Equity Strategy

Global Portfolio Advisory Group

2017 Top 10 U.S. Equities

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10 Ways to Play 3 Themes for the Ongoing Economic Expansion

The U.S. business cycle remains intact as the latest macro-economic data suggests we have exited a multi-year contraction phase without triggering an economic recession. During this new intra-cycle move up, we believe Cyclicals will outperform Defensives as high single digit earnings growth from positive commodity and corporate stock repurchase trends will persist. Our sector outlook has remained consistent for many months and we see continued tailwinds as we head into 2017 as the U.S. election has only amplified pre-existing trends. The Top 10 U.S. list, summarized in Exhibit 1, consists of names we believe have above average upside potential against a reflationary backdrop. We have elected to highlight and tilt toward three broad plays for the coming year:

1. A General Cyclical Rise (hardware technology, energy, chemicals)
2. Rising Interest Rates (insurance, large bank, regional bank)
3. Trump Fiscal Spend (defense, infrastructure)

Summary company descriptions and an investment thesis for each constituent of the list follow later in this report, along with a performance analysis of the 2016 Top 10 list.

Exhibit 1 - 2017 Top 10 U.S. Equities

Company	Sector	Symbol	Price 30-Dec-16	Dividend	Dividend Yield	Consensus Target	Potential Total Return	FactSet Ratings Buy	FactSet Ratings Hold	FactSet Ratings Sell	Market Cap ($bn)
Bank of America Corporation	Financials	BAC-US	$22.10	$0.30	1.4%	$22.57	3%	24	10	0	$224
MetLife, Inc.	Financials	MET-US	$53.89	$1.60	3.0%	$58.43	11%	11	8	0	$59
First Republic Bank	Financials	FRC-US	$92.14	$0.64	0.7%	$91.74	0%	9	13	0	$14
General Dynamics Corporation	Industrials	GD-US	$172.66	$3.04	1.8%	$185.59	9%	15	5	0	$53
Jacobs Engineering Group Inc.	Industrials	JEC-US	$57.00	$0.00	0.0%	$58.81	3%	5	12	2	$7
Quanta Services, Inc.	Industrials	PWR-US	$34.85	$0.00	0.0%	$34.74	0%	15	3	0	$5
Dow Chemical Company	Materials	DOW-US	$57.22	$1.84	3.2%	$62.12	12%	15	5	1	$64
LyondellBasell Industries NV	Materials	LYB-US	$85.78	$3.40	4.0%	$91.79	11%	8	12	1	$35
ConocoPhillips	Energy	COP-US	$50.14	$1.00	2.0%	$55.22	12%	16	10	1	$62
QUALCOMM Incorporated	Information Technology	QCOM-US	$65.20	$2.12	3.3%	$74.32	17%	15	13	0	$96
Average					**1.9%**		**8%**				**$62**

Sources: FactSet, Scotia Wealth Management GPAG.

Company	Investment Thesis
Bank of America (BAC - US) **Company Description:** Top three in terms of assets (alongside JPM and C), BAC maintains an extensive branch network of 4,700 locations, 16,000 ATMs, 33 million active online users and 20 million mobile users. Core services include consumer/small business banking, corporate banking, credit cards, mortgage lending, and asset management ($2T AUM thanks largely to its acquisition of Merrill Lynch.)	**Investment Thesis:** • BAC in our opinion is the most interest rate sensitive (beneficiary of rising rates) and one of the more domestically oriented (protectionist policies could be near-term tailwinds) large cap banks. • Capital return (dividends, buybacks) has room to improve in 2017 as (1) BAC's profitability profile improves (rising interest rates, asset growth, cost reduction, decrease in legacy asset servicing, corporate tax reduction, easing of regulations, unlocking capital reserves) and (2) BAC plays catch-up as capital return efforts have recently lagged peers. • Macro environment improvements should continue to provide tailwinds (GDP growth could rise to the 3%-4% range with corporate defaults remaining stable). • BAC as a value play trades at 12.8x NTM earnings and 1.25x tangible book value and 10% of analysts have upgraded their recommendations and 36% have raised their price targets in the past month alone.
MetLife (MET - US) **Company Description:** MET provides individual insurance, employee benefits, and financial services with operations throughout the world. The company's products include life insurance, annuities, automobile and homeowners insurance, retail banking, and other financial services to individuals, as well as group insurance.	**Investment Thesis:** • We believe MET will restart its share repurchase plan in 2017 with plans of growing the program in 2018 due to an expected net increase in capital from the Brighthouse Financial spinoff and ongoing cost reduction efforts. The remaining company will be less interest rate sensitive after the spinoff but still one of the most interest rate sensitive amongst large cap insurers. • Long-term/conservative investors will welcome management's efforts to de-emphasize the variable annuity business in favour of international opportunities (similar to prior acquisitions like ALICO and Provida); thereby enhancing the business mix and lowering the overall corporate risk profile. • MET trades at a discount to the life group on both a P/BV and P/E basis despite similar growth prospects. MET shares yield 3.0%.
First Republic Bank (FRC - US) **Company Description:** FRC is a mid-sized bank with 60 offices in the major metropolitan areas across the U.S. and assets approaching $65B. FRC offers personal banking, business banking, trust, brokerage, and wealth management services. In 2009 FRC was sold by BAC for about $1B in one of the only bank sales during the crisis that did not require assistance from the Federal Deposit Insurance Corporation as it was able to avoid difficulties caused by toxic assets such as subprime mortgages. In 2010 FRC went public.	**Investment Thesis:** • Since FRC was spun off from Bank of America (BAC) its assets have nearly tripled and the value of its stock has increased over 140%. • FRC differentiates itself as a regional bank by targeting only high-net-worth (HNW) individuals in seven metro areas (where 56% of all HNW households in the U.S. reside) instead of targeting only certain geographies and by establishing a community presence through an extensive branch network. • FRC is growing over 2 times faster than its peers as NTM EPS growth is expected to be 15%. FRC's industry leading ROE is backed by strong loan growth, 3.2% net interest margin, and double-digit revenue growth from wealth-management. • FRC's low-risk credit culture gives it the lowest risk profile in the industry with a lower percentage of "nonperforming assets" than its peers (0.1% vs 0.7%) and median residential-loan down payment at 40% - double industry norms. • High ROE and relatively low business risk through its focus on the very best clients makes FRC a rare find in a high beta sector.

General Dynamics (GD - US)	Investment Thesis:
Company Description: GD is a diversified defense company offering a broad portfolio of products and services in business aviation, combat vehicles, weapons systems, munitions, shipbuilding design and construction, and information systems and technologies.	• Revenue breakdown: Information Systems (30%), Aerospace (27%), Marine Systems (27%) and Combat Systems (17%). • GD is a prime military contractor to the Pentagon as the U.S. government accounts for about 57% of sales. North America represents its largest market, generating 77% of sales. • After years of U.S. defense spending decline ($100B+ cut), use of sequestration, and emphasis on intelligence capabilities and drone warfare, more traditional military spend could well be the new world order over many years as Trump attempts to rebuild the U.S. defense program. • If it comes to fruition, Trump's plan to increase the U.S. Navy's fleet to 350 ships ($68B cost) would be a multi-year windfall for GD. • In the meantime, GD has been busy with two new business jets, ramping up production of key combat vehicles and accelerating submarine work in order to address the $52B order backlog – a near record high. • Blended forward operating margin for GD is 13.6% vs 9.8% for peers.
Jacobs Engineering (JEC - US)	**Investment Thesis:**
Company Description: Founded in 1947, JEC has 200+ offices in more than 30 countries and provides a broad range of engineering, technical, professional, and construction services to a large number of industrial, commercial, and governmental clients around the world. JEC's services include project services, process/scientific and systems consulting, construction services, and operations/maintenance services.	• JEC has 57% of its revenues from within the U.S. with the largest single customer being the US government (20% of revenues), for which it chiefly performs aerospace and defense work. The Air Force's Arnold Engineering Development Center (AEDC) has been a client for 50 years and NASA has had a 40 year history of contract work. • Revenue composition: Petroleum & Chemicals 30%, Industrial 25%, Aerospace & Technology 24% and Infrastructure 21%. Going forward infrastructure revenue is expected to rise. • Typical projects include providing development/rehabilitation plans for roads/highways, bridges, transit, tunnels, airports, oil refineries, manufacturing plants, railroads and maritime ports. • Backlog at the end of FY 16 was $18.7B, of which 27% was infrastructure. • JEC's history of acquisitions implies future deal possibilities. Most recently, JEC acquired Van Dyke Technology (cybersecurity firm) which complements recent investments in cloud-based technologies. • LTM free cash flow (FCF) yield is 8.9% vs 4.5% for peers.
Quanta Services (PWR - US)	**Investment Thesis:**
Company Description: Founded in 1997, PWR has 24,500 employees and provides specialized contracting services to electric utilities, telecommunication and cable television operators, and governmental entities. It also installs transportation control and lighting systems and provides specialty electric power and communication services for industrial and commercial customers.	• Houston-based Quanta Services generates around 80% of its revenue in the U.S. and builds out and repairs electric transmission facilities and power lines (60% of revenues) and builds natural gas pipelines (30%). • Quanta's 10 largest customers accounted for about 36% of its revenue in 2015; its largest customer, 8%. Clients include American Electric Power, Australia Pacific, Duke Energy, Google, PG&E, TransCanada, etc. • Backlog at the end of 2015 was $6.3B, against $7.5B in revenues. • Trends PWR is well positioned for include emphasis on modernizing and expanding the aging electric power grid (potentially a $30B opportunity through 2020) and increased construction of natural gas-fired power plants and pipelines to tackle the supply increase for the next two decades and eventually deliver renewable electricity from new generation sources. • Notable high-voltage electric transmission projects PWR recently secured include the 1,100 km-Labrador Island Link HVdc Transmission Project in Newfoundland and the 500 kV Transmission Project in Alberta -- two of the largest transmission projects in North America.

<table>
<tr><td>Dow Chemical Company (DOW - US)</td><td rowspan="2">Investment Thesis:
Like LYB (see below), Dow provides exposure to a higher oil-to-gas ratio but not to the same extent. DOW is a more diversified play and has a history of rewarding shareholders in both good and bad environments.
The ongoing combination of DOW and DuPont (DD) should drive cost and revenue synergies coupled with an overall decrease in capital expenditures for the next two years (post-merger) with DOW's experience from the successful Corning integration serving to help realize/exceed targets.
In late 2018, a proposed split into three unrelated businesses (Agriculture, Material Science and Speciality Products) should eliminate the conglomerate discount and unlock even greater shareholder value.
Major capex spends are mostly complete and we believe free cash flows are at the cusp of a multi-year inflection point. DOW's dividend yield is forecasted at 3.6% over the NTM with analysts expecting an increasing trend (projected three-year dividend growth of 10%).</td></tr>
<tr><td>Company Description: DOW is the largest overall chemicals company in the U.S. and second largest worldwide (behind BASF). DOW is a horizontally-integrated diversified chemical company that provides a wide array of chemical, plastic, and agricultural products and services to global customers in many industries (food, transportation, healthcare, medicine, consumer products, construction, automotive, etc.)</td></tr>
<tr><td>LyondellBasell Industries (LYB - US)</td><td rowspan="2">Investment Thesis:
Petro derived revenues should get a lift from the improved crude oil outlook and OPEC coordination while profitability should improve given the significant feedstock cost advantage from low-cost U.S. natural gas.
LYB's vertically integrated business model (80%-85% of upstream output used in downstream derivatives) gives the company significant advantages over competitors.
LYB continues to reward shareholders through dividends (expected NTM yield 4.2%) and share repurchases (7% of shares outstanding repurchased YTD) with last quarter totaling $1.2B in capital returned.
Overall LYB is a quality chemicals play with a solid track record of cash flow generation and strong shareholder returns.</td></tr>
<tr><td>Company Description: Niche chemical producer LYB is the world's largest producer of polypropylene and Europe's largest maker of polyethylene; both are key ingredients in producing a variety of plastics. LyondellBasell also makes advanced polyolefins and licenses its polymer technology.</td></tr>
<tr><td>ConocoPhillips (COP - US)</td><td rowspan="2">Investment Thesis:
COP has proved reserves of 9B barrels of oil equivalent and produces about 1.5M barrels/day. Regionally the U.S. accounts for about 55% of revenues.
COP is a value play (P/B and LTM P/S lower than the industry average) and has underperformed its peers over the past couple of years due to its debt and dividend obligations in a declining oil price environment.
During the decline COP cut spending ($2.5B) and its dividend (by 2/3), still leaving it with a higher dividend yield than its peers (2% vs 1.4%).
This, coupled with planned debt reduction efforts ($7B through 2019), proposed asset divestitures ($6B through 2018) and possible share buybacks (up to $3B), makes COP an excellent comeback candidate given an improving oil supply/demand backdrop.
Under a sustained oil price recovery (our base case), we expect COP to be one of the first amongst peers to achieve positive free cash flow to dividend coverage.</td></tr>
<tr><td>Company Description: COP is the world's largest independent exploration and production company based on reserves and oil production. Formerly an integrated company but since spun off of Phillips 66 (downstream business), COP explores for, produces, transports, and markets crude oil, natural gas, natural gas liquids, liquefied natural gas, and bitumen on a worldwide basis.</td></tr>
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QUALCOMM (QCOM - US)	Investment Thesis:
Company Description: QCOM manufactures digital wireless communications equipment and pioneered the commercialization of its CDMA technology. QCOM also licenses technology rights from its large intellectual property portfolio.	• For the long term, we are positive on QCOM's shift toward integrating the recently announced acquisition of NXP Semiconductors for more than just realizing basic synergies as the acquisition should help QCOM diversify its revenue sources from slowing mobile and PC centric revenues to the growing automotive electronics segment. • In the near term, China smartphone sales continue to recover from the 2014-2015 global growth over-hang, helping the company handily beat Street forecasts. • LTM FCF yield is 7.1% vs the peer group average 3.3%. In addition, QCOM shares' NTM dividend yield is expected to be 3.4%, sustainable in our view given an EPS payout ratio of 45% based on F17 consensus estimates.

In A Year of Changes, 2016 Top 10 U.S. Equity List Notches Small Gain

Performance of the 2016 Top 10 U.S. Equity list, as selected by GPAG's prior U.S. equity team, is provided in Exhibit 2 below. The 2016 list included both cyclical and defensive stocks, aligned with the view that U.S. and global economic growth would drive earnings growth and positive returns for the S&P 500. The companies selected offered attractive growth profiles and solid balance sheets, and most traded at discount valuations relative to peers, providing a measure of downside protection.

Exhibit 2 - Performance of 2016 Top 10 U.S. Equities

Company	Symbol	Price 31-Dec-15	Price 30-Dec-16	Note	Change
Comcast Corporation Class A	CMCSA-US	$56.43	$69.05		22.36%
NIKE, Inc. Class B	NKE-US	$62.50	$54.93	1	-12.11%
Citigroup Inc	C-US	$51.75	$59.43		14.84%
MetLife, Inc.	MET-US	$48.21	$53.89		11.78%
Allergan plc	AGN-US	$312.50	$213.44	2	-31.70%
McKesson Corporation	MCK-US	$197.23	$163.63	3	-17.04%
Facebook, Inc. Class A	FB-US	$104.66	$115.05		9.93%
Broadcom Limited	AVGO-US	$145.15	$176.77		21.78%
Mondelez International, Inc. Class A	MDLZ-US	$44.84	$44.01	4	-1.85%
Union Pacific Corporation	UNP-US	$78.20	$70.16	5	-10.28%
Average price-only return for Top 10 list					0.77%
S&P 500 Index		2,043.94	2,238.83		9.54%
Outperformance (Underperformance)					*-8.76%*

Notes:

[1] 01 Jun/2016 closing price, when GPAG first grew cautious on NKE.

[2] 28 Oct/2016 closing price, when GPAG downgraded the U.S. Healthcare sector.

[3] 11 Oct/2016 closing price, when GPAG downgraded MCK to Hold.

[4] 09 Nov/2016 closing price, when GPAG sold MDLZ in the U.S. Core guided portfolio.

[5] 28 Jan/2016 closing price, when GPAG removed UNP from the U.S. Recommended List.

Sources: FactSet, Scotia Wealth Management GPAG.

A number of changes were made to the list over the course of the year. In early 2016, following a cautious management update and Q4/2015 earnings report, Union Pacific (UNP) was removed. This crystallized a 10% loss; had UNP been maintained on the list for the entirety of the year, it would have been the best performer with a +33% price return. Three of the other changes helped performance relative to holding the positions through year-end. These included the removal of Allergan (AGN) and McKesson (MCK) in October as we grew concerned about the U.S. healthcare supply chain, and a cautious stance we took on Nike (NKE) in early June after identifying several potential performance headwinds. We removed Mondelez (MDLZ), a constituent of the defensive Consumer Staples sector, from the list at a modest loss following the U.S. presidential election as we positioned our portfolios for a year-end cyclical rally.

The remaining five positions stayed on the list through the end of 2016, all of which managed to outperform the benchmark (S&P 500). These included both Technology sector stocks (Facebook [FB] and Broadcom [AVGO]) and both Financials sector stocks (Citigroup [C] and MetLife [MET]), the latter two benefitting from a rising interest rate environment in the latter part of 2016. Comcast (CMCSA) was the best performer with a 22.4% return, helped by a strong post-U.S. election rally.

Overall, the 2016 list delivered a positive price return of 0.8% on average, though this trailed the benchmark's 9.5% performance. Had the list been held for the entire year, the price return would have been approximately 3.2%.

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