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U.S. Equity Strategy Weekly

Commodity Prices Breaking Down: Underweight Energy

We are moving S&P 500 Energy to Underweight from Market Weight. The rationale for this and associated strategy decisions:

- 1) **Global growth is weakening.** Europe's problems are not improving and Chinese data has recently taken a turn for the worse. Contrary to conventional wisdom, however, Chinese monetary easing is associated with falling commodity prices and the latter usually stabilizes only nearer to the end of the PBoC's easing campaign. Our Emerging Markets team thinks China could have 200–300 bps of RR cuts to push through this year.
- 2) **The dollar is a gathering headwind.** Dollar strength is needed by weaker nations to help bail them out of their growth funk. This will only work with a long lag. In the interim, it is likely to provide a drag on dollar-based commodity prices such as crude oil.
- 3) **From a micro perspective, both sides of the price equation are weighing on crude oil.** Demand destruction via rationing, conservation, and efficiency is in widespread evidence throughout the developed world (e.g., driving fewer miles, use of more energy-efficient modes of production/transportation), while high oil prices are incentivizing an impressive volume of new production.
- 4) **Speculators remain uncomfortably long crude oil.** They are long ~184k contracts versus a more normal 57k. Panic liquidation that takes oil down to last fall's \$77 cannot be ruled out on further global macro disappointment.

While forward earnings estimates for Energy are already coming down, the factors cited above could further weigh on oil prices and the sector's earnings outlook for a good portion of the remainder of this year. We continue to favor lower beta and more diversified groups and, in particular, still like Integrates.

Meanwhile, we'd use the proceeds from the sale of Energy shares to add to groups whose performance is most inversely correlated with crude oil. These areas include Health Care (e.g., Pharma & Biotech), Consumer Staples (e.g., Food & Staples Retailing), and Consumer Discretionary (e.g., Hotels, Restaurants & Leisure, Retailing).

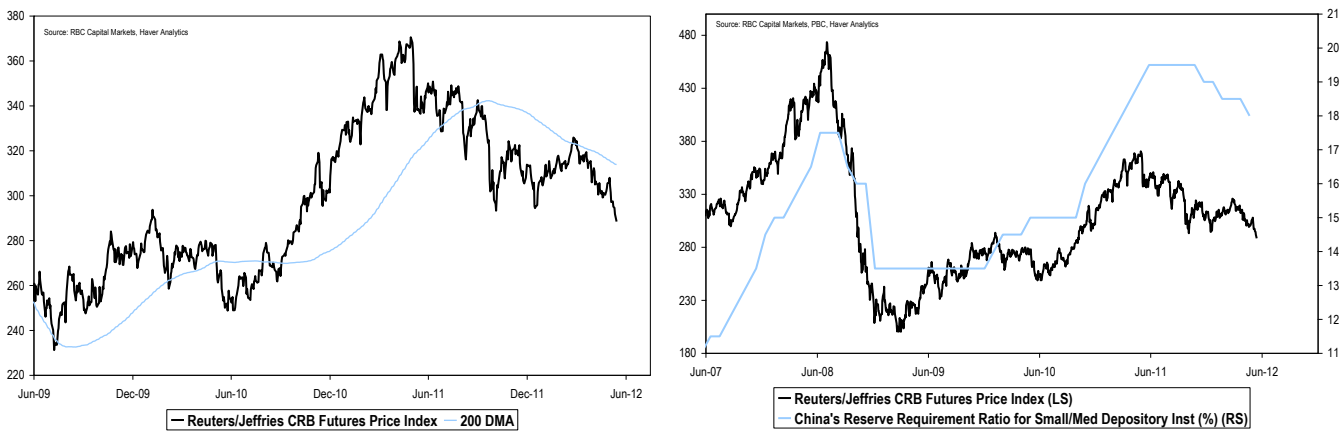
Finally, and on a related note, we think the equity market is setting up for a bounce. Some of the faster-turning investor sentiment data is already looking pretty bearish. Meanwhile, lower Energy costs—via margin support and a boost to real disposable income—could help to harden the floor under the market.

Macro Challenges for Resources

We remain underweight Materials. Commodity price benchmarks are in confirmed downtrends and are beginning to undercut their fourth-quarter, 2011 low. Agricultural (e.g., milk, coffee), textile (e.g., cotton), and metals (e.g., aluminum, nickel) commodities have lost a lot of steam (Exhibit 1, LHS), with the selling now infecting the oil market. As a result, we are also moving our Energy sector recommendation from Market Weight to Underweight.

Concerning European and Asian data is an important part of the commodity price story. China’s recent efforts to ease should help lift the outlook, but this might only occur after a relatively long lag. Commodities are usually pressured from the point when the PBoC first starts easing until much closer to the time it moves to the sidelines (Exhibit 1, RHS). Most analysts, including our Emerging Markets colleagues, believe that the Chinese monetary authorities are only in the early innings of an easing campaign.

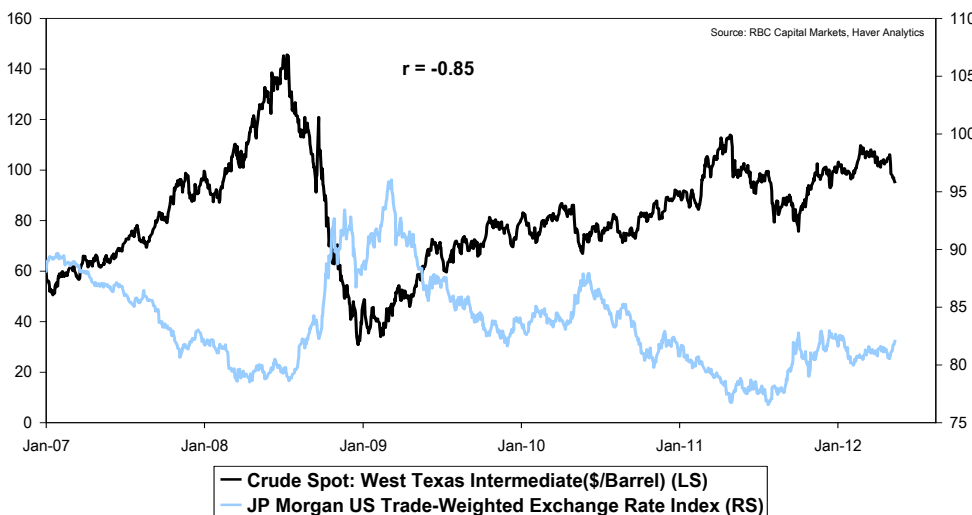
Exhibit 1: Commodities in a Downtrend; Lagged Impact from Lower Reserve Requirements



When it comes to Energy specifics, we see the following issues:

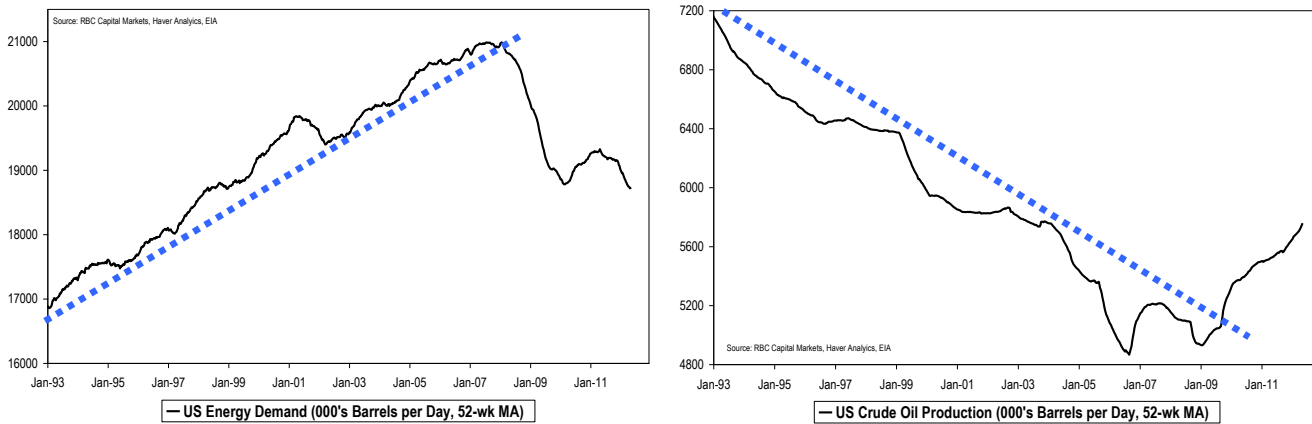
- 1) The dollar is a gathering headwind. Dollar strength is needed by weaker nations to help bail them out of their growth funk. This will only work with a long lag. In the interim, it is likely to provide a drag on dollar-denominated commodity prices such as crude oil (Exhibit 2, LHS).

Exhibit 2: Strong Dollar Will Act as a Headwind to Commodity Prices



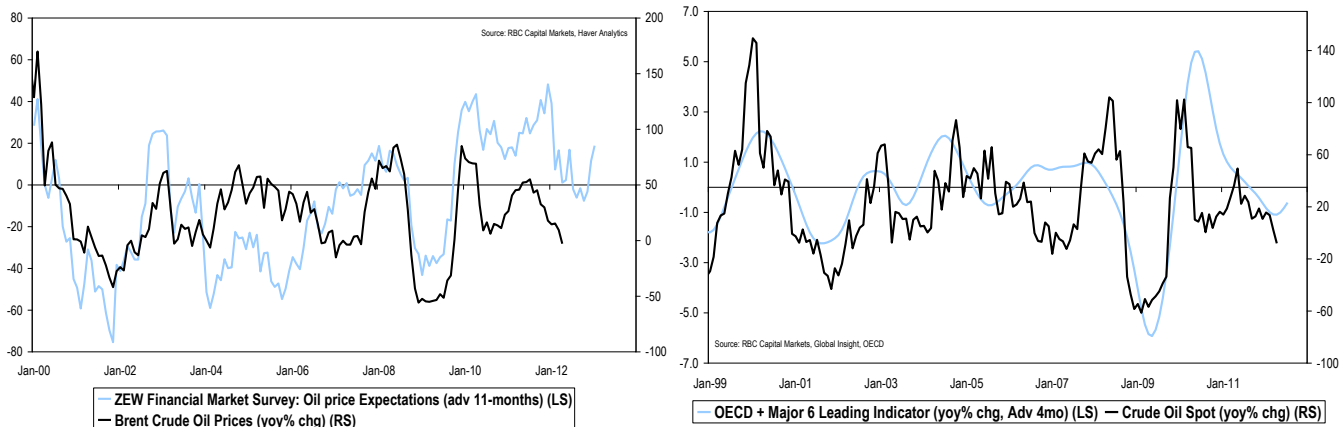
- 2) From a micro perspective, both sides of the price equation are weighing on crude oil. Demand destruction via rationing, conservation, and efficiency is in widespread evidence throughout the developed world (e.g., driving fewer miles, use of more energy-efficient modes of production/travel), while high oil prices are incentivizing an impressive volume of new production (Exhibit 3). While some might blame the deterioration in European demand as cyclical, the same can be seen in the U.S. over the past three years of economic recovery. In other words, we believe important changes in behavior are taking place in the developed world, which is no longer as supportive as it once was for oil prices.

Exhibit 3: Long-Term Supply/Demand Behavior Has Shifted



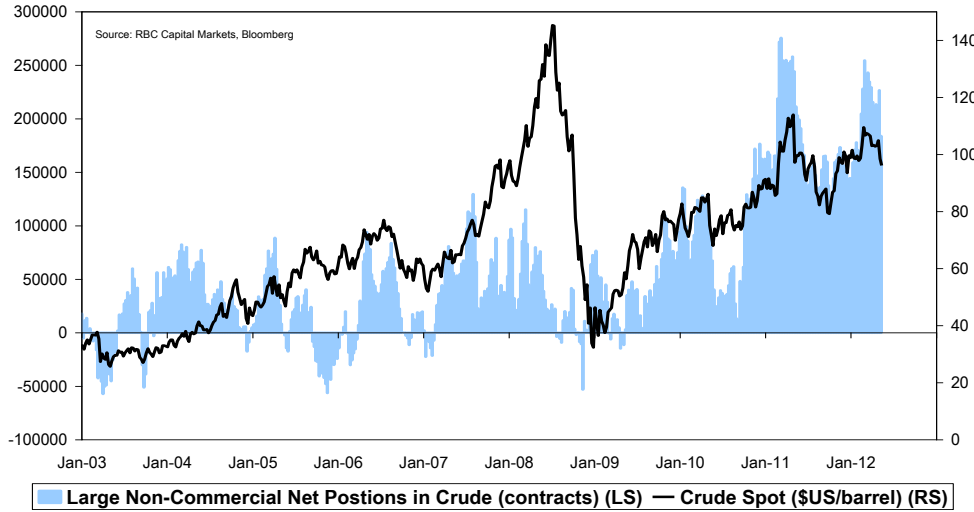
- 3) Leading price indicators are cautionary. The Chinese stock market, the ZEW survey of oil price expectations (Exhibit 4, LHS), and the OECD’s global leading index (Exhibit 4, RHS) argue that crude price weakness could persist into the fourth quarter.

Exhibit 4: Leading Indicators Point to Weak Oil Prices into Q4



- 4) Speculators remain uncomfortably long WTI crude oil. They are long ~184k contracts versus a more normal 57k (Exhibit 5). Perhaps this is an attempt to capture a spread between WTI and Brent or to protect against a flare-up in the Middle East. Nevertheless, panic liquidation that moves oil down to last fall’s \$77–87/bbl range cannot be ruled out on further macro disappointment.

Exhibit 5: Speculators Extremely Long WTI Crude

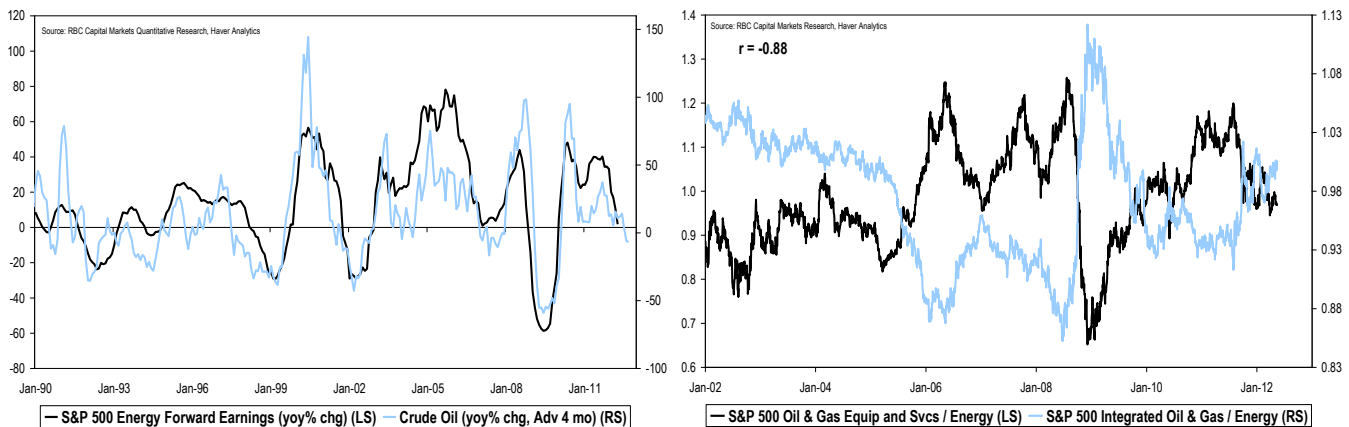


Reduce Energy Sector Exposure from Market Weight to Underweight

Bottom-up analysts expect S&P 500 energy earnings to contract by 1.8% this year and expand by 10.9% in 2013. While these forward earnings estimates are already coming down, the factors cited above could further weigh on oil prices and the sector’s earnings outlook for a good portion of the remainder of this year (Exhibit 6, LHS).

The traditional playbook has been to favor lower beta, more diversified, Energy groups during soft energy price markets. We are sticking with this thesis by continuing to recommend Integrateds over Energy Equipment & Services (Exhibit 6, RHS). The only difference now is that we are doing so from an Underweight, rather than a Market Weight, Energy sector position.

Exhibit 6: Soft Crude Prices to Weigh on Earnings Estimates; Favor Integrateds over Equipment & Svcs



Most groups, obviously with the exception of those in the Energy sector, demonstrate inverse correlation with the price of oil. However, we’d use the proceeds from the sale of Energy shares to add to groups whose performance is most inversely correlated with crude oil (Exhibit 7), which include Health Care (e.g., Pharma & Biotech), Consumer Staples (e.g., Food & Staples Retailing), and Consumer Discretionary (e.g., Hotels, Restaurants & Leisure, Retailing). Lower oil prices provide lift for these stocks through margin relief (e.g.,

transportations costs, packaging costs), an indirect boost to real discretionary incomes, or increased demand for a macro hedge.

Exhibit 7: Industries Likely to Outperform from Oil Weakness

US Sector	US Group	Correlation with Crude Oil Spot (yoy % chg)
Consumer Staples	Food & Staples Retailing	-0.41
Consumer Discretionary	Consumer Discretionary	-0.40
Health Care	Pharmaceuticals & Biotechnology	-0.36
Consumer Discretionary	Retailing	-0.35
Consumer Discretionary	Hotels, Restaurants & Leisure	-0.33

Note: Correlations were calculated between the relative y-o-y% chg of the sectors & groups and the y-o-y% chg in crude oil spot from Jan-81 to Present.

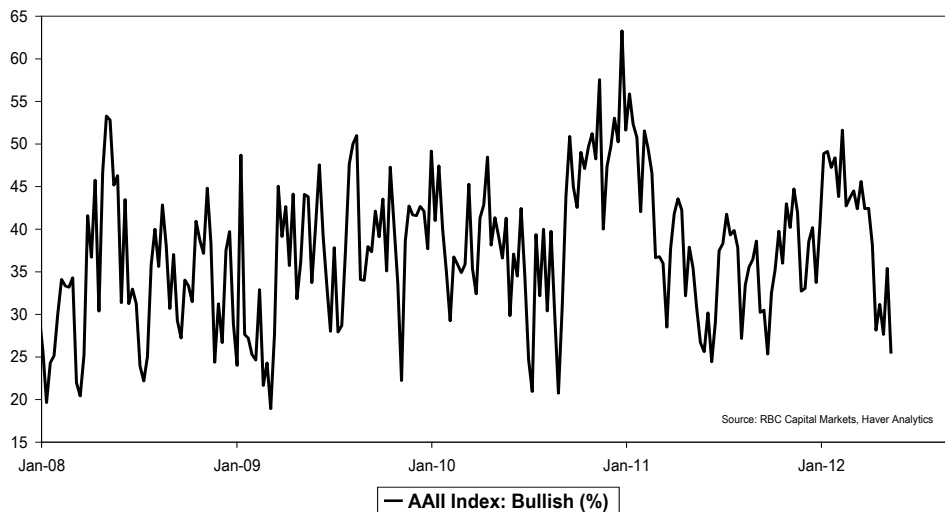
Source: RBC Capital Markets, Global Insight

The Equity Market: Setting Up for a Bounce?

The S&P 500 is down by ~5% from its early-April peak. Europe is a huge concern given that Italian spreads are surging, Spanish yields are again above 6%, and the current fiscal roadmap is being challenged by recent election results spanning from Greece to Germany.

An increasing number of short-term (a.k.a., faster-turning) sentiment indicators show that investors are quite stressed or pessimistic. One indicator, in particular, is the AAI bull-bear ratio, which has declined to 0.60 due to both a sharp drop in the percentage of bulls (Exhibit 8) and a surge in the percentage of bears.

Exhibit 8: Investor Optimism at Depressed Levels



We took a closer look at the AAI bull-bear ratio going back to its 1980s inception and can make a couple of simple observations: (1) in the 1–3 months leading up to similar bull-bear readings, we saw a similar sized market correction; (2) in the 1–3 months after the bull-bear ratio was at or below its current level, the market was usually up and by ~2–3% (Exhibit 9).

Exhibit 9: Current Bull/Bear Ratio and S&P 500 Performance

S&P 500 Performance and Bull/Bear Ratio: Before and After First Incident of Current Level				
		4-wk chg	8-wk chg	12-wk chg
Before				
	Avg	-3.4%	-4.3%	-4.3%
	Median	-3.0%	-3.0%	-2.6%
After				
	Avg	1.3%	1.7%	2.4%
	Median	1.9%	1.7%	2.7%

Latest datapoint = .604 as of May 9, 2012.

Source: RBC Capital Markets

The 5% correction has done quite a bit of short-term psychological damage and equities seem poised for a bounce. However, help from macro data or policymakers will be needed for a bounce to last. The Empire State index released yesterday rose from the prior month by 11 points. Keep on the lookout for May data from the Philly Fed on Thursday.

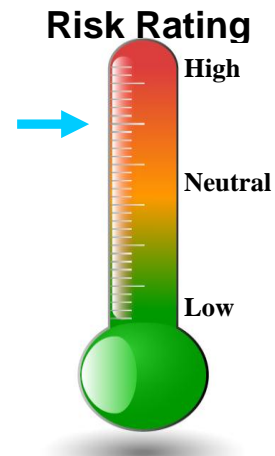
Bottom line: The equity market is setting up for a bounce. Some of the faster-turning sentiment data is already looking pretty stretched. Meanwhile, lower Energy costs—via margin support and a boost to real disposable income—could help to harden the floor under this market.

RBC CM U.S. Equity Market Views

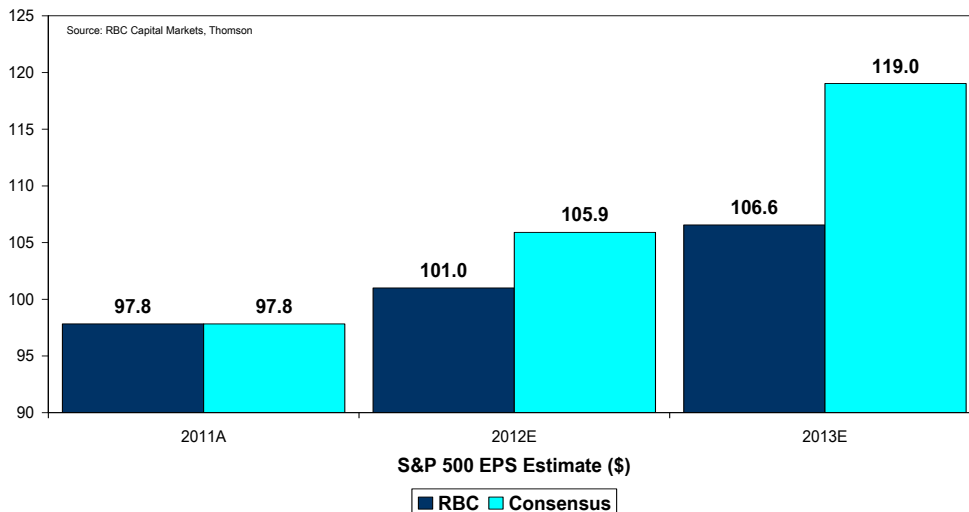
Market Outlook (Next 6 - 9 months)

Overweight	
Market Weight +	X
Market Weight	
Market Weight -	
Underweight	

▲/▼ Directional Bias. Source: RBC Capital Markets



S&P 500 Earnings Outlook



S&P 500 Sector Recommendations Summary

U.S. Equity Sectors	Current Recommendation	Recent Change (May 16, 2012)
Financials	Overweight	None
Industrials	Overweight	None
Information Technology	Overweight	None
Consumer Staples	Market Weight	None
Health Care	Market Weight	None
Energy	Underweight	<i>Downgraded from Market Weight</i>
Utilities	Underweight	None
Telecom Services	Underweight	None
Materials	Underweight	None
Consumer Discretionary	Underweight	None

Source: RBC Capital Markets



Market Update

Benchmark Performance Review (% chg)						
	1wk	1mo	3mo	12mo	QTD	YTD
CAPITALIZATION						
S&P 500	(2.4)	(2.9)	(0.9)	(0.5)	(5.5)	5.8
S&P 400	(1.9)	(1.6)	(2.2)	(4.5)	(4.6)	7.9
S&P 600	(1.5)	(1.5)	(3.1)	(1.8)	(5.2)	5.8
STYLE						
S&P 500 Pure Value	(3.2)	(6.3)	(8.4)	(9.5)	(10.8)	3.8
S&P 500 Pure Growth	(2.0)	(4.0)	(1.9)	(2.2)	(5.7)	7.3
S&P 400 Pure Value	(2.8)	(3.4)	(5.1)	(7.2)	(7.6)	5.4
S&P 400 Pure Growth	(1.2)	(2.0)	(3.1)	(3.3)	(4.3)	9.3
S&P 600 Pure Value	(1.4)	(3.6)	(9.0)	(7.4)	(9.1)	3.4
S&P 600 Pure Growth	(1.1)	(1.3)	(2.2)	(0.0)	(4.2)	5.7
S&P 500 SECTOR BENCHMARKS						
Energy	(4.0)	(4.9)	(10.5)	(10.8)	(9.1)	(6.1)
Materials	(4.4)	(6.1)	(7.6)	(10.8)	(8.4)	1.3
Industrials	(3.1)	(3.5)	(4.5)	(7.1)	(6.5)	3.5
Info Tech	(2.3)	(5.9)	(0.2)	8.1	(7.7)	11.8
Consumer Disc	(1.9)	(2.3)	2.7	7.4	(3.5)	11.5
Financials	(4.4)	(4.7)	(0.4)	(8.6)	(8.9)	10.6
Consumer Staples	(0.6)	0.6	3.5	5.5	(0.8)	3.9
Health Care	(1.3)	0.1	1.6	1.7	(2.7)	5.5
Utilities	0.1	3.5	2.9	5.2	1.3	(1.4)
Telecom	0.6	7.2	8.1	1.4	4.7	5.4

As of May 15, 2012. Source: RBC Capital Markets, Bloomberg

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