Altman Investment Management

Market Perspective

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> "Judgment singles out opportunities, fortitude enables you to live with them while the rest of the world scrambles in another direction."
> John Neff

IN VIEW: The Fed Signals an Improving Economy

Investors received a surprising holiday present in the form of a 4.1% real GDP growth rate for the third quarter, as determined by the Bureau of Economic Analysis. This compares with 2.5% in the second quarter and 1.1% in the first quarter. The acceleration of economic growth against the backdrop of higher taxation and the government sequester surprised investors, supporting continued positive flows into equity markets. The expansion of monetary policy in the form of an approximate 7% annual growth in money supply and a 0-25% federal funds rate helps explain the faster economic growth.

The announcement in December by the Federal Reserve - of a reduction of $10 billion in its $85 billion of monthly purchases of mortgage and Treasury bonds due to start in January - should be interpreted as a positive development and the beginning of the end of quantitative easing. With this action the Federal Reserve is signaling that it is more comfortable with the improvement of the economy. The above positive developments are reinforced by the falling annual inflation rate as measured by the CPI of 1.5% through December and by the PPI of 1.2%.

The equity markets responded positively at year end to the above developments by reaching new record highs and, in conjunction with improving housing prices, adding to overall wealth.

The woes of emerging economies could temper the Fed's tapering in coming months by strengthening the dollar, which could push U.S. inflation closer to zero. The JP Morgan Trade-Weighted Dollar Index has been trending higher since mid-2011. A strong dollar tends to depress inflation and lower bond yields.

Indeed, the U.S. import price index excluding petroleum has been falling over the past 10 months on a y/y basis through December, when it was down 1.3%. A stronger dollar would be bad news for commodity producers, especially in the emerging economies. When the dollar is rising, commodity prices tend to fall. Weak commodity prices have depressed the currencies of commodity-producers Canada and Australia over the past year.

The latest FOMC statement noted that near-zero inflation could be a problem for the U.S. economy: "The Committee recognizes that inflation persistently below its 2 percent objective could pose risks to economic performance, and it is monitoring inflation developments carefully for evidence that inflation will move back towards its objective over the medium term." The emerging markets crisis, strength in the dollar, and weakness in commodity prices could frustrate the Fed's expectations that inflation will rise back closer to 2%.

CLOSE-UP: The Economic Landscape

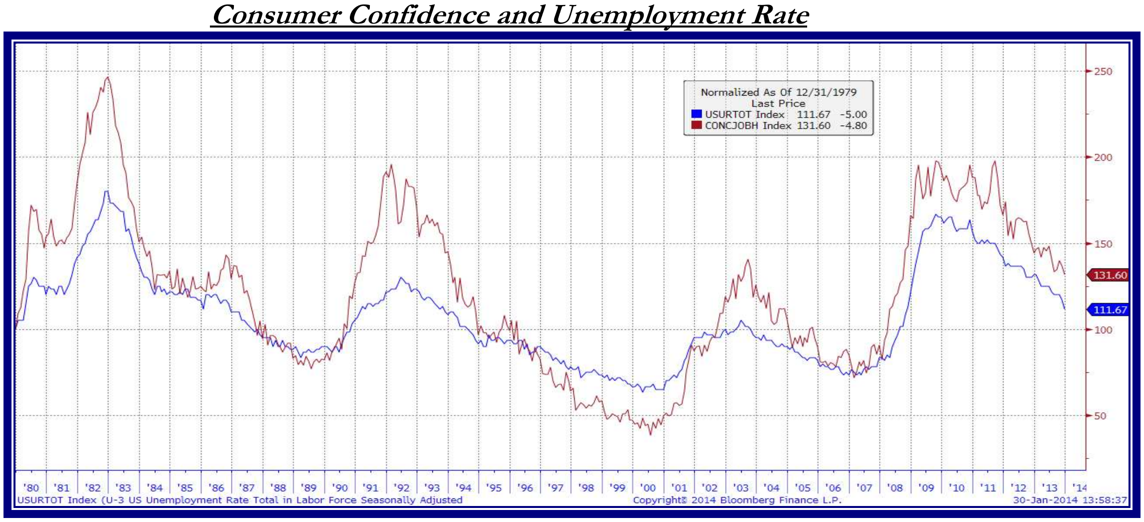
Specifically, improvements in third quarter growth included a 2.0% advance in consumption with durable goods up 7.9%, nondurables up 2.9%, and service expenditures increasing 0.7%. Although these numbers are supportive of an improving economy, we would expect some volatility in the reported numbers in the months ahead. Keep in mind that exports increasing by 3.9% with imports up 2.4% confirm the positive trend as well aided by increasing energy independence caused by the fracking boom. While federal spending declined in the most recent month, this was offset by a comparable increase in state and local expenditures brought about by the improved finances resulting from the economic expansion. Residential spending advanced 10.3% with nonresidential up 4.8%.

Intellectual property products increased 5.8% (a new category made up of business investments in software, research and development as well as artistic endeavors such as movies, theatre, music and books, etc.). Inventories added 1.67% to growth versus 0.41% in the second quarter. If the second and third quarters are adjusted for inventory additions, growth would have been 2.1% and 2.4% respectively. There is no way at present to know if the inventory additions were voluntary or involuntary. However, the trend in final sales suggests they were probably voluntary.

Over the past year unemployment has fallen from 7.8% to 7.0% while nonfarm payroll employment throughout the first eleven months of 2013 has averaged 189,000, slightly higher than the corresponding periods in 2012 and 2011. For 2013, about 2.3 million jobs will have been added, continuing a steady improvement since the Great Recession ended in June, 2009.

Exhibit I

Consumer Confidence and Unemployment Rate



Source: The Conference Board and the US Department of Labor, Bloomberg and AIM, LLC Research

Looking ahead into 2014, we believe that investors should remain optimistic regarding the overall economy. At present, the leading indicators are up 5.4% through December and are in a rising trend after some weakness in the summer. Fiscal policy should be less restrictive with monetary policy modestly less expansive, assuming that quantitative easing ends by the end of 2014. We would expect short-term interest rates (the federal funds rate) to remain close to zero until 2015, as stated by the Federal Reserve. Much will depend upon the rate of inflation!

Corporate profit margins were a record 11.1% in the third quarter, as measured by after-tax profits as a percentage of gross domestic product, versus an average of 6.1% since 1929. With income inequality becoming a serious political and social issue as 2014 unfolds, some modest reversal to the mean could be expected. Real wages at present are growing at an annual rate of 0.3%.

Overall, we have revised our forecast for real GDP growth +.5% to 2.75% in 2014 versus an expected 1.8% in 2013. We are holding our inflation forecast at 2.5% and remaining with a corporate profits forecast of 7%, the same as in 2013. We would highlight the fact that the currently low (by historical standards) capacity utilization rate of 79% and high unemployment rate of 7% suggest that the current business cycle will expand far longer than the normal period of five years.

The Outlook for the Financial Markets

Last year was an exhilarating year for equity owners, a cautious year for bond investors and a depressing one for commodity investors. The modest economic recovery, accompanied by falling inflation, yielded moderate gains in corporate profits; however rising p/e ratios led to an ebullient stock market with the S&P 500 up approximately 29.6%. YTD, Treasury bonds declined approximately 2.6%, high quality corporate bonds were down 0.6%, and municipal bonds fell 3.0% with high yield bonds up 5%.

Exhibit II

Ten Year Generic Treasury Yield

Bloomberg and AIM, LLC Research

The current weakness in commodity prices should reverse, assuming global economies continue to expand and Europe begins to recover from its double-dip recession. Commodities (454 CRB Index) fell 6.4% with copper ($3.34 per lb.) down 6% and oil ($99 per barrel) up 12%, largely because of the Middle East conflicts. Gold ($1205 per ounce), after a twelve year rally, plunged by 27%. Paradoxically, if quantitative easing to head off a feared deflation helped stocks, it failed to rally gold or the majority of commodities.

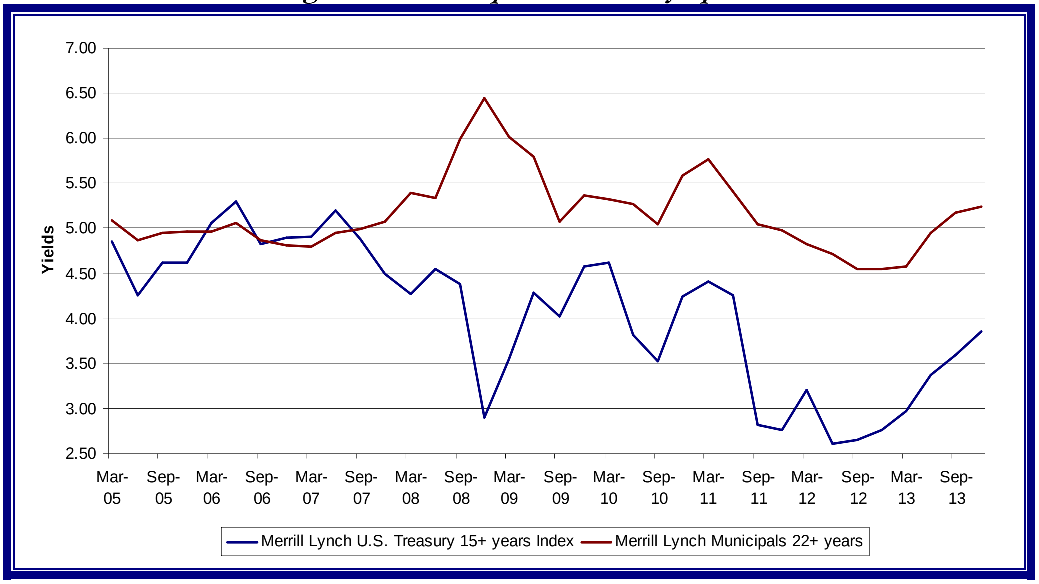
Also, falling inflation failed to rally bonds but aided stocks as costs were contained. Municipal bonds were hurt by news about the Detroit bankruptcy and a small number of other municipal bankruptcies, as well as news media stories about future risks in Puerto Rican bonds, which are widely held because of triple tax exemption. The U.S. dollar index has been stable over the past year.

Through year end, 10-year Treasury bonds yield 2.9% versus 2.7% in November and 30-year mortgage bonds yield 4.51% compared to 4.35% in the prior month. The rise in yield is attributed to the news of the start of tapering in January and the expectation that the process will be completed in the next 6-9 months. In contrast, long-term high quality corporate bonds fell in yield to 5.3% versus 5.5% a month ago. Corporate bonds have been favored by investors due to the strong finances of corporations amidst a good outlook for the future. Short-term money remains low yielding 0.05%.

Looking ahead, we expect a rise in longer term interest rates based on the discounting of the end of tapering in 2014 and an increase in inflation to 2.5%. This could lead to a 3.0% - 3.5% yield on the 10-year Treasury bond later in the year. Municipal bonds could do relatively well because at present, many issues yield more than Treasuries and the improving economy could do much to improve their finances. Any reform of state and local pension liabilities would greatly improve the outlook for municipal bonds.

Exhibit III

Long Term Municipal to Treasury Spreads



Bloomberg and AIM, LLC Research

This is becoming a major issue because basic services are being squeezed by pension liabilities as politicians cater to labor union, at the expense of taxpayers and bondholders. Commodities could be the investment of choice looking ahead because of their depressed prices at a time when global economies appear to have improved economic outlooks.

We do not expect the Fed's tapering to ultimately drive market sentiment in 2014, because low real rates of interest have both positive and negative effects on the overall economy. On the one hand, low rates increase earnings by lowering borrowing cost for business expansion and provide opportunistic debt refinancing. On the other hand, low interest rates keep marginal businesses operating and encourage capital to be allocated to low ROI (Return on Investment) ventures resulting in increasing competition.

We are focusing our attention on what we believe will be the main investment drivers in 2014: valuation, psychology and investment flows. The S&P 500 Index sells at 16.9 times and 15.8 times our earnings estimates of $109 and $117 per share for 2013 and 2014 respectively. One should add that bottoms-up earnings estimates by brokerage house analysts are approximately $120 per share for 2014. If interest rates rise in 2014, theoretically, P/E ratios should fall, all else being equal. Of course, P/E ratios could also fall based on the anticipation of higher earnings should the future outlook deteriorate.