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Stifel Equity Strategy Views for 2014

"Thinking doesn't make the big money, sitting does. Sitting tight."

In our view:

- ***Stock Market*** – Our title is from the book *Reminiscences of a Stock Operator.* As investors discount policy support eroding a "thinking" approach to deflation risk leads to our flat ~ 1,850 S&P 500 forecast for 2014, but the embedded option of "sitting tight" is also wise since a case may be made for an up ~10% S&P 500 to ~2,000 in 2014. We describe both views…..(Pages 2 – 21)

- ***Sectors*** – Either believe in world GDP, or expect EPS to fall! As U.S. policy (fiscal, monetary, trade) goes global, cycles synchronize and recessions end. Then, "normal" pre-1st rate hike sectors (Materials, Energy, Industrial, & Tech) rise. The opposing view is "more disinflation boom" prolonging Healthcare, Discretionary & Financial strength. We discuss both sides..(Pages 22 – 37)

- ***Long-Term View*** – A leveling S&P 500 P/E as bond yields trough and EPS catalysts erode (labor/dollar/rates/D&A rise, buy-backs moderate) underpins our view of a ~7%/yr. S&P 500 total return this decade. But if "capitalism won" its proliferation could spark a ~12%/yr. total return with more top-line that is a "Secular Bull Market." We describe both possibilities……..(Pages 38 – 47)

Dec-31, 2013 S&P 500 1,848 (range-bound ~1,850+/- in 2014) S&P 500 EPS '13E $106 '14E $113 (Street $106 & $116) Brent $111 Gold $1,202

EURUSD 1.37 USDJPY 105.31 DXY 80.04 10-Yr. 3.03% U.S. GDP 2013E 2.7% , 2014E 3.1%, 2015E 3.4%

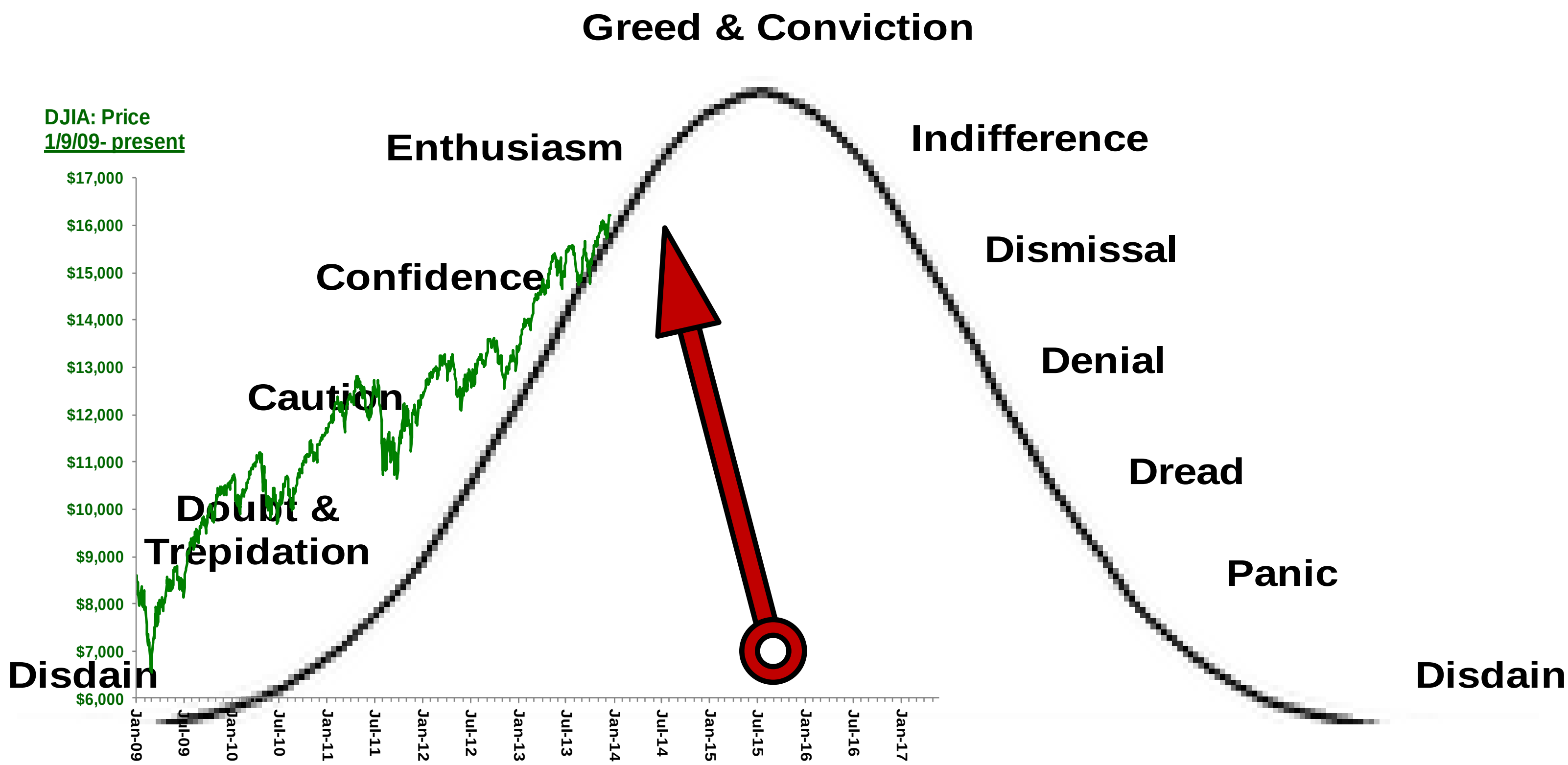
Barry B. Bannister, CFA
***Managing Director, Equity Research – Chief Equity Strategist,* Stifel bbbannister@stifel.com 443-224-1317**

2014 U.S. Stock Market Strategy

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

Investor psychology has soared since the 1Q09 low. **Having been a bull for several years we also recognize that the giddiness isn't in our nature. As a result, we take a "if you believe in growth own cyclicals, if not don't own stocks" view, and this report examines the Bull vs. Bear case in a point/counter-point format.**

The Cycle of Investor Psychology



Source: Stifel adaptation chart, Bloomberg prices, Stifel format and conclusions.

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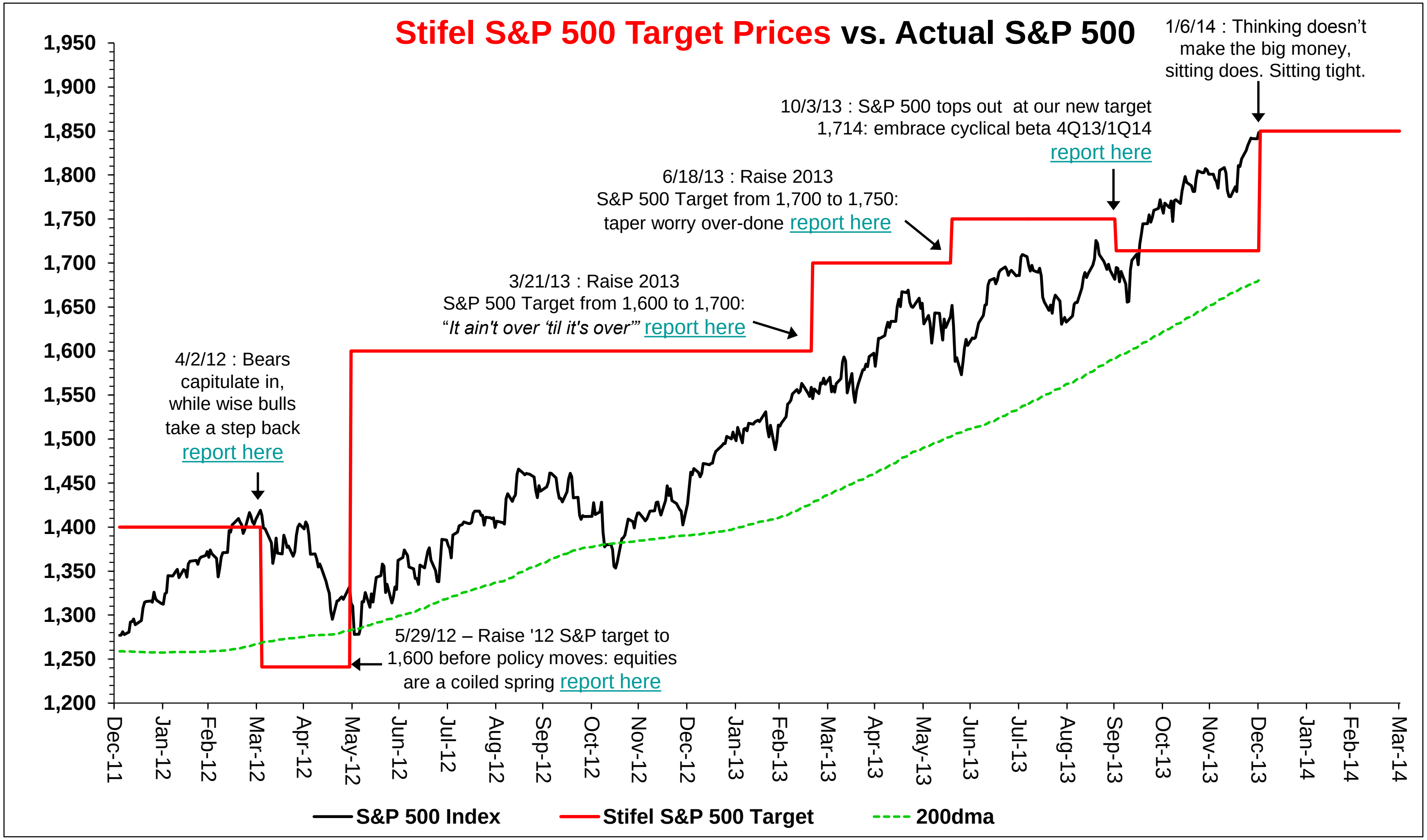
Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

Our target in 2014 centers on 1,850 S&P 500. **With money relaxed and U.S. policy "going global[(1)]" perhaps late arriving[(2)] bulls may push stocks higher. But our view is a market consolidation while rates and policy *expectations* normalize in 2014.**



Source: Bloomberg prices, estimates, Stifel format. **Price through 12/31/13 close.**

(1) A combination of fiscal, monetary, and macro-policies first employed by the U.S./UK appear to us to be spreading globally, increasing investor confidence.
(2) Investors who bought gold and Treasuries as hedges and (unexpectedly) achieved equity-like returns had the luxury of remaining on the sidelines, concurrent with a perch from which to criticize policy. Now that Fed policy at least *appears* to be working, these late bulls could push equity up despite elevated prices and valuation.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

2014 U.S. Stock Market Strategy

Presenting the case for a flat S&P 500 ~1,850 in 2014

In our view:

Capitulatory year-end window dressing helped the S&P 500 surge, and overall we believe equity strength in 2013 foreshadowed (and discounted) GDP recovery in 2014. We've migrated recently from a near high-on-the-Street S&P 500 view at the start of 2013 to a near low-on-the-Street (flat) view for 2014 **(Pages 3-4)**

- **We are wary of the *artificiality* of policy, the failure of which may cause deflation and EPS weakness (Pg. 6)**
- **For decades the current S&P 500 P/E on forward EPS has implied a mid single-digit forward price return (Pg. 7)**
- **We think QE and the P/E-led bull market of 2012-13 were linked, so now credit growth matters for EPS (Pg. 8)**
- **Worrisome for credit, if mortgage debt (half of lending) shrinks, general U.S. price deflation may ensue (Pg. 9)**
- **The jury is out whether the Fed can restart home lending (the laggard sector) and forestall deflation (Pg. 10)**
- **We feel sentiment [Bulls/(Bulls + Bears)] is stretched, sitting at the highest level since the 1987 Crash (Pg. 11)**
- **A key indicator is flashing red as it did in 2000 & 2007 (Pg. 12); complacency in a "Depression" is risky (Pg. 13)**
- **Composite price cycle analysis supports the flat 2014 view as a period of consolidation for the S&P (Pg. 14)**

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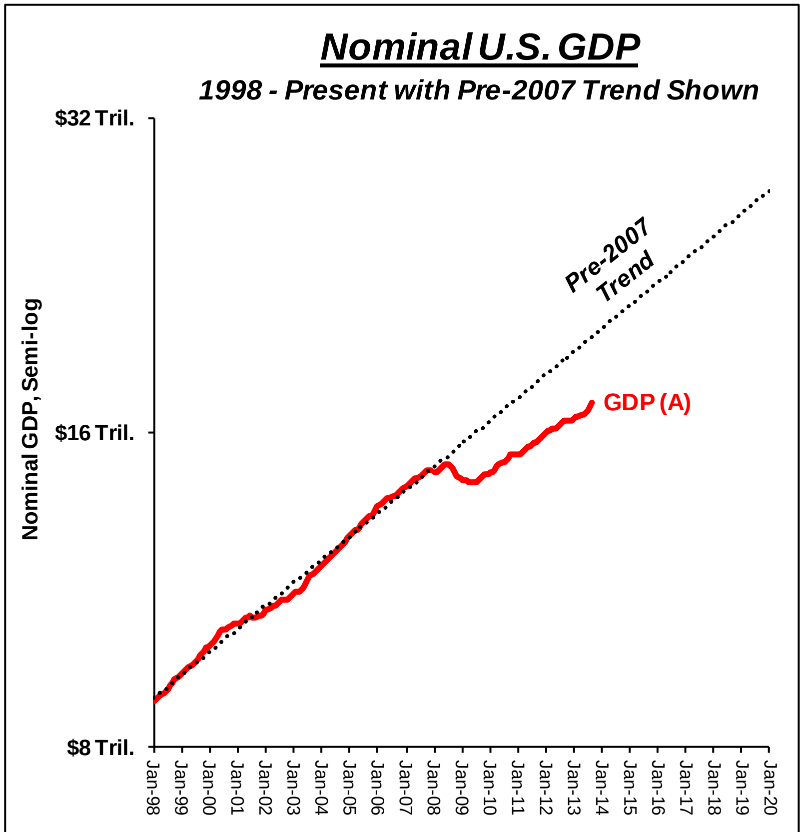
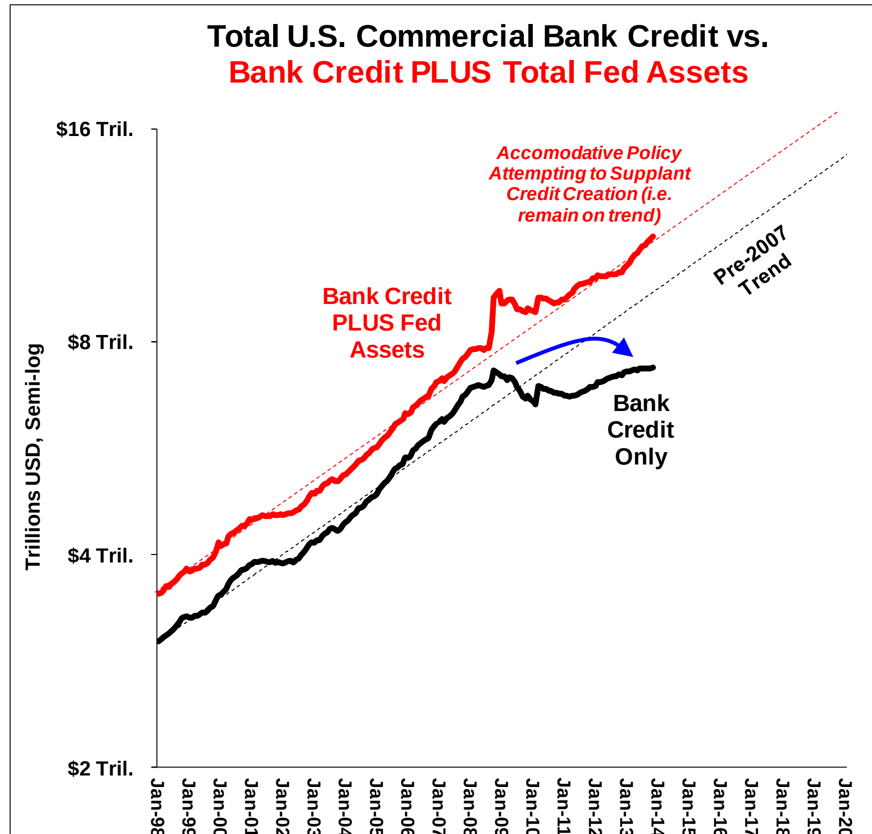
Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

The Fed has attempted to resurrect nominal GDP (left chart) and bank credit (right chart) with QE, but we are wary of policy failure that leads to deflation, which is often destructive to EPS. **Monthly S&P data(1) for the century since 1913 shows that while 37% of all months featured negative y/y EPS, when deflation was present EPS fell 61% of the time. Thus, <u>deflation almost doubles the chance of negative EPS.</u>**





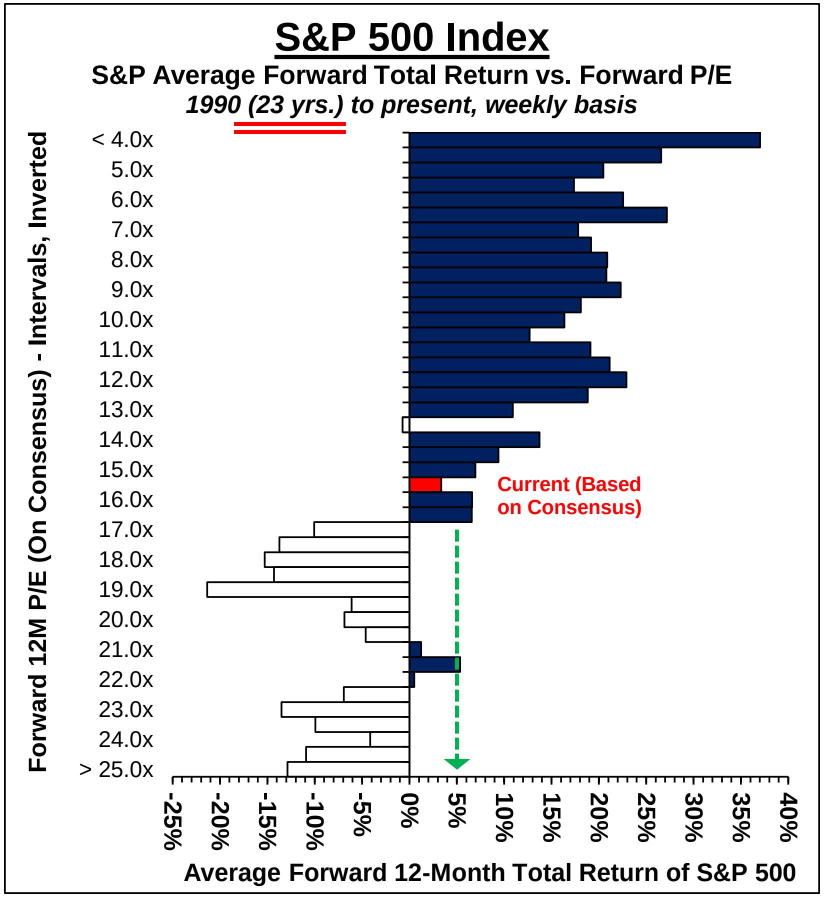
Source: Bloomberg data, Stifel format.

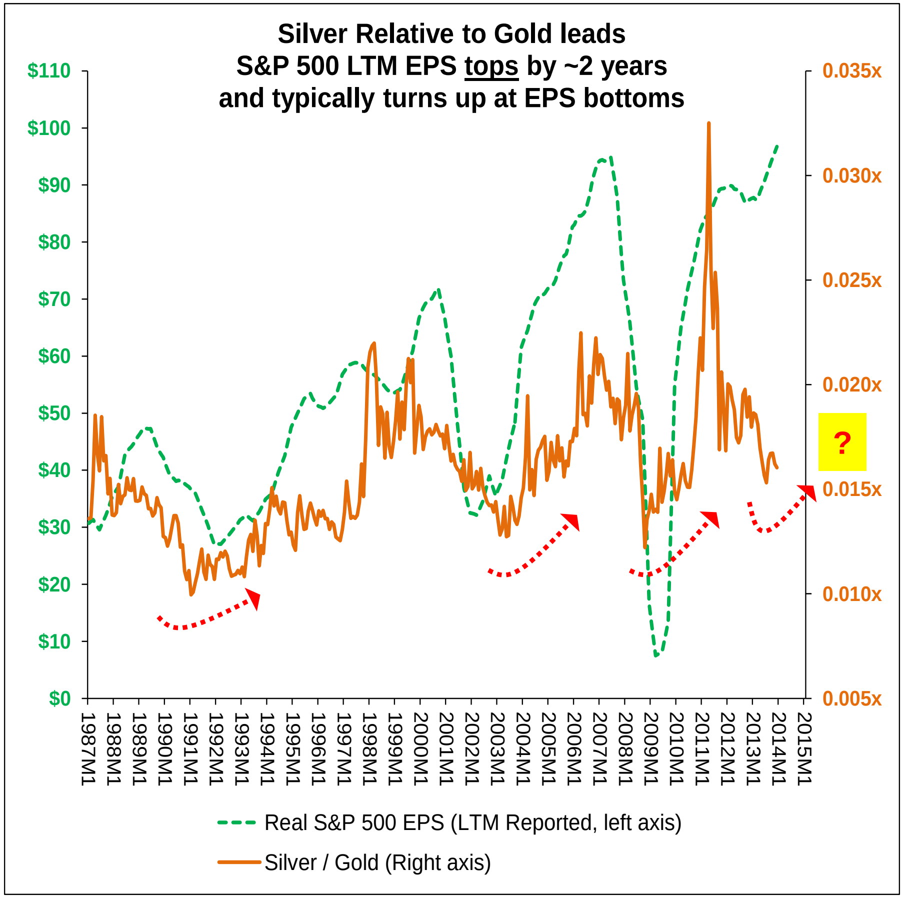
(1) Shiller online data here.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

Psychology meets valuation? **A high S&P P/E on forward EPS may limit the S&P 500 to a ~5% total return (~3% excl. dividends) in 2014, in our view.**

Ominously, if the 2014 return depends on EPS growth, one key indicator has not turned. **Silver(1) relative to gold bottoms with S&P EPS(2), but has *not* yet turned up.**



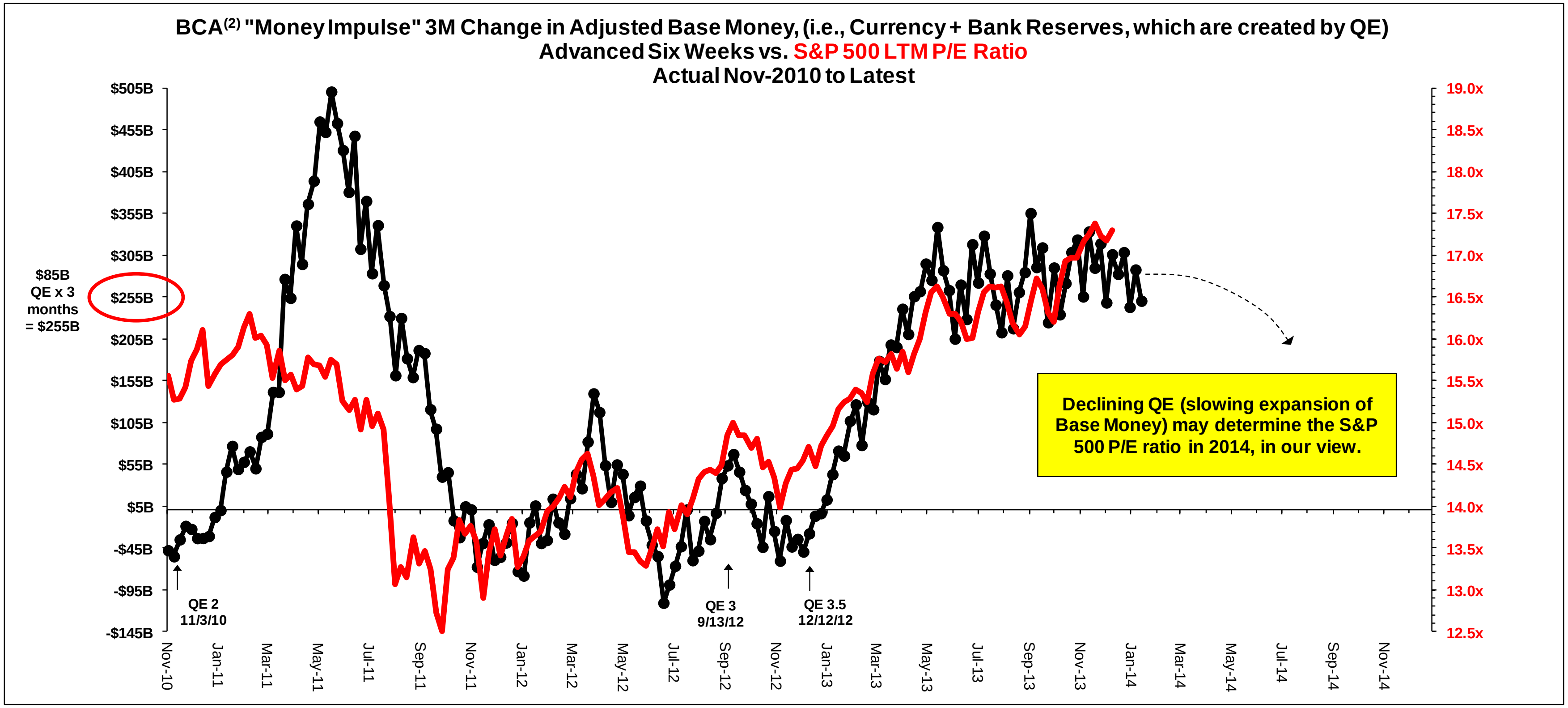


Source: Factset prices, U.S. Federal Reserve., U.S. Census CPI deflator. Standard & Poor's consensus estimates. **Updated through Dec-31, 2013.**

(1) Silver is an industrial metal (antiseptic medical, bearings to electrical connections, batteries, microcircuits, etc.) and has greater price volatility than gold.
(2) The 2011 peak of silver/gold didn't lead to S&P 500 EPS dropping two years later as was historically the case. We believe the effect of QE lowered the domestic cost of capital while exporting price deflation (devalue dollar, revalue foreign FX). The U.S. thus exported EPS weakness to the EM and Europe via QE dollar debasement.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

We think QE and the P/E-led bull market of 2012-13 were linked, so now credit growth matters for the S&P 500 price level. **As *Base Money* (currency + reserves, left axis below) growth slows with QE taper, only credit growth(1) can keep *overall money supply* from contracting. Since reducing QE deflates(2) the S&P P/E (chart below), a falling P/E may offset 2014 EPS growth. So, we watch credit *(see next page)*.**



Source: Standard & Poor's, Bloomberg. Stifel format.

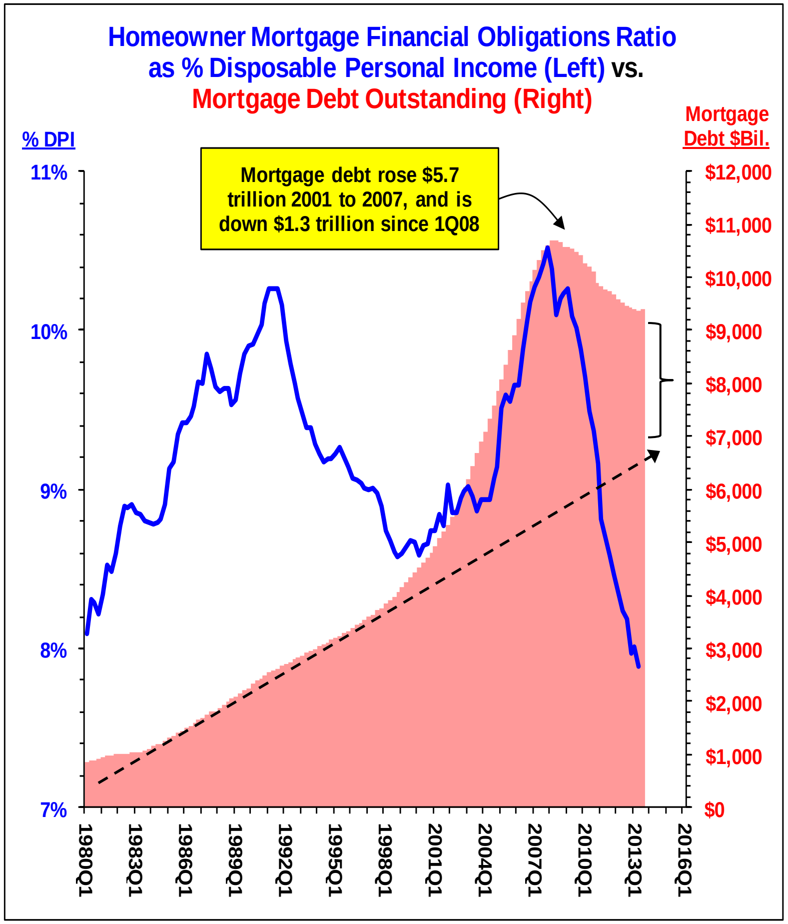
(1) Base Money (via the bank reserves at the Fed component) expanded via QE. Banks draw upon reserves and other liquidity to make loans, thus increasing the money supply. This is the money multiplier, and key to the Fed's efforts to forestall deflation (the shrinkage of money via loan repayment raises its value, *ergo* deflation).

(2) QE tightened the S&P 500 P/E correlation to Base Money growth. Bank Credit Analyst (subscriber) observed this first. Since the Fed affects rates, earnings yield (E/P) may be viewed as a discount rate. QE lowered the Treasury Term Premium, which is the premium rate the Treasury must offer to entice investors to buy longer bonds in lieu of rolling over sequential short-term notes. QE drove the Term Premium to a negative level, so we think unwinding QE raises the Term Premium.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

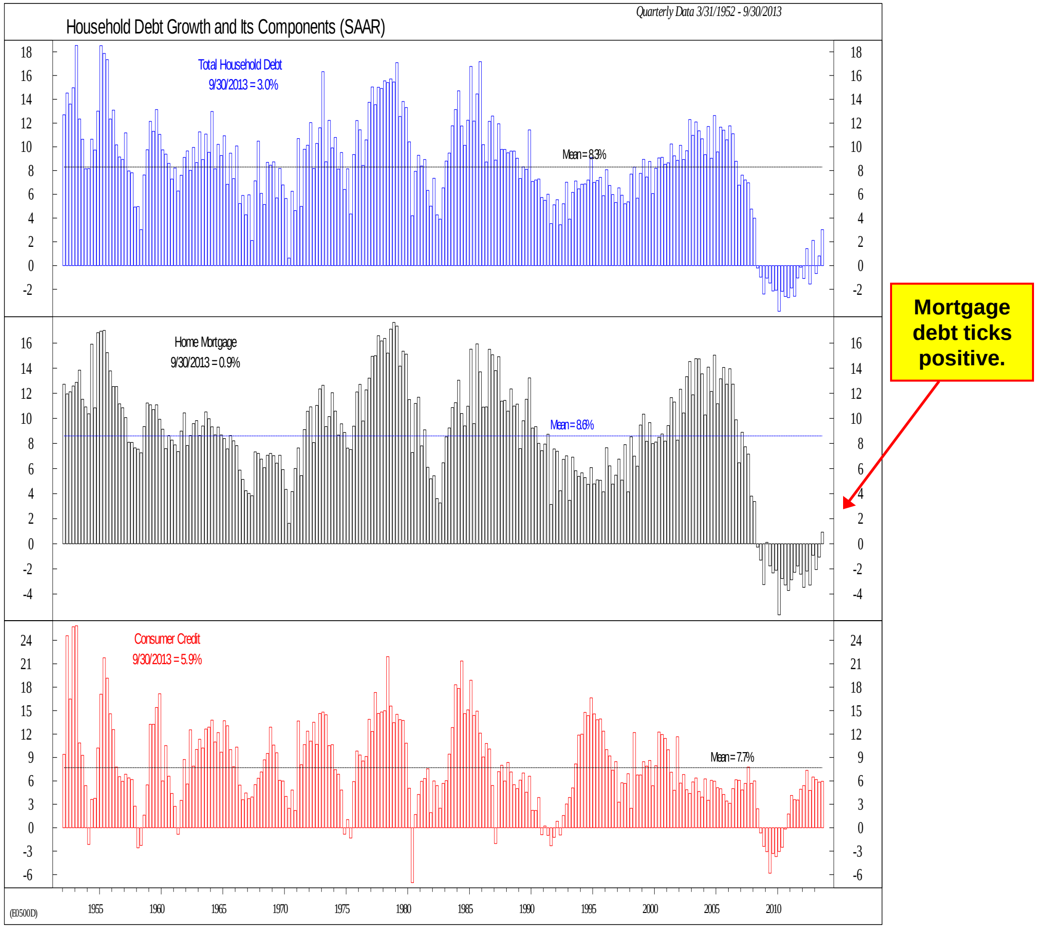
If mortgage debt (half of lending) shrinks, general U.S. price deflation may ensue(1).

Mortgages were the democratization (and dénouement?) of credit, and despite *cheap* debt we believe it is the excess *level* of debt (i.e., money, left chart) that restrains lending. Some good news: mortgage debt up-ticked 3Q13 (right charts).



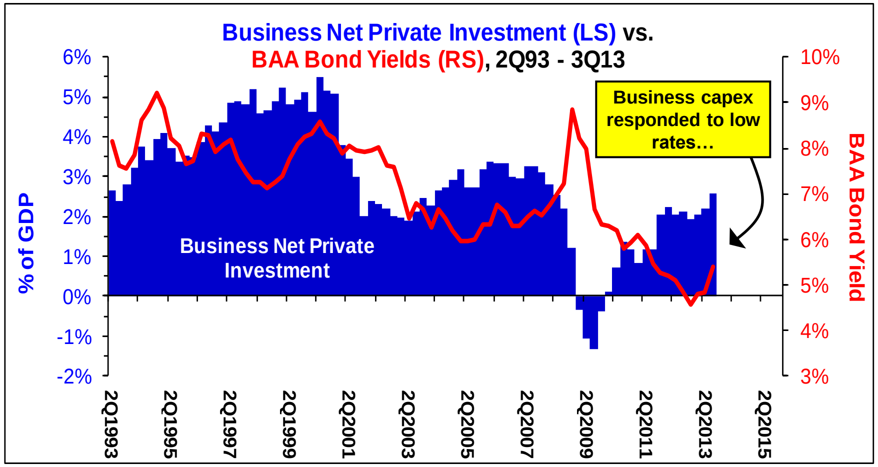
Source: U.S. Federal Reserve, Census, Stifel interpretation and annotations.

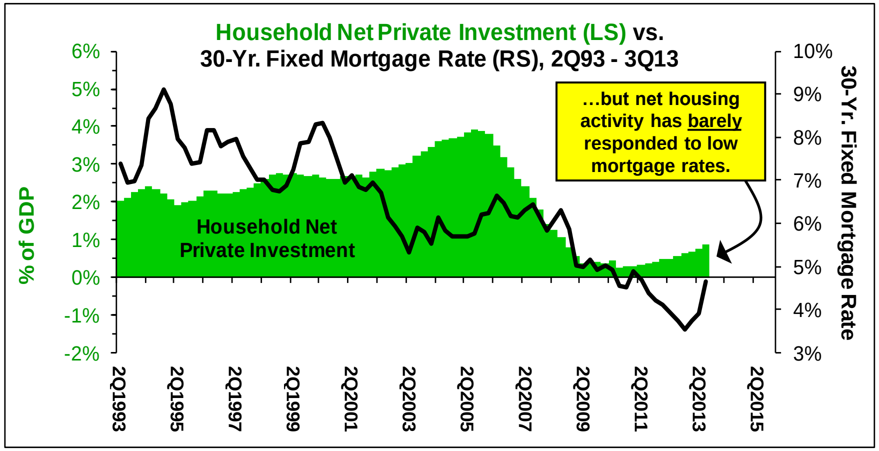
(1) MV = PQ, see the Appendix to this report. MV/Q = P with "P" price inflation. Bank credit creates money, which depresses "V" velocity (GDP/Money). Shrinking money supply is deflation (*i.e.*, less money vis-à-vis things, prices fall).

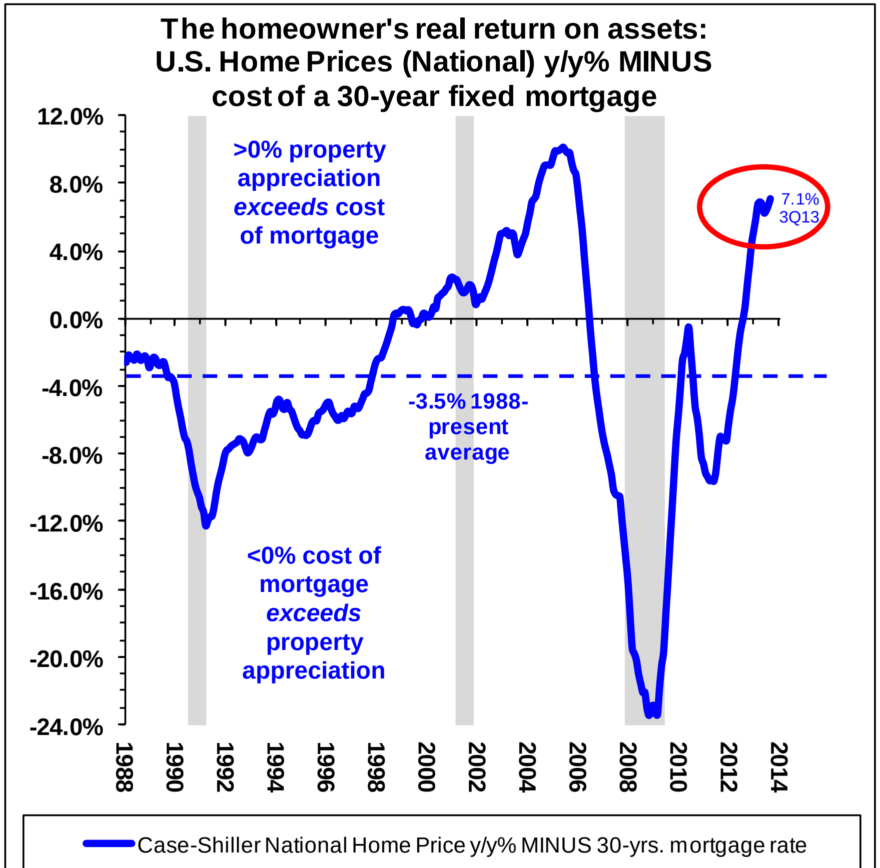


Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

We feel the jury is out whether the Fed can restart home lending and forestall deflation. **While the Business Sector responded to rate (and tax) policy by lifting fixed investment (top, left), Household fixed investment (bottom, left), mostly single-family homes, has lagged. We are wary if housing sector "ROA" (right chart) drops in 2014.**





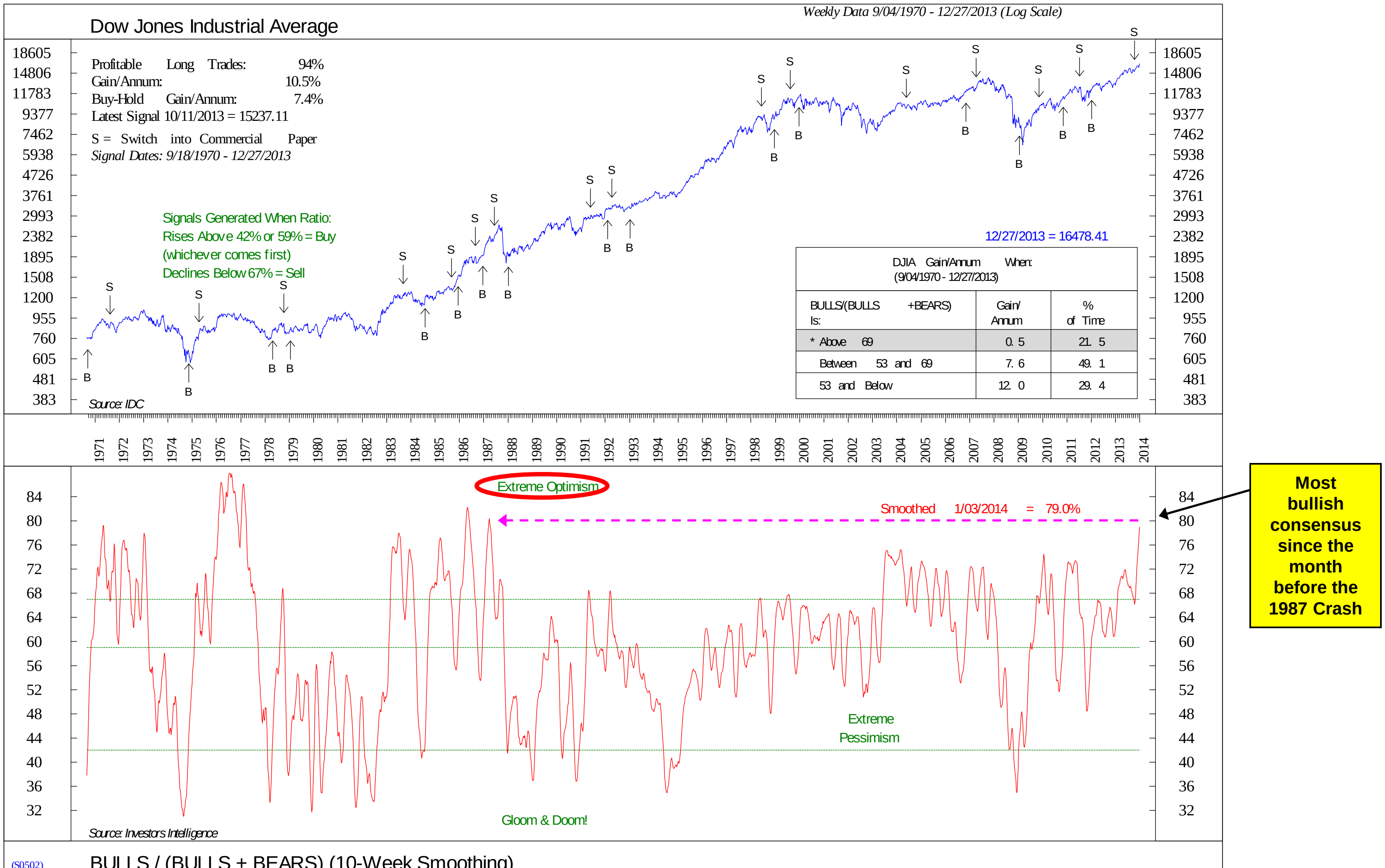


Shaded areas indicate NBER U.S. recessions.

Source: Bureau of Economic Analysis, Stifel estimates. Multi-family, purchase-to-rent not included in right chart.

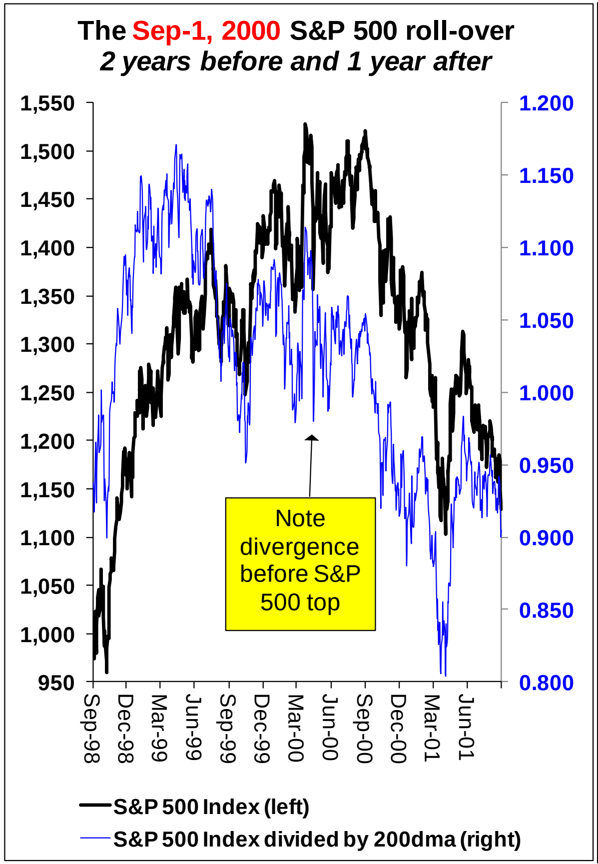
Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

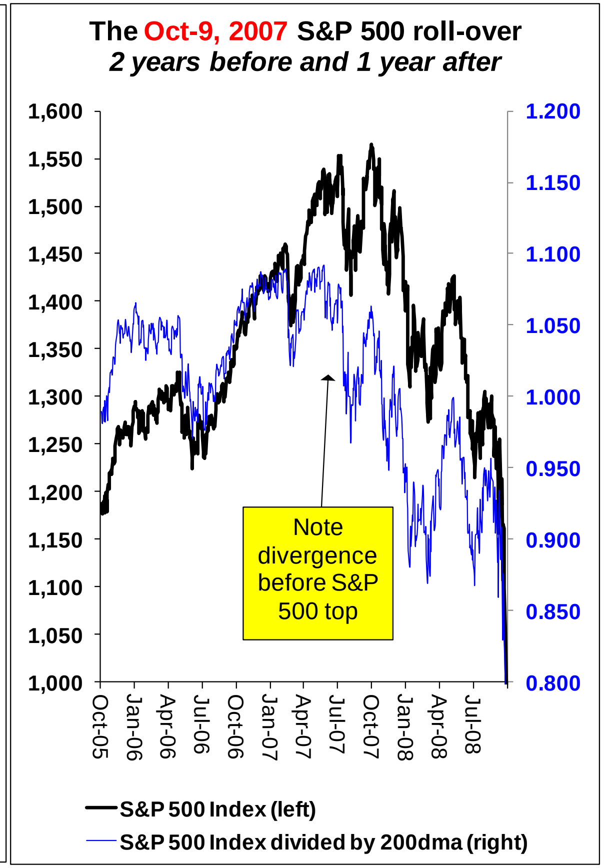
We feel sentiment [Bulls/(Bulls + Bears)] is stretched. After 60 months and 177% of a roaring Bull, with a P/E 15x forward and 17x trailing EPS, are we bullish? Not really. We're just neutral in 2014 (flat, consolidating S&P view).

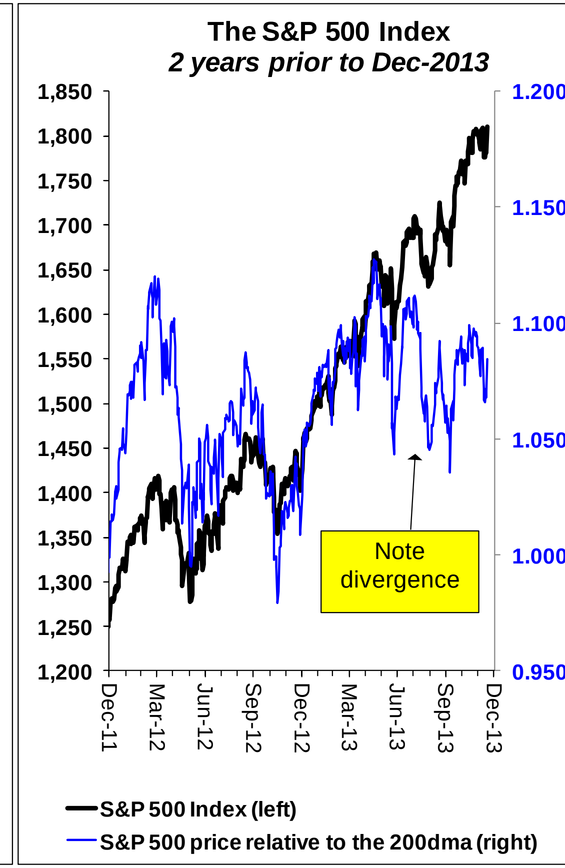


Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

A key technical indicator is flashing red. **The S&P *relative to its* own 200 day moving average (blue line) diverged from the S&P 500 index (black line) ~6 months before the past two major bear markets began (2000, 2007), and has diverged since mid-2013. Recent market strength just recognized the obvious U.S. improvement (plus window dressing), but could lose lift as 2014 begins, in our view.**







Source: Standard & Poor's, Bloomberg & Factset data, Stifel format.

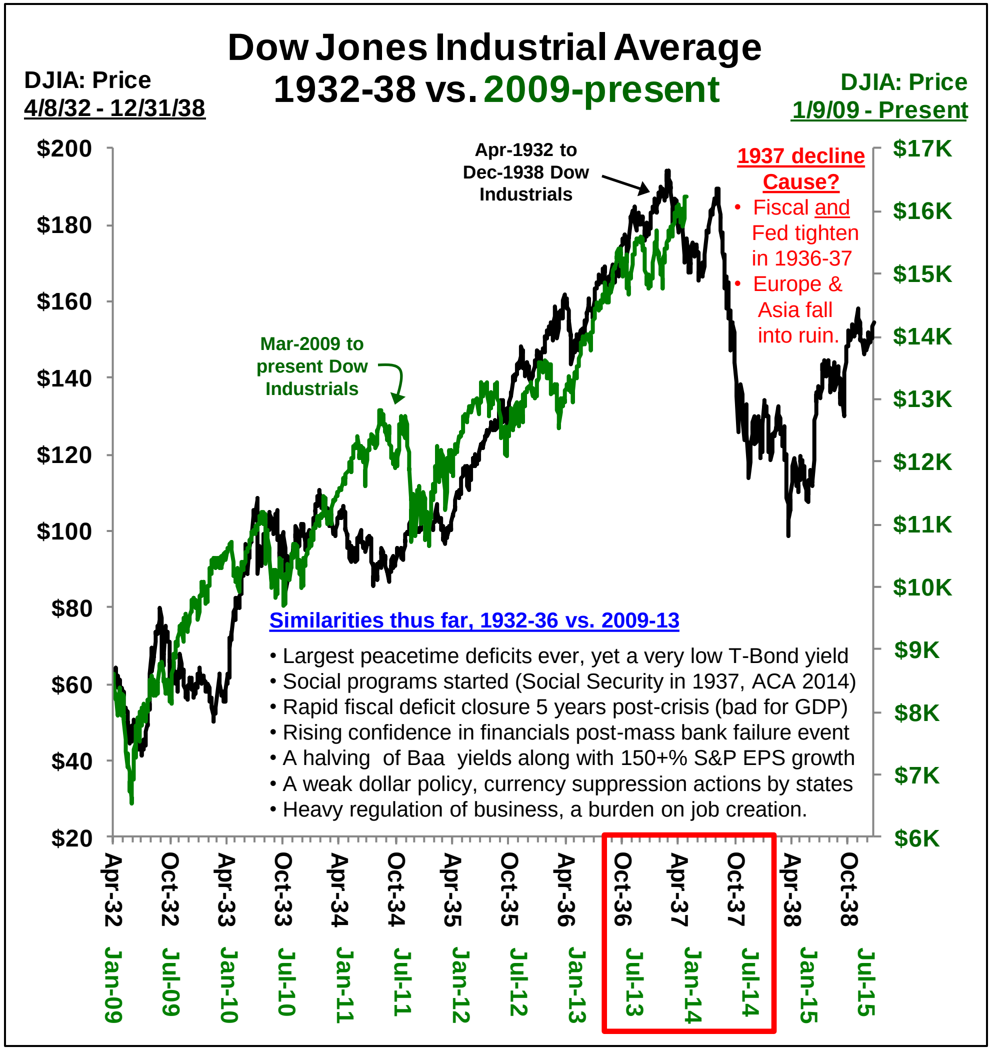
Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

Frothy sentiment = complacency? We sense a 1937 Depression/Super-Bear analogy to 2014 (described here), so we watch U.S., Eurozone, and China policy moves/success.

No time for complacency? Keynes' definition of economic depression describes conditions today:

"…a chronic condition of sub-normal activity for a considerable period without any marked tendency either towards recovery or towards complete collapse. Moreover, the evidence indicates that full, or even approximately full, employment is of rare and short-lived occurrence."

– Keynes / The General Theory / 1936



Source: Dow Jones & Co. prices, "The General Theory of Employment, Interest and Money" John Maynard Keynes, Stifel commentary and format.

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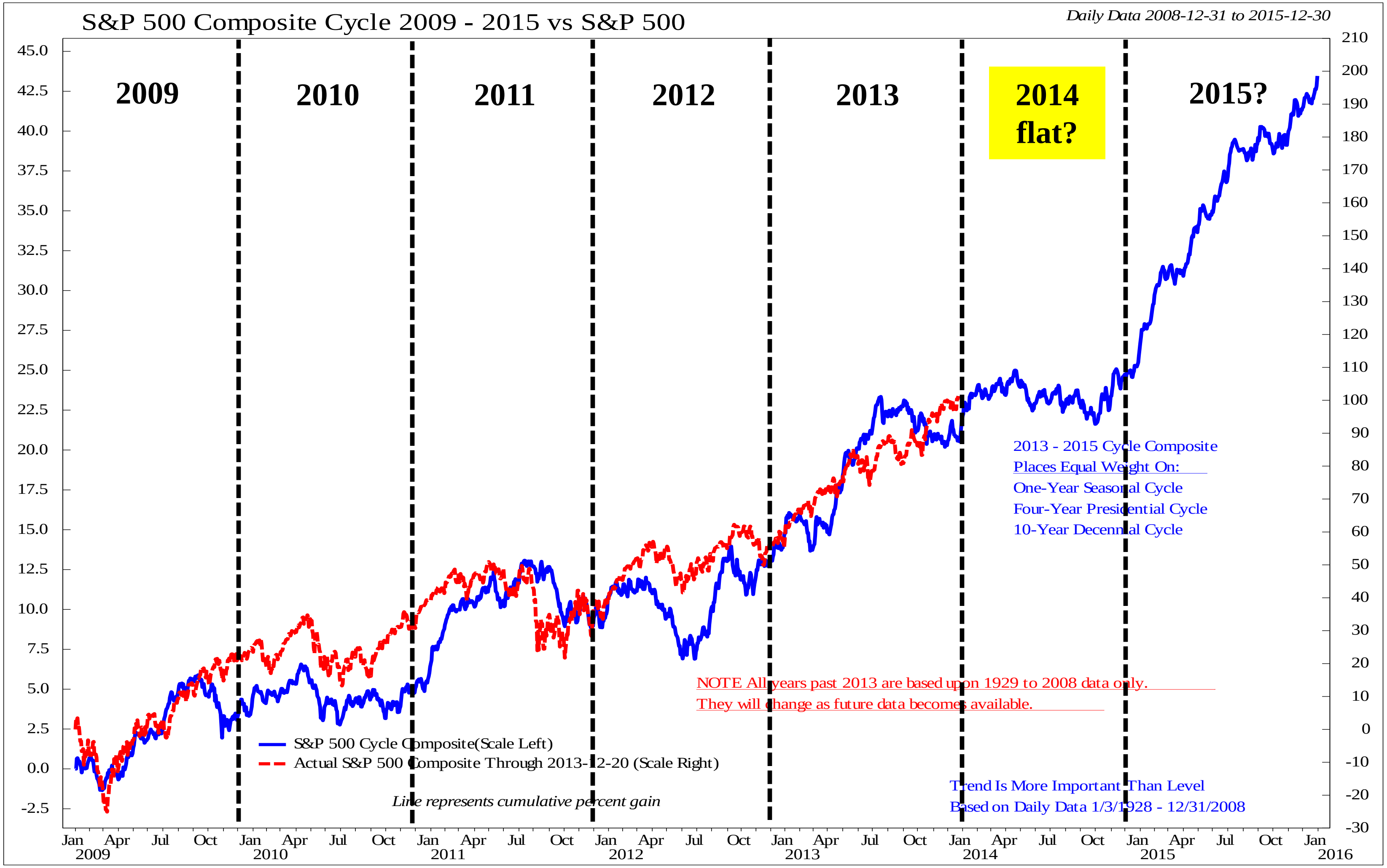
Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

2014 pause that refreshes? **The S&P (red line) has closely followed a composite Seasonal + Presidential + Decennial cycle (blue line), which points to a flat 2014E (and up 2015E?).**



2014 U.S. Stock Market Strategy

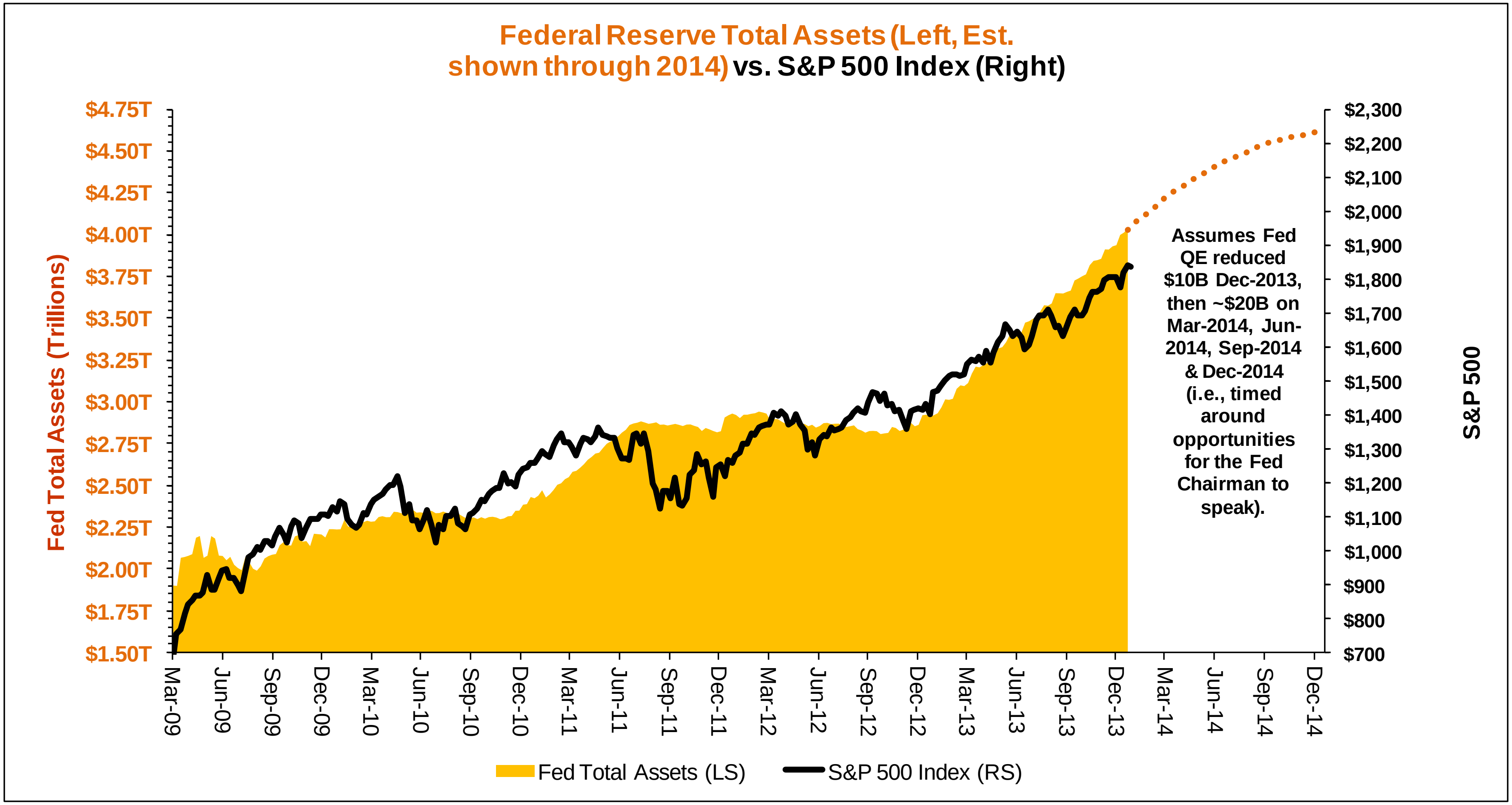
The opposing case to our view: why might there be a ~10% S&P 500 increase in 2014?

With respect to the case presented, in our view:

- **Supporting a +10% S&P 500 view: Don't fight the Fed *or* the tape. Growing Fed assets may lift stocks (Pg. 16)**
- **P/E on forward EPS plus the 10Y yield *one year out* supports a higher S&P *even if* the 10Y yield is 4% (Pg. 17)**
- **As long as nominal GDP growth exceeds the 10Y yield, as it now does, we do not see a Bear Market (Pg. 18)**
- **Corporate bonds are sending signals of favorable risk/reward, and rising T-bond yields signify growth (Pg. 19)**
- **U.S. ISM Orders minus Inventories supports +10% S&P 500 price in 2014 even if ISM moderates (Pg. 20)**
- **A P/E 17x trailing is right for 2% inflation. The Street sees ~10% EPS growth, so the S&P math is +10% (Pg. 21)**

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

Supporting a +10% (or more) view: Don't fight the Fed or the tape. **We believe QE has shaped this market, albeit at a diminishing[(1)] rate. Even with a gradual taper[(2)] through Dec-2014 the Fed's assets grow, perhaps lifting the S&P 500, in bull's view.**



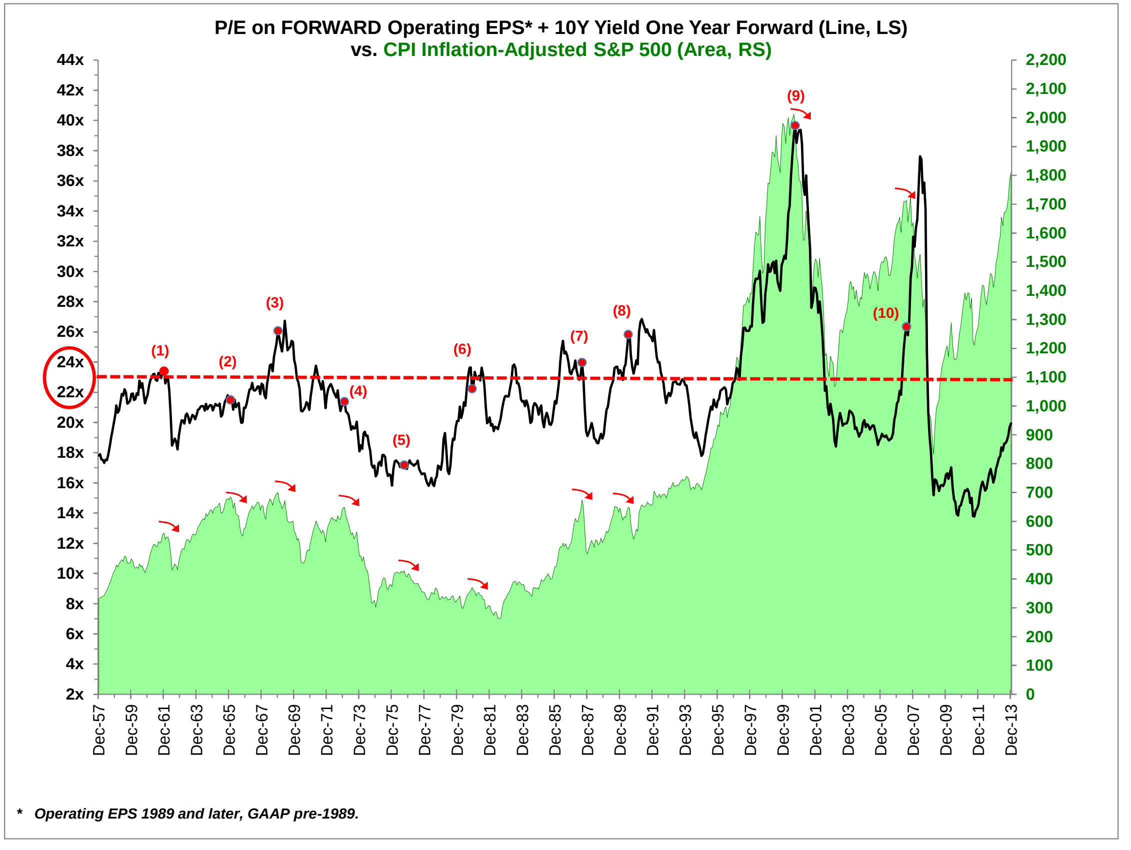
Source: U.S. Federal Reserve, U.S. BEA, Bloomberg prices, Stifel format.

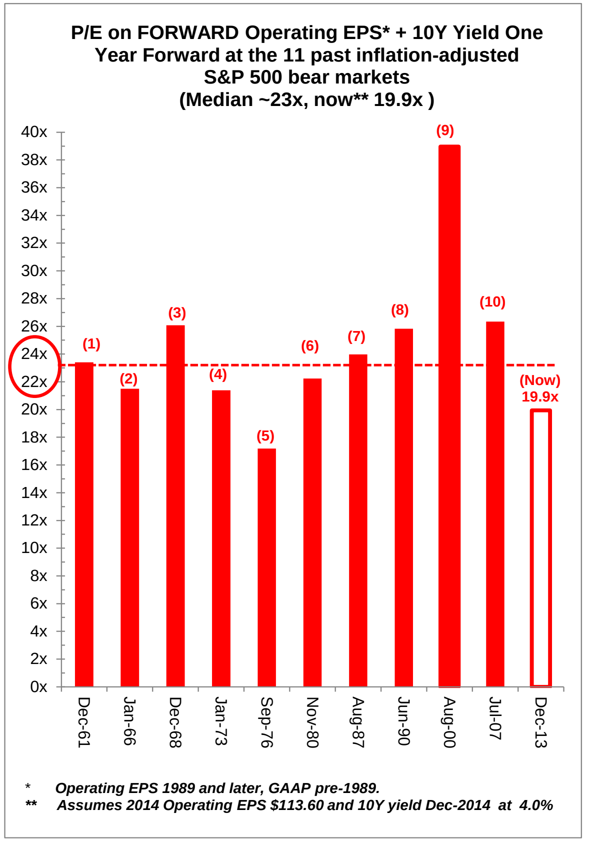
(1) We believe the Fed effect has largely been via its ability to manipulate interest rates and thus P/E ratios (earnings yield), with some effect on EPS via cost of money. The annualized total return of the S&P 500 per $250B increment of QE has somewhat steadily diminished since 2009 even as the policy/S&P 500 correlation tightened.

(2) Assumes Fed QE is reduced a further ~$20B on Mar-2014, Jun-2014, Sep-2014 & Dec-14 (*i.e.*, timed around opportunities for the Fed Chairman to speak).

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

Bulls can cite valuation as favorable in 2014 even if the 10Y yield soars to 4%. **The sum of the P/E on forward operating EPS plus the 10Y yield *one year out* has been ~22-24x in front of inflation-adjusted S&P 500 peaks the past six decades (left chart). That sum of 19.9x (P/E 15.9x consensus(1) 2014E EPS + hypothetical 10Y of 4.0% in 12/14E) is still below the level present at past (#1-10 below) S&P peaks (right chart).**



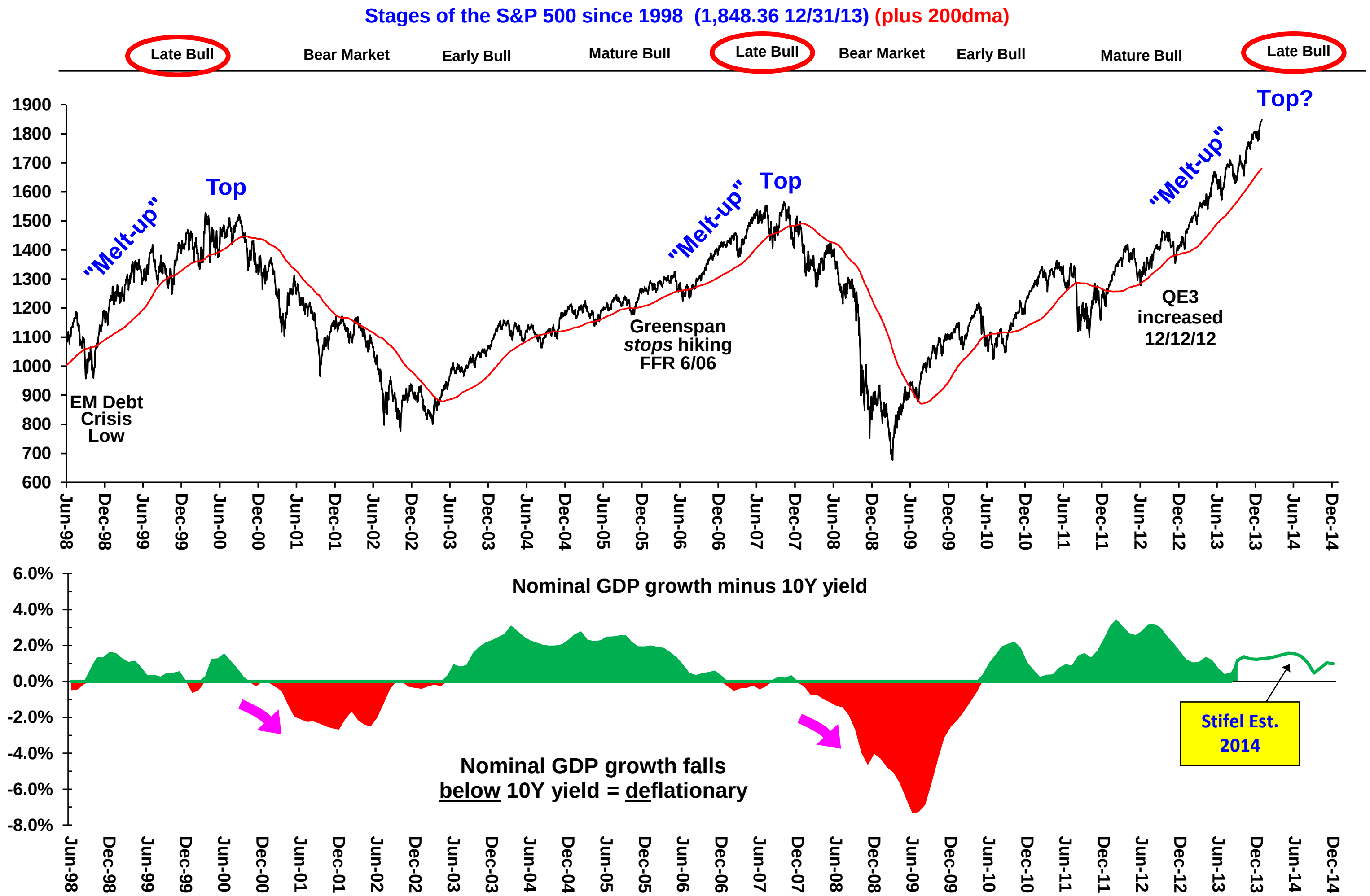


Source: Bloomberg, Standard & Poor's, operating EPS post-1989, GAAP pre-1989, Shiller data pre-1989 here, Stifel format. **Prices through 12/31/13.**

(1) We estimate S&P 500 EPS in calendar 2014 of $113.40 +6.8% y/y, while S&P 500 consensus average of top-down/bottom-up is $106.20 in 2013 & $116.12 in 2014.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

A key ingredient for a bear market is not in place. Though we believe this is the Late Bull(1) market phase, as long as nominal GDP growth exceeds the 10Y yield (bottom clip), which is our 2014 forecast, we do *not* see a Bear Market.

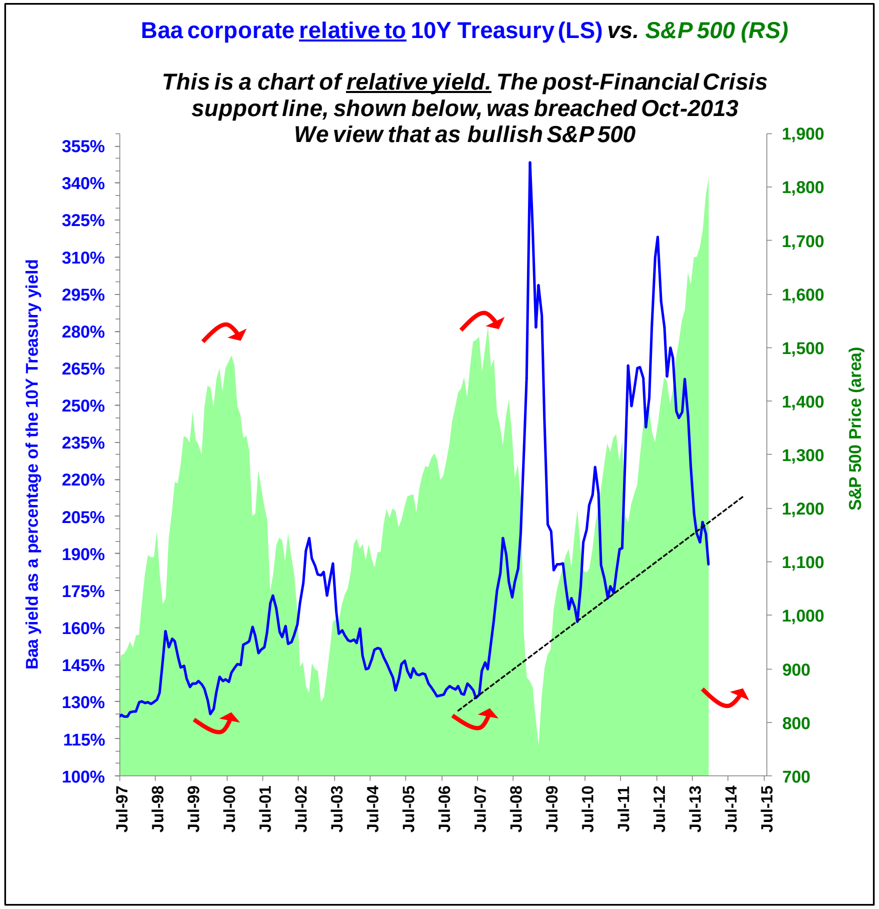


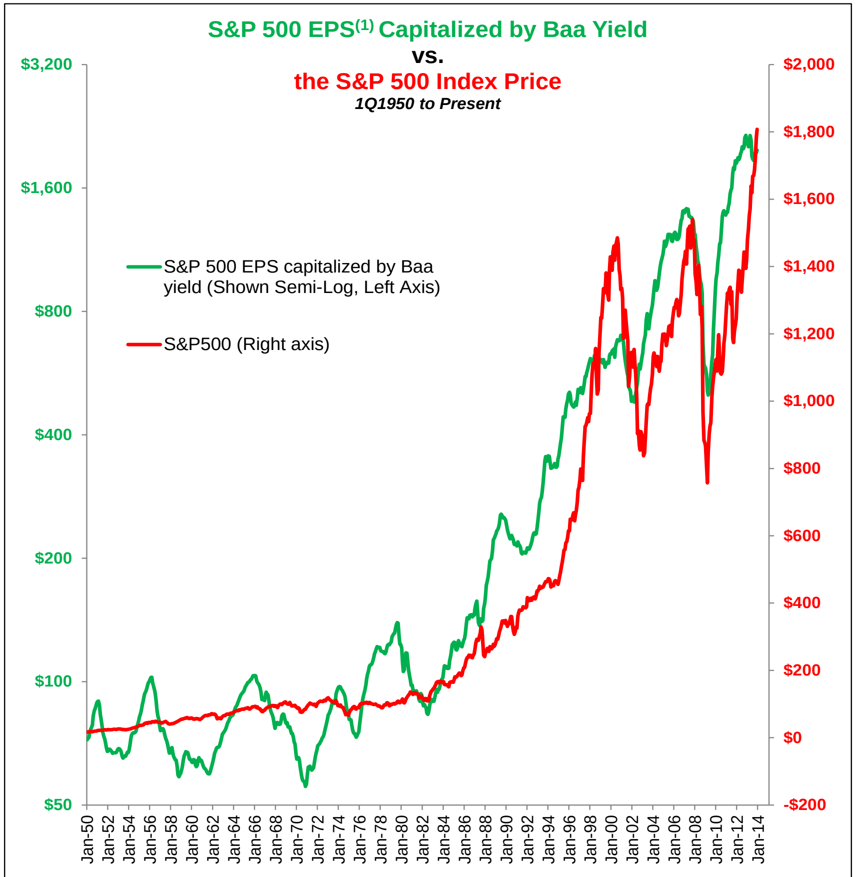
Source: Standard & Poor's, Bloomberg & Factset data, Stifel format.

(1) On 12/12/12 the S&P 500 was 1,428.48. We believe the "melt-up" already occurred since QE3.5 began 12/12/12.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

Bulls can cite corporate bond signals of favorable risk/reward. The Baa yield *relative to* the 10Y Treasury continues to plunge (left chart), and typically bottoms ~130% (ex., Baa/10Y ~5.25%/~4% = ~130%), so investors *may be ready for a rising 10Y yield.* Though S&P 500 EPS capitalized *by the Baa yield* (right chart) looks fully valued to us, perhaps the S&P 500 *could* over-shoot as has occurred in the past.





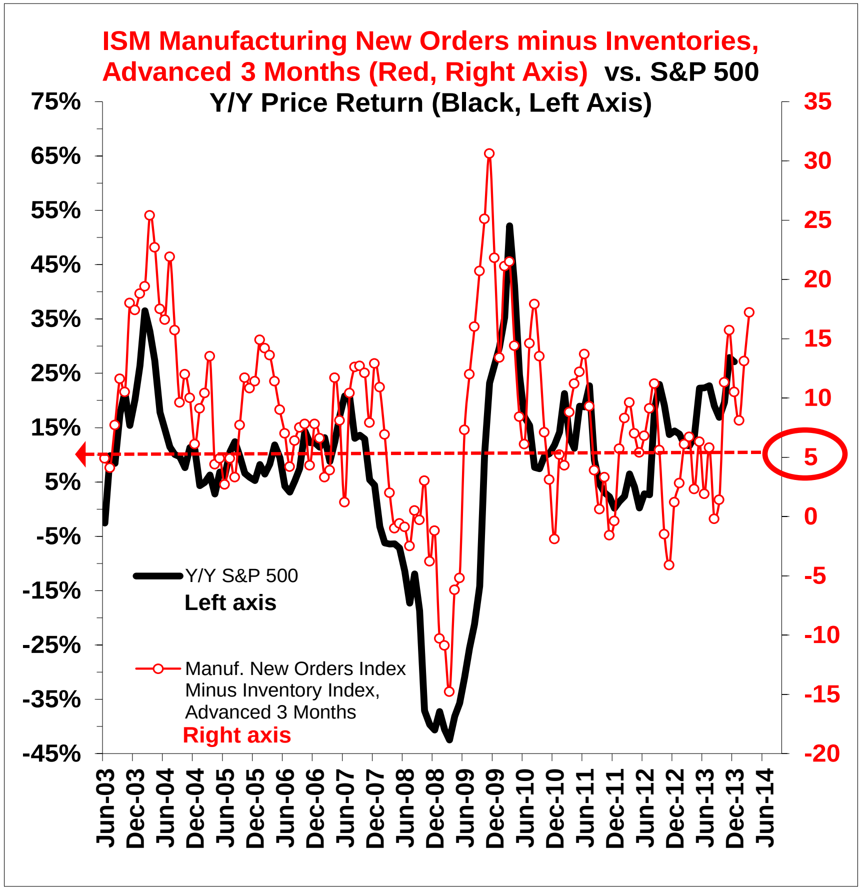
(1) Linked series: S&P 500 earnings as reported prior to 1989, operating thereafter.

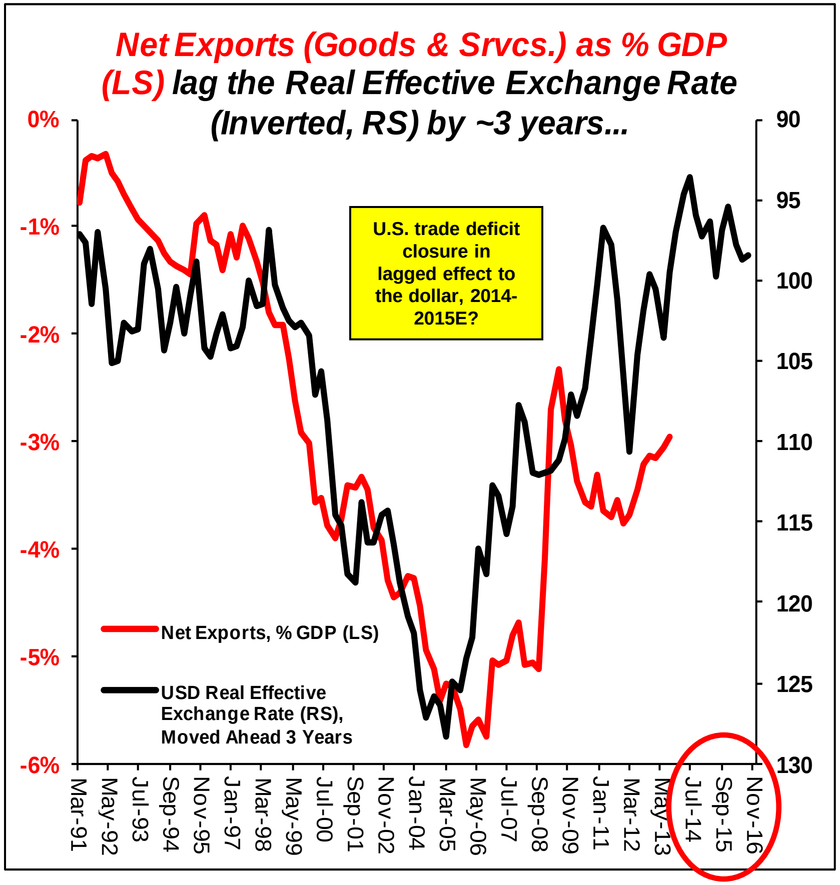
Source: U.S. Federal Reserve, U.S. BEA, Bloomberg prices, Stifel format.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

ISM may support +10% S&P 500. **We see Orders minus Inventories moderating to +5 (right axis) in 2014, which supports +10% S&P 500 (left axis, line across).**

Exports probably support the ISM **if dollar weakness helps the U.S. close its trade gap by 2016, thus validating ISM strength *ex post facto*.**



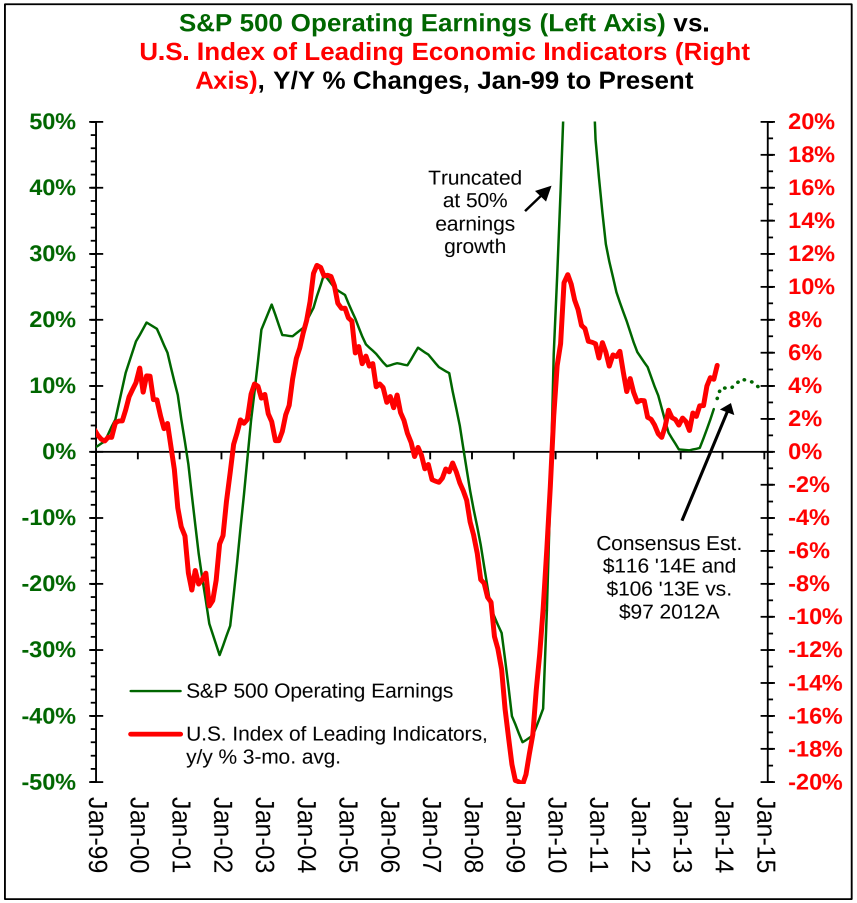


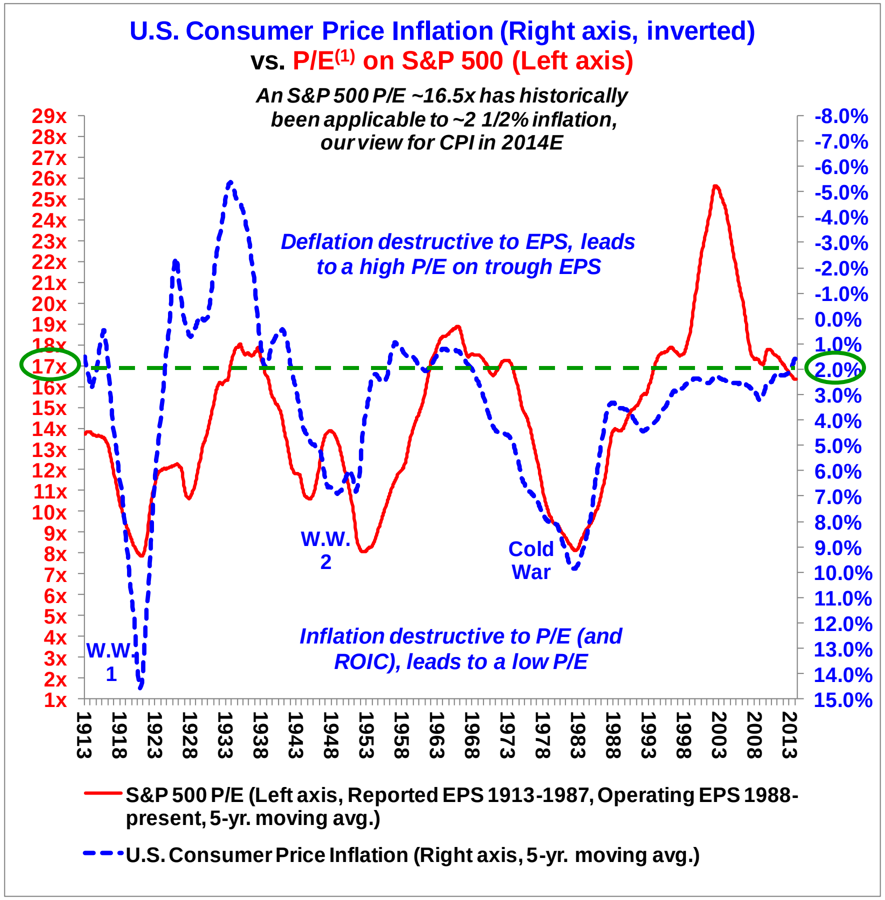
Source: Factset prices, U.S. Federal Reserve., U.S. Census CPI deflator. Standard & Poor's consensus estimates.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

The consensus sees S&P 500 EPS up almost 10%, **foreshadowed by the U.S. Leading Economic Indicator. The Street mean is 2014 EPS of $116.12 +9.3% y/y.**

Maintaining the current P/E 17x could give investors ~10% y/y in 2014. **Note that 2% inflation historically(1) supports a P/E 17x trailing EPS, so that math is +10% S&P.**





Source: Factset prices, U.S. Federal Reserve., U.S. Census CPI deflator. Standard & Poor's consensus estimates. **Updated through Dec-31, 2013.**

(1) Per Shiller data here, the P/E on TTM reported EPS has been at its high, 17.15x, ~1.0%-2.9% CPI the past 143 years (monthly data).

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

2014 U.S. Sector Strategy

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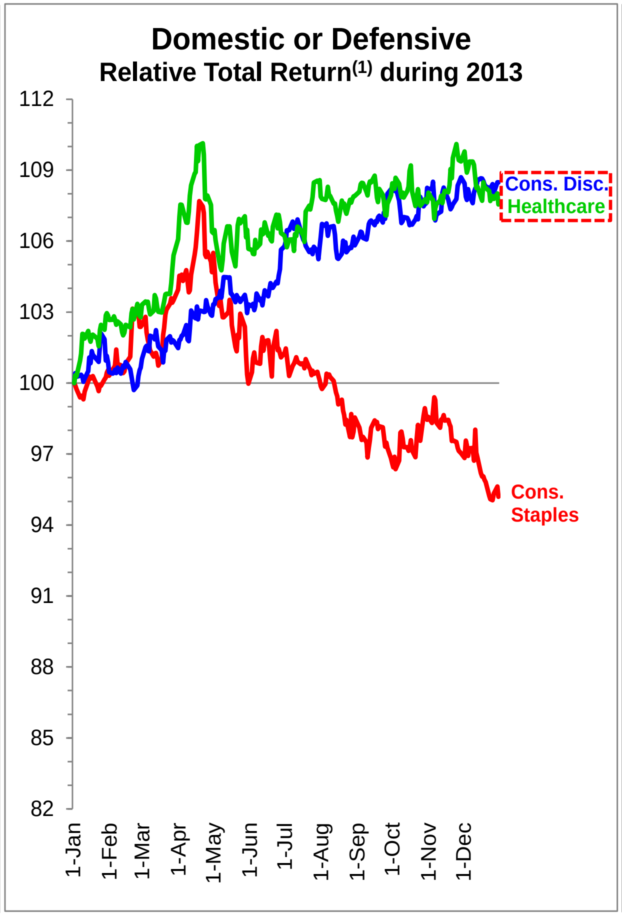
Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

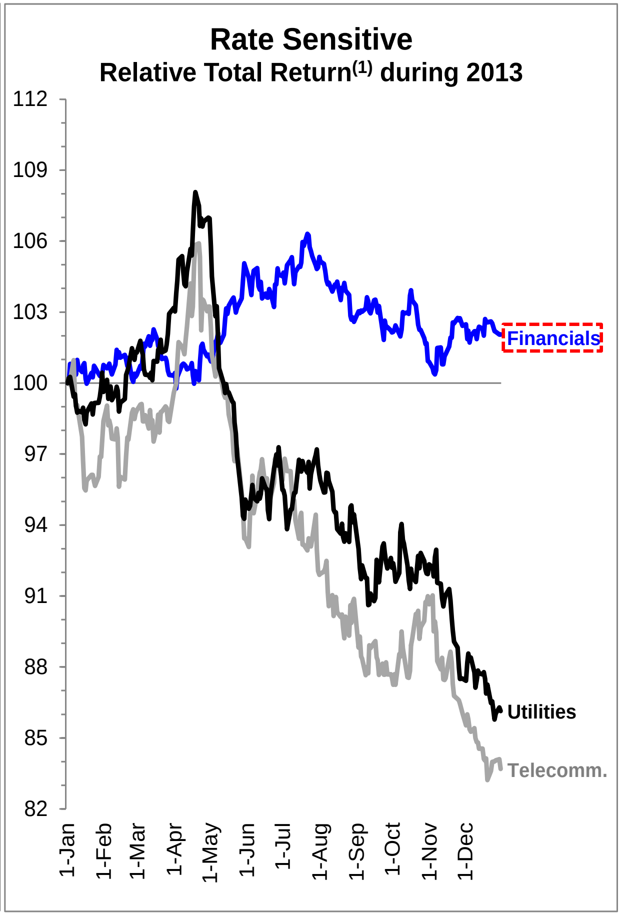
Sectors we like the next 6-9 months are circled, shorts for pairs are in squares.

Global GDP sectors: **Synchronous, reaccelerating global GDP (China growth floor, less EU & U.S. fiscal austerity) in 2014. Foreign FX rises.**

We think Domestic & Defensive sectors are expensive **(except Staples), and until there is more deflation we'll avoid safety sectors.**

For Rate Sensitive, wait. **Low loan growth and erosion of policy support undermines Financials. Not enough deflation (yet?) for yield (Utility, Telco).**





Source: S&P Sectors, Bloomberg prices. Stifel format. **Updated as of Dec-31, 2013 close.**

(1) Relative to S&P 500 Total Return index, which has returned 32.4% to Dec-31, 2013 close.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

2014 U.S. Sector Strategy

The case for Materials, Energy, Industrials & Tech in 2014

In our view:

Synchronous, reaccelerating global GDP via a China growth floor, less EU & U.S. fiscal austerity may result in a late cycle surge, supporting S&P Energy, Materials, Industrials & Technology. We think Domestic & Defensive sectors (Healthcare, Consumer Discretionary) are expensive (except Staples), and until there is more deflation we will avoid safety sectors. For Rate Sensitive, low loan growth and erosion of policy support undermines Financials, and we need to see more deflation signs to buy yield (Utility, Telco) **(Pg. 23)**

- **Energy, Tech, Industrials & Materials typically do well in the year leading up to the 1st rate hike (Pg. 25)**
- **We are optimistic about capital-for-labor substitution driving Enterprise Technology spending (Pg. 26)**
- **U.S. equity psychology has largely recovered, but commodities round-tripped the 2009 relative low (Pg. 27)**
- **We believe the G7 + BRIC LEI (weighted by fixed investment) signals commodities +15% in 2014 (Pg. 28)**
- **Forget the "secular" story, we think commodity stocks just need a "normal cycle" to bounce (Pg. 29)**
- **We watch EM equity for future commodity price and dollar direction clues, and see a trend reversal (Pg. 30)**
- **Helping commodity stocks: it isn't that we see the "dollar falling," we see "other currencies rising" (Pg. 31)**

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

Energy, Tech, Industrials & Materials typically do well in the year leading up to the 1st rate hike, and we see 2014 as a full year before any hike. **Seeing signs of economic growth, we take our risk in those four sectors (highlighted, left table). We also note that investors do not expect Fed Funds hikes until ~1Q15 as evidenced by the months to rate hike(1) and corollary 10Y-2Y Treasury yield spread (right chart).**

Ned Davis Research Study

S&P 500 Sector Performance 1-Year Leading Up to First Fed Rate Hike

		SORT 1			SORT 2
Sector	% Gain 252 Days Before	Batting Average (%)	Median Rally (%)	Median Correction (%)	Median Risk/ Reward
Energy	21.2%	88%	32.2%	-10.9%	3.0
Information Technology	21.5%	75%	38.1%	-17.5%	2.2
Industrials	14.7%	63%	27.1%	-9.4%	2.9
Materials	11.0%	50%	27.8%	-14.0%	2.0
Consumer Staples	7.9%	50%	22.0%	-11.1%	2.0
Health Care	8.6%	38%	30.0%	-17.1%	1.8
Telecom. Services	7.2%	38%	21.6%	-13.7%	1.6
Consumer Discretionary	9.9%	38%	20.2%	-16.2%	1.2
Financials	6.4%	25%	22.9%	-14.2%	1.6
Utilities	1.3%	13%	15.9%	-13.3%	1.2

Date of first Fed rate hike: 8/31/77, 9/26/80, 4/9/84, 9/4/87, 2/4/94, 3/25/97, 6/30/99, 6/30/04; based on Fed Funds target rate since 1989, Discount Rate prior. S&P 500 median performance = 12.6%. Batting Average = % of cases outperforming S&P 500, price-only.
Sources: S&P Index Alert, Ned Davis Research Group.

Months to First Fed Funds Rate Hike(1) (Left) vs.
10-Yr. minus 2-Yr. Treasury Yields (Inverted, Right)

Source: Ned Davis Research report (May 31, 2013) *"Rising Interest Rates & Sector Themes"*

(1) Per Bloomberg, months until 30-day Fed Funds futures rise above 0.25%.

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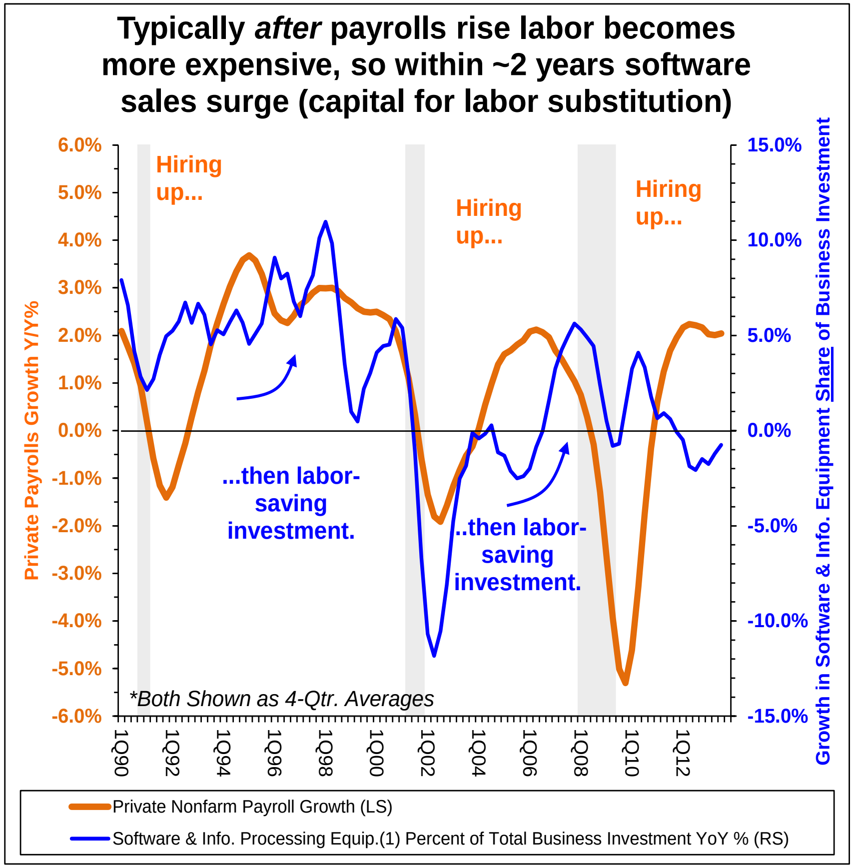
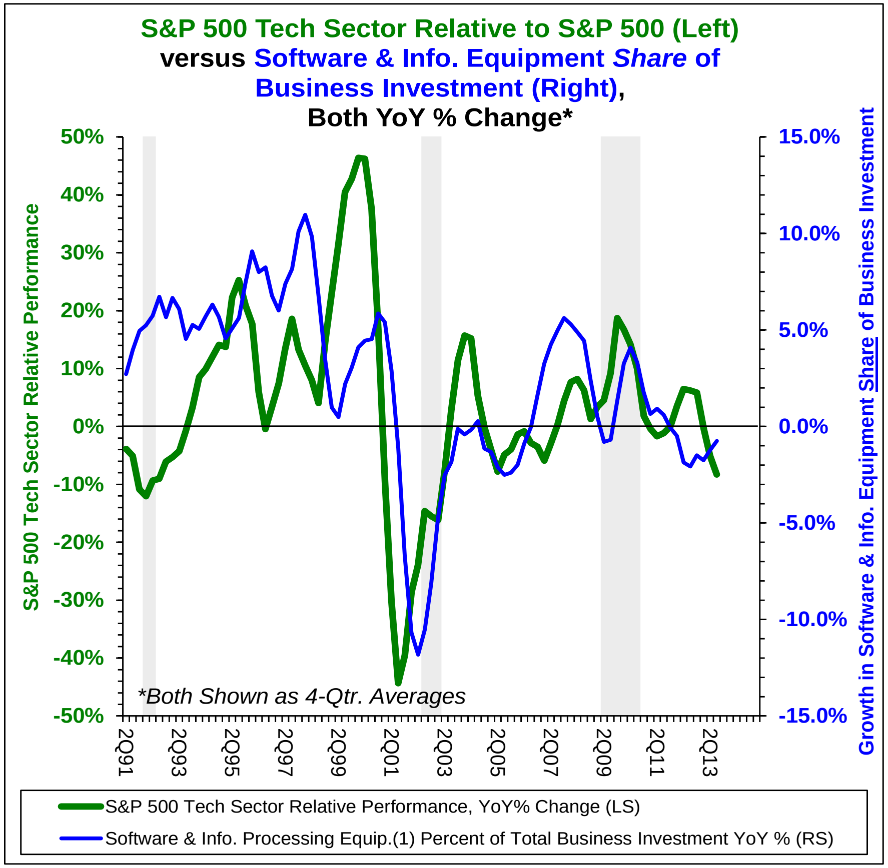
Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

We are optimistic about Business & Enterprise Technology spending. Cheap capital allows for capital → labor substitution by business. As labor recovers very late cycle (left chart), quite normal in a balance sheet recession, Enterprise Tech may turn up late cycle. This should eventually lift Technology stocks, in our view (right chart).





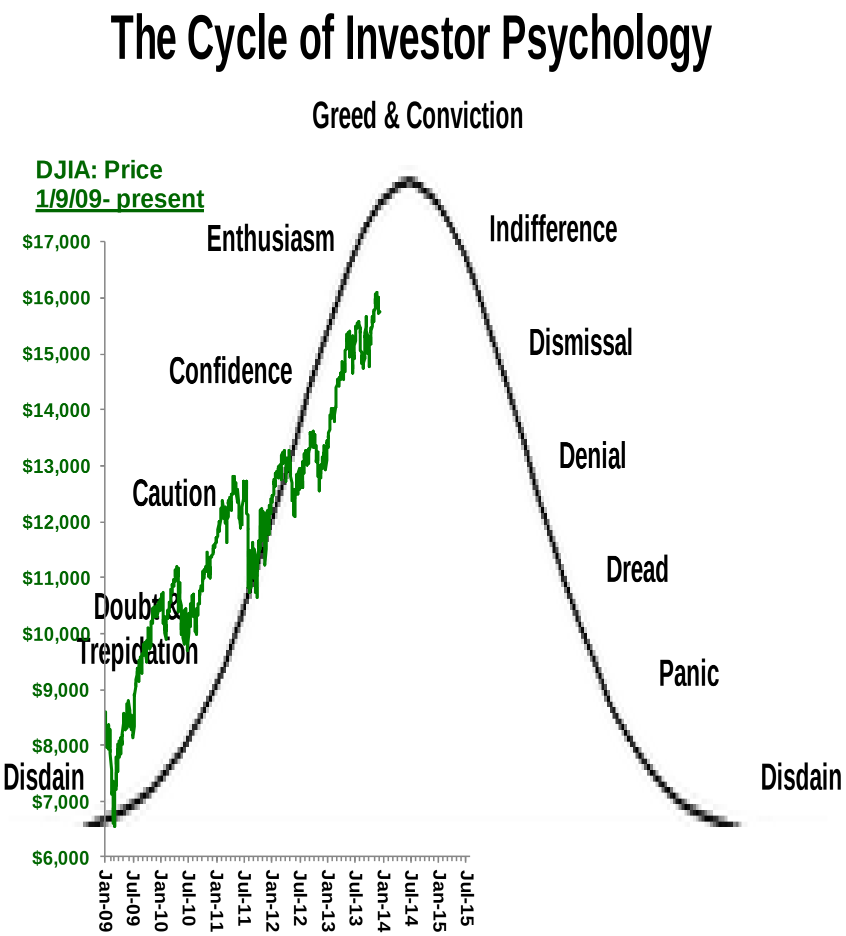
Source: U.S. Bureau of Economic Analysis, China Bureau of Statistics. Stifel format.

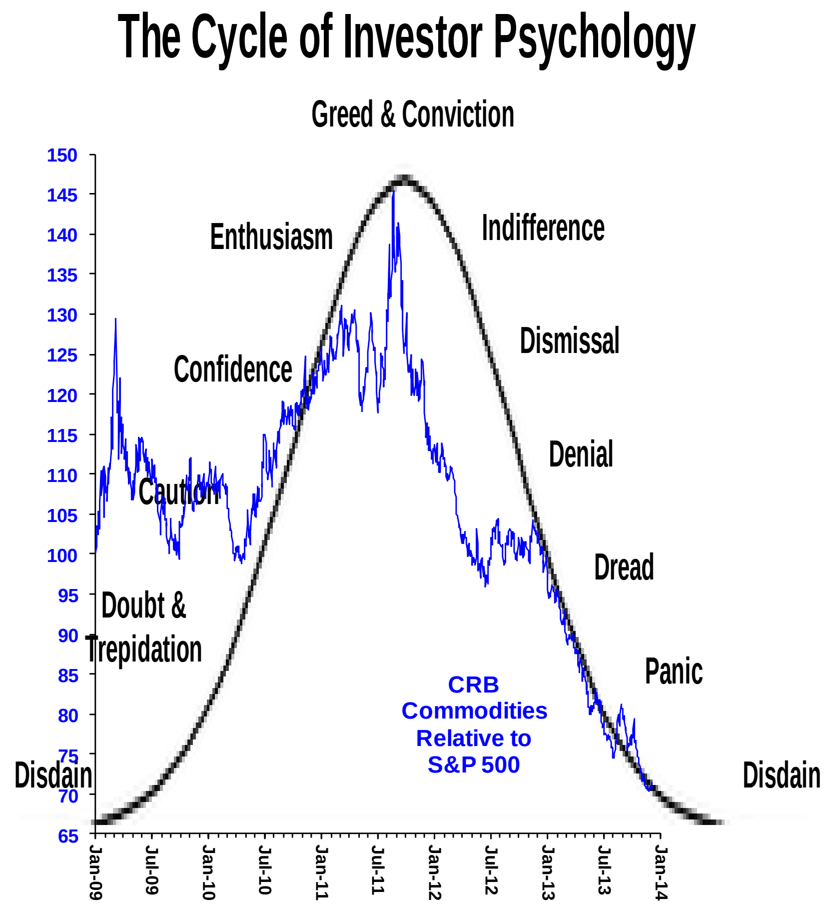
(1) Includes all information processing equipment, namely computers, medical and nonmedical instruments, and equipment relating to photocopy, office, accounting, computer-peripheral & communication.

Barry B. Bannister, CFA Stifel Equity Strategy *bbbannister@stifel.com*

U.S. equity investor psychology has largely recovered, **in our view, having progressed since the 1Q09 low from "Disdain" for stocks to "Enthusiasm."**

***But we think commodities (and related stocks) may be the other side of the trade*, attractive having *round-tripped* the "Disdain" stage since 1Q09.**

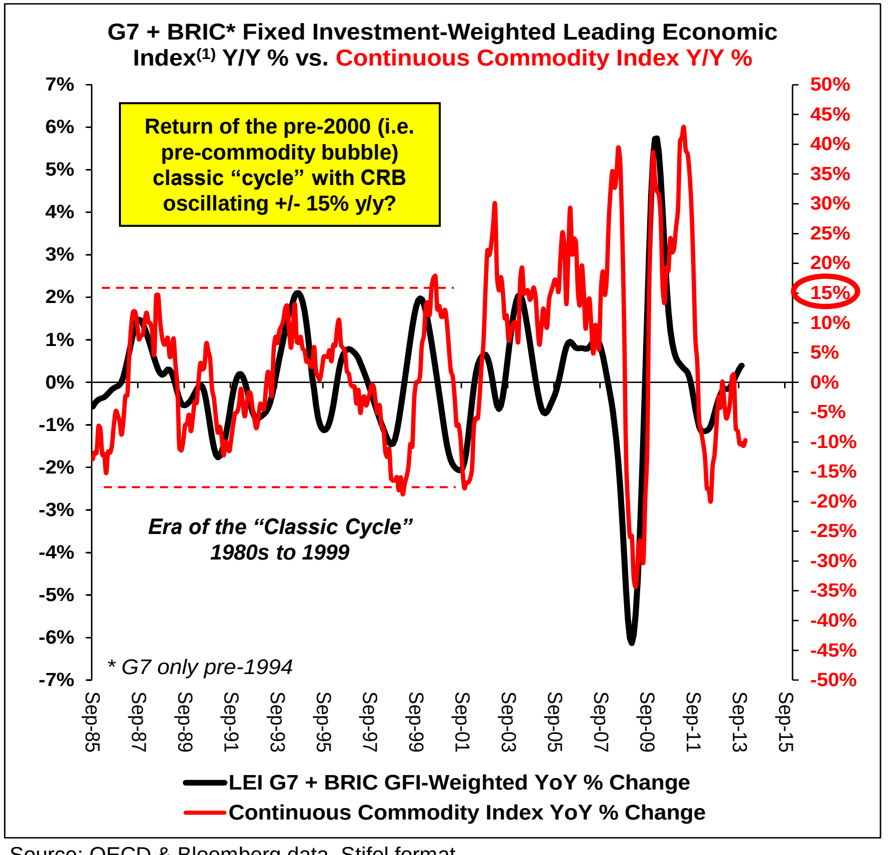


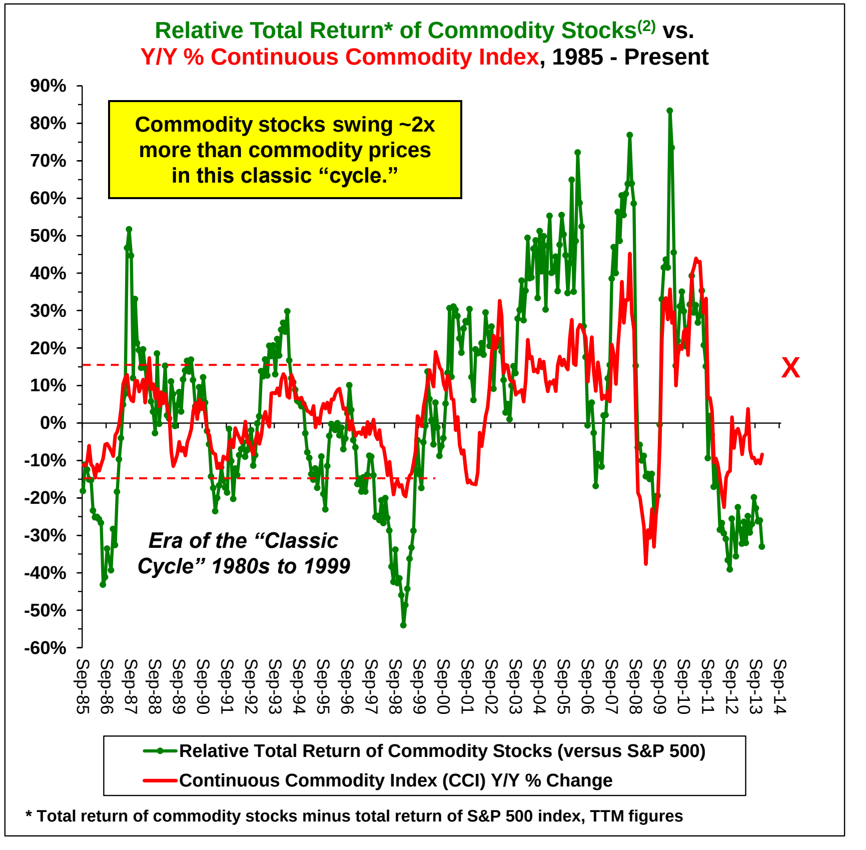


Source: Stifel adaptation chart, Bloomberg prices, Stifel format and conclusions.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

We believe the Leading Economic Indicators (LEI) signal commodities +15% y/y in 2014, perhaps lifting commodity-equities sharply. The G7 + BRIC LEI[(1)] *weighted by each country's fixed investment* (left chart) may foreshadow the Energy, Materials & Industrial stocks[(2)] (right chart) bouncing sharply higher in 2014, in our view.





Source: OECD & Bloomberg data. Stifel format.

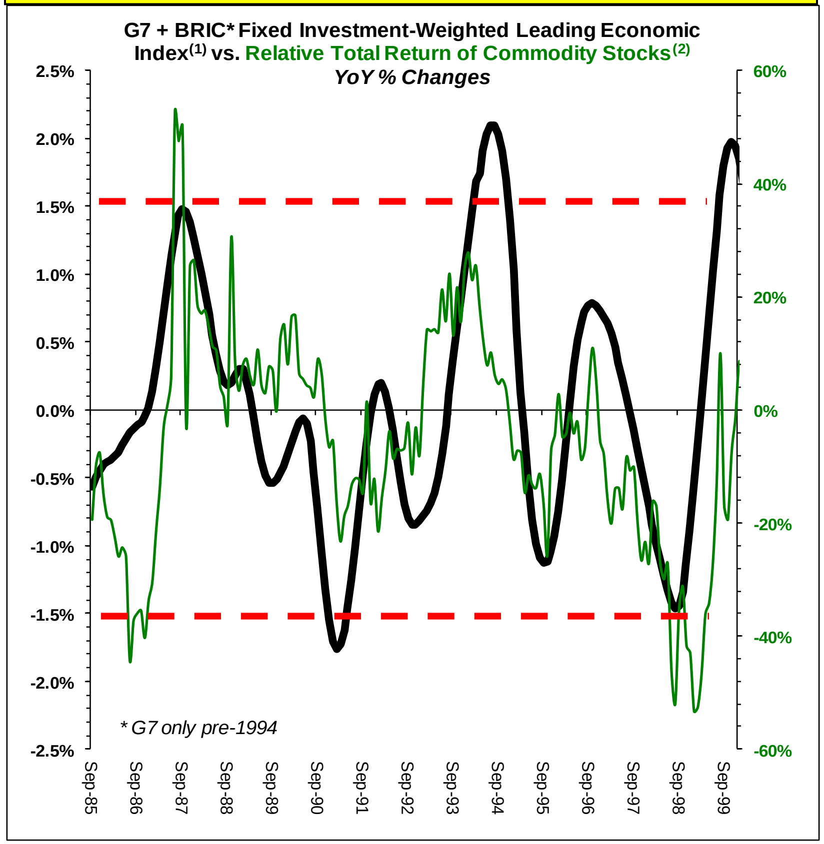
(1) Equal-weighted composite average of G7 (G7 only pre-1994) + BRIC (Brazil, Canada, China, France, Germany, India, Italy, Japan, Russia, United Kingdom & United States) Amplitude Adjusted CLI's (source: OECD). In the Appendix of this report we provide some background on the current state of global GDP growth.

(2) Commodity industry/producer index is as follows: For the period 1985-2013 Caterpillar (CAT), Deere & Co. (DE), Cliffs Natural Resources (CLF), Newmont Mining (NEM), Schlumberger (SLB) and Apache Corp (APA). Also, Phelps Dodge (PD) and Freeport-McMoRan (FCX) separately 1985-2007 and as FCX following the 2007 merger, Anadarko Petroleum Corp. (APC) after 1987. Joy Global (JOY), Fluor (FLR) and Peabody Energy (BTU) after 2001 and Bucyrus (BUCY) 2004-2010.

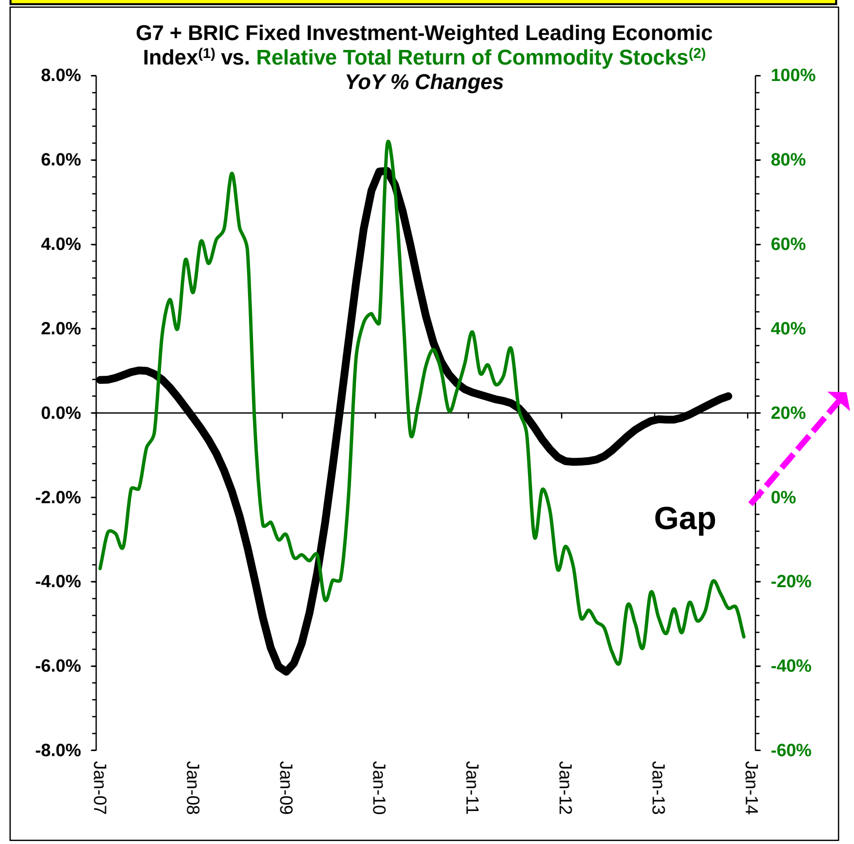
Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

Forget the "secular" story, we think commodity stocks just need a "normal cycle" to bounce. The 1985-1999 period (left chart) featured "normal" commodity cycles that pre-dated the Commodity Bubble of 2000-2011. But commodity stocks look cheap (right chart, gap) if a "normal" commodity cycle begins (right chart).

Aug-85 to Dec-99



Jan-07 to Present



Source: OECD & Bloomberg data. Stifel format.

(1) Equal-weighted composite average of G7 (G7 only pre-1994) + BRIC (Brazil, Canada, China, France, Germany, India, Italy, Japan, Russia, United Kingdom & United States) Amplitude Adjusted CLI's (source: OECD). In the Appendix of this report we provide some background on the current state of global GDP growth.

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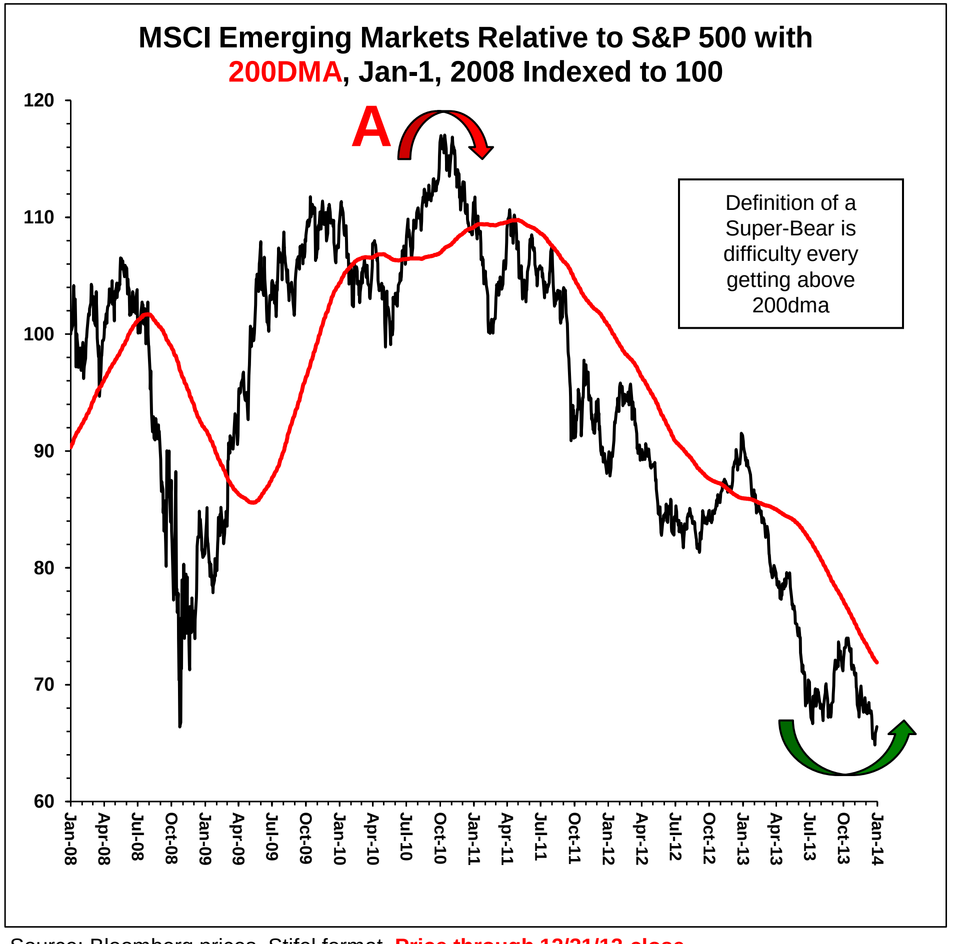
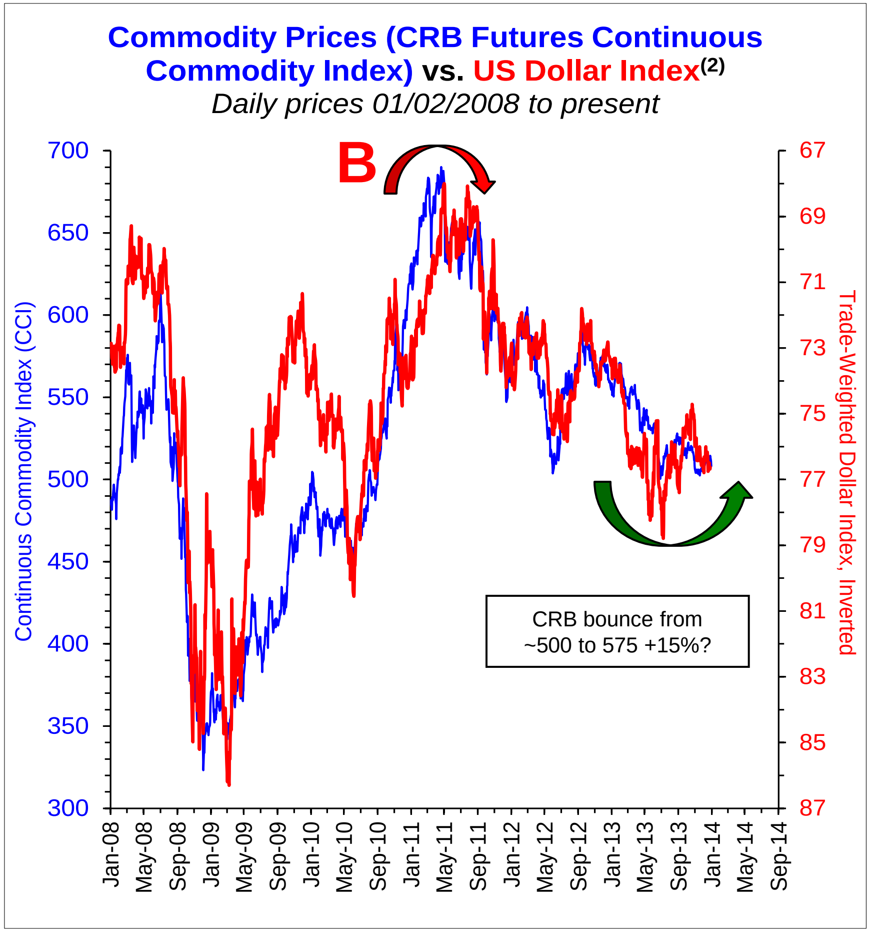
Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

We watch EM equity and FX for commodity price clues. **The EM major bear market[(1)] began 4Q10 ("A" below, left), and CRB Commodities rolled over 6 months later ("B" below, right). So we watch whether EM equity relative to the S&P 500 (left chart) pierces the 200 day moving average and the CRB bounces/U.S. dollar weakens (right chart).**



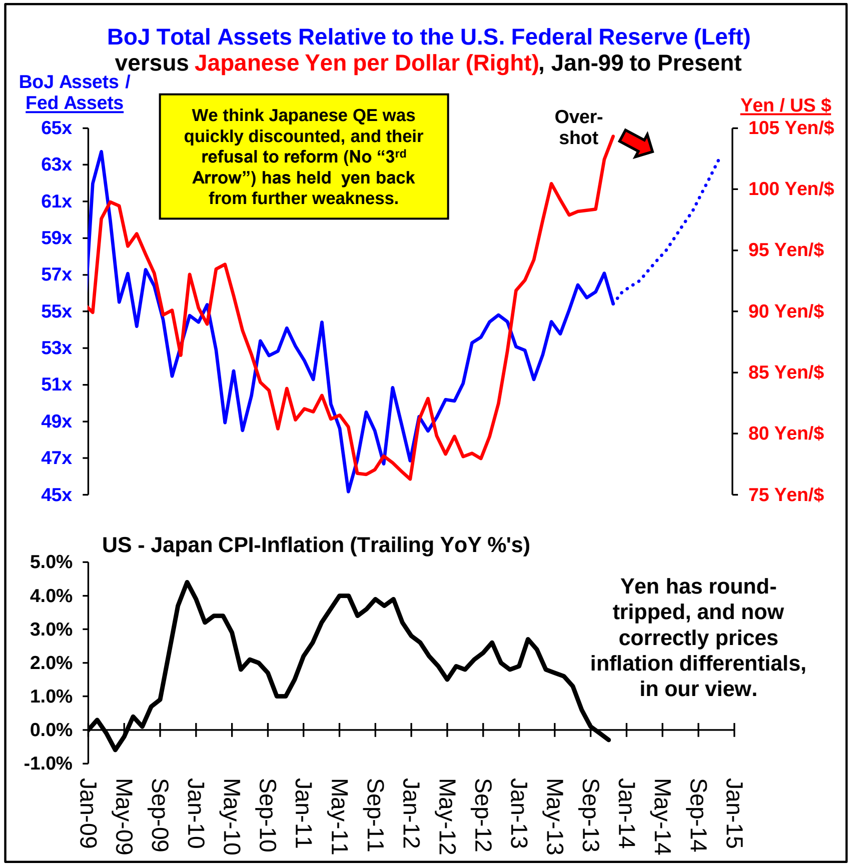


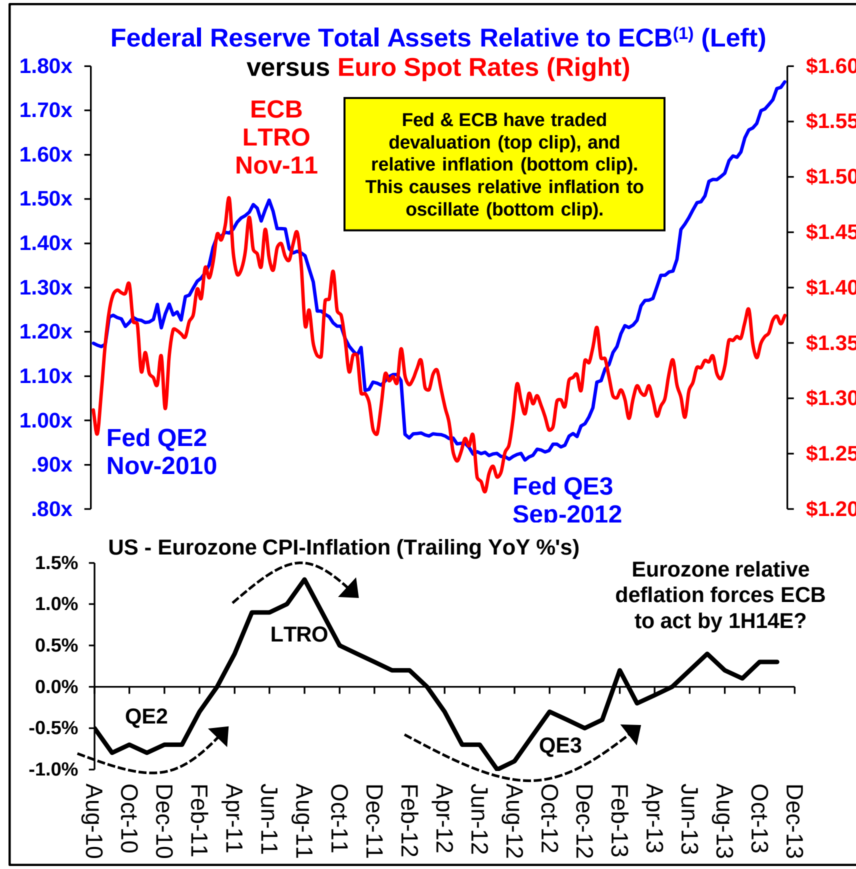
Source: Bloomberg prices, Stifel format. **Price through 12/31/13 close.**

(1) Severe equity bears markets throughout history uniformly feature significant difficulty reaching or exceeding the 200 day moving average (red line, left chart).
(2) CRB CCI is equal-weighted and 17 commodities (metals, agricultural, hydrocarbon and other). U.S. Dollar is the trade-weighted major currency index series (Mar-73=100).

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

Commodity stocks usually need a weaker dollar, and it is not that we see the "dollar falling," we see "other currencies rising." **The BoJ(1) may nix additional QE, so yen may stop weakening (left), and we believe even tapered QE(2) keeps the euro up, deflating Europe (right) until the recalcitrant ECB is forced to creatively stimulate.**





Source: U.S. Fed, Bank of Japan, Bloomberg, Stifel format.

(1) BoJ plans to double base money by Dec-2014 through purchases of JGBs, CP, corp. bonds, ETFs, J-REITs & loan support, bringing total assets of the BoJ to an anticipated 220 trillion (T) yen by year end 2013 and 290T by 2014, equating to about ~5.6T yen / mo. or ~$56.1B (we assume yen flat ~100 Yen/USD for illustrative purposes in the chart). For ECB assets, assumes unwinding of 3-yr. LTRO's consistent with average pace of repayment thus far, ex. initial eligibility repayments. Currency, like oil, is globally traded, so it is the absolute amount of QE versus other central banks that drives exchange rates, in our view.

(2) Assumes Fed QE reduced $10B Dec-2013, then ~$20B on Mar-2014, Jun-2014, Sep-2014 & Dec-14 (i.e., timed around opportunities for the Fed Chairman to speak).

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

2014 U.S. Sector Strategy

The opposing case to our view that favors Healthcare, Consumer Discretionary & Financials in 2014 (or is against Commodity stocks)

With respect to the case presented, in our view:

- **A falling U.S. trade deficit could prolong current S&P Healthcare, Consumer & Financials leadership (Pg. 33)**
- **As for Tech stocks, as long as labor is cheap enterprise capex on technology may be low (Pg. 34)**
- **With the commodity "Super-Cycle" over[1] investors may simply avoid commodity stocks entirely (Pg. 35)**
- **Broad money supply growth of ~4%-5% (today) supports a flat decade for commodities (Pg. 36)**
- **Weak commodities may be getting a jump on 2015 Fed rate hikes (which may undermine commodities) (Pg. 37)**

(1) The commodity "Super-Cycle" ending was a call we made in Spring 2011 here.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

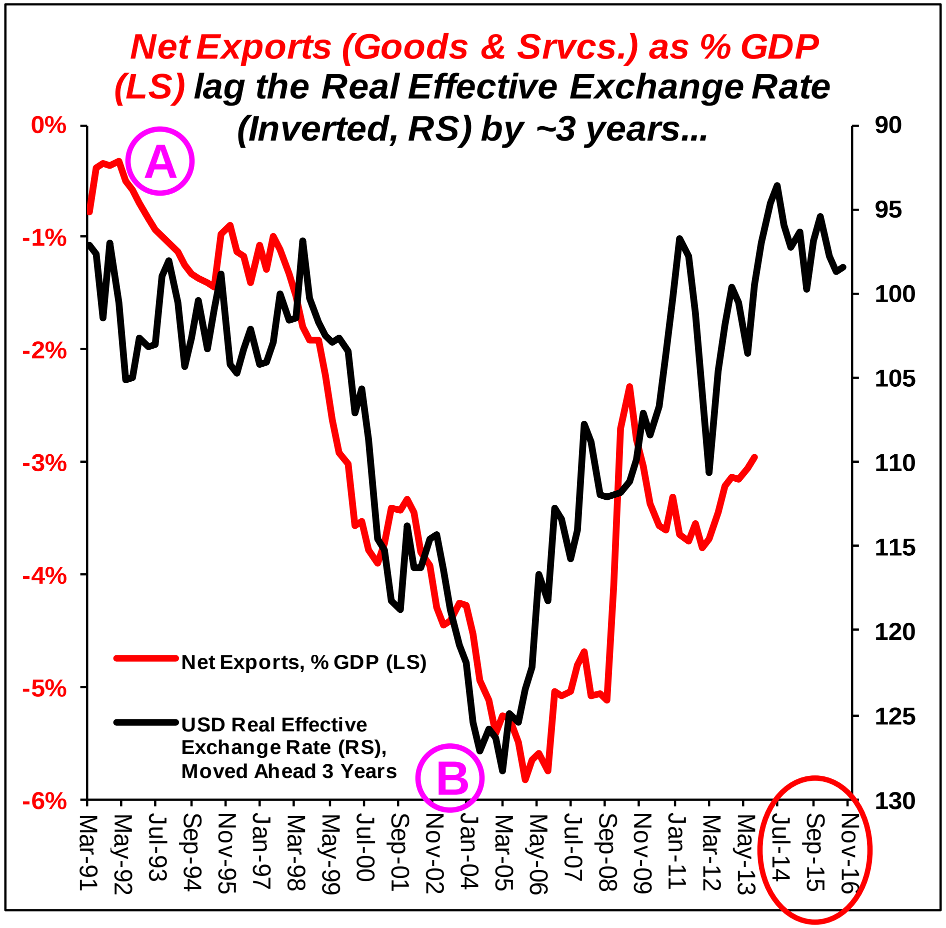
In a counter-point to our sector picks, a falling U.S. trade deficit could prolong current S&P Healthcare, Consumer & Financials leadership through 2015. The dollar inverted and _moved ahead 3 years_ aligns with the trade gap. Trade gap closure lifts disinflation sectors(1) and typically hurts commodity stocks (Point "A") and may again by 2015. In contrast, commodity stocks do best in wide trade gaps (point "B").

(Point "A")

Sector Total Returns 2 Years Leading Up to Feb-92 Trade Deficit Trough	
Health Care	81.5%
Consumer Staples	77.6%
Consumer Disc	39.1%
S&P 500	33.0%
Financials	29.9%
Industrials	26.5%
Materials	25.6%
Utilities	20.0%
Info Tech	18.8%
Energy	4.6%
Telecom	4.1%

(Point "B")

Sector Total Returns 2 Years Leading Up to Oct-05 Trade Deficit Peak	
Energy	93.3%
Utilities	53.7%
Industrials	23.7%
Materials	20.5%
Telecom	20.4%
S&P 500	19.0%
Financials	17.7%
Consumer Staples	14.4%
Health Care	11.5%
Consumer Disc.	7.9%
Info Tech	4.5%



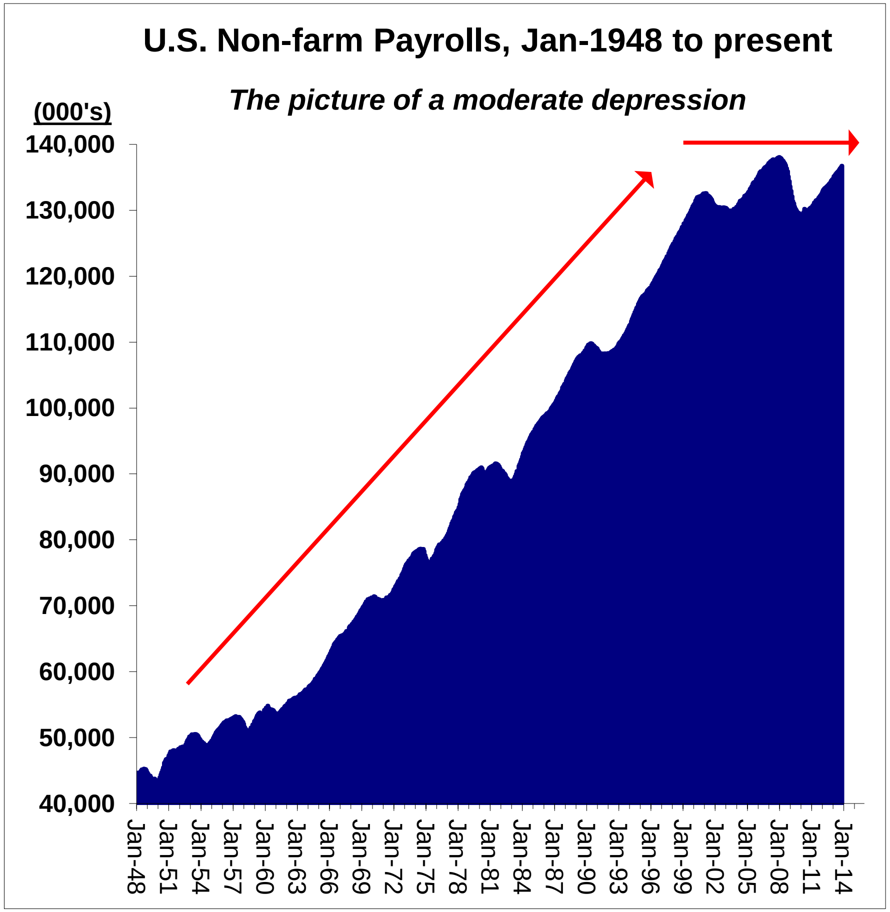
Source: Bloomberg data, Stifel format.

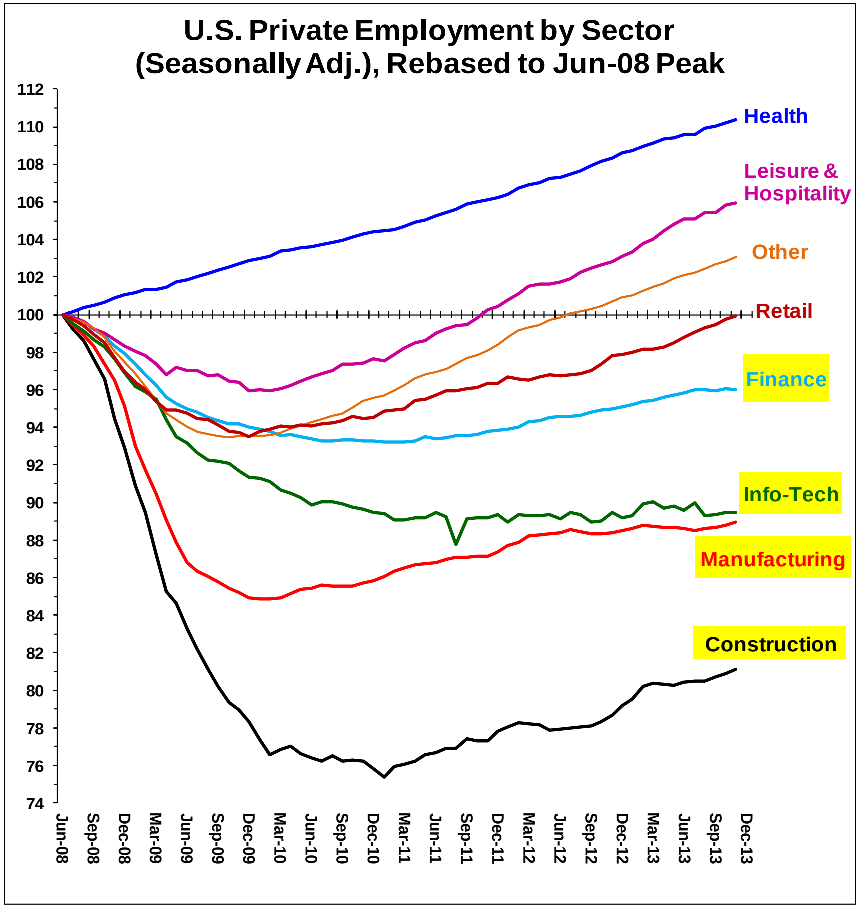
(1) Earlier in this report we provided substantial detail on sluggish credit and the disinflationary (or deflationary) pressure that creates. Also, EM ex-China runs a current account deficit, so US improvement could lead to a self-reinforcing cycle of reduced inflows to the EM in total and worsening EM current accounts in aggregate.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

As for Tech stocks, as long as labor is cheap enterprise capex may be low. **Payrolls flat ~13 years is a "Depression," essentially a '30s Depression replay.**

Capex and Tech. **Due to soft labor markets in the "capital/capex" economy we may not see wage pressure (or Tech capital for labor substitution) in 2014.**

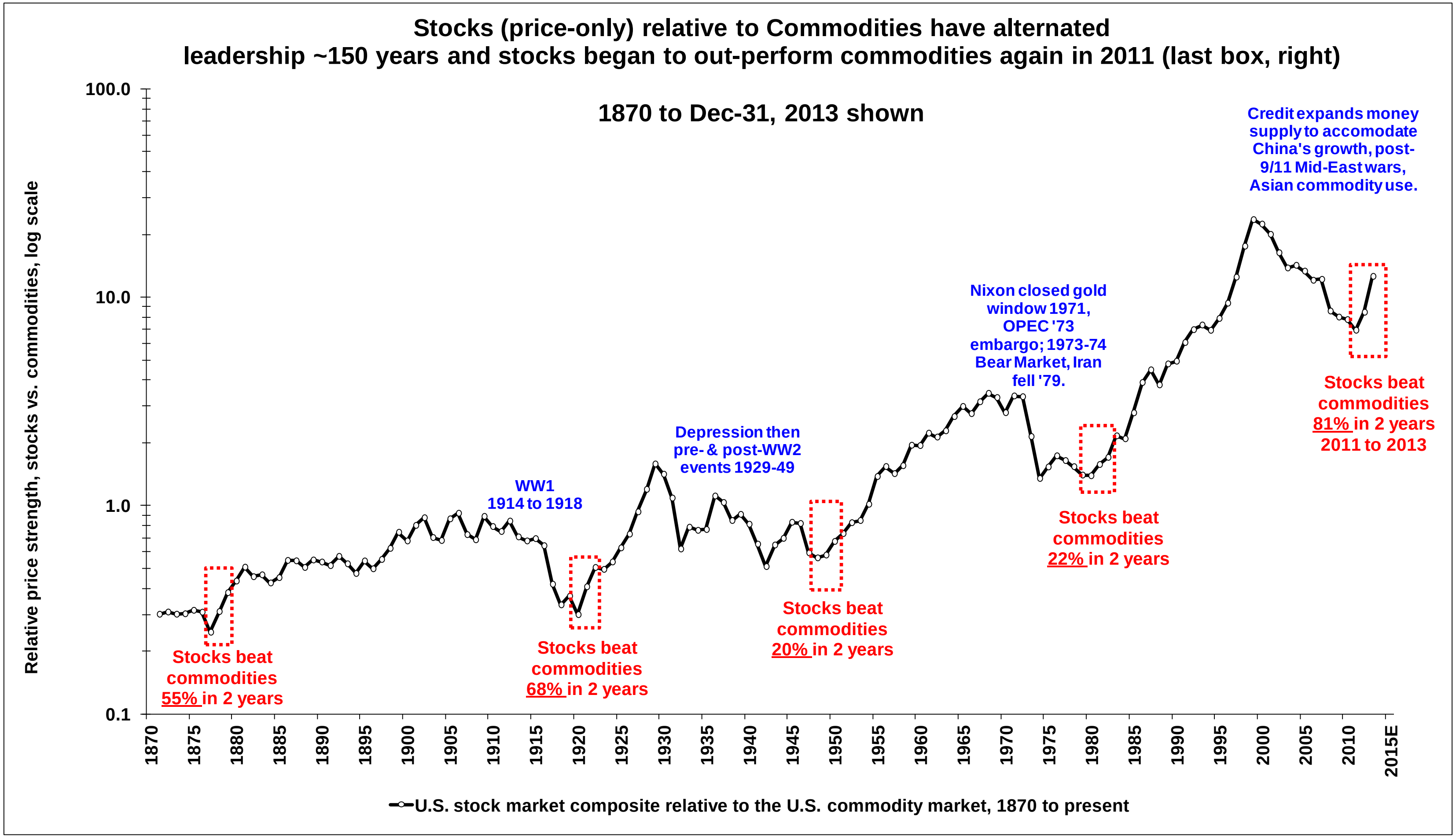




Source: Bureau of Economic Analysis, Stifel estimates.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

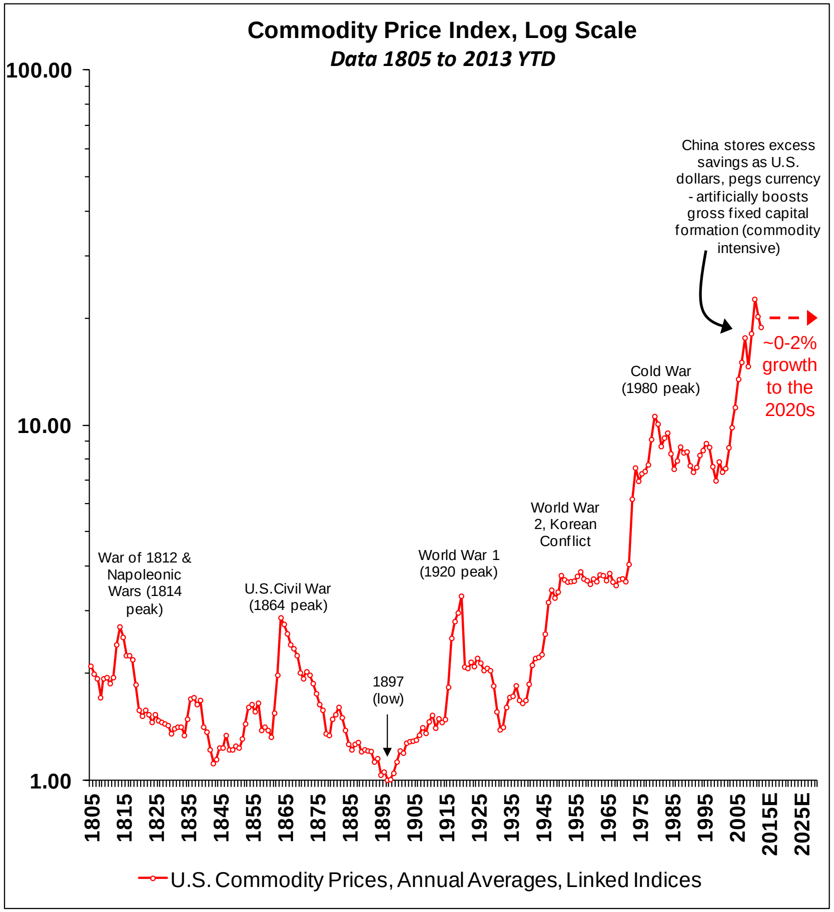
With the commodity "Super-Cycle" over, a call we made in Spring 2011 here, investors may just choose to avoid commodity stocks entirely. **But extreme S&P 500 out-performance versus commodities compared with past rotations (boxes) may support commodities bouncing relative to the S&P 500 in 2014, in our view.**

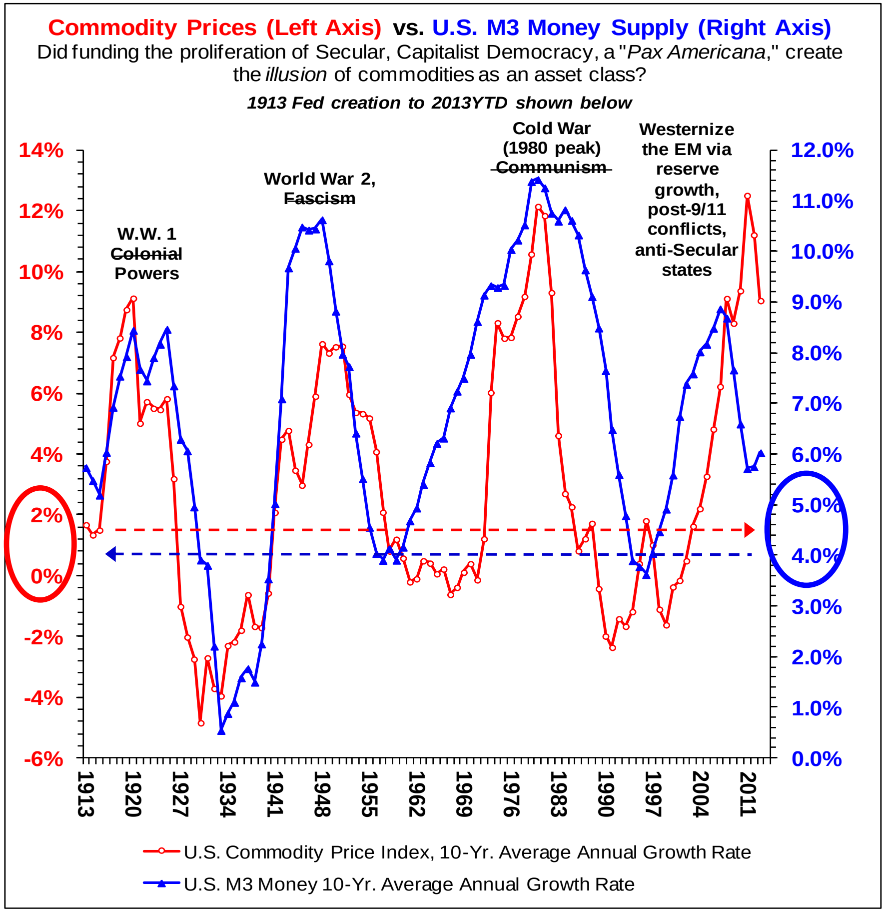


Source: Stifel format. S&P, 1870 to 1913 is the WPI for Commodities from the BLS and other agencies. 1914-56 is the PPI All Commodities, and 1957-present is the CRB Continuous Commodity Index, now an equal-weighted index of 17 commodities including most high-use energy & agricultural commodities.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

***Low money supply growth = flat decade for commodities, eroding investor interest (note: we just see a strong commodity bounce not a bull market)*. Fiat money is used to win conflicts (right chart, including China[1]). Absent conflict, commodities may rise 0%-2% at M3 growth of 4%-5% (circles).**





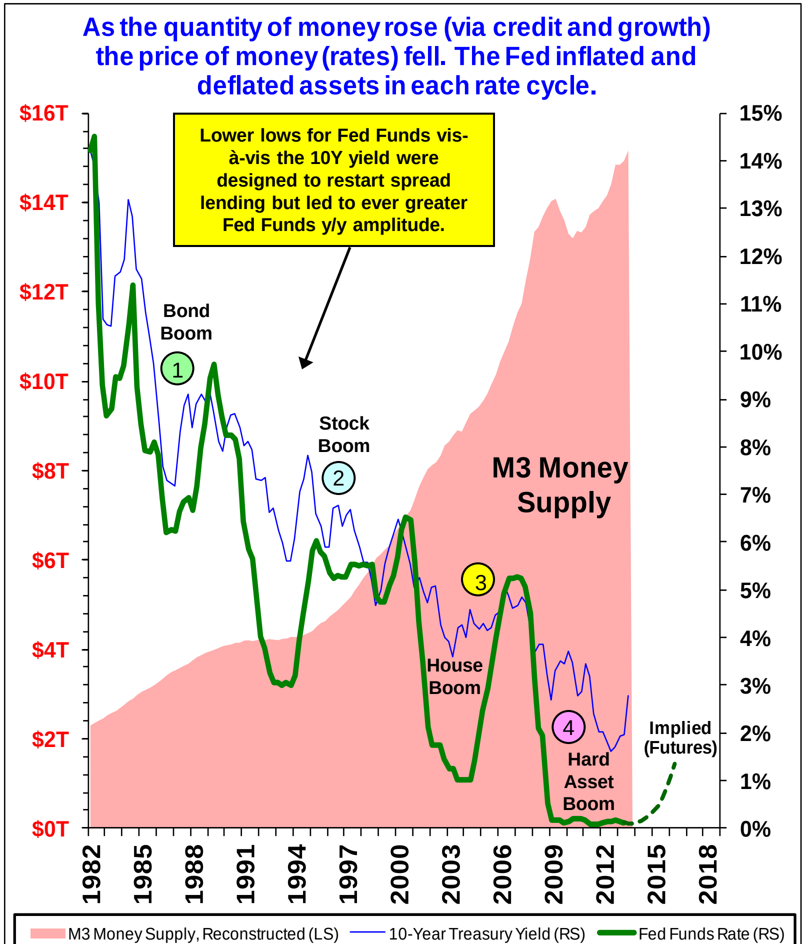
Source: U.S. Census Bureau. Commodities 1805 to 1956 is the PPI for All Commodities, and 1957 to present is the CRB Continuous Commodity Index, currently an equal-weighted index of 17 commodities including energy and agricultural. Annual values are the average of CRB CCI values for each month, except for the latest decade, which considers all individual trading days of the year. For M3 1897-1958 we use M1 + vault cash + monetary gold stock + bank time deposits + mutual savings bank deposits + S&L deposits. From 1959-2005 the Fed reported M3 (SA). For 2006-Current we use: M2 + large time deposits + institutional money market + Reverse repos with non-banks + interbank loans + eurodollars (regression-derived).

(1) Under a classical gold standard Chinese growth would *not* have been possible because RMB currency appreciation would have slowed Chinese GDP and U.S. credit would not have been available to recycle Chinese savings. We believe that only by having the ability to "store" growth within a fiat dollar was China able to grow at that pace and become a capitalist country.

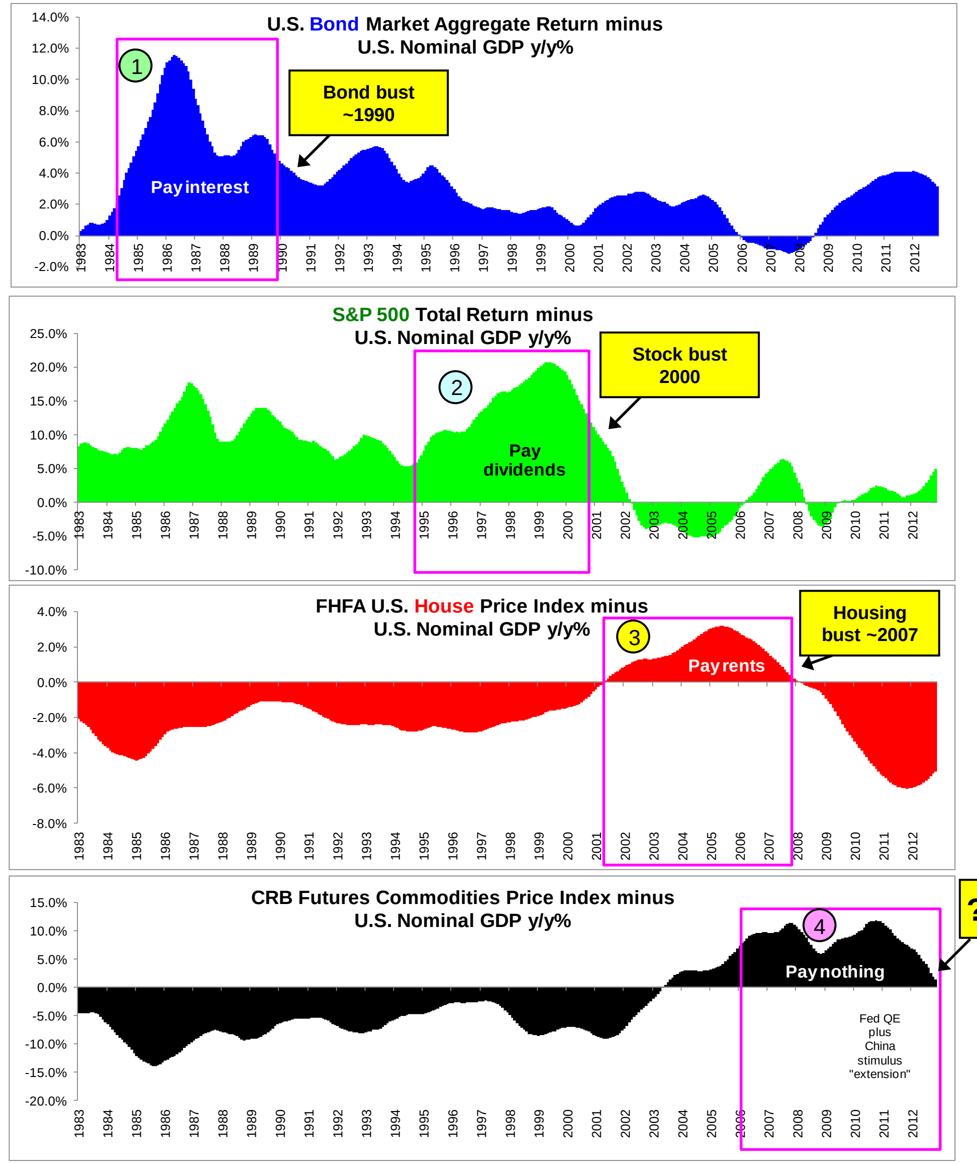
STIFEL

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

Are commodities getting a jump on 2015/16 rate hikes? **Fed hiking from 15bps→150bps is a 10x increase (left chart), perhaps crippling commodity prices/countries (right chart). We just think it is too early to discount rate hikes.**



Asset booms rolled downhill in order of income characteristics.



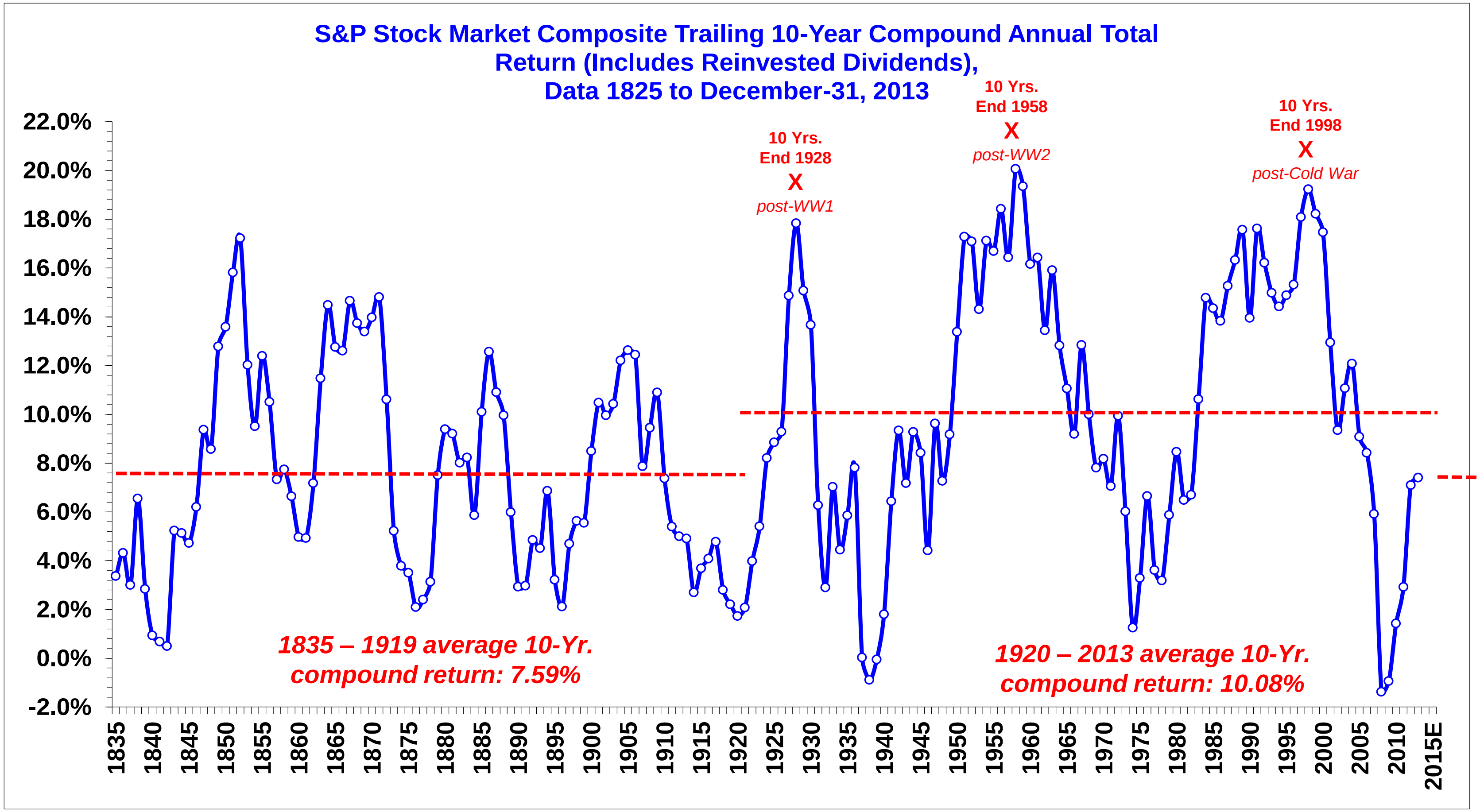
Source: Factset, Bloomberg/Standard & Poor's, Stifel format.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

The Decade Ahead for the S&P 500

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

Back to the future, ~7%/year total return? A reflationary bias after W.W. I (second half of chart) and low post-war valuation starting points led to three mega-bull market peaks (see red "X" marks) followed by busts since ~1920. But we think an era of de-leveraging, global rebalancing, productivity and low population growth going forward may resurrect pre-1920 (left half) ~7% average annual returns.



Source: Data from *"A New Historical Database for the NYSE 1815 to 1925: Performance and Predictability,"* Yale University used with permission, Post-1925 data for stocks are Ibbotson/Morningstar and S&P large-cap equity. Stock market returns include dividends. Chart format and annotations Stifel.

Barry B. Bannister, CFA Stifel Equity Strategy *bbbannister@stifel.com*

The Decade Ahead for the S&P 500

The case for a 7%/yr. S&P 500 total return through 2023E

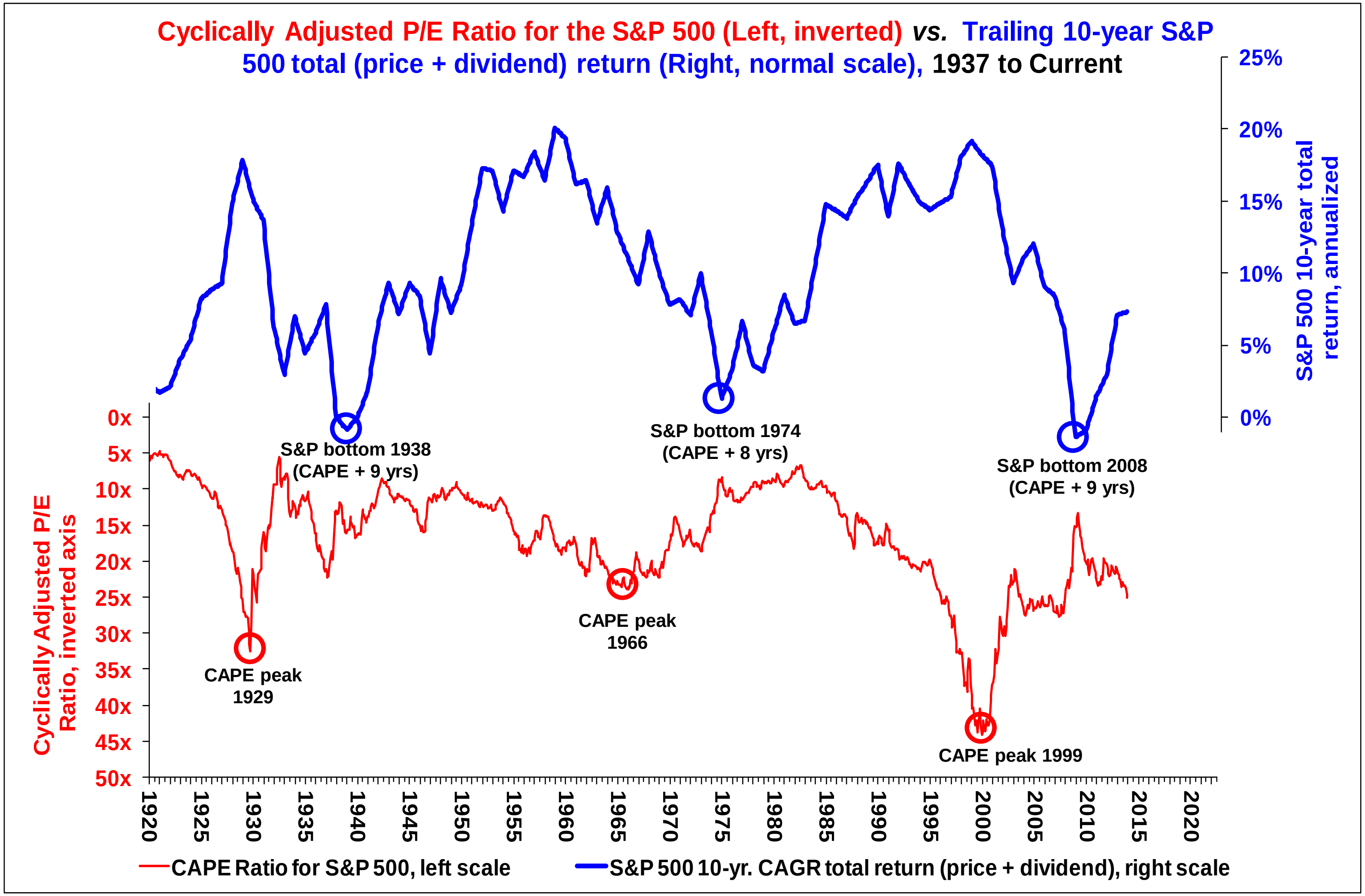
In our view:

We think an era of de-leveraging, global rebalancing, productivity and low population growth may resurrect an era of ~7% average annual nominal returns (and close to that level in real terms given low inflation) for the S&P 500. Contrast that with post-1920, in which world wars/struggles and the use of fiat money in those conflicts caused the average S&P 500 nominal total return to exceed 10% of which ~3% was inflation. Not seeing struggles on the scale of world war or the peaceful development of China since ~1993, we see ~7% annual total returns going forward **(Pg. 39)**

- **Cyclically adjusted P/E (CAPE) weakness "predicts" the S&P 500 return ~ 9 years ahead** **(pg. 41)**
- **Moving the CAPE forward 9 years signals an S&P 500 total return of ~7%/yr. 2013 to 2023E** **(Pg. 42)**

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

A plunging cyclically adjusted P/E (CAPE) "predicts" a ~0% total return for the S&P 500 ~ 9 years ahead. As for 2013 to 2023E *(see next page)…*



Source: Shiller historical data, Standard & Poor's as reported earnings data, Stifel estimates.

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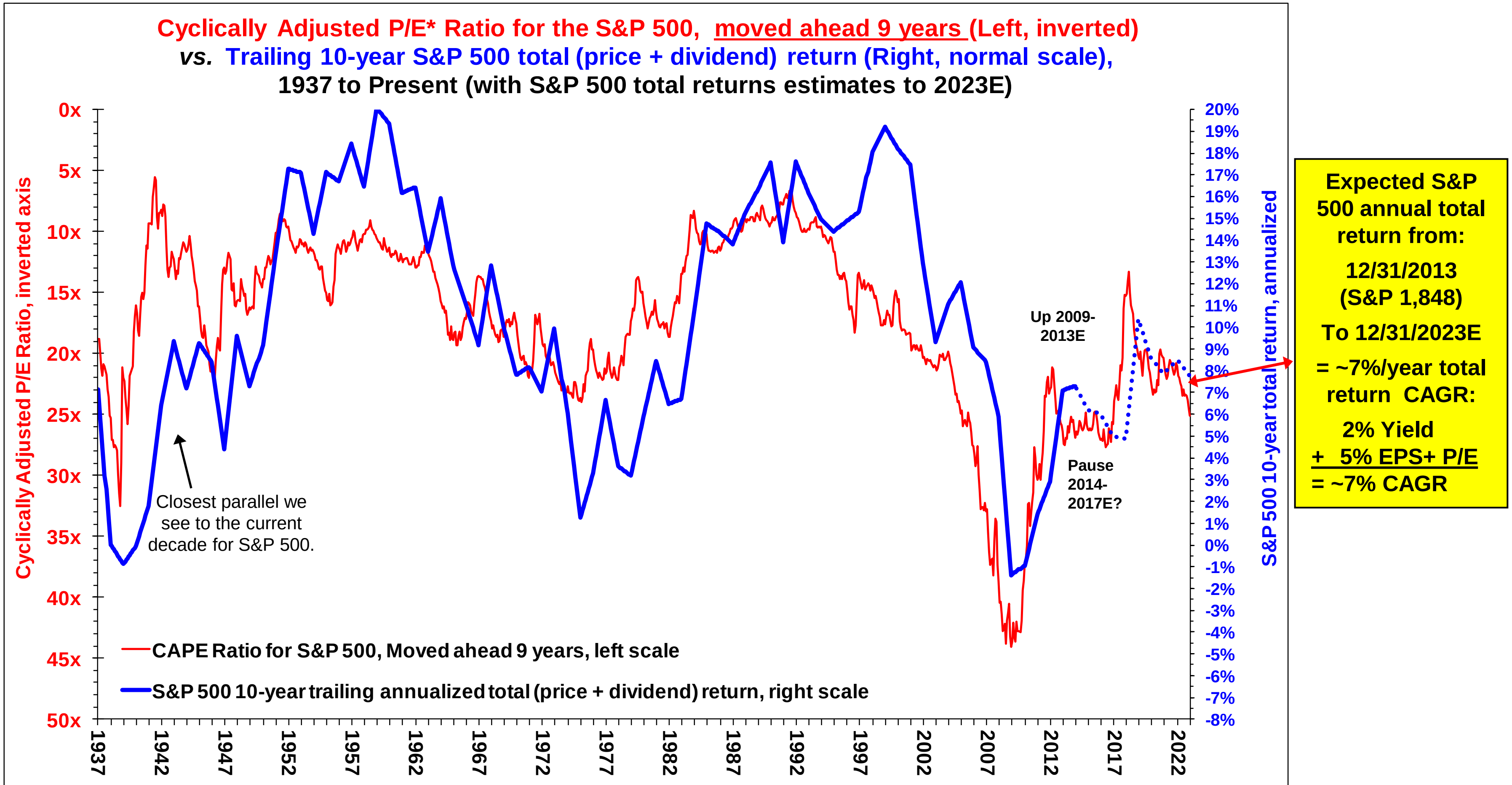
Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

Moving the CAPE forward 9 years signals an S&P 500 total return of ~7%/yr. 2013 to 2023E (yellow box). This is a total return "double" for stocks (7%/year over 10 years) by 2023E (if dividends are reinvested).



*CAPE is inflation-adjusted S&P 500 divided by trailing 10-year average of inflation-adjusted S&P 500 EPS.
Y1 & Y2 axes above aligned based on a best fit post Jan-1960 to present regression y=-110.12x+29.229 R^2=0.6899
CAPE is moved forward 108 months to show where the trailing S&P 500 return may be at future dates.

Source: Shiller historical data, Standard & Poor's as reported earnings data, Stifel estimates.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

The Decade Ahead for the S&P 500

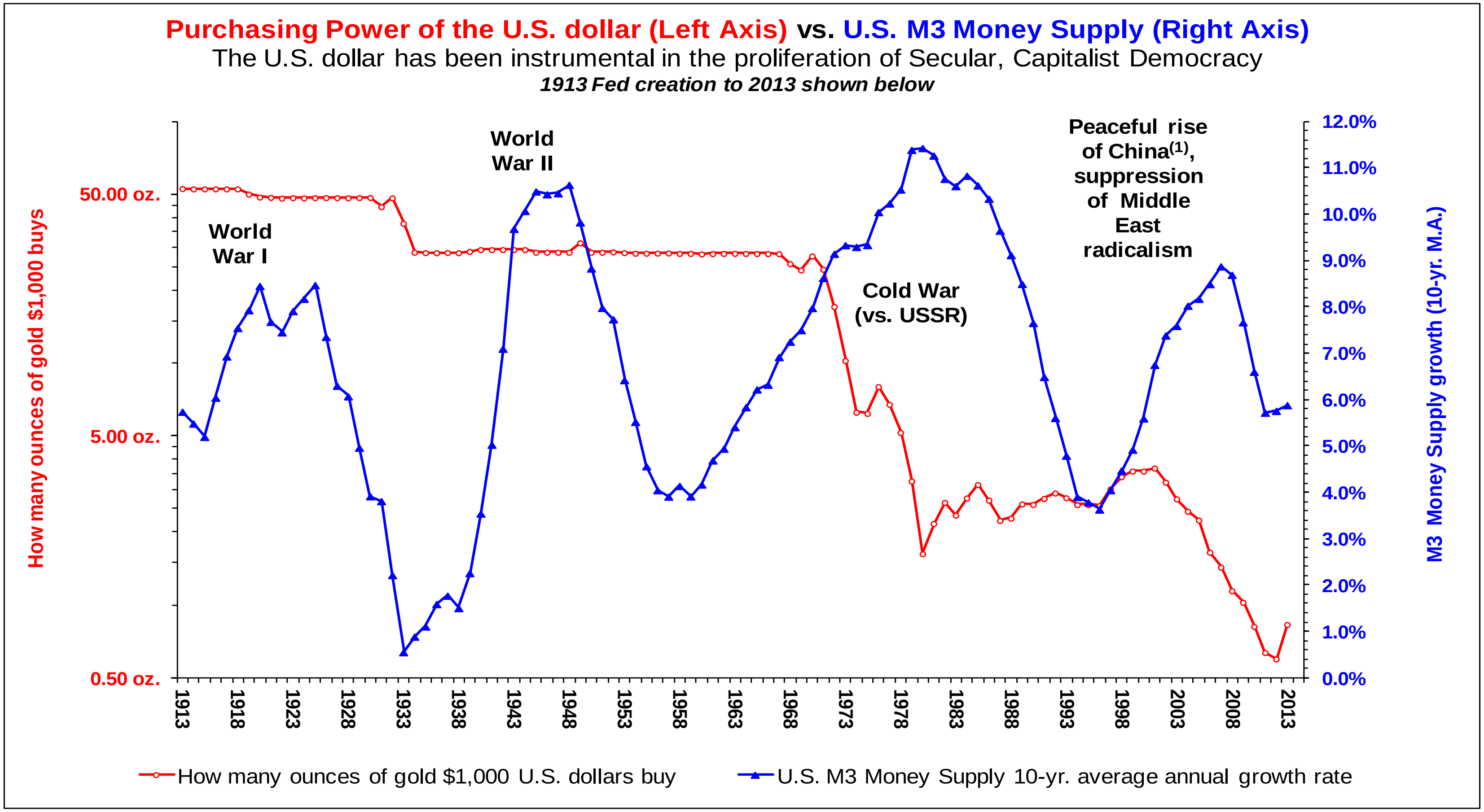
The opposing case to our view: a more bullish 12%/yr. S&P 500 total return through 2023E

With respect to the case presented, in our view:

- **Analysts forget that the fiat dollar was used to promote secular, capitalist democracy for 100 years (pg. 44)**
- **U.S. money supply leads growth of democracies and points to ~5% growth in their total (Pg. 45)**
- **If democracy growth steps up from ~1% now to ~5%, S&P 500 total return could rise from ~7% to ~12% (Pg. 46)**
- **Secular Bulls say "stay long," with stocks up 4.8 years +153% vs. past runs of 16.4 years and +959% (Pg. 47)**

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

We've described here the way analysts who bemoan the century decline of the fiat dollar, shown below vs. gold, overlook its role promoting secular, capitalist democracy. **Wall Street fails to ask what would have happened to the U.S. dollar if the struggles(1) shown below *had gone the other way.***

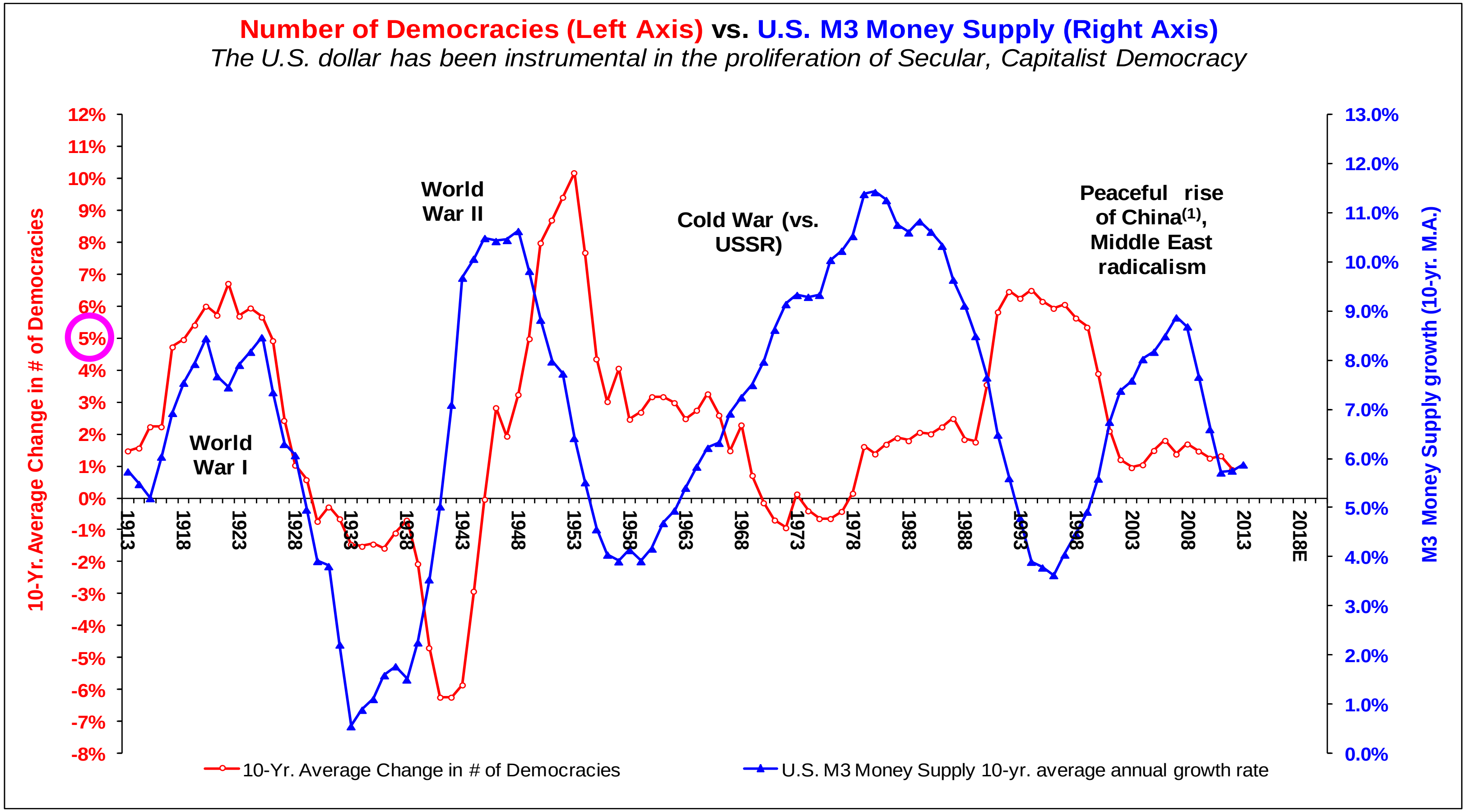


Source: For M3 1903-1958 we use M1 + vault cash + monetary gold stock + bank time deposits + mutual savings bank deposits + S&L deposits. From 1959-2005 the Fed reported M3 (SA). For 2006-Current we use: M2 + large time deposits + institutional money market + Reverse repos with non-banks + interbank loans + eurodollars (regression-derived). Count for democracies is the Polity IV Project. Concept and format Stifel.

(1) Besides wars listed, note that under a gold standard Chinese growth would have slowed because RMB currency appreciation would have impeded Chinese GDP and U.S. credit would not have been available to recycle Chinese savings. Only by having the ability to "store" growth within a fiat dollar was China able to grow at that pace and become a capitalist country.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

U.S. money supply leads the growth of democracies (via war, trade, debt etc.). It is possible in the chart that ~5% growth in the number of democracies in the world (versus ~1% currently) may lie ahead, foreshadowed by _past U.S. money supply growth_ that peaked in 2007. Why does this matter? (see next page)

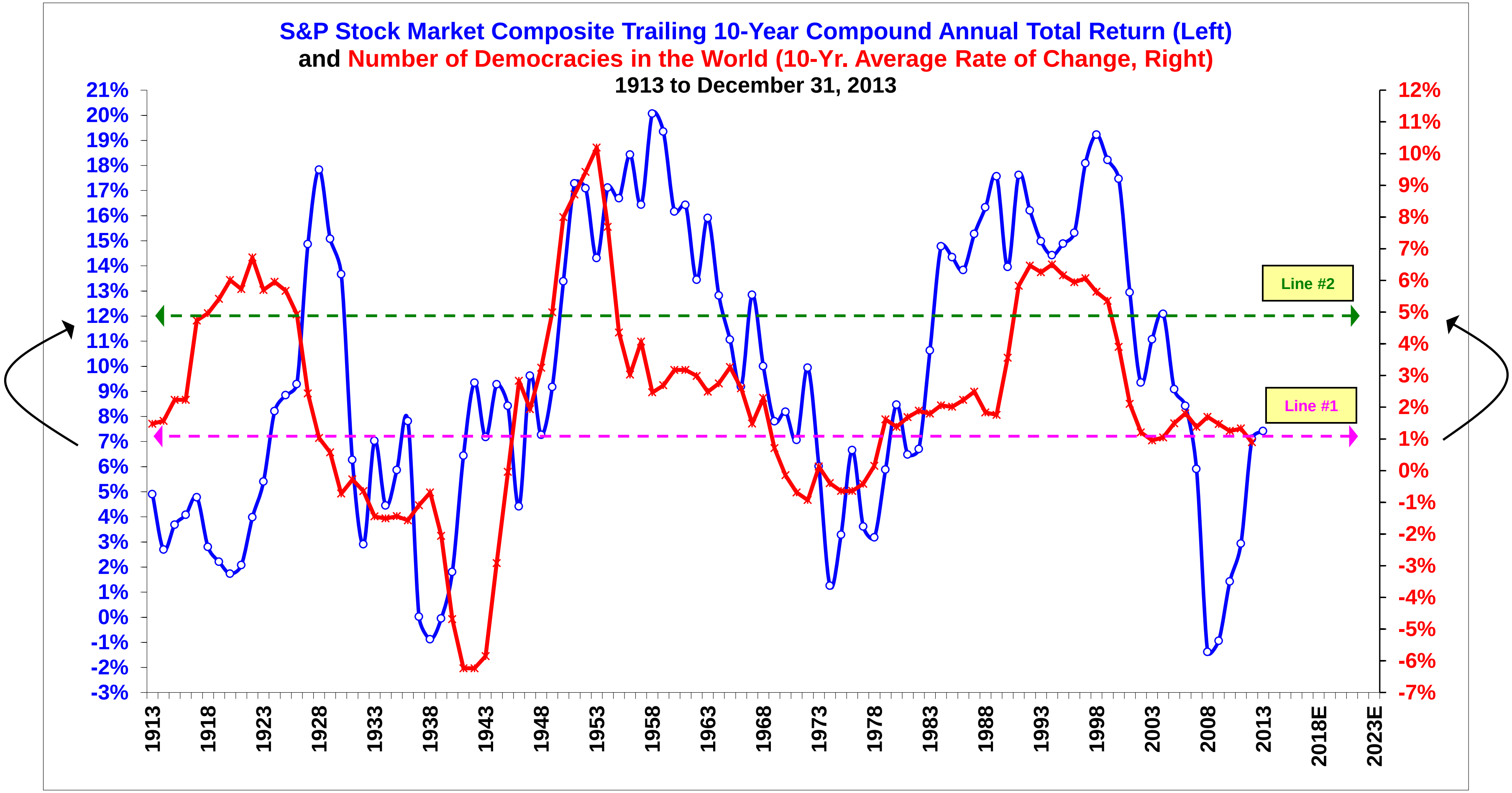


Source: For M3 1903-1958 we use M1 + vault cash + monetary gold stock + bank time deposits + mutual savings bank deposits + S&L deposits. From 1959-2005 the Fed reported M3 (SA). For 2006-Current we use: M2 + large time deposits + institutional money market + Reverse repos with non-banks + interbank loans + eurodollars (regression-derived). Count for democracies is the Polity IV Project. Concept and format Stifel.

(1) Besides wars listed, note that under a gold standard Chinese growth would have slowed because RMB currency appreciation would have impeded Chinese GDP and U.S. credit would not have been available to recycle Chinese savings. Only by having the ability to "store" growth within a fiat dollar was China able to grow at that pace and become a capitalist country.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

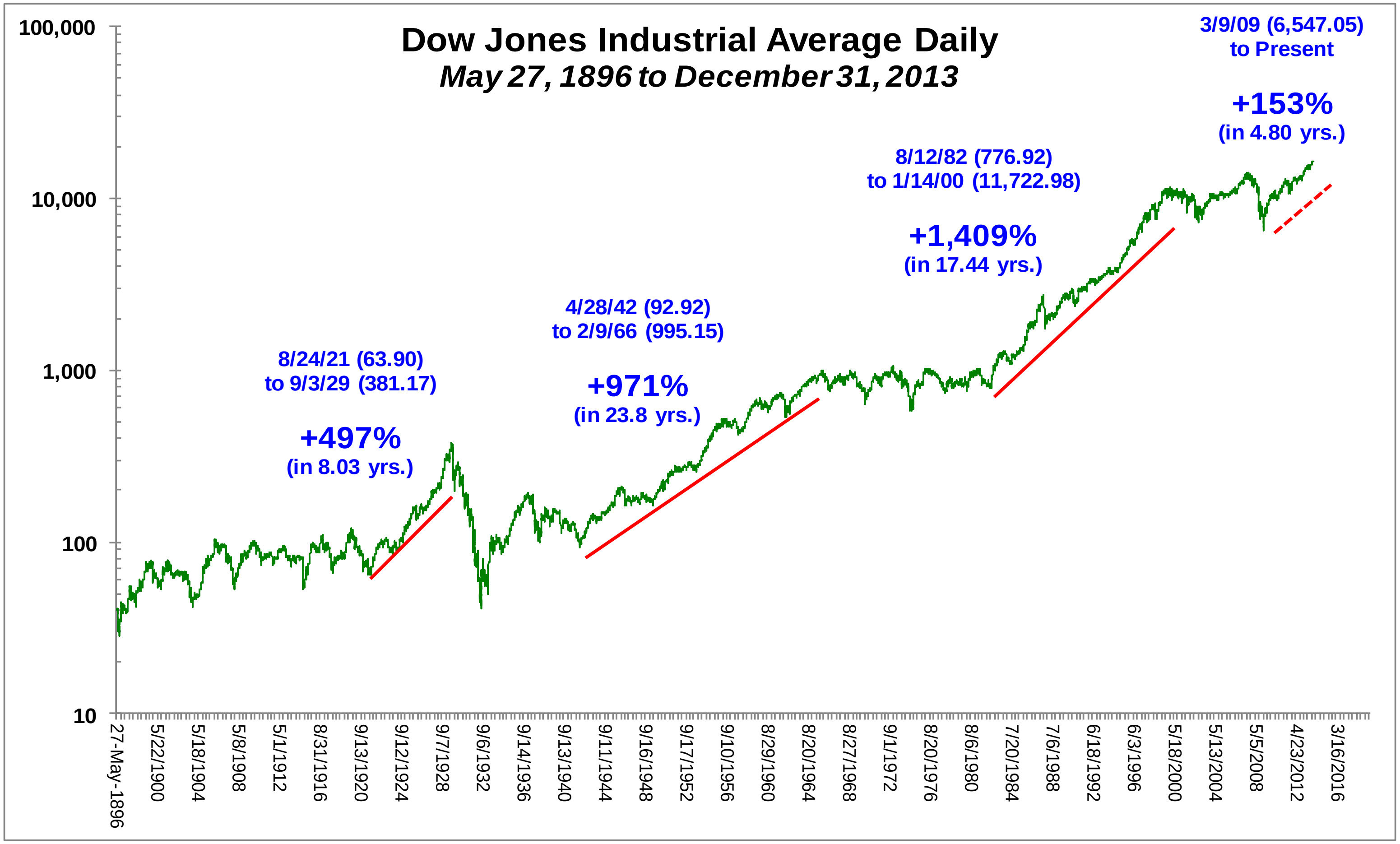
The S&P 500 total return has tracked the growth of democracies for 100 years, and if the relationship then 5% growth in democracies may up-shift S&P 500 total returns to ~12%/yr. Current ~1% growth in democracies aligns with ~7% S&P total return (Line #1), but 5% growth of democracies (prior page) aligns with 12% (Line #2).



Source: *"A New Historical Database for the NYSE 1815 to 1925: Performance and Predictability,"* Yale University used with permission, Post-1925 data for stocks are Ibbotson/Morningstar and S&P large-cap equity. Stock market returns include dividends. Count for democracies is the Polity IV Project: Concept and format Stifel.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

For now, we see 5%/year price-only return (7% incl. div.) for the next decade, but Secular Bulls may say this trend "has only just begun." **From the March 2009 Dow Industrials low of 6,547 to present has been +153% in 4.8 years. That compares with past Secular Bull Markets averaging 16.4 years and +959%.**



Source: Daily Dow Industrials prices in "The Dow Jones Averages, 1885-1980," Phyllis S. Pierce (editor) and FactSet.

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Appendix

- *Decade inflation (real 10Y yield, P/E) outlook (pages 49-50)*
  - ➢*We see real yields constrained by low velocity of broad money supply*
  - ➢*We see P/E elevated by low inflation and real yields (i.e., low bond yield)*

- *GDP issues: U.S., China, Eurozone (pages 51-55)*
  - ➢*U.S. – We believe less fiscal drag boosts 2014 GDP to 3%+*
  - ➢*China seems quite capable of doubling GDP/capita 2011-21 (i.e., 7%/yr.)*
  - ➢*Watch China's PMI & IP for their effect on commodities*
  - ➢*Europe moved from austerity to credit crunch, watch for policy moves*

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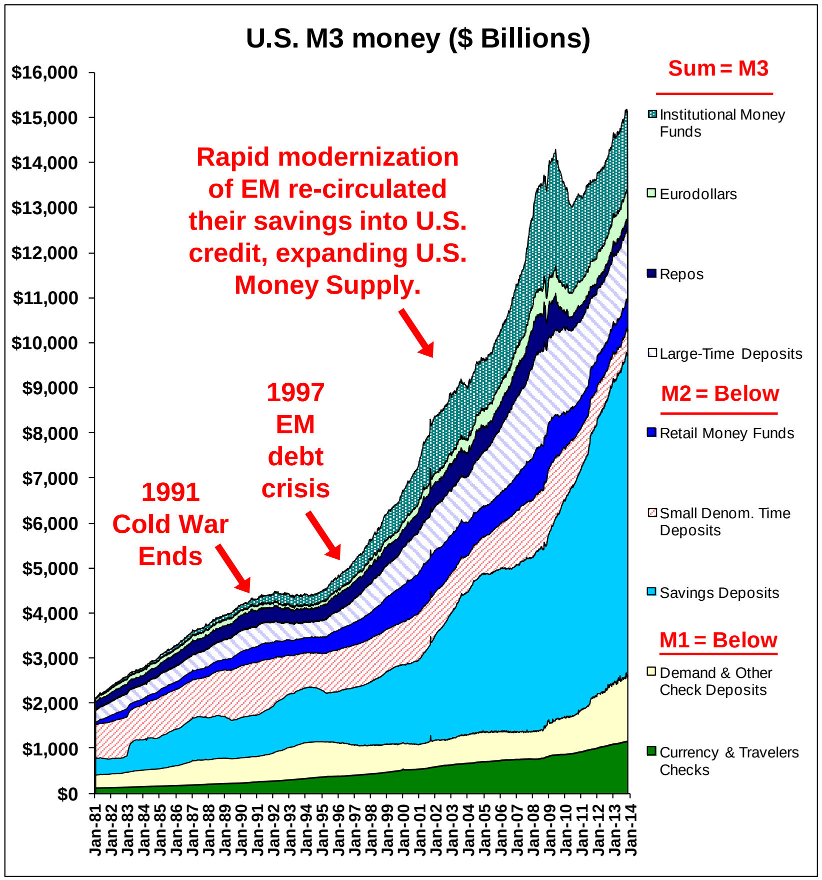
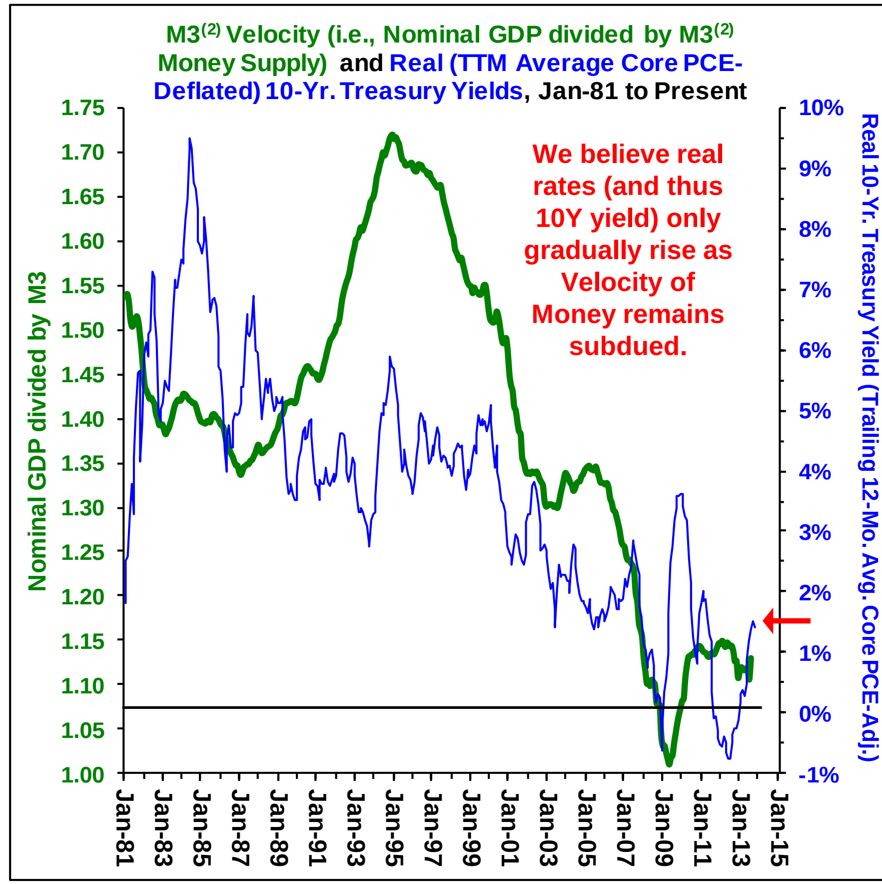
Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

We think 10Y yields will be shaped by the velocity of broad money. **Post-Cold War the Emerging Markets modernized, and their savings glut(1) fed U.S. money(2) supply growth (left chart) as U.S. debt soared. This caused money Velocity (GDP/money) and real rates to collapse (right chart), increasing the risk of deflation.**





Source: Federal Reserve, U.S. Census, Stifel format.

(1) That the price of money (the real rate) fell even as the demand for money (credit) grew tells us this was an excess savings supply-side (not credit demand) event. Excess EM savings resulted from modernization and a reaction to the late 1990s crises when inadequate reserves and external deficits caused economic hardship.

(2) For M3 1913-1958 we use M1 + vault cash + monetary gold stock + bank time deposits + mutual savings bank deposits + S&L deposits. From 1959-2005 the Fed reported M3 (SA). For 2006+ we use M2 money + large time deposits >$100k + institutional money market + non-bank repos + interbank loans + eurodollars(E), which had been the Fed's definition of M3 money but is no longer provided as an aggregate by the Fed.

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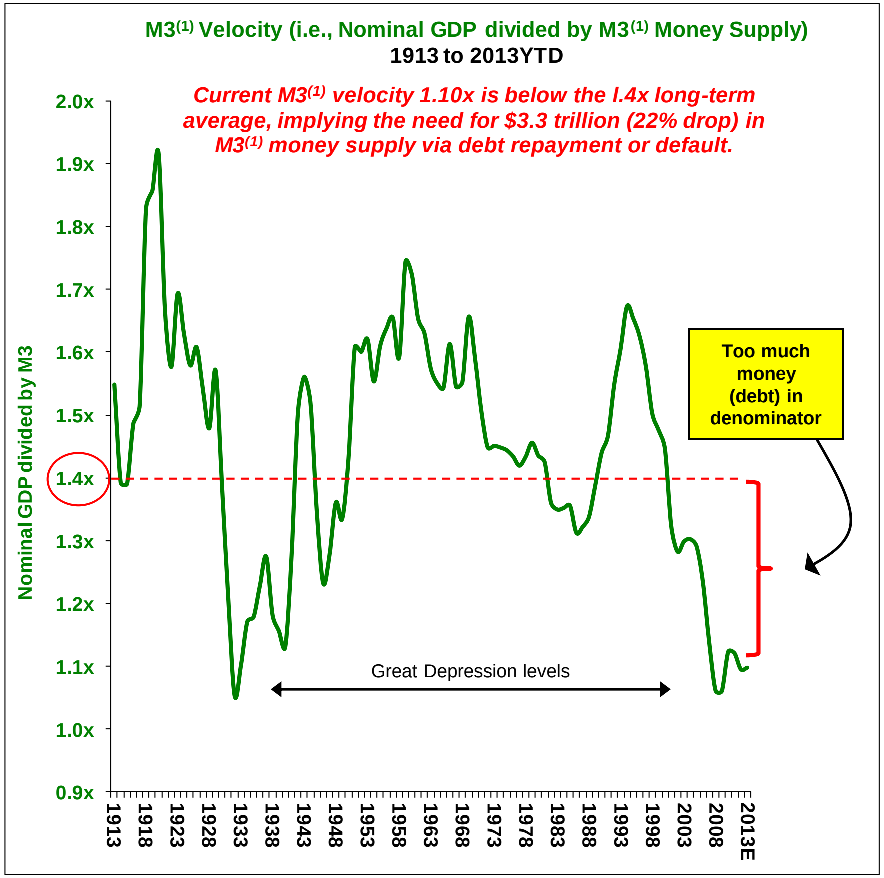
Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

We see excess money (i.e., debt) suppressing inflation and keeping the S&P 500 P/E(1) high. Velocity(2) (GDP/Money) of M3(3) has collapsed (left chart), and its slow recovery plus other inputs produces our 3.4% CPI CAGR view to 2023E (box right).



Given MV = PQ then MV/Q = P

Money Supply (M3)
x Velocity (V) (or, nominal GDP/M3)

Equals

Price (P) Inflation
x Quantity (Q) of Real GDP

Solve for Inflation "P" annual rate 2013 to 2023:

M3 growth 4%/year(4) over 10 years = 1.04^{10} = 1.48

x

V velocity 1.1 now to 1.4 in 10 years(5) = (1.4/1.1) = 1.27

/

Q real GDP growth of 3%(6) over 10 years = 1.03^{10} = 1.34

=

P Inflation [(1.48) x (1.27)] / 1.34 = $1.40^{(1/10)}$ = 3.4% inflation

(4) M3 growth of 4%/year mirrors our expectation for bank credit growth slightly below U.S. nominal GDP growth (real + inflation) in order to facilitate de-leveraging.

(5) Given the many parallels between the current period and the end years of the Great Depression in the 1930s, we note that absent WW II it took a decade for the Velocity of M3 to recover to 1.4x from a level of 1.1x similar to today.

(6) We assume real GDP growth of 3% equal to labor force growth of ~1.25-1.5% (we see higher wages improving the participation rate plus immigration reform) added to U.S. Productivity growth of ~1.5%-1.75% equaling ~3.0% real GDP growth.

Source: U.S. Federal Reserve, Census, Stifel interpretation and annotations.

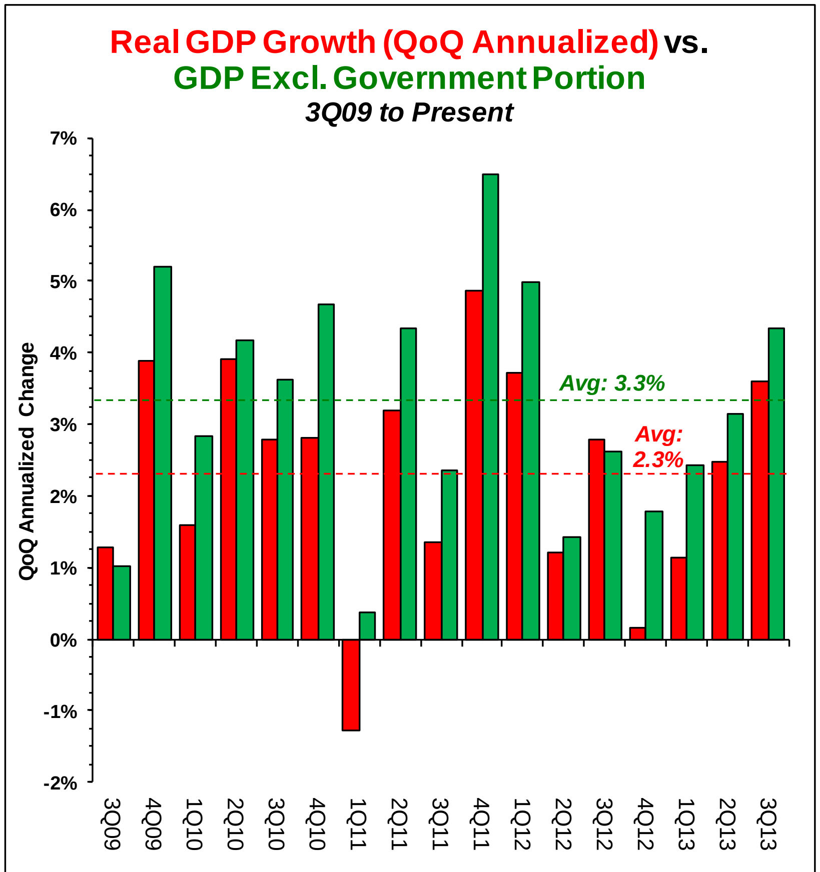
(1) The past 143 years the S&P P/E has been 16.2x TTM reported EPS at 3.0-3.9% CPI inflation.

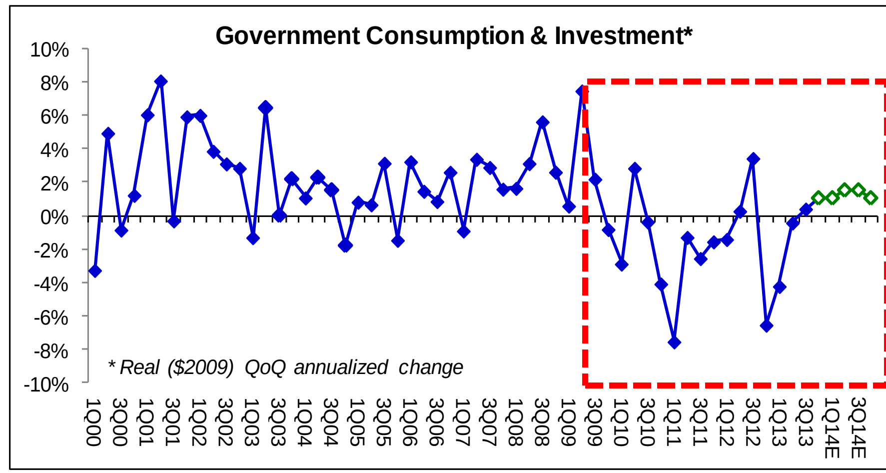
(2) Money “M” x Velocity (GDP/Money) “V” = Inflation “P” x Real GDP “Q.” Low M growth (private non-financial credit) and depressed V add deflationary pressure.

(3) For M3 1913-1958 we use M1 + vault cash + monetary gold stock + bank time deposits + mutual savings bank deposits + S&L deposits. 1959-2005 the Fed reported M3 (SA). 2006+ we use M2 + large time deposits >$100k + institutional money market + non-bank repos + interbank loans + eurodollars(E), the Fed’s definition of M3 that is no longer aggregated by the Fed.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

There is no "secular stagnation," GDP sluggishness below 3% was solely due to reduced government expenditures. **GDP is Consumption + Fixed Investment + Government + Net Exports (C + I + G + Nx). It was the drag from Government post-2010 (State & Local, Non-Defense & Defense) that lowered U.S. real GDP from ~3.3% to ~2.3% post-3Q09. Now we see Government ("G") up moderately in 2014.**





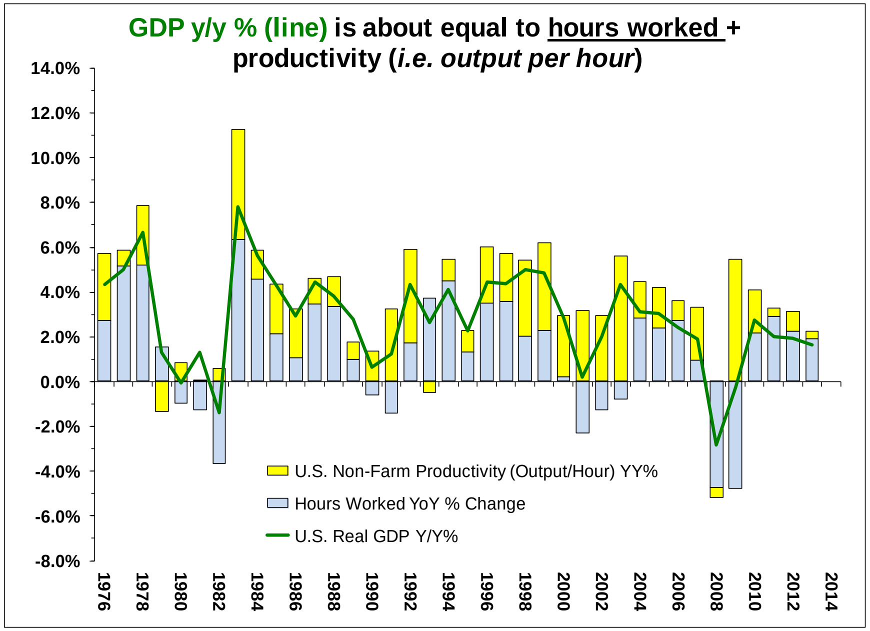
U.S. Real ($ 2009) Government consumption expenditures and gross investment 2007 to 2014E

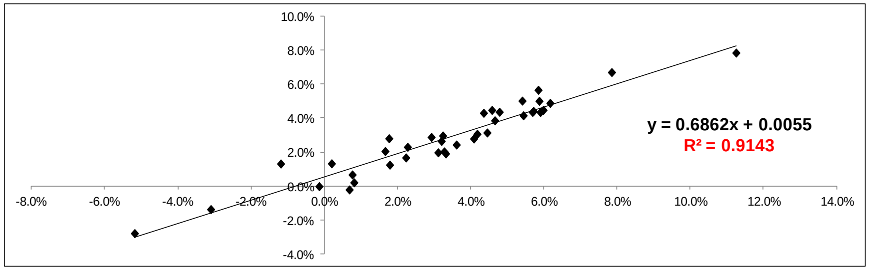
	2007 Avg.	2008 Avg.	2009 Avg.	2010 Avg.	2011 Avg.	2012 Avg.	2013E Avg.	2014E Avg.
National defense	696	748	788	814	795	769	731	725
	Y/Y%	*7.5%*	*5.4%*	*3.2%*	*-2.3%*	*-3.2%*	*-4.9%*	*-0.8%*
Nondefense	383	404	429	457	443	451	448	435
	Y/Y%	*5.5%*	*6.2%*	*6.5%*	*-3.0%*	*1.8%*	*-0.8%*	*-2.8%*
State and local	1,836	1,842	1,871	1,821	1,755	1,743	1,751	1,802
	Y/Y%	*0.3%*	*1.6%*	*-2.7%*	*-3.6%*	*-0.7%*	*0.5%*	*2.9%*
Government Consumption & Gross Investment	**2,915**	**2,995**	**3,089**	**3,091**	**2,992**	**2,963**	**2,930**	**2,962**
	Y/Y %	*2.7%*	*3.2%*	*0.1%*	*-3.2%*	*-1.0%*	*-1.1%*	*1.1%*

Source: Bureau of Economic Analysis. Stifel format & estimates.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

U.S. real GDP growth is about half of its 3% very long-term trend growth. Productivity (output/hour) is a source of future GDP to ~3% potential, but *cannot rise without capital spending, manufacturing & construction recovery*, in our view.

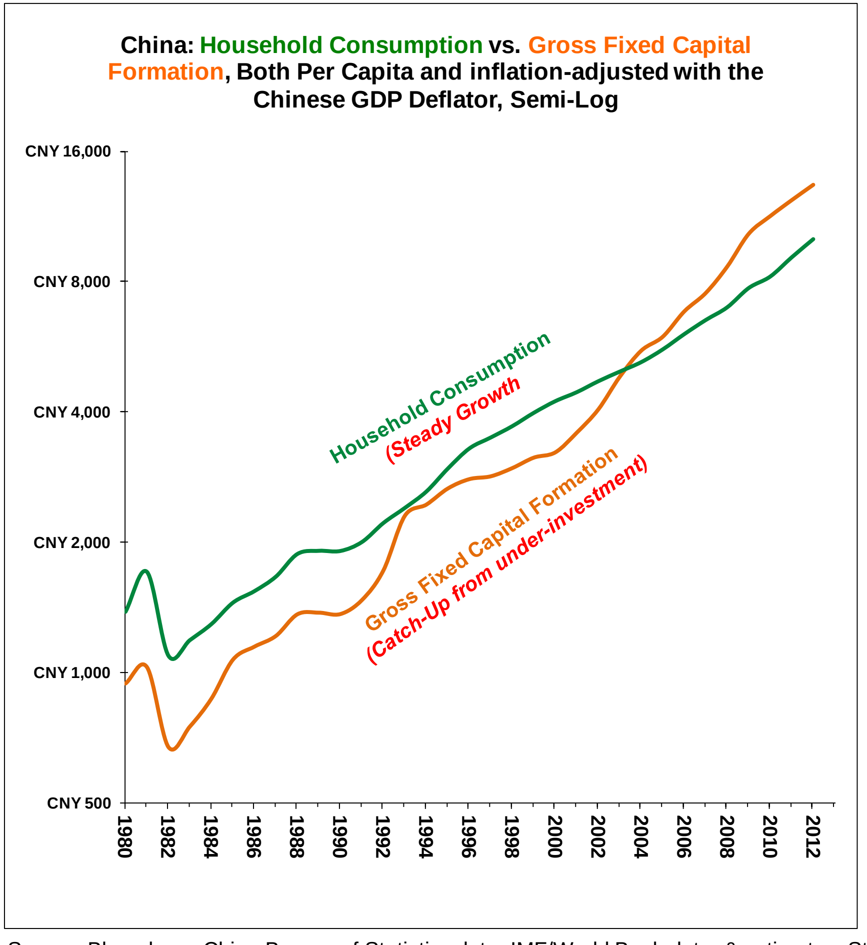


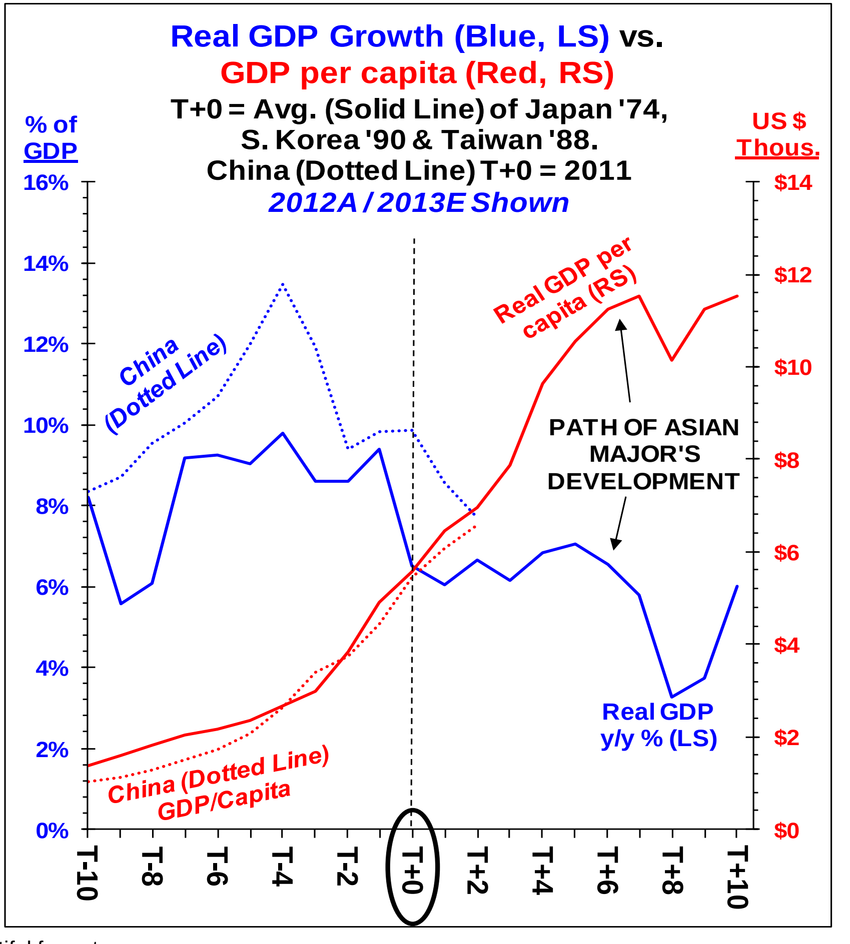


Source: *Historical Statistics of the United States* Cambridge University Press. For Real GNP 1890-1908 "Productivity Trends in The United States;" 1909-1928 "The National Income and Products of the U.S.;" 1929-present Gross Domestic Product [Billions of chained (2009) dollars], BEA recent GDP components, Stifel format.

Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

Having out-grown the fixed investment approach, we think doubling GDP from 2011 to ~2021 with greater consumption is China's top priority. **In reality, China's fixed investment since 2000 has really just been a catch-up from an almost Stone Age level of fixed infrastructure before Deng Xiaoping (left chart). As for doubling GDP, the "Asian norm" (right chart) suggests that it is possible by the early 2020s.**





Source: Bloomberg, China Bureau of Statistics data. IMF/World Bank data & estimates. Stifel format.

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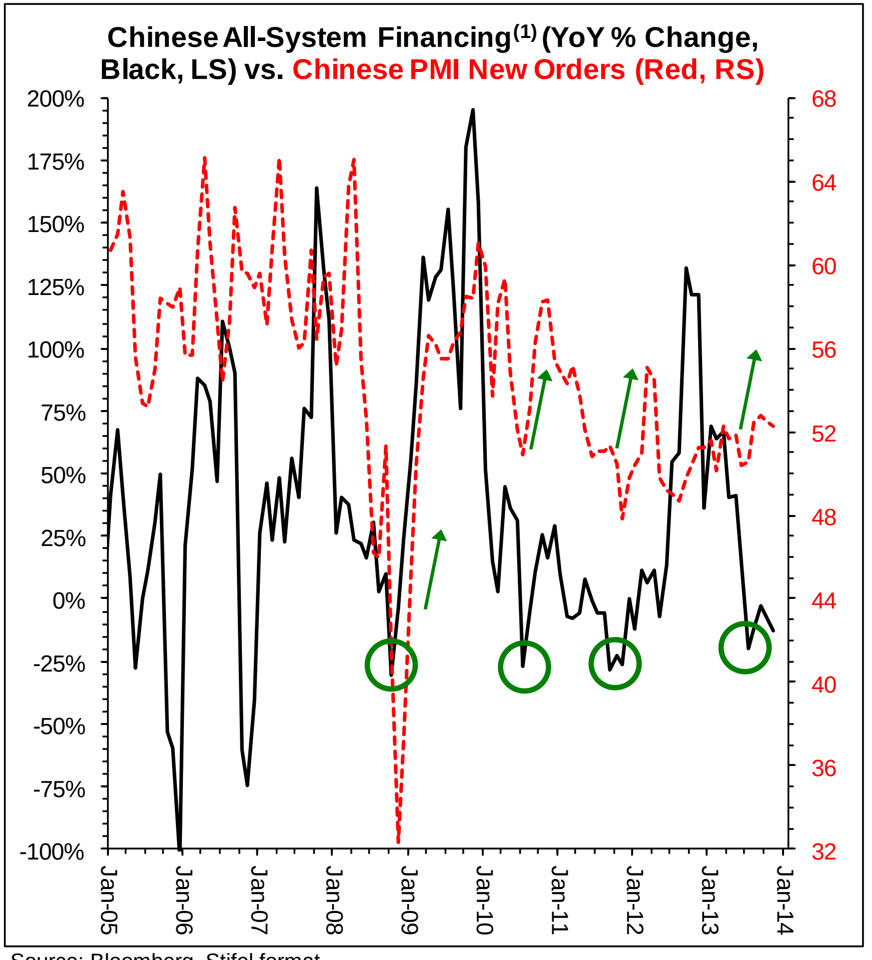
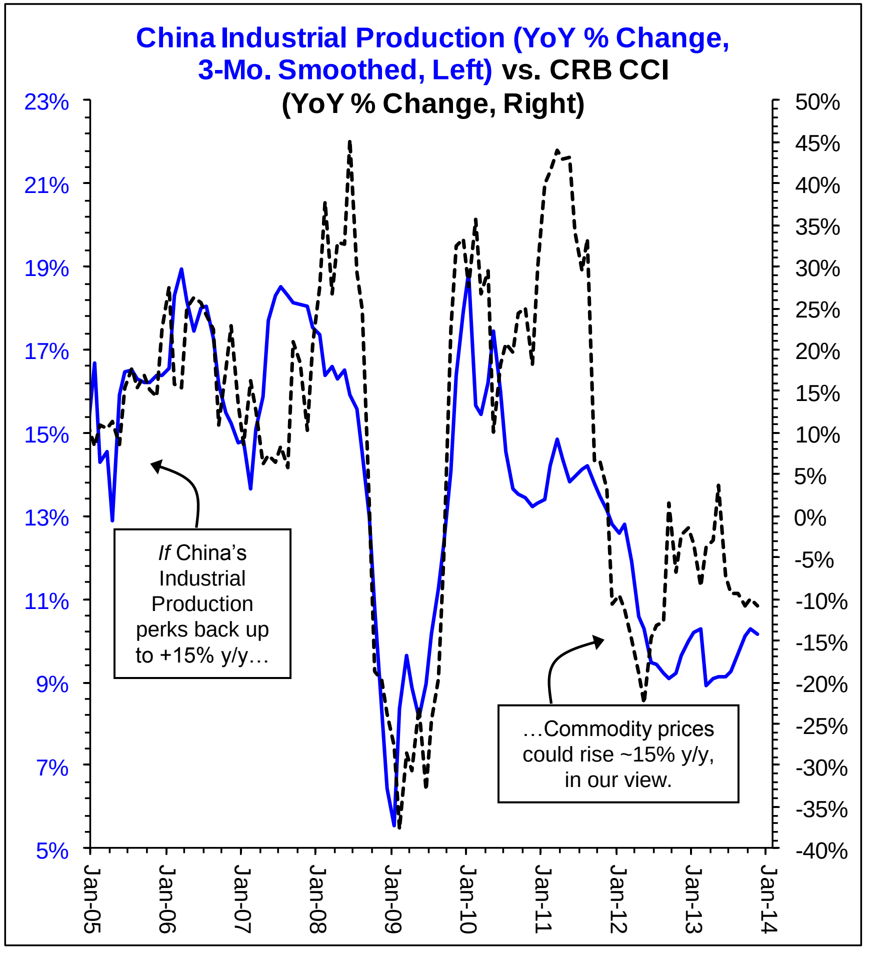
Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

Watch China's PMI & IP for their effect on commodities. **China's capital raising[(1)] may put a floor under Industrial Production (IP) growth to facilitate restructuring[(2)].**





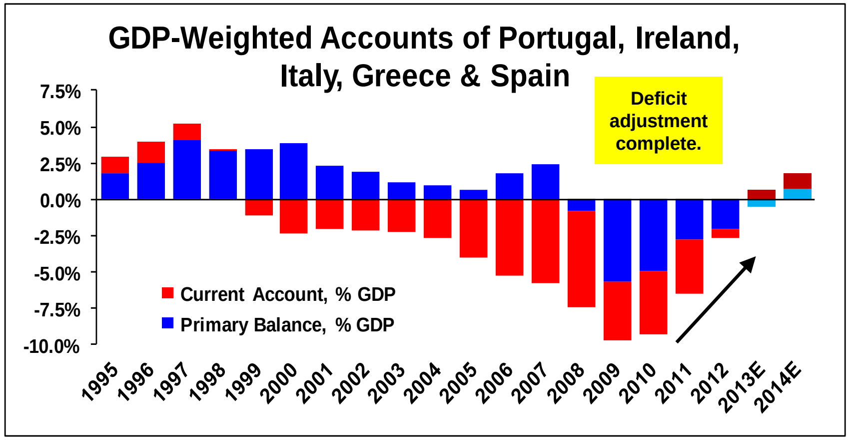
Source: Bloomberg. Stifel format.

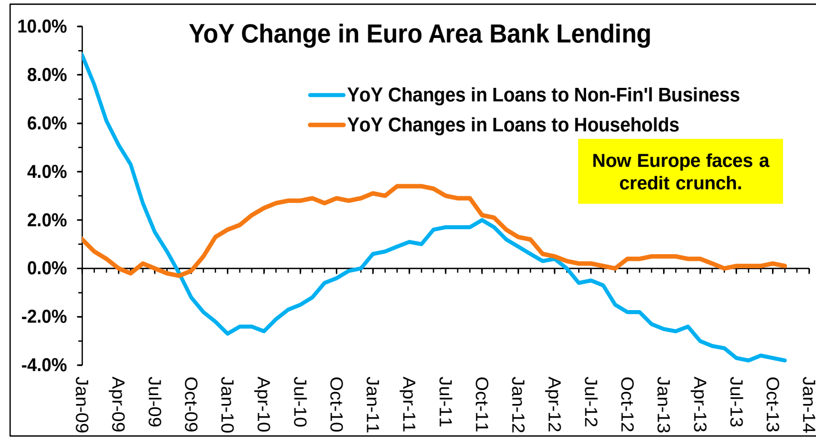
(1) Shown 3-month smoothed. Includes corporate bonds, equity financing, trust loans, loans of local and foreign currencies, entrusted loans, bank acceptance bills, foreign direct investment and foreign debt. Refers to the incremental liquidity the financial system provides to the real economy in a certain period.

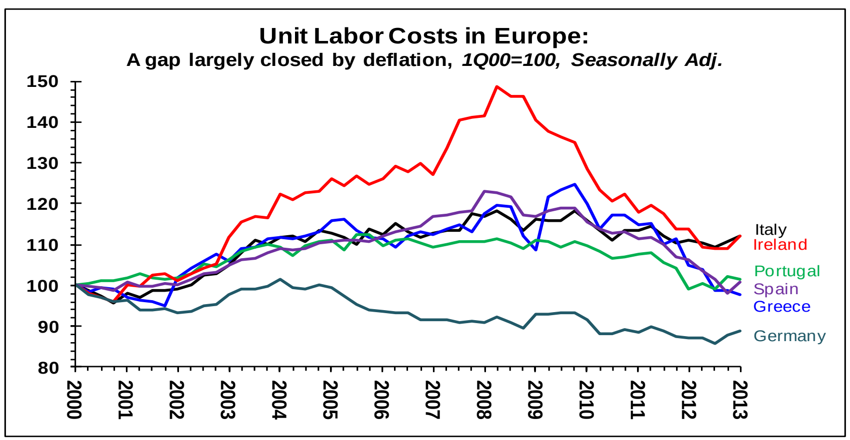
(2) Issues include: (a) the difficulty of reducing profit share of GDP and raising wage share while unwinding subsidies, (b) deflation of profits due to a strong currency, high real interest rates & rising unit labor costs, (c) creating a deep sovereign bond market when top-down regimes rarely have deep sovereign bond markets, (d) recognizing bad debts in the banks while allowing bank net margin to be set by the market, and (e) opening the capital account to inflows and outflows.

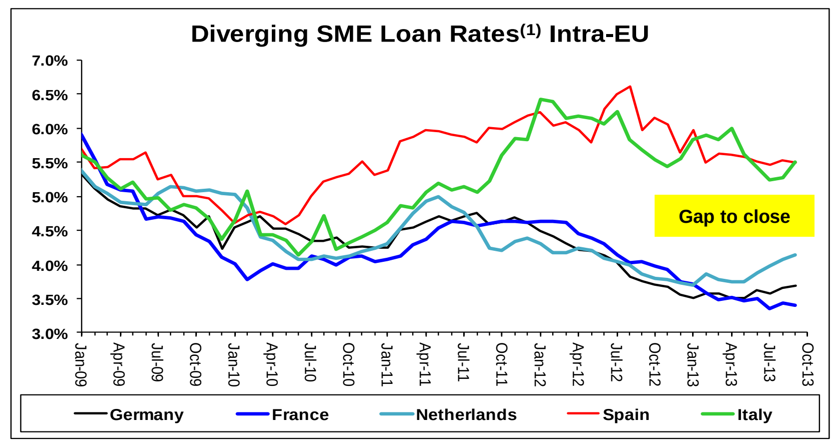
Barry B. Bannister, CFA Stifel Equity Strategy bbbannister@stifel.com

We see evidence the worst of European adjustment has probably passed, a positive for both the euro and global GDP. **Austerity (left charts) has segued to a credit crunch (right charts) in the periphery, but now that national accounts are balanced it is incumbent upon Europe/ECB to better coordinate policy in 2014.**









Source: IMF, Bloomberg, ECB, Stifel format.

(1) Loans less than or equal to €1M Euro, 1 – 5 yr. maturity. Excludes revolving loans & overdrafts, convenience and extended credit card debt.

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