ALTMAN INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

OCTOBER, 2013

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> **"THE MARKET'S BOUNDLESS CAPACITY FOR POOR JUDGMENT ENSURES A STEADY SUPPLY OF OUT OF FAVOR CANDIDATES"**
>
> **JOHN NEFF, "ON INVESTING"**

IN BRIEF:

As investors fear that a "melt up" of markets is devoid of fundamentals, we remind ourselves that the purchase price for our investments represents ownership in companies with intrinsic value. This margin of safety should protect those investments when markets change direction. Despite focusing our efforts on companies with the greatest propensity to surprise investors, and reward patience, we are compelled to outline the macro landscape which sets the stage for the overall direction of markets.

IN VIEW: The Fed Continues To Support Markets into Year End

The Federal Reserve announcement in September surprised markets by continuing its asset purchase program, rallying bonds sharply and pushing the Standard and Poor's Industrial Average to an all-time high. Yet investor sentiment remains skeptical of the low interest rates, primarily due to concerns about the visibility of longer term growth.

The benefits of lower rates to the real economy should translate into lower mortgage rates and financing costs for both corporations and consumers. There was only one member of the Federal Reserve Board who dissented on the decision, reinforcing a more dovish Fed.

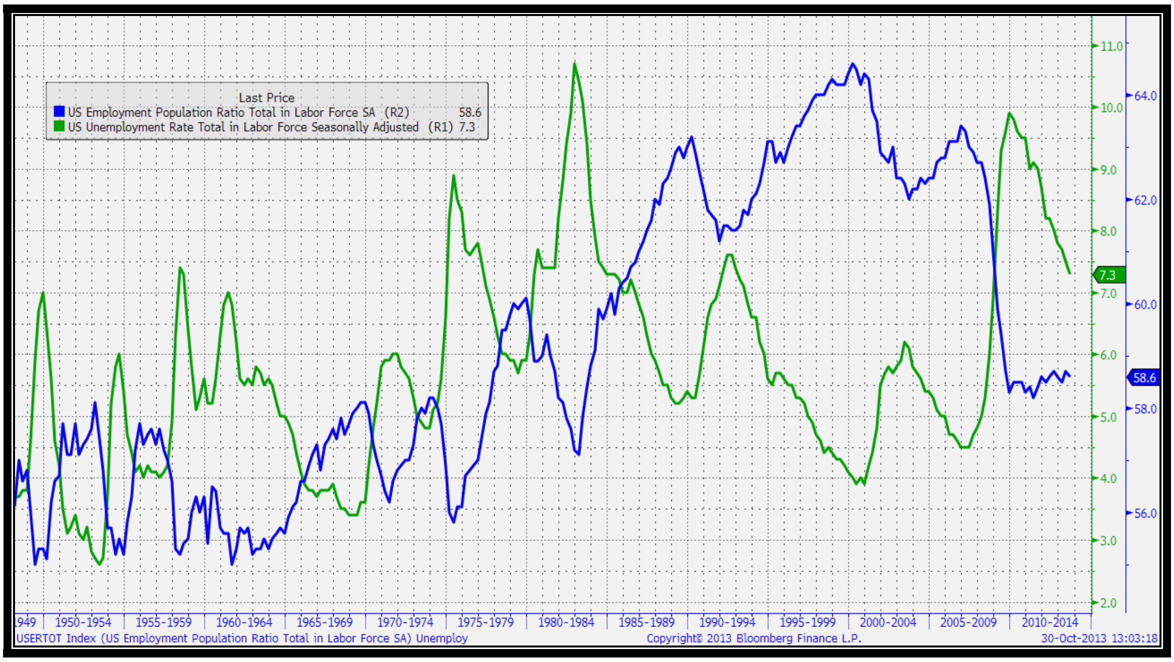
Bernanke & Co. appears to have anticipated our political challenges, and provided some assurances against the possibility of a stalled process in Washington over the debt ceiling, budget debate and the pending nomination of a new Fed Chairman. Should the markets continue climbing into the yearend, Janet Yellen, the next Fed Chairman, would in effect be taking over with a potential bubble in the stock market. In addition, January's unemployment rate which will be released in early February could be down at the 7.0% level - not far from the current 7.2% rate reported in September. Back in June, you might recall that during Bernanke's press conference he did indicate that he would terminate the quantitative easing program (QE) when unemployment reached 7.0%, despite downplaying it in September. Yellen's much-anticipated first press conference will follow this unemployment report.

It is quite possible that even the 7.0% unemployment rate may not cause the Yellen Fed to start tapering. It is clear that the doves still dominate the FOMC and most of its members believe that the fall in the employment rate has exaggerated the improvement in the labor market - essentially because many participants have dropped out of the labor force. As Exhibit I illustrates on the next page, the Fed recognizes that the employment-to-population ratio has been stuck near the 2009 lows for the past five years. While the recent weakness in the U.S. labor market may be worrisome to economists, investors are encouraged by the prospect that the Fed won't rush to taper the QE program. Many economists conclude that the jobless rate would be closer to 10%, if the labor force participation rate was closer to 65% versus the current 63% rate, the lowest reading since the summer of 1978.

Relative to our previous discussion on the Fed's official goal, in effect, to lower the Misery Index, we revisited the lows of 8.7% experienced in May of this year. In the past, bull markets in stocks have tended to occur when the "Misery Index" (the sum of the official unemployment rate and the inflation rate) is falling, or at least not rising. The index is down from a cyclical peak of 13% during November 2011. We reiterate our forecast that it will remain around 9% through the end of next year, suggesting that the current bull market may last at least until then, if not longer.

Exhibit I

Employment-to-Population Rate versus the Unemployment Rate



Source: Bloomberg and AIM, LLC Research

CLOSE-UP: The Economic Landscape

The economic expansion which began in June 2009 is now a little over four years old. On average, a business expansion normally lasts about five years. However, since the Great Recession was the deepest since the Great Depression of the 1930s, we believe that this expansion could outlast previous cycles because of the current underutilization of resources, including capital and labor. At present, capital utilization is at 77.8% versus a normal level of 82% and the unemployment rate is at 7.3% after four years of recovery. As we mentioned earlier, the employment-to-population ratio has fallen, partly because of demographics as older people retire from the work force but also due to a significant rise in part-time workers. The unemployment rate is particularly high among the young.

While the peak unemployment rate was 10% in October 2009, there are still an estimated two million more people looking for work than in 2007. This current unemployment phenomenon is the result of structural changes in the economy, rather than the monetary policy which has been historically expansive. During the second half of the previous century, the U.S. economy evolved from a manufacturing based economy to a service based one. Since 1950, employment in services increased an estimated 85 million to a record 117 million in September. On the other hand, manufacturing employment peaked at close to 20 million - 35 years ago - and is down to 12 million today.

Corporations have voiced the difficulty of finding qualified people, suggesting that the current educational system is lacking particularly in mathematics and sciences. Furthermore, regulations have grown exponentially, particularly with regard to the environment and worker's benefits which have raised costs for employers, while real wages, adjusted for inflation, are barely growing. The above structural employment problems require Congressional action and changes in educational policies rather than relying solely on expansive monetary policy.

The revised economic forecast for the second quarter came in at 2.5%, which compares to 1.1% for the first quarter. Personal consumption increased 1.8%, led by durable goods which was up 6.1%. Private domestic investment was strong, up 9.9%, with residential spending advancing 12.9% and capital spending, as measured by equipment and software spending, up by 2.9%. Inventory growth added 0.6% to the overall growth of 2.5%. International trade had zero effect on growth, as strong exports, up 8.6%, were accompanied by a large increase in imports which advanced 7.0%. Finally, government expenditures declined with federal spending down 1.6% and state and local spending falling 0.5%. At present, we expect third quarter growth to advance by 2.5%.

The U.S. economy currently presents a hybrid picture, with some statistics improving and others slowing down. Overall, however, we believe that growth is steadily improving at a 2.0-2.5% rate. One should add that when the Bureau of Economic Analysis revised all of its economic data back to 1929, it concluded that while annual growth in real GDP was 3.3% for the period 1929-2012, it was only 1.8% for the period 2002-2012. As a result, the current data, while disappointing to some, is still an improvement from the past decade. In terms of current data, the leading indicators increased by 0.7% in August and are up 4.2% from year-ago levels. Existing home sales advanced 1.3% in August to a 5.48 million seasonally adjusted annual rate and are up 13.2% over the past year. Motor vehicle sales rose again and are the highest since November 2007.

The ISM Manufacturing Index was higher at 55.7 in August versus July. The ISM Non-Manufacturing Index (services) rose as well to 58.6, representing strong growth. Any number above 50 represents expansion. Industrial production increased last month, and up 2.7% from year ago levels. On However, durable goods orders for August were up only modestly - excluding defense which has been hit by the sequester. The auto sector remains strong with orders up 2.5%. Non-defense capital goods orders, although a very volatile statistic, increased 1.5% after declining 3.3% in July. Keep in mind that this latter statistic is most probably the best measure of the outlook for private capital spending.

Our disappointments during the quarter are centered on the fact that slower growth has not curtailed overzealous expectations by investors. Perhaps much of this has been fueled by a strong stock market so far in 2013. We continue to believe that the economy will grow at a 2.5% rate in 2013, accompanied by 2.0% CPI inflation and a gain of 7.0% in corporate profits. For 2014, we expect slightly higher economic growth of 2.5%, with 2.5% inflation and another 7.0% gain in profits. We are assuming that monetary policy will remain expansive with the federal funds rate remaining at 0.25% until mid-2015.

Third Quarter Earnings Season Beat Street Estimates

- With 57% of the S&P 500 companies having finished reporting, their results for the Q3-2013 earnings season are mixed compared to the same point in Q2. Of the 284 Q3 reporters to date, 75% have exceeded industry analysts' estimates. That exceeds the report of 71% during the same time period in Q2-2013. On the revenue side, 52% are beating the estimates so far as compared to 45% in Q2. The 4.7% earnings surprise is ahead of Q2's 2.8% surprise, and the revenue surprise of .2% is slightly behind Q2's .5%.

- Earnings for these companies are up 5.7% y/y on a sales gain of 3.5%, slightly better than the 3.6% earnings and 1.5% sales in Q2. We don't expect the current season will have much of an impact on earnings expectations for 2014 and 2015.

The Outlook for the Financial Markets

Over the past month, which included the Federal Reserve's decision to continue its policy of quantitative easing with no "tapering", bond yields fell, equities rallied - and commodities, while modestly falling over the month, increased in price from their lows prior to the decision not to taper. At present, the 10-year Treasury bond yields 2.5% compared to 2.8% a month ago, long-term high quality corporate bond yields are an additional 100-120 basis point spread over the comparable Treasury, and long-term municipal bond yields declined 45 basis points over the prior month as well.

Both domestic and foreign equities rallied - with the S&P 500 Stock Index (1760) up 10.35% since the second quarter and foreign stocks, as measured by the Morgan Stanley EAFE Index (1888), up 3.9% over the same period. Recently foreign stocks have moved up faster because they were much more depressed than U.S. equities selling at lower P/E ratios. Keep in mind that the U.S. monetary policy has global ramifications.

While commodities were lower at the beginning of Q3 a month-ago, they also rallied on the no "tapering" news. Gold ($1,339) per ounce is now flat from September, copper ($3.25 per lb) although still off recent highs is up ~8.0% from late June, and oil ($110 per barrel) has recovered from the June lows of $100/barrel. Commodities in general, as measured by the CRB Index, are down ~2.7% since the end of the second quarter and down 5.5% since year end.

Ben Bernanke, Chairman of the Federal Reserve, wanted a monetary policy with more clarity and better communication, although the recent confusion about monetary policy decisions has had the effect of dissuading speculation in the market place. Nevertheless, his recent course of action to continue quantitative easing at its current rate ultimately reflects his view that the Federal Reserve tightened monetary policy too early back in 1937-1938 as fiscal policy was also being tightened. The result was a 40% fall in stock prices and a recession during that period following the recovery from the Great Depression. As a noted historian of that period, Ben Bernanke probably concluded that "tapering" too early might result in another possible recession. However, dissenters of this policy believe that we may also run the risk of a pick-up in inflation at a time when many people are still suffering from the results of the last recession.

At current equity prices, the S&P 500 Stock Index sells at 16.2 and 15.57 times our estimates of $108 and $113 per share for 2013 and 2014, respectively. While a correction in stock prices after a 25% gain so far in 2013 would not be surprising, current equity prices offer reasonable value in the context of current interest rates.

IN SUMMARY:

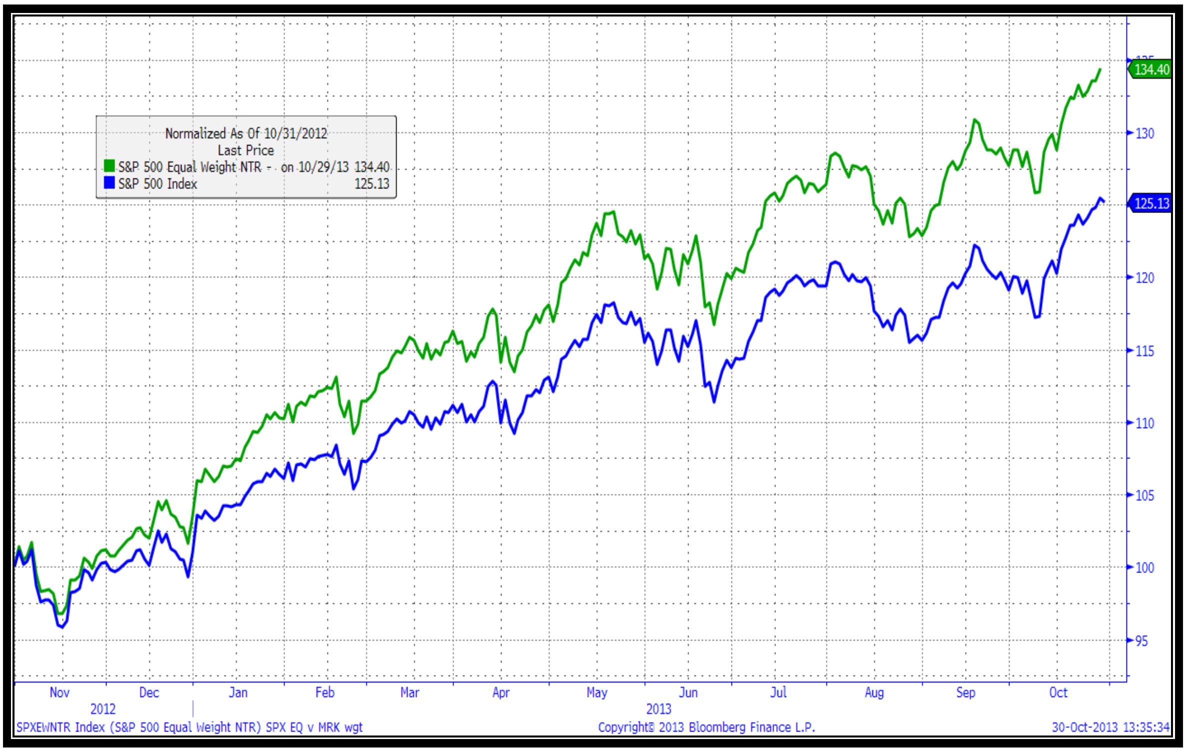
Although we recognize that the positive case for equities still hinges on an accommodative Fed, the upcoming debt ceiling/budget debate and pending nomination of the new Fed Chairman still represent some headwind risk. However we still conclude that the underlying economic growth should support equity prices into the year end. We continue to be encouraged by the leadership of cyclicals, with Materials, Technology and Industrials outperforming in the recent quarter. Furthermore, the interest-sensitive groups or "bond-like" alternatives have taken a back seat. Many investors have argued that consensus was too bullish in the third quarter, even as most Wall Street strategists were mostly bearish. The extent of recent short covering suggests more investors were positioned for the downside - or at minimum were indecisive.

Bottom line, we continue to be constructive on the U.S. equity markets with a cyclical tilt and are encouraged by the breadth of the market rally. Exhibit II provides a good picture of how the equally weighted performance of the Standard and Poor's has outperformed the capital weighted index. Because earnings have not kept pace with the price movement of the market, valuations might at first glance appear stretched. The price-to-earnings (P/E) multiple is at the midrange of its historical average and the dividend yield of close to 2.0% provides a compelling return to the fixed income alternative. The strength of corporate balance sheets provides companies with a number of options to enhance shareholder value in the foreseeable future.

Signs of improving U.S. economic growth remain intact supported by continued recovery in housing and consumer confidence. However, we do see risks as we enter 2014 associated with the budget debate/debt ceiling issues as well as the Federal Reserve response to both fiscal policy restraint on growth and global weakness. Rising stock valuations has shrunk the universe of investment opportunities and again reinforces that our disciplined process of embracing equities with low price-earnings ratios has stood the test of time.

Exhibit II

Standard and Poor's –Equal Weight vs. Capital Weight (Price Returns)



Source: Bloomberg and AIM, LLC Research