

US Equity Strategy FLASH

Sell-Off Post Election Shows More Hoped for a Romney Win; Reasons for Selling Improves Equity Risk/Reward; 30 Ideas

Equity markets sold off sharply today (S&P 500 down 34 pts), more than reversing the 11-pt gain yesterday. We spent a lot of time on the phone with PMs and found most investors trying to understand the catalyst behind such a large sell-off and it seems there is disappointment, owing to a combination of: (i) an election outcome without a mandate (poor voter turnout, Obama and Romney garnered fewer votes than in 2008); (ii) shift to focus on the fiscal cliff; (iii) concerns about higher taxes, particularly capital gains taxes, with an Obama regime; (iv) some hoped for a Romney surprise.

- **We see the sell-off more due to disappointment with outcome (more Romney hopefuls than we realized) vs. fiscal cliff. Why? Investment Grade and High Yield markets should be selling off if this is a "fiscal cliff" issue, similar to 2011's weakness.** The fiscal cliff (fiscal drag) is large enough to potentially push the US into a recession, which would have negative consequences for both IG and HY bonds. But notice the contrast in those markets. In 2011, HY and HG spreads widened sharply as investors worried about the fiscal cliff. In 2012, HY and HG spreads have rallied since October. And liquidity (issuance) remains strong. These markets do not seem as concerned with the fiscal cliff as the US equity markets.
- **Where do we go from here?** So let's say this weakness is indeed due to a knee-jerk reaction to an Obama win (Romney disappointment). One might argue there are some reasons the market can recover from here.
- **#1) Since September, US gasoline prices have fallen \$0.38 from \$3.84 to \$3.46, resulting in \$50 billion in annualized savings for households, or 0.40% lift to GDP.** The US consumes 134 billion gallons annually, so the \$0.38 drop in price per gallon is worth \$51 billion, or 0.4% annualized lift to GDP. As shown in Figure 2 and Figure 3, the S&P 500 has historically rallied following a drop in gasoline prices. In other words, this is a potential upside driver in the next few months.
- **#2) Potential that, with the election over, compromise on the fiscal cliff could be less political.** One element of uncertainty around the fiscal cliff has been reduced, as we now know three of the key players in negotiating the fiscal cliff: (a) President Obama; (b) Senate Majority Leader (Reid); and (c) Speaker of the House (Boehner). And unlike 2011, when 2012 election political calculus interfered with negotiations, there is a possibility of reaching an agreement, or at least deferring the difficult decisions (punting). Our economists' base case remains a portion of the fiscal cliff is avoided in 2013 (1.6% fiscal drag is the result).
- **#3) US housing continues its recovery regardless of the White House.** One of the upside stories in 2012 has been the better-than-expected improvement in US home prices and housing demand (absorption and starts). The latest data point is 3Q12 US household formation (Census Vacancy Report) exceeded 1.1mm for the first time since 2Q06 as the recovery in labor markets and pent-up demand drive a surge in household formation. And, as we noted in the past, the recovery in home prices has delivered already in 2012 wealth effect of \$1.7T (see "S&P 500 3Q EPS..." dated 10/11/12). And, as we noted in the past, each 250k increase in starts is worth 1mm jobs and an estimated \$4 in S&P 500 EPS.

See page 7 for analyst certification and important disclosures.

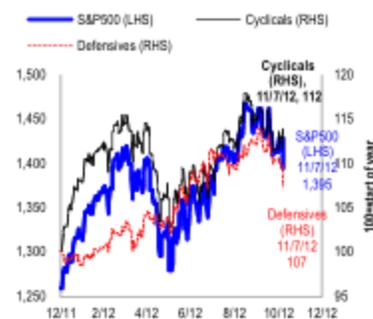
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Portfolio Strategy

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	1Q12	2Q12	3Q12	QTD	YTD
S&P500	12%	-3%	6%	-3%	11%
Cycl (Mat, IT, Disc, Ind)	14%	-5%	5%	-3%	12%
Near- Cycl(Ener, Fin)	12%	-7%	8%	-2%	11%
Def (Stpl, HC, Tel, Util)	3%	5%	3%	-4%	7%

Valuation:

	2012E	2013E
S&P500 Level	1395	—
EPS	\$105	\$110
P/E (current)	13.3x	12.7x
Div Yield	2.3%	2.5%

Year-End Target:

S&P500	1430	—
P/E	—	13.0x

Source: J.P. Morgan, FactSet.

- **#4) US corporates still have record cash balances.** As we noted a few weeks ago, US corporates which have enjoyed unusual liquidity in this expansion now boast the largest cash balances in history with \$1.5T in cash (up 7% y/y vs. 0.8% EPS growth), in part due to inventory liquidation in the quarter. Shareholders will eventually pressure corporates to deploy this cash either via buybacks, dividends or [REDACTED] (the latter more likely if there had been a Romney victory). But this remains a positive for US equities.
- **#5) Equity markets traded cheap relative to credit prior to this weakness, and discount is wider today—HY remains the “harbinger” to equity valuations and it remains strong.** The lag of equities to corporate credit has been discussed by our fixed income team for some time and in past episodes this has led to equities outperforming. Take HY markets, for instance. HY YTW is now 6.59%, down 38bp from 6.97% on 9/1, lifting the implied P/E (inverse of yield) to 15.2X from 14.3X. The S&P 500 has fallen 30 points since to 1390-ish and now trades at 12.7X. Since 1980, the S&P 500 P/E has EXCEEDED the HY P/E by at least 3 turns (i.e., should be 18X now), meaning the risk/reward in equities is substantially greater. And corporate credit is NOT IMMUNE to a fiscal cliff. Thus, those markets should be converging.
- **#6) Investors are still underperforming, thus unlikely to write off the beta chase.** Investors are still badly lagging their benchmarks. Thus, the weakness, in our view, is coming at a time when active managers (mutual funds) are underperforming. Thus, we see pressure for funds to improve returns during what is seasonally a strong quarter for stocks. Thus, the beta chase should continue, while tempered by concerns of the US fiscal cliff.
- **What could go wrong? We have a fiscal cliff.** The biggest risk to our view in the short term is the US fiscal cliff becomes unavoidable. That could justify further downside from here pushing the S&P 500 into the 1350-ish level from the 1400s today. However, as we noted above, there are some reasons to expect the US to avoid this (see reason #2 and also reason #1).

MARKET STRATEGY: Focus on Global Cyclical and High-Dividend stocks, among others. We believe once the initial selling exhausts itself, investors will reconsider the positive risk/reward in equities. One notion is that the current White House policies are less pro-growth (than Republican ones), and thus growth outside the US becomes more attractive. As a consequence, investors are likely to favor global cyclicals (see Figure 4) which include **Technology (semis, hardware, software) and Industrials (multinationals, machinery, etc.)**. We also maintain our 2012 YE target of 1430. We have identified 30 Global Cyclical using the following criteria: (a) % revenue from outside the US > 50%; (b) positive FCF yield; (c) belongs to a Cyclical sector; and (d) rated OW by [REDACTED]. Morgan. The tickers are: DELL, PAY, KBR, FLR, AA, AAPL, NLSN, TRW, ORCL, BWA, MA, GOOG, SNPS, CCK, MCD, PCLN, QCOM, EBAY, MOS, DHR, XLNX, TXN, IBM, ETN, ALB, CREE, PPG, TRMB, YUM, and ADI.

Exhibits

Figure 1: Investment Grade and High Yield Sold Off in 2011 During the Debt Ceiling Debacle...

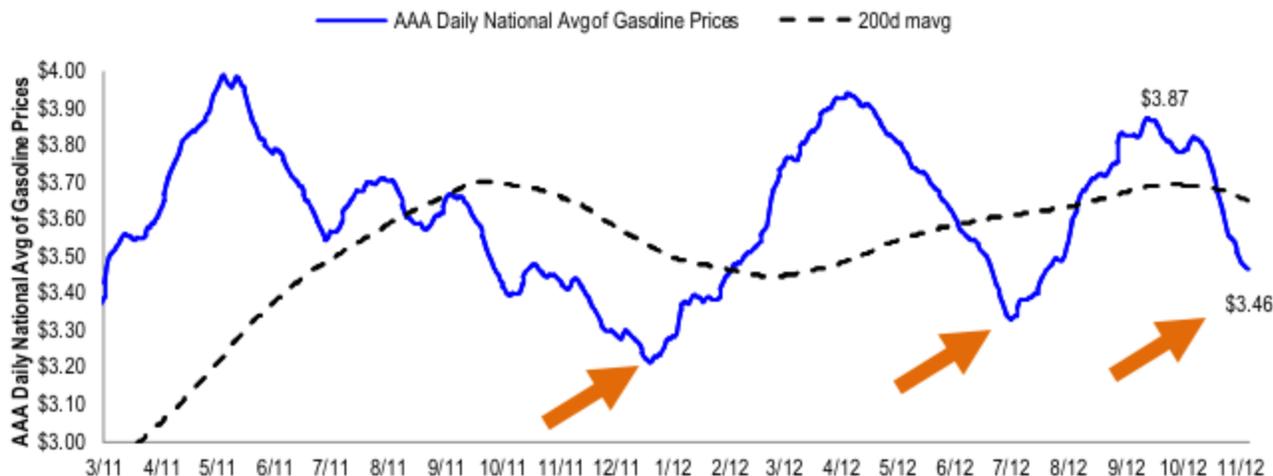
bp on spreads



Source: Morgan and Bloomberg.

Figure 2: Gasoline Prices

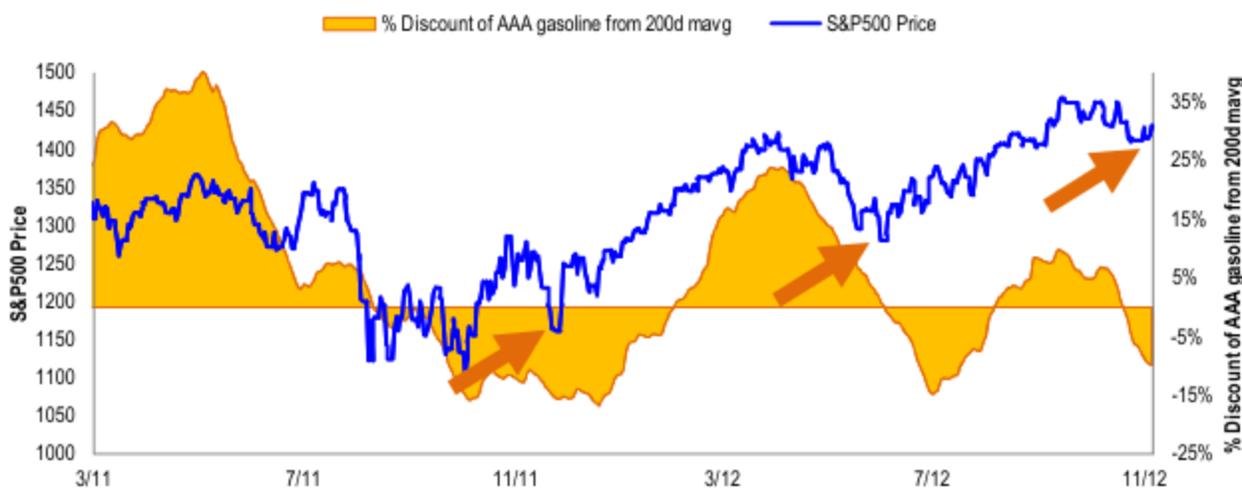
AAA daily gasoline price – 3AGSREG Index GP



Source: Morgan and Bloomberg.

Figure 3: Declines in Gasoline Prices and S&P 500

AAA gasoline prices



Source: Morgan and Bloomberg.

Figure 4: Comparative Market Implications of Obama vs. Romney Victory

Romney Policy Implications . . .	Impact on Groups . . .	Obama Policy Implications . . .	Impact on Groups . . .
Romney seen as pro-business—incentives for capital spending, boosting activity, including [REDACTED]	Long Small-Caps ([REDACTED]) and Domestic Cyclical s	Affordable Care Act maintained	Long Hospitals
Tax repatriation holiday	Long Health Care and Technology and Industrials	Maintain QE and Fed policy	Long High-Dividend stocks and Defensives and avoid Financials
Expand energy exploration and coal	Long Energy stocks and Coal names	Less pro-business climate, higher taxes, so global growth is more important	Long Global Cyclical s and China plays
Affordable Care Act repealed	Long most Healthcare stocks	Subsidies to alternative energy	Long Solar
China labeled currency manipulator	AVOID Global Cyclical (China) LONG Domestic Cyclical (Homebuilders, Consumers) and Small-Caps	Higher income taxes	Reduce Luxury Consumer
Pressure to end QE/change Fed, leading to steepening yield curve	Long Banks and Financials	Expanded government regulation	Regulatory impact across sectors
Simplify tax code (lower rates but offset by removing deductions). This should aid small-business formation.	Long Domestic Cyclical s		

Source: [REDACTED] Morgan.

MARKET STRATEGY

We believe that once the initial selling exhausts itself, investors will reconsider the positive risk/reward in equities. One notion is that the current White House policies are less pro-growth (than the Republican ones), and thus growth outside the US becomes more attractive. The companies in Figure 5 are cyclical stocks that have high revenue exposure to international markets. We used the following criteria:

- Percentage of Revenue from Outside the US >50%;
- Positive FCF Yield;
- In a Cyclical Sector (Materials, Industrials, Discretionary or Technology); and
- Rated Overweight rated by J.P. Morgan.

These 30 companies have an average upside of 22% to J.P. Morgan target prices, an average 2013E P/E of 14.0x, and an average P/B of 2.9x.

Figure 5: Global Cyclical – 30 Stock Ideas
Priced as of 11/6/12

Name	Sub-Industry	Ticker	Current Price	Market Cap	JPM Coverage			Screen Metrics		EPS and Valuation			
					JPM Rtg	JPM Analyst	Target Price	Implied Upside	% Rev from Outside the US	Positive FCF Yield	2013E EPS	P/E ('13E)	P/B
1 Dell Inc.	Computer Hardware	DELL	\$9.53	\$16,531	OW	Mark Moskowitz	\$16.50	73%	51%	15.2%	\$1.79	5.3x	1.70x
2 VeriFone Systems Inc.	Data Processing & Outsourced S	PAY	\$32.31	\$3,483	OW	Tien-tsin Huang, I	\$54.00	67%	63%	4.2%	\$3.28	9.9x	2.86x
3 KBR Inc.	Construction & Engineering	KBR	\$28.41	\$4,192	OW	Scott Levine	\$44.50	57%	78%	5.5%	\$3.07	9.2x	1.61x
4 Fluor Corp.	Construction & Engineering	FLR	\$54.49	\$9,073	OW	Scott Levine	\$78.00	43%	53%	3.3%	\$4.40	12.4x	2.47x
5 Alcoa Inc.	Aluminum	AA	\$8.74	\$9,327	OW	Michael F. Gamb	\$12.50	43%	51%	2.4%	\$0.68	12.9x	0.69x
6 Apple Inc.	Computer Hardware	AAPL	\$582.85	\$548,282	OW	Mark Moskowitz	\$770.00	32%	65%	7.3%	\$53.27	10.9x	4.63x
7 Nielsen Holdings	Research & Consulting Services	NLSN	\$29.61	\$10,724	OW	Andrew C. Stein	\$39.00	32%	51%	5.4%	\$2.06	14.4x	2.16x
8 TRW Automotive Holdings	Auto Parts & Equipment	TRW	\$49.60	\$6,060	OW	Ryan Brinkman	\$63.00	27%	77%	4.1%	\$6.54	7.6x	1.70x
9 Oracle Corp.	Systems Software	ORCL	\$31.63	\$152,427	OW	John DiFucci	\$40.00	26%	54%	7.8%	\$2.91	10.9x	3.53x
10 BorgWarner Inc.	Auto Parts & Equipment	BWA	\$68.10	\$7,970	OW	Ryan Brinkman	\$85.00	25%	76%	4.6%	\$5.83	11.7x	2.62x
11 MasterCard Inc. CI A	Data Processing & Outsourced S	MA	\$471.78	\$56,272	OW	Tien-tsin Huang, I	\$575.00	22%	60%	4.5%	\$25.65	18.4x	8.50x
12 Google Inc. CI A	Internet Software & Services	GOOG	\$681.72	\$180,626	OW	Doug Anmuth	\$802.00	18%	54%	5.6%	\$49.76	13.7x	3.29x
13 Synopsys Inc.	Application Software	SNPS	\$32.42	\$4,835	OW	Sterling Auty, CF	\$38.00	17%	54%	8.4%	\$2.28	14.2x	2.02x
14 Crown Holdings Inc.	Metal & Glass Containers	CCK	\$38.79	\$5,588	OW	Phil Gresh, CFA	\$45.00	16%	73%	0.9%	\$3.37	11.5x	
15 McDonald's Corp.	Restaurants	MCD	\$87.97	\$88,320	OW	John Ivankoe	\$101.00	15%	68%	1.2%	\$5.96	14.8x	6.36x
16 Inc.	Internet Retail	PCLN	\$644.90	\$32,158	OW	Doug Anmuth	\$740.00	15%	60%	4.6%	\$36.31	17.8x	8.99x
17 QUALCOMM Inc.	Communications Equipment	QCOM	\$60.37	\$102,831	OW	Rod Hall, CFA	\$69.00	14%	94%	3.5%	\$4.13	14.6x	3.17x
18 eBay Inc.	Internet Software & Services	EBAY	\$49.49	\$64,039	OW	Doug Anmuth	\$56.00	13%	53%	3.4%	\$2.72	18.2x	3.22x
19 Mosaic Co.	Fertilizers & Agricultural Chemi	MOS	\$53.64	\$15,925	OW	Jeffrey J. Zekausl	\$60.00	12%	60%	2.6%	\$5.26	10.2x	1.82x
20 Danaher Corp.	Industrial Conglomerates	DHR	\$52.80	\$36,574	OW	C. Stephen Tusa,	\$59.00	12%	58%	7.8%	\$3.62	14.6x	1.94x
21 Xilinx Inc.	Semiconductors	XLNX	\$34.06	\$8,887	OW	Christopher Dane	\$38.00	12%	69%	5.2%	\$2.15	15.9x	3.23x
22 Texas Instruments Corpora	Semiconductors	TXN	\$29.94	\$33,557	OW	Christopher Dane	\$33.00	10%	89%	5.8%	\$2.01	14.9x	2.94x
23 International Business Mar	IT Consulting & Other Services	IBM	\$195.07	\$220,416	OW	Mark Moskowitz	\$215.00	10%	58%	5.6%	\$16.74	11.7x	10.23x
24 Eaton Corp.	Industrial Machinery	ETN	\$50.42	\$17,037	OW	Ann Duignan	\$55.00	9%	50%	2.9%	\$4.75	10.6x	2.07x
25 Albemarle Corp.	Specialty Chemicals	ALB	\$57.02	\$5,090	OW	Jeffrey J. Zekausl	\$62.00	9%	61%	3.1%	\$5.27	10.8x	2.81x
26 Cree Inc.	Semiconductors	CREE	\$31.57	\$3,671	OW	Christopher Blans	\$34.00	8%	62%	5.8%	\$1.23	25.8x	1.42x
27 PPG Industries Inc.	Diversified Chemicals	PPG	\$123.19	\$18,891	OW	Jeffrey J. Zekausl	\$130.00	6%	51%	5.0%	\$7.79	15.8x	4.89x
28 Trimble Navigation Ltd.	Electronic Manufacturing Service	TRMB	\$53.64	\$6,742	OW	Paul Coster, CFJ	\$56.50	5%	55%	4.1%	\$3.03	17.7x	3.73x
29 Yum! Brands Inc.	Restaurants	YUM	\$73.15	\$33,050	OW	John Ivankoe	\$75.00	3%	70%	2.0%	\$3.74	19.6x	15.05x
30 Analog Devices Inc.	Semiconductors	ADI	\$41.33	\$12,354	OW	Christopher Dane	\$42.00	2%	77%	2.8%	\$2.50	16.5x	3.07x
Average								22%	63%	4.8%		14.0x	2.94x

Source: J.P. Morgan and FactSet.

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