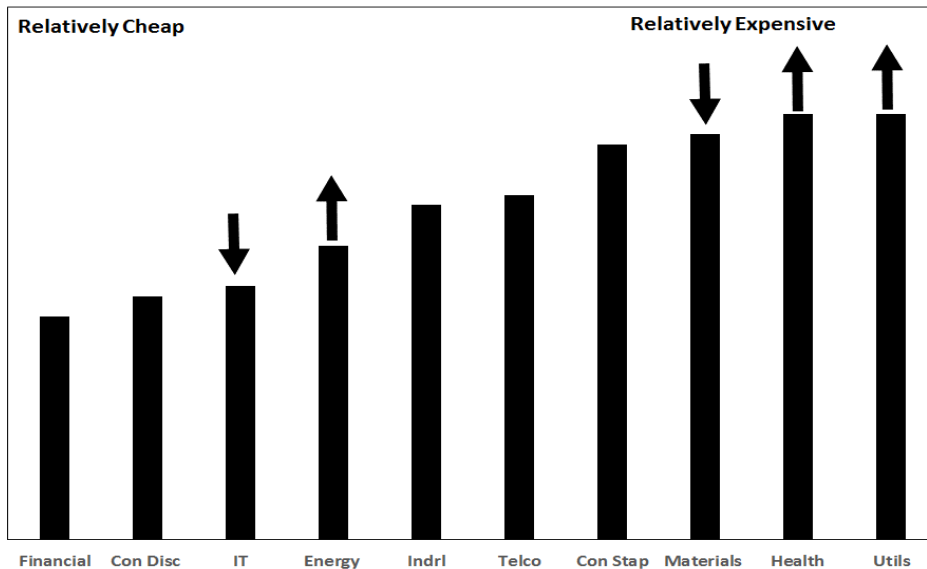
Source: Cornerstone Capital Inc.

Sector Strategy Update

We have updated the inputs to the Cornerstone Capital Sector Strategy Model in which we rank the ten GICs in the MSCI ACWI.

Figure 10 illustrates that, even with the sharp decline in share prices, the Energy sector has actually gotten *more expensive* on a relative basis suggesting, perhaps, that stock prices in the Energy sector have not fallen as fast as earnings estimates.

Figure 10: Sector Valuations (20% of Aggregate Weight)
Arrows Indicate Change vs. Last Month

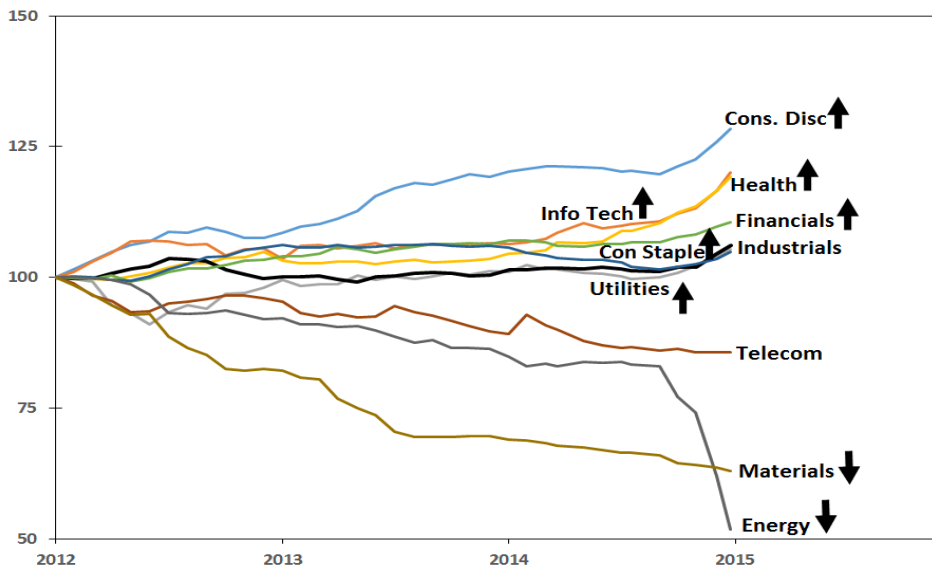


Up = More Expensive
 Down = Less Expensive

Source: Cornerstone Capital Inc.

Figure 11 illustrates that earnings momentum in the Health Care, Financials and Information Technology sectors — our three Overweights — improved last month. Earnings momentum in the Energy and Materials sectors — two of our three Underweights — weakened significantly once again.

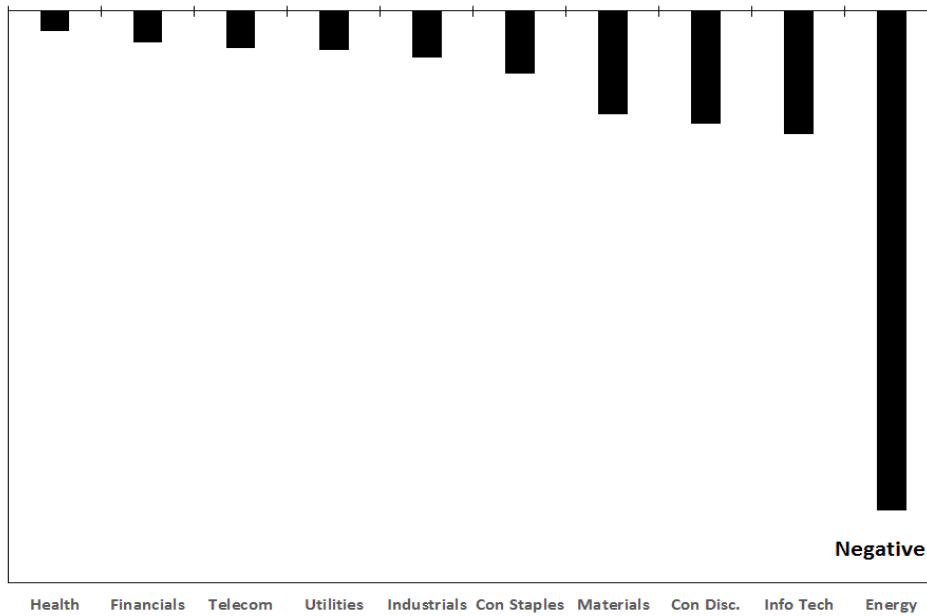
Figure 11: Earnings Momentum (33% of Earnings Weight)
Arrows Indicate Change vs. Last Month



Source: Cornerstone Capital Inc.

Figure 12 shows that the Energy sector's earnings estimate revisions continued to be sharply negative i.e., downward revisions by far outpaced (any) upward revisions.

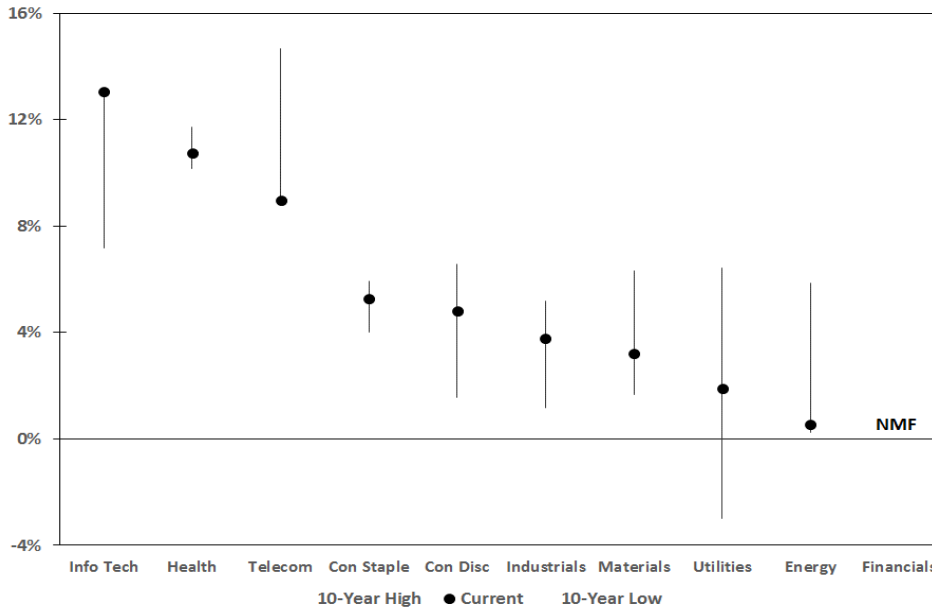
Figure 12: Earnings Revisions (25% of Earnings Weight)



Source: Cornerstone Capital Inc.

Figure 13 illustrates that free cash flow margins in the Information Technology and Health Care sectors remain materially higher than most other sectors.

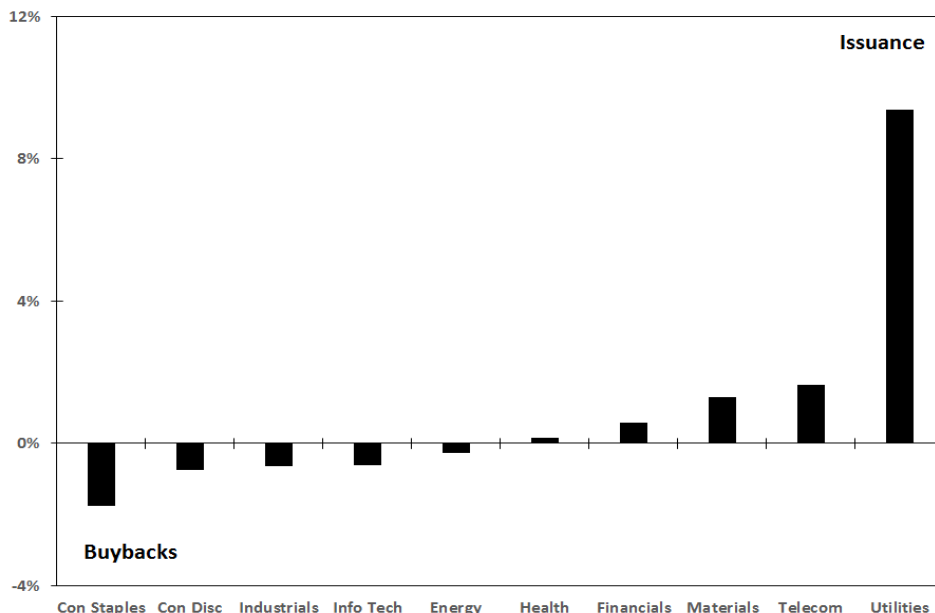
Figure 13: Free Cash Flow Margins (25% of Earnings Weight)



Source: Cornerstone Capital Inc.

Figure 14 illustrates that two of our three Underweight sectors — Utilities and Materials — have experienced a significant amount of share issuance over the last twelve months.

Figure 14: Net Share Issuance = 15-20% of Earnings Weight



Source: Cornerstone Capital Inc.

Figure 15 summarizes the current sector recommendations.

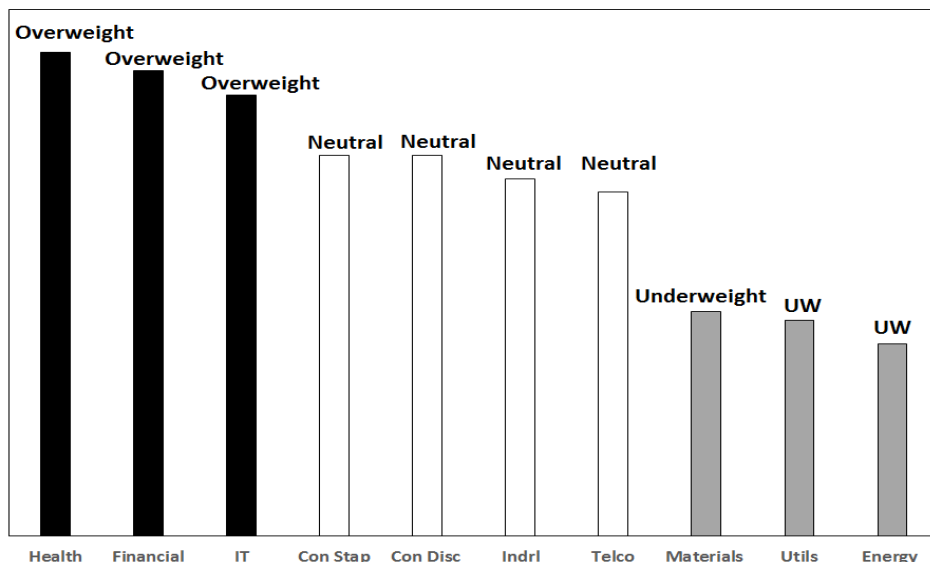
Figure 15: Sector Recommendations

Sector	Recommendation	Valuation (Relative)	Earnings Momentum	Earnings Revisions	Margins (Relative)	Share Buybacks	Environmental (Relative)	Social (Relative)
Health Care	Overweight	Negative	Positive	Negative	Positive	Neutral	Negative	Negative
Financials	Overweight	Positive	Positive	Negative	Neutral	Negative	Negative	Neutral
Info Tech	Overweight	Positive	Positive	Negative	Positive	Positive	Neutral	Neutral
Cons Staples	Neutral	Neutral	Neutral	Negative	Neutral	Positive	Positive	Neutral
Cons Disc	Neutral	Positive	Neutral	Negative	Neutral	Positive	Positive	Neutral
Industrials	Neutral	Neutral	Neutral	Negative	Negative	Positive	Positive	Negative
Telecom	Neutral	Neutral	Negative	Negative	Positive	Negative	Neutral	Negative
Materials	Underweight	Negative	Negative	Negative	Neutral	Negative	Neutral	Positive
Utilities	Underweight	Negative	Neutral	Negative	Negative	Negative	Negative	Positive
Energy	Underweight	Neutral	Negative	Negative	Negative	Neutral	Neutral	Positive

Source: Cornerstone Capital Inc.

Figure 16 illustrates the dispersion of the sector scores.

Figure 16: Ranking Sectors by Weighting Valuation, Earnings and ESG Scores
Arrows Indicate Change vs. Last Month



Source: Cornerstone Capital Inc.

Combining the Regional and Sector Models

Combining our regional and sector models, Figure 17 illustrates sector Over- and Under-weights by region.

- We are Overweight *Health Care* in North America, the U.K. and Europe ex U.K.
- We are Underweight or Neutral *Energy* in the majority of regions.

Figure 17: Combining the Regional and Sector Models

	EM Asia	Japan	Australia	North America	Latin America	U.K.	CEEMEA	Europe x U.K.
Health Care	NMF	Neutral	Neutral	Overweight	NMF	Overweight	NMF	Overweight
Financials	Neutral	Underweight	Overweight	Underweight	Overweight	Underweight	Overweight	Neutral
Info Tech	Overweight	Overweight	NMF	Overweight	NMF	NMF	NMF	Neutral
Cons Staples	Underweight	Underweight	Neutral	Neutral	Overweight	Overweight	Underweight	Overweight
Cons Disc	Neutral	Overweight	Underweight	Overweight	Underweight	Underweight	Overweight	Neutral
Industrials	Neutral	Overweight	Underweight	Overweight	Underweight	Neutral	NMF	Overweight
Telecom	Overweight	Neutral	Underweight	Underweight	Overweight	Neutral	Overweight	Underweight
Materials	Underweight	Underweight	Overweight	Underweight	Underweight	Underweight	Neutral	Neutral
Utilities	NMF	NMF	Neutral	Neutral	Underweight	Underweight	NMF	Underweight
Energy	Neutral	NMF	Underweight	Overweight	Neutral	Underweight	Underweight	Underweight

Source: Cornerstone Capital Inc.

Food for Thought: Is Deflation Always “Bad” for Equities?

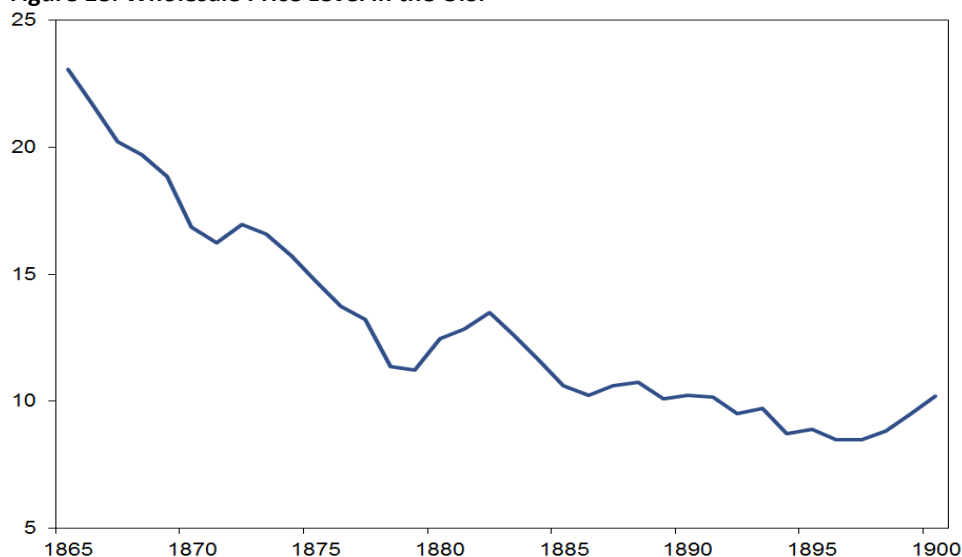
As discussed, our global equity strategy is unchanged, even with a heightened focus on monetary policies and exchange rates in the past month driven, in part, by fears of deflation. Which raises the question: Is deflation *always* “bad” for equities? History suggests not. In the decades after the U.S. Civil War, a sustained period of deflation was associated with explosive economic growth *and a rising stock market*.

The completion of a continental railroad network, and the concomitant telegraph system, created a national market that encouraged a spate of technological innovations. The number of patents issued doubled between the 1860s and 1880s. Among the specific innovations introduced were:

- Use of electricity in factories;
- The electric streetcar;
- Refrigerated cars for meat-packing;
- The telephone;
- The typewriter;
- The roller mill to process oatmeal and flour; and
- Major advances in making steel, which replaced iron for many uses.

In the last four decades of the 19th century, value added by U.S. manufacturers grew at a pace of 5-7% annually. From the 1870s to the 1890s — a period of rapid population growth driven by heavy immigration from Europe — national income per capita expanded by a remarkable 88%. All the same, wholesale prices in the U.S. in 1900 were 56% *below* their 1865 level — Figure 18.

Figure 18: Wholesale Price Level in the U.S.

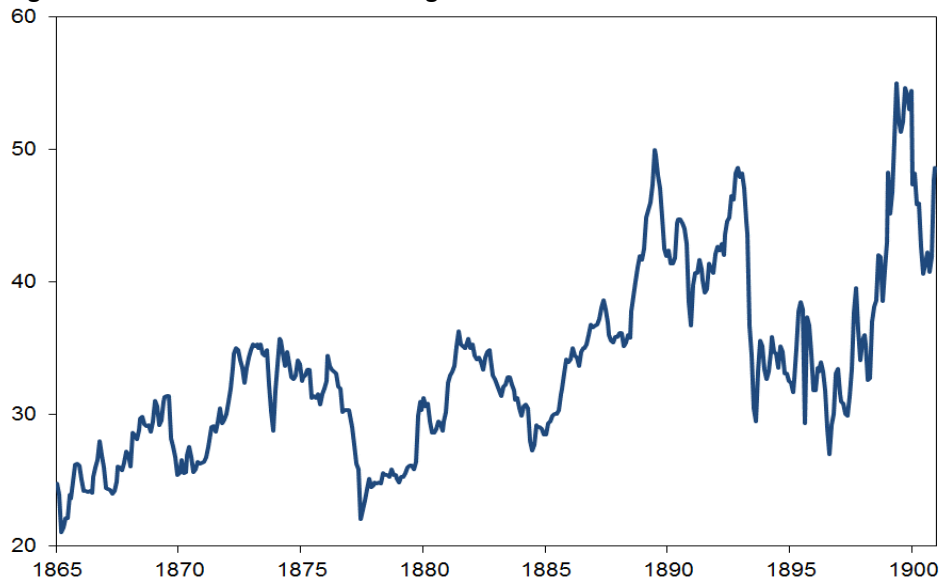


Source: *Historical Statistics of the United States*

It is quite possible that the deflation of the late 19th century to some degree caused this spate of technological innovations. Unable to raise prices in order to boost profits, businesses had no choice but to cut costs via innovation — whether that involved using electricity in a factory, replacing clerks’ pens with typewriters, installing labor-saving manufacturing equipment, or using railroads to distribute products more efficiently. And plenty of capital was available to finance such innovations, because interest rates were declining.

As for equity investors, between 1865 and 1900 the Dow Jones Industrial Average gained 96% — Figure 19.

Figure 19: Dow Jones Industrial Average



Source: *Historical Statistics of the United States*

Appendix 1: Summary Statistics

Figure 20: Global Equity Markets Data

1/28/2015	Weight in MSCI ACWI	% chg 1 Month (\$)	% chg YTD (\$)	P/E Ratio Trailing	P/E Ratio 20-yr Avg	2015 EPS Growth (e)
MSCI AC World	100%	-1.7%	-0.8%	16.7	20.1	13%
North America:	54%	-4.2%	-2.9%	17.9	19.3	13%
----U.S.	51%	-4.0%	-2.6%	18.1	19.4	13%
----Canada	3%	-6.8%	-6.9%	18.3	19.1	16%
Europe x UK:	15%	-0.2%	1.2%	22.4	17.2	12%
----France	3%	0.2%	1.5%	28.4	30.0	13%
----Switzerland	3%	0.2%	0.8%	18.3	24.8	9%
----Germany	3%	0.6%	1.9%	18.7	24.4	10%
----Spain	1%	-8.1%	-5.5%	17.5	16.3	16%
----Sweden	1%	0.9%	0.8%	15.9	49.2	8%
----Netherlands	1%	-0.6%	0.3%	23.4	31.7	12%
----Italy	1%	-1.9%	0.2%	NA	40.1	21%
U.K.	7%	0.7%	1.2%	19.4	25.4	12%
Japan	8%	2.1%	2.9%	16.1	19.5	12%
Australia	3%	1.1%	0.1%	17.6	18.9	7%
Emerging Asia:	7%	5.3%	4.4%	12.8	16.0	12%
----China	4%	2.7%	0.6%	17.5	17.3	18%
----South Korea	2%	2.2%	4.0%	12.3	13.6	12%
----Taiwan	1%	5.7%	4.3%	15.1	27.9	6%
----India	1%	12.9%	10.4%	20.1	17.2	17%
Latin America:	2%	-1.4%	-2.0%	16.1	13.7	16%
----Brazil	1%	-0.9%	-1.6%	14.1	13.2	17%
----Mexico	0%	-1.2%	-1.6%	21.2	15.7	15%
CEEMEA:	2%	0.5%	2.0%	9.9	16.3	16%
----South Africa	1%	8.1%	5.5%	14.9	14.1	15%
----Russia	1%	-6.9%	3.8%	3.8	6.9	15%
----Turkey	0%	3.5%	3.2%	10.8	10.1	16%
----Poland	0%	-6.1%	-6.1%	15.0	21.6	6%

1/28/2015	Weight in MSCI ACWI	% chg 1 Month (\$)	% chg YTD (\$)	P/E Ratio Trailing	P/E Ratio 20-yr Avg	2015 EPS Growth (e)
MSCI AC World	100%	-1.7%	-0.8%	16.7	20.1	13%
Consumer Discretionary	12%	-1.0%	-0.6%	17.9	25.3	15%
Consumer Staples	10%	1.0%	2.1%	21.3	20.2	9%
Energy	8%	-5.7%	-4.4%	11.7	15.2	31%
Financials	21%	-3.9%	-3.4%	13.0	25.1	10%
Health Care	12%	2.2%	3.1%	24.0	22.5	12%
Industrials	11%	-2.2%	-1.1%	17.0	21.0	11%
Information Technology	14%	-3.2%	-1.4%	18.2	33.8	11%
Materials	5%	-0.7%	-0.5%	18.8	19.9	17%
Telecom	4%	1.0%	2.5%	16.8	53.8	6%
Utilities	3%	-0.3%	1.6%	19.9	16.5	5%

Source: Cornerstone Capital Inc., Bloomberg

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