ALTMAN INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

OCTOBER, 2016

"Knowing trees, I understand the meaning of patience. Knowing grass, I can appreciate persistence."
— Hal Borland, author, journalist and naturalist

IN FOCUS:

Under the new Republican administration we would expect the big banks, insurance companies, E&Ps and refiners to be beneficiaries - due, in part, to decreased regulatory risk. In his first speech after his election win, President-Elect Trump noticeably shifted away from his usual rhetoric (i.e. building a wall, banning Muslims) and was more focused on traditional Republican initiatives such as trade reform and tax cuts. Fiscal stimulus over the past few years has been additive to overall GDP growth and additional relief could potentially help offset any drag from higher rates and lower capex structures leading into this election. On the other hand, trade re-negotiations could potentially raise the costs of conducting trades and could pose pressures on both imports and exports. Finding a balance between expansionary fiscal policy and potentially anti-growth trade negotiations will be key.

One thing for sure is that investors are braced with a heightened level of uncertainty awaiting clarity from the new administration as to what will be its major initiatives. Many corporations are putting merger plans on the back burner, for now, while they wait to see just how the Republican administration under Trump is going to address mega-mergers. Foreign leaders have taken different approaches in welcoming our new President. Some offered simple congratulations while others offered support on conditions of continued shared core values. The uncertainty within the U.S. markets is shared globally as to the behavior of our next President. Will he act on the populist initiatives he touted during his campaign or will he assume a more moderate tone, one that is more in line with traditional Republican values? Time will tell.

CLOSE-UP: The Economic Landscape

The first half of the year we began with very modest growth and below our forecasted GDP rate of 2.5% for the year. With only one quarter left in 2016, it appears that GDP growth for the year will be closer to 1.6% and below our original forecast. This compares with average annual real growth of 2.6% and 2.4% for 2015 and 2014. Overall, it was a disappointing year for overall growth with only consumption providing an underpinning of real strength. Capital spending has been weak throughout the year as companies focused on stock buybacks and financial engineering to offset disappointing top line growth. It also doesn't help matters as companies announced plans to move offshore in increasing numbers. Today an estimated 13.8% of GDP or as much as $2.5 Trillion is held abroad centered in the pharmaceutical and technology companies.

Another contributing factor to the recent quarters of coincident economic weakness is the result of flat government spending and lackluster trade growth dependent on an anemic global recovery. In addition, the budgetary deficit continued to creep up to $587 billion this year compared to $439 billion last fiscal year. This represents a larger percentage of GDP versus a year ago as a result of a slow economy and accelerating expenditures in entitlements such as Medicare and Social Security and a host of other programs.

Economists at the Federal Reserve are concerned that demographic factors associated with the post-war Baby Boomers will translate into less real GDP growth in the coming decades. In a recent paper "Understanding the New Normal: The Role of Demographics." The FRB staff found that low real GDP growth since the Great Recession was "largely predictable" based on their demographic model, which takes into account family composition, life expectancy, and labor market activity. They concluded: "Our results further suggest that real GDP growth and real interest rates will remain low in coming decades, consistent with the U.S. economy having reached a 'new normal'.

Because of the demographics of an aging population economic growth needs to be reinvigorated along with a careful review of entitlements. The good news is that after weaker economic data in the July-August period, the September-October data has been modestly improving. The ISM manufacturing Index rose, payrolls increased, and unemployment came in at 5.0% along with an increase in the employment participation rate. Average hourly earnings rose with an increase in personal income growing at 2.8% y/y supporting spending. The savings rate at 5.7% is significantly higher than at the start of the recovery and retail sales continue to improve. Net private spending appears to be trending higher. Auto sales, building permits, and existing home sales support an expanding economy resulting in a consumer price index (CPI) that stands at 1.5%. With energy prices recovering and money supply (M-2) growing at 7.4% we are anticipating a pickup of inflation could portend an additional headwind for consumption, the mainstay of the recovery. These factors will most likely cause the Federal Reserve to raise rates by 0.25 basis points in December following the election, and this is most probably already priced in the markets. We expect corporate profits to continue at a 5.0% growth rate with a shift to higher revenue growth against a background of rising costs.

Stock Valuations:

With nearly 97% of S&P 500 companies already reporting Q3-2016 results, earnings surprise metrics are encouraging while the revenue surprises are in line. However, Q3 results do suggest that Q2 was the bottom for y/y revenue and earnings comparisons. Overall earnings are beating expectations by 5% with sales reporting in line. Aggregate earnings continue to benefit from a reduced share count. We believe that the earnings recession bottomed in Q2 coincident with a recession in the Energy sector, which seems to be behind us given that the price of a barrel of Brent crude oil has recovered from February's low of $26.21 back up to a range of roughly $40-$50. As a result, both S&P 500 forward revenues and forward earnings, which had been depressed by the Energy sector since the second half of 2014, recently climbed back and confirming that the earnings recession is over and augur well for both revenues and earnings over the coming year.

Our concern with many stocks in previous commentaries was overall valuations on trailing earnings against a background of a generally subpar economic growth. The price earnings ratio on the reported trailing earnings of the S&P 500 is 20.0X as of November 7th and approximately 18.0X on forward operating earnings as measured by the consensus estimates by Bloomberg of $188.8 per share. In past we have mentioned high historical valuations on the S&P 500 using one of Warren Buffet's favorite models as related to the GDP and only the year 2001 exceeds the current high valuations caused by the exceedingly low interest rates. When it comes to valuations, the future path of the economy and the earnings trends of the various sectors and individual stocks will determine the final outcome coupled with other factors such as investor psychology, etc.

IN SUMMARY:

Economic conditions have improved in the recent months with credit conditions remaining generally favorable. Since the end of the second quarter, consumption continues to strengthen, housing remains strong, and there is evidence that manufacturing and industrial production are improving. At present, both income and employment are healthy year-over-year, and we continue to forecast real GDP growth in excess of 2.0% with CPI inflation of 1.7% and corporate profits exceeding 5.0% for the year. While current valuation multiples are elevated, they aren't excessive given record low bond yields. As we begin to focus on 2017, we remain a generally optimistic about market participation, although we recognize the sustainability of the earnings recovery is dependent on the economic environment.

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