ALTMAN INVESTMENT MANAGEMENT

MARKET RESEARCH INSIGHTS   JULY, 2009

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MARKET RECAP

CURRENCIES & COMMODITIES: INTERNATIONAL/ INDUSTRIAL OVERWEIGHT

- **It's summer time again! Last summer the price of a barrel of crude oil soared to a record high of $147.27 on July 11. The price of a pound of copper peaked last summer at $4.08. A bushel of soybeans was in the mid-teens early last year. Gold hit a record high of $1,011.25 an ounce on March 17, 2008. Those were the days many thought they would never end, and they predicted that the next stop for crude was $200 or even higher.** Instead, the next stop was a low of $33.98 on February 12. But, it is already back over $70 for no good reason: Supply exceeds demand, which remains depressed by the global recession. It is most difficult to explain this remarkable rebound in the price of crude. Other commodity prices have also rebounded smartly so far this year. At $12.01, beans are getting closer to the teens again after troughing at $7.84 late last year. Copper is up more than a dollar after falling to a low of $1.25 at the end of 2008. The fundamentals of supply and demand can account for the rebound in some commodity prices. The Baltic Dry Index, which has stalled recently, is up 382% since the end of last year as freighters are getting hired to haul commodities. China's iron and steel imports are up 18.6% over the past four months through May. China is spending over half a trillion dollars on infrastructure such as railroads and power plants to stimulate the economy.

- **In addition to the fundamentals, easy money and credit may be inflating yet another commodity bubble and hence our long term outlook for bonds is muted.** We are very concerned with China's M2 money supply which is up a whopping 25.7% y/y through May. Chinese banks have loaned out in excess of $700bn during the first four months of the year, more than during all of 2008. This has supported the global stock market rallies responding more to China's rather than America's monthly survey of purchasing managers. No one paid much attention to the Chinese survey until this year. The Chinese have also embraced the Federal Reserve's approach to absorbing the recent asset bubble implosion. When one bursts, monetary policy should be eased aggressively to clean up the mess as rapidly as possible. In a 2002 speech honoring Milton Friedman's 90th birthday, Ben Bernanke said, "Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again." The Chinese approach seems to be even more effective than that adopted by the Obama Administration. That's because they've more effectively combined easy money with stimulative fiscal policy. Even the excessive liberal, Paul Krugman, complained in his 6/26 column that there is "not enough audacity" in the Administration's stimulus program.
- **On June 24, the European Central Bank announced an audacious plan to lend banks 442 billion Euros ($621 billion) for 12 months, the most it has ever allotted in an auction, as it steps up efforts to unblock credit markets in the 16-nation euro region.** The Fed continues to target a near-zero federal funds rate and to buy Treasury and Agency securities. This easy money could result in yet another bubble down the road. On June 4, Goldman oil analysts Currie and Greely raised their firm's forecast for the price of oil.

The bank set a 12-month price target of $90 a barrel for West Texas Intermediate crude, up from $70, and introduced a forecast of $95 for the end of 2010. Goldman's New York-based energy equities research team was the first group in early 2005 to correctly predict a "super spike" in prices over $100. And again in May last year, that same analyst said oil may rise to between $150 and $200 a barrel within two years. Of course the team revised its forecast after prices crashed. One tends to wonder whether the folks at Goldman really base their analysis on the fundamentals, or are they just supporting another oil bubble?

CYCLICALS: HOUSING UNDERWEIGHT:

- **Some good news and some bad news about home prices :** According to the Case-Shiller survey, home prices rose in eight of the cities measured on a monthly basis. The bad news is that home prices fell again in 12 of the 20 cities covered by the survey. From the peak, the national average is down 32.2% based on the Case-Shiller survey and 25.1% based on data collected by the National Association of Realtors. There is some good news and some bad news about mortgage delinquencies. The good news is that about 90% of all mortgages were current and performing at the end of Q1-2009, about the same percentage as the previous quarter. This is according to the latest report from the Office of the Comptroller of the Currency Office of Thrift Supervision. This report however does not reflect actions taken under the Administration's "Making Home Affordable" program, announced in March. The same is true of initiatives to enhance the Federal Housing Administration's (FHA) "Hope for Homeowners" program. Nor do these numbers reflect the OCC's and OTS's direction to servicers to review the modifications they had previously undertaken to ensure they are affordable and sustainable. The bad news in the OCC/OTS report is that prime loans, which represented two-thirds of all mortgages in the portfolio, experienced the highest percentage increase in serious delinquencies, which climbed by more than 20% from the prior quarter to 2.9% of all prime mortgages. Subprime serious delinquencies increased by 1.5% from the previous quarter, to 16.7% of subprime mortgages. A number of factors contributed to the increase in seriously delinquent prime loans, including rising levels of unemployment, a continuing decline in property values, and high debt levels. We conclude that calling for a housing recovery is still premature.

PORTFOLIO STRATEGY: BANKING OVERWEIGHT

- **Although it seems that Investment Bankers (MS) are getting little respect these days, they appear to be getting plenty of business.** Equity offerings reached nearly $260bn during the second quarter. Ironically, this big bonanza included new issues of equity to raise capital for financial firms. They raised $89bn via 92 deals during the quarter. We monitor the divisors that are used to adjust the S&P 500 and its 10 sectors for changes in the number of shares outstanding. At the end of June, it was up 0.3% y/y for the overall index. For the S&P 500 Financials, it was up 15.9% y/y, 10.1% ytd, and 8.1% qtd. The S&P 500 Investment Banking & Brokerage stock price index is up 63.5% ytd through yesterday's close.

- **I recently picked up a copy of *Rolling Stone* magazine, to which one of my sons subscribes, and noticed an article on Goldman Sachs featured on the cover titled: "The Great American Bubble Machine."** The article goes on to describe the investment bank's role in the tech stock bubble to high gas prices and accuses Goldman Sachs of engineering every major market manipulation since the Great Depression . Of course the author Taibbi, surmises that they are about to do it again in carbon credits. The author makes the case that the firm helped to engineer the Tech, Housing, and Oil Bubbles of recent years and accuses the firm of gross securities fraud. He notes that the AIG bailout was a bailout for Goldman too. Of the initial $85bn that the government used to shore up AIG, $13bn went to Goldman. Why? That seems like a reasonable question. With respect to carbon credits, Taibbi states that the firm has been pushing for cap-and-trade for a long time, and is positioned to profit handsomely from it. He quotes

Michael Masters, the hedge-fund director on this subject: "If it's going to be a tax, I would prefer that Washington set the tax and collect it. But we're saying that Wall Street can set the tax, and Wall Street can collect the tax. That's the last thing in the world I want. It's just asinine." I happen to agree with Taibbi on this issue and would encourage you get a copy of the July 9-23 issue of *Rolling Stone* and read Taibbi's provocative article. We remain in the camp that the financials are necessary for the economy and the market to recover and hence have moved our weighting up since the market bottomed in Q1. We are currently at ~17.0% financial weight versus 13.5% for the S&P 500.

MATERIALS INDUSTRY: MARKET WEIGHT

- ***Industry details:*** Has the earnings decline hit rock bottom yet for the S&P 500 Materials sector? The sector's forward earnings has taken a huge hit since September, but edged higher in June for the first time in nine months. Materials is the second best performing sector with its stock price index up 13.0% ytd, but is down 47.0% from a record high in May 2008. Forward earnings are down a whopping 62.2% from its record high in September, the second worst performance among the S&P 500 sectors. Consensus annual forecasts are still falling for 2009 and 2010 after rising during 2005-2008. Valuation edged down to 21.1 in June from a seven-year high of 21.2 in May, but is now the highest in the S&P 500 and up from a record low of 8.5 in October as earnings have fallen faster than the stock price index. The sector's P/E was at a record high 53% premium to the market. The aggregate profit margins were down to a record low of 2.5% in Q1 from a record high of 8.7% in Q2-2007 and are likely to stay depressed until commodities prices recover.
- **In terms of Aluminum (AA) there haven't been any added negative surprises to the story since late 2008.** The commodity's cash price has rebounded recently and forward earnings were up for a second straight month in June. The industry was an outperformer in 2007 with a rise of 21.8%, but fell 69.2% in 2008 and is down another 4.4% so far in 2009. Analysts expect a loss in 2009 for the first time since 1993 and think 2010 earnings will be below the 1995-2008 levels too. The consensus forecasts for 2009 and 2010 are still falling in June, but at a slower pace. Net earnings are up from a record low in November, but are still negative for a twelfth straight month in May. The profit margins have tumbled to a record low of 2.2% in Q4 from a cyclical peak of 7.7% in Q1-2008. With aluminum scrap and spot prices weak and the recession mostly global now, earnings forecasts are likely to remain depressed.

- **With respect to Chemicals (DD) nothing exciting to report but an improving economy with emerging signs of a bottom would be helpful.** Forward earnings rose in June for the first time in nine months from a 15-year low in May. Although Net earnings for the group have been negative over 18 of the past 21 months, they have seen some improvement again in June. Earnings expected to fall for a third straight year in 2009. Forward earnings are down -60.6% y/y and have been negative nearly every month since March 2006, but improved in June from a record low of -62.2% in May. Valuation fell to 15.7 in June from a five-year high of 16.7, but remains at a near record high 15% premium to the market. The profit margin fell to a seven-year low of 3.9% in Q1 from 4.1%, but could stabilize soon if energy prices don't start soaring again. Chemical pricing is down -23.4% y/y and at the lowest level since the data series began in 1933, but its m/m change has stabilized recently.

THIRD QUARTER MARKET EXPECTATIONS

- **The stock market has been rising on "green shoots". Now it needs more substantial "green stalks" to climb higher. In other words, the P/E-led rally is over.** We expect that we'll need an earnings led rally to move stock prices higher. The S&P 500's forward P/E rallied from 10.3 on March 6 to a recent peak of 14.4 on May 28. The S&P 500 Industrials sector bottomed on March 9, along with the overall market. It is the third best performing sector since then with a gain of 40.9%. But the sector performance ytd is still - 9.7%. The anemic corporate profits recovery so far in the US and lower
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forecasts for global economic growth are certainly weighing on the sector. Corporate profits are down all over and causing sharp cutbacks in capital spending plans. So the sector's forward earnings forecast has been falling for the past nine months and caused the earnings to underperform the other sectors in the S&P 500 which in aggregate have begun to see their forward earnings bottom or turn higher over the past several months. The industrial sector's net income although less negative is still lagging the other S&P 500 sectors hindered by lagging international earnings. The industrial earnings recovery is likely to take a while to play out and hence why we have been more cautious with respect to our earnings expectations in this group the ensuing months.

- **Over the past week, we have sensed that institutional managers are moving some shorter term profits out of the market, following the rally they've enjoyed since early March.** Investors may be worried about giving back some of their near term winnings rather than about missing the next leg up. The technicians among them observe that the S&P 500 has failed to decisively move above its 200-day moving average, as it did during the initial bull market rallies of 1982, 1991, 1998, and 2003. The fundamentalists say that the green shoots phase of the rally is nearing an end and it's time to see some green stalks. It was nice to see the rebounds in consumer confidence, purchasing managers surveys, and leading indicators in recent months. But, we believe the market needs to see some real money, not just promissory notes. In other words, the Q2 earnings season, which is about to begin, could push the market decisively higher above its 200 day moving averages or send it back down coupled with rising fears of revisiting the March 9 closing lows. I expect that the S&P 500 will meander through its 200 day moving averages, rather than blast through it this summer, unless the banks materially surprise investors on the positive side. Observing the markets technically there is potentially an inverted head-and-shoulders formation. In other words, the Q2 earnings season isn't likely to fire up the stock market from here. However, I still expect that the Q3 earnings season during October should propel the market significantly higher once the general economy shows more positive signs of recovery.