

US Equity Strategy

The 5-Minute Strategy Workout
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MORGAN STANLEY RESEARCH

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Menu – The 5-Minute Strategy Workout

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Market Color – What’s On Our Minds?

- 1. Style and Sector.** Over the last few weeks several clients have asked us about tilting away from growth, given its strong run. We did some cluster analysis earlier this month and showed there appear to be several “clusters” or types of growth, and several types of value. The type of growth that has worked recently is unlikely to result in a short-term reversal into value. We investigate this in detail in our note [US Quant Research: This Is Not 2000 \(10 Aug 2015\)](#).
- 2. We don’t have amplitude, all we have is periodicity.** More and more it seems like the key to risk taking, and the key to our US stock market outlook, is that investors start to focus on and increasingly believe in the Morgan Stanley thesis that this will be a very long US expansion. If the US economy is in a low growth channel, and yes, the consensus and Fed outlook seem to be in their seasonal, yet annual, downward adjustment to this channel, then it seems all the bulls have left to hang their hats on is a growing belief that this will be a very long expansion. We need periodicity if we can’t have amplitude.
- 3. 2020.** Our laundry list of items to monitor the length of the cycle includes economic factors, corporate behaviors, and credit cycle metrics. If we “mark to market” where we are on this list of signposts today vs. a year ago, it is mixed, but not really that negative, despite current emotion.
 - **The economy** still seems to have a low probability of a recession here in the US for the foreseeable future. US housing, US jobs, consumer obligations, signs of consumer stress in the form of delinquencies on mortgages and credit cards all seem like they are improving, and non-recessionary.
 - **Corporate behaviors** don’t look incrementally hubristic to us vs. a year ago. Capital spending remains constrained relative to sales ex-energy, inventory is down, hiring is under control, and there is limited evidence of wage pressure. M&A may be a bit more frothy, but in the end it is difficult for us to conclude that management teams are putting a lot of costs in place and increasing the probability of a huge earnings correction if there’s a more material revenue slowdown.
 - **Credit metrics** to us look mixed, maybe a bit worse than a year ago, but not more than that. Interest coverage for value stocks has remained steady. Growth stocks have taken on more debt, but in many cases this has been borrowing against non-domiciled cash to buy back stock. Ex-energy, the metrics really haven’t deteriorated much at all. Ultimately, we net it out and conclude the expansion is likely to continue to last a long time.

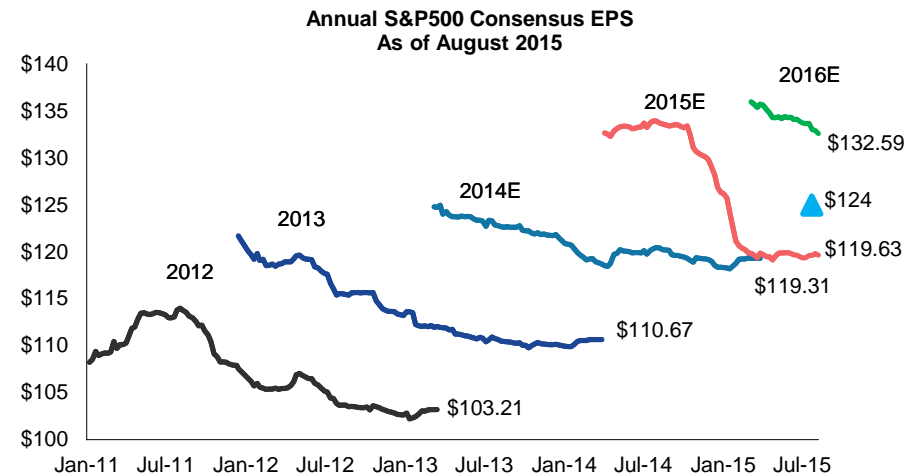
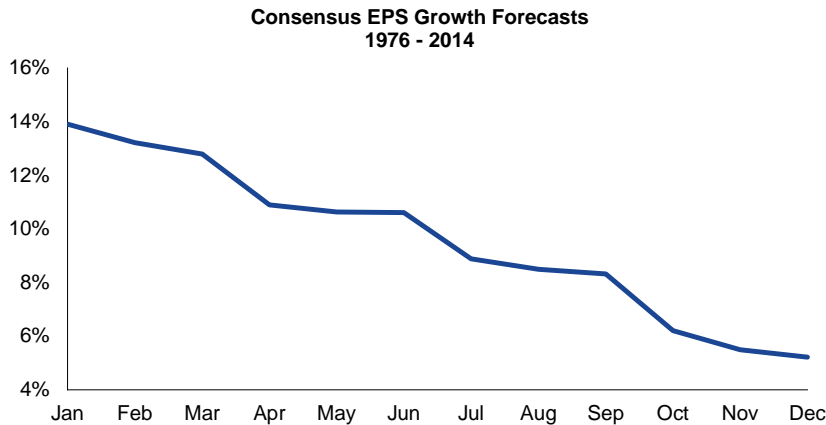
Our 12-Month Forward Price Target Is 2275

Morgan Stanley 12-Month S&P 500 Price Target Methodology

EPS Landscape	Probability of Scenario	2015E	2016E	Multiple	Scenario Target	Upside / (Downside)
Bull Case	20%	132.1	141.3	18.1x	2600	25.0%
<i>Growth</i>		11%	7%			
Base Case	60%	124.0	131.0	17.2x	2275	9.4%
<i>Growth</i>		4%	6%			
Bear Case	20%	111.9	106.3	16.0x	1700	(18.3%)
<i>Growth</i>		(6%)	(5%)			
Current S&P 500 Price					2080	

We forecast 4% operating earnings growth and a 2.4% net buyback. With a 1.9% dividend yield we see mid-single digit US equity market returns as a reasonable base case.

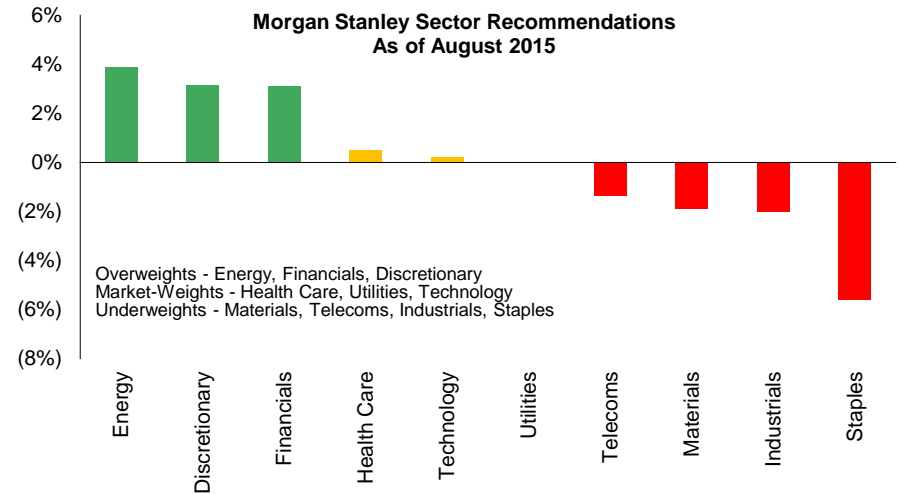
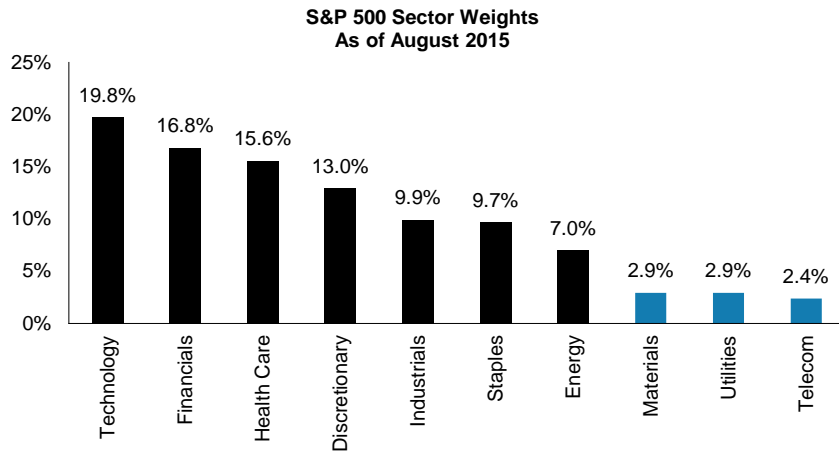
2015 Bottom-up Estimates Have Fallen Sharply and We Think Are Too Low



Historically, bottom-up numbers start the year too high, averaging 14% growth in January of a given year, only to finish at 6%. In 33 of 39 years, bottom-up earnings estimates proved to be too high, and all six years they were too low were recession recoveries or the year after. We think the 40th year of data – 2015 – could be the first “mid-cycle” year where numbers are too low.

Source: Thomson Reuters, Morgan Stanley Research

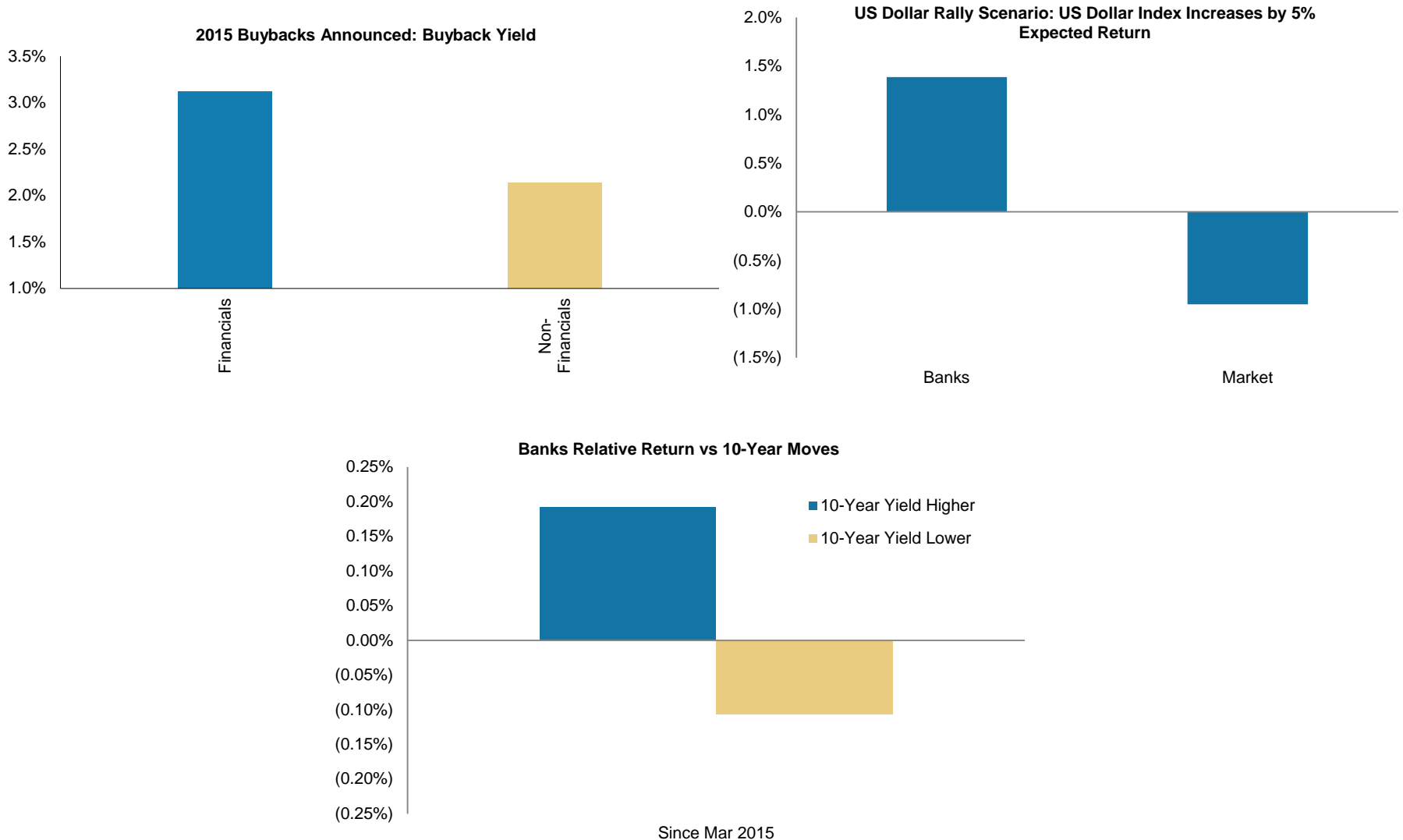
We Are Overweight Energy, Financials, and Consumer Discretionary



The S&P 500 is half technology, financials, and health care, and Apple is bigger than materials, utilities, and telecom. We like energy over industrials, discretionary over staples, and financials. We would avoid overcrowded defensives like staples and telecoms.

Three Reason We Like Financials:

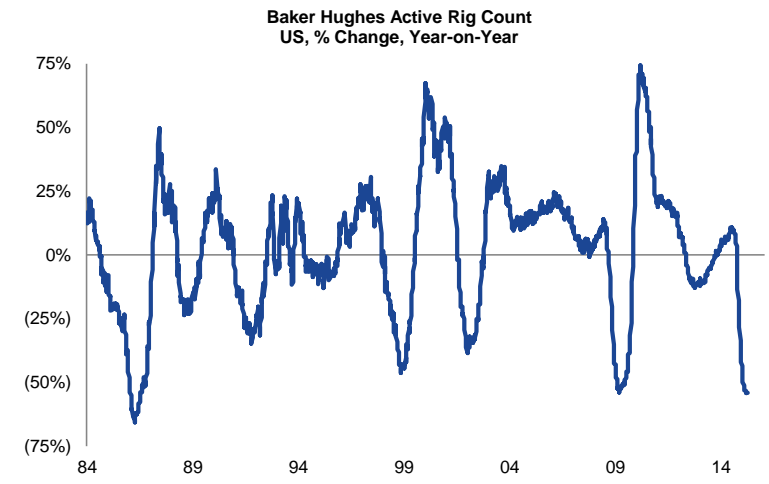
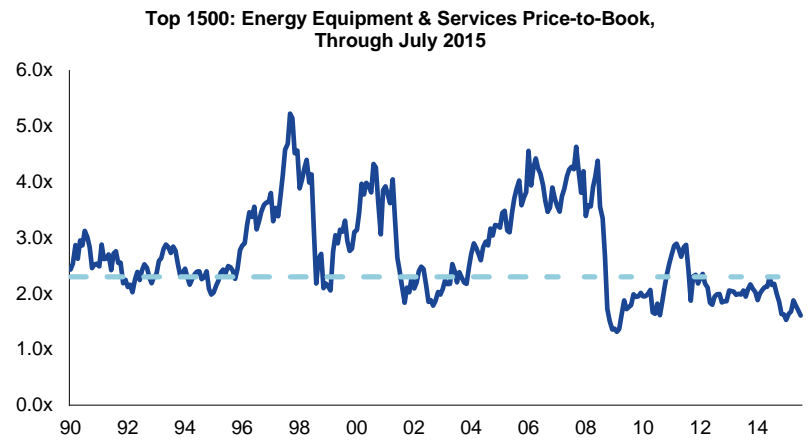
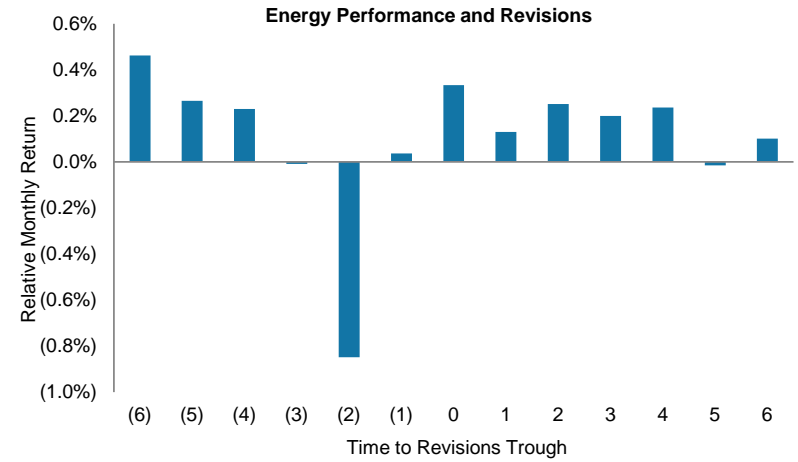
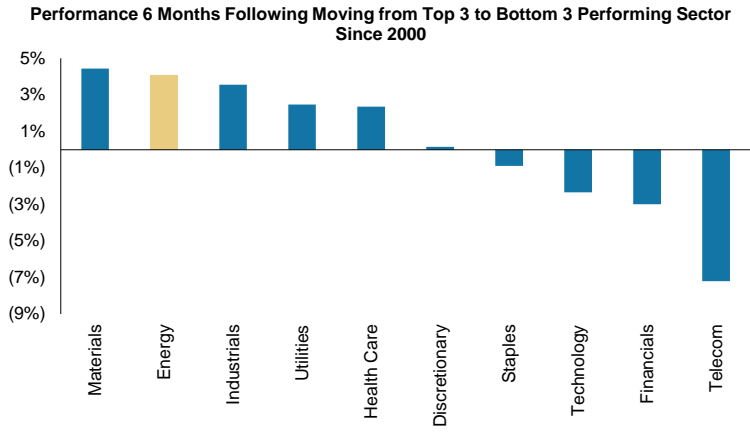
Financials Should See the Most Growth in Shareholder Return, Outperform When USD Appreciates, and Go Down Less When 10-Year Falls Than They Rise When it Increases



Source: Capital IQ, Thomson Reuters, Morgan Stanley Research

Four Reasons We Like Energy:

Energy Usually Reverses After Extreme Downward Movements and Troughs Two Months Before Revisions; Valuation is Compelling, and Capital Spending Is Falling, Fueling the Dream that Oil Could Be Higher by 2017

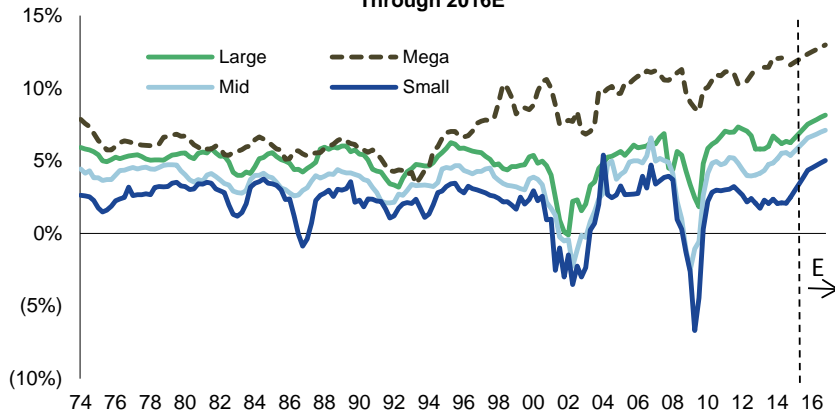


Source: Capital IQ, Thomson Reuters, Morgan Stanley Research

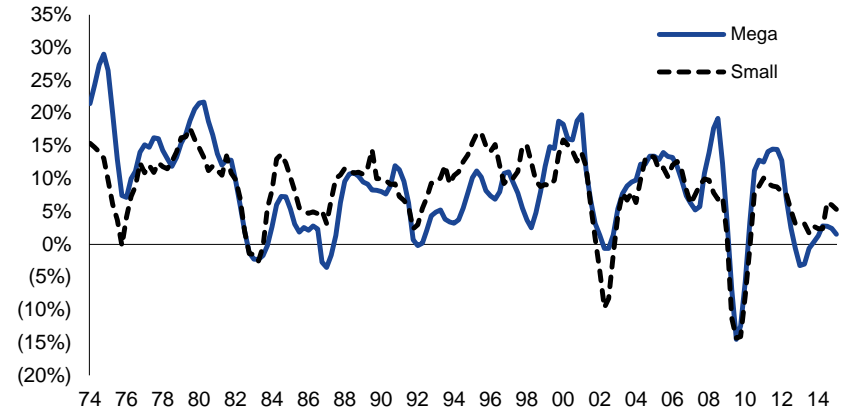
Four Reasons We Like Small-Caps:

Margin Expansion Potential, Fast Sales Growth, A Pickup in M&A Would Be Beneficial, and Valuations Are Not Stretched

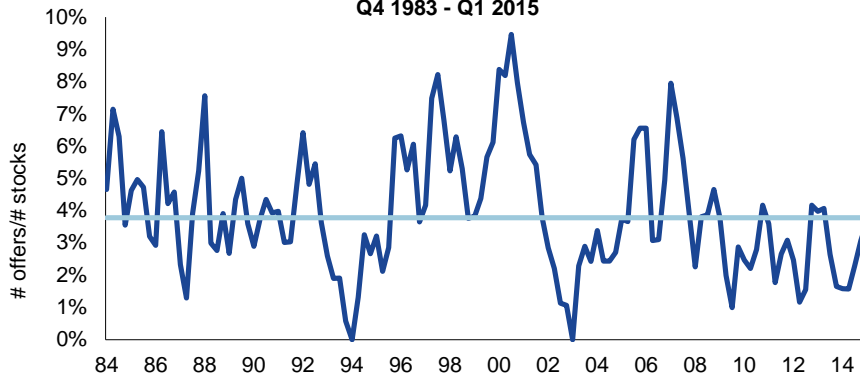
Top 1500: Net Margins by Market Capitalization, Through 2016E



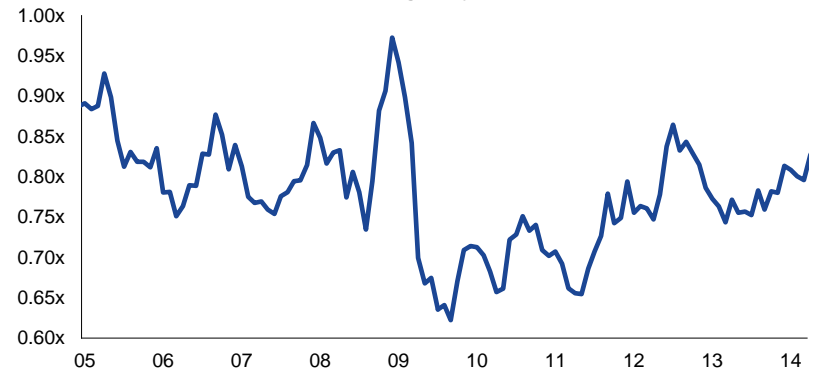
Top 1500 Sales Growth: Mega vs. Small Caps 1974 Through Q1 2015



Small Cap Offer Intensity Q4 1983 - Q1 2015

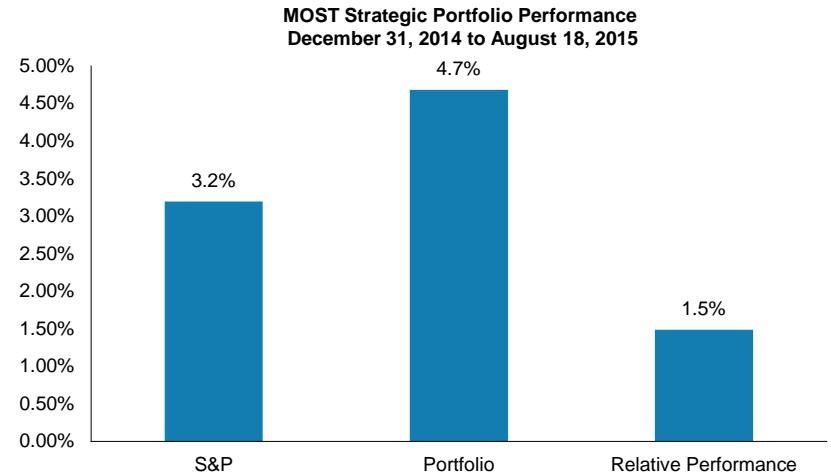
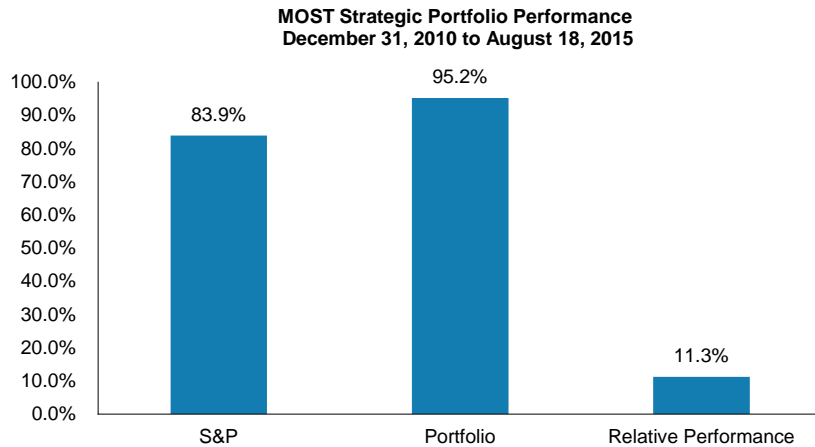


Mega- vs. Small-Cap Relative Valuation: Price-to-Forward Earnings Through July 2015



Source: Capital IQ, Thomson Reuters, Morgan Stanley Research

Portfolio Performance Since Inception and YTD:



We have shown a combination of Overweight-rated stocks and stocks preferred by our alpha models, MOST and BEST, generate superior returns.

Source: Capital IQ, Thomson Reuters, Morgan Stanley Research. Past performance is no guarantee of future results. Results shown represent total absolute return (including dividends) and exclude brokerage commissions. These figures are not audited

The MOST Strategic Portfolio

	Ticker	Company	Weight		Price		Inclusion Date	MOST Quintile	MS Analyst Rating
			S&P 500	Portfolio	Latest	Inclusion			
Consumer Discretionary			12.8%	16.0%					
Auto Components	DAN	Dana Holding Corporation		1.0%	18.30	20.37	1/20/2015	Q2	Overweight
Media	CBS	CBS Corporation		1.0%	48.52	19.05	12/31/2010	Q1	Overweight
Auto Components	DLPH	Delphi Automotive PLC		3.0%	77.00	69.06	5/30/2014	Q1	Overweight
Hotels, Restaurants and Leisure	HOT	Starwood Hotels & Resorts Worldwide Inc.		2.0%	76.96	79.00	11/28/2014	Q1	Overweight
Textiles, Apparel and Luxury Goods	NKE	NIKE, Inc.		2.0%	114.96	77.06	8/8/2014	Q2	Overweight
Automobiles	HOG	Harley-Davidson, Inc.		2.0%	59.84	56.49	10/13/2014	Q3	Overweight
Media	FOXA	Twenty-First Century Fox, Inc.		3.0%	29.96	30.36	3/15/2013	Q1	Overweight
Specialty Retail	LB	L Brands, Inc.		2.0%	81.18	50.49	4/26/2013	Q2	Overweight
Consumer Staples			9.6%	4.0%					
Food Products	WWAV	The WhiteWave Foods Company		2.0%	46.52	21.27	11/29/2013	Q1	Overweight
Tobacco	PM	Philip Morris International, Inc.		2.0%	83.74	85.53	7/31/2015	Q1	Overweight
Energy			7.1%	11.0%					
Oil, Gas and Consumable Fuels	APC	Anadarko Petroleum Corporation		1.0%	72.38	96.48	4/11/2014	Q5	Overweight
Energy Equipment and Services	SLB	Schlumberger Limited		2.0%	80.67	108.38	8/8/2014	Q1	Overweight
Oil, Gas and Consumable Fuels	PSX	Phillips 66		2.0%	80.80	63.62	1/20/2015	Q3	Overweight
Energy Equipment and Services	ATW	Atwood Oceanics, Inc.		1.0%	17.81	20.80	7/31/2015	Q1	Overweight
Energy Equipment and Services	CAM	Cameron International Corporation		1.0%	47.41	50.46	7/31/2015	Q1	Overweight
Oil, Gas and Consumable Fuels	OXY	Occidental Petroleum Corporation		1.0%	72.16	79.77	11/28/2014	Q4	Overweight
Oil, Gas and Consumable Fuels	VLO	Valero Energy Corporation		3.0%	67.87	55.93	5/9/2014	Q1	Overweight
Financials			16.9%	20.0%					
Capital Markets	KKR	KKR & Co. L.P.		2.0%	21.50	23.98	2/21/2014	NA	Overweight
Banks	FITB	Fifth Third Bancorp		3.0%	20.99	21.63	7/3/2014	Q5	Overweight
Banks	ZION	Zions Bancorporation		1.0%	30.09	27.33	4/10/2015	Q4	Overweight
Banks	BAC	Bank of America Corporation		3.0%	17.46	15.82	11/29/2013	Q1	Overweight
Real Estate Investment Trusts (REITs)	CCI	Crown Castle International Corp.		3.0%	85.43	67.55	11/23/2012	Q3	Overweight
Consumer Finance	AXP	American Express Company		1.0%	80.95	92.42	11/28/2014	Q1	Overweight
Banks	HBAN	Huntington Bancshares Incorporated		2.0%	11.64	10.70	2/17/2015	Q1	Overweight
Banks	CIT	CIT Group Inc.		2.0%	45.91	47.20	4/10/2015	Q2	Overweight
Banks	JPM	JPMorgan Chase & Co.		3.0%	67.60	42.42	12/31/2010	Q1	Overweight
Health Care			15.5%	16.0%					
Healthcare Providers and Services	MCK	McKesson Corporation		4.0%	215.51	77.74	2/4/2011	Q1	Overweight
Pharmaceuticals	LLY	Eli Lilly and Company		4.0%	83.77	73.92	4/10/2015	Q2	Equal-Weight
Biotechnology	BIIB	Biogen Inc.		2.0%	315.82	330.48	9/5/2014	Q1	Overweight
Healthcare Providers and Services	AET	Aetna Inc.		3.0%	122.18	91.98	1/20/2015	Q2	Overweight
Healthcare Equipment and Supplies	ZBH	Zimmer Biomet Holdings, Inc.		1.0%	106.14	104.07	7/31/2015	Q1	Overweight
Health Care Technology	ATHN	athenahealth, Inc.		1.0%	138.96	139.96	7/31/2015	Q1	Overweight
Pharmaceuticals	PFE	Pfizer Inc.		1.0%	35.27	18.15	9/16/2011	Q4	Equal-Weight

The MOST Strategic Portfolio (cont'd)

	Ticker	Company	Weight		Price		Inclusion Date	MOST Quintile	MS Analyst Rating
			S&P 500	Portfolio	Latest	Inclusion			
Industrials			10.0%	8.0%					
Aerospace and Defense	HON	Honeywell International Inc.		2.0%	105.04	61.72	9/17/2012	Q4	Overweight
Road and Rail	UNP	Union Pacific Corporation		1.0%	92.16	65.45	1/4/2013	Q4	Overweight
Aerospace and Defense	BA	The Boeing Company		1.0%	142.72	128.51	7/3/2014	Q2	NC
Airlines	DAL	Delta Air Lines, Inc.		1.0%	47.08	31.76	2/21/2014	Q2	Overweight
Aerospace and Defense	UTX	United Technologies Corporation		3.0%	98.21	78.85	12/30/2010	Q1	Overweight
Information Technology			19.8%	20.0%					
Internet Software and Services	GOOGL	Google Inc.		3.0%	694.04	529.80	11/29/2013	Q5	Overweight
Communications Equipment	CSCO	Cisco Systems, Inc.		3.0%	27.80	28.07	1/20/2015	Q2	Overweight
Technology Hardware, Storage and Peripherals	AAPL	Apple Inc.		3.0%	115.01	60.34	1/6/2012	Q1	Overweight
Internet Software and Services	LNKD	LinkedIn Corporation		1.0%	188.71	192.62	2/21/2014	Q5	Overweight
Technology Hardware, Storage and Peripherals	HPQ	Hewlett-Packard Company		3.0%	27.74	28.34	1/3/2014	Q2	Overweight
Communications Equipment	PANW	Palo Alto Networks, Inc.		1.0%	174.12	142.22	2/27/2015	Q4	Overweight
IT Services	XRX	Xerox Corporation		1.0%	11.24	12.39	10/13/2014	Q2	Overweight
IT Services	VNTV	Vantiv, Inc.		2.0%	44.88	31.95	8/8/2014	Q5	Overweight
IT Services	MA	MasterCard Incorporated		3.0%	96.60	34.60	1/17/2012	Q1	Overweight
Materials			2.9%	1.0%					
Chemicals	LYB	LyondellBasell Industries N.V.		1.0%	84.93	34.50	10/28/2011	Q1	Overweight
Telecommunication Services			2.4%	1.0%					
Diversified Telecommunication Services	VZ	Verizon Communications Inc.		1.0%	47.44	46.79	7/31/2015	Q1	Overweight
Utilities			3.0%	3.0%					
Electric Utilities	NEE	NextEra Energy, Inc.		3.0%	109.07	104.90	4/10/2015	Q4	Overweight
			100%	100%					

Source: Capital IQ, Thomson Reuters, Morgan Stanley Research. Past performance is no guarantee of future results. Price performance does not take transaction costs into account. For companies in the portfolio, all important disclosures including personal holdings disclosures and Morgan Stanley disclosures appear on the Morgan Stanley public website at www.morganstanley.com/researchdisclosures. ++Rating for this company has been removed from consideration in this report because, under applicable law and/or Morgan Stanley policy, Morgan Stanley may be precluded from issuing such information with respect to this company at this time. NA = Not available NC = Not covered

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(as of July 31, 2015)

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	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	1198	36%	321	44%	27%
Equal-weight/Hold	1449	43%	325	44%	22%
Not-Rated/Hold	93	3%	10	1%	11%
Underweight/Sell	623	19%	78	11%	13%
Total	3,363		734		

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months.

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