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US Equity Strategy | North America

Weekly Warm Up: Follow the Money - QE & Fiscal Stimulus Growing Money Supply

QE and fiscal stimulus are creating unprecedented growth in the money supply - deposits and money market balances have surged. Where will the money end up? Equity market indices do not reflect the nervousness that still lurks under the surface. Is this a concern or an opportunity?

A different kind of QE is growing the money supply... The US money supply has been growing quickly since QE restarted. M2 money supply and near money equivalents have grown by 22% of the money supply in 3 months, an amount multiple times bigger than in 2008. Money supply growth is also *larger* than the Fed's B/S expansion to date as the combination of large Fed asset buying and fiscal stimulus is creating a powerful transmission mechanism to money supply.

... and we think there is more to come. With QE and fiscal stimulus programs both set to continue into the foreseeable future, we expect the growth in money supply will continue. Contrary to the 2008 experience, Treasury issuance is not blunting money supply growth – money from QE asset sales is flowing into money market funds, which buy new Treasury paper issued to support deficit spending, meaning the QE dollars are moving into M2.

A tailwind for inflation. We see a good chance that as we move through the year and into 2021 that an increase in money supply may provide a tailwind to inflation, which supports the view of our economists that inflation will move higher in 2021 and beyond. Global Economics: The Return of Inflation (11 May 2020). Among the signposts to watch, money market flows into M2 and new bank lending that further propels money supply.

Trust the cycle and embrace the cyclical side of the barbell. It's always difficult to trust the cycle at the trough. However, price action suggests it's not different this time. In fact, the cheapest stocks have never been cheaper and this argues for leaning even harder into the wind. Banks and financials look to be the greatest outlier as long rates continue to hold the key to any meaningful rotation.

MORGAN STANLEY & CO. LLC

Michael J Wilson
EQUITY STRATEGIST
M.Wilson@morganstanley.com +1 212 761-2532

Adam Virgadamo, CFA
EQUITY STRATEGIST
Adam.Virgadamo@morganstanley.com +1 212 761-1376

Andrew B Pauker
EQUITY STRATEGIST
Andrew.Pauker@morganstanley.com +1 212 761-1330

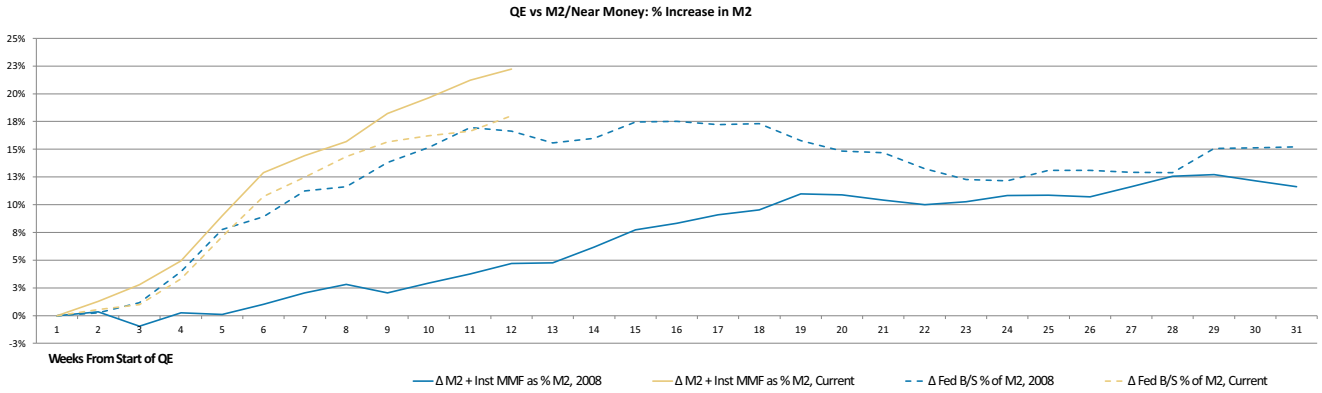
Michelle M. Weaver
EQUITY STRATEGIST
Michelle.M.Weaver@morganstanley.com +1 212 296-5254

What to Focus on This Week

Follow the Money: QE + Fiscal Means More Money to the Real Economy

QE + fiscal = increased money supply. The latest round of QE is more likely to be inflationary than past QE as QE and the stimulus loan programs are effectively inflating M2 and near money equivalents more effectively. From the start of QE through 2 weeks ago, M2 money supply and near money (institutional money market funds) have grown by ~22% of M2, compared to a peak of around 13% during the first wave of QE (Exhibit 1). The current growth in M2/near money is actually in excess of the current Fed B/S expansion, whereas in 2008 this growth was running well below the Fed's growth during a similar period. As we move through the year and into 2021 that increase in money supply may provide a tailwind to inflation, which supports the view of our economists that inflation will move higher in 2021 and beyond. Global Economics: The Return of Inflation (11 May 2020).

Exhibit 1: Money Supply Growing Much Faster Today Than With QE1

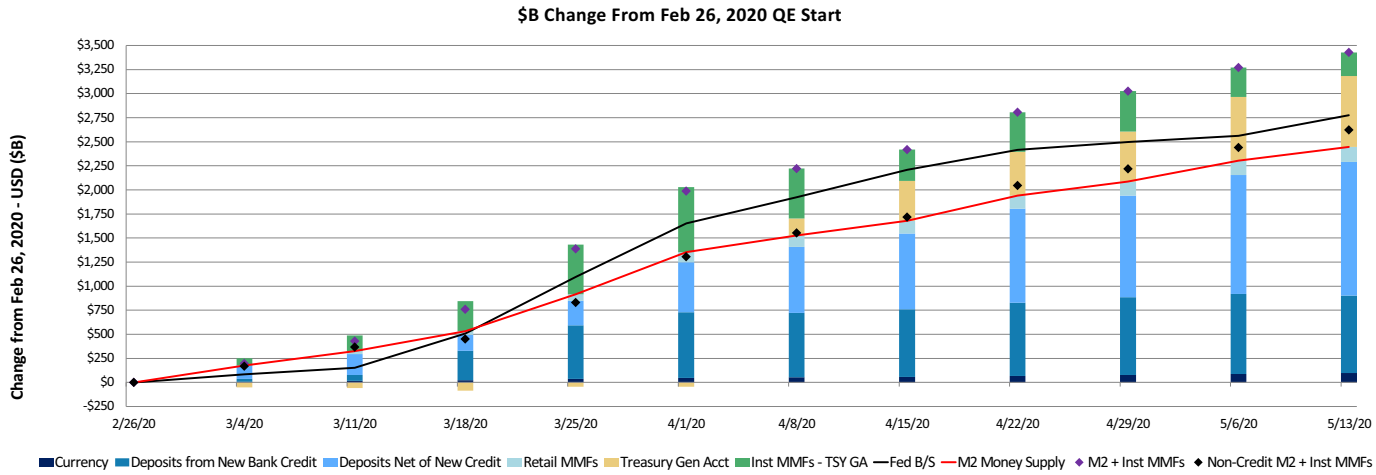


Source: Source: US Federal Reserve, ICI, Bloomberg, Morgan Stanley Research.

Money supply is entering the economy - bank deposits are growing and growing AUM in government money market funds is supporting new treasury paper that will find its way to M2 via deficit/stimulus spending. Last week, we noted that M2 growth is tracking closely with the growth of the Fed's balance sheet. Exhibit 2 goes into some detail on where the money from the Fed's asset purchases is flowing. For those interested in the detailed build up, we provide a breakdown of the various chart components/fund flows below, but here we highlight a few key points:

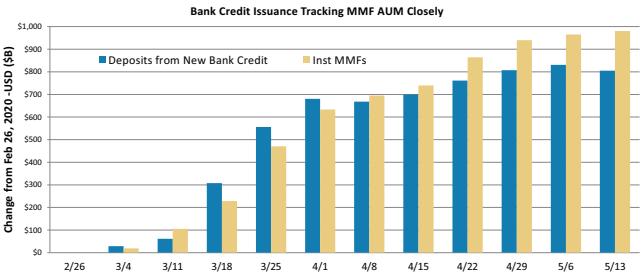
- **M2 growing with QE:** M2 money supply growth is tracking the expansion of the Fed's balance sheet in $ terms on a weekly basis (red vs black lines in Exhibit 2).
- **M2 + near money > QE:** A slightly broader measure of the money supply - M2 + funds flowing to institutional money market funds (MMFs) - is running well ahead of the QE amount to date. See the purple diamonds in Exhibit 2.
- **Credit creation explains the money supply upside to QE:** It seems cash from QE is sitting in a mix of bank deposits and MMFs as asset sellers seek a safe home for cash. That means new bank credit is the primary upside driver to the increase in the broader money supply beyond funds from QE. To date these credit increases are a bit below MMF inflows, an indirect offset or sidelining of cash (Exhibit 3), but we expect that money to find its way to the money supply and the real economy as well.
- **Defensive credit growth:** Credit growth can almost all be explained by the payroll protection program (PPP) and revolver drawdowns to support liquidity (Exhibit 4). Both of these are fairly defensive forms of money creation as they are meant to cover shortfalls from a drop in economic activity, but they nevertheless represent flow of new money into the economy.
- **MMF AUM has surged, driven by institutional govt funds:** Retail MMFs have seen an increase that is substantial (~$160B) but the flows to institutional MMFs has been over 6x as large (~$1T).
- **Deficit spending by way of inst MMFs:** The $1T in flows to institutional MMFs have gone to government funds, which are in turn buying short term treasury paper. This paper is newly issued to support further deficit spending, meaning if the new QE money in MMFs isn't in M2 now, it will be soon as the government continues spending. See Global Macro Strategy: Do Deficits Destroy Liquidity? (22 May 2020)
- **Watching further new credit creation:** Organic credit creation using the QE enhanced deposit base and fractional reserve lending would be a bullish signal for the real economy and reflationary trades. This future growth will hinge on the strength of organic credit demand as we move further along in the recovery and merits watching.

Exhibit 2: Money Supply Has Been Rising With QE



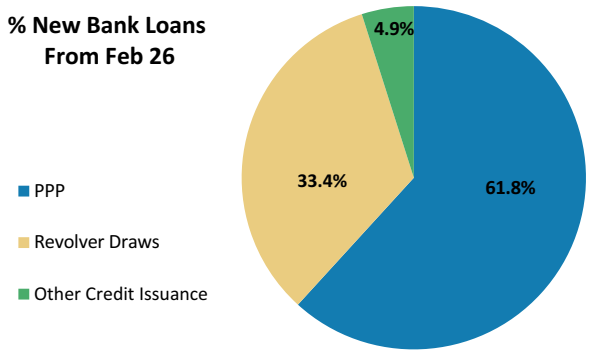
Source: US Federal Reserve, ICI, Bloomberg, Morgan Stanley Research.

Exhibit 3: Credit Based Money Creation Has So Far Been Indirectly "Absorbed" in MMF Flows



Source: US Federal Reserve, ICI, Bloomberg, Morgan Stanley Research.

Exhibit 4: New Credit Creation Explained By PPP and Liquidity Draws



Source: US Federal Reserve, ICI, Bloomberg, Company Filings, Morgan Stanley Research.

Following the Money - A Closer Look at QE Flows

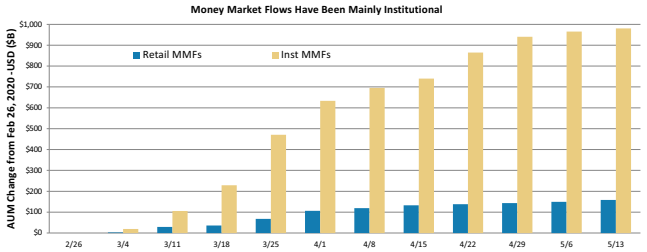
All line items in Exhibit 2are shown as cumulative net change from when QE restarted on Feb 26 through the week of May 13, the latest period available in Federal Reserve data.

- **Black line - Fed B/S Expansion:** The Fed's balance sheet with a total net change of just under $2.9T. (Bloomberg - FARBAST Index)
- **Red line - M2:** Net change in the M2 money supply. (Federal Reserve H6 Statistical Release)
- **Blue bars - M2 Decomposed:** The M2 money supply consists of M1 - currency, demand deposits, and other checkable deposits (including travelers checks) - and non-M1 M2 - small denomination time deposits (CDs), savings deposits, and retail MMFs. For simplicity, we aggregate all of the deposit series in the blue bars, and break down growth in M2 according to a different structure, showing currency (dark blue), deposit growth tied to the issuance of new bank credit (medium blue, defined as the change in loans and leases in bank credit, line 5 of the Fed's H8 Statistical Release), and the growth in deposits not tied to credit growth (light blue).
- **Yellow bars - US Treasury Gen Acct:** The US Treasury's general account at the Fed. Treasury holdings at the Fed are not a part of the money supply, but large issuance of US Treasuries that pull money from M2, are a potentially material destination for funds from QE. (Federal Reserve H6 Statistical Release)
- **Green bars - Inst MMF Flows > TSY Gen Acct:** Institutional MMFs are a near money item and included in M3. Within this group of MMFs, there are government and prime funds, but the recent growth in institutional MMFs has been primarily in government money market funds, which have been buying US government paper. Since these funds are buying from the US Treasury and those funds could flow through to either the Treasury's general account (or back to M2 if Treasury spends that money), we're showing only the growth in institutional MMFs greater than the growth in the Treasury's general account to avoid double counting. (Federal Reserve H6 Statistical Release and ICI)
- **Purple diamonds - Broader Money Supply:** Since institutional MMFs are a near money item, we aggregate M2 and institutional MMFs flows to show a measure of the broader money supply increase.
- **Black diamonds - Non-Credit Broader Money Supply:** For a closer look at how the money supply is growing more directly from QE, this series removes the growth in new bank credit issuance, or private money creation via the credit channel. In practice this means removing the boost to the money supply from PPP lending and revolver draws for liquidity purposes.

The MMF "cash on the sidelines" is not retail. Over the last few weeks, we've seen many point out the rapid rise in MMF AUM, over $1.1T since the end of February, as a sign of retail cash on the sidelines. As part of the analysis here, we looked at the breakdown of where the new AUM in MMFs is sitting and it is overwhelmingly in institutional MMFs, not retail funds. Exhibit 5shows the side by side comparison of AUM growth where inst. MMFs flows have outpaced retail by a factor of ~6x ($160B vs $1T). $160B of funds into retail oriented MMFs is not a small number, but lines up more closely with observed flows out of equity mutual funds and ETFs over the similar period. The bigger flows to MMFs seem to be from either (1) asset owners that have sold assets to the Fed via QE or (2) businesses that have drawn on credit liquidity, both of which are now likely putting cash in short term MMFs primarily servicing institutional clients and holding government paper.

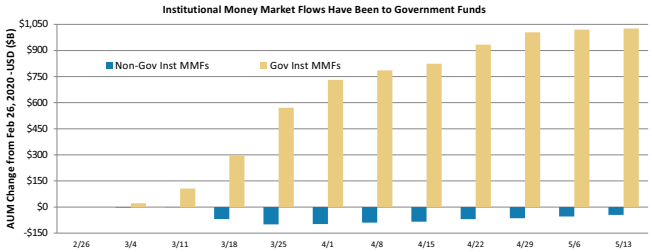
Over 100% of the flows to MMFs have gone to government funds, effectively financing deficit spending. The bulk of MMF flows have gone to institutional funds and, of these flows, government funds are the entire story. Exhibit 6 shows the breakdown of cumulative flows to government vs non-government institutional MMFs. The government MMFs invest in short term Treasury securities and repo loans securitized by short term Treasury paper. While the AUM flows are massive, they amount to ~70% of the net T-bill issuance from the Treasury in March and April, money that will likely soon find its way into the real economy (M2) via the various stimulus programs being supported by the federal government.

Exhibit 5: Money Market Flows - QE Asset Sales and Liquidity Drawdowns Funneling Money to Inst Funds



Source: US Federal Reserve, ICI, Bloomberg, Morgan Stanley Research.

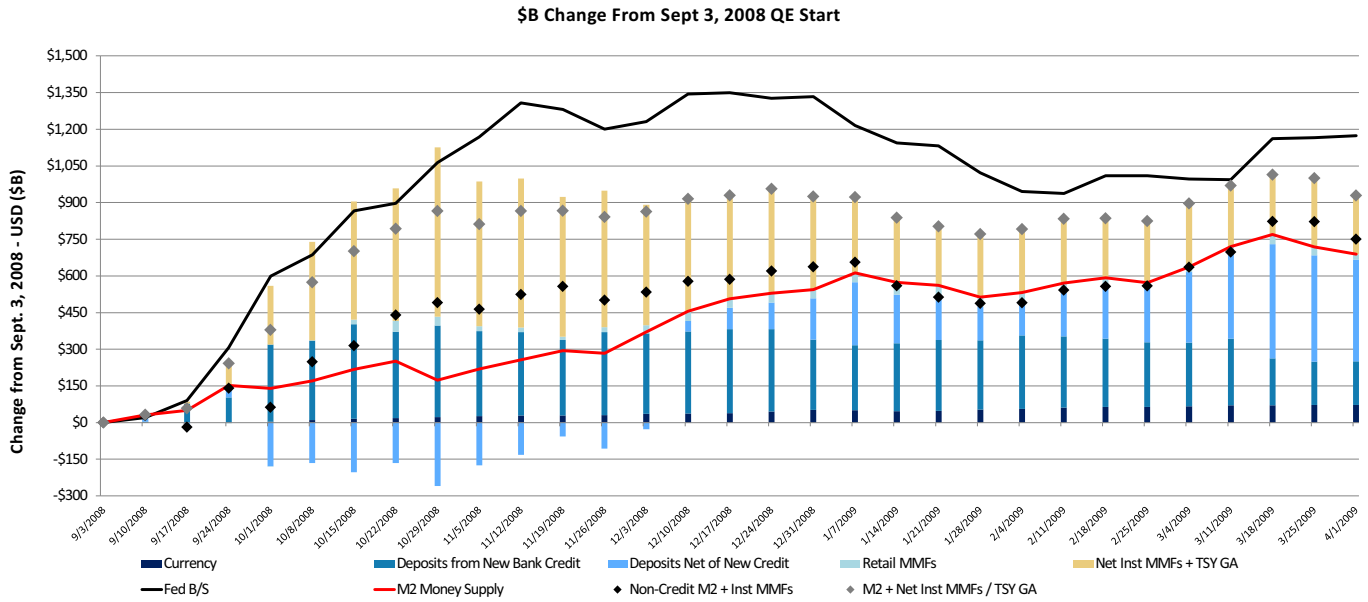
Exhibit 6: Money Market Flows - Govt Funds Explain > 100% of the Inflows



Source: US Federal Reserve, ICI, Bloomberg, Morgan Stanley Research.

QE's transmission to M2 was much slower in 2008. Exhibit 7 shows a similar comparison between QE and M2 when QE first launched in the US in 2008. There are some differences that make the charts slightly different but the key point is that M2 growth lagged the balance sheet expansion by $500B even 7 months after QE started as the Fed's balance sheet stabilized at levels $1.2T higher, indicating a much less effective transmission mechanism to M2. Part of the slower transmission to M2 was by design given the use of the Supplementary Financing Program ("extra" Treasury issuance stored in the general account to keep a check on liquidity). Today though we also have large Treasury issuance and the transmission to M2/near money is obviously stronger in the current environment due, at least in part to the Treasury spending. We suspect the shoring up of bank balance sheets in 2008 also played a meaningful role in blunting this transmission mechanism as well.

Exhibit 7: In 2008 Money Supply Did Not Rise As Closely With QE



Source: US Federal Reserve, ICI, Bloomberg, Morgan Stanley Research.

Among the differences visible in our charts on QE/M2 now vs 2008: (1) Credit growth outpaced deposit growth for the first few weeks such that > 100% of the growth in bank liabilities was explainable by deposits from new credit growth and indicating a liquidity draw away from the M2 base measured here. (2) The MMF flow dynamic was very different with non-govt inst MMFs first seeing greater outflows than inflows to govt MMFs. This trend changed after about 8 weeks as inst govt MMFs eventually drew in more assets than flows out of non-govt funds. (3) Similar to the current period, the US Treasury issued heavily, drawing M2 into its general account, but unlike this time, it is harder to make the case that was funded by QE driven flows into govt MMF given the shift form non-govt to govt funds noted above. For simplicity and to avoid potential double counting we condense flows to institutional money market funds and the Treasury general account into the yellow bar below. We make assumptions similar to those made above - that new AUM in institutional govt MMFs flowed to the Treasury's general account - and that the flows from non govt institutional MMFs went into govt funds.

Headlines Don't Match the Subtext

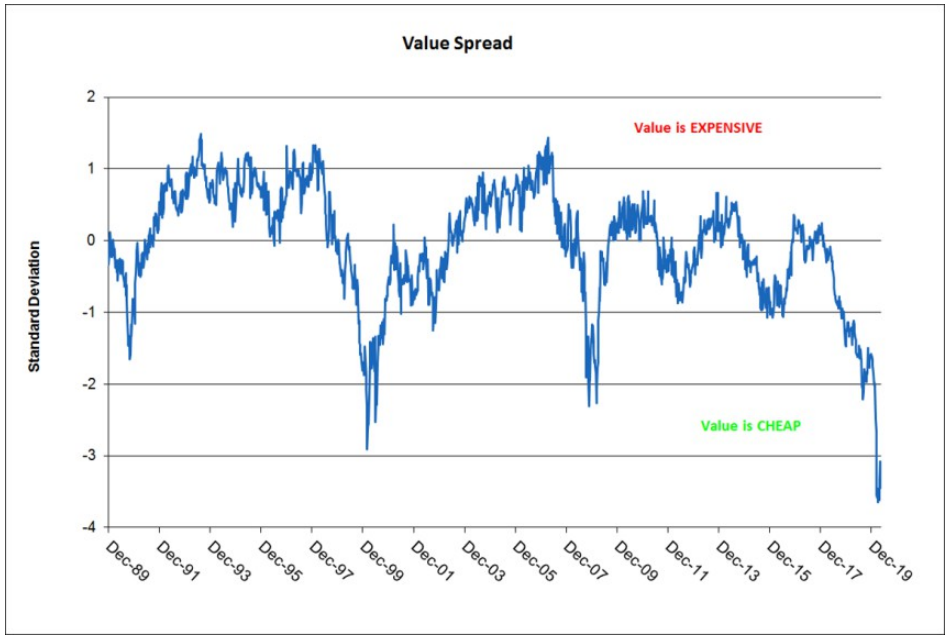
Headline indices have rebounded sharply since the March lows which makes sense in the context of the very steep recession we are experiencing and the sharp rebound we expect as the economy reopens. While our equity risk premium framework analysis can justify the move, many believe the rally has come too far, too fast and does not reflect the adverse current state of the economy and/or the risks we face in trying to restart it. Furthermore, even if we are able to get it going again, there are questions about the pace of consumer re-engagement and the sustainability of any recovery if unemployment remains close to 10 percent next year.

Our view is that this is very similar to how things felt in the spring of 2009 during the Great Financial Crisis (GFC). Not since the Great Depression had we faced such uncertainty about the economy, state of the banking system and the capital markets. Fast forward to today and we find ourselves facing a possibly more uncertain economic future given the nature of this crisis. However, our banking system remains quite sound while capital markets are operating extremely well as we set records for both debt and equity / equity-linked issuance. Most of these deals have been oversubscribed and priced with normal discounts. In short, the money is finding its way to where it's needed and that's a major reason to remain constructive on the path of the recovery.

The majority of investors we speak with remain skeptical of the rally and unwilling to embrace a more aggressive early cycle positioning. Such a view is confirmed by our prime brokerage data which shows net exposures still in the lowest quartile of the past 10 years and cyclical exposures historically low. Having said that, our barbell of high quality growth with low quality cyclicals is being adopted by many but to varying degrees and with a strong preference still for the high quality growth side--i.e. a barbell with a 45 pound plate on one side and a 10 pounder on the other.

Exhibit 8 shows how defensively the market is still trading beneath the surface even as the S&P 500 approaches 3000. The chart comes from our colleagues in MSIM's Applied Equity Advisors and is quite revealing about the market's underlying sentiment. Specifically, it shows the valuation spread between the cheapest 10 percent of the stocks in the Russell 100 versus the median on 3 normalized measures--Price/Book, Price/Cash flow and Earnings Yield. First, we are still trading at the widest spread of the past 30 years which includes 3 recessions, the bursting of the tech bubble and the Great Financial Crisis. Second, the widest spreads occur during recessions, like today. Finally, the spread narrows as quickly as it widens as the economy recovers. We see no reason why it won't be the same this time around.

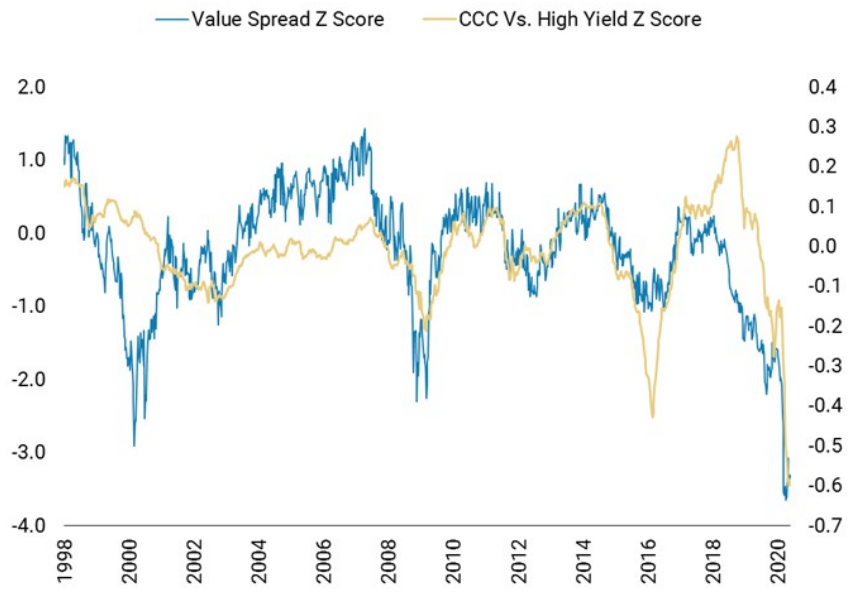
Exhibit 8: Value is always cheapest during recessions but it's never been this extreme.



Source: Morgan Stanley Investment Management (MSIM), Applied Equity Advisors

Meanwhile, the credit markets seem to be saying the same thing with the spread between the lowest quality segment of high yield (CCC) and the overall high yield index also at its all time widest (Exhibit 9). In short, both equity and credit markets are still trading conservatively even as the main indices recover.

Exhibit 9:



Source: Morgan Stanley Research, MSIM, Bloomberg.

In last week's note we illustrated that early cycle sectors are doing better and even leading from the low points in March. What Exhibits 8 and 9 suggest is that these unloved sectors could still have a long way to go should the recovery continue to make progress as we expect. Exhibit 10 shows the current constituents of the cheapest 10

percent of the Russell 1000 by sector. Clearly, banks are the most disliked. As discussed last week, we believe this is mainly due to the very low level of rates rather than any balance sheet issues like during the GFC. In fact, very little of the CCC index consists of financials (Exhibit 11).

Exhibit 10: Cheapest decile of stocks heavy in Banks/ Fins

Value	
Industry Group Short	%
Banks	22%
Diversified Fins.	16%
Insurance	13%
Energy	11%
Real Estate	6%
Transports	5%
Materials	4%
Retailing	4%
Cap. Goods	3%
Consumer Durables & Apparel	3%
Media & Entertainment	3%
Autos	2%
Consumer Services	2%
Software & Srvcs.	2%
Tech. Hardware	2%
Telecom.	2%
Comm. & Prof. Srvcs.	0%
Food & Staples Retailing	0%
Food Beverage & Tobacco	0%
HH & Personal Products	0%
Health Care Equip. & Srvcs.	0%
Pharma, Biotech	0%
Semis	0%
Utilities	0%

Source:

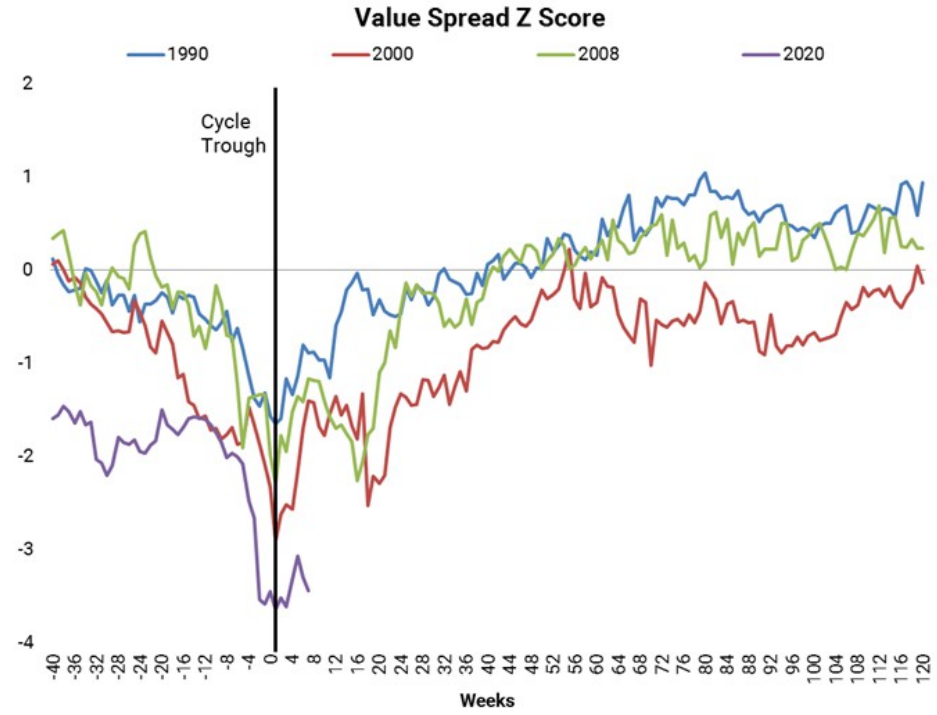
Exhibit 11: While CCC index has very little Fins/Banks.

CCC		
Industry Group	Count	%
Energy	43	19.55%
Basic Industry	23	10.45%
Healthcare	21	9.55%
Leisure	18	8.18%
Services	17	7.73%
Capital Goods	16	7.27%
Technology & Electronics	15	6.82%
Telecommunications	12	5.45%
Retail	12	5.45%
Media	10	4.55%
Consumer Goods	10	4.55%
Insurance	6	2.73%
Automotive	6	2.73%
Transportation	4	1.82%
Financial Services	2	0.91%
Utility	2	0.91%
CASH	1	0.45%
Real Estate	1	0.45%
Banking	1	0.45%

Source:

Finally, we show how the value spread behaves coming out of prior recessions (Exhibit 12). First, the recovery is messy and choppy. It's not a straight line higher. This seems to fit nicely with what we have witnessed over the past month – i.e. a very good week followed by a very bad one for these junkier stocks. Second, we are at the lowest starting point today which suggests the market is not complacent at all about the depth and seriousness of this recession/pandemic. Finally, the upside could be even greater for this cheap cohort than in prior troughs. The bottom line is that we continue to recommend a barbell of high quality growth stocks with low quality cyclicals.

Exhibit 12: Value Spread has a long way to go if the recovery progresses as we expect.



Source: Morgan Stanley Research, MSIM–Applied Equity Advisors

Fresh Money Buy List Updates

Each week, we will use a section of our Weekly Warm Up to provide brief updates on select stocks on our Fresh Money Buy List.

Exhibit 13: Fresh Money Buy List - Stats & Performance

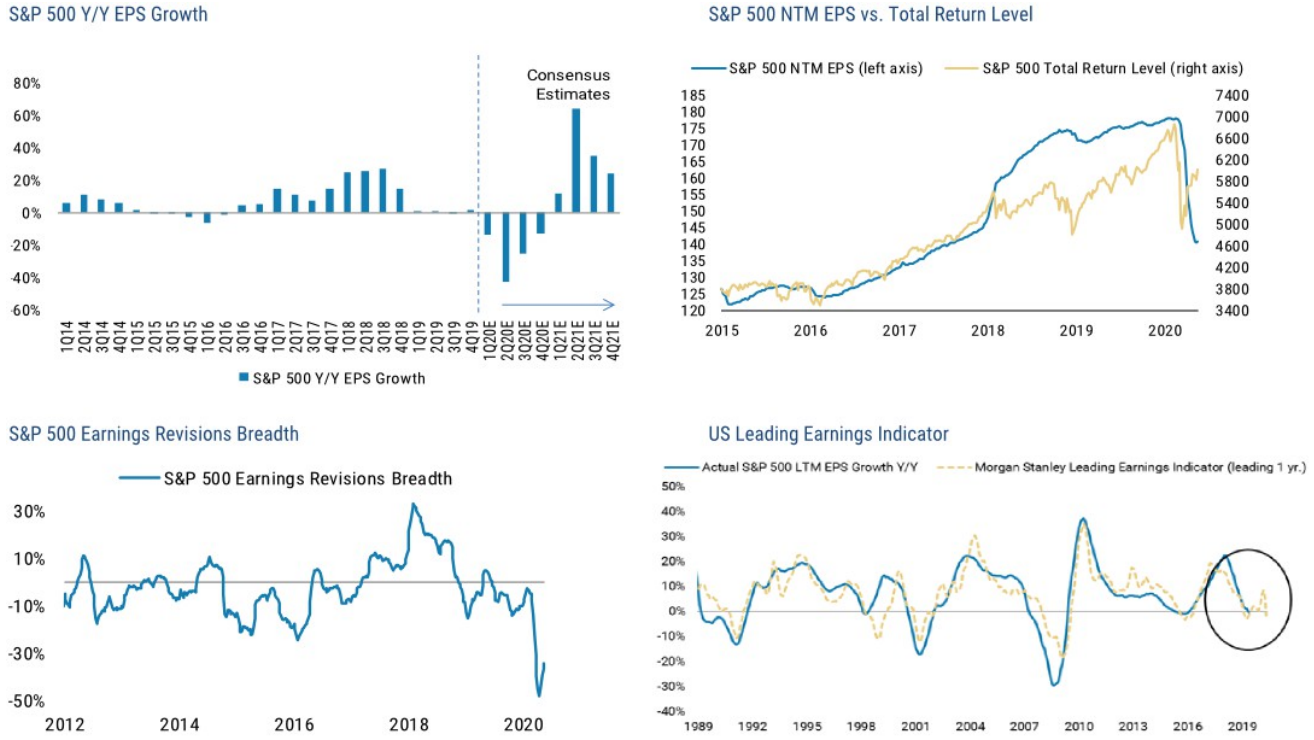
Company Name	Ticker	MS Rating	Sector	Market Cap ($Bn)	Price	MS PT	% to MS PT	MS Analyst	Date Added	Total Return Since Inclusion	
										Absolute	Rel. to S&P
Citizens Financial Group, Inc	CFG	Overweight	Financials	$9.1	$21.28	$32.00	50.4%	Zerbe, Ken	4/20/2020	9.0%	5.9%
Walt Disney Co	DIS	Overweight	Communication Services	$214.1	$118.02	$125.00	5.9%	Swinburne, Benjamin	3/14/2018	17.0%	5.4%
Humana Inc	HUM	Overweight	Health Care	$53.4	$394.43	$500.00	26.8%	Goldwasser, Ricky	7/19/2018	26.1%	17.1%
Johnson & Johnson	JNJ	Overweight	Health Care	$391.7	$144.37	$170.00	17.8%	Lewis, David	2/3/2020	(1.7%)	6.0%
Linde PLC	LIN	Overweight	Materials	$102.4	$190.87	$205.00	7.4%	Andrews, Vincent	3/23/2020	26.2%	(2.5%)
MasterCard, Inc.	MA	Overweight	Information Technology	$297.2	$294.91	$311.00	5.5%	Faucette, James	3/2/2020	1.8%	1.2%
Microsoft	MSFT	Overweight	Information Technology	$1,405.6	$183.51	$198.00	7.9%	Weiss, Keith	3/14/2018	100.9%	89.2%
Procter & Gamble Co.	PG	Overweight	Consumer Staples	$291.7	$112.60	$134.00	19.0%	Mohsenian, Dara	3/18/2019	13.5%	6.3%
PVH Corp.	PVH	Overweight	Consumer Discretionary	$3.4	$44.15	$77.00	74.4%	Greenberger, Kimberly	4/20/2020	(1.6%)	(4.7%)
S&P Global Inc	SPGI	Overweight	Financials	$75.2	$311.86	$316.00	1.3%	Kaplan, Toni	3/23/2020	49.4%	20.7%
T-Mobile US, Inc.	TMUS	Overweight	Communication Services	$82.0	$95.80	$107.00	11.7%	Flannery, Simon	3/14/2018	47.4%	35.8%
Current List Performance											
Average (Eq. Weight)				$266.0			21%			26.2%	16.4%
Median				$102.4			12%			17.0%	6.0%
% Positive Returns (Abs. / Rel.)										82%	82%
% Negative Returns (Abs. / Rel.)										18%	18%
Avg. Hold Period (Months)											11.8
All Time List Performance											
Average (Eq. Weight)										14.0%	7.6%
Median										11.3%	3.3%
% Positive Returns (Abs. / Rel.)										63%	54%
% Negative Returns (Abs. / Rel.)										38%	46%
Avg. Hold Period (Months)											10.4

Performance returns shown above represent local currency total returns, including dividends and excluding brokerage commission. Returns are calculated using the closing price on the last trading day before the date shown in the "Date Added" column through close on the last trading day prior to publication of this report for stocks currently on the list and through close on the day of removal for stocks formerly on the list. These figures are not audited. Past performance is no guarantee of future results.

Source: Bloomberg, Morgan Stanley Research

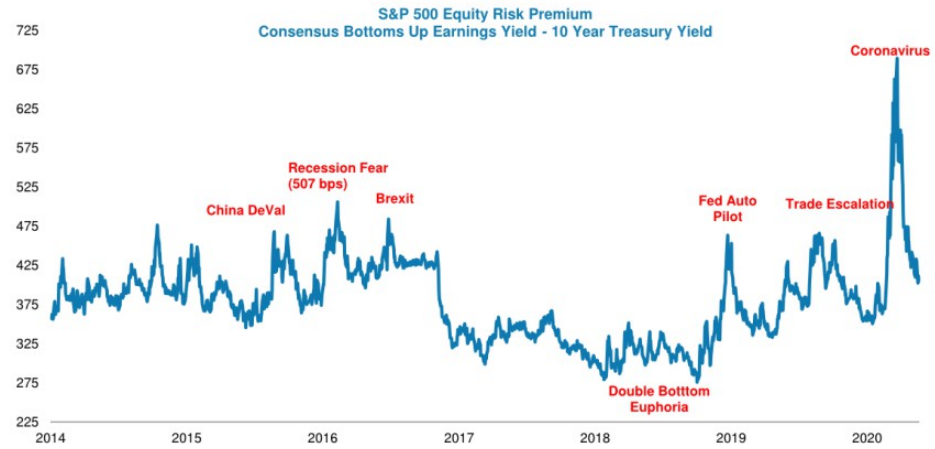
Weekly Charts to Watch

Exhibit 14: US Earnings Snapshot



Source: Thomson Financial, FactSet, Morgan Stanley Research. As of May 21, 2020 Bottom right As of April 30, 2020. MS Leading Earnings Indicator is a macro factor based earnings model that leads actual earnings growth by one year with a 0.7 12-month leading correlation. Note: S&P 500 fundamental data used post March 1993; Top 500 by market cap data used before 1993. LTM equity risk premium average is since 1920. ERP based on forward earnings yield and 10-year Treasury Yield.

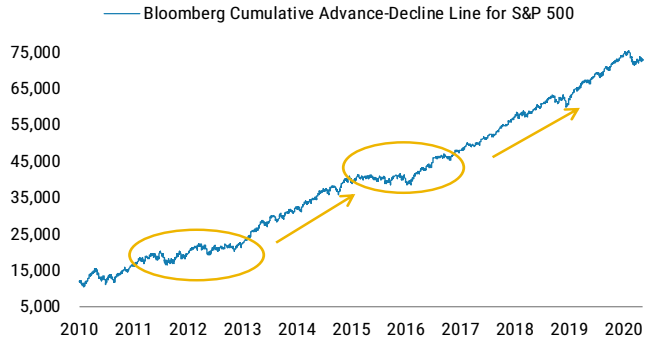
Exhibit 15: S&P 500 Equity Risk Premium



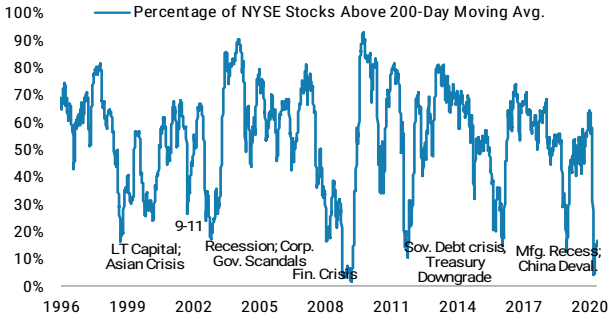
Source: Bloomberg, Morgan Stanley Research. As of May 21, 2020

Exhibit 16: US Equity Market Technicals and Financial Conditions

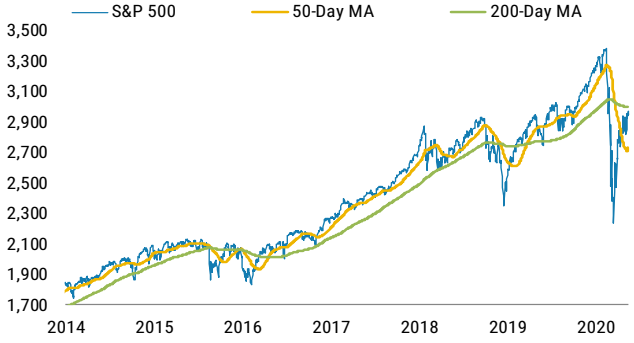
S&P 500 Cumulative Advance-Decline



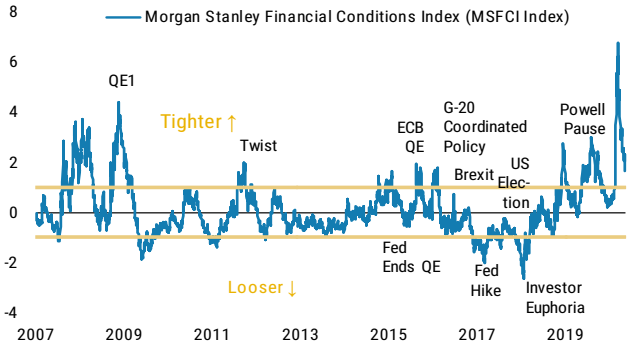
S&P 500 Percent Members Above 200-Day Moving Average



S&P 500 with Moving Averages

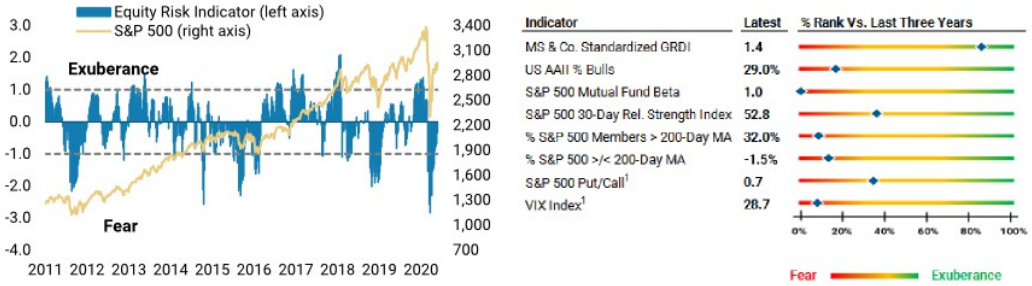


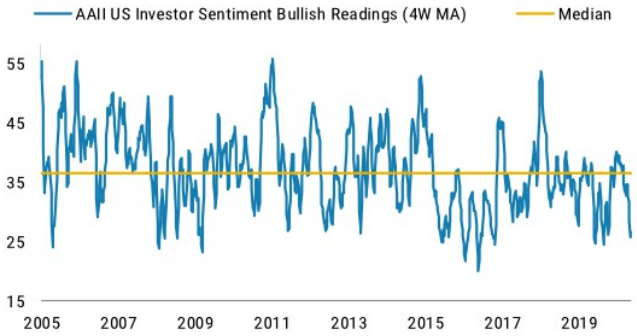
Morgan Stanley Financial Conditions Index



Source: Bloomberg, Morgan Stanley Research. All: As of May 21, 2020

Exhibit 17: US Equity Market Sentiment

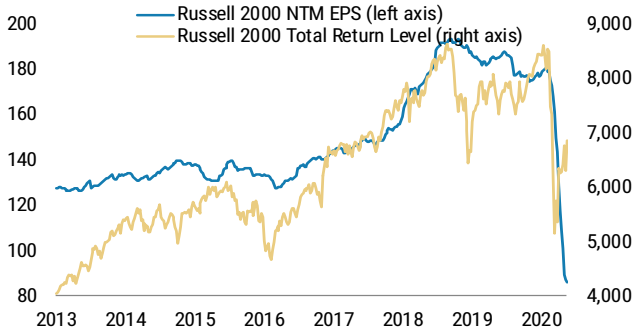




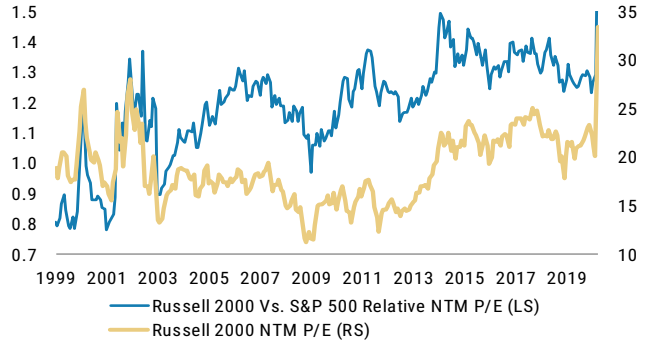
Source: Bloomberg, FactSet, Morgan Stanley Research. As of May 21, 2020.

Exhibit 18: US Small Cap Equities

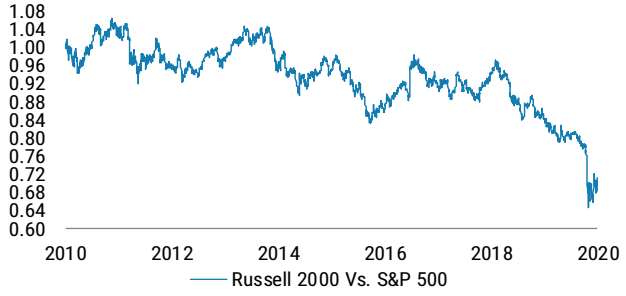
Russell 2000 NTM EPS vs. Total Return Level



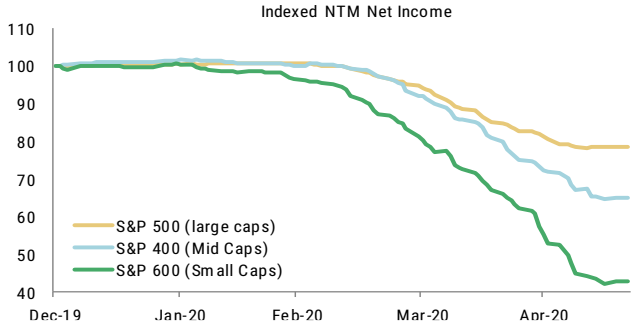
Russell 2000 NTM P/E and Relative NTM P/E vs. S&P 500



Russell 2000 Relative Performance vs. S&P 500



NTM EPS by Cap Size



Source: FactSet, Morgan Stanley Research. Top Right: As of April 30, 2020. Top Left and Bottom: As of May 21, 2020

Exhibit 19: Our Year End Bull, Base, and Bear Cases

Morgan Stanley S&P 500 Price Target: Year End 2020

Landscape	Earnings	Multiple	Price Target	Upside / Downside
Bull Case	$170	19.1x	3,250	10.2%
Base Case	$156	19.1x	3,000	1.7%
Bear Case	$149	16.7x	2,500	-15.2%
Current S&P 500 Price as of:		5/21/2020	2,949	

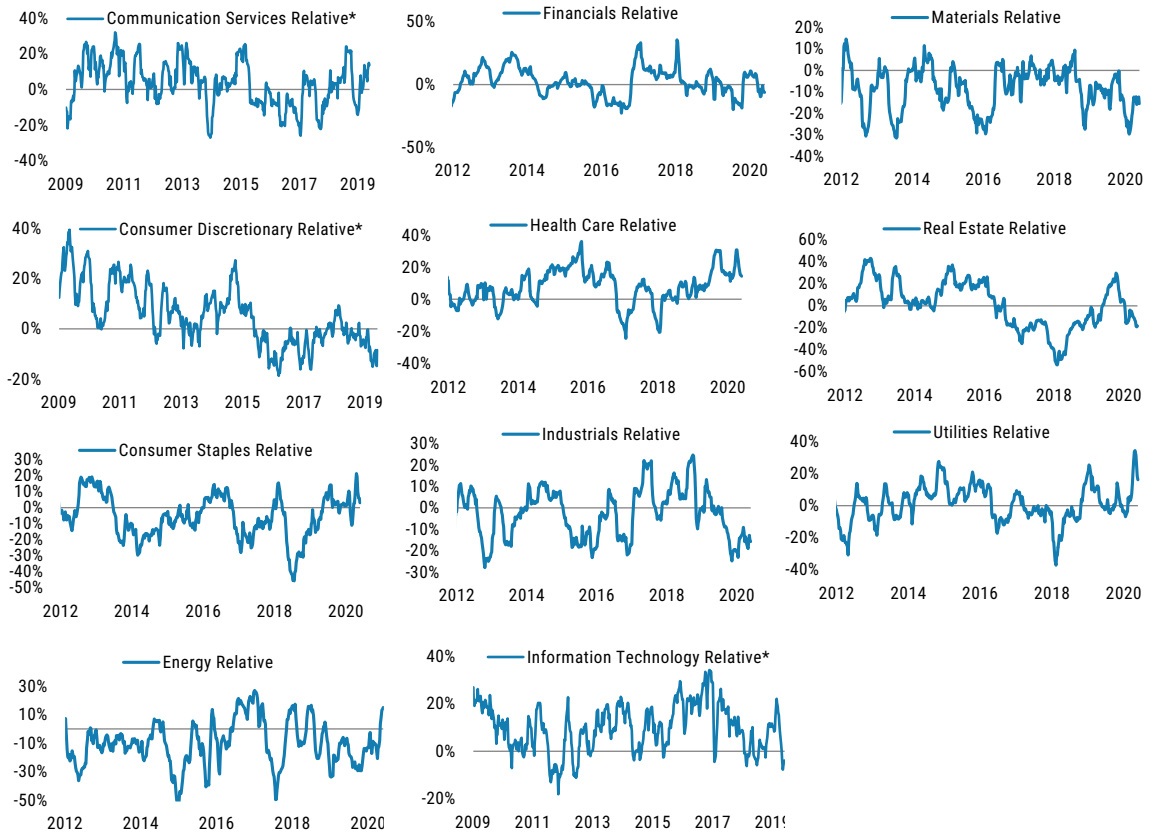
Source: Morgan Stanley Research.
Note: We apply a forward PE multiple to 2021 EPS estimates.

Exhibit 20: Sector Ratings

Morgan Stanley Sector Recommendations			
Overweight	Consumer Staples	Financials	Health Care
Neutral	Comm Services	Energy	Industrials
	Materials	Real Estate	Utilities
Underweight	Discretionary	Technology	

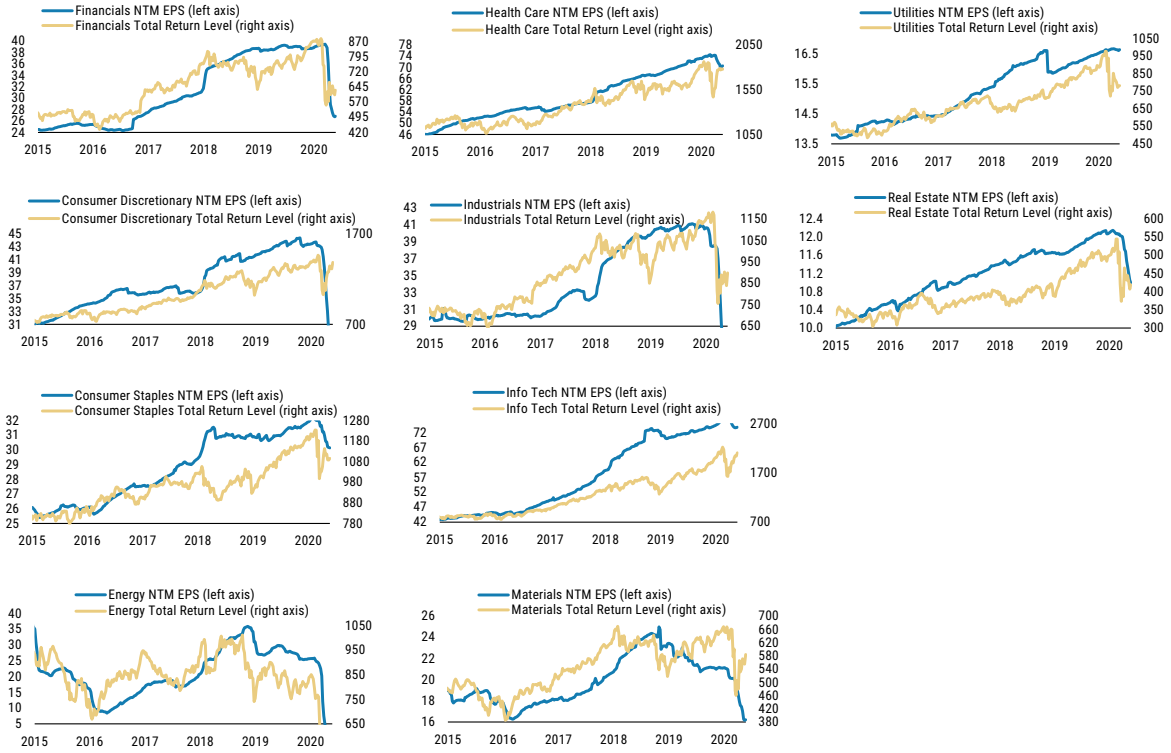
Source: Morgan Stanley Research

Exhibit 21: Earnings Revisions Breadth



Source: FactSet, Morgan Stanley Research. As of May 21, 2020. Sectors with * use current, fixed constituents.

Exhibit 22: US Sector NTM EPS vs. Total Return Level



Source: FactSet, Morgan Stanley Research as of May 21, 2020.

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STOCK RATING CATEGORY	COVERAGE UNIVERSE COUNT	COVERAGE UNIVERSE % OF TOTAL	INVESTMENT BANKING CLIENTS (IBC) COUNT	INVESTMENT BANKING CLIENTS (IBC) % OF TOTAL IBC	INVESTMENT BANKING CLIENTS (IBC) % OF RATING CATEGORY	OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC) COUNT	OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC) % OF TOTAL OTHER MISC
Overweight/Buy	**1216**	**38%**	**300**	**42%**	**25%**	**533**	**37%**
Equal-weight/Hold	**1432**	**45%**	**325**	**46%**	**23%**	**698**	**48%**
Not-Rated/Hold	**3**	**0%**	**1**	**0%**	**33%**	**3**	**0%**
Underweight/Sell	**553**	**17%**	**81**	**11%**	**15%**	**220**	**15%**
TOTAL	**3,204**		**707**			**1454**	

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