

## Global Market Strategy Research

# Regional and Sector Strategy: Monthly Update

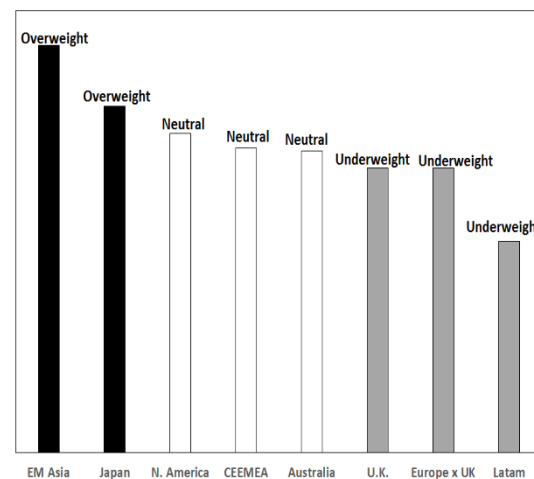


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- **It's Still about Cyclicity** — We are now underweight the most cyclically sensitive sectors: Industrials, Materials, Energy. While we upgrade the CEEMEA region to Neutral from Underweight — in large part because of an improved earnings outlook — this likely reflects a modest rebound in oil prices, which remain 40% below year-ago levels.
- **Downgrade Industrials to Underweight from Neutral** — The earnings outlook for Industrials has weakened further, at the same time that the sector's relative valuation has become less attractive.
- **Upgrade the CEEMEA region to Neutral from Underweight** — Likely reflecting a modest rebound in oil prices, the earnings outlook of the CEEMEA region (26% Russia) has improved after over two years of deteriorating earnings momentum. Relative valuations have also become more attractive, likely reflecting an easing in geopolitical tensions. However, renewed weakness in the price of oil and/or a resumption in geopolitical tensions could quickly change the outlook for the region.

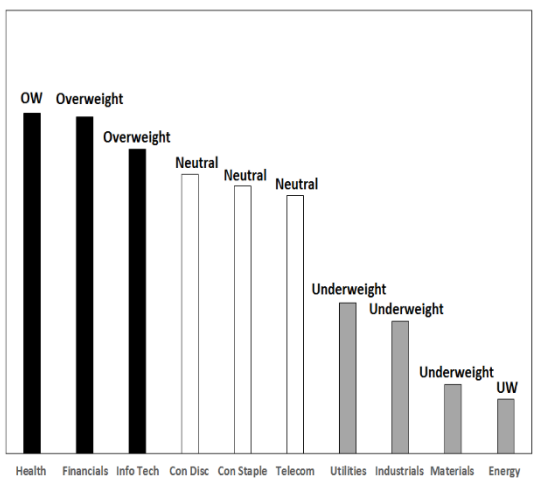
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Figure 1: Regional Rankings



Source: Cornerstone Capital Group

Figure 2: Sector Rankings



Source: Cornerstone Capital Group

## Regional and Sector Strategy: Monthly Update

This month there are changes to the recommendations in *both* our regional and sector strategy models. Our previous regional and sector recommendations were published in the April 2015 edition of the Cornerstone Capital [Regional and Sector Strategy: Monthly Update](#).

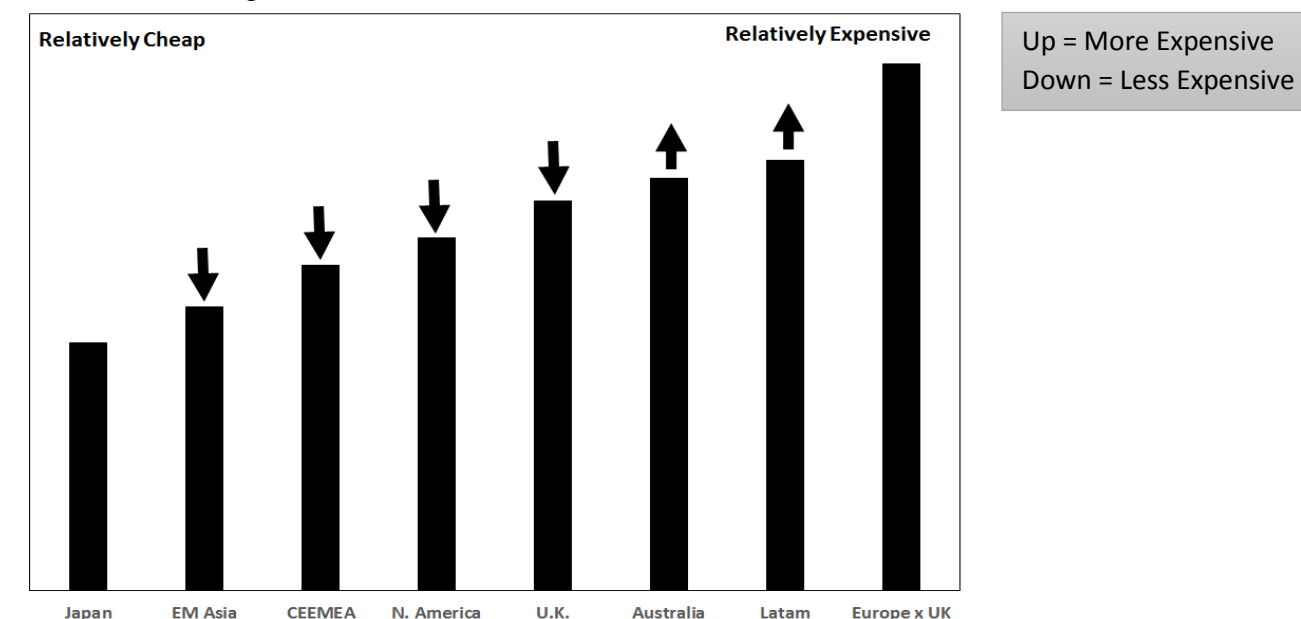
We are upgrading the Central and Eastern Europe, Middle East and Africa (CEEMEA) region to Neutral from Underweight. Likely reflecting a modest rebound in oil prices, the earnings outlook of the CEEMEA region (26% Russia) has improved after more than two years of deteriorating earnings momentum. Relative valuations also improved, likely reflecting an easing in geopolitical tensions. However, renewed weakness in the price of oil and/or a resumption in geopolitical tensions could quickly change the outlook for the region.

We are downgrading Industrials to Underweight from Neutral. The earnings outlook for the sector has weakened further, at the same time that relative valuations have become less attractive.

### 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 the CEEMEA region, which is now ranked Neutral, has improved on a relative basis, likely reflecting, in part, an easing in geopolitical tensions — the Bank of Russia has cut interest rates three times thus far in 2015.

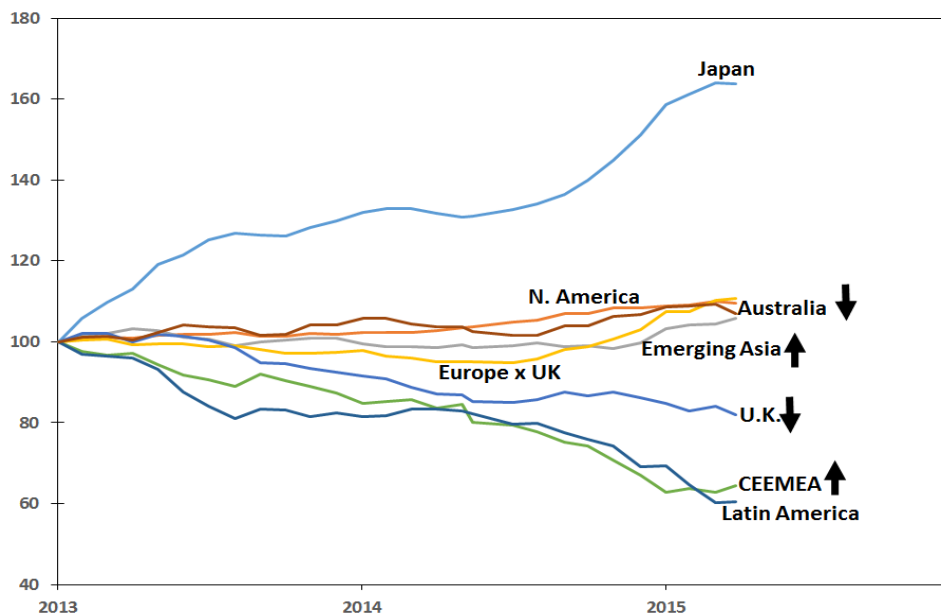
**Figure 3: Regional Valuations (50% of Aggregate Weight)**  
*Arrows Indicate Change vs. Last Month*



Source: Cornerstone Capital Group

Figure 4 illustrates that earnings momentum in the CEEMEA region has improved — after over two years of deteriorating momentum — likely reflecting a modest rebound in oil prices.

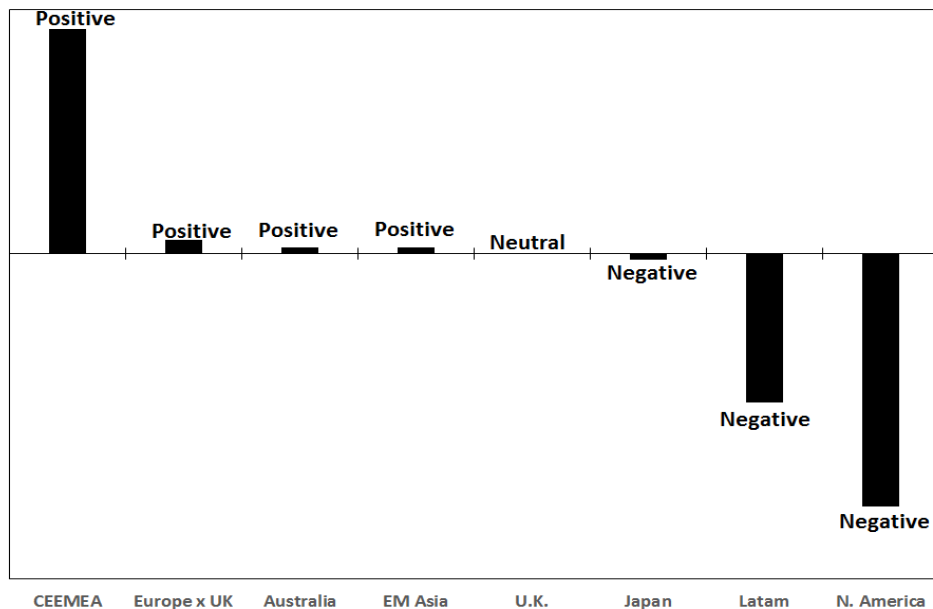
**Figure 4: Earnings Momentum (33% of Earnings Weight)**  
*Arrows Indicate Change vs. Last Month*



Source: Cornerstone Capital Group

Figure 5 illustrates that the earnings revisions trends in the CEEMEA region were sharply positive i.e., upgrades significantly exceeded downgrades.

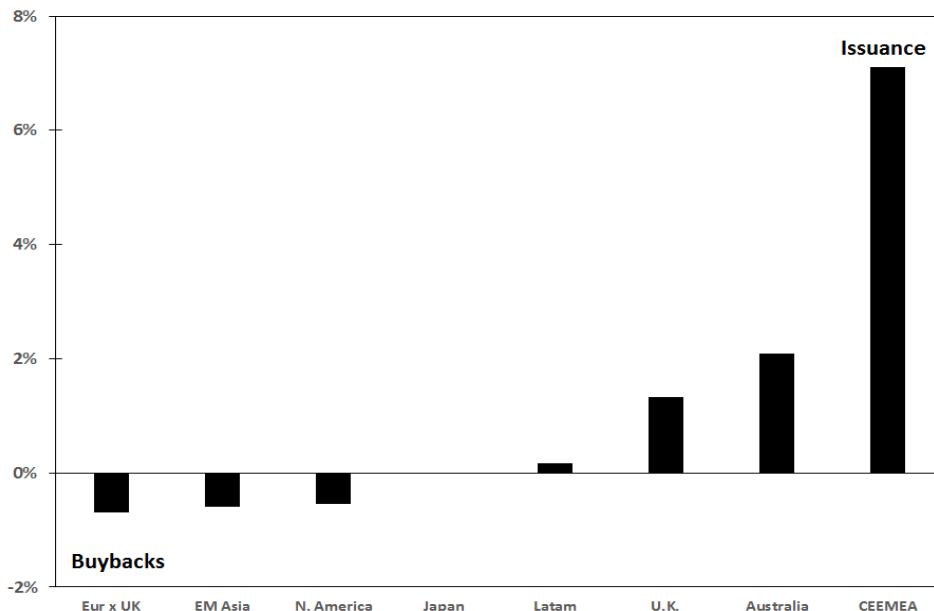
**Figure 5: Earnings Revisions (33% of Earnings Weight)**



Source: Cornerstone Capital Group

Figure 6 illustrates that, last month, share issuance in Japan was once again flat on a year-over-year basis, suggesting a continued shift in corporate governance in that country aimed at rewarding shareholders.

**Figure 6: Net Share Issuance (15-20% of Earnings Weight)**



Source: Cornerstone Capital Group

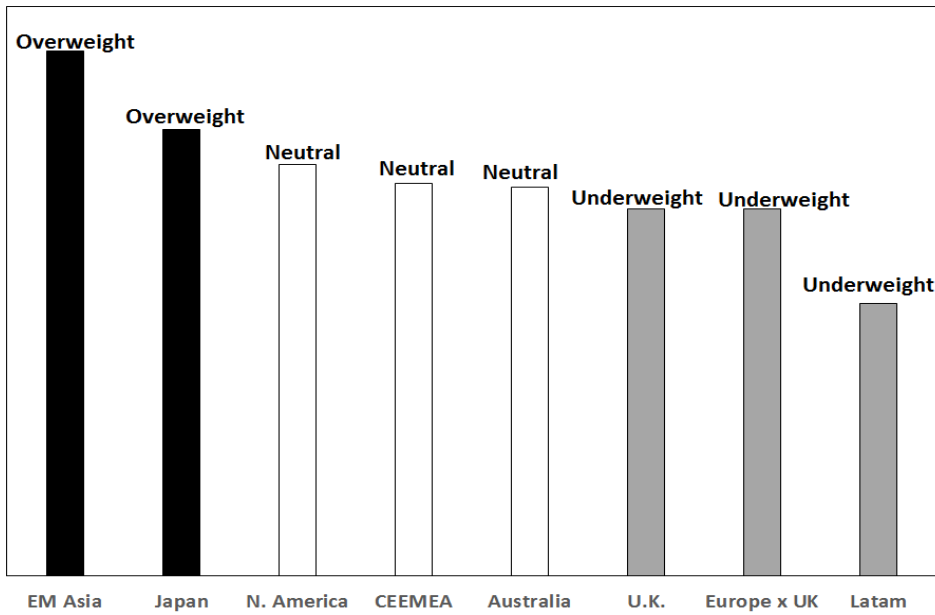
Figure 7 summarizes the current regional recommendations and Figure 8 illustrates the dispersion of the regional scores.

**Figure 7: Regional Recommendations**

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

Source: Cornerstone Capital Group

Figure 8: Ranking Regions by Weighting Valuation, Earnings, Environmental and Governance Scores



Source: Cornerstone Capital Group

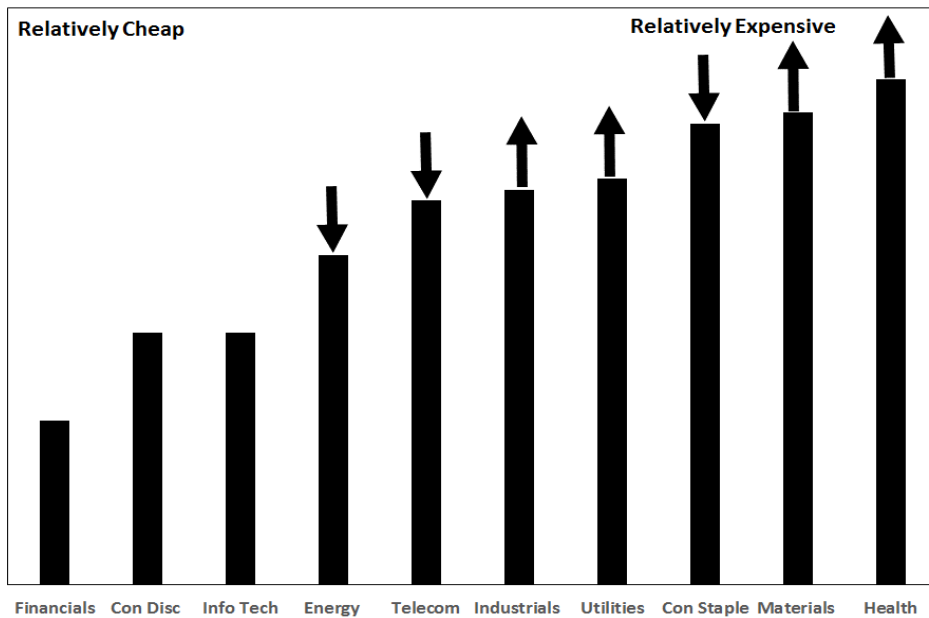
## Sector Strategy Update

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

Figure 9 illustrates that the relative valuation of the Industrials sector — now ranked Underweight — has become less attractive.

Figure 9: Sector Valuations (20% of Aggregate Weight)

Arrows Indicate Change vs. Last Month



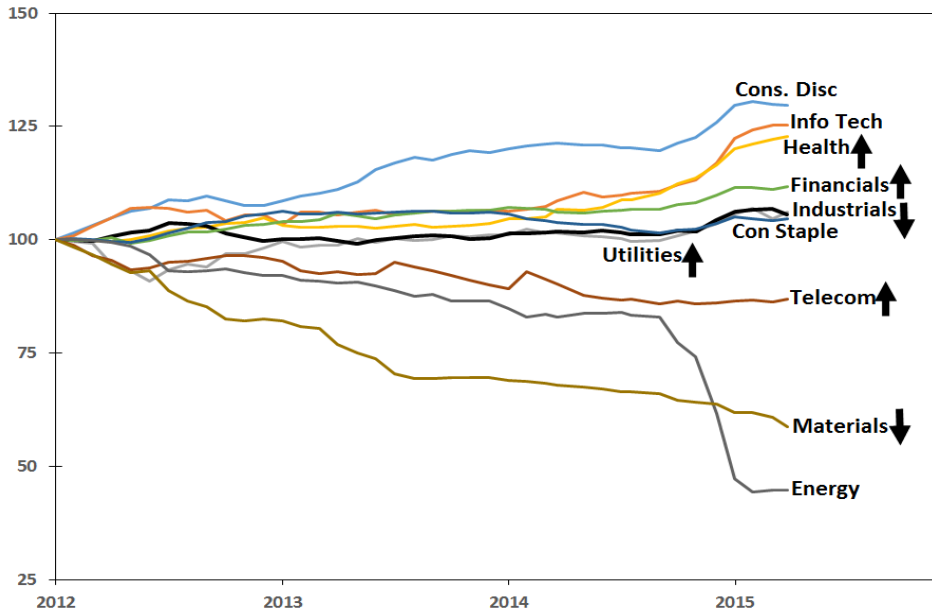
Source: Cornerstone Capital Group

Up = More Expensive  
Down = Less Expensive

Figure 10 illustrates that earnings momentum in the Industrials sector has weakened further.

**Figure 10: Earnings Momentum (33% of Earnings Weight)**

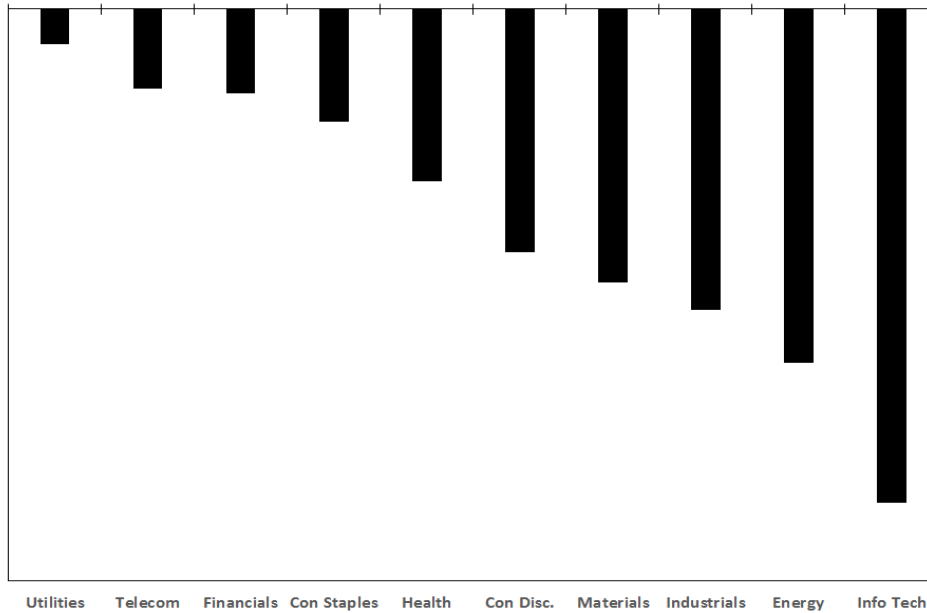
*Arrows Indicate Change vs. Last Month*



Source: Cornerstone Capital Group

Figure 11 shows that the Industrials sector's earnings estimate revisions were sharply negative i.e., downward revisions by far outpaced (any) upward revisions.

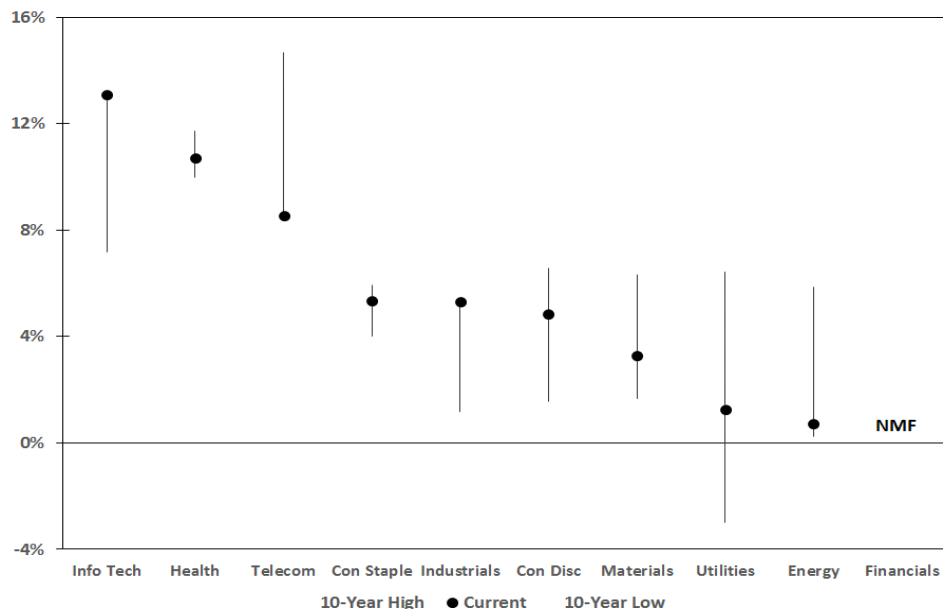
**Figure 11: Earnings Revisions (25% of Earnings Weight)**



Source: Cornerstone Capital Group

Figure 12 illustrates that free cash flow margins in the Overweight Information Technology and Health Care sectors remained materially higher than most other sectors.

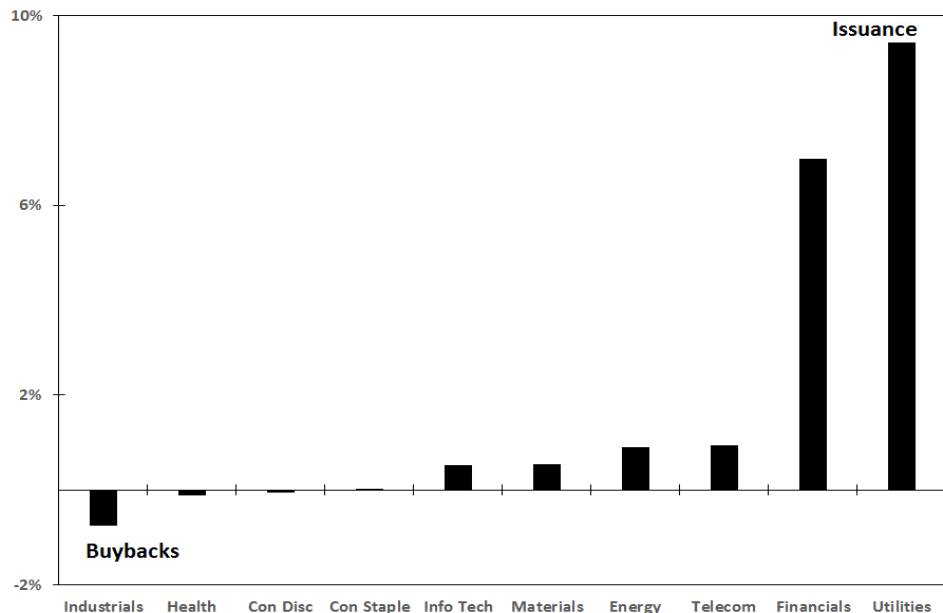
**Figure 12: Free Cash Flow Margins (25% of Earnings Weight)**



Source: Cornerstone Capital Group

Figure 13 illustrates that Utilities, an Underweight sector, has experienced a significant amount of share issuance over the last twelve months. A possible explanation for this is heavy capital spending on new equipment — from power plants to pollution-control devices.

**Figure 13: Net Share Issuance = 15-20% of Earnings Weight**



Source: Cornerstone Capital Group

Figure 14 summarizes the current sector recommendations.

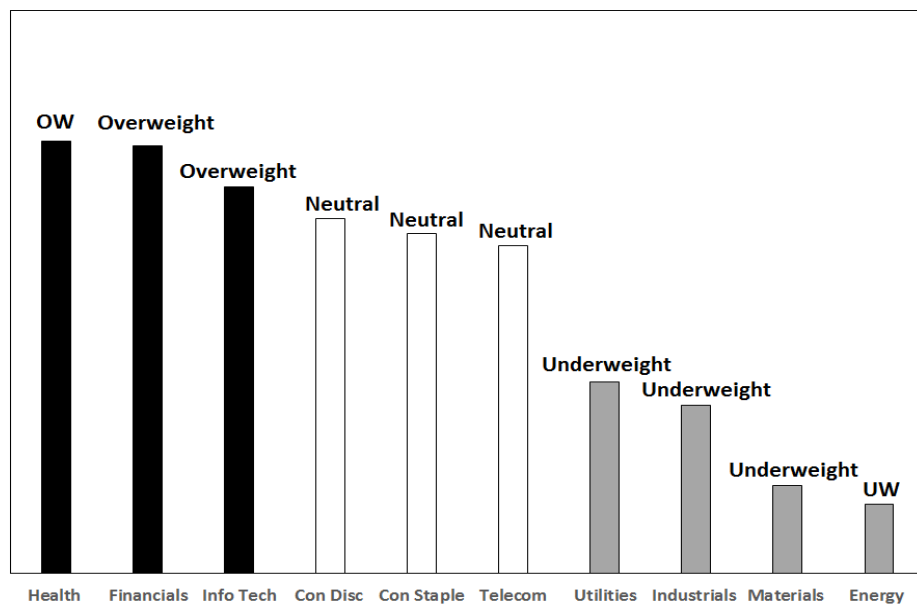
**Figure 14: Sector Recommendations**

| 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           | Negative       | Neutral                  | Neutral           |
| Cons Disc    | Neutral        | Positive             | Neutral           | Negative           | Neutral            | Neutral        | Positive                 | Neutral           |
| Cons Staples | Neutral        | Negative             | Neutral           | Negative           | Neutral            | Neutral        | Positive                 | Neutral           |
| Telecom      | Neutral        | Neutral              | Neutral           | Negative           | Positive           | Negative       | Neutral                  | Negative          |
| Utilities    | Underweight    | Neutral              | Neutral           | Negative           | Negative           | Negative       | Negative                 | Positive          |
| Industrials  | Underweight    | Neutral              | Negative          | Negative           | Negative           | Positive       | Positive                 | Negative          |
| Materials    | Underweight    | Negative             | Negative          | Negative           | Neutral            | Negative       | Neutral                  | Positive          |
| Energy       | Underweight    | Neutral              | Negative          | Negative           | Negative           | Negative       | Neutral                  | Positive          |

Source: Cornerstone Capital Group

Figure 15 illustrates the dispersion of the sector scores.

**Figure 15: Ranking Sectors by Weighting Valuation, Earnings and ESG Scores**  
*Arrows Indicate Change vs. Last Month*



Source: Cornerstone Capital Group



## Combining the Regional and Sector Models

Combining our regional and sector models, Figure 16 illustrates sector Over- and Underweights by region.

- We are Overweight *Health Care* in North America, the U.K. and Europe ex U.K.
- We are Overweight *Information Technology* in Emerging Asia, Japan and North America.
- We are Underweight or Neutral *Energy, Materials* and *Industrials* in the majority of regions.

Figure 16: Combining the Regional and Sector Models

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

Source: Cornerstone Capital Group

## Appendix 1: Summary Statistics

Figure 17: Global Equity Markets Data

| 4/29/2015        | Weight<br>in MSCI ACWI | % chg<br>1 Month (\$) | % chg<br>YTD (\$) | P/E Ratio<br>Trailing | P/E Ratio<br>20-yr Avg | 2015 EPS<br>Growth (e) |
|------------------|------------------------|-----------------------|-------------------|-----------------------|------------------------|------------------------|
| MSCI AC World    | 100%                   | 3.7%                  | 5.6%              | NA                    | 20.2                   | 13%                    |
| North America:   | 54%                    | 2.6%                  | 2.7%              | 18.9                  | 19.4                   | 13%                    |
| ----U.S.         | 50%                    | 2.2%                  | 2.7%              | 19.0                  | 19.4                   | 13%                    |
| ----Canada       | 4%                     | 9.0%                  | 2.1%              | 19.1                  | 19.2                   | 18%                    |
| Europe x UK:     | 15%                    | 1.4%                  | 7.5%              | 22.6                  | 17.4                   | 13%                    |
| ----France       | 3%                     | 2.5%                  | 8.7%              | 26.9                  | 30.5                   | 14%                    |
| ----Switzerland  | 3%                     | 2.4%                  | 6.6%              | 18.3                  | 24.7                   | 9%                     |
| ----Germany      | 3%                     | -1.9%                 | 6.2%              | 19.0                  | 24.3                   | 11%                    |
| ----Spain        | 1%                     | 2.4%                  | 2.1%              | 19.0                  | 16.4                   | 17%                    |
| ----Sweden       | 1%                     | 1.3%                  | 4.6%              | 15.6                  | 50.5                   | 9%                     |
| ----Netherlands  | 1%                     | 2.6%                  | 7.9%              | 31.1                  | 32.2                   | 13%                    |
| ----Italy        | 1%                     | 2.2%                  | 9.6%              | 114.2                 | 41.4                   | 21%                    |
| U.K.             | 7%                     | 5.4%                  | 4.9%              | 26.8                  | 25.8                   | 13%                    |
| Japan            | 8%                     | 5.0%                  | 16.3%             | 17.8                  | 19.7                   | 9%                     |
| Australia        | 3%                     | 2.0%                  | 6.3%              | 18.7                  | 19.0                   | 6%                     |
| Emerging Asia:   | 8%                     | 9.9%                  | 13.5%             | NA                    | 15.7                   | 12%                    |
| ----China        | 5%                     | 19.9%                 | 39.5%             | NA                    | 17.9                   | 16%                    |
| ----South Korea  | 2%                     | 7.8%                  | 11.6%             | 13.2                  | 13.5                   | 10%                    |
| ----Taiwan       | 1%                     | 7.1%                  | 10.3%             | 14.4                  | 28.0                   | 7%                     |
| ----India        | 1%                     | -3.7%                 | -0.5%             | 21.1                  | 17.2                   | 18%                    |
| Latin America:   | 2%                     | 13.3%                 | -0.1%             | 20.8                  | 13.7                   | 23%                    |
| ----Brazil       | 1%                     | 21.5%                 | -1.0%             | 19.5                  | 12.9                   | 27%                    |
| ----Mexico       | 0%                     | 2.6%                  | 0.6%              | 26.3                  | 15.9                   | 14%                    |
| CEEMEA:          | 2%                     | 11.0%                 | 10.9%             | 13.3                  | 15.9                   | 16%                    |
| ----South Africa | 1%                     | 8.5%                  | 9.6%              | 19.5                  | 14.2                   | 14%                    |
| ----Russia       | 0%                     | 20.8%                 | 39.8%             | 6.8                   | 6.9                    | 16%                    |
| ----Turkey       | 0%                     | 3.7%                  | -13.2%            | 11.1                  | 10.1                   | 16%                    |
| ----Poland       | 0%                     | 11.0%                 | 6.6%              | 22.9                  | 21.7                   | 6%                     |

| 4/29/2015              | Weight<br>in MSCI ACWI | % chg<br>1 Month (\$) | % chg<br>YTD (\$) | P/E Ratio<br>Trailing | P/E Ratio<br>20-yr Avg | 2015 EPS<br>Growth (e) |
|------------------------|------------------------|-----------------------|-------------------|-----------------------|------------------------|------------------------|
| MSCI AC World          | 100%                   | 3.7%                  | 5.6%              | NA                    | 20.2                   | 13%                    |
| Consumer Discretionary | 12%                    | 2.5%                  | 7.8%              | 19.3                  | 25.2                   | 14%                    |
| Consumer Staples       | 9%                     | 1.4%                  | 3.5%              | 22.3                  | 20.3                   | 9%                     |
| Energy                 | 8%                     | 10.3%                 | 5.6%              | 17.2                  | 15.2                   | 37%                    |
| Financials             | 21%                    | 4.6%                  | 4.5%              | 13.7                  | 24.9                   | 10%                    |
| Health Care            | 12%                    | 0.3%                  | 8.7%              | 25.2                  | 22.6                   | 12%                    |
| Industrials            | 11%                    | 2.9%                  | 4.7%              | NA                    | 21.0                   | 11%                    |
| Information Technology | 14%                    | 3.8%                  | 6.1%              | 19.0                  | 33.5                   | 11%                    |
| Materials              | 5%                     | 5.4%                  | 6.6%              | 21.2                  | 19.9                   | 18%                    |
| Telecom                | 4%                     | 6.1%                  | 7.9%              | 18.0                  | 53.1                   | 9%                     |
| Utilities              | 3%                     | 3.8%                  | -1.8%             | 17.1                  | 16.5                   | 3%                     |

Source: Cornerstone Capital Group, Bloomberg



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