

TEMATICA INVESTING

THEMATIC COMMENTARY, EQUITY RESEARCH & INVESTING STRATEGIES



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Tematica Investing, a weekly publication by Chris Versace, is designed for the experienced or professional investor, providing in-depth information on real-time developing thematic strategies, economic outlook, investment trading ideas, and analysis of the most pressing developments for the market, as well as forces that drive both our thematic perspectives and thematic recommendations.

ECONOMICS & EXPECTATIONS

While many might have been transfixed by the news that Donald Trump swept primaries in five states last night, we in the investment community were busy pouring over March quarter earnings from a growing list of companies. We are just scratching the surface of what's to come over the next week and a half, but from what we've heard thus far from **Apple (AAPL)**, **Microsoft (MSFT)**, **IBM (IBM)**, **Twitter (TWTR)**, **Alphabet (GOOGL)**, **Buffalo Wild Wings (BWLD)**, **Starbucks (SBUX)**, **General Electric (GE)**, **Danaher (DHR)**, **Netflix (NFLX)** and others like **Boeing (BA)** has been a combination of softer than expected March quarter growth, weaker than expected outlooks and tepid organic growth.

There are of course some exceptions, but for the most part, growth has fallen short of expectations and we're seeing the fall out in corresponding stock prices as those expectations are reset.

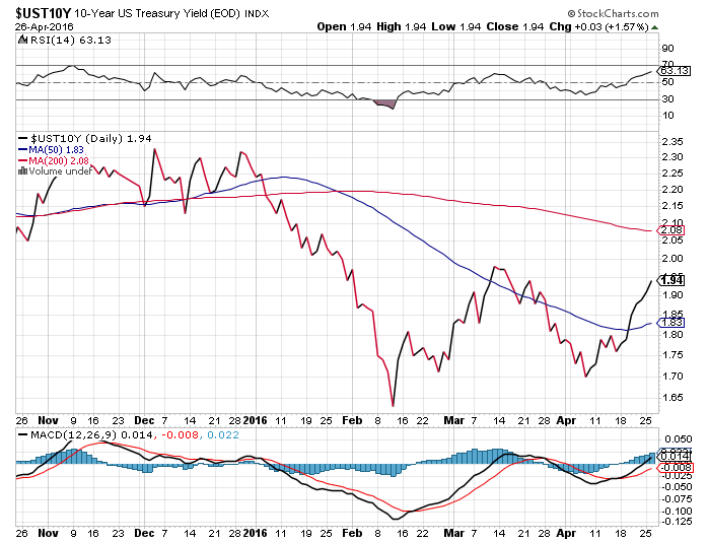
After having shared such concerns over the last few weeks amid the market melt up, we're not surprised by what's emerged. Plus, with the vast majority of companies yet to report their results, it means there is a high probability that more is to come. As we navigate the maze of earnings reports to be had in the coming days, we'll continue to refine our thematic shopping list and look to pounce on opportunities that offer a compelling risk to reward trade off.

Fed Meeting on Tap for Today is Likely a Snoozer, But...

This morning's market is likely to feel the hangover from last night's disappointing earnings reports —particularly from **Apple (AAPL)**, which suffered its first quarterly revenue decline since 2003. As the hours tick by however, the gears will switch so that come 2 PM ET today, all eyes and ears will be focused on what spins out of the **Fed's April Federal Open Market Committee meeting**.

Granted, the expectation is for the Fed to do nothing. The rash of economic data we've gotten over the last few weeks since Fed Chairwoman Janet Yellen last discussed monetary policy has continued to put a sour taste in people's mouths, so it would be a bit of a shock for the Fed to boost interest rates. In short, we expect dovish comments to be had yet again.

Even so, we prefer to let the data talk to us, and in keeping our Tematica eyes and ears open, we could not help but notice the move higher in the 10-year Treasury yield —creeping back to 1.94 percent from 1.70 percent just a few weeks ago. This rebound is something to ponder as we parse the Fed’s commentary this afternoon for its latest views on the economy and inflation. Per several Fed watching surveys, the new consensus for when the Fed may raise rates has slipped to August from its next FOMC meeting in June. Rest assured, we’ll continue to watch the economic tea leaves, while we keep a look out for inflation as well between now and then.



March Quarter Earnings Results Trickle In

As we mentioned at the start, we’re wading deeper into March quarter earnings season, and that means companies on the Tematica Select List have started to report their results as well.

So far, from the companies on our list, we’ve heard from **AT&T (T)** and **American Capital Agency (AGNC)**. While there were quite a few moving parts to AT&T’s results, the core wireless business performed well, with the wireless business delivering margin expansion and the company tracking to deliver \$1.5 billion in cost synergies associated with its acquisition of DirecTV. North American wireless net adds for of 2.3 million were driven by connected devices and the company’s full-year guidance is “on track.”

We continue to like AT&T as a defensive **Connected Society** play given the inelastic nature of its mobile service and enviable dividend. As we move toward the second half of 2016 we look forward to hearing more about the company’s plan to drive its video business as it embraces bundled offerings with the core wireless business. We would look to add back to our AT&T position near \$35, at which point the shares would be trading near the 5.5% dividend yield at which they have historically bottomed out.

Turning to American Capital Agency, the company’s core book value continued to decline during the March quarter falling to \$22.09 from \$22.59 at the end of 2015. As one would expect, the company’s book value continues to be hit by wider spreads between yields and interest rates associated with its interest rate hedges. At current levels, AGNC shares continue to trade at a meaningful discount to book value — roughly 17%.

As we mentioned upfront, our expectation for dovish comments from the Fed today should bode well for higher dividend paying stocks like AGNC, and thus, we’ll continue to collect the monthly dividend stream as we evaluate our next move with our AGNC shares.

The same goes for our other dividend yielding stocks - Physicians Realty Trust (DOC), Regal Entertainment (RGC) and of course AT&T (T).

Checking in on Chipotle Mexican Grill

Several months back we put shares of **Chipotle Mexican Grill (CMG)** on the Tematica Contender List as a potential Food with Integrity play. As most know, the company's business came under significant pressure over the last several months following the high profile reports of several E.coli outbreaks. As the news of those reports spread, lines dwindled and the company's revenue and profits were hit hard. Chipotle vowed to upgrade its food handling measures and before long instituted those new measure. Soon thereafter the company was cleared by the CDC.

Last night Chipotle reported its March quarter results that missed expectations, coming in at \$834.5 million (down 23.4 percent year over year) vs. the consensus forecast of \$863.2 million. There were a number of issues that led to the sharp revenue drop compared with year ago levels:

- An almost 30 percent drop in comparable restaurant sales, which was mitigated by new openings.
- Lower number of transaction.
- A modest lower average check size, which reflected promotion strategies used to lure customers back into the stores.

Given the sharp drop in sales, margins were negatively impacted by unfavorable sales leverage and fixed cost absorption, which led EPS for the quarter to come in at $-\$0.88$. That number was better than the expected loss of $-\$1.05$ per share for the quarter, but compared to $\$3.88$ per share in the year ago quarter, you can see how heavy a blow the company has taken in recent months.

That was the bad news. The not so bad news was that in the second half of the quarter, Chipotle saw a rebound in its same-store comparisons. Year over year comps came in at -34 percent in January. But by the end of the quarter, the comps were just -22 percent. We expect it will take additional time for the company to win back the level of trust it once had with consumers, and in the near-term initiatives

| Chipotle Mexican Grill, Inc. | | | | |
|---|------------------------------|----------------|-------------------|---------------|
| Condensed Consolidated Statement of Income and Comprehensive Income | | | | |
| (in thousands, except per share data) | | | | |
| (unaudited) | | | | |
| | Three months ended March 31, | | | |
| | 2016 | | 2015 | |
| Revenue | \$834,459 | 100.0 % | \$1,089,043 | 100.0 % |
| Restaurant operating costs (exclusive of depreciation and amortization shown separately below): | | | | |
| Food, beverage and packaging | 294,166 | 35.3 | 369,026 | 33.9 |
| Labor | 257,681 | 30.9 | 244,151 | 22.4 |
| Occupancy | 70,592 | 8.5 | 63,185 | 5.8 |
| Other operating costs | 155,189 | 18.6 | 113,541 | 10.4 |
| General and administrative expenses | 62,010 | 7.4 | 63,061 | 5.8 |
| Depreciation and amortization | 34,788 | 4.2 | 30,643 | 2.8 |
| Pre-opening costs | 4,421 | 0.5 | 3,435 | 0.3 |
| Loss on disposal of assets | 2,216 | 0.3 | 4,200 | 0.4 |
| Total operating expenses | <u>881,063</u> | <u>105.6</u> | <u>891,242</u> | <u>81.8</u> |
| Income (loss) from operations | (46,604) | (5.6) | 197,801 | 18.2 |
| Interest and other income (expense), net | 2,126 | 0.3 | 1,223 | 0.1 |
| Income (loss) before income taxes | (44,478) | (5.3) | 199,024 | 18.3 |
| Benefit (provision) for income taxes | 18,046 | 2.2 | (76,383) | (7.0) |
| Net income (loss) | <u>\$ (26,432)</u> | <u>(3.2) %</u> | <u>\$ 122,641</u> | <u>11.3 %</u> |
| Other comprehensive income (loss), net of income taxes: | | | | |
| Foreign currency translation adjustments | 1,929 | | (4,712) | |
| Unrealized gain (loss) on investments, net of income taxes of \$1,182 and \$0 | 1,893 | | - | |
| Other comprehensive income (loss), net of income taxes | <u>3,822</u> | | <u>(4,712)</u> | |
| Comprehensive income (loss) | <u>\$ (22,610)</u> | | <u>\$ 117,929</u> | |
| Earnings (loss) per share: | | | | |
| Basic | <u>\$ (0.88)</u> | | <u>\$ 3.95</u> | |
| Diluted | <u>\$ (0.88)</u> | | <u>\$ 3.88</u> | |
| Weighted average common shares outstanding: | | | | |
| Basic | <u>29,893</u> | | <u>31,036</u> | |
| Diluted | <u>29,893</u> | | <u>31,592</u> | |

to aid in that effort — like the free burrito program — will weigh on revenue, margins and earnings. Other initiatives include a more robust marketing program and potentially a buy one, get one or BOBO burrito offer. With the company offering no guidance for the current quarter, odds are Wall Street will once again take a cleaver to its revenue and earnings expectations and that will more than likely pressure CMG shares lower.

It's been a smart strategy, if we say so ourselves, to sit on the sidelines when it comes to Chipotle's shares even though our first hand channel checks show the lines are improving and the food tastes as good as ever. As Wall Street resets expectations in the coming days, we'll look to revisit our entry point in Chipotle realizing that any move into the shares will require ample patience that will be measured in several quarters, not several months.



Ask Tematica

In the vein that there is no such thing as a bad question, we encourage subscribers to ask questions about particular investing themes, holdings on the **Tematica Select List**, the Contender List or on another topic. It's all good as far as we're concerned. This week's question surrounds recent **Tematica Select List** addition **Costco Wholesale (COST)**:

I read over the weekend that Costco is considering a membership price hike. Do you see this as likely and if so when do you think the company may hike the annual fee?

This is a great question and one that we mentioned as a potential catalyst for the shares. If we look at Costco's operating profit, its membership fees drive roughly 65%-75% of the company's overall operating income and a boost to the fees would quickly drop to the company's bottom line. Let's also remember Costco's soon to be launched co-branded credit card with **Citibank (C)** and **Visa (V)** should also help with new membership sign ups. Given the launch of the co-branded credit cards in May and June, Costco is likely to hold off on bumping up membership fees until the back half of 2016.

If you have a question on something you just read or on one of our live positions, a contender or even something that may be burning your ears and eyes as it relates to one of our investing themes, drop us a line at customerservice@tematicagroup.com.

Thematic Signals

Amid the frenzy of earnings reports this week we've cobbled together a number of Ripped from the Headlines data points that reinforce a number of our investing thematics.



Cash Strapped Consumer

One of the most telling signs of the new normal in the US economy is Americans' attitudes toward saving money. Ten years ago, saving was like making your bed or changing the oil in your car on schedule: Nice to do but hardly essential. In the early 2000s, 18-to 29-year-olds were the least interested in saving of any age group, with just 43 percent saying they prefer saving over spending. Today, they're the most determined to save, with 66 percent saying that's their preference. Among 31-to-49-year-olds, just 61 percent favor saving.

With the waves of announced layoffs coming from what seems like every corner of the retail ecosystem these days, the latest consensus out of analysts that 2016 will be the worst year for retail segment layoffs since 2010 probably comes as a shock to just about no one. Layoffs are currently pegged to reach 37,000 by the end of 2016 — the biggest figure since 30,273 were shed during 2010. 24,000 of those jobs have already been cut, according to Credit Suisse (CS), whose analysts also noted that total job losses in the sector could be even higher than currently forecast, given the wave of bankruptcies rolling through retail at present.

Cashless Consumption

Usage of Starbucks mobile ordering feature doubled year-over-year during the most recent quarter. The company's Mobile Order & Pay program first launched in Portland more than a year ago and there are now 8 million mobile order-ahead transactions per month according to the company. That's a 33 percent spike from the most recent quarter.

Connected Society

Pedestrians' smartphone habits have become so dangerous that a German company has put lights in the ground to protect them from traffic accidents. Stadtwerke Augsburg, a privately owned utilities company in the southern city of Augsburg, installed LED lights along the curbs at two tram stops in the city last week. The lights flash red whenever a vehicle is approaching, functioning as a traffic light warning pedestrians not to cross the street.

Surging consumer and business demand for mobile content, either at home or on the go, will outpace the ability of service providers to provide it unless investments are accelerated in areas like 5G and the cloud, according to a report by Bell Labs Consulting, a division of Nokia Bell Labs. Across the study's five identified application areas — streaming, computing, storing, gaming and communicating — Bell Labs Consulting found that audio and video streaming will be the highest contributors to the increased traffic demand in coming years, accounting for a 79 percent total increase by 2020.

Content is King

After years of on-and-off flirtations, Comcast (CMCSA) is in talks to buy DreamWorks Animation (DWA), the boutique studio run by Jeffrey Katzenberg that has struggled to move past the boom-and-bust cycle driven by its sporadic film releases.

Economic Acceleration/Deceleration

A gauge of business investment—orders for non-defense capital goods excluding aircraft—declined 2.4% in the first quarter according to the Commerce Department. This suggests firms are hesitant to spend on staples like computers, machinery and electrical appliances.

Weak demand at home and abroad threatens to hamper an economic expansion already restrained by low productivity, struggling corporate profits, weak wage growth and global financial volatility. Recent measures of consumer confidence and spending, which generates more than two-thirds of total US economic output, have also shown signs of faltering despite historically low gasoline prices.

Food with Integrity

After making untold billions of dollars as probably the brand name most associated with chocolate in America, **Hershey (HSY)** is quickly trying to position itself as something other than a purveyor of sweets. After last year's acquisition of the Krave line of beef jerky products, Hershey is hoping that folks will gobble up its upcoming dried meat bars. Chocolate sales have slowed in the US since 2010, with the market's annual growth rate at only 4%. Compare that to the more than 10% growth rate for meat snacks during the same time period.

Rise & Fall of the Middle Class

By 2050, India will beat China to become home to the most number of working-age people in the Asia Pacific region. From 0.86 billion people aged between 15 and 64 years in 2015, India's working-age population will grow to over a billion by 2050, suggests the Regional Human Development Report of the United Nations Development Programme (UNDP) on April 26.

Automakers are showcasing a new generation of luxurious SUVs at China's biggest auto show of the year as they battle for buyers in the country's cooling, crowded market.

- **Honda Motor (HMC)** held world debuts for two SUVs, reflecting China's high profile in the global industry.
- **Ford (F), Volkswagen, General Motors (GM)** and China's Chery also displayed new SUVs, many never meant to be driven off-road and equipped with heated seats, Web-linked navigation, entertainment centers and other features.
- Sales of SUVs, the popular option on China's rough roads, soared 52% last year, the only product segment that still is growing in the world's largest market.
- Sedan sales contracted by 5.3% and those of minivans plunged 17.5%.

Safety & Security

Starting next year, all mobile phones sold across India must include a panic button. In addition, by 2018, all cell phones need to come with a built-in GPS chip, so a person in trouble can be more easily found. Last year, Uber added a panic button inside its app in India after the alleged rape of a female passenger by her male Uber driver.



What We're Enjoying

AMAZON ECHO

In an effort to bring a more personal feel to Tematica Insights, we're reviving a feature that harkens back to my very first newsletter called "What We're Enjoying." Each week, it will feature a service, product or equivalent that we here at the Tematica offices are enjoying. It could be something new or something that's new to us and of course, if you have something you think we should check out be sure to email us and let us know.



Several months back I picked up the Amazon Echo in order to test drive first hand its voice interface capabilities. I have to say I was impressed not only with its accuracy, but also the list of things one could do with it (ask for the latest news, stream music from the Amazon Prime music library, add items to a shopping list and get answers to all sorts of question) which has only grown over the last several months. More recent capabilities include being able to add events to your Google Calendar or order a pizza from **Domino's (DPZ)**. We suspect Amazon is just getting started with its Echo offering, and this past week it started shipping its latest member of the Echo family — the Echo Dot. The Dot is smaller form factor compared to the original Echo and carries a more affordable price tag. If you give it a test drive, we think you'll love it as much as we do.

Tematica Contenders

As we roll up our sleeves each week we add companies and discard others to our list of Tematica Select Contenders. These are companies that we're doing more work on and in some cases we're waiting for the risk to reward tradeoff to reach more appetizing levels.

| | | |
|------|-------------------------|---|
| AHS | AMN Healthcare Services | <i>Aging Population / Scarce Resources</i> |
| AMZN | Amazon.com | <i>Connected Society</i> |
| CHGG | Chegg Inc. | <i>Tooling & Retooling</i> |
| CMG | Chipotle Mexican Grill | <i>Foods that Are Good for You</i> |
| SCOR | Comscore | <i>Connected Society</i> |
| GLW | Corning Inc. | <i>Disruptive Technologies</i> |
| IMMR | Immersion Corp. | <i>Disruptive Technologies</i> |
| KIM | Kimco Realty | <i>Rise & Fall of the Middle Class</i> |
| LOCK | Lifelock | <i>Safety & Security</i> |
| MKC | McCormick & Co. | <i>Cashstrapped Consumer / Middle Class</i> |
| MRK | Merk & Co. | <i>Aging of the Population</i> |
| NKE | Nike Inc | <i>Affordable Luxury</i> |
| NLSN | Nielson NV | <i>Connected Society</i> |
| PANW | Palo Alto Networks | <i>Safety & Security</i> |
| SYNA | Synaptics Inc. | <i>Disruptive Technologies</i> |
| SBUX | Starbucks Inc. | <i>Rise & Fall the Middle Class</i> |
| UNFI | United Natural Foods | <i>Foods with Integrity</i> |
| VZ | Verizon Communications | <i>Content is King / Connected Society</i> |
| XYL | Xylem, Inc | <i>Scarce Resources</i> |

TEMATICA SELECT LIST PERFORMANCE

as of market close April 26, 2017

(AGNC) AMERICAN CAPITAL AGENCY CORP

| DATE ADDED | ADD PRICE | CURRENT PRICE | DIVIDENDS | STOP PRICE | RETURN (%) | TARGET | RATING |
|------------|-----------|---------------|-----------|------------|------------|---------|--------|
| 7/17/15 | \$18.98 | \$18.23 | \$1.60 | \$17.00 | 4.5% | \$23.00 | (BUY) |

(XLY) CONSUMER DISCRETIONARY SPDR (ETF)

Content is King

| DATE ADDED | ADD PRICE | CURRENT PRICE | DIVIDENDS | STOP PRICE | RETURN (%) | TARGET | RATING |
|------------|-----------|---------------|-----------|------------|------------|--------|--------|
| 4/20/16 | \$79.57 | \$79.74 | -- | -- | 0.2% | -- | (BUY) |

(COST) COSTCO WHOLESALE CORPORATION

Cashstrapped Consumer

| DATE ADDED | ADD PRICE | CURRENT PRICE | DIVIDENDS | STOP PRICE | RETURN (%) | TARGET | RATING |
|------------|-----------|---------------|-----------|------------|------------|----------|--------|
| 4/13/16 | \$152.83 | \$152.60 | -- | \$140.00 | -0.2% | \$170.00 | (BUY) |

(DIS) THE WALT DISNEY CO.

Content is King

| DATE ADDED | ADD PRICE | CURRENT PRICE | DIVIDENDS | STOP PRICE | RETURN (%) | TARGET | RATING |
|------------|-----------|---------------|-----------|------------|------------|----------|--------|
| 4/20/16 | \$102.16 | \$104.25 | -- | \$87.00 | 2.05% | \$125.00 | (BUY) |

(DOC) PHYSICIANS REALTY TRUST

Aging of Population

| DATE ADDED | ADD PRICE | CURRENT PRICE | DIVIDENDS | STOP PRICE | RETURN (%) | TARGET | RATING |
|------------|-----------|---------------|-----------|------------|------------|---------|--------|
| 6/27/14 | \$14.33 | \$18.26 | \$1.80 | \$16.00 | 38.4% | \$18.00 | (HOLD) |

(SH) PROSHARES SHORT S&P 500 (ETF)

| DATE ADDED | ADD PRICE | CURRENT PRICE | DIVIDENDS | STOP PRICE | RETURN (%) | TARGET | RATING |
|------------|-----------|---------------|-----------|------------|------------|---------|--------|
| 1/14/16 | \$22.55 | \$20.06 | -- | -- | -11.0% | \$24.00 | (BUY) |
| 3/23/16 | \$20.56 | \$20.06 | -- | -- | -2.4% | \$24.00 | (BUY) |

(RGC) REGAL ENTERTAINMENT GROUP

Content is King

| DATE ADDED | ADD PRICE | CURRENT PRICE | DIVIDENDS | STOP PRICE | RETURN (%) | TARGET | RATING |
|------------|-----------|---------------|-----------|------------|------------|---------|--------|
| 11/23/15 | \$18.51 | \$21.19 | \$0.44 | \$19.00 | 16.9% | \$24.00 | (BUY) |

(T) AT&T, INC.

Connected Society

| DATE ADDED | ADD PRICE | CURRENT PRICE | DIVIDENDS | STOP PRICE | RETURN (%) | TARGET | RATING |
|------------|-----------|---------------|-----------|------------|------------|---------|--------|
| 7/21/15 | \$34.67 | \$38.09 | \$0.95 | \$36.00 | 12.6% | \$42.00 | (BUY) |

Companies Mentioned

Alphabet (GOOGL)
Amazon (AMZN)
American Capital Agency (AGNC)
Apple (AAPL)
AT&T (T)
Boeing (BA)
Buffalo Wild Wings (BWLD)
Chipotle Mexican Grill (CMG)
Citibank (C)
Comcast (CMCSA)
Costco Wholesale (COST)
Credit Suisse (CS)
Danaher (DHR)
Domino's (DPZ)
DreamWorks Animation (DWA)
Ford (F)
General Electric (GE)
General Motors (GM)
Hershey (HSY)
Honda Motor (HMC)
IBM (IBM)
Microsoft (MSFT)
Netflix (NFLX)
Physicians Realty Trust (DOC)
Regal Entertainment (RGC)
Starbucks (SBUX)
Twitter (TWTR)
Visa (V)

Analyst Positions

At the time of publication, Mr. Versace, Chief Investment Officer of Tematica Research had no positions in the shares of companies mentioned in this issue.

Important Disclosures and Certifications

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Investment opinions are based on each stock's 6-12 month return potential. Our ratings are not based on formal price targets, however our analysts will discuss fair value and/or target price ranges in research reports. Decisions to buy or sell a stock should be based on the investor's investment objectives and risk tolerance and should not rely solely on the rating. Investors should read carefully the entire research report, which provides a more complete discussion of the analyst's views.

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