ALTMAN INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

April, 2017

"If men could learn from history, what lessons it might teach us! But passion and party blind our eyes, and the light which experience gives us is a lantern on the stern which shines only on the waves behind."

Samuel Taylor Coleridge

IN FOCUS:

Throughout history, economies have navigated through the choppy waters of geopolitical risks and political uncertainty, but have shown resilience. Today, the French election and issues such as Trump's stimulus plans are weighing on investor sentiment, but the global reflation cycle is still proceeding in earnest. The global Purchasing Managers Index (PMI) and our world leading indicator are showing no signs of losing momentum. With the recovery now broadening to the business sectors of the world's main economies, rising prices are more than simply an energy recovery.

China's economy, which is now responsible for as much as 15% of global growth according to OECD estimates, is showing signs that producer inflation has turned the corner and is now on the rise. We expect this phenomenon will take months for the upswing to ripple through the global supply chain. Moreover, demand in the U.S., core Europe and the UK has already outstripped supply, leaving factories and workers working beyond their potential to bridge the gap. To varying degrees, their economic cycles have reached the stage in which increased spending by businesses results in rising inflation and the ensuing erosion of real household income. We expect that strong capital expenditures and foreign demand should imply a further tightening in the labor market and should support consumer income. This is especially true if labor productivity fails to regain its pre-crisis rate of growth.

As growth becomes more broad-based and the labor market runs out of capacity (if it has not already), traditional domestic labor cost pressures should rise and drive up core inflation. The widespread pick-up in advanced economies is good news for emerging markets, notably China, where growth is still highly dependent on excessive investment. However, as global yields are poised to move higher, financial conditions will become less favorable and investors in emerging market assets will need to be selective.

Global GDP grew at a pace of 3.1% for 2016 and is expected to increase by 3.5% and 3.6% respectively for 2017 and 2018, according to the International Monetary Fund (IMF). Accommodative policies within the United States, Japan, Europe, and China helped reinvigorate global demand. Reflation has begun to take hold as stabilizing oil prices helped lift commodities, thereby reducing deflationary pressures. The financial markets have recognized this change, with foreign currencies and equity prices advancing relative to those in the U.S. We could conclude that the threat of future deflation is now much diminished and that the exceedingly expansionary Central Bank monetary policies since 2008 have accomplished their goal. There are still some particular examples of countries still in deflation, such as Greece and Venezuela, but these are exceptions to the overall picture and are caused by circumstances unique to those countries. As a result, it is now far more important that Central Banks begin to focus on coordinating activities to ensure that monetary policies are geared to preventing future above-average rates of inflation developing as a result of former expansionary excesses.

Among developed markets, the economic cycle in the U.S. is in the later stages. Although the economy appears to have been through a soft patch in Q1, it should continue to expand at a 2.5% plus pace, and undoubtedly above the trend rate of around 1.5%. Consumer spending has slowed somewhat as a result of temporary weakness in wages – a lagged response to previously low inflation. It now appears that capital spending has taken over as a principal engine of growth. Housing starts are also trending higher, supported by the rising employment especially for first-time home owners in the 25-35 age group.

Considering the Implications of the Proposed 15% Corporate Tax Rate:

The Trump administration has unveiled a brief outline of its tax plan, with the legislative details to follow in June. The White House proposed a robust tax cut plan, including cuts in the corporate tax rate to 15% (from the current 35%) and in personal tax rates. The administration is reportedly leaning against including Speaker Ryan's revenue-neutral proposals for a border adjustment tax (which would raise $1.1 trillion over a decade) and the elimination of the corporate interest deduction (which would raise $1.2 trillion over a decade). As an offset to tax cuts, the administration has only talked about stronger economic growth as well as revenue from repatriating corporate profits overseas. Without big revenue offsets, the administration may be forced to rely on 10-year tax cuts rather than permanent tax cuts, in order to stay within the reconciliation requirement that a tax bill cannot increase the budget deficit beyond a 10-year budget window.

The consensus seems to be that President Trump is not going to be able to cut the corporate tax rate all the way to the 15% floor. Speaker Ryan's plan involves a cut in the corporate tax rate to 20%. The worldwide average corporate tax rate is 22.5%, according to the Tax Foundation. Republicans in the end might find that they can only manage a cut to the 20%-25% area taking into consideration the lack of attractive offsets and a desire not to blow up the budget deficit.

Of course, any cut in the corporate tax rate would be supportive for the stock market, since it would boost the after-tax profits available to shareholders. A 10% point cut in the statutory U.S. corporate tax rate to 25%, for example, would boost annual earnings growth by an additional 11.2%, according to estimates by Standard & Poor's. Assuming an unchanged P/E ratio, a cut in the corporate tax rate to 25% should in theory boost the stock market by about 10% or more. Of course, those are only very rough estimates and the effects of a corporate tax cut would vary widely from company to company.

Despite the recent proposed tax cut, we are somewhat skeptical that the likelihood of major U.S. tax cuts and spending increases will materialize. However, we do expect some tax reform to begin to take shape by the end of this year, but will probably have only a limited impact on the economy in 2018. On the fiscal side, if a substantial stimulus package is passed early next year, against a maturing business cycle, then an overheated and inflationary condition could quickly materialize. That risks a boom-bust scenario in which growth exceeds its potential and could jeopardize 2019 growth trajectory.

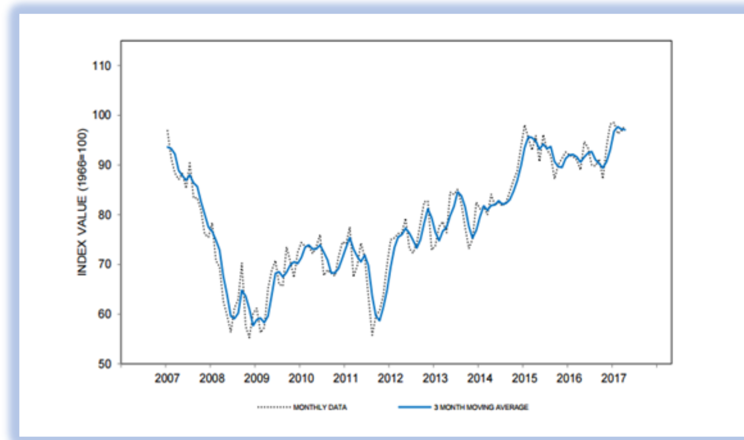
CLOSE-UP: The Economic Landscape

The year 2016 concluded as one of the weakest years for the U.S. over the past decade, with real GDP growth of 1.6%, the lowest rate of annual growth in the post war period. As we pointed out in previous commentary, the shortfall in growth from the historic trend line has not been caused by lack of monetary growth but by structural issues. These would include low productivity growth, excessive regulation, and possibly the high relative corporate and individual taxation. Some of the more serious structural problems have been low labor participation rates, lack of capital investment when compared to the past, and growing skill deficits because of inadequate education with regard to new technologies. One could also argue that the country has suffered from excessive spending on defense associated with intervention in foreign wars that has distorted the country's financial priorities and resulted in excessive debt burdens. However, we believe that the outlook has begun to improve based on some recent statistics.

Our forecast for 2017 remains positive with real GDP growth of 2.5% plus, a gain of 2.7% in the CPI and corporate profits up 10% plus. Improving statistics include the recent reports that dropped the unemployment rate to 4.5%. While retail sales have weakened recently they are still advancing better than 5.2% year over year. Housing and capex plans, two major pillars of strength in our growth outlook, remain strong and the leading indicators suggest that risks to achieving our growth forecast has been reduced. The ISM surveys of manufacturing and services have returned to 2014 levels are very strong and small business optimism is approaching a 13-year high. Also, non-defense capital goods orders are now in an uptrend after a weak year in 2016. The leading indicators increased 0.4% in March and are up 3.5% y/y. Looking beyond the U.S. economy, Emerging Asia growth is gaining momentum as well and political risks are receding, while China continues to positively surprise.

Within the United States, sentiment has gotten a boost from the recovery in earnings, in addition to anticipated tax relief and deregulation.

The Index of Consumer Sentiment



Source: University of Michigan

There are however, several risks to continued global economic strength. For one, policy shifts such as the protectionist stance the U.S. administration is taking on trade has the potential to negatively impact domestic growth. Second, should domestic interest rates rise too fast, the subsequent strengthening of the U.S. dollar could work against emerging market economies that help support the world economy. Sentiment is highly contingent upon economic data to this point.

Keep in mind that evidence now reveals a new threat of inflation that has surfaced within the service sector. The CPI is currently 2.4%, twelve months through March, with import prices up 4.2% bolstered by housing, transportation services and medical care all up in excess of 3.5% y/y. The U.S. is mainly a service economy (70%) both with regard to employment and production. Also, while average hourly wages are up 2.7% year over year, *real* average hourly wages remain flat year over year. Because energy prices have recently weakened, some economists believe it's possible that inflation has peaked. Accordingly, if the Federal Reserve maintains a more hawkish tone with regard to future rate hikes, inflation should back off to lower levels.

It is noteworthy that the federal budget deficit has begun rising since last summer, aggravated by weakened receipts against a background of rising entitlement spending. Improving economic growth could help resolve this problem which economists believe should occur. Nevertheless, we remain concerned that debt to GDP has grown significantly over the past decade to new highs. This has given rise to concerns that budgetary discipline is a major political issue among many Congressmen. This issue represents a possible stumbling block in furthering the administration's goal of fiscal expansion.

Should geopolitical risks intensify or ambiguity surrounding U.S. policies ware on investors, sentiment could soften and adversely impact financial markets. But for now, our domestic benchmarks are trading off the growth in demand, production, global trade, and macro-economic conditions that accelerated during 2016 particularly in developed markets. What the market is not reflecting at this time is the pickup in both consumption and investment, which are critical to continued economic growth but not keeping up with the pace of previous recoveries.

Although the Fed has already increased interest rates twice over the past six months, it remains behind the curve. With policy rates still deep in negative territory, we expect the Fed to raise interest rates by an estimated 75 basis points by mid-2018 – reflecting a more aggressive tightening path than most are assuming. The FOMC has discussed whether to start shrinking the Fed's balance sheet by the end of this year, but holding the policy rates moderately low is likely to remain its stance for now.

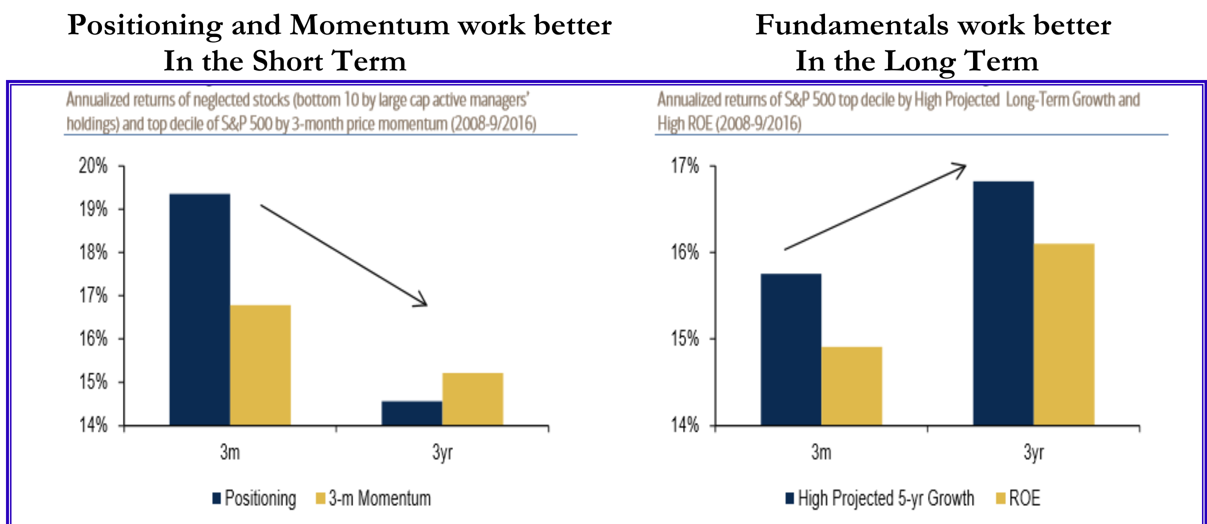
The Outlook for Financial Markets:

The S&P 500 forward P/E ratio is 18.1 based on the consensus $130 per share earnings outlook, a 10% gain. As mentioned in prior commentaries, the equity markets are considerably over-valued by historical measures, and although widely recognized by forecasters have shown little inclination to significantly decline. In our view, as long as inflation remains contained and the current administration can successfully implement its programs of tax reduction, regulatory reforms and infrastructure programs, then stock market corrections should be contained. Overall, we maintain a cautious but optimistic stance and anticipate rebalancing portfolios, as the individual asset classes exceed our longer-term allocation strategies.

The Rise of Quant investing over Fundamentals

In his book "Stocks for the Long Run", Jeremy Siegel, a renowned Value investor, suggests that stocks while volatile in the short run can provide the most stable returns over time. His findings are based upon diversified portfolios of stocks with relatively low valuations with long term time horizons. Over the last few decades there has been a significant shift in analysis favoring quantitative investment strategies, in efforts to produce higher short term returns. The significant growth in factor-based investing has given rise to market inefficiencies and thus creates an opportunity for fundamental investors. An analysis by Bank of America Merrill Lynch suggests that over time the alpha from short term trading strategies diminishes with time, while fundamentals provide more sound support for long run performance. In fact, over a ten-year period or longer, valuations explain over 80% of stock market returns.

Positioning and Momentum work better In the Short Term | **Fundamentals work better In the Long Term**



Source: BofA Merrill Lynch US Equity & US Quant Strategy

Secular bull markets, defined as upward trending markets that are driven by such things as demographics, sentiment, and/or governmental policies, have varying degrees of longevity. The one we believe we are in now began in 2009 and has had an average annualized return of approximately 14%. A recent analyst conference highlighted several data points in support of continued secular strength on a global basis, while not ruling out the possibility of a near term market correction. In fact, in the current bull market there has been 2 short term corrections, one in 2011 and one in 2015. The Global Stock Sentiment Composite, (a proprietary index measured and released by Ned Davis Research) has been in over-bought territory since the U.S. election, but now appears to be reversing its course. This could be a healthy leveling off, however the downward trend could be interpreted that sentiment is becoming more sensitive to the political turmoil surrounding healthcare, judicial appointments, foreign affairs, and Russian election meddling.

The S&P volatility index which has experienced a few spikes during the past few years, triggered by a significant drop in oil prices, Brexit and U.S. elections, remains at relatively low levels in support of continued market strength. Moving averages are climbing as well, signaling confidence. The Top Notch Indicator, (Ned Davis) is within bullish territory; however, a noticeable downward trend is developing.

For now, we are confident that the industrial production and economic liquidity provided throughout this past decade by the U.S. Federal Reserve, the Eurozone, and the Bank of Japan has been supporting stock markets. That all being said, periodic market corrections are a fact of life. Should the domestic or geopolitical landscape turn more negative, it may be enough to warrant a pullback in equity prices in the short term.

IN SUMMARY:

Overall, the U.S. economy is expanding at a healthy pace with no structural imbalances, and credit conditions remain generally supportive. Consumption continues to strengthen, housing remains strong, and there is evidence that manufacturing and industrial production have strengthened in recent months. At present, both income and employment are healthy year-over-year, and we continue to forecast real GDP growth in excess of 2.5% with CPI inflation of 2.7% and corporate profits exceeding single digit growth record of 2016. The consensus estimate for S&P 500 earnings for 2017 among Wall Street strategists is $130 per share, a gain of 11%. 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 quarter of 2017, we continue to remain positive on the economy and corporate profits, although we recognize that the expectation of accelerated earnings is dependent on the successful adoption of at least some of the economic proposals in the current year. The greatest risks ahead lie in foreign policy which includes the U.S. stance on proposed protectionist initiatives.

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