ALTMAN
INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

JULY, 2015

"Whenever you find yourself on the side of the majority, it is time to pause and reflect"

Samuel Langhorne Clemens

IN VIEW

We are beginning to conclude that, although below historic GDP trend line growth, we are in the midst of what could be the longest U.S. economic expansion in many decades. What would change our mind? Broad-based economic factors such as corporate behavior or credit cycle contraction could raise warning flags, confirming a more cautious approach to a longer duration investment portfolio allocation. We continue to see evidence that consumer sentiment is still improving based on a recovering job market, and this confidence is reaffirmed by declining corporate delinquencies. With corporate spending behavior under control, as shown by muted capital spending surveys relative to past cycles, coupled with restrained hiring and inventories below historic levels, the probability of a cost-induced earnings decline has been substantially reduced. Many improving observations have reinforced the base case that the U.S. recession has been pushed out farther into the future.

An early sign of a maturing market cycle is corporate deal activity - addressing the need for increased capacity and strategic alliances as a solution for accelerating business activity. On the other hand, despite elevated merger and acquisition (M&A) activity over the past year, many of the deals have been immediately accretive and replaced with what may have been a substitute for an upswing in capital spending surge. In the past this activity may have been an early warning sign of a late cycle. This phenomenon of corporate leaders concluding that surging demand justifies a premium paid for M&A usually defines market tops. This time it could be the acceptance that corporate synergies replace disappointing top line growth in a paltry demand environment. In outlining our bullish stance, we continue to emphasize that Fed quantitative easing has extended corporate financial obligations and has allowed balance sheets to more effectively weather recessions with interest coverage ratios in far better shape than past cycles. This reaffirms that the typical signs of an economic cyclical top are absent or pushes out the possibility of an imminent recession farther into the future, especially given the health balance sheets and low interest rates.

In the last quarterly commentary we published in April, we outlined our preference for U.S. over European equities, and reiterated our constructive view on U.S. stocks in the near term. To summarize, we highlighted three key catalysts for the U.S. markets to outperform in the second half: 1) the bottom-up earnings estimates were too low, emphasizing the financials, energy, and technology stocks as leading groups; 2) we also forecasted that the U.S. economy would do better in the second half of 2015 than it fared in the first half; and 3) we concluded that for the most part investor appetite concerning investing in U.S. equities was still relatively low.

Despite our emphasis on U.S. equities, the resumption of dollar strength in the second quarter has negatively impacted reported earnings in the quarter for specific industry groups that derive a disproportionate amount of sales exposure outside the United States. As the third quarter unfolds, investors appear to be shunning internationally exposed companies, preferring their domestic counterparts. This phenomenon continues to be supportive of the financial sector in particular. One can surmise that defensive attributes of this sector has been driving growth in shareholder returns; and the lack of currency exposure has helped fuel our confidence that the group can achieve above-average earnings estimates in the second half. Moreover, this is an economically sensitive sector that does not discount much of a recovery in terms of today's relative valuation. We also see sentiment continuing to improve as the timing signal from the Fed on the first rate hike becomes more apparent.

CLOSE-UP: The Economic Landscape

At the close of the second quarter, the final revision of real GDP data for the first quarter was -0.2%, after a 2.2% growth rate in the fourth quarter of 2014. The reasons for the slippage are well known and include the severe winter, the port strike on the west coast, and a significant decline in exports caused by the strong U.S. dollar and the weak economy in Europe. Specifically, consumption grew at a rate of 2.1% with gross private investment increasing by 2.4%, including a 6.5% advance in residential investment. However, these gains were more than matched by a large trade deficit caused by a 5.9% decline in exports and a 7.1% increase in imports. Overall, trade subtracted 1.9% from the first quarter GDP results. Although the government sector expenditures declined less than 1.0%, federal spending was flat while state and local expenditures fell. Within the federal sector, national defense declined close to 1.2% while nondefense expenditures increased by 2.0%. Consumption added to GDP growth this quarter, while the overall government sector subtracted from growth, resulting in an overall decline of 0.2% in GDP growth.

Our current view remains that the real GDP will advance 2.8%, with the first half closer to 2.0% levels and the second half will be closer to 3.0% level. Consequently, we expect the Federal Reserve to raise the Federal Funds rate by 25 basis points in September, with potentially another increase of the same magnitude in December. We believe that the Federal Reserve wishes to move towards normalizing monetary policy, after eight years of a zero interest rate policy combined with quantitative easing during part of that period. The primary reason for the change is an effort to rectify some of the structural damage that was done to financial markets by maintaining interest rates close to zero. The obvious harm done to investors, particularly the elderly, who had to expose themselves to more speculative investments in order to obtain interest or dividend income, is a key concern.

Traditional valuation metrics also need to be restored back to historic parameters that were altered by the nullification of "free" financial markets. Expanding the Federal Reserve's balance sheet by $4 trillion also changed the nature of financial markets. While the initial changes in monetary policy was no doubt necessary to stave off the harmful effects of the 2008-2009 financial crisis, a quantifiable time limit seems necessary so as to prevent further damage to the economic and financial system.

The Bureau of Economic Analysis has recently indicated that its methodology of computing the GDP using output data, as opposed to income data, has over a period of thirty years tended to understate first quarter data. Beginning in July, the Bureau will change its methodology to one of averaging the two approaches that will hopefully produce a more accurate picture of how the economy is performing. They will also study more carefully the way seasonality is calculated since some economists believe that process is also distorting winter data.

The current business expansion, now starting its seventh year in July, has been the weakest in the postwar period growing at only 2.2% annually, as measured by real GDP. This compares to rates of 3.0-4.0% growth in other business cycles. The current economic data presents a mixed picture of whether this phenomenon will continue. Our view is that the business cycle will be extended in length because the usual signs of an approaching recession are not visible - perhaps because it has been a gradual recovery.

There is, at present, no sign of rising inflation, which usually is a precursor of economic trouble. The producer price index (PPI) is currently -2.6% y/y through June, against a global backdrop of weak commodity prices. The consumer price index (CPI) is also flat confirming the weakness in the reported PPI. Real hourly wages are up 2.0% y/y with durable goods orders down 5.8% and industrial production up only 1.3%. However, the leading indicators are up close to 5.5% with personal income up 4.4% and the personal savings rate increasing 3.8%. Employment is running at close to 3.0 million y/y, after creating 223,000 jobs in June, with unemployment declining to 5.3%. Auto sales are booming at a 17.1 million annual rate, and the ISM Manufacturing Index (53.0) and the Non-Manufacturing Index (56.0) both in June show strength. All in all, we feel that the economy is healthy with few excesses.

We believe that corporate profits will advance by 5.0% by year end, aided by buybacks and CPI inflation rising to 2.0%. We also believe that the U.S. dollar is potentially close to peaking in the near term and that oil will trade between $50 and $60 per barrel as it forms a base. Commodities in general, including gold, should rebound, aided by the U.S. dollar reversing its current upwards bias in the coming months.

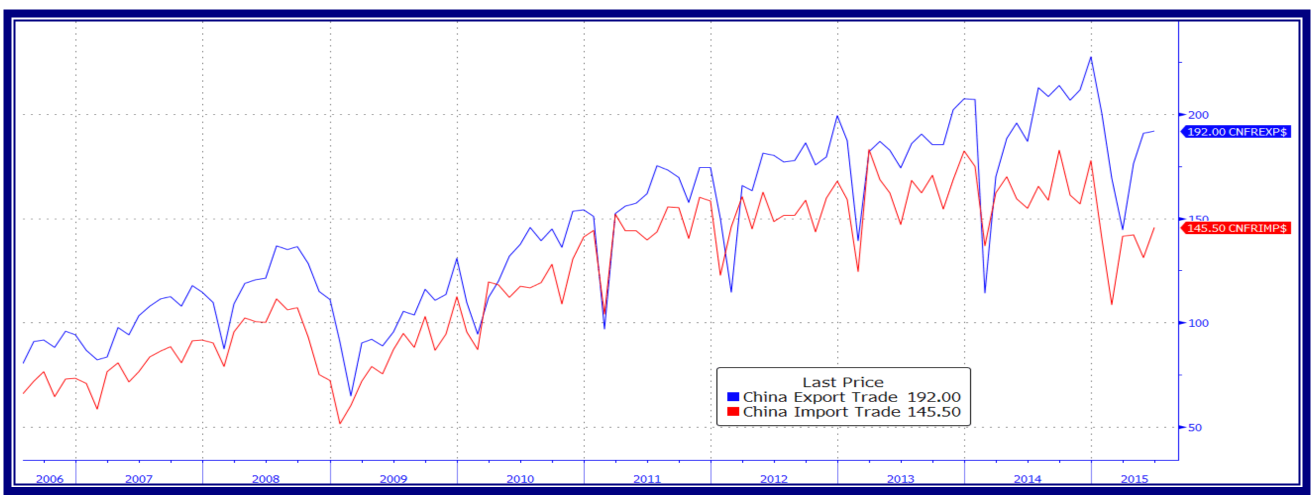
The Outlook for the Financial Markets

Over the past quarter, interest rates have risen while stocks and commodities have moved sideways. At present, the 10-year Treasury bond is priced to yield 2.27% versus 2.45% a month ago supported by recent weakness in commodities in general. The higher yields in the second quarter reflected less a fear of inflation than the fact that Federal Reserve statements indicate a desire to change the zero rate monetary policy this year. The fact that gold ($1085 per ounce) has fallen significantly in recent months reinforces this idea. The modest increase in real GDP so far in 2015 against a backdrop of flat to down commodity prices would suggest that while interest rates could rise further, the increases should be modest.

The CRB Index of commodities (415) has returned to first quarter levels while the U.S. dollar Index (97) has slightly risen since the close of the second quarter in the low 90's. Oil has weakened recently, trading below $50 per barrel versus $58 per barrel a month ago, whereas copper has fallen 18.0% since peaking in late April. The latter development is probably a reaction to further slowing in the Chinese economy since China buys about 40% of the world's copper. Although Chinese exports and imports have declined, they remain positive (see Exhibit I). Although oil has risen from a low of $43 per barrel in the spring to its current price, huge inventories have put tremendous pressure on the spot price in the past several weeks. Nevertheless, oil companies have slashed capital spending and the rig count has dramatically fallen, in an attempt to halt the slide in prices from a year ago. This approach seems to be working for the time being and we will see the effectiveness of this strategy as the quarterly results unfold. It is our belief that most commodity prices are bottoming, and we expect future price increases depending upon the rate of economic growth.

EXHIBIT I

Chinese Merchandise Trade- Imports and Exports



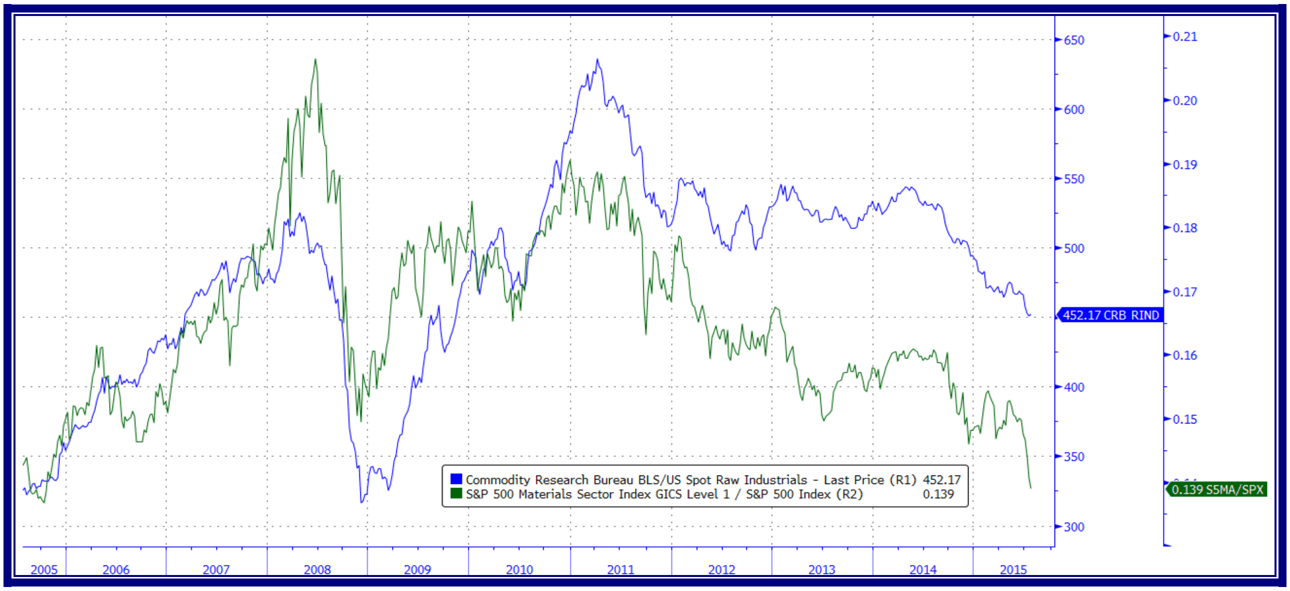
Source: Bloomberg and Altman Research

The recent stock market retreat in The Singapore Index must certainly be a setback for the Chinese government who was counting on the equity capital markets for funding economic growth. That may explain why Chinese authorities have been scrambling to end the rout and restore the bull market. Chinese officials are obviously counting on kicking the proverbial can down the road. They desperately need a new source of growth to replace their export-led model, and the hopes of a domestic consumption revival taking hold has yet to play out. In the meantime, commodity prices continue to signal that there remains a lot of capacity. The ratio of the S&P 500 Materials sector to the S&P 500 is down to the lowest reading since November 9, 2005 (see Exhibit II).

It is highly correlated with the CRB raw industrials spot price index, which is also falling and is now down to its lowest level since November 12, 2009. The CRB index is inversely correlated with the trade-weighted dollar, which is up 16% since July 1, 2014 (see Exhibit III).

EXHIBIT II

The CRB and the S&P 500 Materials Sector – Performance



Source: Bloomberg and Altman Research

EXHIBIT III

The CRB and the U.S. Dollar

Source: Bloomberg and Altman Research

Investors have been fleeing commodities since last year and continue to do so, encouraging our contrarian instincts to consider the viability of taking the opposite stance. However, we remain hard pressed to make the case for a sufficient pickup in global economic growth to move proactively against the crowd at this time. The recent stock market rout in the Singapore market must be a real setback for the Chinese government which was certainly counting on the equity capital markets for funding.

Equities, as measured by the S&P 500 Stock Index (2083), are virtually unchanged from the end of the first quarter. During the second quarter, daily volatility was and should continue to be dependent upon the events concerning the direction of the global economic growth, as well as the euro currency versus the U.S. dollar. A Greek bailout, which is not only a financial event but a geopolitical one, makes the outcome even more difficult to predict. However, Greece's influence on the currency is set to be outweighed by the more fundamental force of a substantial divergence in monetary policy between the U.S. and the euro-zone. Our expectation that U.S. official rates will rise more than the markets currently anticipate, while the ECB holds steady, points to a further erosion in the euro. We still see a fall to parity over the next year.

Given Ukraine's desire to seek closer ties to the European Union, President Putin of Russia would like to split off Greece from Europe's influence. This will be a consideration as Germany and its partners mull the cost of further lending to Greece. Since Greece has a GDP that reflects 2.0% the size of the European GDP, a split would have more of a geopolitical cost than a financial one.

IN SUMMARY:

We remain cautious on the S&P 500 based on valuation at 16.9 times our forward estimate of earnings at $123 per share (a gain of 5.1%), with a modest rate hike anticipated for September. The long-term average P/E of forward earnings is 14.0. Nevertheless, except for a few popular stocks, we don't see excessive speculation in the stock market. Rather than the current wave of mergers, acquisitions, and stock buybacks (financial engineering), we would rather see companies invest in their future through more research and development and capital spending projects.

A tighter monetary policy is the biggest threat to the U.S. stock market, although its onset did not have a strong effect during the last three major Fed tightening cycles. What's more, the fact that the cyclically-adjusted earnings yield is higher today than the yield of 10-year Treasuries – unlike at the outset of these three tightening cycles – suggests the latter could increase in response to tighter monetary policy without making the prospective return on equities appear unreasonably low.

Of course, equity bears would point to the fact that, irrespective of the relative valuation of U.S. equities and bonds, the cyclically-adjusted earnings yield is low compared to its *own* average. But the cyclically-adjusted earnings yield is currently being depressed by the plunge in earnings during the Great Recession; bear markets typically occur only during economic downturns, and valuations can stretch a long way before they snap.

Our forecast is that the U.S. stock market grinds higher on earnings prospects, independent of valuation expansion. This view is primarily based on our forecast that a strengthening U.S. dollar will continue to be a headwind to corporate profits and contain job growth. As we enter the next phase of a maturing bull market, we cannot emphasize enough the important task of our securities analysts who concentrate their efforts on the risks associated with estimating the fundamental earnings power of each of our investment choices - the stability of those earnings (cyclical or leverage), their growth rate, and/or vulnerability to accidental loss or to technological change.