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U.S. Equity Strategy

Research Analysts
Jonathan Golub, CFA
212 325 6239
jonathan.golub@credit-suisse.com
Patrick Palfrey
212 325 7970
patrick.palfrey@credit-suisse.com
Manish Bangard, CFA
212 325 6632
manish.bangard@credit-suisse.com
Dana Nentin, CFA
212 538 5287
dana.nentin@credit-suisse.com
Erica Cid
212 538 8148
erica.cid@credit-suisse.com

ECONOMICS AND STRATEGY

Further Upside in 2018 and Beyond

S&P 500 to 2,875 by Year-End 2018, 10-11% Return Trajectory

We are initiating our 2017 and 2018 targets of 2600 and 2875, implying a 10-11% annualized price trend over the next 15 months. This assumes an EPS trajectory of 6-7% over the next two calendar years (from $130 in 2017 to $147 in 2019), with the remainder of returns coming from rising multiples.

Multiples to Expand as Cycle Extends

At 17.9x consensus EPS, multiples are a concern for many investors. Historically, P/Es rise throughout a recovery, declining viciously into an economic contraction. With recessionary risks contained, volatility depressed, and BAA yields at 4.4%, we see upside to multiples.

Slower for Longer, Stronger for Now

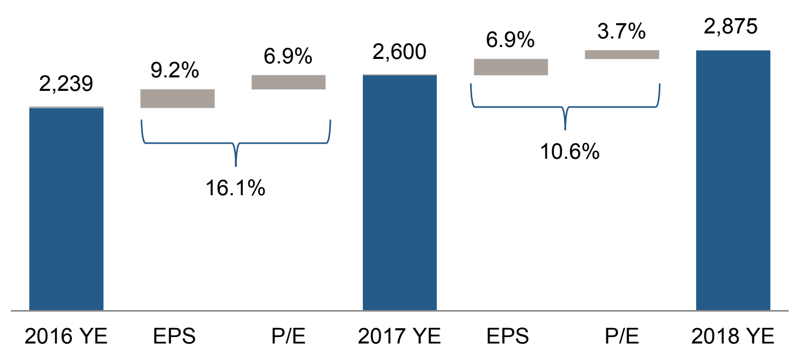
Longer Term: Global growth has been tepid for over a decade on challenging demographics and other macro forces. While a headwind for revenues, this has created a greater corporate focus on expenses and a more abundant return of capital to shareholders, and has pushed discount rates lower.

Near Term: Since mid-2016, the global economy has ticked up, with all G7 and BRIC economies in expansion mode (PMIs above 50).

Sector Leadership: Tech to Outperform, Energy and Bond Proxies to Lag

Strong fundamentals should drive further upside for New Economy stocks in Tech and Discretionary, while a pickup in rates and less regulation should benefit Financials. Energy remains pricey despite underperformance, and Bond Proxies remain uninspiring. Deep cyclicals are weaker than they should be given robust PMI readings.

Figure 1: 2017 & 2018 Credit Suisse S&P 500 Price Target Breakdown



Source: Standard & Poor's and Credit Suisse estimates

Summary of Outlook & Recommendations

Market Outlook

Our S&P 500 price targets for year-end 2017 and 2018 imply a 10-11% annualized return over the next 15 months. These targets are the result of separate underlying estimates for EPS and multiples, as shown below. EPS estimates are in turn based upon revenue, margin and share count (buyback) forecasts. Line-item details and quarterly projections behind the EPS numbers are provided in the Appendix to this note.

Market targets imply a 10-11% annualized return

Figure 2: Credit Suisse S&P 500 Price and Earnings Targets

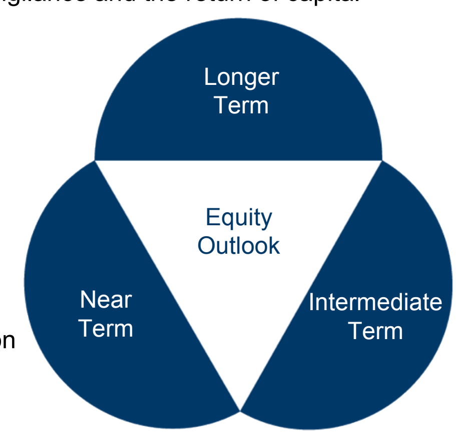
S&P 500 Price Level	**Price**	**% Change**
Current (as of 10/06/2017)	2,549	
2017 Year-End Target Price	2,600	2.0%
2018 Year-End Target Price	2,875	10.6%
Operating Earnings	**EPS**	**YoY Change**
2016 Actual	$119.08	
2017 Estimate	$130.00	9.2%
2018 Estimate	$139.00	6.9%
2019 Estimate	$147.00	5.8%
P/E Multiples	**P/E**	**Change**
Current on NTM EPS Estimate	18.5x	
Year-end 2017 on 2018 EPS	18.7x	0.2x
Year-end 2018 on 2019 EPS	19.6x	0.9x

Source: Standard & Poor's, Thomson Financial, FactSet, Credit Suisse estimates

Our market views are predicated on a supportive economic backdrop, with benign recessionary risks and a pickup in near-term indicators. While we expect more muted longer-term growth, this has focused corporations on cost containment and the return of capital to shareholders, extended the business cycle and lowered discount rates.

Figure 3: Strategic Framework

Longer-Term: Slower growth extends the business cycle, driving down volatility and discount rates, while also promoting cost vigilance and the return of capital



Near-Term: Over the past year, global economic data has inflected higher while inflation readings have declined

Intermediate-Term: During expansions, multiples tend to rise. Despite the age of the current recovery, recessionary risk is quite contained

Source: Credit Suisse

Portfolio Positioning and Sector Recommendations

Our sector calls are based on a top-down view of the economy combined with sector-specific fundamentals, including earnings growth, revisions, relative valuations and the unique insights of Credit Suisse sector analysts.

Our primary assumptions are that the U.S. and global economies will continue on a slow but steady path of economic expansion (U.S. GDP of 2-2¼%) for at least the next 18-24 months, and that a tight labor market will begin to put upward pressure on inflation, interest rates and margins.

While forward-looking indicators have been quite robust (most recent ISM reading of 60.8), relative stock and sector performance seems unmoved by this near-term strength. This suggests that investors are well-anchored in their longer-term expectations of modest, secular growth and explains why cyclical groups — namely Industrials, Materials and Discretionary — have performed in-line with the market, despite an uptick in recent data.

Our market view is predicated on the belief that recessionary risks remain well contained, and that interest rates will continue to drift higher. Against this backdrop, Financials should outperform the broad market, with deregulation providing a tailwind to the sector. Conversely, Bond Proxies will likely underperform given uninspiring fundamentals and their propensity to lag in periods of rising yields. Within the defensive sectors, Staples should deliver higher earnings growth in 2018.

Technology is our favorite sector despite elevated multiples. Fundamentals remain strong given the group's exposure to secular growth themes in subgroups such as Internet and software-as-a-service. While historically categorized as a growth sector alongside Tech, Health Care's fundamentals look relatively uninspiring given decelerating earnings trends in biotech and pharma. Robust earnings growth in the Energy sector is the result of easy comps; however, it is unattractive given poor revisions and high valuations. We recommend a market weight in Industrials and Materials, which have disappointingly performed in-line with the benchmark, despite a pickup in the forward-looking economic indicators.

New Economy stocks in Tech and Discretionary should continue to stand out

Figure 4: Credit Suisse Sector Recommendations

Overweight	Market Weight	Underweight
Financials	Industrials	Energy
Technology	Materials	Utilities
Discretionary	Health Care	Telecom
	Staples	REITs

Source: Standard & Poor's and Credit Suisse

Details Behind Market Forecast

Earnings Outlook

Our earnings numbers are based on separate forecasts for revenue, margins and changes in share count. These estimates are driven by macro inputs and consolidated financial statement data for the broad market.

Breaking down our earnings forecast by line item allows us to provide more accurate estimates and gain greater insight into underlying business dynamics affecting stock prices.

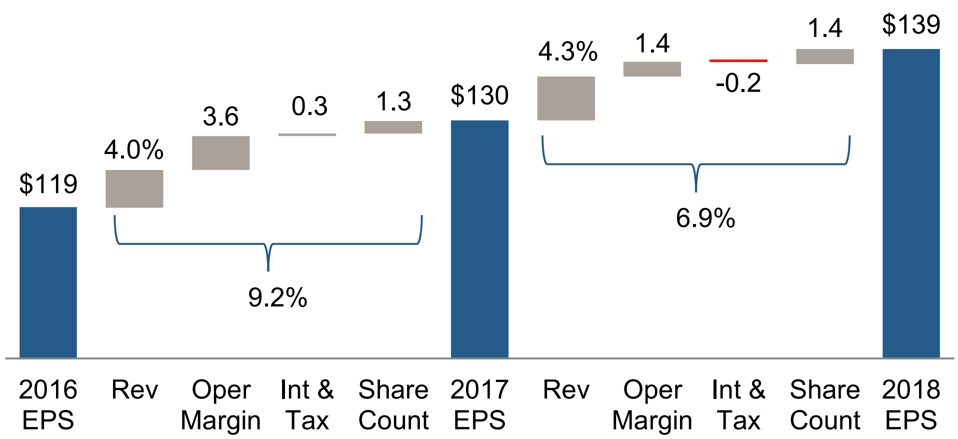
For example, global trade impacts sales volumes, whereas wages affect margins. Taxes are variable early in the cycle, whereas interest expense is influenced by the shape of the yield curve and leverage ratios.

These top-down projections are then analyzed relative to consensus bottom-up estimates as well as the views of Credit Suisse analysts. This allows us to identify any idiosyncratic inputs that might not be pickup up by our models.

The results of this process are EPS forecasts of $130, $139 and $147 for 2017-19.

More than half of 2018 EPS growth should come from revenues

Figure 5: Credit Suisse 2017 and 2018 Projected EPS Growth Breakdown



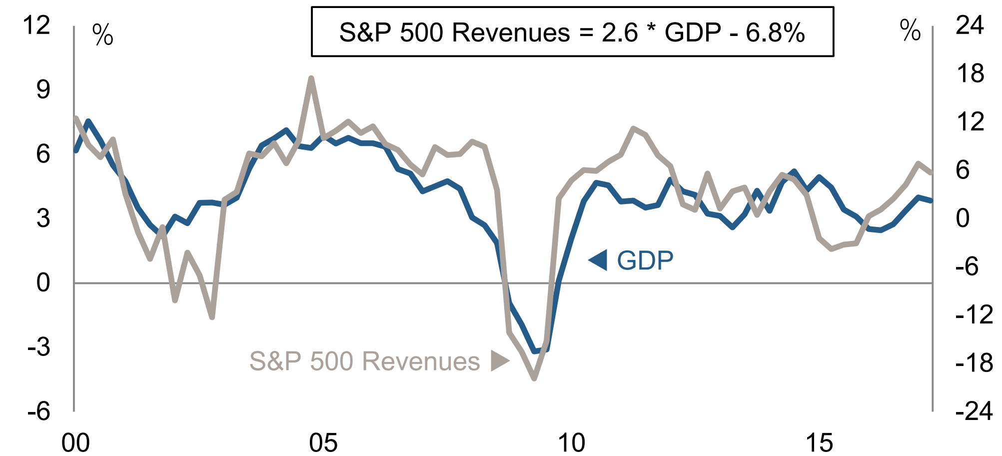
Source: Standard & Poor's, Thomson Financial, Credit Suisse estimates

Revenues

Many things affect corporate sales; however, revenues are most highly correlated with overall measures of economic growth. As the exhibit below highlights, S&P 500 top-line growth marches to the beat of U.S. nominal GDP (R^2 of 0.8).

Nominal GDP is the primary driver of S&P 500 revenues

Figure 6: Revenues vs. Nominal U.S. GDP



Source: Standard & Poor's, Bureau of Economic Analysis, FactSet, Haver Analytics®, Credit Suisse

At first glance, revenues and GDP appear to share a one-to-one relationship. A closer look shows that sales are meaningfully levered to changes in the economy, with each incremental unit of GDP generating 2½ units of top-line growth. This is important in the current environment given the pickup in forward-looking indicators.

Stronger global PMIs point to a pickup in top-line growth

Figure 7: Global PMIs

	Sep-17	Dec-16	Dec-15	Dec-14
Global	53.2	52.7	50.7	51.5
U.S.	60.8	54.5	47.9	54.9
Canada	55.0	51.8	47.5	53.9
Japan	52.9	52.4	52.6	52.0
UK	55.9	55.8	51.2	52.3
Euro Area	58.1	54.9	53.2	50.6
France	56.1	53.5	51.4	47.5
Germany	60.6	55.6	53.2	51.2
Italy	56.3	53.2	55.6	48.4
Spain	54.3	55.3	53.0	53.8

Expanding ≥ 52 **52 > Neutral ≥ 50** **Contracting < 50**

Note: ISM PMI for U.S., Markit PMI for all others

Source: Markit, ISM, Haver Analytics®, Credit Suisse

While S&P 500 revenues are most tightly correlated to U.S. nominal GDP, we are also cognizant of the substantial exposure to global trends. For this reason, we use a number of additional indicators such as global trade volumes, the price of oil and the trade weighted dollar to enhance our revenue forecasts.

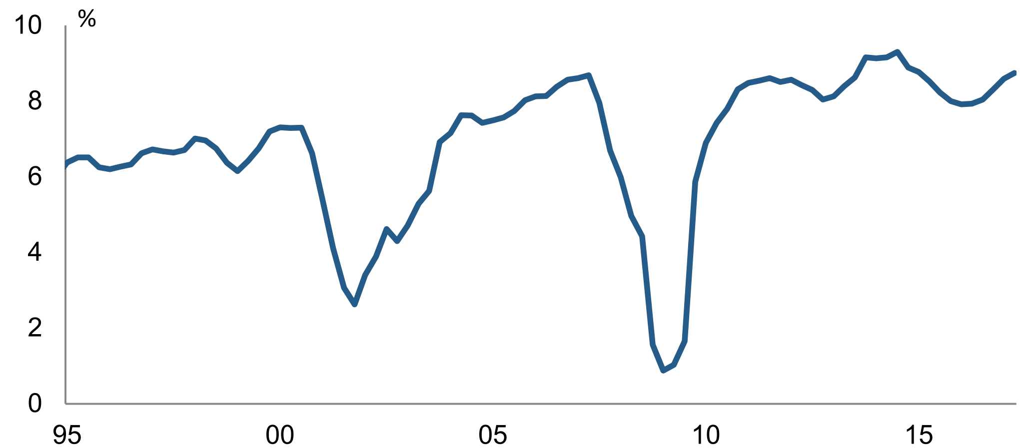
Margins

Investors have a reasonably high level of comfort when it comes to sales data, but have more difficulty evaluating and projecting margins.

In recent years, many investors have pointed out that margins are elevated, and pose a risk to corporate profits. The chart below supports this argument.

At first glance, margins appear toppy…

Figure 8: Net Income Margin



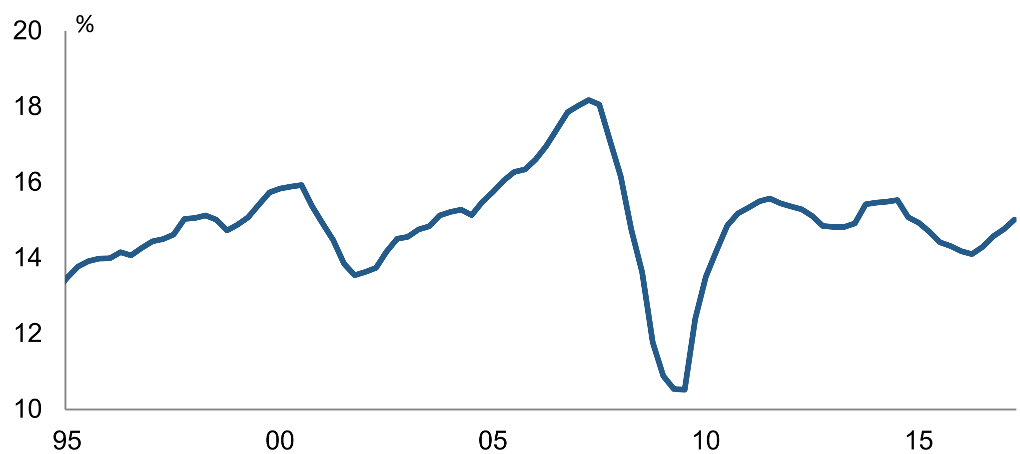
Note: S&P 500, Trailing 4Q basis

Source: Standard & Poor's, Compustat, FactSet, Credit Suisse

A deeper look at the data provides a different — and far more constructive — perspective. More specifically, it shows that EBIT (operating) margins are closer to mid-cycle levels with room to expand further.

…however, operating margins seem more mid-cycle

Figure 9: EBIT Margin



Note: S&P 500, Trailing 4Q basis

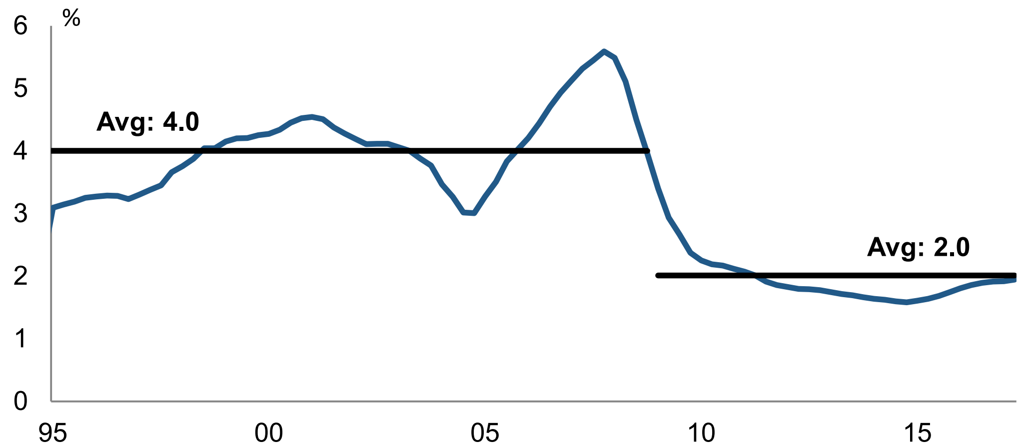
Source: Standard & Poor's, Compustat, FactSet, Credit Suisse

So how do we reconcile these two opposing views on corporate profitability? The answer is simple…interest rates. With bond yields depressed, interest expense has been cut in half over the past decade, boosting overall profitability. This leaves operating margins in perfectly fine shape, with the potential to move higher.

Parenthetically, given our views that interest rates are likely to rise modestly over the upcoming year, we are forecasting a 15- to 20-basis-point drag on profit growth from this line item.

Declines in interest expense are adding 200 bps to net income margins

Figure 10: Interest as a % of Sales



Note: S&P 500, Trailing 4Q basis

Source: Standard & Poor's, Compustat, FactSet, Credit Suisse

As we build our projections, we find that margins move as a function of three key economic forces: (1) pricing power, (2) variable input costs (primarily labor), and (3) the amortization of fixed expenses per unit of sale (primarily GDP trends). The current outlook for each of these inputs is captured below. More specifically, the upturn in cyclical economic indicators more than offsets the lack of corporate pricing power and the potential for higher wages.

Stronger cyclical indicators are offsetting a lack of pricing power and the potential for higher wages

Figure 11: Inputs to Margin Forecast

Driver of Margins	Key Inputs	Current Outlook
Pricing Power	Inflationary measures Commodity prices	Modestly Negative
Variable Input Costs	Wages (Lower = Better)	Modestly Negative
Fixed Expense Per Unit of Sale	Cyclical economic indicators	Positive

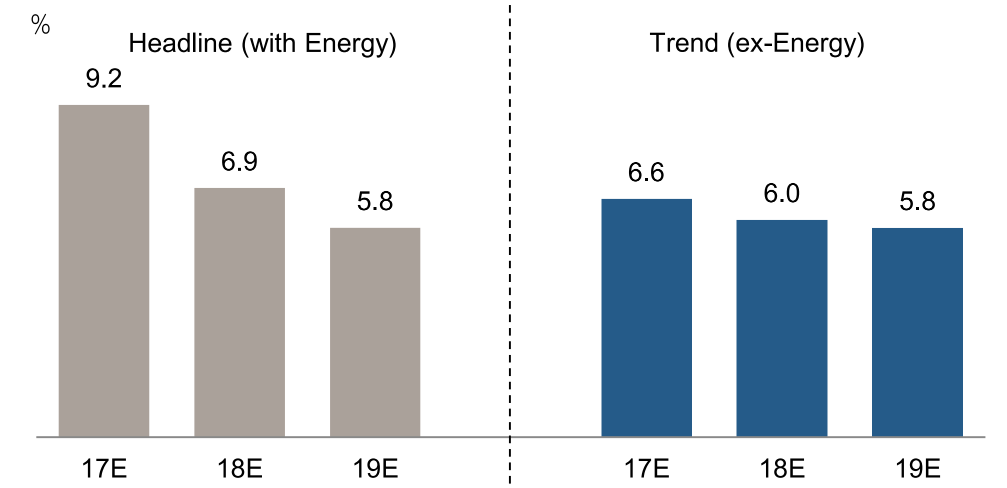
Source: Credit Suisse

Energy Impact on Earnings

We forecast corporate profits based on top-down economic inputs; however, there are times when our models need to be overridden due to large disruptive events. The collapse and (partial) rebound in energy prices is such a situation. As the exhibit below highlights, the Energy sector is likely to distort EPS by 260 basis points in 2017 and 90 basis points in 2018. Absent these impact, the trend in earnings would be far more stable in our view.

Easy comps in Energy overstate the underlying pace of EPS growth in 2017-18

Figure 12: Credit Suisse Projected EPS Growth



Source: Standard & Poor's and Credit Suisse estimates

Distortions from Energy and other commodity sensitive groups largely explain the increase in margins in our formal projections despite neutral readings presented in Figure 12.

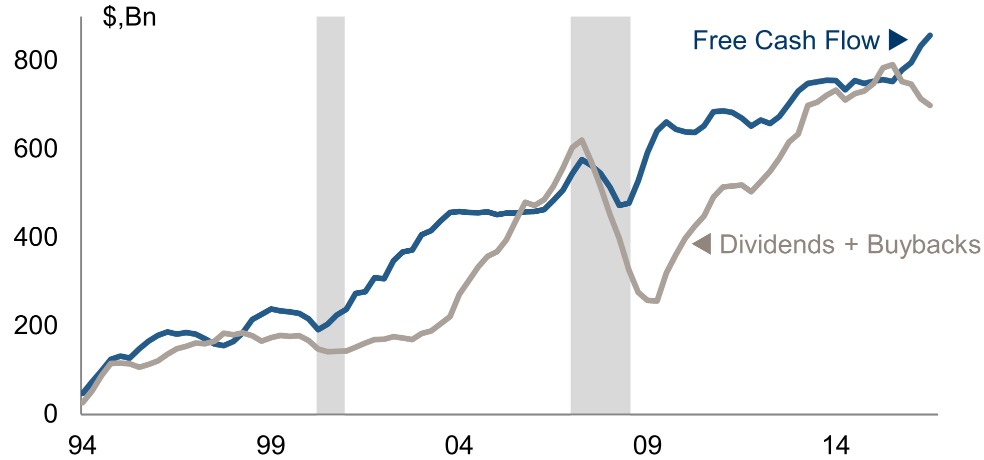
Return of Capital / Share Count

When evaluating corporate prospects, we prefer to focus on earnings rather than EPS, as changes in share count provide little insight into a company's ability to generate profits. Unfortunately, this is not the convention among investors.

Over the past five years, buybacks have added 1½-2% to EPS annually. While this overstates the S&P 500's profit power, we believe the consensus narrative that easy monetary policy is the catalyst behind these repurchases is off base. More specifically, more than 100% of dividends and buybacks are covered by free cash flow.

More than 100% of dividends and buybacks are funded by free cash flow

Figure 13: Return of Capital vs. Free Cash Flow Generation



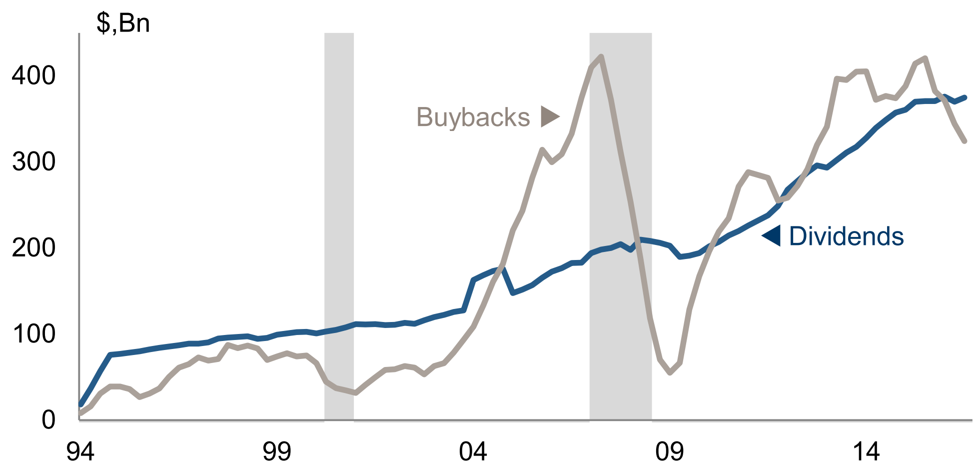
Note: S&P 500 ex-Financials, Trailing 4Q basis

Source: Standard & Poor's, National Bureau of Economic Research, Compustat, FactSet, Credit Suisse

In 2016, S&P 500 companies returned $450B of capital in the form of stock repurchases, adding 2.1% to EPS. As the exhibit below shows, the pace of buybacks has slowed since, as companies are redirecting a greater portion of cash flows back into operations. This recent trend is evident in all sectors, save Financials. We assume that companies will buy back shares at the current pace, 1½% annually.

Buybacks have recently fallen as companies redirect capital internally

Figure 14: Return of Capital – Dividends vs. Buybacks



Note: S&P 500 ex-Financials, Trailing 4Q basis

Source: Standard & Poor's, National Bureau of Economic Research, Compustat, FactSet, Credit Suisse

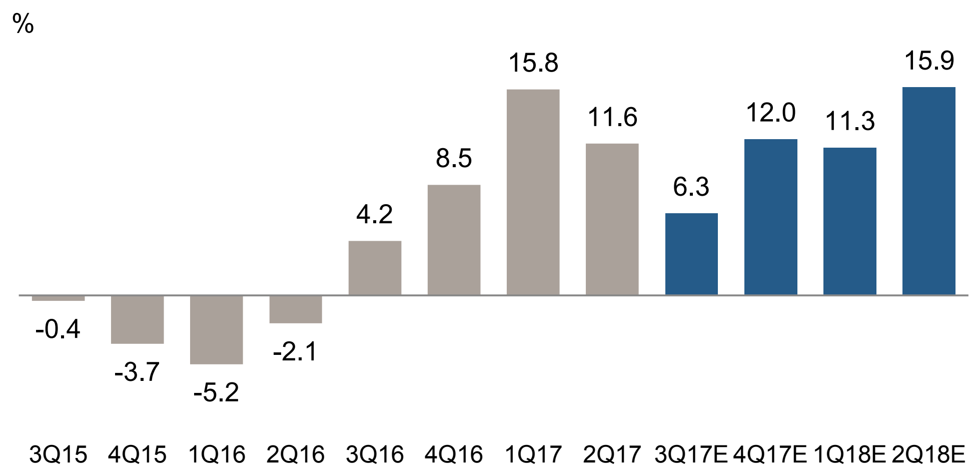
Analyst Estimates

Once our estimates are complete, we find it helpful to analyze our projections against consensus forecasts. This often uncovers idiosyncratic behaviors that are not picked up by our models.

Unfortunately, analyst projections have inherent biases that must be taken into account in order to make an apples-to-apples comparison. Historically, analysts tend to understate near-quarter estimates by 3-5% (at the current time, this would apply to 3Q17). By comparison, out quarters are typically overstated by similar amounts. After making these adjustments, we find bottom-up estimates to be roughly in-line with our forecasts.

Consensus bottom-up estimates are likely too low in 3Q17 and too high in out-quarters

Figure 15: EPS Growth YoY



Note: Estimates are based on consensus forecasts; YoY growth of quarter-end/current constituents

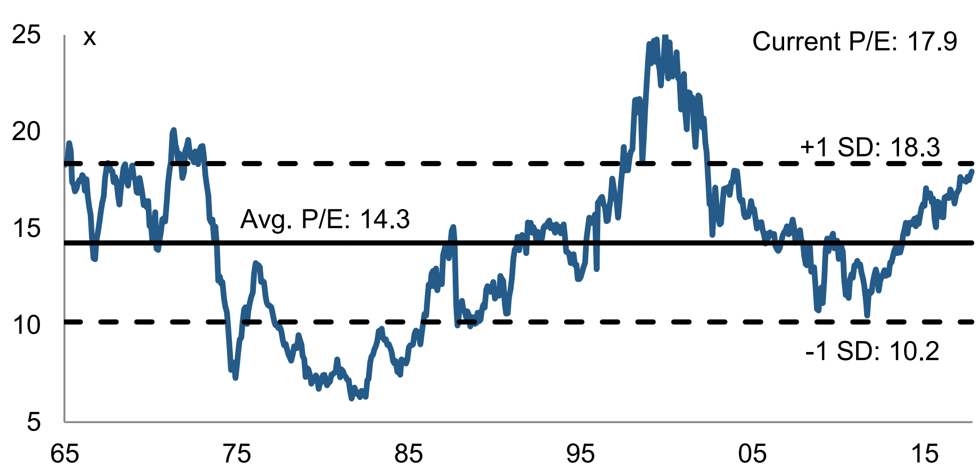
Source: Standard & Poor's, Compustat, Thomson Financial, FactSet, Credit Suisse

Valuations

Analysts spend far more time forecasting earnings and cash flows than discount rates and stock multiples. This is unfortunate, as the majority of the market's return in any given year is likely to be driven by changes in valuations rather than earnings.

Valuations are above long-term averages but not yet at troubling levels

Figure 16: Forward P/E

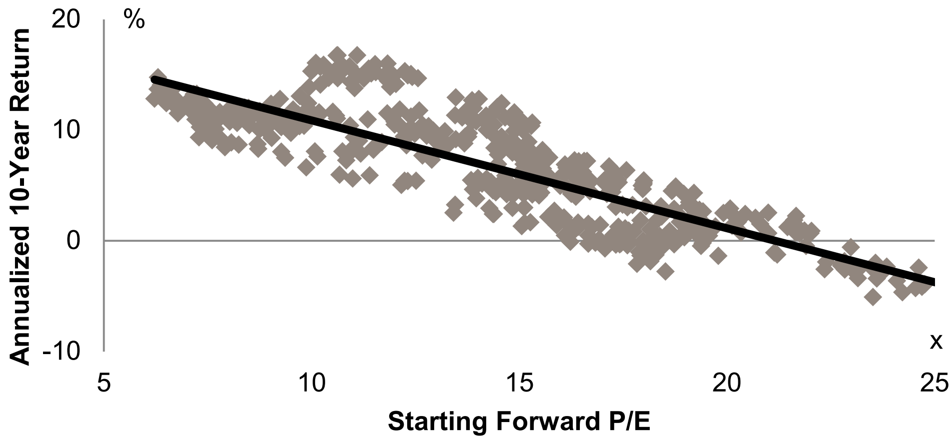


Source: Standard & Poor's, Thomson Financial, FactSet, Credit Suisse

Forward P/Es are within their normal range, although closer to the high end. This is fueling investor concerns that valuations will either limit future returns—at best—or lead to an outright correction. Such assertions are well founded given the extensive research linking the level of valuations with longer-term returns. As the exhibit below highlights, investing at higher valuations does result in weaker returns over the subsequent 10 years.

Over longer periods (10 years), higher multiples have led to weaker returns

Figure 17: 10-Year Annualized Stock Returns vs. Starting P/E Levels



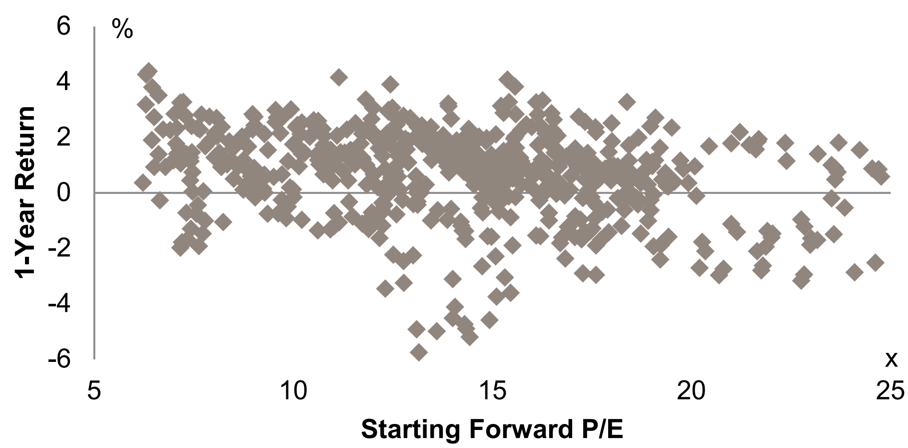
Note: 1964 to present

Source: Standard & Poor's, Federal Reserve, Thomson Financial, FactSet, Haver Analytics®, Credit Suisse

This research fails to capture the weak relationship between the level of stock multiples and returns over shorter periods. As the exhibit below shows, there is virtually no relationship between P/Es and returns in the subsequent 12 months. Put differently, valuations might be elevated, but this tells us very little about return prospects for 2018.

Over the near term, multiples are less predictive of performance

Figure 18: 1-Year Stock Returns vs. Starting P/E Levels



Note: 1964 to present

Source: Standard & Poor's, Federal Reserve, Thomson Financial, FactSet, Haver Analytics®, Credit Suisse

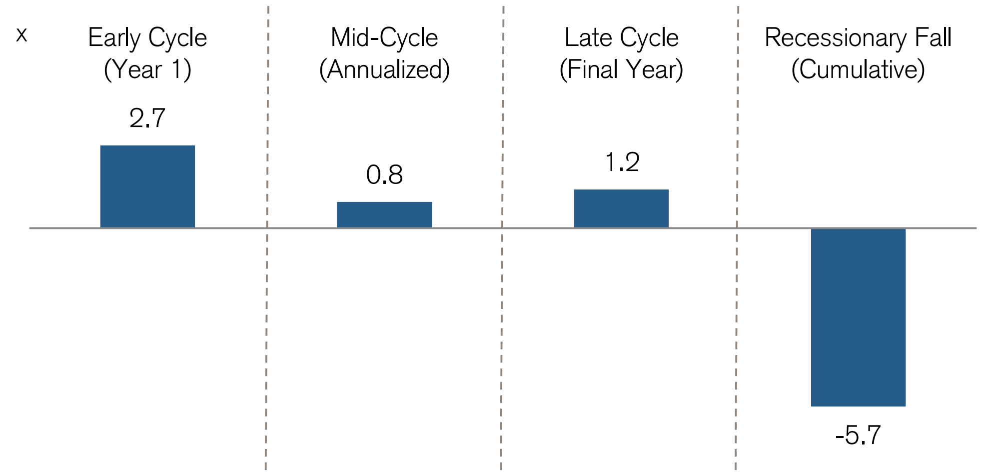
While the current level of valuations might not be a useful near-term roadmap for investors, the dynamics around the business cycle and discount rates are more instructive.

As the exhibit below highlights, P/Es tend to expand throughout the cycle, contracting viciously heading into and during recessions. With recessionary risks below average, we would expect to see multiples rise further, despite their current levels.

Our forecasts assume that forward P/Es will rise from ½-¾ multiple points over the next 15 months. This increase would add 3½-4% to the market's return above EPS growth.

Multiples typically expand throughout a recovery, but contract meaningfully entering recessions

Figure 19: Average Multiple Expansion Throughout the Cycle



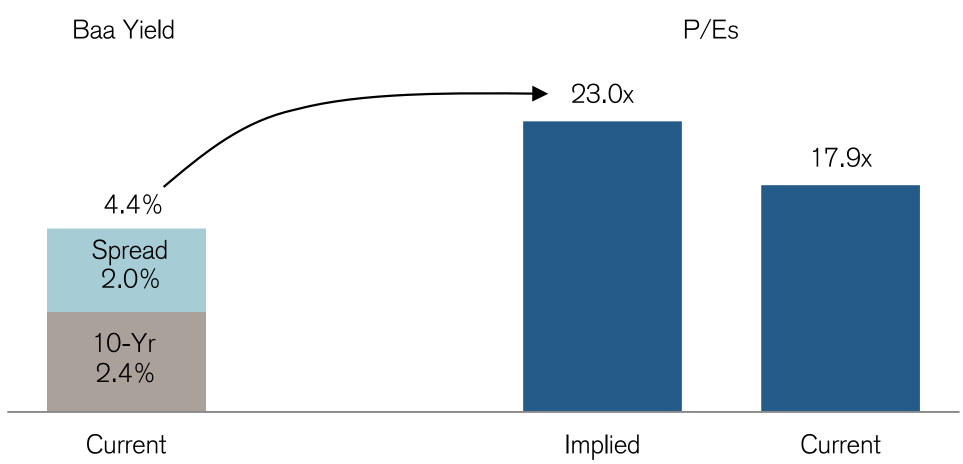
Note: 1982 to current

Source: Standard & Poor's, FactSet, Credit Suisse

The relationship between the cost of capital and stock multiples is a complex one. As the chart below highlights, corporate bond yields imply a 23.0x multiple, while stocks trade at only 17.9x. Put differently, stocks look extremely cheap compared to credit, in our view. We would expect this spread to narrow over time as interest rates edge higher and stock multiples re-rate.

Bond yields imply a much higher market multiple

Figure 20: Bond Yields vs. S&P 500 Multiples



Note: Implied P/E is the inverse of the Baa Yield

Source: Standard & Poor's, Moody's, Thomson Financial, FactSet, the BLOOMBERG PROFESSIONAL™ service, Haver Analytics®, Credit Suisse

Portfolio Positioning

Sectors and Industries

Our formal sector recommendations are organized by traditional GICS sectors; however, this structure can be improved upon to more closely align with the stock selection process. See exhibit below. For example, New Economy companies such as Facebook and Amazon are categorized in Tech and Discretionary within the GICS scheme, yet are thematically quite similar. Semiconductors and Materials companies tend to both respond to changes in forward-looking economic indicators, although they are traditionally categorized separately.

We prefer New Economy companies, Financials, Housing and Semis

Figure 21: Credit Suisse Sector Schematic

S&P 500

Non-Cyclical Growers		**Cyclical**		**Rate Sensitive**	
Secular (12% of Mkt)	**Stable (26)**	**In-Favor (4)**	**Old Economy (35)**	**Financials (15)**	**Bond Proxies (8)**
▲ **New Tech**	◄ Heath Care	▲ **Housing**	▼ ***Energy***	▲ **Fin'ls**	▼ ***REITs***
▲ **New Consumer**	◄ Staples	▲ **Semis**	◄ Materials		▼ ***Telecom***
	◄ Biz Svcs		◄ Old Tech		▼ ***Utilities***
	◄ Aerospace & Defense		◄ Old Consumer		
			◄ Industrials ex-Svcs and A&D		

Key: ▲ **Overweight** ◄ **Neutral** ▼ ***Underweight***

Source: Standard & Poor's, FactSet, Credit Suisse

Secular Growers (12% of S&P 500)

New Tech and New Consumer

Secular Growers are innovative companies whose success is less tied to the health of the economy. These firms are most concentrated in the New Tech and New Consumer areas of the market, and would include FAANG stocks. There are relatively few businesses that qualify for this category; however, those that do carry a substantial weight in the benchmark.

We are positive on this group despite its recent outperformance, which can largely be attributed to business success as opposed to speculation surrounding these names. For this reason, they are quite different than the Secular Growers of the late 1990s. We believe their outperformance will continue in the year ahead. The companies in this group are forecast to deliver market-leading growth over the next several years as these firms take share from legacy business models.

Within New Tech, our preference would be for Internet and software-as-a-service companies. Valuations for these names look more favorable, especially considering their bottom-line growth trajectory. Among New Consumer businesses, Internet retailing and online media distribution companies should command a premium valuation given fundamental tailwinds as these firms take share from traditional brick & mortar stores and legacy media platforms.

Stable Growers (26%)

Health Care, Staples, Business Services and Aerospace & Defense

Stable Growers deliver less volatile earnings and cash flows than the broad market, with less interest rate sensitivity than Bond Proxies. At the same time, they provide less EPS upside than Secular Growers. Consumer Staples clearly qualify for this group, as does Health Care given its recent growth rate decline. Within the Industrials sector, business services and aerospace & defense names exhibit these characteristics.

We are currently neutral on these names. That said, these stocks have a tendency to surprise investors with their strong relative price performance in weak economic environments, despite their modest earnings growth. While defensive in nature, Stable Growers do not hold up as well as Bond Proxies in down markets.

Among these groups, we favor Health Care given its more attractive valuations. Within this sector, our preference is for services & devices given stronger fundamentals. We view biotech & pharma less favorably given lackluster bottom-line trends resulting from generic competition and pricing concerns. Fundamentals within business services and aerospace & defense look quite attractive, but are fully recognized in their valuations, in our opinion. Opportunities within Staples appear more limited given tepid bottom-line trends, with tobacco and packaged foods a relative standout.

In Favor Cyclicals (4%)

Housing and Semiconductors

This category is opportunistic in nature based on bottom-up criteria. More specifically, it represents those groups of stocks that are currently in favor based on cyclical factors affecting their industries as opposed to the broader economy. Currently, we view homebuilders and semiconductor companies in this light, and recommend overweighting this space.

While we find housing-related stocks attractive in general, we prefer those focused on repair and remodel activity. Within semiconductors, we prefer businesses exposed to the cloud, as well as those levered to the greater presence of chips in automobile, consumer and industrial devices.

Old Economy (35%)

Old Tech, Old Consumer, Energy, Materials, and Industrials excluding Services and Aerospace & Defense

This disparate group, which includes companies across sectors that rise and fall with the economy, is the broadest. It consists of Energy and Materials, the majority of Industrials (except services and aerospace & defense), as well as brick & mortar retail and tech hardware. At 35% of the S&P 500, it drives the economic sensitivity of the stock market. This bucket is much larger in non-U.S. benchmarks, making international stocks more economically sensitive than the S&P 500. In periods of economic acceleration and a steepening yield curve, Financials would trade alongside this category.

This group tends to lag in periods of weaker economic growth. Given the success of New Economy business models, and with the U.S. and global economies becoming more service-oriented, these stocks are likely to face secular headwinds. To the extent that we are in a slower for longer environment, this category could lag for some time. Somewhat surprisingly, corporate results and stock prices for these names have not been stronger over the past year, despite the pickup in forward-looking data.

Industrials are forecast to see stronger trends in 2018. This is led by late stage companies in industries such as machinery, building products, construction and transports. Among commodity-sensitive groups, fundamentals and valuations look more attractive for Materials than for Energy. Old Consumer appears lackluster as brick & mortar companies continue to lose share to online retailers. Similarly, tech hardware firms (ex-Apple) remain uninspiring as the commoditization of their businesses results in a loss of pricing power.

Financials (15%)

While it is an oversimplification to hitch the success of an entire sector to the direction of interest rates, history shows that the correlation between Financials and Treasury yields is quite high. Financials are also exposed to credit performance and business activity, which makes it economically sensitive. This sector makes up a much larger portion of EAFE than of the S&P 500. As such, when banks lead the market, the S&P 500 is likely to trail.

Given our expectation of higher rates, strong loan performance and continued (though modest) economic success, we believe Financials will outperform in the year ahead. Analyst EPS expectations are above the market average, valuations remain attractive, and changes in the regulatory environment provide the potential for further upside.

Within the group, banks are projected to deliver the most attractive earnings growth as interest rates inch higher and credit performance remains supportive. We are less constructive on insurance. Earnings growth for life insurers is expected to lag the Financials sector in 2018 as low interest rates limit their ROE. Recent natural disasters will lead to a pickup in catastrophic losses over the next 12-18 months, pressuring margins and bottom-line growth for the P&C group.

Bond Proxies (8%)

REITS, Telecom and Utilities

REITs, Telecom and Utilities, which make up 8% of the S&P 500 index, tend to lag the market as interest rates rise. Hence, we conveniently lump them together as Bond Proxies. Given our view that yields will rise and recessionary risk is contained, we would expect these stocks to underperform. Additionally, underlying fundamentals for the three sectors are the most uninspiring within the market, with analyst estimates for 2018 earnings growth at just 4%.

Within the REIT space, the only category expected to deliver growth rates above the sector average is specialized REITs, which is benefiting from rising demand for cloud computing. Growth remains challenged for other REIT subgroups with apartments battling rising capacity, offices challenged by falling property values, and retail facing weak demand.

Intense price competition among the major wireless carriers continue to weigh on the revenues and margins of AT&T and Verizon, which make up more than 90% of the Telecom space. Slower revenue growth for electric utilities, which dominate its sector, can be attributed to lower commodity prices.

Sector Recommendations

While we prefer to categorize stocks a bit more thematically, we understand that GICS classifications are the standard for investor sector decisions. As such, the table below organizes our recommendations into these 11 groups.

New Economy stocks in Tech and Discretionary should continue to stand out

Figure 22: Credit Suisse Sector Recommendations

Overweight	Market Weight	Underweight
Financials	Industrials	Energy
Technology	Materials	Utilities
Discretionary	Health Care	Telecom
	Staples	REITs

Source: Standard & Poor's and Credit Suisse

Our sector calls consider each group's exposure to macro themes along with their specific fundamentals.

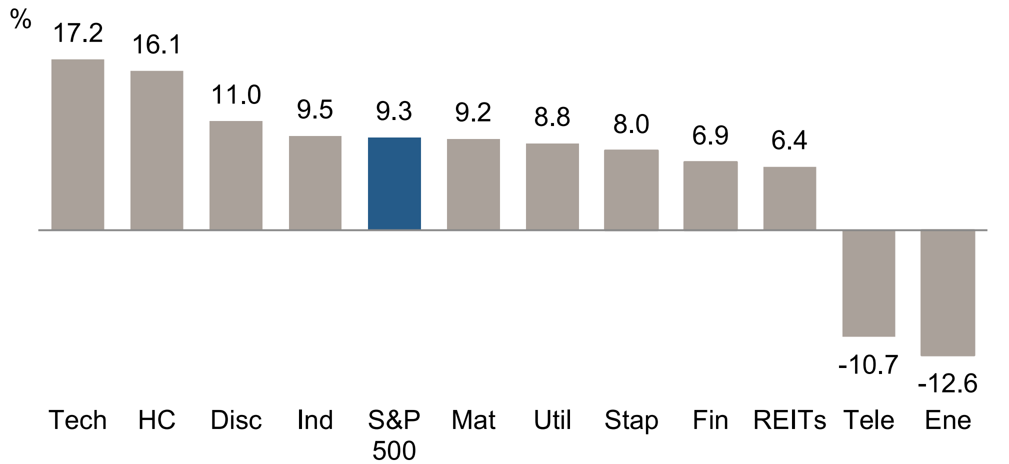
Figures 23-26 highlight a number of the metrics that we find most instructive in evaluating sectors and subsectors including price momentum, forward earnings growth, three-month EPS revisions and relative valuations.

As we review each sector, we come to the following conclusions:

- Technology appears the most attractive on a fundamental basis, and is our favorite despite elevated multiples.
- Energy growth is a standout on easy comps, but it appears to be the least attractive given poor revisions and high valuations.
- Given our belief that interest rates will drift higher, we are overweight Financials and underweight defensive sectors. By comparison, Staples are expected to deliver faster earnings growth in 2018 than traditional Bond Proxy sectors.
- Cyclical groups are demonstrating weak underlying fundamentals despite the recent pickup in forward-looking indicators. This is reflected in in-line market performance in a period of stronger economics.
- While historically categorized as a growth sector along with Tech, Health Care's fundamentals look far less inspiring. We see strong recent performance as a valuation bounce and are skeptical that it will have legs.

Tech's success has been driven by fundamentals; Health Care is a valuation bounce

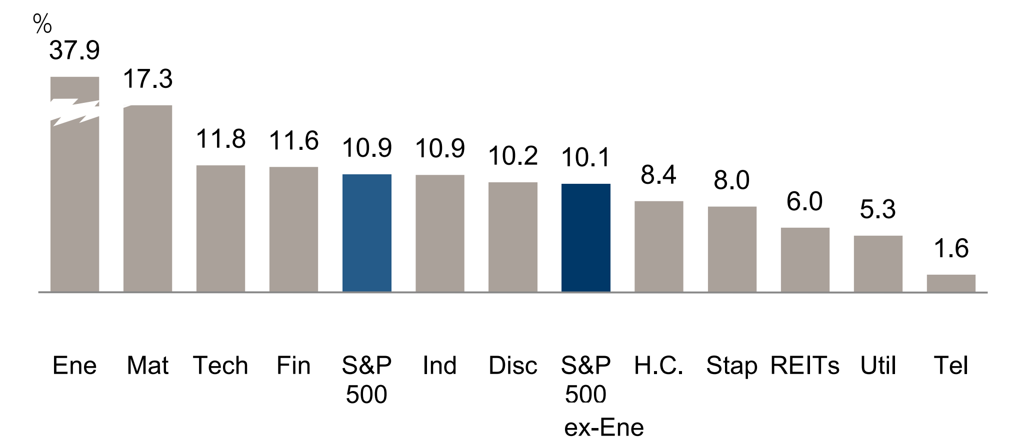
Figure 23: YTD Performance



Source: Standard & Poor's, FactSet, Credit Suisse

EPS growth in Energy and Materials is about easy comps, Tech and Financials are more sustainable

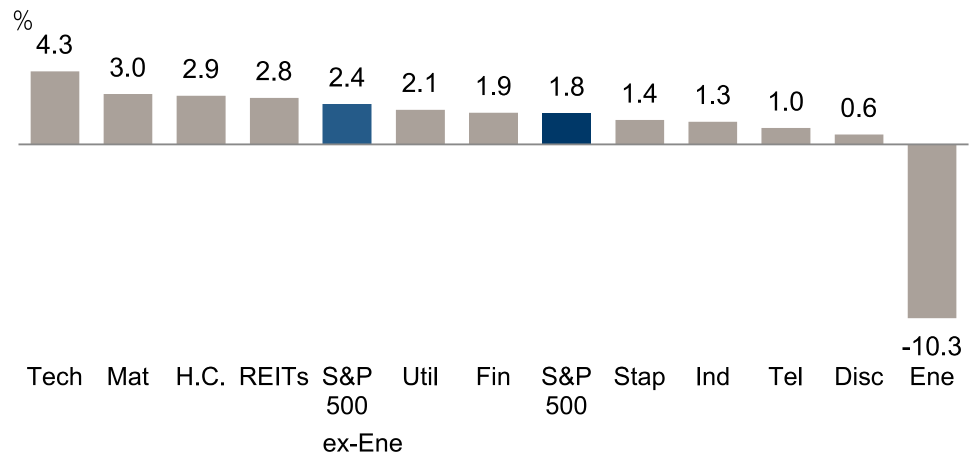
Figure 24: Consensus 2018 Earnings Growth



Source: Standard & Poor's, Thomson Financial, FactSet, Credit Suisse

We prefer Materials over Energy on stronger fundamentals

Figure 25: Earnings Revisions – Prior Three Months

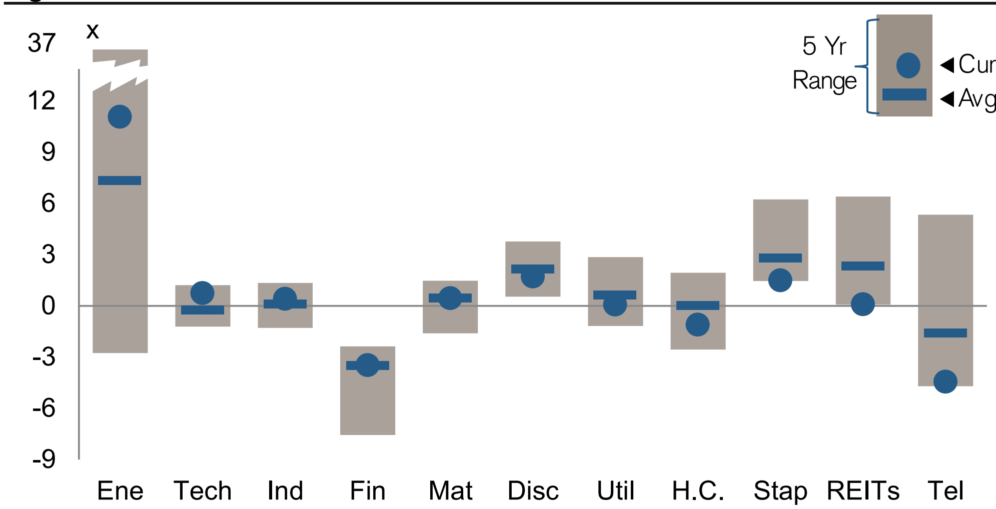


Source: Standard & Poor's, Thomson Financial, FactSet, Credit Suisse

Interest rate concerns are weighing on Bond Proxy multiples

Energy valuations remain extended

Figure 26: Relative Valuation



Note: Relative Forward P/E; multiple point +/- to the S&P 500

Source: Standard & Poor's, Thomson Financial, FactSet, Credit Suisse

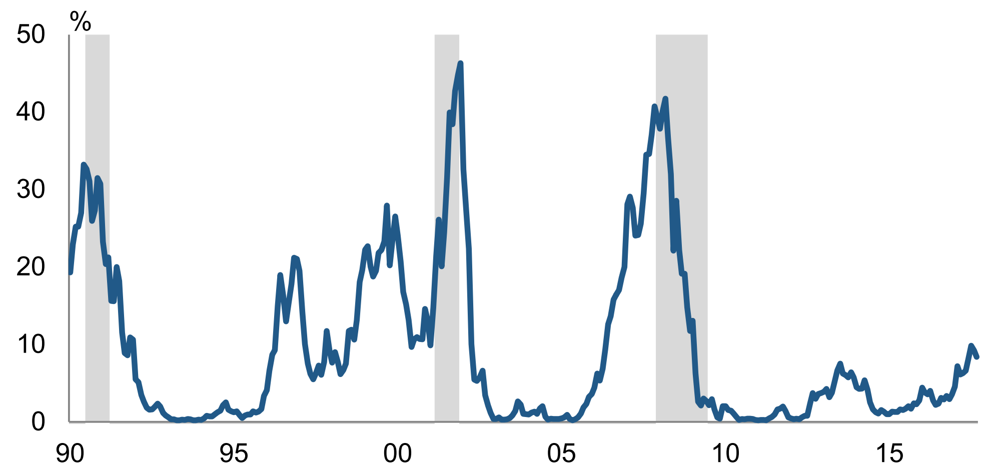
Importance of the Business Cycle

Investors are often taught that stock performance is normally distributed around some average return. In reality, equities deliver above-average returns throughout an expansion, contracting violently heading into and during a recession. As such, it would make logical sense to be long the market when the likelihood of a downturn is below average and rotate aggressively toward safety as risks increase.

Fortunately, at the current time, the probability of a recession appears to be well contained. According to the NY Fed, the probability of a downturn over the next 12 months is roughly 8%.

The NY Fed places only an 8% probability of recession in the next 12 months

Figure 27: NY Fed Probability of Recession in Next 12 Months



Source: Federal Reserve, National Bureau of Economic Research, Haver Analytics®, Credit Suisse

Given the importance of the business cycle in determining stock returns, we have created a comprehensive dashboard of recessionary indicators that have foreshadowed economic downturns in the past. At present, none of the readings suggest that we are near a recession.

Recessionary indicators point to limited downturn risk

Figure 28: Credit Suisse Recessionary Indicators Dashboard

Start of Recession	Yield Curve	Inflation Trends	Labor Market	Credit Performance	ISM Mfg.	Earnings Quality	Housing Market
Nov-73	↓	↓	↓	↓	↓	↓	↓
Jan-80	↓	↓	↓	↓	↓	↓	↓
Jul-81	↓	↑	↑	↓	↓	↓	↓
Jul-90	↓	↓	↓	↓	↓	↓	↓
Mar-01	↓	↓	↓	↓	↓	↓	↔
Dec-07	↓	↓	↔	↓	↓	↓	↓
Present	↑	↑	↑	↑	↑	↑	↑

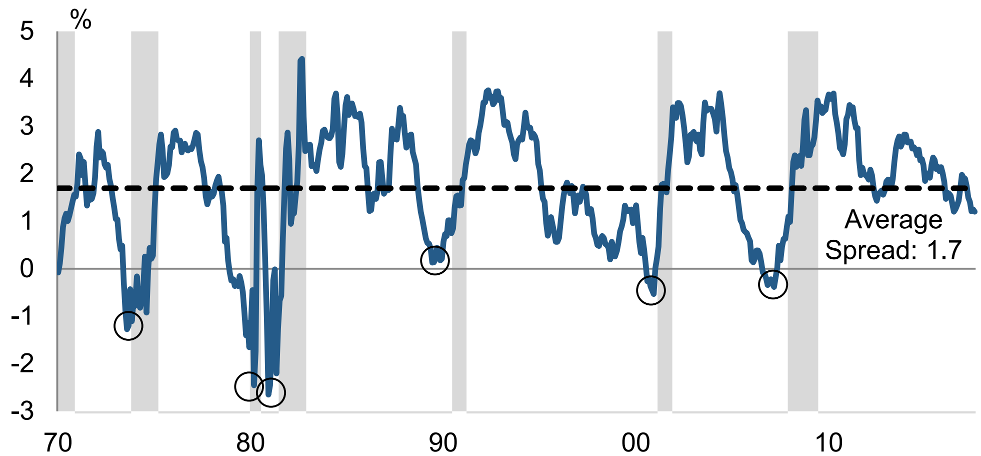
Key: ↓ Recessionary ↑ Expansionary ↔ Neutral

Source: Standard & Poor's, Federal Reserve, Bureau of Labor Statistics, National Bureau of Economic Research, ISM, Census Bureau, Haver Analytics®, Credit Suisse

Of all of these recessionary signals, the one most often cited is the steepness of the yield curve. As the exhibit below shows, it is typical for the curve to flatten significantly or invert in advance of a downturn. While Credit Suisse economists expect some flattening of the curve in the next year, they also believe that it will remain positively sloped.

The yield curve is the most often cited recessionary indicator and is far from inverted

Figure 29: Yield Curve



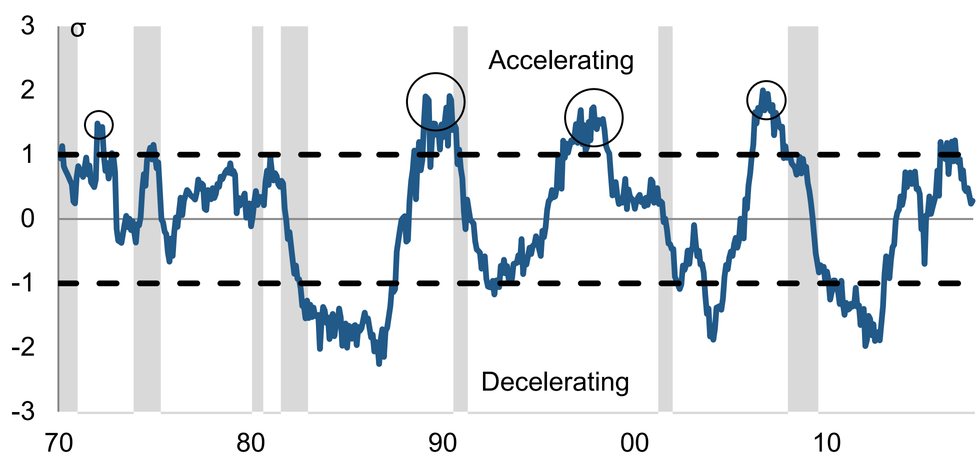
Note: 10 Year Yield minus 3 Month Yield

Source: Federal Reserve, National Bureau of Economic Research, Haver Analytics®, Credit Suisse

The data also shows that wage and inflation expectations provide a useful warning. While the level of wage inflation appears to be less important to the business cycle, accelerating wages pose a problem. More specifically, as wages accelerate, they tend to drive up broad-based inflation measures, squeeze margins and cause the Fed to take a more hawkish stance. Since the beginning of 2016, wage growth has been relatively stable, signaling little recessionary risk.

History shows that accelerating wages tend to precede recessions

Figure 30: Wage Inflation Acceleration



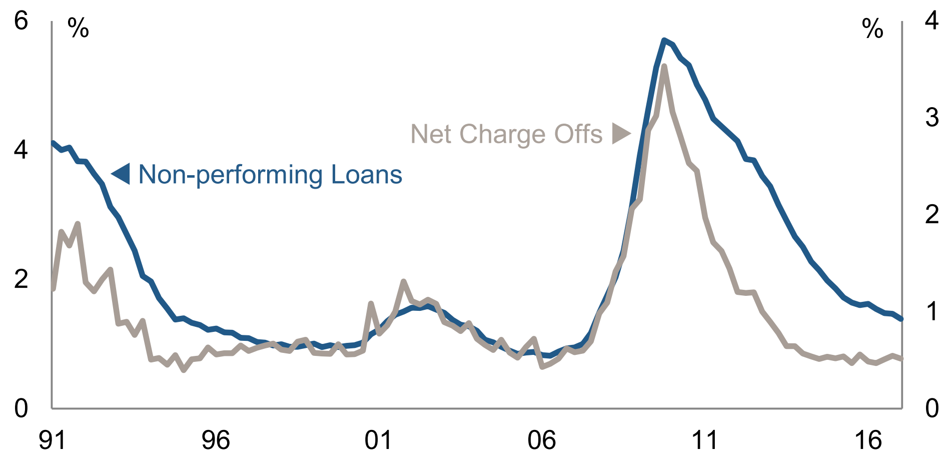
Note: Current change relative to prior 5 year average

Source: Bureau of Labor Statistics, National Bureau of Economic Research, Haver Analytics®, Credit Suisse

As the cycle reaches its final stages, it is typical to see corporate finances come under pressure. This is evident in the ability of companies to make timely debt payments. It also shows up in increased write-downs, as businesses more aggressively manage their profit reports. At the current time, neither loan performance nor the pace of corporate write-downs signal any stress.

Credit performance indicates limited stress in the economy

Figure 31: Loan Performance



Source: Federal Reserve, Haver Analytics®, Credit Suisse

Risks and Other Considerations

Our forecasts are built upon the most historically important drivers of corporate profits and stock prices. That said, many things can alter the market's path over the near term. Below we highlight a number of issues that have the potential to enhance or derail stock prices over the next 1-2 years.

Trump Policy

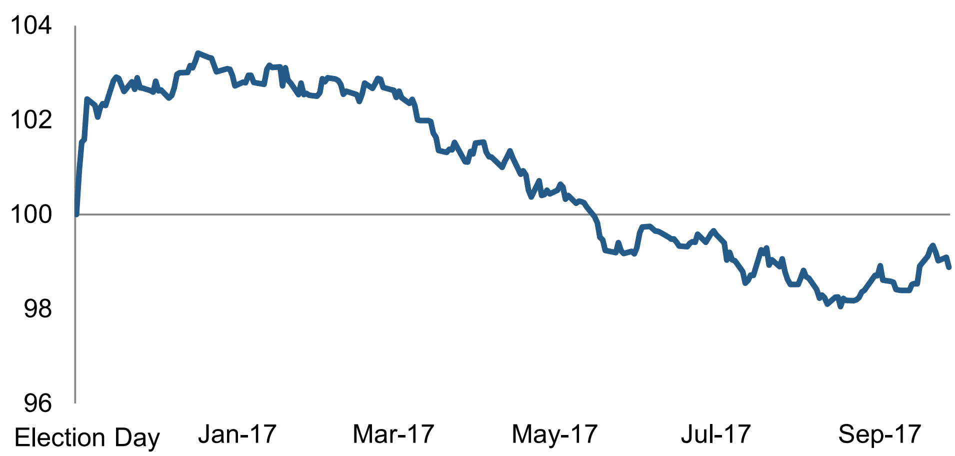
Stocks have returned roughly 20% since Donald Trump's unanticipated victory. Not surprisingly, many investors are chalking up the market's success to the potential impact of lower taxes and less regulation. With the recent announcement of a tax reform framework by "The Big Six" (Orrin Hatch, Mitch McConnell, Paul Ryan, Kevin Brady, Steven Mnuchin and Gary Cohn), these issues are again taking center stage.

Our work indicates that the market's appreciation since last November is more accurately attributable to a supportive economic and earnings backdrop. A look at the data shows that the global economy began to strengthen in mid-2016, well ahead the election.

The performance of Credit Suisse's basket of high-tax rate stocks further supports this assertion. As the exhibit below highlights, companies with high effective tax rates — expected to benefit from proposed Trump policies — did well relative to the market in the three weeks following the election, but have lagged since. This basket has outperformed only incrementally since the announcement by the Big Six.

The market appears to doubt the success of Trump's tax policies

Figure 32: Relative Return of High-Tax Rate Stocks



Note: Industry Group Neutral High Tax vs. Low Tax Baskets; Indexed at 100 on 11/8/16

Source: Standard & Poor's, Compustat, FactSet, Credit Suisse

We expect that the proposed tax plan will be difficult to pass, or will have less of an impact than hoped for. While we believe that the market would initially applaud such actions, we anticipate that the investment conversation would quickly shift toward higher potential deficits and wage inflation, both negatives for stocks.

By contrast, we are big fans of less burdensome regulation, and see this as the greatest policy opportunity for Mr. Trump.

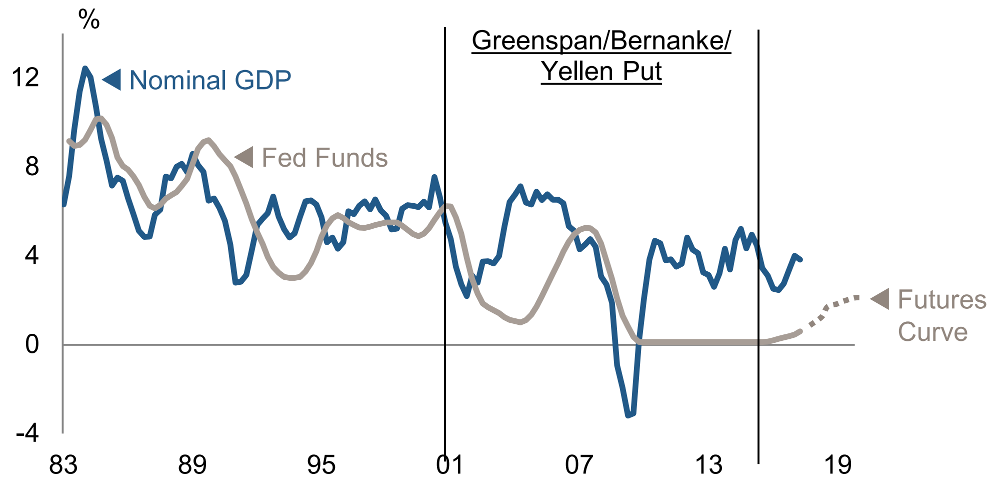
Change at the Fed

Investors are keenly focused on the actions of the Fed and other central banks as a key driving force behind capital markets. By contrast, our work focuses primarily on underlying economic trends, which we believe determine both market behavior and policy decisions. Regardless, it appears that we are weeks away from a nomination for Janet Yellen's replacement, an event that the market awaits eagerly.

We believe that there are two key issues surrounding Yellen's replacement that could unsettle the market: (1) a change in the perceived independence of the Fed, and (2) an end to the period of uber-dovish policy. This latter point is highlighted in the exhibit below, which shows the more accommodative policy over the past 15 years.

Investors are concerned that the regime of uber-accommodative policy might shift under a new Fed chair

Figure 33: Nominal GDP vs. Fed Funds



Note: Nominal GDP YoY Change, Fed Fund 4Q MA

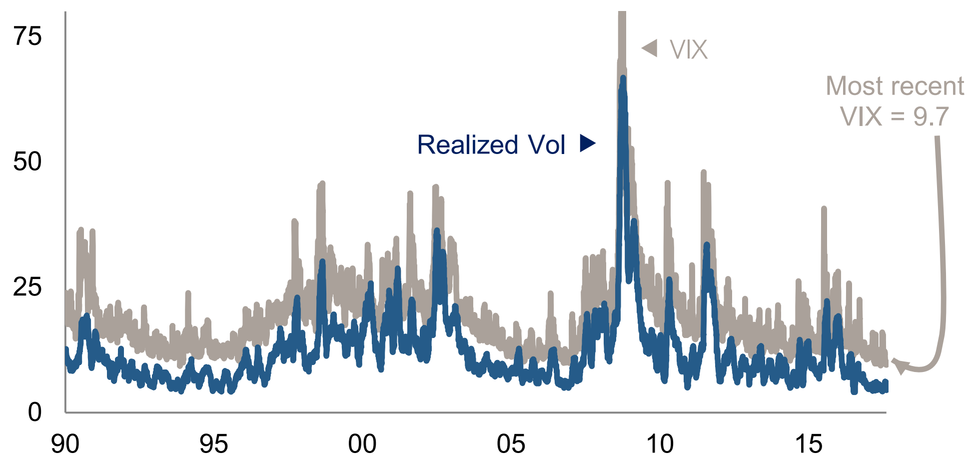
Source: Bureau of Economic Analysis, Federal Reserve, Haver Analytics®, Credit Suisse estimate

Market Volatility

Market volatility has been extremely low throughout the recovery, with the VIX currently reading 9.7. This has led many pundits to characterize investors as complacent and the market vulnerable to a pullback. We disagree with these assertions.

Despite macro concerns, volatility has been extremely low

Figure 34: VIX vs. Realized Volatility



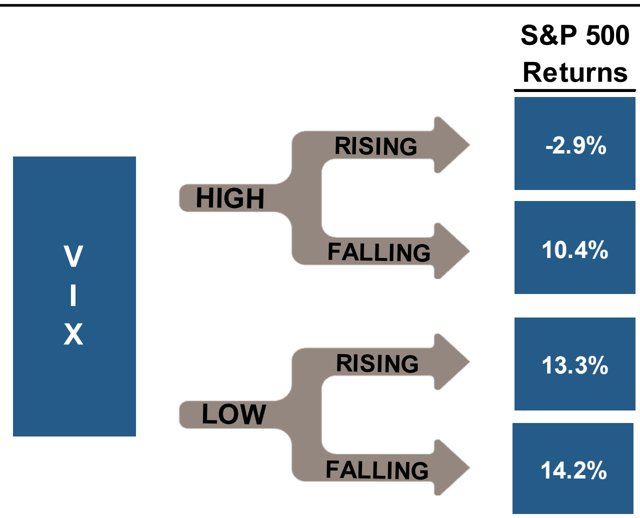
Note: Realized Volatility based on Trailing 1 month S&P 500 Price Change

Source: Standard & Poor's, Chicago Board Options Exchange, Haver Analytics®, Credit Suisse

As the exhibit above highlights, the VIX is being driven lower by realized volatility, rather than market sentiment. More importantly, history shows that equities are most at risk when the VIX rises from elevated levels, rather than from below-average readings. See exhibit below.

Stocks have done well historically when the VIX is below average

Figure 35: VIX vs. S&P 500 Performance



Note: 1970 to Present, trailing 12-month return.

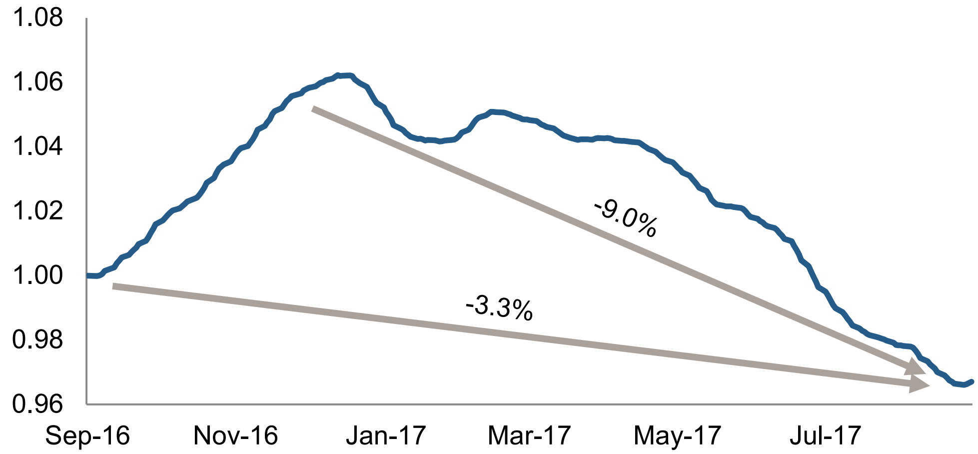
Source: Standard & Poor's, Chicago Board Options Exchange, Haver Analytics®, Credit Suisse.

Currency

The U.S. dollar has depreciated roughly 9% on a trade-weighted basis since the beginning of the year, a significant benefit for S&P 500 profits. Our work indicates a 10:1 ratio between currency moves and corporate profits (in the opposite direction). Unfortunately, the dollar's move is much more muted when measured on a year-over-year basis, and is therefore a much smaller consideration in our forecasts.

Every 10% move in the dollar generates a 1% move in EPS in the opposite direction

Figure 36: Trade-Weighted Dollar



Note: Indexed to 1 on Sep.30, 2016. As of Sep.30, 2017

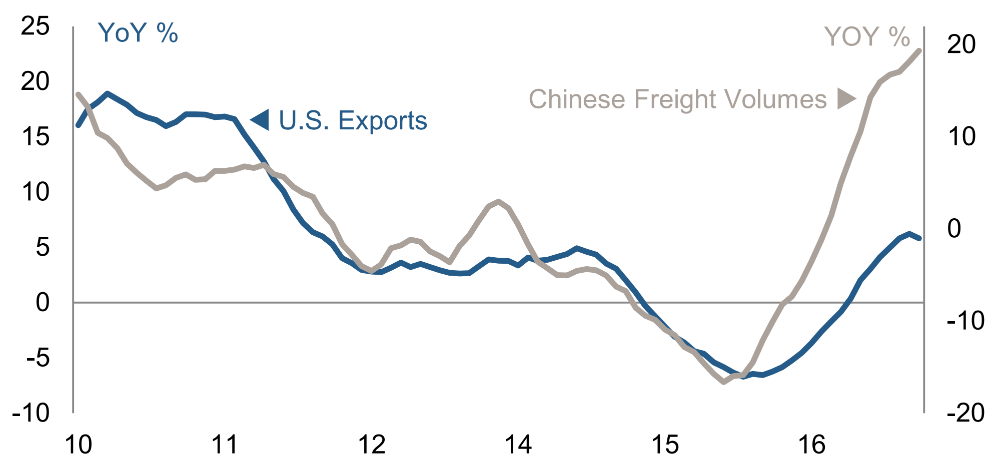
Source: Federal Reserve, the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

North Korea

While the market does not anticipate a military confrontation between the U.S. and North Korea, the Administration could sanction those countries doing business with DPRK — most notably China — as a means of pressuring the Regime. While such actions would likely be targeted, with little economic impact, they have the potential to escalate, disrupting global growth. As the chart below clearly shows, the recent improvement in the Chinese economy has had a large impact on global trade and corporate profits.

Aggressive sanctioning of North Korean trade partners could impact economic growth

Figure 37: China Freight vs. U.S. Exports



Note: 6 Month MA

Source: Census Bureau, National Bureau of Statistics of China, the BLOOMBERG PROFESSIONAL™ service, Haver Analytics®, Credit Suisse

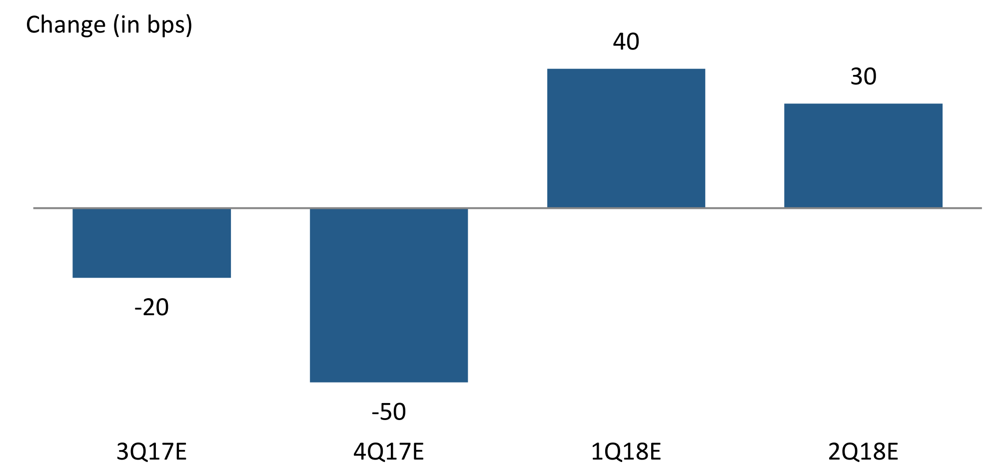
Hurricane

According to James Sweeney, Credit Suisse Chief Economist, Hurricanes Irma and Harvey will meaningfully distort employment and other economic data in the latter half of 2017 and early 2018, obfuscating underlying economic trends. More specifically, as the exhibit below highlights, he expects a portion of current year GDP to shift forward. However, these impacts should vary by industry. For example, stronger recent car sales are already being attributed to replacements due to these events.

Separately, we would not be surprised to see some companies using these natural disasters as an opportunity to conveniently take write-downs.

Credit Suisse economists see hurricanes shifting GDP between 2017 and 2018

Figure 38: Likely Shift in Quarterly GDP Pre- and Post-Hurricanes Season



Source: Credit Suisse U.S. Economics Team

Appendix

Figure 39: EPS Estimates Detail

	2016	2017E	2018E	2019E
Dollars ($bn)				
Sales	9,962	10,336	10,777	11,309
EBIT	1,535	1,649	1,742	1,832
Interest Expense	193	204	217	242
EBT	1,342	1,445	1,525	1,591
Taxes	311	334	354	371
Net Income	1,031	1,111	1,171	1,220
Per Share ($)				
Sales/Share	1150.59	1209.00	1280.00	1363.00
EPS/Share	119.08	130.00	139.00	147.00
Contribution to Growth (%)				
Sales	0.3	4.0	4.3	4.9
Operating Margins	1.4	3.6	1.4	0.3
Int & Tax	-2.0	0.3	-0.2	-1.0
Interest	-3.6	-1.6	-0.1	-0.8
Taxes	1.6	0.1	-0.1	-0.2
Share Count	1.0	1.3	1.4	1.5
Buybacks	1.5	1.7	1.9	2.0
Issuance	-0.5	-0.4	-0.5	-0.5
Chg in EPS	0.7	9.2	6.9	5.8

Source: Standard & Poor's, Computstat, Thomson Financial, FactSet, Credit Suisse estimates

Figure 40: Quarterly EPS and Revenue Estimates ($)

	Operating EPS	Sales/share
2015	**118.20**	**1,127.13**
1Q	26.96	274.03
2Q	29.61	284.59
3Q	31.21	290.85
4Q	31.30	301.12
2016	**119.08**	**1,150.59**
1Q	30.90	292.78
2Q	32.52	300.98
3QE	33.25	307.00
4QE	33.33	308.23
2017E	**130.00**	**1,209.00**
1QE	33.00	307.00
2QE	34.50	315.00
3QE	35.50	326.00
4QE	36.00	332.00
2018E	**139.00**	**1,280.00**
2019E	**147.00**	**1,363.00**

Source: Standard & Poor's, Computstat, Thomson Financial, FactSet, Credit Suisse estimates

Companies Mentioned *(Price as of 09-Oct-2017)*
AT&T (T.N, $38.59)
Alphabet (GOOGL.OQ, $993.64)
Amazon com Inc. (AMZN.OQ, $989.58)
Apple Inc (AAPL.OQ, $155.3)
Facebook Inc. (FB.OQ, $172.23)
Verizon Communications Inc (VZ.N, $48.81)

Disclosure Appendix

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Neutral (N) : The stock's total return is expected to be in line with the relevant benchmark* over the next 12 months.
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**Relevant benchmark by region: As of 10th December 2012, Japanese ratings are based on a stock's total return relative to the analyst's coverage universe which consists of all companies covered by the analyst within the relevant sector, with Outperforms representing the most attractive, Neutrals the less attractive, and Underperforms the least attractive investment opportunities. As of 2nd October 2012, U.S. and Canadian as well as European ratings are based on a stock's total return relative to the analyst's coverage universe which consists of all companies covered by the analyst within the relevant sector, with Outperforms representing the most attractive, Neutrals the less attractive, and Underperforms the least attractive investment opportunities. For Latin American and non-Japan Asia stocks, ratings are based on a stock's total return relative to the average total return of the relevant country or regional benchmark; prior to 2nd October 2012 U.S. and Canadian ratings were based on (1) a stock's absolute total return potential to its current share price and (2) the relative attractiveness of a stock's total return potential within an analyst's coverage universe. For Australian and New Zealand stocks, the expected total return (ETR) calculation includes 12-month rolling dividend yield. An Outperform rating is assigned where an ETR is greater than or equal to 7.5%; Underperform where an ETR less than or equal to 5%. A Neutral may be assigned where the ETR is between -5% and 15%. The overlapping rating range allows analysts to assign a rating that puts ETR in the context of associated risks. Prior to 18 May 2015, ETR ranges for Outperform and Underperform ratings did not overlap with Neutral thresholds between 15% and 7.5%, which was in operation from 7 July 2011.*

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Underperform/Sell*	13%	(54% banking clients)
Restricted	2%	

**For purposes of the NYSE and FINRA ratings distribution disclosure requirements, our stock ratings of Outperform, Neutral, and Underperform most closely correspond to Buy, Hold, and Sell, respectively; however, the meanings are not the same, as our stock ratings are determined on a relative basis. (Please refer to definitions above.) An investor's decision to buy or sell a security should be based on investment objectives, current holdings, and other individual factors.*

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