

*“It is easy in the world to live after the world’s opinion; it is easy in solitude to live after our own; but the great man is he who in the midst of the crowd keeps with perfect sweetness the independence of solitude.”*

Ralph Waldo Emerson

## IN FOCUS:

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**There continues to be uncertainty with regards to the challenges of Trump’s administration to pass legislation.** However, the markets have basically shrugged off any mishaps or delays to the agenda thus far. The markets rallied since election day in response to promises of infrastructure build, healthcare repeal, tax reform, and regulatory relief. Congress did, in fact, avoid a shut down this quarter by extending the budget through September at which time negotiations will open up once again for 2018. Several concessions had to be made in order for the extension to be considered. The current version includes increased funding to defense and national security and cuts to sanctuary cities, at least temporarily.

**On the global front, Prime Minister Theresa May of the UK, in a risky attempt to gain a stronger conservative majority in Parliament, called for a snap election in early June.** Normally, Parliamentary elections are every 5 years, with the next scheduled one not until 2020. The loss in majority seats that resulted, when there is already widespread division within the party, means greater opposition for PM May. The complication surrounding this division lies mostly between those who want to maintain close economic ties with Europe and those in pursuit of complete sovereignty. The opposition to sovereignty is concerned about limited access to Euro markets that reside within the European Union. This could come at considerable costs to UK businesses and thus impact GDP growth, via higher inflation and consumer spending pressures. The EU in turn will face obstacles such as how to fill the funding gap created by Brexit. The UK is one of the largest contributors to the EU budget which funds pensions and other projects. This is an important consideration since the UK is the world’s 5<sup>th</sup> largest economy. The second half of the year should generate revelations as to how Brexit will proceed as a majority of legislation will be negotiated and voted upon. All things considered, should an early election occur, as they often do when a PM’s position is weakened, there is potential for a softer stance to be taken regarding Brexit which would allow for a softer exit.

## CLOSE-UP: The Economic Landscape

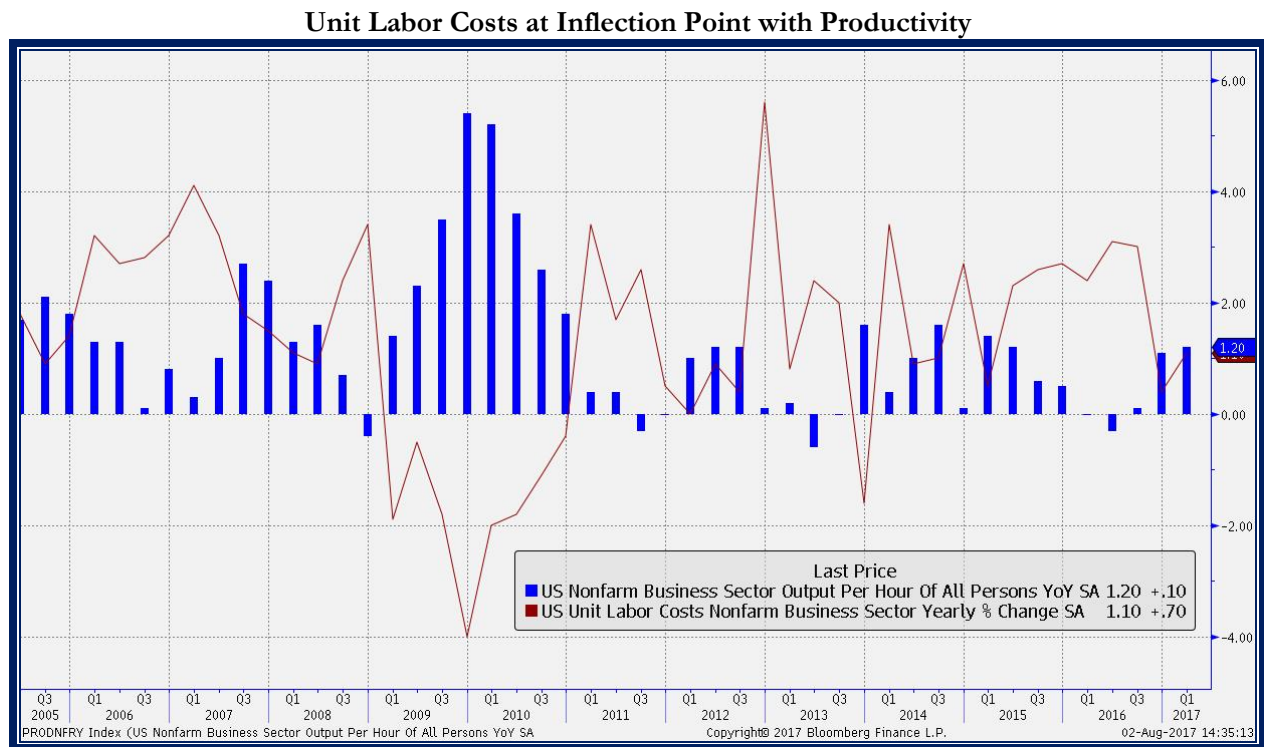
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**The IMF has world GDP forecasted at 3.4% and 3.6% for 2017 and 2018 respectively.** Emerging market growth forecasts at over 4.5% are the primary drivers with developed markets’ estimates near 2%. The U.S. received a modest uptick in expectations, while the Euro area received a modest downtick. The U.K. also is not surprisingly experiencing a slowdown.

**The final estimate for U.S. Q1 2017 GDP came in at 1.4%, down from 2.1% in Q4 of last year.** Business spending was strong and net exports were also additive to growth. Personal consumption expenditures, both services and goods, contributed to overall growth. Changes in private inventories and government expenditures detracted from GDP. The GDP slowdown is transitory in our view and we expect it to pick up later in the year. Personal Income and outlays came in marginally positive up .4% for the month of May, due primarily to a rise in dividend income. Wage growth continues to trail expectations which we have previously acknowledged as a lagged response to low inflation. Payrolls too are slowing but remain “solid” as characterized by the Fed.

**Looking ahead, we still expect real GDP to be 2.5%** for the year assuming the Trump agenda of deregulation continues. Continued improvement in 2018 will depend on promised tax cuts and a major capital infrastructure program currently delayed by the passage of a healthcare program to replace Obamacare. Healthcare has been a politically divisive and excessively expensive issue in the U.S. Current estimates put Healthcare in the U.S. at about 17.8% of GDP and growing close to 6.0% annually. U.S. demographics is most certainly a head wind negatively impacting productivity. Reforming health service costs and getting drug pricing under control, as well as providing for the less fortunate, remain the major challenges for both parties this year. Keep in mind that despite these apparent obstacles, elsewhere outside the U.S. long wait times and a limited choice of hospital or physician remain a problem. That's why large participants in the EU use private insurance to pick up the slack.

**Unemployment has hit record lows in several major economies, but there is still no sign of an acceleration in wages.** Core inflation has edged lower. This is good news for risk assets, as it extends the economic cycle. But for markets to continue to expand, investors will need a resurgence in productivity – similar to the 1990's Tech boom.



Source: Bloomberg and BLS

**The return of slow steady growth with low inflation has eased the pressure on corporate margins and should allow central banks to tighten policy albeit gradually.** This could extend the economic cycle beyond 2018. But an expansion in productivity is needed for a more pronounced move in asset prices transformation and new technologies might be the only solution.

**While we would still describe the global economy as ‘reflationary’, the risk of a significant inflation scare has diminished.** There is still little evidence of an acceleration in wages in any major economy, even with unemployment hitting very low levels. This is keeping core inflation rates down, and alleviating pressure on central banks to tighten policy proactively - a bullish case for equities. The continued weakness of wages and inflation is clearly an enigma for economists. It provides further confirmation that the traditional link between unemployment and inflation – the Phillips Curve – has broken down. Understanding this development is important, both for policymakers and investors. Is this shift permanent, or will the old Phillips Curve eventually reassert itself? The answer could have profound implications for financial markets over the next couple of years. Economists have identified several reasons why the failure of wages to respond to low unemployment might be a temporary phenomenon that takes into account that the jobless rate might not be a good proxy for the amount of slack in the economy.

**US participation rates have plunged since the great recession and changes in demographics – lower paid, younger workers are replacing higher-paid retirees, reducing average wages.** There might also be a time lag in wage and price-setting behavior, which could mean the latest decline in core inflation is temporary – reflecting the global slowdown and associated deflation scare in 2015/16. Although these reasons might offer some explanation, there are also structural forces at work. Crucially, the combination of globalization and new technologies seems to have permanently supported solid growth with no immediate inflation threat. This phenomenon of a ‘not too hot, not too cold’ economy has returned confirming a looser monetary policy response with less pressure on corporate profits. Together, these trends suggest the current economic cycle is likely to last longer than most economists expected, depending on what happens to productivity the cycle. There are similar parallels with the 1990s, when Alan Greenspan ignored the traditional Phillips Curve and instead bet on a major productivity revival.

**On the home front, the Federal Reserve raised interest rates once again in June while also announcing plans to reduce its balance sheet by setting reinvestment limits on principal payments or bond expirations.** Fed Chairwoman Yellen views the recent drop in inflation as transitory, citing a strong underlying labor market, and looks to move forward with reducing the balance sheet beginning in September of this year. The Fed also modestly increased its GDP growth rate to 2.2% and lowered its inflation outlook to 1.6%-1.7%. This move by the Fed underscores the confidence they have in the strength of the economy going forward and its potential impact on longer term inflationary pressures. The markets were little changed in response to the meeting, as a rate hike this time around was highly anticipated. Bonds, however, have rallied in recent months indicating additional rate hikes may be pushed further out.

**In conclusion, we believe that economic growth could pick up and reach 3.5% real GDP in 2018, if some of the present administration policy initiatives materialize.** That will require a bipartisan effort by Congress as they tackle the difficult issues of healthcare and tax reform. Our forecast remains that the U.S. economy will grow by 2.5% in 2017, with the CPI at 2.5% (revised down from 2.7%) and corporate profits up 10%.

### **The Financial Markets:**

**Global equity markets continued their unrelenting advance in the second quarter, led by continued strength in continental European equities coupled with their respective currencies.** According to market observers, we are now entering the ninth year of what now has become the second longest bull market in modern history. Despite the economy trending at a historically low annual rate of 2.1% growth, as measured by real GDP and a weak April-May period, the growth rate for the second quarter rebounded at 2.6%.

**Enthusiasm for equities remains extraordinarily high, market breadth has narrowed considerably, valuations are elevated especially for the market leaders, and bargains are harder to find.** While we continue to diligently scour the markets for undervalued equity securities, we are ever mindful of the near-term impact of trading algorithms on daily security prices, along with the virtual absence of price discovery associated with massive flows into passively managed investment vehicles. Investors should heed Warren Buffet's caution that the market is "here to serve us, not to instruct us". Despite what might appear to be a rather "goldilocks" global economy (not too cold, not too hot), it is accompanied by capital market behavior that in our view would suggest that a cautious approach is prudent.

**Most stocks and industry groups in our portfolios produced positive returns for the quarter.** The most significant exception was our Energy-related holdings, which followed oil prices down and restrained the quarter's results. Returns for the quarter were led by the Financial, Industrial, and most of the Technology holdings with a few exceptions. The portfolios' oil & gas related holdings led decliners as news of increasing inventory stockpiles pushed oil prices down, negatively impacting the stock prices of holdings such as Devon Energy, Marathon, and Halliburton, among others. As we have mentioned in previous commentary, this tug and pull between cost lowering technological improvements in shale production and increasing demand for oil will likely lead to continuing volatility near term in the oil sector. We continue to believe that in light of overall supply/demand considerations, the prospects for ongoing Saudi constraint and continued rationalization of capital spending by the oil majors, oil prices should drift higher over the longer term. In the interim, most of these companies continue to pay substantial dividends, which appear safe for the time being while we wait for value recognition in their stock prices.

**Near-term equity market behavior remains somewhat of a conundrum** - market prices in selective issues, in our view, continue to irrationally and/or algorithmically react to the daily headlines, and discount what appear to be rather benign near term economic conditions. From our perspective, while we are very comfortable with the current positioning of our portfolios, with valuations in our equity markets potentially stretched in aggregate, we continue to guard against complacency in this environment.

### *The U.S. Dollar - Implications on Earnings Visibility*

**The US Dollar has been exceptionally weak this year, particularly against the Euro and emerging market currencies.** This has had a positive impact easing financial conditions even as central banks have become hawkish. Large global companies should benefit, improving asset prices and company fundamentals.

**The US dollar has softened this year, against improving economic developments outside the U.S., particularly in Europe and parts of the emerging markets.** In reaction to the better economic data, the ECB has appropriately been more hawkish than we previously anticipated earlier in the year. Lastly political uncertainty and concern has materialized in the first six months of the Trump presidency and appears greater in the U.S. on a relative basis for the first time since the financial crisis. It's also worth mentioning that central bank uncertainty with several new Fed governors including possibly a new Chair is expected next year. However, U.S. equity investors recognize that a weaker US dollar could provide yet another tail wind, not only in terms of looser financial conditions but for sales and earnings growth. Given the very strong US dollar in the second half of 2016, the tail wind will only build on a year over year comparison even if the dollar remains flat from here until the end of the year.

We think it is likely that the US dollar, as measured by the DXY, will remain flat to down another 5% between now and yearend driven by a forecast for a stronger Euro that reaches 1.18 to the USD. This would give a needed boost to 4Q earnings pushing estimates to achieve analysts' current bottom up forecast of close to 13% y/y growth. Unsurprisingly, multi-nationals with greater international sales exposure should benefit the most - and our large capitalized global cyclical bias in portfolios should help close the performance gap that has widened in the past quarter.

The overall trend in the earnings revision ratio (EER - ratio of upwards revisions to analyst earnings estimates compared to downward revisions) has been trending higher in recent months into positive territory, pushing through its long-term average (Chart 1 below). Industrials, Financials, Technology, and Healthcare have the strongest EER ratios. Consumer Discretionary, Staples, Utilities, and Materials have all shown improvement over a 3-month period. Energy and Telecom were the only sectors that delivered weakening EERs (Chart 2 below). However, it is notable that Energy on a shorter term/one-month basis showed a sizable improvement. The accompanying rise in the sales revision ratio (SRR) also underscores the strength in forward estimate revisions, which reached its highest level in over 5 years.

Chart 1:

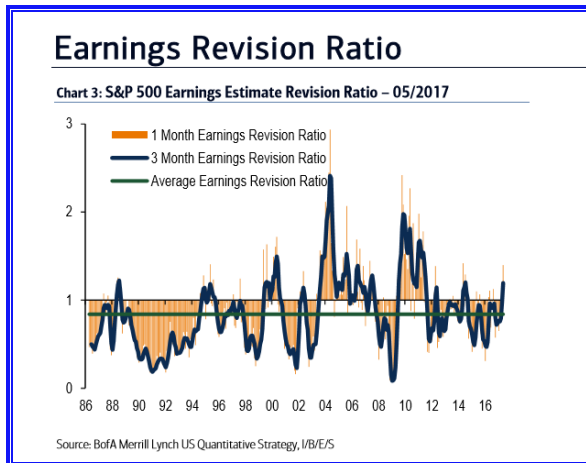
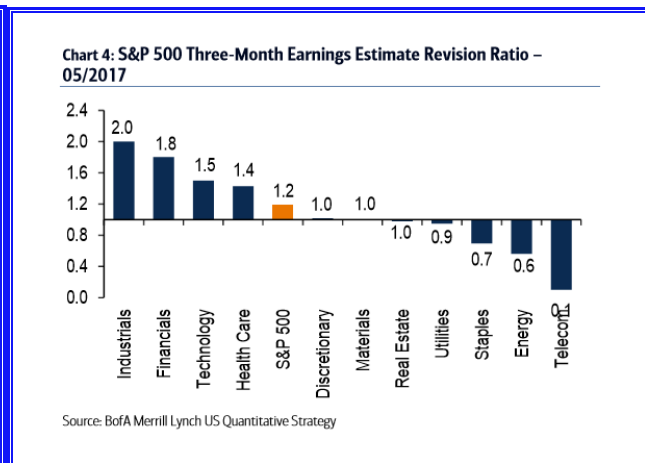
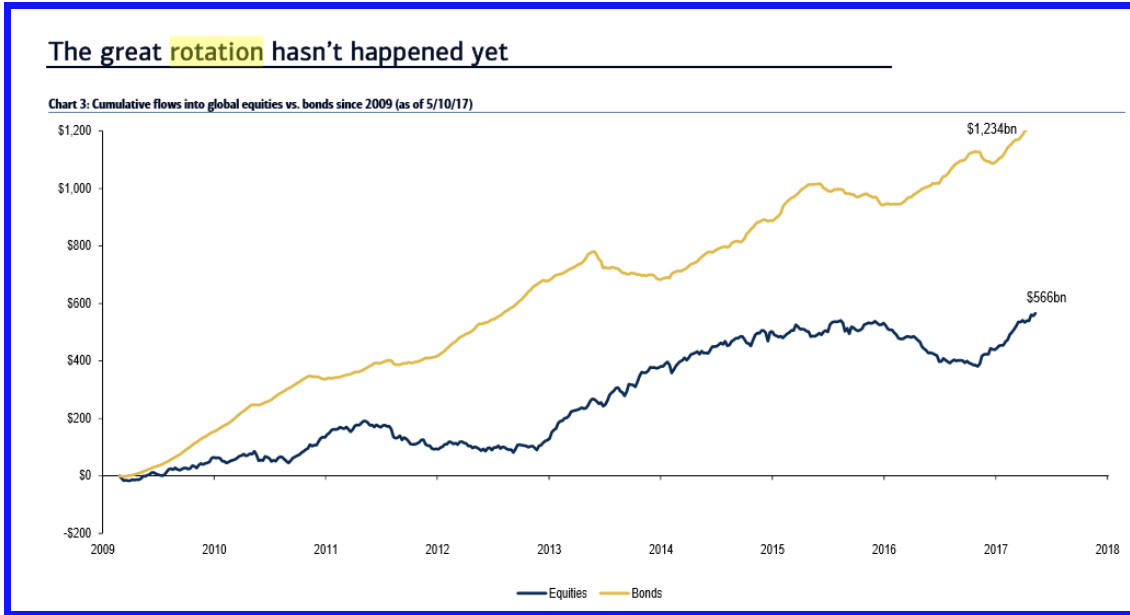


Chart 2:



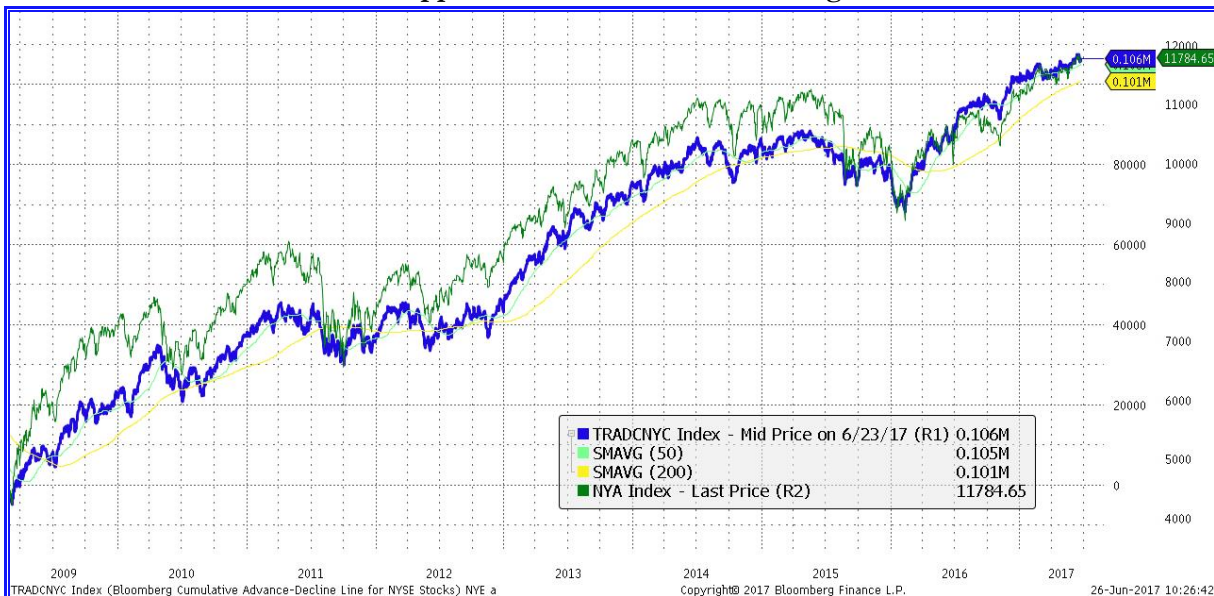
Source: BofA Merrill Lynch US Quantitative Strategy May 2017

Looking at inflows into global equities as compared to bonds since the bottom of the financial crisis in 2009, you can see that monies into global bonds has been almost double that of global equities. This suggests that the rotation into bonds by investors in response to the great recession has yet to be undone. Money remains on the sideline, not only in bonds but also in cash that has yet to return to the equity market. This trend, along with the fact that corporate revenues are beginning to recover adding to the quality of bottom line profits, both support continued stock market breadth and strength over the long run. We recognize market corrections occur periodically and this current cycle is not an exception. However, we feel as though any pull back in price levels would in fact be a temporary correction within a longer-term bull market.



The Advance/Decline (A/D) line for the New York Stock Exchange (NYSE) index, which calculates the number of stocks advancing over those declines line, continues to indicate the breadth of the market is strong (chart below). A/D lines are used by analysts in determining implied direction of market performance by comparing it to the index performance itself. In this case, we are considering the NYSE index, the green line. At 21.5x earnings, and above its 10-year average of 18x, the market is considered expensive by most analysts. While it is true valuations have expanded substantially, our process focuses on finding value within the marketplace in sectors that are out of favor. The direction of the A/D line is used to confirm the direction of market performance. As in this case, the blue A/D line is trending higher along with the market. As long as this trend continues we believe that any pull back in the current market would be short lived.

### The A/D Line is Trending Upwards in Support of Continued Market Strength



## IN SUMMARY:

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**The U.S. economy improved in the second quarter, with little evidence of structural imbalances as productivity rebounded.** Real Disposable Income continues to rise at a 3.2% rate versus 2.8% in the first quarter, with housing sales rebounding in June and inventory levels at 7.1% below year ago levels. The Industrial Manufacturing Index continues expanding at 57.8. We continue to forecast real GDP growth in excess of 2.5%, with CPI inflation of 2.5% and corporate profits exceeding 10% growth versus 2016. The consensus estimate for S&P 500 earnings for 2017 among Wall Street strategists is \$130 per share, a gain of 12%. While current valuation multiples are elevated, they aren't excessive given record low bond yields and the expectation of accelerating corporate profits in 2017. As we enter the second half of 2017, we continue to remain positive on the economic expansion as corporate profits accelerate.

**Despite very low levels of unemployment, there is no sign yet of the acceleration in wages that could have turned the deflation trade into an outright inflation scare.** Bond yields have fallen back and equities have continued to rally, an obvious response to the return of the Goldilocks economy. Central banks will most likely adopt monetary policy tightening, but at a more gradual pace than seemed likely at the start of the year. The return to economic expansion will most likely extend the current cycle beyond 2018. However, we would expect a longer cycle would require a sustained productivity revival.

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