It’s Trump…what to do now

**The Trump economy**

Our economics team now thinks the Fed will go ahead with a hike in December. On the economy, they are sticking with their view of slower growth in 1H 2017 given heightened uncertainty. However, they now think the risks are to the upside for 2H 2017 and 2018 growth. Inflation will also likely accelerate more quickly given the combination of fiscal stimulus, trade tensions (higher import prices), changes to the Affordable Care Act as well as potential changes to immigration. In their view, this means somewhat stronger growth and faster inflation, which should lead to a faster Fed hiking cycle.

**Winners and losers under Trump**

US Equity Strategist Savita Subramanian believes the proposed tax cuts plus less upward wage pressure could benefit Discretionary stocks, especially higher-end retailers. Corporate tax cuts would favor domestic companies over multinationals, though the latter could see a one-time benefit from repatriation of cash held overseas (estimated at >$2T) and largely the Tech sector. The overhang to Biotech/Pharma multiples may be lifted given potential for less pricing scrutiny. And Financials could benefit from volatility, less regulatory risk, potential for lower investment taxes, and higher interest rates over time. Infrastructure investment projects would likely benefit stocks in the Energy, Industrials and Materials & Defense sectors but Subramanian believes further multiple expansion for fiscal stimulus beneficiaries may be limited given they already appear to be discounting lofty expectations.

**Election may change ACA with less focus on drug prices**

With Donald Trump winning the Presidency, and continued Republican control of Congress, our health care team expects that there will be efforts to significantly modify the Affordable Care Act (ACA). In addition, the expectation is there will be less pressure on drug pricing and costs under a Republican administration, which could benefit the pharma industry. However, considerable uncertainty remains as to other health care policy issues, including Medicare payment reforms, value based payments, ACOs, bundled payments, Medicare/Medicaid demonstrations, etc. Hospital and provider industries may be negatively affected due to uncertainty regarding the future of the ACA, with reduced health care coverage, and the potential for increased numbers of uninsured. Managed Care may also see a modest negative impact under a Trump administration in the near term due to uncertainty.

**Republican sweep could boost defense spending**

Defense Analyst Ron Epstein expects the Republican victory in the White House and the Senate to be seen as incrementally positive for defense, as political control is a key driver of defense spending. A Republican president and Republican Senate is the best case for Budget Authority in defense modernization accounts. Our BofAML Political Control Model (PCM) analysis suggests that the actual political outcome for the White House and 115th Congress could increase the Budget Authority for defense investment accounts by a CAGR of 12-13% (FY17E-21E).
Uncertainty shock, a surprise to markets
With Trump winning the election, expect heightened volatility and downside risk in the near term as polls and prediction markets until last night had been pointing to a Clinton victory. We expect lack of clarity around Trump’s policies – from feasibility to prioritization – will likely weigh on sentiment and pressure already muted business investment, as investors and corporates weigh the balance between the potential for higher growth and rates against the risks of trade friction, geopolitical conflict and discontinuous Fed policy.

Downside risk in the short term is likely
The S&P has historically sold off 6% (median decline) around macro shocks (Table 1), and is currently just 1% off its one-month high (and 2% off its Aug. peak). But we believe risks to the downside may be more pronounced and long-lived than post-Brexit vote, in that positioning in risk today is far more aggressive: in a thinly traded market, uncertainty can roil a bullishly positioned market, as we saw in Jan. We maintain our S&P 500 year-end target of 2000, where our cautious view is based on a host of signals besides the election, but see more downside than upside risk to our target based on today’s results.

History suggests muted returns for the next four years
Avg. returns (since 1936) have historically been stronger under Democratic presidents (+14% ann.) than Republican presidents (+10% ann.), and the make-up of Congress has not changed the line-up (see Election 2016). The S&P also saw better returns the year after elections that resulted in a leadership change w/in the same party vs. both a leadership and party change. But the initial post-election reaction has favored Republicans, where the S&P has gained 3.4% on avg. in the last 2mos of the year when a Republican was elected vs. 1.5% when a Democrat was elected. Ultimately, profits have been a more important driver of the S&P than politics.

Winners and losers under Trump
We think Trump’s proposed across-the-board-tax-cut for individuals and corporations could benefit equities broadly through the wealth effect. Tax cuts plus less upward wage pressure could benefit Discretionary stocks, especially higher-end retailers. Corporate tax cuts would favor domestic companies over multinationals, though the latter could see a one-time benefit from repatriation of cash held overseas (estimated at >$2T) and largely the Tech sector. The overhang to Biotech/Pharma multiples may be lifted given potential for less pricing scrutiny under Trump. And Financials could benefit from volatility, less regulatory risk, potential for lower investment taxes, and higher interest rates over time. Trump has also called for the replacement of Fed Chair Yellen when her term expires in 2018, where risks of a more hawkish Fed could hurt levered sectors and those with high dividend yields, which have seen performance erode as rates have risen. But in the N/T, we see downside risk to interest rates & a potential delay in the next Fed hike amid the uncertainty/risk-off reaction.

Fiscal stimulus likely – but priced in
Infrastructure investment projects would likely benefit stocks in the Energy, Industrials and Materials & Defense sectors, as Trump has called for an infrastructure plan “at least double” the amount Clinton was proposing, with a military “so big, powerful and strong that no one will mess with us”. We think further multiple expansion for fiscal stimulus beneficiaries may be limited, however, given they already appear to be discounting lofty expectations.

Republican sweep ups the risk of significant reforms
With Republicans maintaining control of Congress, the sweep by the party increases the likelihood of Trump’s proposals being enacted, especially those that can be enacted by decree or share Congressional Republican support and avoid a filibuster in the Senate. These include the replacement of the Affordable Care Act and further restrictions on immigration. Other key risks we see include trade wars, geopolitical risk and a higher budget deficit. On the flip side, the sweep increases the likelihood of tax cuts/stimulus, likely leading to stronger growth and higher rates, which could hurt higher dividend yielding stocks.

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Global Economic Weekly

Trump, Reagan and Abe

Global Letter: Trump, Reagan and Abe
The economic impact of the election depends on whether Congress or the president dictates policy. The most bullish growth scenario combines a Trump policy (fiscal expansion) with a House Republican policy (free trade). A replay of the Reagan years is unlikely in the US, but combined fiscal and monetary easing in Japan could beat deflation.

United States: the Trump economy
There is a high degree of uncertainty regarding the policies that President-elect Trump will implement. In the short-term, the outlook is dependent on financial conditions and confidence, and so far, so good. We are therefore restoring our pre-election day view and now expect the Fed to hike in December.

Euro Area: the ECB, Trump and the Fed
The ECB will (again) meet before the FOMC, on 8 December. It will need to rely on its own and the market’s expectations of the Fed’s next move(s). Whether we see more fiscal support or more protectionism in the US higher real rates in the EA are the risk. There is only one possible action: more QE.

Asia: Malaysia: no turnaround in sight
Growth has declined by almost 1ppt per annum since 2014 and we expect it to bottom at 4.1% this year and 4.2% in 2017. Potential improvement in net exports will be offset by weaker investment demand due to lower public development expenditure and subdued business sentiment.

Emerging EMEA: Poland: a moderate, temporary slowdown
Newsflow on growth has been negative lately, but nothing alarming. GDP growth should reaccelerate in 2017 on improving investment and consumption. We continue to see a stable policy rate at 1.50% through 2017, but dovish market pricing could emerge in view of softer data. We would look for paying opportunities.

Latin America: Brazil – fragile green shoots
Confidence and activity data signals a weaker recovery. We now expect 2017 GDP growth at 1% (vs 1.5%), keeping 2016 at -3.5%. With a slower recovery, we revise down 2017 inflation to 4.7% (vs 4.9%) and delay the unemployment rate peak to 2Q17.

United Kingdom: risk of hard Brexit underappreciated
Last week’s court ruling that parliament must approve Article 50 triggering is, in our view, very unlikely to prevent Brexit or shift the chance of a ‘hard Brexit’ much, which is our base case. The risks of ‘hard Brexit’ seem to be increasingly unappreciated.

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**Offstage**
The US election is hogging the spotlight, but unless there is a surprising outcome, we think the focus will shift back to the outlook for inflation. Read further if you need something less depressing to think about.

**A nonlinear world?**
The economic debate is often shaped by hidden assumptions. One way to frame an argument is to declare certain mechanisms inactive, leaving one dominant answer. Another is to assume high nonlinearities—effects only work in one direction. Both can be useful, but also misleading pedagogical tools. Let’s consider three nonlinearities that shape (and misshape) today’s economic recovery and inflation debate.

**A kinky curve?**
Very high and persistent unemployment caused a relatively moderate drop in inflation in the developed world. For the Big Three economies and for the OECD as a whole, big, persistent unemployment and output gaps produced small slowdowns in wage and price inflation. This may partly reflect downward rigidity in wages and prices, but it is also consistent with the idea that there is a relatively flat Phillips Curve. And yet, as labor markets improve, inflation hawks seem to believe that just touching the NAIRU threatens a surge in inflation. In other words, the Phillips curve must have a dramatic kink: when the unemployment rate jumps above NAIRU it has a tiny disinflationary impact, but when it falls below NAIRU, it quickly creates inflation.

**Slippery slope, but only to the upside?**
A second nonlinearity relates to inflation expectations. Hawkeyed analysts argue that years of below-target inflation has had virtually no impact on inflation expectations. They remain “well anchored.” By contrast, they warn, even a brief period of above-2% inflation risks unanchoring inflation to the upside. If correct, it is dangerous for central banks to even contemplate overshooting their inflation target.

**No help for hysteresis**
A final nonlinearity relates to “hysteresis.” The severe recession and weak recovery seem to have created significant lasting damage to the supply-side of the economy. Persistently high unemployment has caused many to abandon the job market. Weak growth and a lack of confidence have caused a feeble recovery in the capital stock, ending the trend toward more capital per worker. And weak business formation has probably slowed innovation, helping weaken productivity growth. By some accounts policy makers should simply accept the new negative “reality.”

**As a first approximation, the world is flat**
While there may be some nonlinear elements to the economy, in our view, this narrative (and related forecasts) grossly exaggerates the constraints on policy makers.¹ Empirical evidence confirms that since the early 1990s, the Phillips Curve is relatively flat both above and below NAIRU.

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¹ Indeed, some models argue for the opposite: slack only impacts inflation once it reaches a certain threshold. See Rich, Peach and Coronaton (2011) “How Does Slack Influence Inflation?” Federal Reserve Bank of New York. They argue that inflation is relatively insensitive to slack until the unemployment deviates more than 1.56 pp from NAIRU.
BofA on USA

Consumer spending increased in October but with Hurricane distortions

**Strong gain in October retail sales**
Consumer spending accelerated in October, according to internal aggregated BAC credit and debit card data. Using the BAC card data, retail sales ex-autos climbed 0.8% mom seasonally adjusted in October. This follows the 0.5% mom gain in September, leaving an improving trend. On a smoother yoy basis, the retail sales ex-autos aggregate is up 3.4% yoy sa and has been growing in line with the Census Bureau data. This is indicative of a solid pace of consumer spending. Indeed, as we argue in *Saving for a rainy day*, the consumer has strong support from wealth gains and income creation, but has restrained spending somewhat given the propensity for greater savings and deleveraging.

**Preparing for Matthew**
Hurricane Matthew affected spending trends in October. Based on the BAC credit and debit card data, we find that spending accelerated in advance of the Hurricane, particularly in building material and grocery stores. As we show in the Chart of the Month, we calculate that the combined sales of building materials and grocery stores were up 2.3% mom SA for the hurricane-impacted states (which include Florida, Georgia, South Carolina and North Carolina). This compares to a trend-like increase for the rest of the country. We think this contributed to the strong gain in overall spending at home improvement stores in the month.

Using daily card data, we can pinpoint the exact timing of the Hurricane distortions to card spending. We find that there was an increase in overall spending in advance of the hurricane but a slowing thereafter in those four states (Chart 2). It seems that the gain was almost entirely offset by the post-hurricane decrease. This means that the hurricane did not have an impact on monthly retail sales ex-autos but clearly did impact some sectors, particularly home improvement stores.

**Chart of the Month: Spending at building material and grocery stores (SA, % mom)**

Source: BAC internal data
Note: Impacted states include Florida, Georgia, South Carolina, and North Carolina.

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Health Care Policy Update

Trump Win may lead to changes in ACA, less focus on drug prices

Potential for significant revisions to Affordable Care Act
With Donald Trump winning the presidency, and continued Republican control of Congress, we expect that there will be efforts to significantly modify the Affordable Care Act. With a Trump presidency and Republicans maintaining control of Congress, we would expect an effort in 2017 to repeal and replace significant portions of the Affordable Care Act. In addition, we expect there will be less pressure on drug pricing and costs under a Republican administration. However, considerable uncertainty remains as to other health care policy issues, including Medicare payment reforms, value based payments, ACOs, bundled payments, Medicare/Medicaid demonstrations, etc. While it will be difficult to fully repeal the Affordable Care Act, Republicans in Congress, led by Speaker Paul Ryan (R-WI) have laid out a framework for significant revisions to the health care law that could lead to reduced number of covered lives. Hospital and provider sectors may be negatively impacted due to uncertainty regarding the future of the Affordable Care Act, with reduced health care coverage, and the potential for increased numbers of uninsured.

Managed Care short-term negatives, longer-term positives
Managed Care may also see a modest negative impact under a Trump administration in the near term due to uncertainty over the future of health care reform. However, over the longer term, Managed Care (and particularly Medicare Advantage) may benefit from Republican health care proposals, as Republicans have called for longer-term reforms to Medicare such as a movement toward a Premium Support model that would benefit Medicare Advantage plans. Republicans in Congress will seek to repeal a range of industry taxes that were part of the Affordable Care Act, including the medical device industry tax, health insurance industry tax, Cadillac taxes on high cost health plans, and other tax provisions.

Major legislation or administrative actions unlikely in Pharma
For the Pharma sector under a Trump Administration and a Republican Congress, we do not expect any significant or aggressive drug price controls or mandatory rebate proposals. A Trump Administration may still include some uncertainty, as he has at times advocated for direct price negotiation of Medicare Part D drugs, and has called for re-importation of drugs, but, more recently, those proposals have not been a focus. In addition, we would expect that a Trump Administration and Republicans in Congress would likely move to limit any drug payment demonstrations, and would likely not use the Independent Payment Advisory Board (IPAB) process to implement any significant drug payment policies. There is one area that attracts bi-partisan support, and that is speeding the approval process for generic drugs at FDA, to help provide additional competition.

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Republicans won control of the White House & Congress
Republicans won control of the White House and the 115th Congress (Senate and House of Representatives). With at least 276 electoral votes, Donald Trump will be the 45th President of the United States. Republicans maintained a majority in the Senate, with 51 seats vs. 47 Democratic seats. The 114th Senate has 54 Republicans, 44 Democrats and 2 Independents. Republicans were also able to maintain the majority in the House, with 236 seats vs. 191 Democratic seats. This compares to the 114th House of Representatives with 246 Republicans, 186 Democrats and 3 vacancies. Please note that a few states are still counting votes.

Republican president and Senate are positive for Defense
We expect the Republican victory in the White House and the Senate to be seen as incrementally positive for defense. Political control is a key driver of defense spending, and defense stock valuations are tied to changes in defense spending related to the modernization accounts (Procurement and RDT&E – research, development, test & evaluation). As highlighted in our recent report: Defense wins with Clinton & Trump, but watch the Senate 07 November 2016, a Republican President and Republican Senate is the best case for Budget Authority in defense modernization accounts. Although control of the House also affects defense spending, it does so to a lesser extent.

Republican sweep could result in 12-13% CAGR
Our BofAML Political Control Model (PCM) analysis suggests that the actual political outcome for the White House and 115th Congress could increase the Budget Authority for defense investment accounts by a CAGR of 12-13% (FY17E-21E). This analysis assumes that Donald Trump votes like a historical Republican. This compares to the BofAML forecast of a 5% CAGR and the FY17 Green Book forecast of a 1% CAGR. See Chart 1.

Republican president: +6-7 pp, Republican Senate: +6 pp
Our analysis shows that: a) the Donald Trump presidency could be incrementally positive by +6-7pp to Budget Authority growth (FY17E-FY21E CAGR) compared to President Barack Obama (see scenarios below), b) an actual Republican majority in the 115th Senate could increase the budget by other +6pp, and c) an actual Republican majority in the 115th House could negatively impact the budget by -1pp.

Trump and 115th Congress could affect FY17 budget
The impact of the recently elected president and the 115th Congress, positive or negative, on the defense budget would likely be felt beginning with the FY17 budget authorization unless President Obama and the 114th Congress pass a FY17 budget before January 2017 (when the term of new President and 115th Congress begins).

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Reflation beneficiaries with structurally higher profitability

After a strong 24% run YTD, the SOX index is underperforming today as investors mull potential policy impacts of the new administration re trade, FX, tax-rates, repatriation etc., on this very global sector. However, we believe the volatility presents enhanced opportunities to consider semis that benefit from: a) increased industrial/infrastructure spending; we specifically like TXN, MCHP and ON; and b) secular growth in cloud/optical spending (AVGO, NVDA, IPHI, INTC). Secondly, we disagree with investor concerns re perceived higher valuation multiples in semis - forward PE multiples are indeed unchanged vs. last year even as the broader market has gotten more expensive. In addition, the valuation pushback ignores the structural expansion profit margins after the intense consolidation and disciplined capex investments of the past three years.

The industrial spending, aka "reflation" beneficiaries

We look for enhanced industrial/infrastructure spending based on: 1) recent pick-up in global PMI indices showing expansion (>50); 2) improving China manufacturing activity; 3) potential for US fiscal stimulus post-elections; and 4) Rally in global commodities and industrial stocks. While semis are not exposed to certain heavy machinery or oil/gas investments, they do benefit from factory automation, control, grid infrastructure, test-and-measurement, motor drives, defense/aerospace etc. Industrial semis is a $42bn market that has grown at a 6% CAGR from 2010-15. It’s very fragmented but TXN is the leader with 9% share with sales growing at an 11% CAGR in the past five years. In addition to TXN, we also like Buy-rated MCHP (microcontrollers) and ON (power discretes). Other beneficiaries include ADI/LLTC, XLNX, NXPI, MXIM and Infineon.

Cloud investments to grow unabated

While cloud services have been deflationary for tech hardware, we believe they remain a secular growth driver for semis that are key enablers of value-creation. Increase in US cloud investments could spur competitive investments in other countries/regions as well (China, Russia, Europe) in our view. We continue to like AVGO (networking, storage); NVDA (deep learning/Al, with potential benefits stretching into defense/aerospace applications); IPHI (data center optical interconnects); and INTC (cloud servers, networking, internet-of-things). Other beneficiaries include CAVM, MTSI.

Don’t fret valuation, M&A driving structurally higher margins

We acknowledge but disagree with valuation pushbacks on semi stocks. First, valuation per se has often been a lagging indicator in picking tech stocks in our experience. Second, we note that: 1) SOX index is trading at 15.8x NTM PE, exactly where it was at the same time last year, and not that far off from the 5-yr average of 15.2x. This is despite the 10-15% jump in broader market valuation, and despite the 24% jump in SOX returns. 2) Valuation arguments miss the structurally higher profitability in this rapidly consolidating sector. Semis are on track to deliver 31% median EBITDA margins in 2017E, up 200bp YoY and up 800bp from the 23% margins in 2013 when the M&A boom started. Fewer semi vendors with more disciplined spending and capacity expansion can continue to deliver strong profit margins/FCF, which they are now consistently returning to shareholders, in our opinion (We do flag the potential for more M&A restrictions created by any trade actions under the new US administration).

Investment decisions should not be made prior to reading the research report, which includes important information and disclosures

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Upgrading to Buy as earnings stabilize in 2017

We are upgrading IBM to Buy as (1) we believe that earnings have stabilized and large negative revisions are unlikely, (2) cash flow per share of flat to up is likely in 2017, (3) a dividend yield of 3.6% is attractive when accounting for the optionality of success in growth markets like Artificial Intelligence, (4) savings from restructuring efforts and lower restructuring charges create tailwinds to 2017, (5) pace of investments is likely to not increase, driving benefits from increased utilization, (6) SaaS revenues will start to drive a higher percentage of growth, (7) constant currency organic growth declining at a slower pace and can potentially cross over to positive in 2018, (8) mainframe cycle in 2017 can drive a recovery in transactional revenues, (9) CIO survey suggests IBM gaining mindshare in business intelligence, analytics and Watson, and (10) shares trade at a discount on earnings to peers. Our PO of $185 is based on ~13x our C2017 EPS of $14.57.

Expect EPS to grow in 2017

2016 saw a significant deterioration in pre-tax margins as the company drove significant investments through M&A, and faced transactional headwinds in software and from tougher mainframe comps (dragging constant currency organic growth down by ~200bps). We expect the pace of M&A to moderate, potentially more offsets on tax/IP income items and a tailwind from a new mainframe in 2017. IBM should benefit from the trends of Cognitive Computing (Watson), and adoption of a Hybrid cloud model.

Stock under-owned and provides upside from accumulation

BofAML Strategist Savita Subramanian notes that in the face of macro uncertainty, technology companies screen well, and that IBM is the most under owned tech name by large-cap US fund managers. In fact, IBM is the most underweighted name with only a 0.30 weighting relative to its weight in the S&P 500 index.

Downside risks from weak IT spend and reversal in FX move

Downside risks to our PO are a weaker IT spending environment, increased FX headwinds, risk with transformation to more strategic initiatives (analytics, cloud, mobility, security & social) and increased pace of deterioration in the core business.

Estimates (Dec)

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Valuation (Dec)

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Investment decisions should not be made prior to reading the research report, which includes the opinion key and other important information and disclosures.

Click here for full report including important disclosures.
Upgrade to Buy on improved margin and profit outlook
We are upgrading SYY to Buy from Neutral as we see greater support for operating margin expansion from the recent Brakes acquisition (which closed in July 2016) as well as ongoing initiatives, including increased private label penetration, revenue and category management, and continued expense management. Given our expectation for modest operating margin expansion in F17 (vs. our prior flat forecast), we are raising our F17 EPS to $2.45 from $2.30. Our PO is now $60 (was $54) is based on roughly 10.8x our F18E adj. EBITDA of $3.4bn (was $3.05) & 22x our adj. F18E EPS of $2.70 (was $2.60).

See greater accretion from Brakes acquisition in F17
SYY now expects high-single digit accretion in F17 from its acquisition of Brakes (vs. low to mid-single digit accretion previously) with an acceleration in subsequent years. We also see opportunity for supply chain and administrative cost improvements at Brakes, which could further enhance operating margins. We believe there could be further upside to our longer-term revenue forecast, as we expect Brakes will serve as a platform for expansion in European markets where food away from home spending is underpenetrated relative to the United States (roughly 42% vs. 50% in the US).

Despite near-term headwinds, SYY better positioned vs. peers
SYY continues to execute well, in our view, with gross profit dollar growth of 5% in F1Q17 (excl. Brakes) despite headwinds from a softer industry environment and high levels of deflation (US broadlines deflation was -2.2% in F1Q). Despite these near-term macro headwinds, we view SYY as better positioned vs. peers to navigate current environment due to the competitive advantages that come from its scale and efficiency.

Long-term trends remain favorable for SYY
We also see favorable industry trends that should support SYY’s outlook over the longer term, namely continued momentum in the higher-margin independent restaurant channel supported by shifting consumer preferences towards local, craft, and experiential dining as well as growth in delivery services such as UberEats. We think SYY is well positioned to gain share at independent restaurants (which use four to six distributors on average) through its competitive pricing, value-added services (ex. menu design, profitability analysis), product assortment (incl. a focus on local), and high service levels.

 Estimates (Jun) (US$)

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 Valuation (Jun)

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<td>5.7%</td>
<td>5.9%</td>
<td>6.1%</td>
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Investment decisions should not be made prior to reading the research report, which includes the opinion key and other important information and disclosures. Click here for full report including important disclosures.
Microchip
High-quality execution machine w/diverse growth, self-help tailwinds, Buy, $75 PO

Rating Change: BUY | PO: 75.00 USD | Price: 62.23 USD

Upgrade to Buy on beat/raise results and execution record
MCHP’s beat/raise results convincingly address our prior concerns re organic growth, debt burden and synergies from the low-growth Atmel deal. While the stock is up 34% YTD, ahead of SOX up 25%, we still think there is another 20%+ upside potential over the next year as investors rotate into high-quality midcap growth semis with: 1) solid profitability at 30% OM with path to 33%-35%; 2) diverse industrial/autos/infrastructure spending exposure with no distraction from smartphone market; 3) strong FCF generation, div yield (2.3%); 4) consistent execution; and 5) potential benefits from industry consolidation. We upgrade MCHP to Buy from Neutral, raise CY16/17E EPS by 12c/26c to $3.39/$3.91, and raise PO to $75 from $63 on 21x 2017 PE, in line with peers that trade in a range of 17x-23x 2017 PE, all including stock-comp expense.

Solid accretion with Atmel underscores disciplined M&A
Post-close MCHP reported SepQ sales/EPS 1.5%/6.7% above consensus, along with strong DecQ outlook. The company reported records in 8/16/32 bit microcontrollers, and raised its targets for Atmel synergies by nearly 50% to 50c from 33c in FY17; to 70c/90c for FY18E/19E. We believe the key driver has been more disciplined pricing actions and more consistent execution with what had previously been good but very poorly managed Atmel assets. We see 200bp upside to GM toward 59% over the next 6 qtrs due to $6.5mn qtrly savings from Micrel, ongoing pricing actions at ATML, and scale benefits from MCHP.ATML fabs. Meanwhile, debt leverage has declined to 2.9x in the last quarter (vs. 3.22x target) with plans to reduce further to 2.35x by end of FY17E (Jun’17). We believe this provides flexibility for additional M&A in 2017.

Faster growth than analog peers without mobile distraction
Unlike analog peers (TXN, ADI), MCHP has no exposure to the volatile smartphone market/Apple. Unlike programmable chip peers (XLNX), MCHP has no exposure to lumpy telecom capex. We model mid-single digit sales and 23%/10% EPS growth in CY17/18E for MCHP, which is ahead of 8-10% EPS growth rate of peers. The key risks here are frequent use of M&A, but the track record is of disciplined acquisition and integration.

Key Changes

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<th>(US$)</th>
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<td>2019E EPS</td>
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Vivek Arya
Research Analyst
MLPF&S

Adam Gonzalez, CFA
Research Analyst
MLPF&S

Stock Data

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<td>Mrkt Val (mn) / Shares Out</td>
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<tr>
<td>Average Daily Value (mn)</td>
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<td>BalAML Ticker / Exchange</td>
<td>MCHP US / MCHP.OQ</td>
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<td>Bloomberg / Reuters</td>
<td>MCHP / NAS</td>
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<tr>
<td>ROE (2017E)</td>
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<td>Net Dbt to Eqty (Mar-2016A)</td>
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Estimates (Mar)

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<tr>
<td>EPS</td>
<td>2.66</td>
<td>2.69</td>
<td>3.61</td>
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<td>GAAP EPS</td>
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<td>EPS Change (YoY)</td>
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<td>1.1%</td>
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Valuation (Mar)

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<tr>
<td>P/E</td>
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<td>17.2x</td>
<td>15.4x</td>
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<tr>
<td>GAAP P/E</td>
<td>37.7x</td>
<td>41.8x</td>
<td>83.0x</td>
<td>35.8x</td>
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<td>Dividend Yield</td>
<td>2.3%</td>
<td>2.3%</td>
<td>2.3%</td>
<td>2.3%</td>
<td>2.3%</td>
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<tr>
<td>EV / EBITDA*</td>
<td>20.7x</td>
<td>20.9x</td>
<td>14.4x</td>
<td>12.8x</td>
<td>12.0x</td>
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<tr>
<td>Free Cash Flow Yield*</td>
<td>4.3%</td>
<td>4.8%</td>
<td>6.3%</td>
<td>7.2%</td>
<td>7.6%</td>
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Table 1: Footnotes

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<th>Ticker</th>
<th>Company Name</th>
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<td>AVGO</td>
<td>Broadcom</td>
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<td>CAVM</td>
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<td>TXN</td>
<td>Texas Inst.</td>
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</table>

Source: BofA Merrill Lynch Global Research

Footnote Key

# - One or more analysts responsible for covering the securities in this report owns stock of the covered issuer.
## - One or more analysts responsible for covering the securities in this report owns bonds of the covered issuer.
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P - Class A shares are variable voting.
Q - Class A shares are subordinate voting.
R - Class A shares are nonvoting.
S - Class B shares are voting.
T - Class B shares are nonvoting.
U - Class B shares are restricted voting.
V - Class B shares are subordinate voting.
W - Class S shares are subordinate voting.
X - Common shares are subordinate voting.
Y - Common shares are limited voting.
Price objective basis & risk

**Analog Devices Inc. (ADI)**

Our $70 PO is based on 14x 2017 EV/EBITDA, at upper end of diversified semis trading at 12-15x. We believe structural growth opportunities in automotive/industrial, defensive business model, and strong dividend yield, and industry M&A could help ADI trade at a premium multiple. Upside to our PE multiple could come from higher analog chip content in key end markets, such as industrial, automobiles and communications infrastructure, while downside could come from a slowdown in the semiconductor cycle.

Downside risks to our price objective are: 1) Analog chips have long product cycles that could mask competitive issues and/or share shifts from new design activities, 2) TI’s 300mm fab could add to competitive and pricing risks in some analog segments, 3) New analog chip vendors from lower-margin product areas are attempting to break into the general purpose analog market, 4) Increased R&D spending to maintain its competitive edge, 5) Inventory cycles and potential double ordering by customers that can often create mismatch between real supply and demand. Other risks to Analog Device’s operational and/or financial performance are manufacturing, currency risks, intellectual property and other litigation, and political climate.

**Broadcom Limited (AVGO)**

Our $215 price objective for Broadcom is based on 18x CY2017E Non-GAAP EPS (includes stock comp expense), in line with the semiconductor sector but below diversified analog peer comps (TXN, LLTC, MXIM), and reflecting: 1) Leadership in mobile, data center, and broadband markets, 2) cyclical rebound in Industrial and Comms Infrastructure demand, 3) Cash return and deleveraging, offset by 1) Integration and financial risks with BRCM acquisition, and 2) customer concentration risks.

Downside risks to our price objective are: (1) Competitive risks in handsets where product cycles are short (6-12 months) which frequently result in changes in power amplifier selection by handset vendors, (2) Technological risks with the migration from 2G->3G->4G wireless standards, (3) Changes in filter technology that could impact competitiveness of BAW/FBAR filters vs. SAW, (4) M&A risks from acquisitions which could create integration, financial, regulatory, and operational challenges, (5) Lead time risks from increasing reliance on foundries for IC production and, (6) Semiconductor cyclicality driven by weak macroeconomic conditions, demand or inventory corrections.

**Cavium (CAVM)**

Our price objective (PO) of $62 is based on 25x FY17E EPS, in line with the company’s three-year historical average. The multiple is justified in our view given our expectation for EPS to grow at a 20-25% annual pace.

Downside risks to our PO are a) continued downturn in service provider spending offsetting potential growth from new products, b) ThunderX processor ramp is delayed due to lack of customer adoption, c) Xpliant switch processor adoption delayed into 2017 due to execution issues, d) M&A integration risks with acquisition of QLGC.

Upside risks to our PO are a) service provider spending grows above our expectations. b) Strong customer adoption of ThunderX in servers and Xpliant switching chip in data center leading to realization of $4 in earnings power sooner than later. c) stronger operating leverage than Street expectation driven by growth in new products.

**Inphi Corporation (IPHI)**

Our PO of $50 is based on a 27x 2017E EPS ex stock options. This multiple is in line with the SMID cap peers and justified, in our view, given a) the secular growth tailwinds in its core comms/data ctr businesses, b) 20%+ EPS growth rate, and c) semi consolidation wave likely to continue especially given large semi peers trying to diversify away from short life cycle consumer to longer and stickier product segments.
Upside risks to our PO are: 1) pull-in of PAM4 (2 laser) shipments to 1H:16 which could pull in the incremental growth dollars into 2016 (from 2017), 2) Competition from BRCM weaker than expected driven by merger distraction, and 3) China LTE spend resumes at full speed and becomes a significant tailwind.

Downside risks to our PO are: 1) macro headwinds impacting metro and data center related spend, 2) strong competition from MTSI and AVGO in metro and data center impacting growth expectations in 2016/17, and 3) premium PE multiple makes stock very sensitive to any potential execution errors or weakness in demand environment.

**Intel (INTC)**

Our $42 price objective reflects 15x PE applied to our 2017 EPS estimate, which is in line with its 13-16x historical trading range and is justified, in our view, as Intel's future is steadily less exposed to mature PC and increasingly more to faster growing/more profitable cloud computing, 3D memory, IoT, and software markets.

Downside risks to our price objective are: 1) Weaker than expected trends in mature PC market, which is largest revenue generator for Intel, 2) Competition from ARM and other architectures in profitable data center market, 3) Inability to drive profitable growth in new mobile and foundry markets, 4) Increasing cost and complexity of semiconductor manufacturing that pressures capex and gross margins, 5) Semiconductor and macro cycle risks, and 6) Financial/integration risks in any M&A.

**International Business Machines Corp. (IBM)**

Our PO of $185 is based on approximately 13x our C2017E EPS estimate of $14.57. Our target multiple is within the historical range of 8-16x. We view 13x as appropriate as it is close to the median of the historical range as the growth of IBM’s strategic initiatives are offset by weakness in core revenues. That said, the multiple is still at a 10% discount to large cap technology peers, as we believe there is still execution risk with its strategy.

Downside risks to our price objective are: (1) failure to execute on the company’s EPS growth roadmap, (2) inability to realize expected cost savings from restructuring, (3) technology/competitor risk in hardware, software, and services, (4) unforeseen currency impacts on revenue and profits, (5) acquisition integration, given IBM’s acquisitive nature, and (6) increased concern of waning consumer spending and tightening corporate IT budgets.

Upside risks are: (1) increased share gains in the high growth cloud and big data/analytics markets, (2) faster move to the on demand model, and (3) significant improvement in free cash flow.

**M/A-Com (MTSI)**

Our $42 PO is based on a 16x CY17E PE multiple. The choice of PE is in line with average comp, and within the historical range of 12x-24x PE. Our PO implies roughly 4x EV/S, inline with IPHI, who is growing sales/EPS at a similar pace but has a stronger balance sheet and FCF (20% of revs vs 6%).

Downside risks to our price objective are: (1) Semiconductor cyclicality driven by weak macroeconomic conditions, demand or inventory corrections, (2) Large private ownership with limited public float could add volatility to the stock price, (3) Demand fluctuations in aerospace and defense markets, (4) High degree of leverage could limit Macom’s flexibility and ability to engage in buybacks/dividends, and (5) Integration risks as Macom frequently uses M&A as a key element of its growth strategy.
Maxim Integrated Products Inc. (MXIM)
Our PO of $42 is based on 15x CY17E EV/FCF. Our choice of multiple is towards the lower end of comps trading at 15-17x and reflects the near term uncertainty around topline growth and M&A.

Downside risks to our PO are: 1) Analog chips have long product cycles, which could mask competitive issues and/or share shifts from new design activities, 2) TI’s 300mm fab could add to competitive and pricing risks in high volume analog segments such as handsets, consumer and PCs, 3) New analog chip vendors from lower-margin product areas are attempting to break into the general purpose analog market, 4) Increased R&D spending to maintain its competitive edge, 5) Inventory cycles and potential double ordering by customers that can often create mismatch between real supply and demand, and 6) Samsung customer concentration. Other risks to Maxim’s operational and/or financial performance are a slowdown in the semiconductor cycle due to weak macroeconomic conditions, manufacturing, currency risks, intellectual property and other litigation, and political climate.

Upside risks to our PO are: 1) Market share gains in analog, especially in automotive and better execution, 2) Faster than expected growth in automotive semis, 3) Opex control can drive margins above expectations, and 4) Strong dividend yield and good free cash flow generation can support higher PE multiples.

Microchip (MCHP)
Our price objective of $75 is based on 21x CY17E PE (incl. stock comp expense), in line with comps trading between 17-23x. We believe our choice of PE is justified given stronger core growth with no mobile exposure, disciplined M&A strategy, and strong operating leverage.

Upside risks to our PO: better than expected synergies from the Micrel/Atmel acquisition, continued strong share gains in the 8/32bit MCU category, and M&A tailwind increasing valuation across the board.

Downside risks to our PO: macro headwinds and increased competition capping any market share gains.

NVIDIA Corporation (NVDA)
Our $95 PO is based on 27x CY17E PE ex cash which is a premium to the sector and inline with NVDA’s long-term earnings growth rate. We believe our chosen multiple is reasonable as it reflects NVDA’s faster and more profitable growth profile.

Risks to our price objective are: 1) Uncertainty around renewal of INTC royalties, 2) exposure to PC market, 3) Competition with INTC & PLD companies in HPC/accelerated computing markets and MCU vendors in Autos. 4) Lumpy and unpredictable sales in new enterprise and autos markets, 5) Potential for decelerating capital returns, and 6) Ongoing litigation.

ON Semiconductor (ON)
Our price objective of $14 is based on 12x CY17E PE, which is inline with ON’s five-year historical trading multiple but at a discount to discrete and analog semi comps on lower GM and higher leverage.

Risks to our PO are: 1) Analog chips have long product cycles that could mask competitive issues and/or share shifts, 2) PC and consumer end-markets could weaken further, 3) Mobile growth is slowing as penetration rates flatten and the mix shifts toward lower priced devices, 4) Pricing pressures in standard products where fixed costs are high and there is little competitive differentiation, 5) Developing differentiated and higher valued analog IC’s could result in elevated levels of R&D spending and lower
profitability for several years, 6) The semi industry is very cyclical where demand sometimes increases or decreases rapidly, and 7) M&A integration risks. Other risks to ON Semi’s operational and/or financial performance are manufacturing, currency risks, intellectual property and other litigation, political climate, etc. Upside to our PE multiple could come from faster sales growth, content or share gains in focus end markets (industrial, automobiles, wireless handsets), margin expansion and/or consistent cash returns to shareholders. Downside could come from a slowdown in the semiconductor cycle, inventory correction, margin pressures, and weak sales growth.

**Sysco Corporation (SYY)**

Our $60 price objective is based on 10.8x our F18 adjusted EBITDA estimate of $3.4b, which is a premium to peer average EV/EBITDA of 9x. We believe SYY deserves a premium multiple vs. peers given its industry-leading operating margins, ongoing productivity initiatives, lower leverage, and dividend yield. Our PO is also supported by a discounted cash flow analysis that assumes 7% expected return and 11x terminal EBITDA multiple on our 2021E EBITDA of $3.8bn.

Risks to the downside: 1) a highly competitive foodservice distribution industry, 2) risks associated with a macroeconomic slowdown or lower consumer confidence that could negatively affect food away from home consumption, 3) case volume growth is dependent on attracting new customers or increasing penetration with existing customers, 4) sales headwinds from product cost deflation or margin pressures from product cost inflation, 5) potential pressures on profitability from high fuel costs, 6) and inability to achieve cost savings initiatives, which could pressure operating margins.

Risks to the upside: 1) better-than-expected local case growth supported by continued macroeconomic improvements and successful sales initiatives, 2) gross margin upside from a favorable customer mix shift, 3) better-than-expected results from productivity initiatives and cost cuts, and 4) potential for accretive M&A given the fragmented market.

**Texas Instruments Inc. (TXN)**

Our $82 PO on TXN is based on 14x FY17E EV/EBITDA, in line with high quality diversified and analog peers trading at 14x-15x, given TXN’s high quality business model and strong FCF generation.

Risks to our price objective: 1) Lumpy telco capex, especially in wireless deployments, 2) Volatile market share as design cycle times are very long, 3) Increased R&D spending pressure to maintain an edge versus the competition, 4) Inventory cycles and potential double ordering by customers that can often create mismatches between real supply and demand, 5) Exposure to several mature markets such as PC and other consumer electronics could limit its growth rate.
**Table: Measurements Definitions**

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<th>Numerator</th>
<th>Denominator</th>
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<td>Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization</td>
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<td>Return On Equity</td>
<td>Net Income</td>
<td>Shareholders’ Equity</td>
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<td>Operating Margin</td>
<td>Operating Profit</td>
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<td>Expected 5-Year CAGR From Latest Actual</td>
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<td>Free Cash Flow</td>
<td>Cash Flow From Operations – Total Capex</td>
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**Quality of Earnings**

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<td>Asset Replacement Ratio</td>
<td>Capex</td>
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<tr>
<td>Tax Rate</td>
<td>Tax Charge</td>
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<tr>
<td>Net Debt-To-Equity Ratio</td>
<td>Net Debt = Total Debt, Less Cash &amp; Equivalents</td>
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<td>Interest Cover</td>
<td>EBIT</td>
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</table>

**Valuation Toolkit**

<table>
<thead>
<tr>
<th>Price / Earnings Ratio</th>
<th>Current Share Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price / Book Value</td>
<td>Current Share Price</td>
</tr>
<tr>
<td>Dividend Yield</td>
<td>Annualised Declared Cash Dividend</td>
</tr>
<tr>
<td>Free Cash Flow Yield</td>
<td>Cash Flow From Operations – Total Capex</td>
</tr>
<tr>
<td>Enterprise Value / Sales</td>
<td>EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities</td>
</tr>
<tr>
<td>EV / EBITDA</td>
<td>Enterprise Value</td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th>Investment Rating</th>
<th>Total return expectation (within 12-month period of date of initial rating)</th>
<th>Ratings dispersion guidelines for coverage cluster*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buy</td>
<td>≥ 10%</td>
<td>≤ 70%</td>
</tr>
<tr>
<td>Neutral</td>
<td>≥ 0%</td>
<td>≤ 30%</td>
</tr>
<tr>
<td>Underperform</td>
<td>N/A</td>
<td>≥ 20%</td>
</tr>
</tbody>
</table>

* Ratings dispersions may vary from time to time where BofA Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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