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## U.S. Equity Strategy Weekly

### Industry pricing power to soften margin pressure—Who has it?

**With Q3 reporting season winding down, what has been prevalent again this quarter is the widening gap between revenue and earnings delivery.**

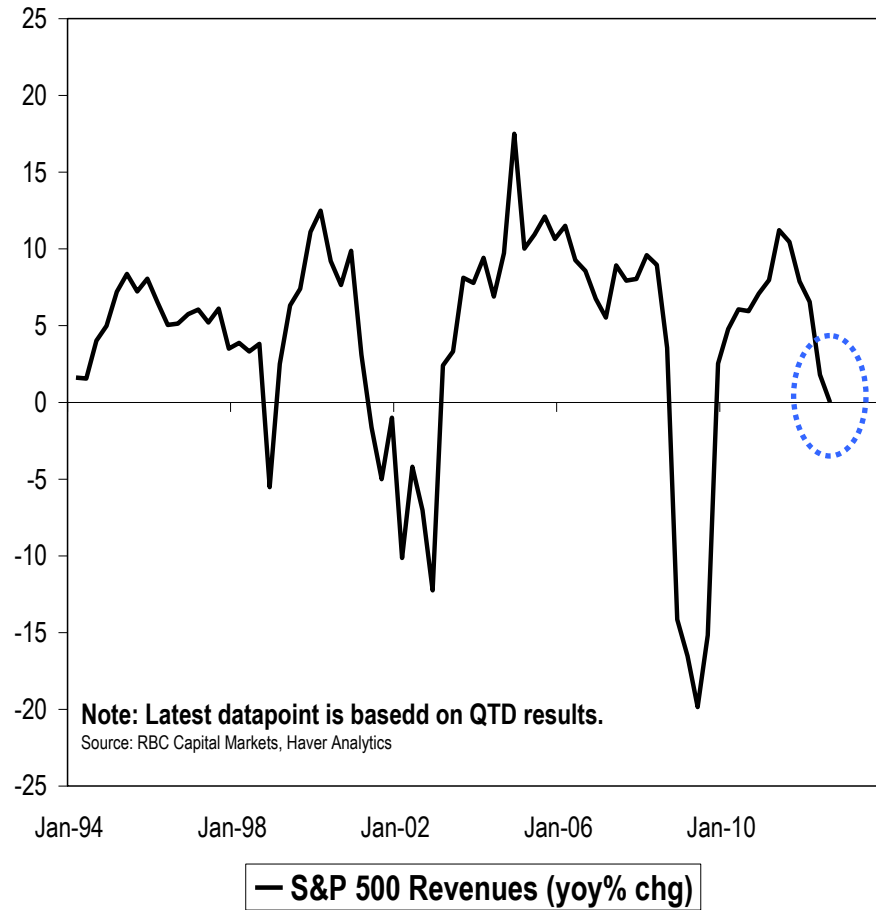
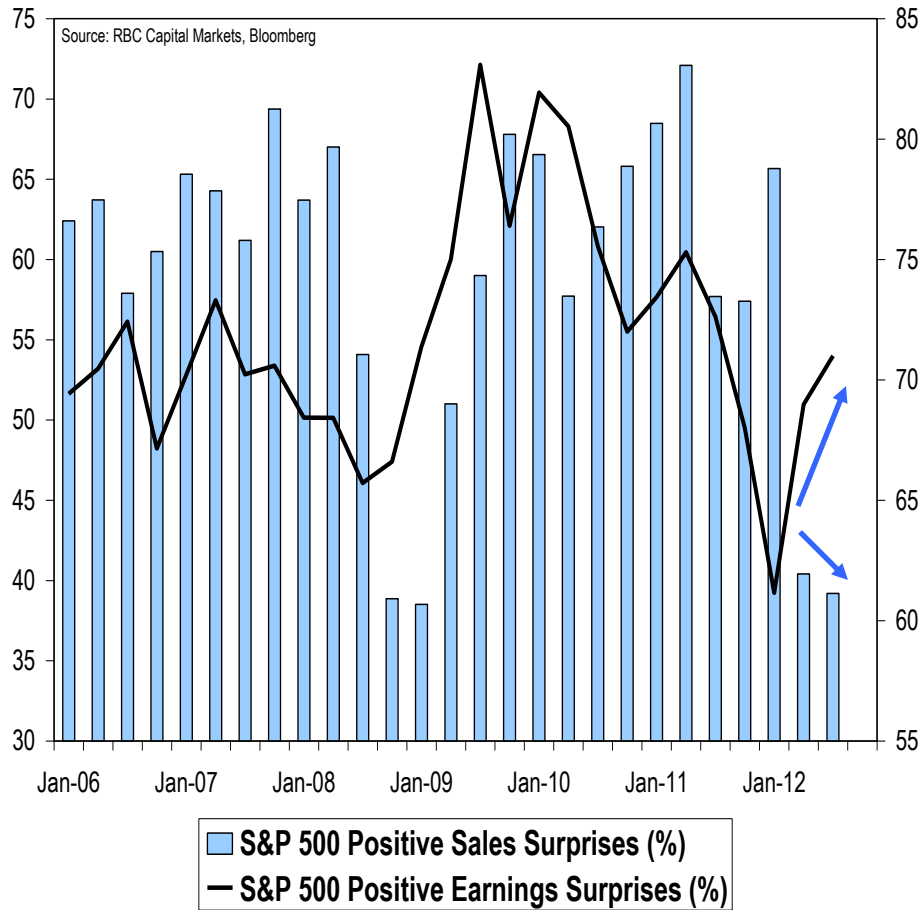
While positive earnings surprises in aggregate have held close to their five-year average of 72%, revenues have only managed to beat expectations at a 39% clip. This is well below the five-year average of 58% for revenue beats and just a touch higher than the lows witnessed in the last recession. Meanwhile, quarter-to-date sales growth on a year-over-year basis for this quarter is tracking in negative territory, which would also be the first negative print since the recession.

**The heat is on for companies to preserve margins.** From a macro perspective, it seems that companies will likely cut capital expenditure over labor, with CEOs assuming the pressure is temporary. At the same time, those with pricing power might have a somewhat easier adjustment.

**We look at pricing power by industry to see which areas of the market have some end-price insulation from market forces.** For a proxy of pricing power, we analyze the recent trends of economic price indices related to S&P 500 industries. **We also note the recent changes in net margins to help pinpoint industries under pressure:**

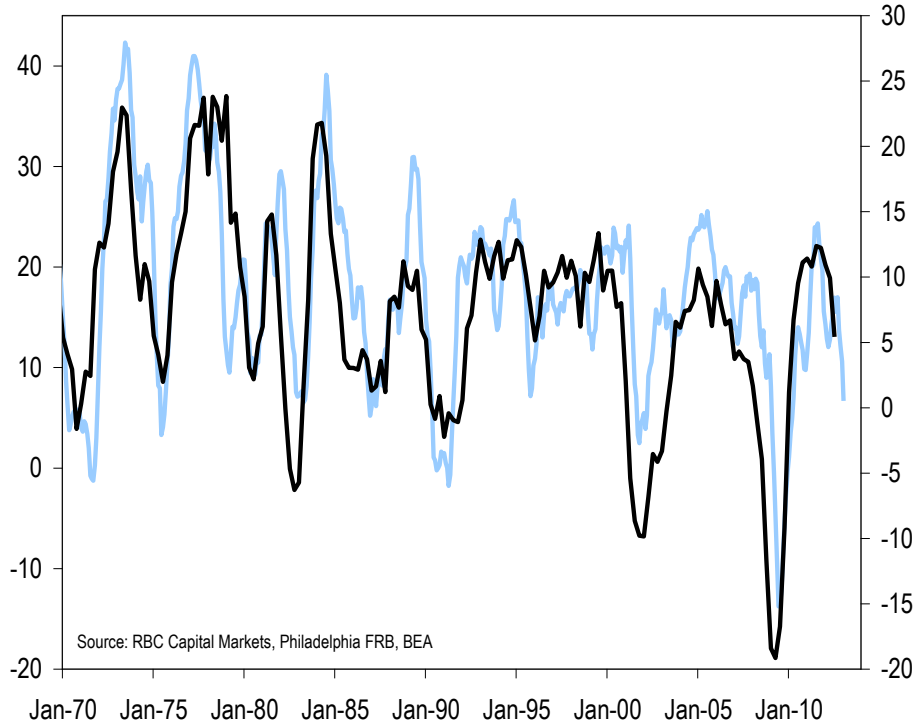
- S&P 500 industries with pricing power and expanding margins include Tobacco, Homebuilding, Broadcasting & Cable Providers, and Commercial & Professional Services.
- S&P 500 industries losing pricing power alongside compressing margins include Software, Paper Products, Chemicals, and Autos & Components.

# Top line under pressure

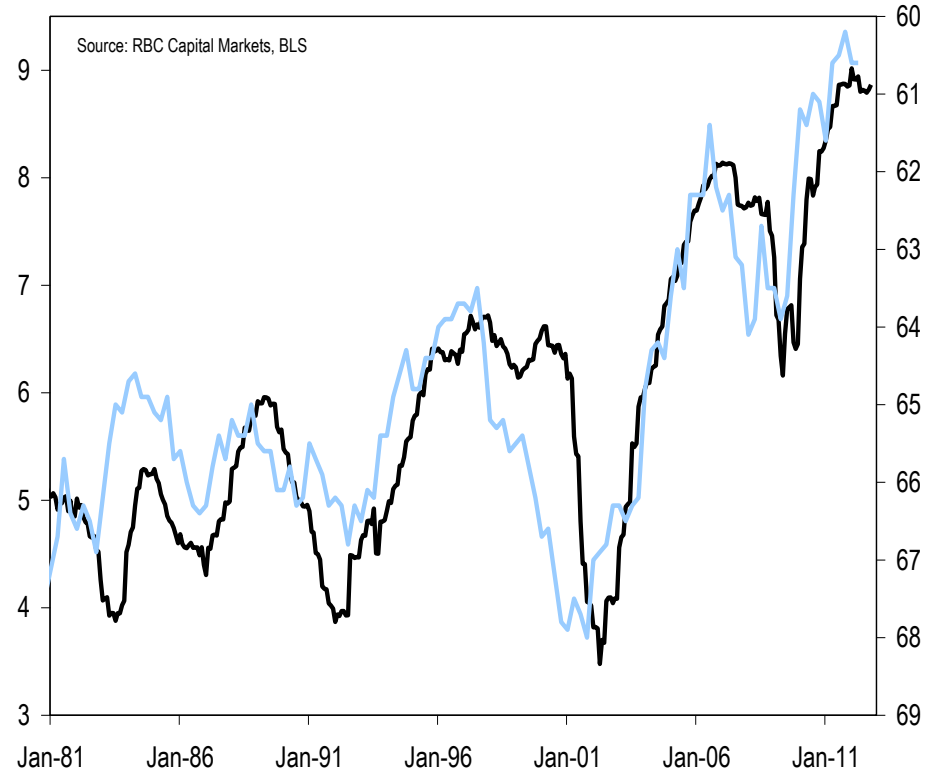


- With just over 10% of companies left to report Q3 earnings, what has been prevalent again this quarter is the widening gap between revenue and earnings delivery. While positive earnings surprises in aggregate have held close to the five-year average of 72%, revenues have only managed to beat expectations at a 39% clip, which is well below their five-year average of 58% and just a touch higher than the lows witnessed in the last recession.
- Meanwhile, sales growth on a year-over-year basis is tracking in negative territory for the first time since the recession.

## Margin pressure to weigh on Capex; less so on employees



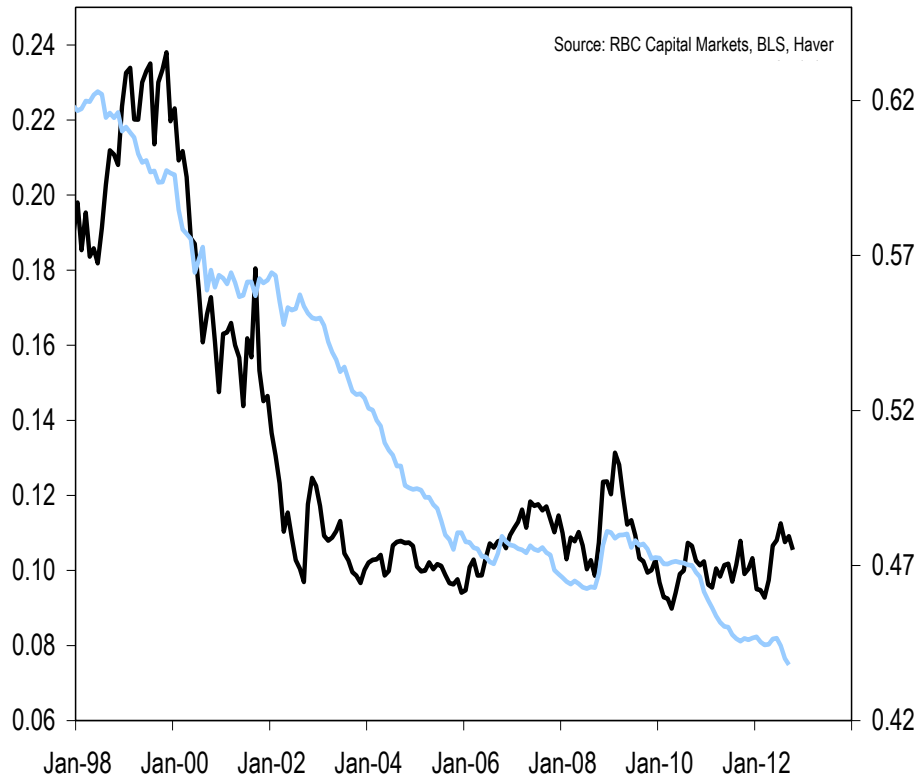
— Philadelphia Fed's Business Outlook Survey: Capital Expenditures in 6 months (6mma, Adv 3mo) (LS)  
 — US M & E Investment (yoy% chg) (RS)



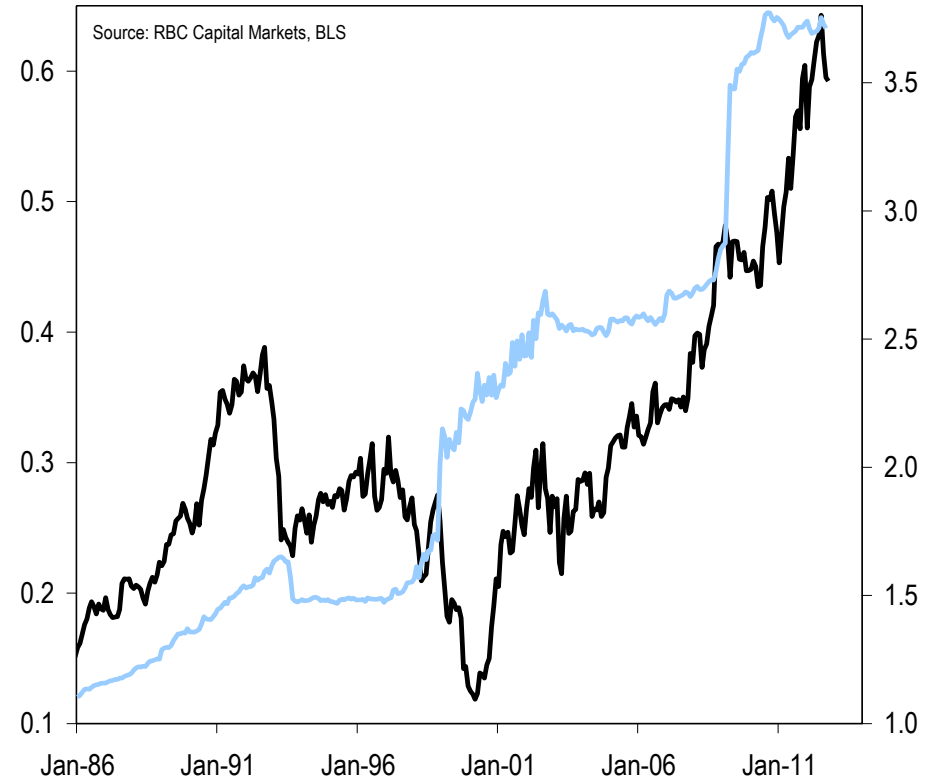
— S&P 500 ex-Financials Net Margins (%) (LS)  
 — Nonfin Corp: Labor Share of Output (% , inverted scale) (RS)

- The heat is on for companies to preserve margins. From a macro perspective, it seems that companies will likely cut capex over labor, with CEOs assuming the pressure is temporary (capex is easier to cut and reinstate than labor given hiring/firing frictions).
- As well, there is also likely no more fat to be trimmed from the labor-side of the equation, as employees have been squeezed over the past three years, helping to boost margins to their highest level in more than 30 years.

## Two examples of pricing power: Telcos versus Tobacco



— S&P 500 Telecom / Composite (LS)  
 — US CPI: Telephone Services / All Items (RS)



— S&P 500 Tobacco / Composite (LS)  
 — US CPI: Tobacco / Composite (RS)

- At the industry level, two contrasting pictures illustrate examples of industries with and without pricing power, both plotted alongside their respective S&P 500 industry's relative price performance.
- The Telecom sector's pricing power has been in deterioration for over a decade while Tobacco's is a polar opposite.

## Pricing power haves and have-nots

S&P 500 Industry Pricing Power and Net Margins:					
		Pricing Power		Net Margins	
		Rank	3-mo chg	Rank	3-mo chg
Energy	Oil, Gas & Consumable Fuels	1	11.3%	29	-0.4%
Energy		2	9.9%	30	-0.4%
Utilities	Natural Gas to Ultimate Consumers	3	4.7%	32	-0.5%
Consumer Discretionary	Broadcasting & Cable Providers	4	3.3%	7	0.3%
Financials	Diversified Financials	5	2.7%	37	-0.9%
Consumer Staples	Packaged Foods & Meats	6	2.2%	26	-0.1%
Consumer Discretionary	Homebuilding	7	1.5%	6	0.3%
Consumer Staples	Tobacco	8	1.2%	11	0.1%
Industrials	Commercial & Professional Services	9	0.9%	13	0.1%
Health Care	Equipment & Services	10	0.9%	25	-0.1%
Health Care	Pharma, Biotech & Life Sciences	11	0.7%	18	0.0%
Financials	Insurance	12	0.6%	22	-0.1%
Consumer Discretionary	Restaurants	13	0.6%	24	-0.1%
Consumer Staples	Personal Products	14	0.5%	23	-0.1%
Info Tech	Semis & Semiconductor Equipment	15	0.4%	34	-0.8%
Info Tech	IT Services	16	0.4%	18	0.0%
Industrials	Capital Goods	17	0.4%	12	0.1%
Consumer Discretionary	Consumer Electronics	18	0.4%	4	0.5%
Consumer Discretionary	Leisure Equip & Products	19	0.4%	5	0.5%
Materials	Mining	20	0.3%	36	-0.9%
Info Tech	Internet Software & Services	21	0.3%	38	-1.7%
Industrials	Rail	22	0.1%	8	0.2%
Consumer Staples	Household Products	23	0.0%	14	0.1%
Consumer Discretionary	Textiles, Apparel & Luxury Goods	24	0.0%	27	-0.2%
Consumer Staples	Food, Staples Retailing	25	0.0%	20	0.0%
Consumer Discretionary	Household Durables	26	-0.2%	21	-0.1%
Consumer Discretionary	Autos & Components	27	-0.5%	28	-0.3%
Materials	Chemicals	28	-0.5%	34	-0.8%
Consumer Discretionary	Hotels & Casinos	29	-0.7%	9	0.2%
Materials	Paper Products	30	-0.8%	31	-0.4%
Consumer Discretionary	Publishing	31	-0.9%	10	0.1%
Telecom		32	-0.9%	15	0.0%
Utilities	Electric Power Generation, Transmiss	33	-0.9%	3	0.7%
Info Tech	Computer Hardware	34	-1.1%	16	0.0%
Info Tech	Communication Equipment	35	-1.6%	17	0.0%
Industrials	Airlines	36	-2.5%	1	1.3%
Financials	Banks	37	-2.6%	2	0.9%
Info Tech	Software	38	-2.7%	33	-0.7%

Note: Ranked on pricing power: Best (1) to Worst (38)

Source: RBC Capital Markets, Haver Analytics

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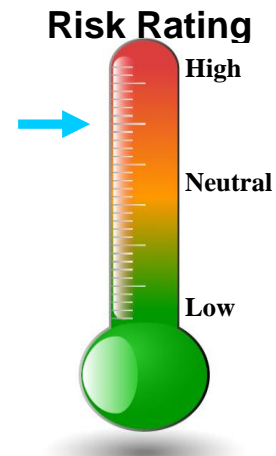
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## RBC CM U.S. Equity Market Views

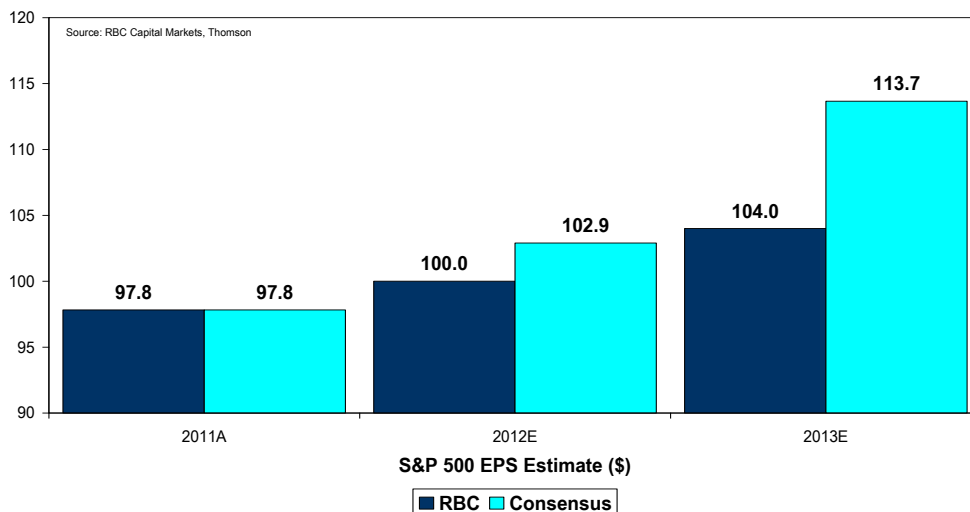
### Market Outlook (Next 6 - 9 months)

Overweight	
Market Weight +	
Market Weight	X
Market Weight -	
Underweight	

▲/▼ Directional Bias. Source: RBC Capital Markets



### S&P 500 Earnings Outlook



### S&P 500 Sector Recommendations Summary

U.S. Equity Sectors	Current Recommendation	Recent Change (July 5, 2012)
Health Care	Overweight	Upgraded from Market Weight
Consumer Staples	Overweight	None
Information Technology	Overweight	None
Industrials	Market Weight	Downgraded from Overweight
Financials	Market Weight	None
Energy	Underweight	None
Utilities	Underweight	None
Telecom Services	Underweight	None
Materials	Underweight	None
Consumer Discretionary	Underweight	None

Source: RBC Capital Markets



## Market Update

Benchmark Performance Review (% chg)						
	1wk	1mo	3mo	12mo	QTD	YTD
<b>CAPITALIZATION</b>						
S&P 500	(3.8)	(3.8)	(2.1)	8.8	(4.6)	9.3
S&P 400	(3.7)	(1.0)	0.7	8.3	(2.3)	9.9
S&P 600	(3.9)	(2.4)	(0.7)	8.5	(4.5)	7.7
<b>STYLE</b>						
S&P 500 Pure Value	(3.9)	(1.0)	3.6	10.7	(0.6)	14.3
S&P 500 Pure Growth	(2.6)	(2.6)	(0.6)	5.1	(3.6)	9.3
S&P 400 Pure Value	(3.8)	(0.4)	2.9	9.9	(0.3)	10.1
S&P 400 Pure Growth	(3.1)	(0.1)	1.8	7.2	(2.2)	11.6
S&P 600 Pure Value	(4.7)	(3.2)	3.1	9.8	(5.2)	9.4
S&P 600 Pure Growth	(3.7)	(3.4)	(2.1)	5.6	(6.0)	5.7
<b>S&amp;P 500 SECTOR BENCHMARKS</b>						
Energy	(5.1)	(4.7)	(3.9)	(3.1)	(5.9)	(0.4)
Materials	(3.5)	(2.7)	(1.0)	1.2	(4.0)	5.6
Industrials	(3.2)	(1.1)	(0.9)	8.2	(1.4)	7.7
Info Tech	(4.7)	(7.0)	(7.8)	5.4	(9.9)	8.7
Consumer Disc	(3.0)	(1.5)	2.2	15.7	(2.7)	16.8
Financials	(4.7)	(2.6)	3.1	16.5	(1.4)	18.2
Consumer Staples	(2.4)	(3.9)	(3.1)	10.0	(3.8)	6.1
Health Care	(2.7)	(2.9)	1.6	15.3	(2.6)	12.8
Utilities	(3.5)	(5.8)	(7.9)	(2.4)	(5.6)	(4.6)
Telecom	(2.8)	(4.3)	(6.1)	15.0	(7.7)	11.7

As of November 13, 2012 except for Style which is as of the prior day.

Source: RBC Capital Markets, Bloomberg

## Recent Publications

[Stock Picking's Demise Creates Opportunity](#) — Indexing creates opportunity for alpha among stock pickers. — Nov 7, 2012

["Chart Toppers" \(vol. 11\)](#) — Reviewing some of our more interesting charts from the past few months — Oct 31, 2012

[The Equity Market Implications of F-cubed](#) — Fear, flows and the Fed are the more important forces driving Treasuries — Oct 24 2012

[Investing in a Macro Dominated World - Rebel of Conform?](#) — Addressing the upward trend in performance correlation — Oct 17 2012

[Q3 Reporting Season: Opportunity given low bar?](#) — Gauging the weak pre-announcements ahead of earnings season — Oct 10, 2012

## Select Thematic Reports over the Past Year

[Market Persuasion](#) — A review of 17 sentiment and market-based indicators as a gauge of the investment environment — Sep 26, 2012

[Big Events into Week's End...and Year's End](#) — Review of some big macro risks, as well as impact of upcoming elections— Aug 1, 2012

[Moderate Long-Term Equity Prospects: A Supply-Side Approach](#) — Estimating longer-term prospects for equity markets — Jul 18, 2012

[Where's the Mo?](#) — Augmenting price momentum strategies with industry fundamentals — Jul 11, 2012

[Remaining Positive Despite Turbulence](#) — Our full marketing handout summarizes our current views — May 23, 2012

[At the Margin](#) — Making the case that additional margin expansion is losing steam, especially for the Discretionary sector — May 2, 2012

[Seasonalize This](#) — We provide empirical support for the existence of seasonal performance patterns (i.e., buy in May) — Apr 25, 2012

[Riding the Next Tsunami: Long-Term Investment Themes and Ideas](#) — We present seven structural investment themes — Apr 4, 2012



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