Altman Investment Management

Market Perspectives

October, 2010

Written By: *Peter J. Altman, President*
Jeffrey S. Bauman, Managing Director
Karen Troiano, Senior Portfolio Manager

Altman Investment Management
34 Chambers Street
Princeton, NJ 08542
609.252.0048
paltman@altman-investment.com

While the business of investing in stocks has been discouraging over the last decade, we remain resolute. We have known and survived rough patches before with the confidence that a value-oriented philosophy and conviction eventually wins out.

GENERAL OBSERVATIONS

- As the financial markets enter into the last quarter of the year, the seminal question remains whether the unprecedented amounts of fiscal and monetary stimulus around the world will ignite a new growth cycle with refreshed vigor and vitality, or whether it will simply produce a new growth trajectory with reduced speed and increasing instability.

- The National Bureau of Economic Research, a panel of academic economists based in Cambridge, Mass., said that the recession that started in December 2007 ended in June 2009, a period of 18 months. Previously the longest post World War ll downturns were those of 1973-1975 and 1981-1982, which lasted 16 months. Some analysts have suggested that the recent recession was similar to the Great Depression, a great exaggeration in our opinion, since it lasted 43 months, ending in 1933, and was followed by another recessionary bout which lasted an additional 13 months and ended in 1938. (1)

- Currently the official U.S. unemployment rate is 9.6% and peaked at 10.1% in October 2009, four months after the recession ended. This compares to a 25% unemployment rate reached during the Great Depression. There are some economists forecasting another recession with unemployment going to even higher levels amid a period of great uncertainty. Our own view is that we are in a period of historically low economic growth that is in the process of bottoming out over the six-month period from March to September of this year. The third quarter growth in Real GDP was 2.0% which takes into account that imports grew at roughly half of the second quarter rate. Frequently, inventories are closely tied to trade, so it was not too surprising that net exports subtracted 2.0 points from growth. It is important to recognize that gross domestic purchases, which exclude net exports, grew at a respectable 3.9% rate. This is a reasonably good proxy for underlying domestic demand.

- Looking ahead however, the continued strength in many foreign economies against the backdrop of U.S. currency weakness should empower exports at the expense of imports resulting in less of a drag from the trade sector. There has already been an improvement in the third quarter. Recent economic statistics have been slightly better than those recorded over the April to July period. For example, the Conference Board Leading Economic Index increased 0.3% in August, the best level since May. The improvement was caused by monetary factors such as interest rate spreads and faster, albeit moderate, growth in the money supply. The M-2 money supply grew at a rate of 3.5% over the past 3 months, an increase again over the level of the previous 6 months. One should add that the Federal Reserve controls these monetary phenomena, as opposed to the government's fiscal policy actions. The producer price index increased in August, bringing the year-over-year rate to 3.1%. The consumer price index rose, bringing the 12-month rate to 1.1%. Import prices increased in August and are now up 4.1% over the past year led by petroleum growth at 8.5%.

- After the snapback surge we experienced following a bad recession, the U.S. economy should settle down to a trend line growth of 2-2.5%, with inflation at 1.5-2.0% and corporate profits at 8-10%. We would expect the monetary authorities to continue stimulation on an economic system that has been burdened with large debt, overleveraged consumers, and external and internal imbalances. Recently the Federal Reserve Chairman, Ben Bernanke, emphasized the risks of deflation suggesting that a little inflation would be a good thing. Our bias remains skeptical that any material pick-up in inflation as the Fed Chairman suggests would be desirable, because it has the potential of lowering living standards and increasing the risk of renewed recessionary pressure. Striking the right balance between these two economic forces is the ultimate challenge of the Fed in the year ahead.

- On a positive note, recent economic news just reported included industrial production in August up 6.2% over the past year, as well as durable goods orders increasing nicely up 9.3% year-over-year, against a backdrop of declining consumer borrowing. The recent rise in the stock market reflects the economic improvements and adds to wealth. This should in turn improve confidence and stimulate consumption. We believe that household wealth will be modestly higher at the end of September, up from the $53.5 trillion level reported in June. This compares favorably to the recent low of $48.8 trillion at the bottom of the recession.

Optimistic Outlook for the Financial Markets

At its September meeting, the Federal Reserve reiterated its monetary policy of keeping federal funds at a rate of 0-25% for an extended period, and we expect will announce another round of quantitative easing following the November FOMC meeting. This implies that the Federal Reserve is likely to purchase additional long Treasuries which should act to further contain interest rates. Dollar weakness and rising commodity prices, which have been fueled by monetary ease, may continue for some time. As a result, most financial instruments have generally been stable. 3-month Treasury bills yield 0.12%, a month ago. The 10-Year Treasury bond yields 2. 54% versus 2.6% a month ago with long-term high-quality corporate bonds yielding 5.7% compared to 5.4%. 30-year mortgage rates reached new lows at 4.45% versus 4.69% a month ago with long-term municipal bonds at 4.44% compared to 4.46%. While measures of inflation such as the CPI and PPI index have been stable, there has been a notable increase in commodity prices.

Overall, commodities are in a strong uptrend perhaps because of the underlying strength of the emerging markets amid wild currency fluctuations. The general weakening position of the U.S. dollar has supported commodity prices in dollars (see EXHIBIT I). An unknown question is the degree to which higher commodity prices will exert pressure on overall inflation measures. Certainly high unemployment and modest wage gains tend to dampen financial demand but supply cost factors will ultimately raise the cost of living. While so far most countries have not engaged in protectionist measures, there have been attempts to weaken currencies to gain competitive advantages for exports. At present in the U.S. political forces in Congress are beginning a process of charging China with currency manipulation and will consider raising tariffs on Chinese goods. Unfortunately, if successful, the outcome would be higher inflation in the U.S.

Equities have rallied in September and October after weakness in August because of somewhat stronger economic statistics. At 1194 the S&P 500 has risen from 1141 a month ago for a gain of 4.6%. The price earnings ratio on our estimate of earnings of $78 per share and $85 per share for 2010 and 2011 respectively, is 15.3 and 14.0. These are reasonable valuations on our below-consensus earnings estimates.

EXHIBIT I

US DOLLAR INDEX

Source: Altman Investment Management Research and Bloomberg

If inflation were to increase from current levels, even modestly, equities would provide greater returns than bonds, which could suffer severe losses depending on the degree of inflation. Bond interest rates are at 60-year lows and much of the buying of bonds has been driven by fear of deflation and the possibility of a double-dip recession. Since we believe that slow economic growth of 2%-2.5% is the most likely outcome, we would favor equities over bonds or cash. Our current asset allocation for balanced accounts would be biased towards equity with 65% equities, 30% bonds (primarily municipals), and 5% cash.

Overall Positive Sentiment Going Forward …

We continue to stand by our view that the normal workings of the free market system, together with current policy initiatives, will support a steady recovery in the global economy over the next several years. And if that occurs, then equity prices should climb their way higher, given their current relative and absolute undervaluation. Stocks should continue to climb the proverbial "wall of worries". Although the returns prospect for stocks is much more modest than previous decades, they don't have to be particularly high to beat returns offered for lower-risk assets.

1. During the four years from 1929 to 1933, the U.S. gross national product in current prices declined 46% from $104.4 billion to $56 billion, and in constant prices the decline was closer to 31%. Industrial production declined by more than one-half: wholesale prices dropped one-third and consumer prices by one-quarter. The most horrible statistics were those of unemployment. Civilian employment dropped by almost 20 percent and unemployment rose from 1.5 million to at least 13 million. Conservatively one-quarter of the civilian workforce was unemployed, but extensive part-time employment and underutilization of skills probably brought the real unemployment rate closer to one-third. Fully one-half of the nation's breadwinners were either out of work or in a seriously reduced circumstance. *History of the American Economy; Fourth Edition by Robertson and Walton, cp. 1979 pg 412.*