ALTMAN
INVESTMENT MANAGEMENT

EQUITY STRATEGY FOCUS

APRIL, 2017

IN BRIEF: A Look at the U.S. Economy

The Fourth quarter GDP came in at 2.1% with personal consumption expenditures having the largest contribution, followed by non-farm inventories, and fixed residential spending. Partially offsetting GDP growth was negative net exports. Q4 corporate profits were up 22.3% over the same quarter a year ago. Profits account for 9.2% of GDP, but are still below the peak reached earlier in the market cycle. On an annualized basis, corporate profits increased 4.3% during 2016, as compared to -8.5% during 2015. The first release of Q1 GDP was disappointing, rising only .7% on weaker Personal Consumption Expenditures and Private Inventory Investment and Government Consumption. A highlight in the report was a return to positive net exports. Despite the recent weaker GDP report, we are forecasting a pick-up in growth reaching 2.5% for the year on the backdrop of recovering earnings and modest inflation.

Industrial Production improved by .5% in March after a nearly flat February and a decline in January. Manufacturing output slipped by -0.4%, after 6 consecutive months of advance, due to low vehicle and parts output. Utility output on the other hand was strong. For the first quarter production was up by an annualized rate of 1.5%. Capacity utilization edged up modestly to 76.1%, slightly below its long-term average of 80%.

On the consumer side, Personal Incomes rose in March by a modest 0.2% with weak wage and salary growth. The pace at which wages and salaries are growing has been on a decline since December. However, the savings rate moved up .2% to 5.9%, but below the long-term average of 8.3%. Personal Consumption Expenditures dropped back down below the FOMC target rate to 1.8%. The employment situation report was strong in both January and February, with unemployment now standing at 4.5% in March. However, private and non-farm payrolls both declined from the prior month, coming in below consensus expectations. Consumer credit rose by $15 billion, following a 10.9% increase the prior month.

We believe the weakness in GDP growth throughout 2016 and into Q1 2017 is due in part to structural issues rather than lack of monetary growth. Although we believe that structural factors (i.e. low productivity, excessive regulation, high taxes) may be holding back wages in the retail and manufacturing industries, an increasingly overheated economy should result in overall pay growth that responds to a positive output gap alongside rising headline inflation. We would expect nominal wage growth to reach 4% next year. Productivity growth, which suffered severe damage during the Great Recession, will take time to recover and remains subdued, keeping unit labor cost pressures in check.

The Federal Reserve in March raised interest rates for the third time since initial initiatives to unwind policy began, underscoring an improving labor market, anticipated moderate economic growth, and evolving inflation. However, should energy prices retreat and settle below the $50 range, or if GDP growth weakens further, it could delay the Fed reversal of policy.

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IN VIEW: The Equity Landscape

The first quarter stock market strength appears to be based more on economics rather than politics. Market performance of 6.07% during Q1 continues to trade off of economic strength, while discounting the domestic political drama surrounding immigration policy, national security, and healthcare legislation. The S&P 500 traded down modestly (about 2%) in mid-March in response to the FBI Director's testimony and the failure to pass current healthcare legislation, only to regain those losses on positive consumer confidence, GDP, and corporate profit reports.

At the forefront of policy initiatives is tax reform. Skepticism looms after the initial healthcare reform legislation failure, which was thought to be highly dependent upon budget cuts to offset higher spending proposals in defense.

A Closer Look at Market Valuations:

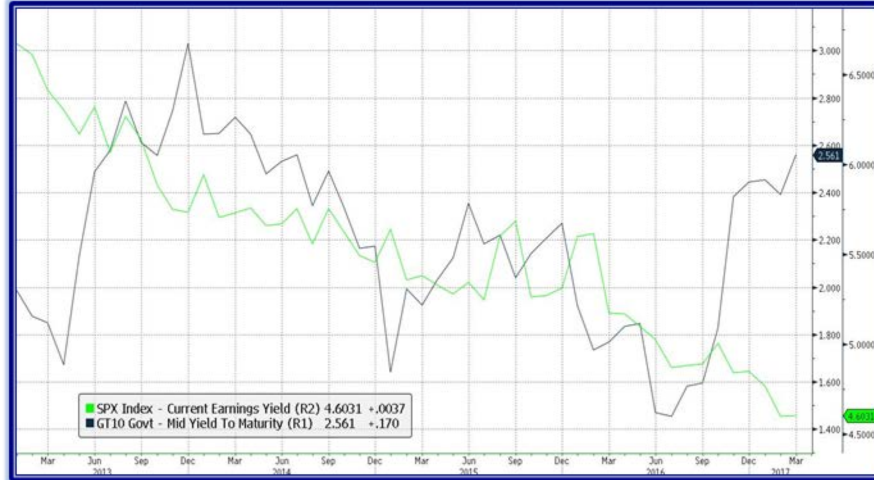
As we have discussed in several of our past commentaries, if bonds are overvalued then does it follow that stocks are overvalued as well? Certainly, valuation metrics indicate that equities are trading at multiples that are far from cheap by historical standards – although they're not as high as they have been in the past, including in the current cycle. But while QE (Quantitative Easing) is seemingly still depressing yields, it is also probable that they are structurally lower due to excess savings. If that is the case, then one might conclude that yields will not necessarily revert to historic levels once Central Bank stimulus ends. There is no reason to expect equity valuations to fall back to the averages of the past. Higher valuations/multiples, in other words, may be here to stay.

We believe it's a more productive exercise to look at what is typical at the present stage of the cycle, rather than looking at average valuations. It is normal for stocks to go from cheap to expensive and back again, as the monetary and business cycles unravel. Interestingly, multiples tend to be above average in a mature-cycle environment such as the one we're in today, and comparing them to cycle averages makes less sense. Of course, this suggests that when the cycle eventually ends valuations will fall, most likely to below-average levels. But this is probably several quarters (if not years) away, since we do not see any obvious signs of overheating or excessive buildup of capacity or inventories in major economies that could bring the current upswing to an abrupt halt. Finally, as long as earnings continue to grow, a repricing in bonds for technical reasons – such as the end/unwinding of QE – could lead to a healthy correction in stocks in the context of a bull market, but not the start of a bear market correction.

In conclusion, equities remain our preferred asset class, for a number of reasons. First, global macro fundamentals favor growth (real) assets over fixed income (nominal) ones. Second, overvaluation is an issue in some industry sectors and some selective markets, but overall price distortions always present opportunities for active portfolios. Finally, corporate earnings remain on an upward trend, so the equity market should be able to bounce back in the event of a temporary correction. Within equities, we continue to like cyclicals such as Energy and Finance as well as international companies benefiting from a pickup in Europe and Emerging Markets. They offer better value as we enter the later stages of the business cycle. Any weakness in these sectors presents a buying opportunity. In the fixed income marketplace, we still like corporate debt, where yield is appealing against a benign inflation backdrop and valuations are often more than reasonable.

The inverse relationship between stocks and bonds has once again emerged - the first time since 2013. The accommodative Fed policy began in 2008 and supported both stock and bond markets with the idea that rates would stay low for quite some time. Since the U.S. election, however, the relationship between stock and bond markets has normalized. In March, the Fed, which relies heavily on economic data to measure labor market conditions and inflation, raised rates for a third time indicating two additional rate hikes throughout the year. If the Fed doesn't deviate from the current anticipated schedule, given their expectation for moderate economic growth, we expect stocks could climb even higher as money moves from sidelines or bonds into stocks.

Spread between Stocks (Earnings Yield) and Bonds (Yields) Has Widened



Source: Bloomberg Analytics and Altman Investment Management

A Note on the Impact of Politics on the Markets:

Historically there have been several political crises that contributed to either a substantial market correction or even a bear market. Capital Economics highlights President Roosevelt's Judicial Procedures Reform Bill and Watergate as examples. However, they are quick to point out that both these events coincided with recessions. But other dramatic political events that occurred independent of a recession, such as the Clinton impeachment proceedings and the election recount debacle during the Bush/Gore presidential race, did not have a substantial impact on stock markets.

Perhaps this helps explain the markets' current strength in 2017 amidst the political uncertainty surrounding the new administration. The Fed's assessment of continued moderate growth, consumer strength (as underlined by unemployment, confidence, and incomes) and improving corporate profits are all pointing towards the economic strength that the market is recognizing.

That being said, the relevance of political events is not nullified and some questions remain. Will the lessons learned after the failure of the first attempt of the Affordable Health Care Act help Trump to reach across party lines and unite Congress? Will a corporate tax overhaul be successful? How will the new protectionist posturing of the United States play out after decades of corporate globalization initiatives? The pro-Trump market rally is in part supported by his campaign promises, therefore the success or failure of initiatives has the potential to have greater ramifications on market performance going forward.

CLOSE-UP: Equity Investment Overview

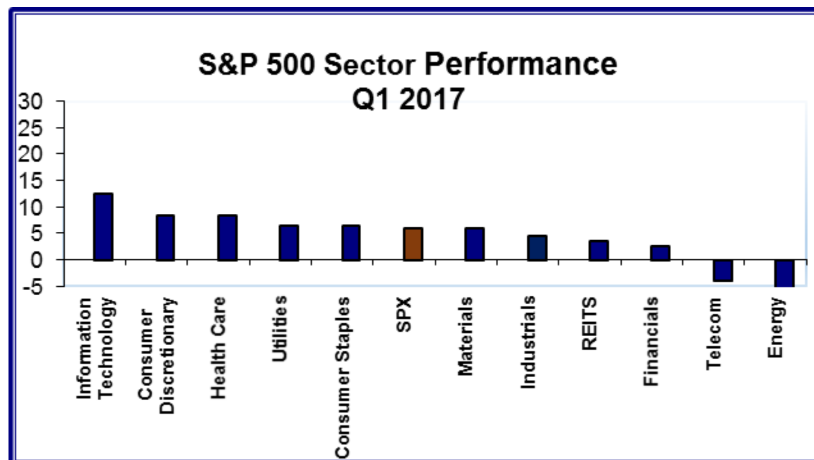
➢ Performance Highlights and Equity Strategy

The S&P 500 benchmark index had a total return of 6.06% during the first quarter of 2017. Large cap stocks outperformed small caps stocks by 360 basis points. Growth out-performed value by 524 basis points in Q1, narrowing the lead value stocks have had to 326 basis points for the past 12 months.

The recent stock market rally is highly dependent upon anticipated corporate tax reform. Contentions revolve around not only the ambitious targeted tax level but on how to pay for the proposed tax cut. A Border Adjusted Tax (BAT) has been proposed that would tax imports but provide rebates for exports. This would work to offset tax revenue losses from what Trump has called the biggest tax cuts in history.

Tax relief for the middle class seems to be put on the side burner for now, which will not bode well for partisan support. At any rate, even though the Trump administration appears to be aggressively pushing corporate tax reform ahead of its budget proposal, negotiations for such high-level initiatives traditionally take months if not years to come to fruition. The main risk to the market at this point is that the details of tax reform in terms of content or timing do not meet expectations. Failure to materialize into anything the resembles Trumps campaign promises could trigger an interim market correction.

Information Technology, Consumer Discretionary, and Healthcare stocks were the top performing sectors, as illustrated in chart below. Energy was the weakest performing sector followed by Telecom.



Source: Bloomberg Analytics and Altman Investment Management

The current global oil supply glut is weighing on oil prices, with West Texas Oil dropping again below $50 a barrel. The rise in oil prices through mid-2014 led U.S. producers in particular to ramp up exploration efforts flooding supply channels. As rig count begins to come back on line, U.S. oil supply growth does not appear to be slowing. In response to heightened supply levels, OPEC did indeed cut production efforts. However, despite high compliance reports, there are still questions surrounding the longevity of OPEC production cuts. The current soft patch in demand is expected to lift in 2H 2017 with seasonal demand. But concern over its ability to fully offset supply growth is weighing on prices as well. Although oil prices may remain weak or volatile in the short term, low sector valuations coupled with what we consider to be temporary setbacks within sector fundamentals lead us to maintain our overweight position in Energy. Currently, our portfolios are positioned with a preference towards higher oil prices, exploration and production companies, as opposed to refiners. We anticipate a more detailed review of the Energy industry in the coming weeks.

Source: Bloomberg Analytics

In the quarter, the AIM composite modestly underperformed the S&P 500 by -1.4%. In Technology, we lost the most relative performance with our Intel and Accenture holdings and by not participating in Apple and Facebook's recovery. Energy as a whole did not perform well following the recent oil price decline, despite the improvement in the refiners and storage companies' stock performance.

Adding to relative performance were Materials, as Dupont rose 10%. Our Lowes position contributed positively to Consumer Discretionary relative performance, as did AT&T to Telecom. Our strongest stocks in the portfolio for the quarter were Applied Materials, Baxter, Oracle, Lowes, and Cardinal Health. The weakest stocks, which all reflect the drop in oil prices, were Occidental Petroleum, Halliburton, Devon, Marathon Oil, and Chevron.

	Sector Wgt. as % of Portfolio as of 3/31/2017	Relative Wgt. versus S&P 500 Index	Q1 2017 Total Return of AIM Composite	Q1 2017 Total Attribution of AIM Composite
AIM Composite			4.6	-1.4
Consumer Discretionary*	8.7	-3.6	14.0	0.1
Consumer Staples	10.4	1.1	2.2	-0.4
Energy	10.8	4.2	-6.9	-0.6
Financials	18.0	3.6	2.2	-0.2
Health Care	14.3	0.4	8.2	0.0
Industrials*	9.4	-0.7	5.5	0.1
Information Technology	19.1	-3.0	9.9	-0.6
Materials	2.9	0.1	13.4	0.2
REITS	0.0	-2.9	--	--
Telecommunication Services	2.3	-0.1	-1.3	0.1
Utilities	2.3	-0.9	11.3	0.1

Source: Bloomberg Analytics and Altman Investment Management

* Philips Electronics (PHG) is categorized as a consumer discretionary stock in our AIM Core Value Composite, but remains an industrial company within the S&P 500 index.

So far in this earnings season, 80% of the companies within the S&P 500 Earnings have reported. Top line sales look to be on track to deliver positive sales growth for the third consecutive quarter. Likewise, earnings are also on par to deliver growth but in the double digits, which we haven't seen since 2011. Industrials so far have surprised, with an average of approximately 0.5% earnings growth against expectations of -9%. Earnings and sales growth look strong in Information Technology, Financials, and Materials. The weakest growth is coming from Telecom, Consumer Staples and Utilities.

Observations on Specific Holdings:

Oracle reported earnings in March that beat analyst expectations. Although revenues were a bit short, Oracle is in the early stage of migrating towards the cloud. Total cloud revenues reached 13%, up from 8 % this time last year. Its initiatives have been focusing on cloud computing and Software as a Service/Platform (SaaS and PaaS). According to CEO Mark Hurd, this year Oracle is beginning to grow revenues at a faster rate than its #2 competitor Salesforce.com. Its largest competitor in the cloud space is Amazon, with which Oracle has positioned its faster and lower cost Infrastructure as a Service (IaaS) against. Oracle also increased its dividend by 27% to $0.19 per share.

Our addition of Oracle in the spring of 2014 was based on the recognition that the company was slow to embrace the transition to the cloud, mainly because of its leadership position in installed, on-site software. This led to stagnating revenues and margin contraction. As a result, Oracle's shares have remained range-bound for the past several years, underperforming their peer group. Investors remained skeptical about Oracle's ability to compete effectively against more established cloud competitors like Amazon, Google, and Microsoft, and smaller, nimbler companies. These perceptions appear overly pessimistic and present an opportunity to own a laggard in the group. We also concluded that market expectations for declines in Oracle's product support revenues and potential threats to its database application business were too negative. The shares continue to be undervalued, in our view. Oracle currently trades near longer-term average multiples, while the S&P 500® Index and the software and services industry group both have valuations near 10-year highs. We also like Oracle's balance sheet attributes and cash flow dynamics. The company has $58 billion in cash and marketable securities. Free cash flow, at $12 billion, was up 10% year over year. There is growing evidence of traction in Oracle's cloud business as quarterly cloud revenue had just exceeded $1 billion for the first time and had risen 69% year over year. In the quarterly release, management indicated that the total cloud revenue is expected to exceed new software license revenue in fiscal 2018 — another positive sign.

This month, expectations for Express Scripts' largest customer, Anthem, to stay on board has diminished, as Anthem publicly announced it will be sending out RFPs (requests for proposals) to multiple vendors in addition to Express Scripts (ESRX). It appears as though ESRX has written off the possibility of retaining Anthem's business whose contract expires at the end of 2019. Anthem has been a substantial customer, estimated to contribute approximately 30% to operating profits, as defined by EBITDA (earnings before interest, tax, depreciation and amortization).

Despite the crucial environment surrounding Anthem, we think ESRX remains a solid holding going forward due to their vast size, negotiating power and suite of services that make the company one of the top three Pharmacy Benefits Managers (PBM). The company's guidance is for 2-4% EBITDA growth for the remaining core business based upon strategic use of capital. Areas of growth include generics, specialty pharmacy, plan design, and clinical programs. An aging population also bodes well for ESRX. Although some risks remain, such as potential margin pressures on the horizon due to increasing PBM costs, we believe that at 13x current and 8.8x forward earnings ESRX trades at a discount to peers and warrants continued representation.

The global beverage and snack maker Mondelez International's performance lagged during the quarter, down -2.4%. The shortfall emanated from disappointing sales, earnings, and margins that came in shy of analysts' consensus estimates for the fourth quarter. Management also indicated that more restrictive trade policies could present challenges to its business (about 70% of its sales come from outside the United States).

Elsewhere in the portfolio, energy exploration and production company Occidental Petroleum was a notable detractor, down -10.0%. Occidental had been a relative outperformer during the oil market correction, due in part to its conservatism and stronger financial position. It has lagged more recently as investors seem to have gravitated toward higher-growth opportunities.

In Healthcare, Baxter, up 17.3%, and Cardinal Health, up 13.9%, were notable outperformers in the sector. Shares of Cardinal Health, a leading pharmaceutical and medical products distributor, have rebounded following a challenging year for distributors in 2016. The company reported solid quarterly results, and while it reduced its fiscal 2017 guidance, investors seem more comfortable with the stability of the pharmaceutical distribution business.

In consumer discretionary, Lowe's, advanced 16.2% against 8.5% and 3% respectively for the consumer discretionary sector of the S&P 500 and Russell 1000 Value Indices. Following a period of subpar performance, the home improvement retailer reported quarterly results that were ahead of expectations for same-store sales and earnings per share. These developments, along with the fact that the company's fiscal 2017 revenue guidance came in ahead of its previous long-term guidance, helped boost the shares.

It is noteworthy that approximately 40% of the portfolios' quarterly returns came from Information Technology. Despite the fact that we do not hold Apple in portfolios, one of the stellar performers both in the sector and the overall market, three of our composite holdings **Applied Materials, Cisco** and **Oracle** contributed positively to the overall results. In addition to Applied Materials in the semiconductor space, our position in Oracle, a leading enterprise software company, has begun to gain some traction. We continue to emphasize the software market building out the portfolios' initial exposure with Microsoft several years ago, as spending in the space is expected to outpace overall Information Technology spending through 2019, according to Morgan Stanley Research. In recent years, the enterprise Information Technology market has been undergoing fundamental changes because of the migration to cloud computing. Cloud-based software offers companies on-demand solutions while reducing their total cost of ownership.

We ran some analysis on our composite performance against the S&P 500 over the 15 past years and were able to quantify the reduced volatility and excess return our composite delivers. On a quarterly basis, our composite beat the index 52% of the time or by 123 bps on an annualized basis. This was accomplished with reduced volatility. Normally we like to position portfolios with a larger discount on standard deviation (variance with the market), however we are currently poised to take advantage of the up-tick in the market being in the later stages of a bull market. Interestingly, our range in out-performance was as high as 6.9% as compared to our under-performance of only -3.6%. On average our under-performance lasted no longer than 2-4 consecutive quarters. Our outperformance was as high as 12.2% compared to underperformance of -4.3%. Our ability to protect against downside risk comes not only from sector allocation but also reduced volatility positioning, industry selection, and stock selection.

While we focus on the S&P 500 index as our main performance and asset allocation benchmark, it is prudent to monitor results along with the Russell 1000 Value index. The Russell index, which is currently more heavily skewed towards Financials and Energy at the expense of Technology and Consumer Discretionary stocks, came in behind both our composite and the S&P 500 this quarter. By utilizing the Russell index (our performance benchmark), in conjunction with the S&P 500 (our process benchmark), we are able to ensure that our portfolio characteristics reflect the margin of safety necessary for risk-adverse value investing strategies.

	AIM LLC	S&P 500 Index	Russell 1000 Value Index
Q1 Total Return	4.6%	6.1%	3.3%
Equal Weighted Market Cap	93,767	44,192	23,204
Weighted Market Cap	112,431	160,988	135,868
Price to Book	2.44	3.11	2.34
Forward Price to Earnings	15.56	16.34	15.39
TTM Price to Sales	1.63	2.03	1.79
Dividend Yield	2.3%	2.0%	2.3%
15 YR Std Deviation	16.86	18.16	17.00

Source: Bloomberg Analytics and Altman Investment Management

IN SUMMARY:

We do recognize there are a number of domestic policy issues to which the market is sensitive. The outcome of those initiatives as well as uncertainty over the U.S. foreign policy remains a risk. However, on the positive side, earnings and revenues have bottomed and corporate guidance is beginning to improve. We anticipate the economy to continue to expand at a healthy pace with our forecasted GDP growth in excess of 2.5% and inflation within target range. We would like to see wages and salary growth stronger, but the employment situation and consumption reports are strong while manufacturing and industrial production are improving. Current valuations are high on a relative basis, but when compared to prior market peaks where bond yields were much higher, we still expect stocks to outperform over bonds.

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