The equity sectors set to thrive in the new reflationary regime.

**UNCOVERING GROWTH**

Look for opportunities to pivot to underappreciated and under-priced market growth areas.

**THINK BEYOND YIELD**

Poised to benefit from stronger-than-average earnings prospects and attractive valuations.

**WATCH GROWTH STOCKS**

Innovation will favor secular, non-GDP dependent growth in sectors such as Health Care and IT.

**SECTOR-SPECIFIC FOCUS**
From Yield to Growth

Even before Trump's election, we saw that equities still had room to run in this extended economic cycle, but that a re-rating of certain parts of the market was driving a change in sector leadership.

Strong corporate balance sheets, low core inflation, strengthening labor markets, and manageable consumer leverage all point to further growth for equities this year.

We think, however, that 2017 is the year equity investors will pivot from a strong focus on yield sectors and their stretched valuations to the underappreciated and underpriced growth areas of the market. Moreover, as clarity grows around how much of Trump's growth agenda he can accomplish, certain sectors are likely to benefit more than others in a new, reflationary environment.

Given the basic equation of stock returns (see below), it is not surprising to see a shift from yield to growth. The extended low-growth, low-rate environment drove yield-hungry investors into low volatility, dividend-paying stocks, bidding up sectors such as Utilities and Consumer Staples and driving valuations to all-time highs (see chart right).

That momentum in low-growth bond proxies vexed active managers focused on fundamentals in 2016 — many of whom found the combination of lackluster growth and high valuations in Consumer Staples and Utilities unappealing. Consequently, the majority of active managers underperformed their indices, choosing to weather short-term underperformance with the view that fundamentals matter most in the long term.

A Turning Point?

However, we believe we have reached a turning point in the cycle where investors will be shifting away from high-yielding sectors because it will be difficult to eke out additional P/E multiple expansion going forward, especially in a reflationary environment. We already began to see some capitulation in the second half of 2016, with Utilities, Staples, and Telecom stocks retreating as Financials and more traditional growth sectors outperformed (for example, S&P 500 Technology stocks rallied 12.5% in 3Q 2016).

Instead, we think investors will increasingly focus on areas of the market that exhibit less cyclical, above-average earnings growth. Such steady growth stocks have been out of favor for as long as investors have been barbelled in high-yield bond proxy sectors and hyper-growth stocks (e.g. the so-called FANG stocks: Facebook, Amazon, Netflix, and Google).

From a fundamental perspective, growth stocks look poised to benefit from stronger-than-average earnings prospects, attractive valuations, and the potential for share dividends or buybacks, boosting all three variables in the total return equation. These companies could potentially benefit from less regulation, lower taxes and cash repatriation in the Trump administration. Time will tell.

Valuations of low vol stocks are at all-time highs

<table>
<thead>
<tr>
<th>Price/Earnings Multiples</th>
<th>20x</th>
<th>15x</th>
<th>Average 12.7x</th>
<th>Current 19.5x</th>
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<tbody>
<tr>
<td>1978</td>
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<tr>
<td>2016</td>
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Source: Factset, CRSP, Bernstein analysis

Stock Math: Shifting Focus from Yield to Growth

<table>
<thead>
<tr>
<th>VALUATION CHANGES</th>
<th>EARNINGS GROWTH</th>
<th>CAPITAL RETURN</th>
<th>TOTAL RETURN</th>
</tr>
</thead>
<tbody>
<tr>
<td>P/E Multiple Expansion or Contraction</td>
<td>+</td>
<td>Dividends, Stock Buybacks</td>
<td>=</td>
</tr>
</tbody>
</table>
New Sector Leadership

We believe companies with organic secular growth potential based on strong balance sheets, high free cash flow, innovation-driven business models, and managements focused on shareholder value should regain historical valuation premiums.

While bottom-up investors can find organic growth opportunities throughout the market, the chart below illustrates above-average long-term EPS growth rates for traditional growth sectors like Consumer Discretionary, Information Technology, and Health Care. While consensus estimated growth rates are likely too optimistic, we agree with the order of the sectors.

Going forward, the defensive Utilities, Telecoms, and Real Estate sectors will be challenged with low growth rates. Materials, Energy, and Industrials rallied on the initial news of Trump’s presidential victory, based on his campaign rhetoric around infrastructure spending.

Likewise, Financials benefited from Trump’s pledges to roll back regulation. Financials are undervalued on a price-to-book basis and could enjoy further upside in a reflationaly environment. We will watch these sectors closely throughout 2017.

Where to Look?

Looking at relative valuations, Health Care and Information Technology at the end of 2016 were the cheapest sectors versus history on relative forward P/E (see table opposite).

These sectors have exhibited sustainable growth throughout the tumult of the past decade, and attractive relative valuations create the possibility of P/E multiple expansion. At this point, we view the superior earnings growth and lower valuations of IT and Health Care as a winning combination.

Trump’s plans to reform the Affordable Care Act are still nebulous, but could result in relative winners and losers. Biotech and pharmaceutical companies, on the whole, look less vulnerable to the curbs on drug price increases that Hillary Clinton had championed, although pharmaceuticals tend to be more global and therefore more susceptible to a strong dollar and trade dislocations.

Growth-oriented biotechnology stocks have been trading at comparable multiples to pharmaceutical companies for the first time in history.

Technology shares, while initially under pressure immediately following the election, could also receive a boost from additional capital spending.

After bond proxy re-rating, earnings growth should drive sector returns

Source: Factset, as of 30 September 2016. The sectors shown are as of the date indicated and are subject to change. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future.
Innovation and Consumer Demand Tailwinds

In addition to strong fundamentals, we believe innovation gives a protective moat of secular, non-GDP dependent growth to sectors such as Health Care and Technology. New therapies for cancer or orphan diseases, for example, will command pricing power and strong earnings growth within Health Care.

Safer, smarter, more fuel-efficient ways to drive cars are innovations creating investment opportunities across sectors (for example, Technology, Industrials, Consumer Discretionary).

A further tailwind for growth is steady consumer demand. Strong momentum and a lack of “value” have contributed to the rise of Consumer Staples in the growth indices. Consumer Staples, for example, has posted low-single digit profit growth in the years since the Global Financial Crisis.

Consider the Options

Investors seeking steady, Consumer Staples-like characteristics with above-average earnings growth and strong free cash flow have other options in traditional growth sectors of the market. For example, cable companies within the Consumer Discretionary sector exhibit Utility-like features: many consumers would be loath to turn off their in-home internet connectivity even in an economic downturn.

In a year of shifting political and policy signals, we believe relative valuations and earnings growth potential rather than yield will take on renewed significance for equity investors.

As a result, we think 2017 will be a time to recalculate the opportunities available in out-of-favor areas within growth sectors to improve the total return results of investors’ equity equation of valuation, earnings, and capital return.
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**Belgium**: State Street Global Advisors Belgium, Chaussée de La Hulpe 120, 1000 Brussels, Belgium. T: +32 2 663 2036. F: +32 2 672 2077. SSGA Belgium is a branch office of State Street Global Advisors Limited. State Street Global Advisors Limited is authorized and regulated by the Financial Conduct Authority in the United Kingdom.

**Canada**: State Street Global Advisors, 770 Sherbrooke Street West, Suite 1200 Montreal, Québec, H3A 1G1, T: +1 514 282 2400 and 3 Adelaide Street East Suite 500, Toronto, Ontario M5C 3G5. T: +1 416 775 6090.

**Dubai**: State Street Bank and Trust Company (Representative Office), Boulevard Plaza 1, 17th Floor, Office 1703, Near Dubai Mall & Burj Khalifa, PO Box 26838, Dubai, United Arab Emirates. T: +971 (0)4 4372800. F: +971 (0)4 4372818.

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**Germany**: State Street Global Advisors GmbH, Briener Strasse 59, D-80333 Munich. T: +49 (0)89 55878 100. F: +49 (0)89 55878 440.

**Hong Kong**: State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103 0288. F: +852 2103 0200.

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**Netherlands**: State Street Global Advisors Netherlands, Apollo Building, 7th floor, Herkenbergweg 29, 1101 CN Amsterdam. T: +31 (0)20 718 17 01. State Street Global Advisors Netherlands is a branch office of State Street Global Advisors Limited. State Street Global Advisors Limited is authorized and regulated by the Financial Conduct Authority in the United Kingdom.


**Switzerland**: State Street Global Advisors AG, Beethovenstrasse, 19, Postfach, CH-8027 Zurich. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16.


**United States**: State Street Global Advisors, One Lincoln Street, Boston, MA 02111-2900. T: +1 617 664 7727.

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