ALTMAN
INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

JULY, 2018

"It is the set of sails, not the direction of the winds, that determines which way we will go."

Napoleon Hill, 1883-1970

IN FOCUS:

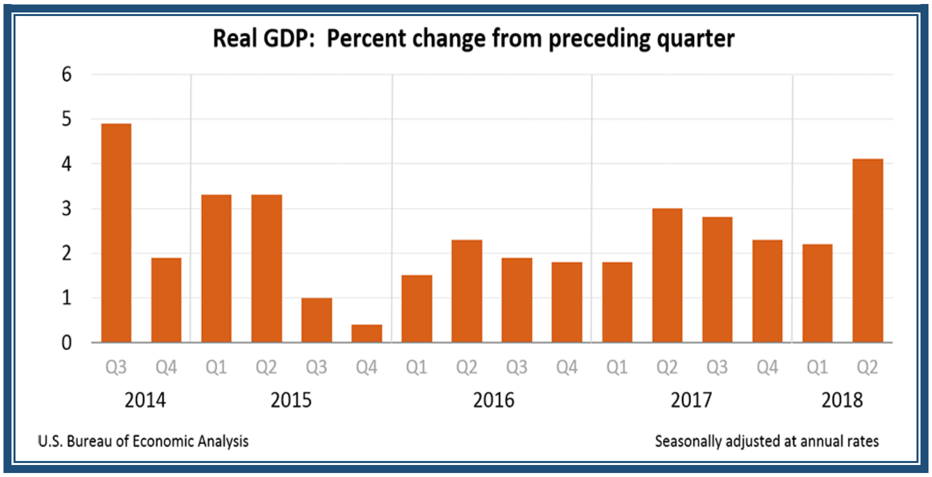
The U.S. equity market as measured by the S&P 500 has certainly been zigzagging so far this year. If you are bearish, then you are seeing a major market top. If you are bullish, it looks more like a consolidation that is forming a base for the S&P 500 to propel to new record highs. We remain in the latter camp.

The S&P 500 has been climbing a "wall of worries", since bottoming in early February at 2580. After retesting the lows in early April, it is up close to 8.0% through the first week of July. We are particularly impressed that the index remains up, despite the imposition in late June of a 25% tariff by the Trump administration on $34 billion of Chinese imports. However, we expect there is more to come and will eventually dampen near term performance results.

There is no disputing that the tax cuts at the end of last year are having a very positive impact on reported earnings this year. Industry analysts were expecting Q2 earnings for the S&P 500 to jump 20.3% with growth rates expected to remain high during the last two quarters of the year. On an industry basis, Q2 earnings growth rates for the S&P 500 sectors were expected to be favorably skewed towards our over weighted exposures in Energy (+141.2%), Tech (+25.5), and Financials (+22.0). The strength in earnings growth is mostly attributable to the tax cut at the end of last year. However, notwithstanding all the concern about a global economic slowdown and the dangers of trade protectionism, the forward revenues of the S&P 500 continued to rise into record-high territory at the end of the second quarter. The same can be said of S&P 500 forward earnings. At current prices, the S&P is selling at 17.9 times our earnings estimate of $157 per share for this year. Based on an estimate of $175 per share for 2019, a gain of 11.5%, the P/E is 16.0. While earnings are growing to record levels, there are increasing headwinds as 2019 approaches, mainly related to the trade dispute with China. Overall, as business cycles age and reach full utilization rates, usually inflation and rising interest rates present valuation challenges. A flattening yield curve is often but not always a signal that a recession is imminent.

CLOSE-UP: The Economic Landscape

We are half way through the year and in the 10th year of an economic recovery. While we are currently in the second longest economic recovery in terms of duration in the post-World War II period, the current expansion ranks only sixth in terms of cumulative real Gross Domestic product (GDP) growth. This month the BEA revised and published a report on the average growth rates for Real GDP covering various economic cycles. They concluded that real GDP average annual growth rates from 1929-1944 were at 5.1%, 1944-1973 at 3.1%, and 1973-1990 at 3.0%. In more recent periods, real GDP was revised slightly up to 3.1% for 1990-2007 and only 1.5% from 2007-2017.



The Bureau of Economic Analysis (BEA) pointed out that output growth during the first half of the year tends to be a bit faster than initially estimated, based on improvements in the BEA's methodology by using seasonal adjustments. This gives more weight to the y/y growth rates of real GDP. Based on these revisions, they reported that the second quarter U.S. real GDP advanced 4.1% led by a similar growth in consumption. They also recognize based on statistical overview that this consumption pattern may not be sustainable into the second half of the year. As we suspected, this recent report ranked as the most rapid growth since the third quarter of 2014. Keep in mind that during the first quarter, real GDP grew by 2.2% with consumption barely positive. In the current quarter, inventories detracted from growth while net exports added to growth.

The export growth rate was materially affected by an expected surge in soybean exports, as buyers accelerated their sales ahead of trade concerns. State and local government expenditures also improved over the first quarter and business spending was also strong, but moderated relative to the first quarter. In addition, federal government spending grew on average by 3.5%, led by a stronger showing in defense spending as compared to the first quarter results. On the weaker side, residential spending growth eroded after a strong showing in the first quarter. We believe that this weakness was caused by both supply constraints in labor and material costs, but not apparently showing up in any weakness from demand. It important to note that inflation (CPI) held constant at 1.8% with overall consumer prices remaining in check.

Overall, it was a strong report which supports our revised 3.3% annual growth rate for 2018. It is noteworthy that consumer confidence still remains supportive and the personal savings rate grew at a healthy 3.3% as well. This growth compares to negative growth rates experienced leading into the financial crisis of 2008. Our concerns today have migrated to the high level of debt associated with credit cards, auto loans and student loans. The long period of extremely low interest rates – implemented by the Federal Reserve to rectify an ailing economy suffering from the Great Recession - has encouraged both consumers, corporations and the federal government to take on excessive debt.

As a result, the Federal Reserve is now faced with the daunting challenge of both normalizing its balance sheet of $4.5 trillion, while at the same time raising interest rates without causing a recession. The main concern of investors centers on the high level of debt that permeates all areas of the economy. However, as demonstrated by the second quarter growth rate, the U.S. economy is extremely strong in almost all sectors and has bolstered impressive corporate profit growth as well. With about 80% of corporations having reported profits for the second quarter, the growth rate is slightly in excess of 20% y/y. Looking ahead, we would expect wage growth to approach 2.7% and continue increasing against a background of 4% unemployment and higher material costs.

In our estimation, the primary driver for the economy's improvement is the lowering of individual tax rates and the reduction in the corporate tax rate from 35% to 21%. According to the IMF, the global economy is currently growing at 3.9% with an expectation of a similar growth rate in 2019. Of course, there are headwinds on the horizon as President Trump addresses our trade deficits, particularly those from China, through the implementation of tariffs. So far, global economies are virtually unaffected and international trade is still supportive of growth. The U.S. is in the enviable position of possessing the primary world reserve currency from which it derives many benefits. Its large borrowing through trade deficits provides liquidity to the world's financial system. However, the Trump administration has concluded that China's ownership of an estimated $1.18 trillion of the U.S. debt is exporting manufacturing jobs offshore. The administration is insisting that China begin the process of reducing its trade surplus with the U.S. by $200 billion by 2020. Realistically, there is no practical way to accomplish this. The U.S. does not have the capacity to fill this trade gap with its economy at such a high level of employment and industrial capacity running at historically high operating rates.

While the actual tariffs implemented so far have had a negligible effect on our economy, **if they were to develop into a full-scale trade war they could do great harm to the global economy - similar to what the Smoot Hawley tariffs did in the Great Depression.** In general, tariffs can be very disruptive to businesses that often lead to gross inefficiencies, bottlenecks and slowing economic activity. It is for these reasons that countries have worked out multilateral trade agreements that involve most countries and make trading beneficial to economic growth.

Overall, economic history shows that the world has greatly benefitted from free trade policies. Of course, there are situations where trading partners do abuse the relationship, taking advantage of the lack of enforceability of abuses. For example, China is guilty of such abuses, with regards to the theft of intellectual property or placing limitations on companies making direct investments in their markets, or where subsidies are given to certain industries that deter competition. In these instances, remediation should be sought in the World Trade Organization (WTO). When these abusive trade practices with the U.S. persist, certainly remedial actions can be taken to ameliorate the issue. However, the costs of implementing such action should be carefully weighed. At present, both China and the E.U. have countered the U.S. policy initiative, resulting in a backlash with both the U.S. farmers and several other sectors of the economy. While President Trump's negotiating tactics might eventually work, the market response so far has not been favorable and has elevated global economic risk.

Of course, some of the relative weakness in the rest of the world reflects the strength of the U.S. economy. In other words, the dollar's strength isn't all about the trade war. Fed officials continue to say that while the trade war may be a threat to U.S. economic growth, they believe the economy will remain strong enough to justify further hikes in the Federal Funds rate from 1.75%-2.00% currently to possibly 2.75%-3.00% next year. Meanwhile, both the ECB and BOJ show no signs of normalizing their official interest rates, which remain abnormally low just below zero.

GDP came in at 4.1% in Q2 - accompanied by improving employment, increasing consumer spending, rising exports and strong manufacturing. We remain confident in the strength of the U.S. economy and have a constructive view on markets. Tax savings and corporate earnings should overshadow potential risks from protectionist policies, as long as trade posturing doesn't escalate into a full-blown longer-term trade war. We are estimating that GDP growth may achieve a 3.3% growth rate for 2018, against 2.7% inflation. We modestly raised our 2018 earnings expectations to 21% growth. We maintain our 10% growth estimate for 2019, as we expect material and labor costs to accelerate over the balance of the year. Rising costs could impact profit growth by yearend and drop our GDP forecast modestly by .02%. Aside from geopolitical issues, the most important data to monitor will be the future rate of inflation and interest rates and their effect on the economy.

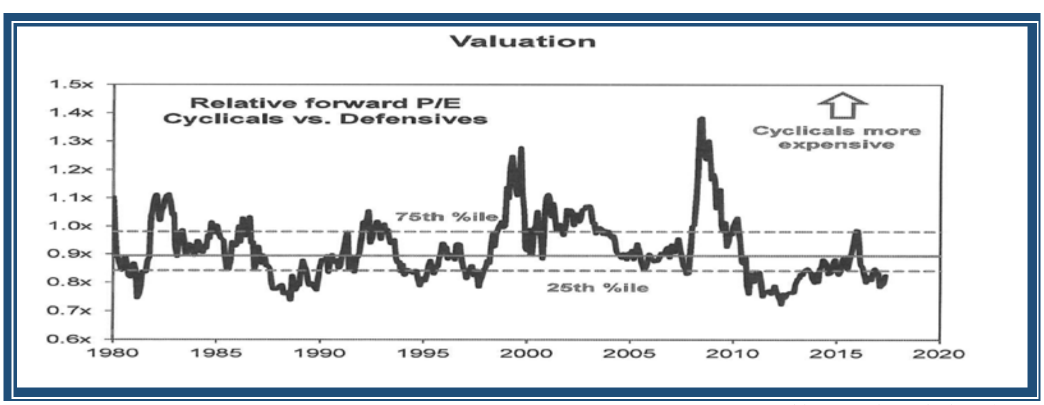
The second round of Trump's tariffs is scheduled to take effect August 23rd on $16 billion of Chinese exports. Beijing will match the move by slapping duties on an equivalent amount of U.S. goods. This follows July's opening salvo when the two placed duties on $34 billion of each other's bilateral exports. More recently, Trump threatened to tax an additional $200 billion of Chinese exports at 25%. That could lead to nearly half the $505 billion China exports to the U.S., about 19% of its total exports, being taxed at 25%, according to the *Financial Times*. China has already taxed $110 billion in U.S. exports.

Should an additional $20+ billion in tariffs go through, the impact would shave 1% from China's GDP, according to *Gavekal Dragonomics*. The trade conflict has exacerbated an already slowing economy, a weakening currency, and a plunging stock market in China. It is eroding the idea that China is invincible, just five months after President Xi Jinping consolidated his hold on power by becoming the country's life long leader and outlining his grandiose vision for China's global ambitions. That move followed Xi's elevation last year to a status on par with the founder of the People's Republic of China, Mao Zedong, and the inclusion of Xi's "new era" political ideas and philosophy in the party constitution.

If new trade agreements with the E. U. ameliorate the trade situation with China, then the future economic outlook should remain resilient. In any event, a balanced approach to investment portfolios with an emphasis on caution in this environment is certainly justified.

IN SUMMARY:

The second quarter earnings season, which is nearly over, has been almost as impressive as the first quarter's earnings result. At the end of last year, industry analysts scrambled again to raise their 2018 and 2019 earnings estimates to reflect the passage of the Tax Cuts and Jobs Act (TCJA). The U.S. economic growth also confirms the earnings reports during the first half of this year. The overall strength reported by the BEA might be attributable to the stimulative impact of the TCJA, as well as to the ongoing lift to earnings from the Trump administration's business deregulation. So far, neither the rise in short-term interest rates, nor the increase in the trade-weighted dollar, nor the escalating trade war has weighed on earnings. We think that earnings will remain strong over the rest of this year. Our year-end target for the S&P 500 index of 3100 is based on earnings for the year that approach $157 per share and an estimate of $175 per share for 2019 and a market multiple of 18 times. Based on the estimates of forward price to earnings, our portfolios emphasize cyclicals versus the defensive stocks, and we remain constructive on the equity markets into 2019.



Source: Goldman Sachs and Bloomberg