ALTMAN
INVESTMENT MANAGEMENT

BRIEF MARKET INSIGHTS

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Weathering the Storm

The market turmoil in recent weeks has certainly been disconcerting to investors. Although we recognize that bull markets have unexpected and often necessary corrections, we also realize that these corrections have been less easy to digest - especially since memories of the dramatic declines in financial markets during the last Great Recession are still vivid. Of course there are those that conclude that rapid market gyrations, or flash crashes, can cause a loss of confidence and tip already-fragile sentiment bearish and cause another global recession. We, however, don't share that concern at this time, and wouldn't rule out a potential "melt-up" after the next FOMC meeting. That could happen if the Fed does nothing - or if the Fed hikes rates by 25bps and Fed Chair Janet Yellen downplays it at her upcoming press conference on September 17th.

One explanation for the market volatility has been attributed to the instability of the Chinese market, representing the second largest economy of the world. It has been trading at unsustainable levels for some time, and intervention efforts by their government to stabilize these markets have been ineffective. Transitioning from an export-led economy into a consumption-led economy may turn out to be an extended challenge for China. Another destabilizing factor in global markets has been the dramatic fall in commodities - especially oil in recent months. The uncertainty associated with where the price levels for commodities should be, with respect to the balance between supply and demand, coupled with geopolitical pressures, needs resolution. Another important variable affecting markets is the anxiety associated with the direction of interest rates. Many fear that either the Federal Reserve will act too soon, tipping the U.S. into recession, or act too late aggravating current financial speculation with low cost capital.

Our current investment strategy focuses on what we *do* know. Recent economic data continues to support a resilient economy. Leading indicators such as durable goods orders, housing, export, industrial production and order rates coupled with improving employment trends all point to a healthy U.S. economy. Consumption growth continues to expanding at a 3.0% rate, all resulting in a rebounding GDP growth from a weak first quarter rate to a revised 3.7% rate in the recent quarter. The capital spending rate however has been clouded by the contraction in the oil patch - but, excluding the oil sector, it appears that most of the leading economic leading indicators point to an economy that is growing at a healthy rate. These improving trends in the United States are consistent with those observed in Europe and Japan and should help drive earnings growth above our forecast of 5.0% for the year.

Near Term Expectations

From a market perspective, we are expecting the recent volatility to remain through October based on the above mentioned uncertainties. With regards to interest rate policy, so far it would appear that the Fed officials have yet to clarify what they plan to do at the FOMC meeting later this month, which has been clouded by financial market instability and global currency dislocations. The recent employment report today suggests that the FOMC may hold off hiking the Federal funds rate by 25bps. We would prefer that the "normalization" process begin sooner than later and the Fed Chair Janet Yellen reassure the financial markets that another rate hike may be pushed out further than originally anticipated.

Positive Factors to Consider

- The fundamental earnings outlook is still positive.
- The dollar appears to be stabilizing against the euro and the yen, concluding that traders in the currency markets are thinking the FOMC might be in no rush to start raising rates given the turbulence in the markets.
- A weaker dollar tends to be positive for commodity prices which have already fallen substantially to price levels that should boost demand and reduce supply.
- Our analysis of global oil demand shows that the plunge in oil prices is stimulating usage, which suggests that the windfall is boosting economic growth around the world. Over the past 12 months through July, world oil demand is rising from year ago levels. The growth rebound can be seen in both advanced and emerging economies. Oil demand was up 5.4% in China during July, from 0.2% a year ago, to a new record high. India's usage is up 5.6%, the fastest pace since May 2008.
- Investors can finally expect to see the benefits of lower energy prices, not just domestically, but throughout the G7 economies. Keep in mind that there is about an 18-month lag between changes in energy prices and changes in economic activity. Although you save money when you fill up your car at the pump, you don't immediately go and quickly spend the money - but will begin to spend your outsized savings over time.
- Although near term corporate profits are negatively impacted by the strong dollar, we expect the effect of this earnings headwind to dissipate in the coming quarters. We estimate that a 10 percent move in the dollar could shave about 2 percent off earnings growth.
- In addition, there appears to be minimal flight to safety in the bond market during this corrective market phase. It could be because the cash raised over the last weeks has not been dragged into the bond market with such low rates or the Chinese have been using the cash to funnel into their stock market. A cash hoard eventually finds its way back into stocks, once markets stabilize.
- Lastly, the forward PE ratios remain resilient. In the past, the drop in markets had been coincident with big declines in the forward PE ratios.

IN SUMMARY:

Through the balance of the year, there are two trends that should take hold. First, the drag from weak commodity prices and the strong dollar will not disappear but will moderate. Second, an economic rebound will kick in, bolstered by labor market and wage growth.

We remain in the camp that a recession is unlikely at this juncture and the markets should begin to repair themselves. Remember to focus on 2016-17, since our investment horizon is not on the short term but out 2-3 years. We remain cautious on the Eurozone and emerging market economies in the near term, and any deterioration from their recovery path could delay the mending process. We believe the issues in China may have caused some market jitters, but their currency and interest rate decisions are unlikely to have a noticeable impact on U.S. GDP given that the dollar is already at historic highs.

In conclusion, we remain bullish on stocks and the recent weakness in stock prices is certainly no cause for alarm and should be viewed as a buying opportunity.