ALTMAN
INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

OCTOBER, 2015

> ***"As many investors have learned the hard way, companies cannot double earnings each year ad infinitum. Just as the pendulum swings back toward the center, exceptional growth rates eventually descend towards the normal range. Experts use a fancy term to describe this process: reversion to the mean."***
> **John Neff**

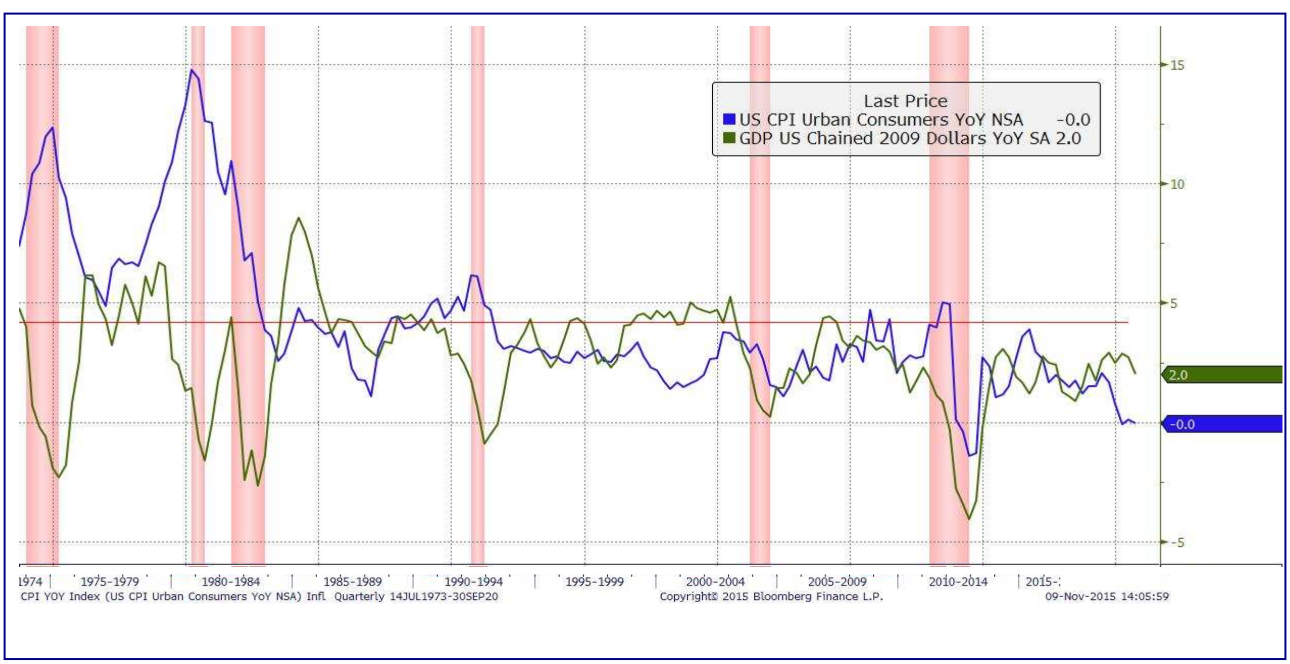
IN VIEW

The U.S. economy "reverted back to the mean", growing only 2.0% over the past twelve months through September 30th, as measured by real GDP, and close to the average annual growth since 2009 after the end of the Great Recession. As mentioned in earlier issues, this is the weakest period of economic growth recorded in post-war business cycles. While this business expansion has pushed beyond the more common duration of six years, we believe this cycle will continue extending with muted inflation and interest rates still exceptionally low. The typical excesses normally found in maturing business cycles are not evident. In *Exhibit I* below, we observe that past cycles have peaked - coincident with the Federal Reserve's monetary response to an overheating inflation environment. The end result of putting on the breaks with interest rates slows GDP growth and in many cases has driven the U.S. economy into a classic recession. The elements of the final stages of the current business cycle aren't evident yet. Although corporate profits growth has moderated in 2015, we believe that substantial declines in the commodity sector should reinvigorate the business cycle. At present, many companies, including those in the Technology sector, have begun a new round of cost-cutting which could exacerbate a slowdown in employment growth. Claims for unemployment insurance, however, are hitting new lows, while many service employment firms continue to hire. We have addressed this structural change in previous commentaries, a phenomenon of "underemployment" that has tended to understate the reported employment picture.

EXHIBIT I

Rising Consumer Price Index leads to GDP Declines

Inflation needs to be rising to set the stage for a recession.



Source: Bloomberg and Altman Research

The third quarter real GDP growth of 1.5% annual rate was considerably lower than in the second quarter which came in at a strong 3.9%. This significant slowdown below the average 2.3% pace in the first half of the year was partly due to the stronger U.S. dollar, weaker global demand, and increased financial market volatility. An improvement in these conditions suggests a moderate pickup in growth in Q4. We expect real GDP to increase between 2.2% and 2.5% this year, about in line with its average growth rate during this expansion. GDP has not only been negatively impacted by the global slowdown in demand by countries such as Russia and Brazil, but the strong dollar has also limited export growth as U.S. goods and services become more expensive. China, the second largest economy, is also slowing as it transitions from an investment-led capital-oriented economy to one that places greater emphasis on consumption and services. We expect this process to take years, include many disruptions along the way, and cause slower economic growth than economists already anticipate.

Is a Rebounding U.S. GDP Good for Equities?

- **The FOMC left interest rates on hold in October**, the event which has had the effect to move U.S. markets higher even before the third quarter GDP release. In the past, a stronger-than-expected GDP release has often caused U.S. equities to fall. This time a consensus beat for GDP growth has only propelled equities higher.
- **The recent GDP release further supports our yearend forecast of 2.8%** that is still above consensus estimates. Admittedly, as we approach the end of the year we may have to revise our forecast down from 2.8% to 2.5% following the recent trade report, but still above the consensus. However, given the uncertainty surrounding the GDP release, particularly in the early estimates, and the scope for small differences to be magnified in annualized data, it is worth considering several possible scenarios.
- **Upon examining the market response to positive or negative surprises on GDP reports**, we have observed that the S&P 500 has performed best on days when the advance GDP data did not differ significantly from the consensus. Equities have often performed poorly on days when GDP data has beaten expectations. And on days when the data was surprisingly weak, they barely moved. Keep in mind that in all cases these movements were fairly small, and factors other than the GDP releases could have been more important. Nevertheless, these observations are still somewhat counterintuitive. It is possible that better-than-anticipated data – which could prompt the FOMC to withdraw monetary stimulus sooner than otherwise – is perceived as bad for equities.
- **That being said, we suspect that equity investors prefer Q3 growth to beat expectations, although a positive surprise of the data could make the FOMC inclined to raise rates sooner rather than later.** Hence the Financial sector may finally gain traction and lead the next leg of the markets. We think investors would welcome any signs that the U.S. and global economies are on a sounder footing. It is also worth keeping in mind that U.S. equities fell when the FOMC did not raise rates in September. Furthermore, the S&P 500 declined after the last two disappointing GDP releases in the first two quarters.
- **We conclude that the domestic economy is relatively strong,** and that growing wage and price pressures will eventually force the FOMC to raise rates more aggressively than many expect in 2016/17. We estimate that consumption growth is still as high as a 3.0% annualized in the third quarter bolstered by lower energy prices.
- **Tighter monetary policy and rising labor costs will, of course, represent significant headwinds for U.S. equities.** On the other hand, valuations are not completely outrageous at 17 times next year's forecasts, and the U.S. economy is unlikely to fall back into recession any time soon (which would normally be required for a major stock market correction).

CLOSE-UP: The Economic Landscape

The other main driver of the deceleration in Q3 was inventory investment, which was reduced in half to \$56.8 billion, the lowest level in six quarters according to our sources. It subtracted 1.44 percentage points from real GDP growth, the most since the fourth quarter of 2012. The correction was expected, given the large inventory accumulation relative to sales this year. Final sales to domestic purchasers, which exclude inventories and net exports, rose at a 2.9% annual rate, about in line with its historical average, as underlying domestic demand remains solid.

Other main GDP components also posted slower rates of growth. Personal Consumption Expenditures (PCE) rose at a 3.2% annual rate, a small deceleration from the 3.6% rate in the previous quarter, as financial market turmoil and increased worries about global growth had little direct impact on consumer spending. It is helpful to note that Services spending rose at a 2.6% rate, led by health care and financial services and insurance. This year consensus estimates are projecting a 6.8% growth rate for these sectors. A reduction in private inventory investment partially offset the increase in real GDP that reflected positive contributions from personal consumption, state and local spending, and nonresidential spending. According to Goldman Sachs Research, the Energy sector has diminished corporate profits this year stealing an estimated 2% from GDP growth.

The public sector overall has slowed at 1.7%, as defense spending grew only 0.3% in the second quarter and non-defense spending actually fell 0.4%. The sequester process has been the major culprit in the slowdown. However, state and local spending was strong at 4.3% during the second quarter and should continue albeit at a slower rate. Finally, capital spending is growing only modestly due to the overall phenomenon of global slowdown and the uncertainties resulting from governmental policies. Corporations in many cases are spending money on corporate buybacks, which do not advance growth on capital projects or research and development. It's interesting to note that buybacks and dividend growth have been the primary drivers of a rising market close to 70% of the time over the past 20 years. Overall economic growth is emanating from consumption (70% of the economy) including automobiles and many services. Durable goods spending also rose at a 6.7% rate, led by vehicles, while nondurables rose at a 3.5% rate. Nonresidential fixed investment, or capex, rose at a 2.1% annual rate, half the 4.1% rate in the previous quarter. Housing also has been contributing to growth because of demographics and higher personal incomes against a backdrop of low mortgage rates. The industrial sectors with weak international demand and a strong dollar have yet to contribute meaningfully to the GDP.

Despite weakened PCE prices below the Fed's longer-term target of 2.0%, real disposable personal income rose at a 3.5% annual rate, mostly reflecting acceleration in wages and salaries and a pickup in farm proprietors' income. The Philly Fed State Leading Indexes for September showed economic activity is projected to increase in 47 states over the next six months.

All this suggests continued broad-based economic growth through Q1 2016. The U.S. Leading Index posted 1.3% projected growth for the next six months, which corresponds to 2.7% annual real GDP growth over this period. Pending home sales fell 2.3% in September, the most since December 2013, and to its lowest level in eight months. Economists expected a 1.0% increase. The decline suggests a pullback in existing home sales in the near-term. The National Association of Realtors noted pending sales were negatively impacted by "stubbornly low inventory conditions." Additionally, the recent volatility in financial markets and signs of slower U.S. growth may have delayed some purchases. Pending sales are still up 3.0% y/y, but that is the slowest pace in nearly a year.

➢ *Employment Trends Show Solid Growth Ahead in the U.S.*

Jobless Claims trended the lowest since 1973. Initial claims for unemployment insurance edged up 1,000 last week to 260,000. Economists expected an increase to 265,000. The four-week average continued to decline to the lowest level since December 1973, as layoffs continue to trend lower and the labor market tightens further. Lastly, Bloomberg's Consumer Comfort Index fell 0.7 points to 42.8, to a five-week low, and slightly below the average for this year. The report noted that weaker payrolls growth and modest wage gains are suppressing comfort, but cheaper gasoline is boosting it, particularly among low-earning workers. All three components of the index fell, despite the buying climate.

Employment trends illustrate strong growth in October - rising to its highest level in 15 years - suggesting solid job growth through the first quarter of 2016. Six of its eight components made positive contributions, led by fewer involuntary part-time workers. Its share of total employment is now at par with its average since 1994, a big improvement from the cyclical peak of 6.7% in March, 2010. The report noted that the recent trends in job growth and labor force participation suggest that the unemployment rate could decline below 4.5% over the next 12 months. The latest Employment Trend Index (ETI) is consistent with 3.3% real GDP annual growth in the fourth quarter according to the release. Job surveys showed mixed hiring expectations for November, with services up, but manufacturing down, as compared to a year ago. As expected, new hire compensation rates were nearly flat in manufacturing, but rose in services. The Fed's Labor Market Conditions Index (LMCI) was up in October, indicating a near-steady pace of improvement in labor market conditions.

➢ *Foreign Interpretation of U.S. Growth – A Silver Lining*

We saw further declines in the OECD U.S. Composite Leading Indicator which fell 0.2 points in September to 99.1, down now for over a year and similar to reported data in the late summer of 2011. The index is now back to levels at the bottom of the last cycle below the 100 level for the seventh month in a row, indicating below-trend growth. This would suggest a subdued pace of growth over the next quarter. Because the index is manufacturing-heavy, it likely overstates the degree of weakness in the economy. Despite these forecasts, European investors maintain their optimism about U.S. economic growth. The Sentix Composite Index (European Confidence) rebounded in November, as both private and institutional investors' views on the U.S. current economic conditions are improving. However, it's interesting to note that commercial real estate conditions are sanguine, with asset values growing at a slightly slower pace versus a year ago. It would appear that the prospect of rising interest rates creates a headwind for asset values over the next 12 months according to this data. However, capital for commercial real estate is still robust despite the outlook for tighter conditions.

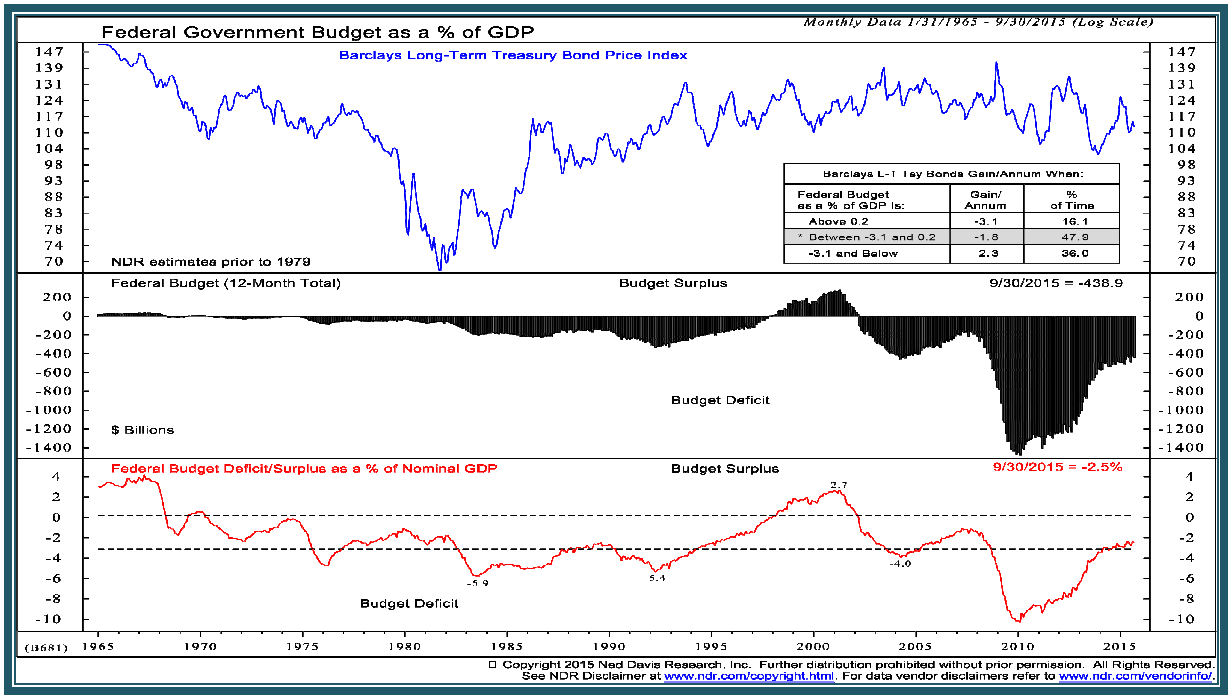
➢ *The Budget Deficit Is Moving in the Right Direction*

The fiscal deficit for the year ending in September, 2015 was $439 billion or 2.5% of GDP and slightly lower than the prior year's deficit of $483 billion (which was 2.8% of GDP). Revenues (taxes) increased 7.6% and total government expenditures rose only 5.2%. While defense spending fell 2.3% and interest costs by 2.0%, Medicare increased 6.7% and Social Security by 5.1%. Looking ahead, as the baby boomers retire, entitlement spending will significantly increase. Since non-defense discretionary spending is only 3.3% of GDP, future cuts will have to come from entitlements with the alternative of raising taxes or continuing to borrow on top of already record debt levels. Healthcare inflation is a major issue with regard to Medicare costs. On a more pressing issue involving the debt ceiling, Treasury Secretary Lew earlier this month indicated that the "Treasury will run out of money". When a similar crisis occurred in 2011, U.S. debt was downgraded. At that time, the crisis contributed to a 2000-point drop in the Dow Jones Industrial Average, while interest rates modestly declined. Despite the large fiscal deficit, *Exhibit II* shows that as long as the budget deficit as a % of GDP is declining, investors maintain a bullish stance towards equity.

EXHIBIT II

Federal Government Budget as % of GDP

The budget deficit is moving in the right direction.



Source: Ned Davis Research

The reported slowdown in the third quarter GDP of approximately 2.0% has resulted in revising our forecast for the year slightly down to 2.5%, as compared to 2.8% previously. We believe that the CPI will increase only a modest .5% with corporate earnings growing in aggregate 5.1% for the year. For 2016, we believe that real GDP will grow again at the 2.5% rate with corporate profits up 5.0% and the CPI advancing 1.8%. To grow the economy at faster rates, regulatory and tax reform will be necessary, as well as improving economic growth from foreign countries. On the domestic front, much will depend on the outcome of the 2016 elections. On the international front, the passage of the Trans-Pacific Partnership (TPP) is one of the trade agenda goals of the Obama administration that affects 40% of world trade by lowering tariffs and accelerating global trade.

The Outlook for the Financial Markets

The third quarter earnings season had a robust start, especially with several large capitalized technology names beating estimates. Estimates had been slashed from a positive 13.7% to a 4.5% over the past year for the Standard and Poor's 500 single quarter operating earnings growth. This lowered bar has enabled about 72% of companies to beat the estimates and is shaping up to be far better than the second quarter on a year-to-year growth basis. However, the bar has been raised at in the fourth quarter due in part to easier comparisons, with consensus estimates calling for 11% growth followed by 14% in the first quarter of 2016 - and still higher expectations in the second quarter of next year. One of the drivers to higher earnings estimates in 2016 will stem from improved conditions in the Energy sector and stabilization in commodity prices. The windfall created from weaker input prices and an improving credit cycle should have a net positive effect on an already sluggish economic growth path.

During the first week of November, the market reacted sharply to the better than expected jobs report, which boosted the possibility that the Fed will act in December to raise rates for the first time in this cycle. Interest rates are now higher than month-ago levels perhaps because of better than expected economic statistics and non-existent inflation. 10-Year Treasury bonds spiked in recent days yielding 2.32% versus 2.15% a month ago, and U.S. investment grade corporate bonds yielding 3.52% compared to 3.43% last month. Long-term mortgage bonds yields and 30 year mortgage bonds are all above last month's levels as well. Outside of equities, the dollar also reacted quite positively, while long-term government bond funds continued their recent woes, shedding 1.5%. Commodities also felt the deflationary sting of rising rates and a strong dollar. It would appear, that in the absence of any significant change in the growth or inflation outlook, the Federal Reserve will leave monetary policy unchanged until March, 2016.

Commodities with a few exceptions have also moved lower over the past month. The CRB Index (396) has fallen 2.2% from 405, as most commodities have continued their year-long fall. Oil at $45 per barrel has been basically flat over the past month, against the backdrop of record inventories, as the major producers refuse to cut production and give up market share. Copper at $2.38 per lb. has risen from $2.30 per lb.

Perhaps China's lowering interest rates again has bolstered markets as they attempt to achieve higher economic growth rates. Gold, at $1089 per ounce down from quarter end of $1129 per ounce, continues to move sideways despite a backdrop of geopolitical tension and currency volatility. Nevertheless, there has been an increase in deflationary fears as opposed to inflationary ones. The U.S. Dollar Index (99) compares to a price of 95.8 at the end of the quarter, reflecting a resumption of better U.S. growth and more stability versus the rest of world. The Baltic Dry Index of 628, a measure of raw material shipping rates, compares to 900 at the end of September - this suggests that there is still weakness in the pricing of shipping rates as world trade remains under pressure. However, the Composite Leading Indicator for the OECD countries, a proxy for future growth, eased for the first time this month perhaps giving an early sign that the global economies are on the mend. This data comes on the heels of the latest global PMI data for October, which suggests that the worst of the global downturn is over.

IN SUMMARY:

With regard to equities, the beginning of the fourth quarter has brought a rally after extreme weakness in August and September. In technical terms, a "double bottom" formed during this period as the August low on the S&P 500 (1867) was successfully tested. Currently, the S&P (2077) sells at 16.8 and 16.1 times our earnings estimates of $123 (for 2015) and $129 (for 2016) per share respectively. While these are modest gains of 5.0%, they do encompass the severe declines found in the commodity sector. Energy earnings will probably recover in the second half of 2016 as oil prices begin to anticipate $50-60 per barrel in 2016-17. At its present price, the S&P is up about 2.7%, including dividends, for the year after its 11.0% correction. One should add however, that during the correction many stock prices fell 20% or more with few making gains. The key to future gains or losses in the stock market will rest with the 2016 outlook for the economy. In our opinion, if economic growth of 2.5% or more is maintained with modest gains in earnings then market prices should move higher despite a normalization of interest rates.

So what will it take to revive the bull market given the potential pitfalls of the global economic situation? As long as it doesn't all add up to a global recession, investors should find comfort in owning good companies that can continue to find growth in a world of secular stagnation. Commodity users should continue to benefit from the woes of the commodity producers. Valuation multiples are also more attractive now than they were earlier this year. Needless to say, earnings have to keep growing and U.S. consumers have to keep consuming for the secular bull market to survive this latest challenge.