Altman Investment Management

Equity Strategy Focus

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IN VIEW: The Economic Landscape

Slow and steady growth keeps business spending tempered – fueling the secular bull market. In past years, October has been a challenging month for the stock market and many market pundits expected this past month to be no exception. However, there hasn't been a significant correction since June of last year, despite a few instances where technicians were spooked along the way. Although the number of companies participating in the rising market has broadened out over the year, higher trading volume has yet to confirm the raging bull.

The government shutdown certainly dowsed any potential inflationary fears, and allowed the Fed to refocus its attention on the potential tendency to deflate. In hindsight, the Fed's reaction to the sharp rise in interest rates, at the mere suggestion of tapering, confirmed the expectation that the beginning of any monetary tightening was indeed premature. The reversal of the Fed's message reassured markets that resumed the 4.6% climb in October, following the 5.2% gain for the previous quarter. Despite any negative news, investors have continued to feed their appetite for stocks.

The Fed policy - coupled with improving relative performance of the economically sensitive or cyclical stocks - continues to support our sector allocation strategy as well as our bias towards equity participation in balanced accounts. Although bonds rallied in September, in response to the Federal Reserve's decision not to begin tapering, bonds still remain negative for the year. The stock market is reflecting investor expectations for continued modest growth and an accommodative Fed.

The third quarter real GDP for the U.S. economy will be announced by the Bureau of Economic Analysis at the end of the month. The final statistics in terms of growth rates for the first and second quarters were 1.1% and 2.5%, respectively. It has been our view that second half growth would approximate 2.5% for a final year total of 2% versus 2.8% growth in 2012. The reasons for the slower growth rate in 2013 have been the higher tax rates for upper income individuals, the restoration of the full payroll tax rate, and the sequester which would lower government spending.

The recent political disagreements between the two parties regarding the government shutdown and the extension of the debt ceiling also created economic uncertainty which has clouded the outlook for the fourth quarter. While the shutdown is now over with the signing of the Continuing Appropriation Act, 2014, which funds the government through January and suspends the debt ceiling through early February, a period of stability is been stretched out by another three months with the possibility of further disruption ahead. A bipartisan committee made up of members of both parties is set to work on budgetary matters with a deadline in mid-December. We would conclude that this is not the most effective way for a leading economic power to work out its longer-term budgetary solutions. Overall, however, while the private economy has been growing about 3%, the government sector has been a drag on the economy because of the sequester. Most economists have been lowering economic forecasts because of the above uncertainties with the consensus estimates of 1.6% growth for 2013 dropping even below our conservative forecasts.

The shutdown caused a dearth of economic statistics over recent weeks broken by an economic report for September of 148,000 jobs which was somewhat lower than the expected 180,000. Over past months, jobs have been growing at about a 190,000 monthly pace and it is difficult to know if the recent jobs data is the beginning of a slowing trend. While the unemployment rate fell to 7.2%, it was largely the result of drop-offs from the labor force as participation rates continued to decline. This is because of the beginning of baby-boomer retirements combining with younger people staying in college longer. The four-week average of initial unemployment claims is only 336,500, suggesting a moderately strong pace of job growth. Overall, the ISM Manufacturing Index (56.2) and the ISM Non-Manufacturing Index (54.4), representing services in September, both suggest that economic growth is moderately growing at a 2.5% rate. Continued improvement in the automobile and housing industries also suggests that the economy is moderately strong. The same can be said for capital spending, personal income, retail sales, and the leading indicators.

Perhaps the healthiest statistic for the economy is the modest pace of inflation which is running at 1.5% for the consumer price index (CPI) and at 1.4% for the producer price index (PPI). Raw material prices have been weak because of the slowing Chinese economy after many years of boom conditions. In addition, the boom in U.S. oil production because of fracking and horizontal drilling is causing a down drift in oil and natural gas prices and gasoline pricing. The lowering of energy prices combined with low labor costs is aiding a renaissance in U.S. manufacturing which is in our opinion only in its early stages. While the U.S. is experiencing a slow-growth recovery after 17 quarters from its low of June 2009, it appears quite sustainable because of low capacity utilization rates of only 77.8% versus a normal rate of 82%. The addition of low labor costs and low interest rates suggests that the current business cycle could be an exceedingly long one beyond the average of about five years.

Overall, therefore, we remain positive on the U.S. economy despite the recent setbacks. At present, we believe that the final data on the U.S. economy for 2013 will be real GDP of 2.5% (formerly 2%), a CPI of 1.5% (formerly 2%) and a gain in corporate profits of 8%. For 2014, we expect higher economic growth of 2.7 with 2.5% inflation and another 5% gain in corporate profits. We are assuming that monetary policy will remain expansive with the federal funds rate remaining at 0.25% until mid-2015.

A LOOK AT BONDS:

Over the past month, despite the government shutdown, both equities and bonds rallied whereas there was significant weakness in commodities. Yields on 10-year Treasury bonds fell to 2.5% from 2.7% a month earlier, long-term high quality corporate bonds reached 5.29% from 5.65%, and yields on 30-year mortgage bonds fell to 4.21% from 4.45%. Long-term municipal bonds had a more muted reaction with yields falling modestly from 4.85%to 4.82%. The reason for the more tepid move in municipal bonds is the uncertainty revolving government financing in Puerto Rico where large deficits have risen. This news was preceded by the Detroit bankruptcy which unnerved some municipal investors. Because Puerto Rican bonds are triple tax-free, they are found in many bond funds and their presence has disturbed some investors who were not expecting financial troubles to emerge in Puerto Rico. The large unfunded pension plans in many states and municipalities have received a lot of publicity because some states, such as Illinois, have legislators who have been unwilling to fix the financial under-funding for political reasons. More detail on our bond strategy is available in our quarterly *Fixed Income Strategy Highlights*. The CRB Index , a measure of a broad mix of commodities, fell 2.5% over the past month with oil ($97 per barrel) down 6.7% and copper ($3.27 per lb.) down 1.2%. Gold has stabilized at $1330 per ounce. While commodities in general might move lower based on economic slowing, gold is influenced by monetary factors such as the amount of quantitative easing. The U.S. Dollar Index is down only slightly during the month and we observed weakness in the Baltic Dry Index suggesting weakness in the shipment rates globally.

EQUITY VIEW:

Equities, as measured by the S&P 500 Index grew +5.2% over the quarter with foreign equities, as measured by the Morgan Stanley EAFE Index, rising +11.3%. The equities market ignored the doom and gloom forecasts surrounding the government shutdown and debt ceiling crisis and continued rising as they have all year. Earnings have presented a mixed pattern in the third quarter and stocks have risen and fallen depending on individual results. Despite some disappointing quarterly results, investors continued to look beyond the current quarter and pushed stocks with higher valuations. P/E ratios have risen in 2013 with the current P/E ratio on the S&P at 15.4 and 14.55 times our estimates of $109 per share, and $116 per share for 2013 and 2014. We have estimated that earnings will increase by 7% in both years. Despite the fact that profit margins are at record highs, we see some additional cost cutting is still possible in selective companies. During the current quarter, however, there have been many instances of revenue disappointments that warrant attention. Higher P/E ratios supported by the high levels of quantitative easing certainly support higher asset prices. We would expect tapering to begin before the new Federal Reserve Chair takes charge in February. Slower economic growth than earlier forecast by the majority of economists against a background of lower than anticipated inflation at a time when unemployment remains stubbornly high suggests such a pattern of continued monetary easing.

AN HISTORICAL PERSPECTIVE:

Since the economy bottomed in the first quarter of 2009, its annual growth rate adjusted for inflation through September 2013 has been 2.1%. This is the slowest post-war expansion after a recession and the Great Recession of 2008-2009 was the deepest since the Great Depression of the 1930s. As a result, capacity utilization in industry at 78% is still below the average of 82% and unemployment at 7.3% is higher than normal after four-and-a-half years of expansion. Economists will argue over the reasons of the below average growth rate but in our opinion much of it can be accounted for by structural changes in the economy.

Demographics have changed significantly and a large portion of the population has left the work force. Since 2010, when the first baby boomers turned 65, approximately 10,000 baby boomers retire every day with fewer younger workers entering the work force. Also, about 8 million women in the millennial generation have left the work force for a better life at home to care for their children. As a result of these and other changes relating to the work ethic, the employment-to-population ratio at 58.6% has reached a 35 year low. Most economists pay little attention to demographics because with the exception of Japan, which has the largest number of older people in its population mix among the larger economies, it has not been a major consideration in determining economic growth. Japan has been suffering the effects of a near deflationary phenomenon since 1980. Japan has not had much immigration to offset the effects of its older population mix. The European Union with its low birth rate is also now approaching some of the characteristics which mark Japan's population and as a result is flirting with deflation. Obviously, there are many factors which determine economic growth other than demographics but Japan provides an early example of an aging population which has affected economic growth. The United States has significant immigration and is in the very early stages of an aging population.

Ben Bernanke, the Chairman of the Federal Reserve, is known for his academic work on the Great Depression and perhaps this is the reason that he has maintained an expansionary monetary policy since the Great Recession began. In the 1930s, as the economy recovered from the depression, it was an early tightening of monetary policy along with fiscal stringency that resulted in a recession in 1937-1938 which caused a severe drop in stock prices. It wasn't until World War II that the deflationary conditions ended. Obviously, wars are not a desirable means to end slow economic growth.

Currently, there is modest fiscal tightening because of the sequester and the fiscal deficit has fallen 37% to $680 billion for fiscal 2013 (year ending in September). The deficit was 4.1% of GDP versus 6.8% in 2012 and 10% in 2009. Higher taxes accounted for 79% of the deficit reduction with lower spending the balance. Third quarter real GDP was 2.8% with inventory additions accounting for 0.8% of the growth. Consumption increased 1.5%, a slowdown from the two earlier quarters, while residential spending grew 14.6%. Capital spending, as measured by equipment and software spending, fell by 3.7%. Exports grew

4.5% with imports up 1.9%. Government expenditures rose 0.2% with state and local spending up 1.5% but federal spending down by 1.7%. First quarter growth was 1.1% and the second quarter 2.5%. In the current quarter economists expected a slower growth rate of about 1.75%.

The U.S. economy has grown at 1.6% for the twelve months ending in September. This compares with 7.8% for China, 2.7% for Japan, 1.5% for Britain, and -0.4% for the euro area. Inflation has fallen in the U.S. to 1.0%, as measured by the CPI, and 0.3%, as measured by the PPI. We have been surprised by the decline in inflation against the background of monetary easing as represented by quantitative easing and a zero to 0.25% federal funds rate. M-2 money supply has been growing at close to an 8.5% annual rate over the last three months. Despite the growing monetary base the shortfall in the velocity of money explains the lack of inflation as the demand for money has fallen.

Looking into 2014, we are positive on the U.S. economy with a forecast of 2.7% real GDP growth versus 2.5% in 2013. Our forecast for CPI inflation is 1.5% (formerly 2.5%) versus the current 1%. Our forecast for corporate profits is a gain of 7%, the same as the forecast for 2013. Profit margins are historically high as a percentage of GDP and should continue at similar levels into 2014. Mergers and acquisitions most probably will expand over the current 2013 rate in 2014. The low capacity utilization rate and high unemployment against a background of easy money should enable the business cycle to expand much longer than the normal period of 5 years.

A NOTE ON SECTORS:

In the cyclical arena (i.e. industrials, financials, and energy), earnings revisions have been on the downside in recent months due to European crisis woes, a slowdown of growth in China, and uncertainty surrounding the impact of the U.S. budget sequestration. As value investors, we are positioned in these sectors to take advantage of what we believe to be a continued cyclical recovery. Many of the companies in the cyclical sectors are levered to global growth and with low near-term expectations. We see opportunity for upside surprises here.

As illustrated in the following charts, earnings growth and revenue growth in the cyclical sectors appears to be forming a bottom, as expectations rise in the latter part of 2013 and into 2014. Investors throughout the quarter continued to favor defensive securities, tilting portfolios towards heavier emphasis on sectors such as consumer staples, utilities, and telecom. Although the valuation spreads for value-style investing continued during Q1, market participants were unwilling to step up in lieu of the potential elevated risks from higher economic sensitivity coupled with tougher quarterly earnings comparisons.

The stretched valuations for defensive versus cyclical sectors, however, do not portend a market collapse within the context of history. Although aggregate earnings revision trends showed modest improvement in developed markets according to our sources, the more economically sensitive stocks in North America, Latin America and Europe saw some eroding expectations driving performance on a macro level. Over the next several quarters, we see easier comps with estimates that do not appear overly optimistic in the U.S. market. With policy sentiment increasingly leaning towards anti-austerity and monetary easing broadening across regions, we believe our pro-cyclical emphasis in portfolios will find favor once again.

We continue to see pricing power as critical in forecasting improving estimates, along with monitoring inventory levels and near term capital spending trends. We believe that the 7.0% earnings growth for the

Standard and Poor's 500 for 2013 is still achievable with the potentially greatest risk in industrial cyclicals. Given this macro landscape, we slightly lowered our industrial exposure - offset with a comparable increase in the defensive healthcare sector.

BENCHMARK PERFORMANCE HIGHLIGHTS

Exhibit I
S&P 500 Index – 3rd QTR and YTD Sector Performance

	Sector Wgt. As % of S&P as of 9/30/2013	3rd QTR Return 6/30/2013 - 9/30/2013	3rd QTR Sector Contribution of S&P 500	YTD Return 12/31/12 - 9/30/2013	YTD Sector Contributin of S&P 500
S&P Index		5.23		19.80	
Consumer Discretionary	12.5	7.80	0.95	29.13	3.32
Consumer Staples	10.1	0.80	0.09	15.93	1.74
Energy	10.5	5.12	0.55	15.37	1.71
Financials	16.3	2.81	0.48	23.08	3.62
Health Care	13.0	6.81	0.86	28.50	3.41
Industrials	10.7	8.91	0.90	23.90	2.38
Information Technology	17.9	6.62	1.17	13.39	2.48
Materials	3.5	10.30	0.34	13.68	0.48
Telecommunication Services	2.4	-4.34	-0.11	5.17	0.19
Utilities	3.2	0.19	0.00	10.13	0.38

Source: Bloomberg

S&P 500 Index – 3rd Qtr Sector Performance Summary

- The S&P 500 returned 5.23% for the third quarter. Growth stocks, up 6.6%, overtook Value stocks by 276 basis points. Small cap stocks outperformed large caps, by a margin of 497 basis points.
- During the third quarter, 6 of the 10 market sectors exhibited strong positive performance led by the Materials, Industrials, Consumer Discretionary, and Healthcare sectors. Utilities and Consumer Staples were nearly flat, and Telecommunications came in negative.
- Diversified Financials which account for half of the market's financial exposure underperformed the broad market, up only 3.4%.
- The largest contributor to market performance was Apple, the largest stock in the benchmark index.

S&P 500 Index – YTD Sector Performance Summary

- The S&P 500 was up nearly 20% through September 2013. Consumer Discretionary was the strongest sector year to date, up 29.1%, aided by a rally in the 2nd and 3rd quarters.
- Strength in performance was mixed, but cyclical sectors were favored with Healthcare, Industrials, and Financials up 28.5%, 23.9% and 23.1% respectively.
- Although performance was positive, the more defensive sectors such as Telecommunications, Utilities, and Consumer Staples underperformed the overall market.

AIM's ATTRIBUTION HIGHLIGHTS

Exhibit II
AIM LLC Composite – 3rd QTR and YTD Sector Performance

	Sector Wgt. As % of Portfolio as of 9/30/2013	Relative Wgt. versus S&P 500 Index	3rd QTR Total Return of AIM Composite	3rd QTR Total Attribution of AIM Composite	YTD Total Return of AIM Composite	YTD Total Attribution of AIM Composite
AIM Composite			5.11	-0.12	21.59	1.79
Consumer Discretionary	10.2	-2.3	12.87	0.15	24.64	-0.71
Consumer Staples	9.0	-1.1	-0.96	-0.12	20.36	0.43
Energy	13.9	3.4	7.42	0.30	21.03	0.66
Financials	17.7	1.4	4.13	0.20	24.44	0.24
Health Care	13.2	0.2	4.10	-0.36	22.07	-0.69
Industrials	11.4	0.7	10.88	0.49	25.33	0.28
Information Technology	16.5	-1.4	2.43	-0.71	20.81	1.41
Materials	2.3	-1.2	12.46	-0.02	33.63	0.51
Telecommunication Services	2.5	0.1	-3.25	0.03	4.44	-0.02
Utilities	2.0	-1.2	-3.64	-0.01	4.15	0.00

Source: Bloomberg

AIM - 3rd Qtr. Sector Performance Summary

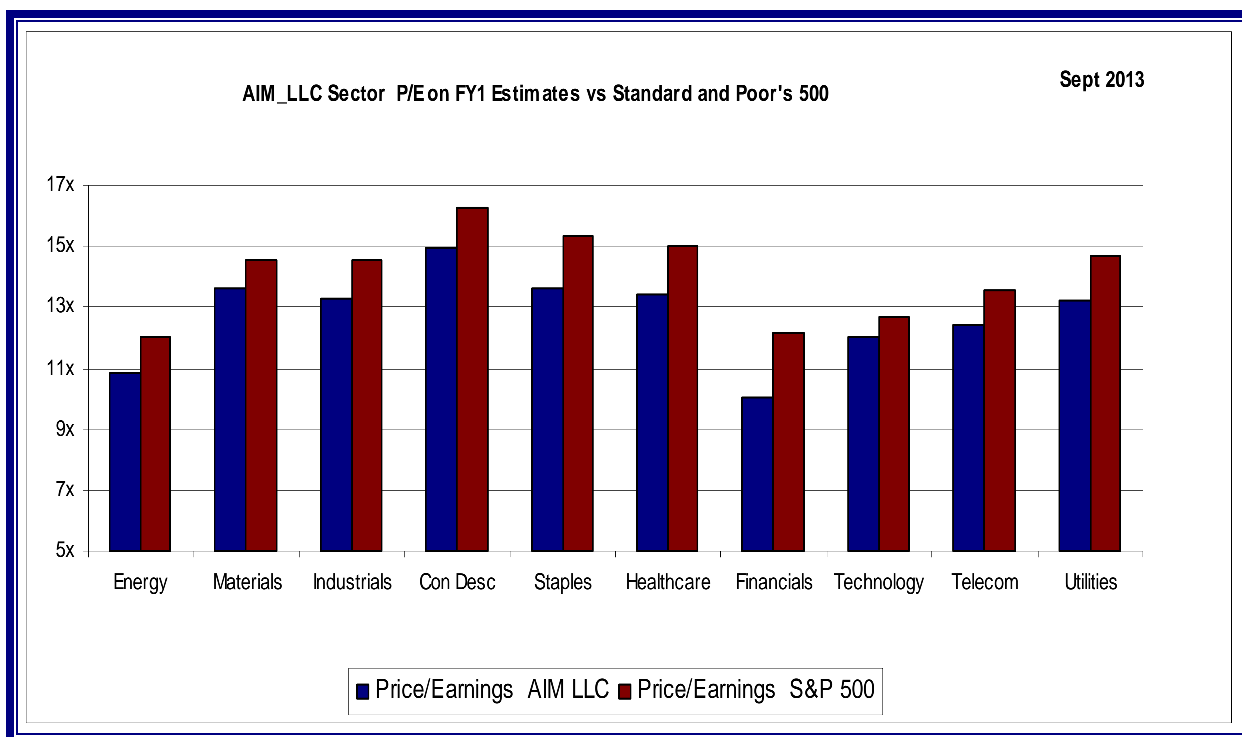
- The AIM composite underperformed the benchmark S&P 500 by 12 bps during the 3rd quarter.
- Contributing most to relative performance were the Industrial, Energy, Financials, and Consumer Discretionary sectors.
- Detracting most from relative performance was Information Technology due to poor performance in Cisco, Microsoft, and Intel down -2.99%, -2.84%, and -4.44% respectively.
- The top 5 performing stocks during the quarter on an absolute basis were Emerson Electric, Philips Electronics, Applied Materials, Lowe's, and Johnson Controls. The bottom 5 performers were Conagra, Kraft, Transocean, Abbott Labs and Intel.

AIM - YTD Sector Performance Summary

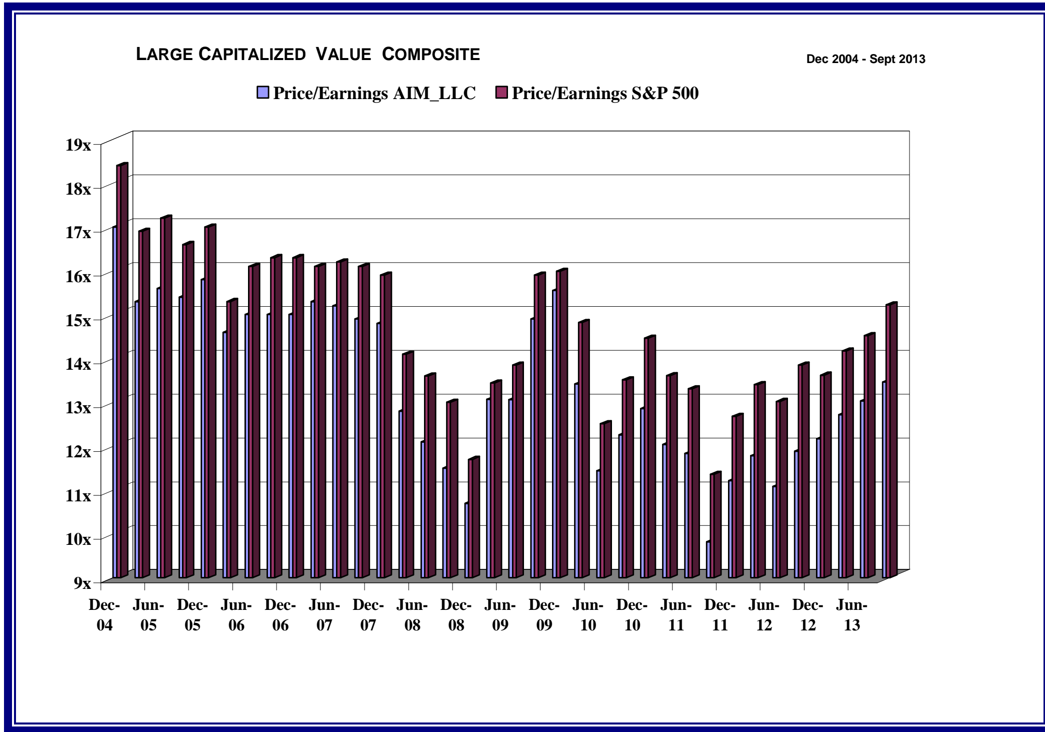
- Due to strong relative performance in the 1st and 2nd quarters, the AIM composite is leading the market by 179 basis points.
- Relative outperformance was strongest in Information Technology led by Applied Materials, Microsoft and Cisco.
- Outside of technology, DuPont, Archer Daniels, and Northrop Grumman contributed most to relative performance trading up 33.5%, 36.7% and 44.15% respectively.
- Our top 5 performing stocks for the first three quarters of the year were Applied Materials, MetLife, Northrop Grumman, Halliburton, and Archer Daniels. The bottom 5 performers were Deere, Oracle, Transocean, Edison International, and AT&T.

S&P 500 – SECTOR VALUATION CHARACTERISTICS

	SPX	Energy	Materials	Industrials	Con Desc	Staples	Healthcare	Fincl	Tech	Telecom	Utilities
# holdings	500	43	31	63	83	40	55	86	67	6	31
Beta	1.00	1.25	1.19	1.08	1.04	0.56	0.73	1.37	1.06	0.66	0.53
P/B	2.49	1.93	2.84	3.27	4.31	4.21	3.40	1.25	3.39	2.49	1.58
TTM P/E	15.93	13.13	17.71	17.01	19.03	17.37	18.69	13.10	15.87	17.13	14.75
P/E cur	15.23	13.25	16.73	16.15	19.07	16.93	16.33	13.19	14.10	15.44	15.36
P/E FY1	13.75	12.00	14.52	14.58	16.28	15.32	15.00	12.14	12.72	13.55	14.70
P/S TTM	1.50	1.11	1.30	1.44	1.30	1.07	1.68	1.81	2.54	1.34	1.42
Div yield	2.14%	2.32%	2.26%	2.11%	1.43%	2.86%	1.83%	1.84%	1.89%	4.94%	4.07%
P/CF	9.06	7.12	10.78	10.80	12.00	12.54	16.66	5.58	10.62	4.33	6.31

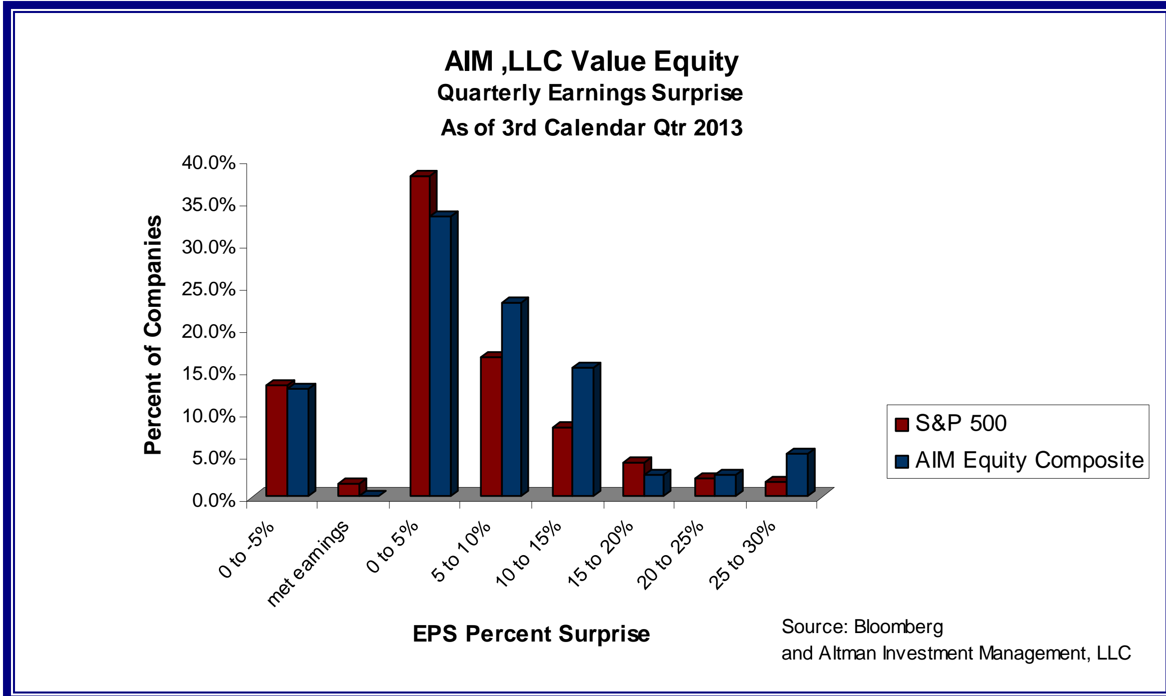


- Multiples expanded over the prior quarter in all sectors, with the exception of Utilities, Consumer Staples, and Telecommunications.



THE MOST RECENT QUARTERLY COMPANY PERFORMANCE RECORD

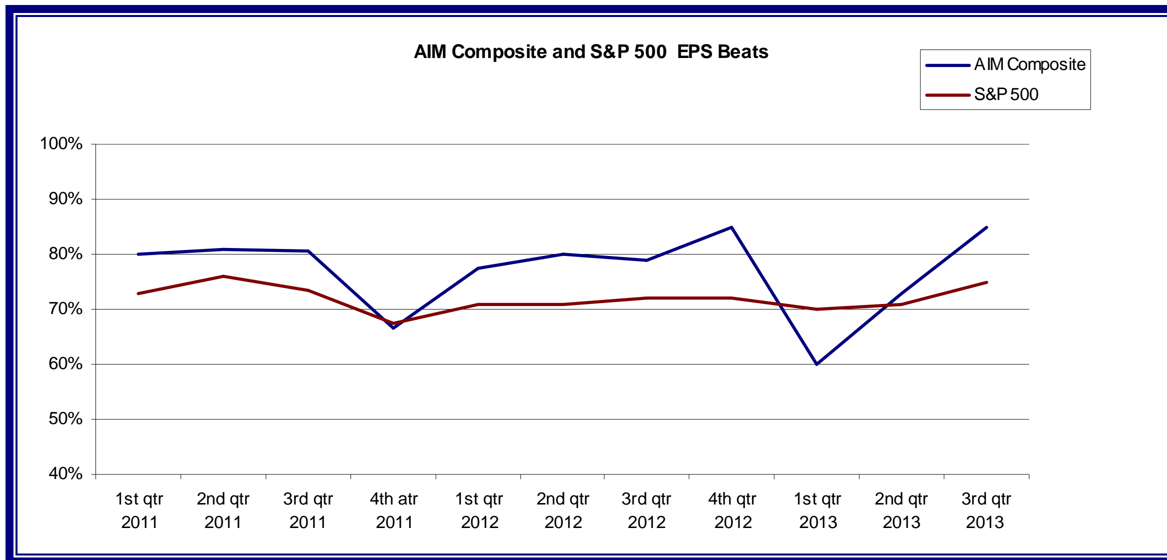
THIRD QUARTER EARNINGS SURPRISES VERSUS MARKET



Source: Bloomberg

The chart above illustrates the percentage of investment holdings within our value portfolio that exceeded street estimates during the 3rd calendar quarter of 2013. Most notably, 85% of our investments exceeded street estimates and 75% of the companies in the S&P 500 exceeded street estimates.

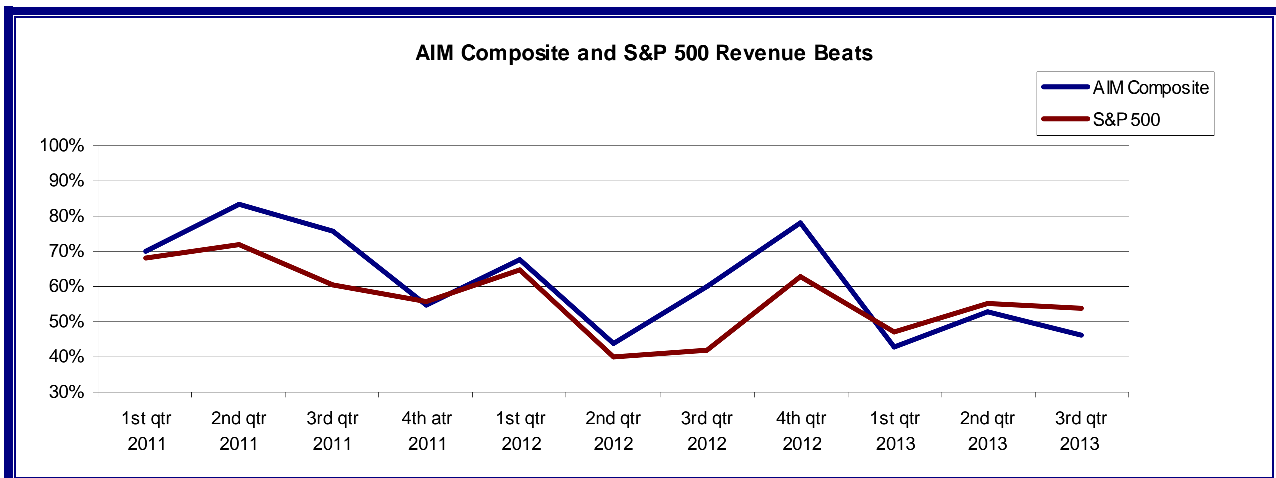
ONE YEAR EARNINGS SURPRISES VERSUS MARKET



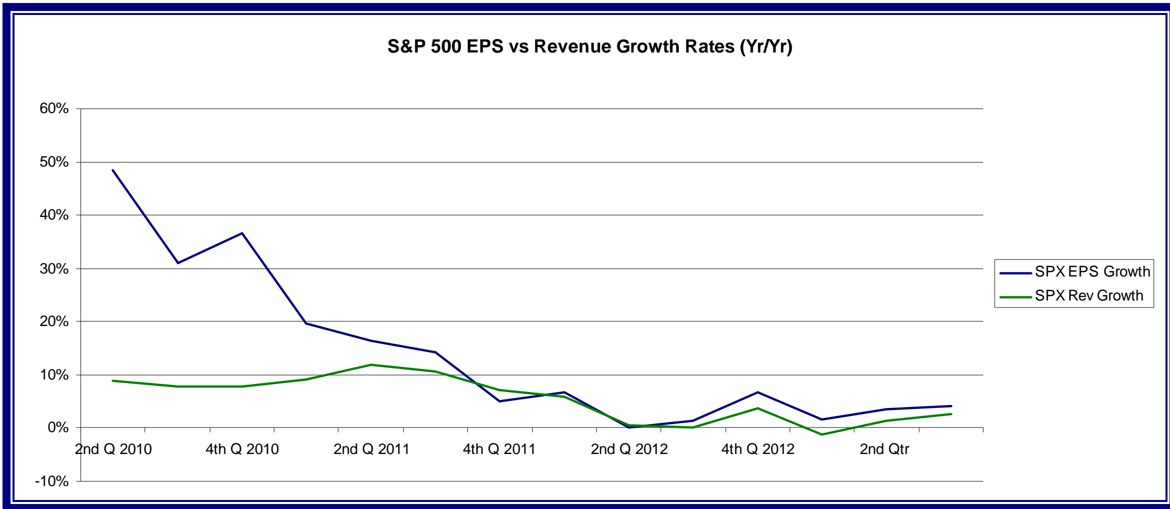
Source: Bloomberg

After taking a brief dip in Q1, the number of earnings beats recovered to above 80% in the AIM composite, while the level of revenue beats contracted slightly.

ONE YEAR REVENUE SURPRISES VERSUS MARKET



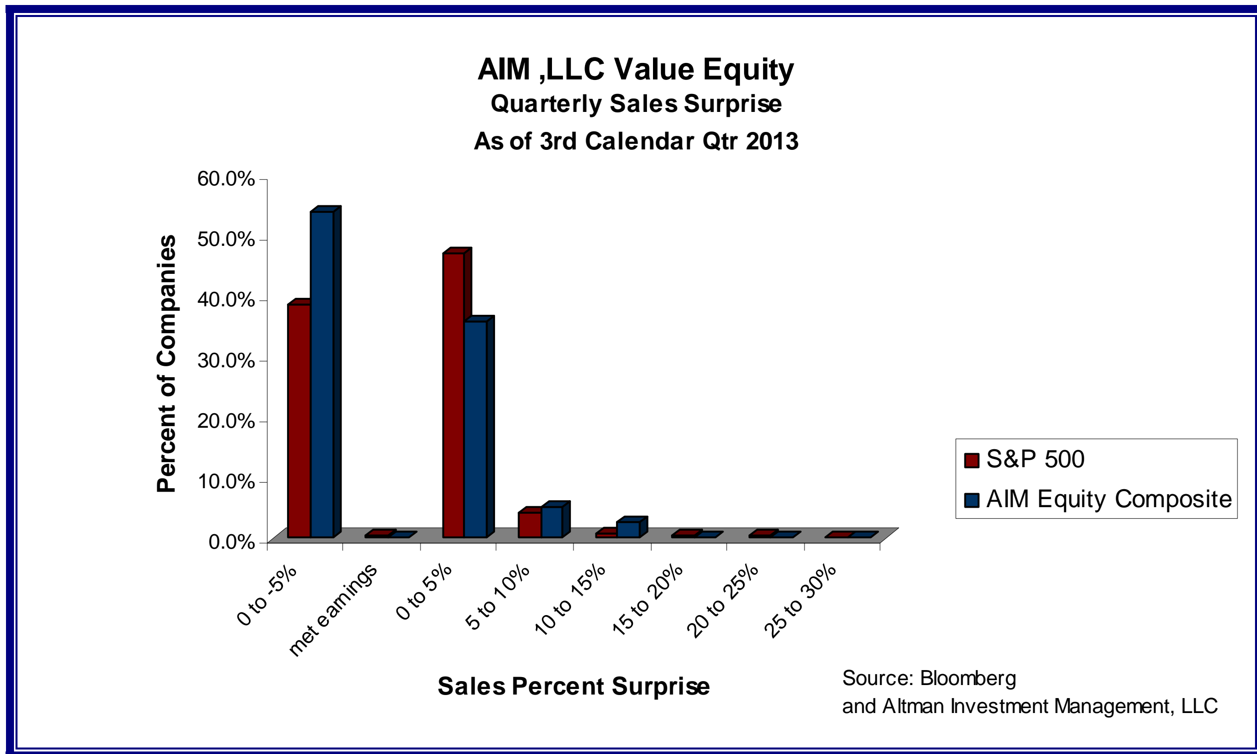
Source: Bloomberg



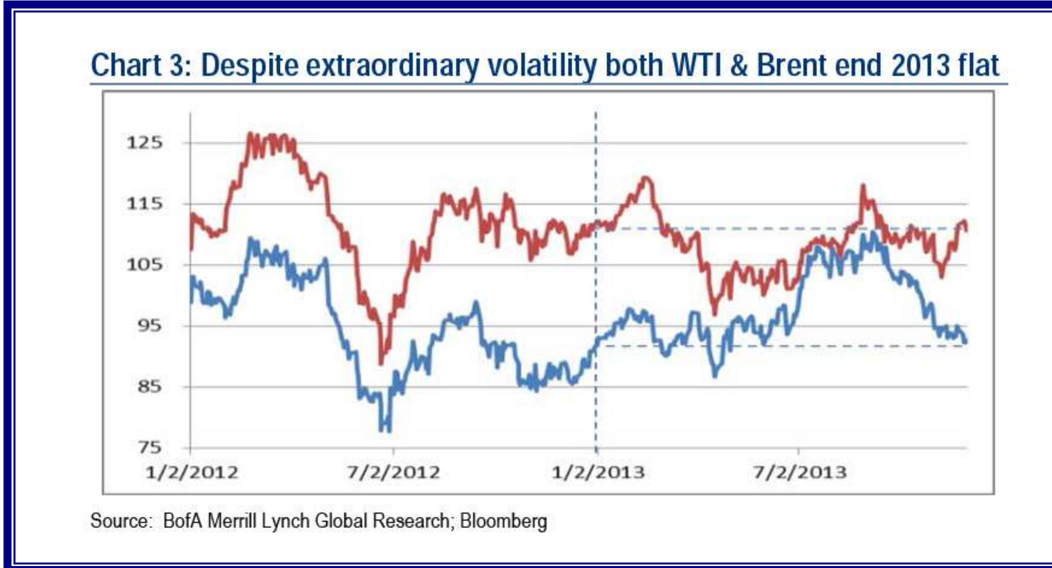
Source: Bloomberg

The rate of earnings and revenue growth continues to form a bottom. Overall earnings growth in the 3rd quarter grew at a rate of 4.3%, up from 3.5% in the prior quarter. 9 of the 10 market sectors exhibited positive earnings growth with only Energy recording negative earnings growth. However, for the first time in 6 quarters, Energy has produced positive revenue growth. Looking at top line sales, 46% of our investments exceeded street estimates as compared to 54% for the S&P.

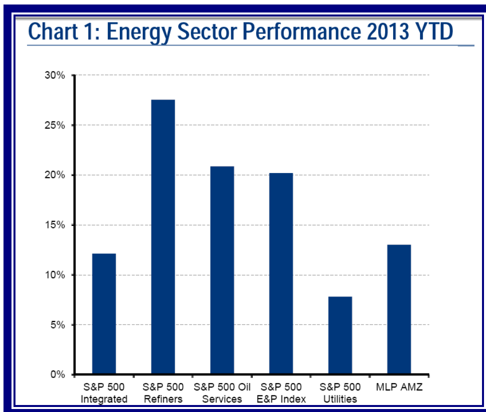
Third Quarter Revenue Surprises Versus Market

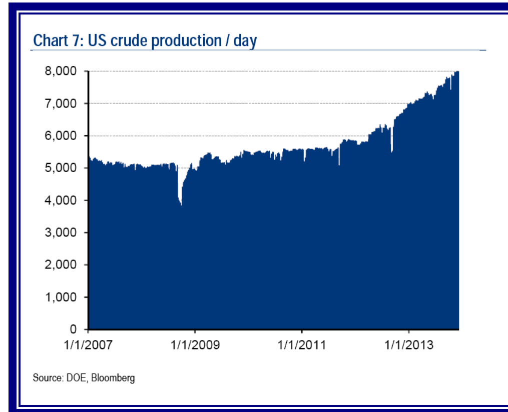


CLOSE UP: The Energy Sector- Overweight?



Companies successful in unconventional resource discovery within in the U.S. were among the energy sector leaders this year, specifically during the 2nd and 3rd quarters. The integrated oil companies lagged sector performance as geopolitical uncertainty persisted. Throughout the year WTI and Brent oil prices experienced heightened volatility. Even with mounting production levels, the WTI reached $110.53 on mounting geopolitical risks, up from mid $80s in the first quarter. Oil prices then collapsed in the 4th quarter as record production levels coincided with seasonal demand weakness. The recent collapse in the commodity price put pressure on the sector as a whole reigning in performance for the final quarter.





The IEA estimates another year of oil production growth of 1.2 mm bpd, creating further expansion between U.S. Production levels and refining demand. Thus we would expect the short term oil price volatility to continue, albeit range bound, as it has over the past few years. The range bound concept stems from the notion that rather than adding to the pressures of global oversupply, U.S. production levels have worked to limit the spike in oil prices resulting from geopolitical risks.

What we look for in the coming year are companies that can capitalize on the recent growth in discovery among the mid-southern states, namely Texas and New Mexico. We also favor companies returning cash to shareholders or those with restructuring stories. Occidental Petroleum, Devon Energy, and Halliburton are a few examples.

Further upside to refining stocks could be somewhat limited given sector outperformance during the past 2 years. However, should crude differentials persist refiners could see another year of outperformance.

IN SUMMARY:

- **The U.S. economy is poised for the fourth year of record profits and expanding GDP** helped by the Eurozone exiting a recession, Japan stimulus and continuation of growth in China. A potential global synchronized expansion is developing.
- **Stocks are likely to benefit from better global growth as profits rise.** Bond prices are generally expected to decline, as the Fed tapers its bond buying program and inflation slowly rises. The great rotation has only just begun.
- **Taper or not, monetary policy remains generously accommodative with the little likelihood of an increase in the Fed Funds target rate before 2015.** The European Central bank and the Bank of Japan are firmly anchored in the expansionary camp as well. Fighting the Fed has not worked.
- **Stock prices are a function of earnings and price to earnings multiples.** While inflation has bottomed, it is expected to be around 2.0% in 2014, which would be favorable in supporting P/E expansion from current 16 to 17 times forward earnings, which is more typical in a 20% inflationary environment historically.
- **Stocks still remained under-owned.** Households with $43 trillion in financial assets are only 38% invested in stocks, compared to 53% in 2000. Private pension funds, with $8.0 trillion in assets are 30% invested in stocks, versus 50% at their peak in 1987.

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