ALTMAN
INVESTMENT MANAGEMENT

EQUITY STRATEGY FOCUS

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

It certainly was a good summer for stock and bond investors. From the end of May through the end of August, the S&P 500 rose 2.5%, while the bond yield remained relatively flat around 2.20%, earning the coupon. On the other hand, the trade-weighted dollar fell 3.5% over this period, but that helped to boost commodity prices as the CRB raw industrials spot price index rose 2.0%. It was a good summer for global investors too, with a solid gain in the All Country-World ex-US MSCI stock price index (in local currencies), up 1.3%, led by the MSCI stock price indexes for Emerging Markets (7.6%) as Europe fell 2.1%.

There may be rough patches during the rest of the year, as domestic political tensions heat up over the debt ceiling and tax reform, and geopolitical tensions with North Korea could come to a boil. The good news is that U.S. and global economic outlooks remain relatively calm.

The growth rate in real GDP has been inching up over the past several weeks from 2.6% to 3.0% for the second quarter. On a y/y basis, real GDP was up 2.2%. It has been fluctuating around 2.0% since mid-2010. Excluding government spending, which has been relatively weak during the current expansion, it was up 2.7%. The Fed is now looking for GDP to hit the estimate of 3.2% in the third quarter. Inflation-adjusted consumer spending in real GDP rose 2.7% y/y during July. Capital spending rose 4.4% y/y to a new record high during Q2, confirming the post-election strength in the CEO confidence index. Leading the way are record-high capital outlays on information processing equipment (up 7.0% y/y) and industrial equipment (6.8%).

Released along with the first revision of GDP was data on corporate profits during Q2. On an after-tax basis, reported profits also continued to remain at record highs, recovering this year from their energy-related declines last year. Inflation so far remains sanguine. The GDP implicit price deflator rose just 1.6% y/y during Q2. The Personal Consumption Expenditures (PCE) again posted a directionless trend, edging down on a y/y basis during July to 1.4% for both the headline and core readings. Once again, wage inflation is unspectacular. The Average Hourly Earnings (AHE) measure rose 2.5% y/y for all workers in the private sector. It has been hovering around this pace since the fall of 2015.

While wage inflation remains subdued, it continues to outpace the PCE headline inflation rate. Real average hourly earnings for production and nonsupervisory employees, who currently account for 70% of all private-sector workers, rose to yet another record high during July. This measure is up 17.5% since the start of 2000, contrary to the widespread myth that real wages have stagnated since then. While private-sector payrolls disappointed during August with a gain of 165,000, the comparable ADP Research Institute data release showed a solid increase of 237,000. Overall business activity, new orders and employment continues to sustain solid levels in the recent quarter.

➢ The Global Backdrop

The global economy is running on all cylinders. It may not be a global synchronized boom, but it is the most synchronized expansion of economic activity that the global economy has had since the recovery from the 2008/2009 recession. The expansion may be attributable to the plunge in the price of a barrel of Brent crude oil from a 2014 peak of $115 a barrel to a low of $28 a barrel in January of last year, followed by the recovery to the mid 50's by quarter end. We estimate that global crude oil revenues dropped from an annualized rate of close to $3 trillion during 2014 to one third of that in early 2016. Currently, we have experienced a 50% retracement to $1.5 trillion today.

IN VIEW: The Equity Landscape

In the second quarter, the prospects for approval of a fiscal policy stimulus package by Congress was tabled. The legislative agenda that addressed tax and regulatory reforms stalled and Congress struggled to finalize an agreement on a healthcare bill. Progress was hampered by the ongoing investigations into the executive branch related to obstruction and Russian meddling in the U.S. election. The result was a partial unwinding of the "reflation" trade that accompanied the Trump administration into office. Longer-term Treasury yields declined with the 10-year Treasury ending the quarter at 2.3%, despite the Federal Reserve moving federal funds up an additional 0.25 percentage points in June.

The second half of the year marks the continuation of tax reform negotiations, as Congress returns from its summer recess. Specifics are not yet known but stock performance tells us that lower taxes are highly anticipated. Any indication that impending corporate tax cuts are no longer on the table may signal a pull-back in markets.

Growth stocks regained their momentum after a weak showing for the past two quarters. Investors moved capital offshore to both international and emerging markets, resulting in strong gains in global indices. The MSCI EAFE Index and the MSCI Emerging Markets Index, both were up greater than 6% during the quarter. The current economic expansion, 8 years and running, is now the third longest market expansion in U.S. history according to the National Bureau of Economic Research. One would expect that a maturing expansion would be accompanied by slower growth rates in both top and bottom line corporate results. This phenomenon is often coupled with investors shunning cyclical businesses in favor of companies with growth characteristics independent or less sensitive to the general economy. As slower rates of economic growth begin to accelerate overseas, we would expect a trend favoring growth stocks could take hold in the near term.

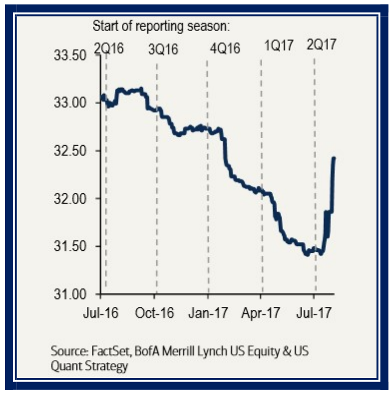
Following the Federal Reserve rate hike in June moving the Fed funds target rate to 1.00% - 1.25%, the Fed telegraphed another increase is possible this year. A plan was outlined for a gradual reduction in the stockpile of Treasury and mortgage securities. It appears that the Fed is intent on normalizing monetary policy and the United States economy will continue to chug along. When they deem necessary, the Fed will move interest rates up slowly to avoid any shocks associated with a tightening cycle. It is important to note that while the unemployment rate touched a 16-year low of 4.3% in May, growth in average hourly earnings has been quite modest, about 2.5% y/y, and core Consumer Price Index (CPI) inflation remains at 1.7%, the lowest post in well over two years.

When value outperforms growth, as was the case in Q4'16 and Q1'17, there is a greater chance of economic surprise. ISM figures came in above 57 while Michigan Sentiment beat expectations. Most reports show employment improving while we continue to await a pick-up in wages. In recognition, managers have increased their relative weighting in cyclicals over defensive stocks during 2017.

Uptick in Value vs. Growth is accompanied by US Economic Surprise

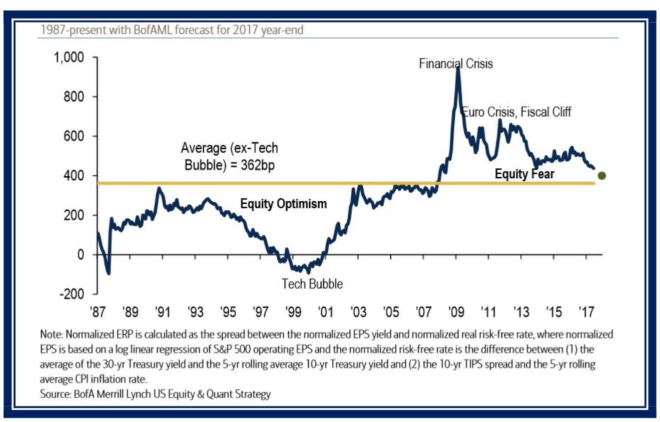
With only a few more weeks to finish out the Q2 earnings season, earnings are trending in at 9% growth and sales at 5%. Healthcare and Technology are beating eps expectations by over 6%, against a -2.8% miss in Energy. Multinational companies are experiencing the most beats on an earnings basis, as those with emerging market exposure are benefiting from a weaker dollar. Although the general tone amongst management is becoming more optimistic, companies that beat expectations are not being rewarded while those that miss are selling off.

Trend in Bottom-Up Consensus 2Q17 EPS

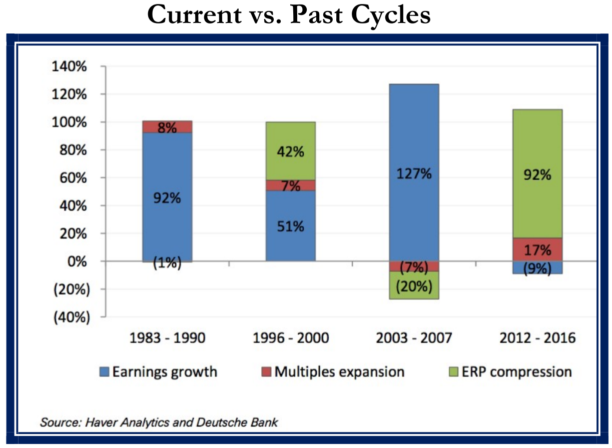


The Equity Risk Premium (ERP) that investors require over bonds has declined since the financial crisis. In the midst of the crisis, investors were demanding over 800 bps above the risk-free rate to own stocks. That number has since retreated to 400 bps (chart below left), suggesting stocks are reverting closer to historical averages. Interestingly, the recent rally has been ERP compression-driven as compared to earnings growth-driven. The ERP which is still trending above fair value suggests that the market does have the potential to move higher.

Normalized Equity Risk Premium

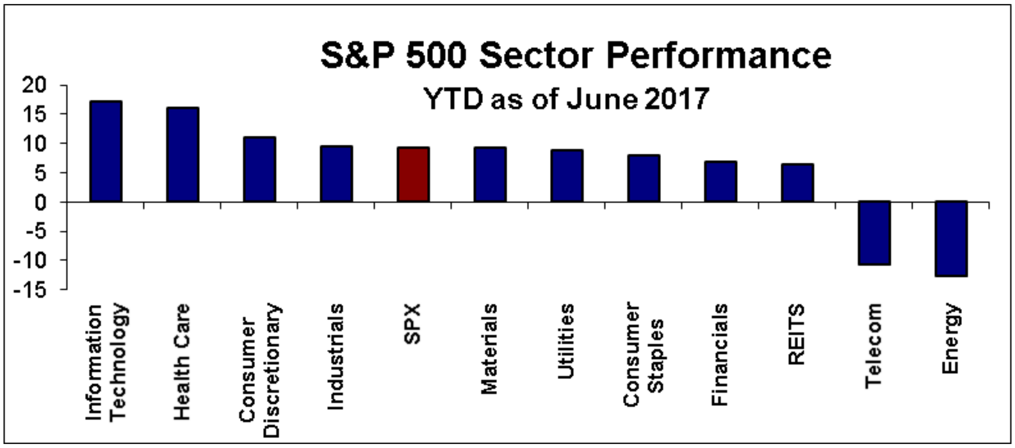


Contribution to S&P 500 Rally Current vs. Past Cycles



CLOSE-UP: Equity Investment Overview

➢ Performance Highlights



- Technology was the top performing sector YTD, finishing the first half up 17%. In the second quarter however, the market appeared to broaden out as Healthcare continued its momentum and Technology tapered off.
- Financials gained momentum in Q2, after trailing the market the previous quarter.
- Consumer Discretionary and Staples sectors lost momentum in Q2, underperforming the market.
- Energy and Telecom remain the worst performers for the year.

AIM Composite– YTD 2017 Performance Attribution

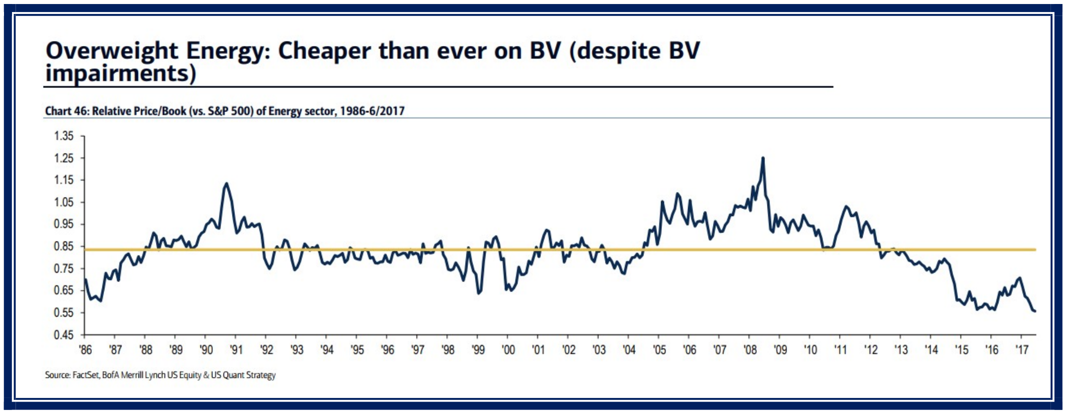
	Sector Wgt. as % of Portfolio as of 6/30/2017	Relative Wgt. versus S&P 500 Index	2nd QTR Total Return of AIM Composite	2nd QTR Total Attribution of AIM Composite	YTD Total Return of AIM Composite	YTD Total Attribution of AIM Composite
AIM Composite			0.8	-2.3	5.5	-3.9
Consumer Discretionary*	8.6	-3.7	1.79	0.04	16.0	0.1
Consumer Staples	9.2	0.1	-5.11	-0.7	-3.0	-1.2
Energy	10.8	4.8	-10.79	-1.03	-17.0	-1.7
Financials	18.6	4.1	4.23	0.06	6.6	-0.1
Health Care	15.3	0.8	2.59	-0.6	11.0	-0.6
Industrials*	9.0	-1.3	6.57	0.29	12.5	0.4
Information Technology	19.9	-2.4	3.65	-0.47	13.9	-0.8
Materials	2.9	0.0	0.78	-0.07	14.3	0.1
REITS	0.0	-2.9	--	0.01	--	0.1
Telecommunication Services	2.1	0.0	-8.08	-0.02	-9.3	0.1
Utilities	2.3	-0.9	-1.1	-0.07	10.1	0.0

*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.

- During Q2, Industrials, Financials, and Consumer Discretionary stocks added to relative performance against the S&P 500 index. The top 5 names adding to attribution were Oracle, McDonalds, Philips Electronics, Baxter, and Applied Materials.
- Energy, Consumer Staples, and Information Technology were the largest relative underperformers for this same time period. This contrarian strategy associated with the Energy sector that hindered first half performance warrants more patience. The top 5 names detracting from relative performance were Archer Daniels, Cardinal Health, Cisco, Conagra, and Lowes.

➢ Equity Strategy

Our composite portfolio is over-weight in cyclical sectors such as Financials and Energy. The longer-term outlook for higher interest rates bodes well for Financials as does decreased regulations that may be on the horizon. Fund managers remain under-weight Energy versus the benchmark S&P 500 index, however their relative weighting has increased to just under 80%, up from 65% in 2015. Oil prices once again dipped below the $50 mark in Q2, making valuations even more attractive and supporting our over-weight position. If the shift from Technology into Energy continues, this would underscore a continuation in the shift from growth to value.



Consensus estimates rank Technology, Financials, and Energy as the largest contributors to earnings through 2018, accounting for nearly 2/3rds of earnings growth expectations. Adding a position in Keysight Technology in Q2 highlights our opportunistic approach to continued investment within the Technology sector.

While the market looks expensive, we continue to seek holdings that present buying opportunities. As a whole, our composite portfolio is constructed with the intention of keeping most valuation metrics below that of the market. We favor large cap high-quality stocks. The average weighted market cap for our composite portfolio is nearly 43% smaller than that of the average benchmark S&P 500 index.

Our beta is currently higher than the market which is attributable to our 3 largest sectors; Financial, Energy, and Technology. Price to book is at a 25% discount and current P/E is at a 7% discount to the market. It is important to note that only four companies within the S&P 500 index (Apple, Facebook, Amazon, and Alphabet) accounted for 23% of its return in the first half of 2017.

Equity Composite Characteristics
As of June 30th, 2017

	AIM LLC	S&P Index	S&P Barra Value Index	Russell 1000 Value Index
# holdings	39	500		
Beta	1.06	1.00	0.97	0.98
P/B	2.36	3.13	2.46	2.30
P/E cur	17.16	18.53	16.95	16.93
P/E FY1	15.36	16.68	15.43	15.50
P/S TTM	1.53	2.03	1.66	1.67
Div yield	2.27%	2.00%	2.44%	2.33%
P/CF	13.10	12.75	11.36	10.77
mrt cap wgt	111,114	166,026	118,542	103,902
EQ wgt	92,277	45,195	39,936	22,726
top 10 Hld.	32.34%	18.40%	19.59%	16.02%

Data Source: Altman Investment Management and Bloomberg

IN SUMMARY

Typically, August and September have been the worst months of the calendar, as measured over the past 29 years according to Ned Davis Research. With typically low trading volume during summer periods, investors return from their vacations in a negative mood. This time around, we hope to use the seasonal weakness as an opportunity to buy the dips, with the expectation that the overall market will hit new highs by yearend. As profit margins expand, market participation increases and monetary accommodation continues with most of the central banks. "The wall of worry" associated with geopolitical uncertainty and declining yields supports an overweight allocation to equities. Our overweight position in the banking industry and the Technology sector, relative to the Value benchmarks, demonstrates our focus on the cheapest segments of the market as the second half of the year unfolds.