ALTMAN
INVESTMENT MANAGEMENT

# MARKET PERSPECTIVE

**OCTOBER, 2017**

**"Indeed, we have usually made our best purchases when apprehensions about some macro event were at a peak. Fear is the foe of the faddist, but the friend of the fundamentalist."**

Warren Buffet, Chairman's Letter 1994

## IN FOCUS:

**Investors continue to tune out the political static and instead focus on what ultimately affects capital markets in the longer run; the sustainability of the economic expansion, corporate profit expansion and job creation.** So, let's first look at the performance record. U.S. stock prices moved higher in the third quarter of 2017, amid a global rally that produced sizable gains across most markets. The S&P 500® Index, which rose 4.5%, and the Nasdaq composite, up 6.1%, ended the quarter at all-time highs. This was the eighth consecutive quarterly advance for the S&P 500 Index and its 18th in the last 19 quarters. International and emerging market share prices had similar results, with the MSCI EAFE Index rising 5.4% and the MSCI Emerging Markets Index gaining an impressive 7.9% during the quarter.

**As the year progresses, investors are faced with a growing conundrum - the Federal Reserve has announced a program to begin reducing the size of its $4.5 trillion balance sheet while also raising interest rates to continue its program of monetary normalization.** Although we expect one more rate increase this year in December, we are forecasting that at least three more hikes are a possibility in 2018 depending upon the rate of inflation and the strength of the economy. At present, the federal funds rate trades at 1.0% - 1.25%.

**Both the economy and stock market are in their ninth year of recovery from the 2008 financial crisis that brought about the Great Recession.** While the economy at present appears resilient enough to maintain real GDP growth of 2.5% or higher, the stock and bond markets could be vulnerable to higher interest rates and record levels of valuation. Previous bullish markets were in response to the Federal Reserve lowering interest rates coupled with a program of quantitative easing to boost the economy. However, the general economy continues to confirm accelerated corporate earnings, after a brief interruption in 2016, and we look for further improvement next year to support valuation premiums.

**In October, the real GDP for the third quarter was announced at 3.1%, despite the negative impact by hurricane damage.** Our expectation was that economic growth would resume the growth rate of the first quarter of 3.0%+ and plow through the second quarter pause of 1.2%. Overall, we believe the underlying trend of growth will begin accelerating in the fourth quarter and could achieve an estimated 3.5%+ growth into 2018. While much economic commentary seems to conclude that the 2.0% economic growth rate that has occurred since the Great Recession is embedded in the future because of structural changes and demographics, we believe that growth could trend higher. The second quarter 3.1% GDP growth suggests that a positive change is well underway in the U.S. economy and has been reflected in the optimism of the financial markets. Not only was there higher growth that led to higher employment, but the share of investment increased while the government sector modestly declined. It is noteworthy to mention that consumption actually accounted for 2.3% of the total growth of 3.1%.

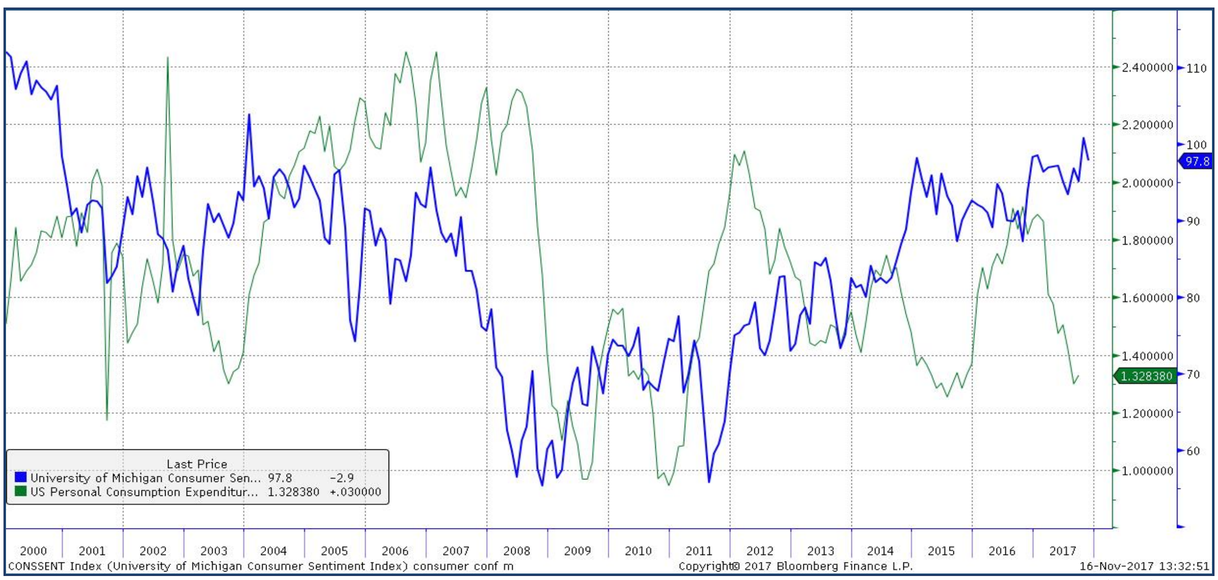
**At present, we remain positive on the U.S. economy with a forecast of 2.7% real GDP growth in 2017, with the CPI at 2.0% and corporate profits up 10.0%+.** For 2018, we believe that GDP can advance by 3.5% with CPI inflation of 2.7% (up from our earlier forecast of 2.5%) and corporate profits continue rising in the high single digits with a possible acceleration based on the potential for tax reform.

## CLOSE-UP: The Economic Landscape

**The combination of tax cuts and reform along with a significant reduction in business regulations, as well as the possibility of an overall infrastructure program, could speed up economic growth as envisioned in the Trump Administration's legislative agenda.** While legislation has been materially delayed in 2017 as a result of the inability of Congress to put together a viable alternative to Obamacare in the fall, a restructure health law in 2018, if properly developed, could lower costs and improve health care efficiency. The second quarter result of 3.1% GDP growth suggests that we are doing just fine without Washington's help. As jobs continue to forge ahead correlating with the unemployment rate, consumer confidence is soaring with the Consumer Sentiment Index jumping to levels not experienced since 2000. Average hourly earnings rose 2.5% y/y and wages rose 2.6% during the third quarter, and should reverse the Personal Consumption Index, as the overall economy resumes a higher level of growth than we have seen over the last several years (see Exhibit I below). Retail and vehicle sales were understandably slow in October, following more robust hurricane-related demand in September. Sales showed solid results within the electronics, appliances, health and personal care industries.

**Exhibit I**

*University of Michigan Sentiment Index vs Personal Consumption*




Source: Bloomberg

**Consumer Confidence is coincident with the jobs data, and the highly correlated unemployment rate suggests that the jobless rate is still falling.** In the past, there has been a reasonably good correlation between wage inflation and the jobs data. This has shown up in the yearly percent change in the average hourly earnings and the Employment Cost Index (ECI). Both remain surprisingly low given the plentitude of jobs.

**On the inflation front, readings remained subdued in the United States as well as globally.** Through October, the Fed's preferred measure of inflation, the Personal Consumption Expenditures (PCE) price index, was 2.6% higher from a year ago. The core PCE index, which excludes food and energy prices, was up 1.3% — the lowest level since November 2015. In the euro zone, however, annual inflation ticked up to 1.4% from 1.3% in the summer. Meanwhile, in Japan, annual inflation was running at 0.7%, which - while low - was the fastest pace in more than two years.

**With respect to energy, crude oil prices rebounded, ending the third quarter near year-end 2016 levels.** Brent crude, the international benchmark, rose 21% to $57, while West Texas Intermediate (WTI), the domestic benchmark, was up 12% to $51 at the time of this writing. The spread between the two benchmarks increased from less than $2 to nearly $6 - owing, in part, to tighter supplies outside the U.S. due to production cuts by the Organization of the Petroleum Exporting Countries (OPEC). U.S. gasoline prices also moved higher following Hurricane Harvey and the storm's destructive effects on Gulf Coast refineries. The average price of a gallon of regular gasoline (all areas, all formulations) jumped 13% in the third quarter, according to the U.S. Energy Information Administration.

**The year-over-year overall CPI rate, which declined by 0.20% in October, has been struggling to hold the 2.0% target set by the Fed.** The overall rate was held down in October by a post-hurricane reversal in energy prices and another flat month for food, where prices are up only 1.3% for the year. On the plus side, an increase in wireless service costs and the pass-through from isolated instances of wage strength have begun to add to inflation.

**Keep in mind that durable goods orders have been mixed this year, but broke out to the upside in August and September with an average 2.0% increase in both months.** Capital goods orders are expected to continue expanding at very healthy rates of growth, and we expect existing home sales will support a 5.4 million annualized rate.

**At its September meeting, the U.S. Federal Reserve decided to leave the federal funds rate unchanged after implementing two 0.25 percentage point increases earlier this year,** three including the December 2016 rate hike. Notably, in a unanimous decision, the Fed confirmed that it will begin shrinking its $4.5 trillion balance sheet by not reinvesting some of its bond holdings as they mature. Reductions of $50 billion per month are expected to begin in the fall of 2018. The odds for a December Fed rate hike is still on track for a third rate hike this year. However, a point of contention that might influence future Fed policy is the flattening yield curve. Shorter-term yields have been rising due to Fed guidance, while longer-term yields have been muted due to lower inflation expectations.

**If the Fed is too aggressive in their rate hike projections this could push short-end yields even higher which hurts profits within the financial sector and could slow economic growth.** The last thing the Fed wants is an unintentional inverted yield curve (short-term yields higher than longer-term) as this has historically signaled an economic recession. The Fed is aware of this and December's policy statement will likely need to convey a slow-and-steady pace in 2018 as a result. Equity investors will certainly keep a close eye on yields. As a backdrop, the 2-year/10-year spread started 2017 at 125 basis points and has narrowed to 75 basis points.

## *The Financial Markets:*

**Recent market euphoria has been in response to Congress attempting to pass legislation before year end potential tax-law changes.** While we understand the enthusiasm generated by the prospect of a simplified tax code and lower rates, especially for the corporate sector, we remain skeptical that there is an appetite for deficit spending in the Senate, despite the vulnerability to midterm elections should nothing get done.

**We are faced with assessing if the market is getting ahead of itself.** What will the tax plan look like, assuming Republicans in Congress can agree on a plan? Will it be revenue-neutral or will it add to the deficit at a time of growing entitlement spending and high indebtedness? Since reconciliation will be required to pass a plan using a simple majority vote, what provisions might expire under budget rules and how might this limit the long-term effectiveness of lower tax rates?

**Tax plan uncertainties notwithstanding, our biggest concern as long-term investors is the stock market's valuation.** The price-earnings ratio of the S&P 500 Index is now above its historic average based on 12-month reported earnings and higher on real 10-year average earnings, according to Ned Davis Research. From these levels, prospective returns could likely be below average. As these potential risks are rising, we remain focused on mitigating downside risk and emphasizing higher-quality companies that we believe offer attractive relative value.

**The pattern of the past few quarters was repeated in the third quarter, as U.S. equities rallied sharply into earnings season and investors realized that earnings estimates in general were far too low especially in Tech, Energy and Financials (ex-insurance).** After months of increasing earnings estimates, analysts began trimming expectations this past summer. Despite these revisions, earnings are still expected to rise better than 12% in all three sectors this year and very close to the forward price to earnings ratio. If earnings materialize as expected, they could be bolstered by additional accounting changes as has been the case in previous quarters, and could further support higher equity prices.

**At present, we continue to forecast a gain of 10% to $143 for 2018 bringing, the P/E multiple to 18.4.** A corporate tax cut to 25% from the current 35% would add another 6.0 -7.0%, bringing S&P earnings to $151 per share and resulting in a P/E multiple of 16.7. Given the complexities of achieving this legislative goal, and making allowances for the fact that many companies do not pay 35% because of various loopholes, one must recognize that the latter earnings figure could be overoptimistic. Given the high valuations of stocks overall and the probable higher interest rate environment looking ahead, we continue to maintain a disciplined approach to our value-oriented philosophy as the overall market trades at a premium to the historic averages.

## *Valuations:*

**In addressing overall market valuations, relative to the economic cycle, we consider many alternative indicators that help frame our perspective on market participation.** One method that is particularly reassuring was put forth by Warren Buffet in 2001 which outlined that when the market trades (market capitalization) at discount to GDP (price to sales), this historically has represented an opportunity to buy securities. Exhibit II below shows that although the relation between the value of stocks against their overall sales receipts has been narrowing, stocks still remain relatively attractive especially when considering investment alternatives in fixed income markets.

**Exhibit II**


Source: Bloomberg

**Merrill Lynch Research has effectively used the ratio – market capitalization relative to book value - as a lead indicator when focusing on sector strategy implementation: o**verweighting sectors that trade at historically low valuations relative to current market capitalization; and underweighting sectors that trade at the higher end of their valuation bands. On an aggregate basis, you can see from the price to book valuation chart below (Exhibit III) that the markets aggregate ratio is still significantly below historic levels, suggesting that asset rich companies found in the value space have room to appreciate against their growth counterparts.

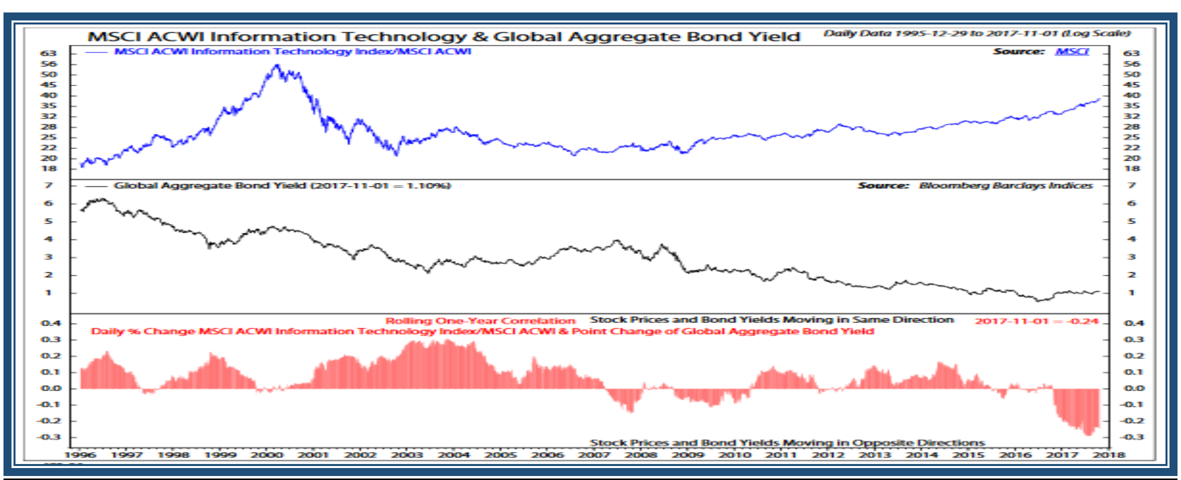
**Exhibit III**


Source: Bloomberg

## *When Will Rising Interest Rates Threaten Equities?*

**Guessing the level where rising 10-year yields will threaten the cyclical bull in stocks is a popular game right now.** But it would be best to let the markets answer the question. When correlations between market indices and bond yields shift from positive to negative, inflection points historically will have been reached, according to Ned Davis. Correlations currently say that for most of the world's market cap, bond yields can be expected to rise in tandem with climbing stock prices. But as bond yields inch higher, this coincident correlation breaks down (see Exhibit IV).

**Exhibit IV**




Source: Ned Davis Research

### *What Do the Tech Sector Correlations Tell Us?*

**Ned Davis also points out that there is early warning that rising interest rates could begin negatively impacting the Tech sector (which has the second highest weight in the ACWI behind Financials).** The correlation of each ACWI sector and its relative strength line to the Global Aggregate Bond Yield is shown in Exhibit V. Tech's relative strength correlation has turned negative, declining more than the correlations of any other sector over the one-year period, and warrants monitoring.

**Exhibit V**

ACWI SECTOR INDEX CORRELATIONS TO GLOBAL AGGREGATE BOND YIELD

| Sector | Current Correlation 11/1/17 | Correlation 11/1/16 | One-Year Change |
|---|---|---|---|
| Financials | 0.59 | 0.42 | 0.17 |
| Industrials | 0.42 | 0.27 | 0.16 |
| Materials | 0.29 | 0.23 | 0.06 |
| Consumer Discretionary | 0.26 | 0.28 | -0.02 |
| Energy | 0.22 | 0.28 | -0.07 |
| Health Care | 0.17 | 0.16 | 0.01 |
| Information Technology | 0.05 | 0.26 | -0.21 |
| Telecommunication Services | -0.04 | 0.14 | -0.18 |
| Consumer Staples | -0.17 | 0.06 | -0.23 |
| Utilities | -0.38 | -0.08 | -0.30 |

***Report Notes:***
*Data sources: MSCI & Bloomberg Barclays Indices.*

Source: Ned Davis Research

## LOOKING AHEAD TO 2018:

Global growth is in the midst of a synchronized upswing, led by developed markets, and with support from recovery in emerging economies. The U.S. is benefitting from loose financial conditions and a strong labor market, while growth surprises are driving up the Eurozone outlook significantly higher. In 2018, we are expecting a modest slowdown overseas, but we expect growth to remain above trend.

Overweighting equities in balanced portfolios remains our preferred strategy. After the run-up in stocks this year, we expect moderate but positive returns next year, supported by the continuing expansion and earnings. Equities in the U.S., as measured by the S&P 500 Index, currently sell at 19.8x earnings, and a 10% growth expectation for next year brings valuations still within historic ranges.

Our portfolios are constructed with investments that trade at a significant discount to their intrinsic value - providing a "margin of safety" during periods of market weakness, as described by Benjamin Graham in his book *The Intelligent Investor*. Over the past several years, the market performance has been dominated by relatively few participants which we have consciously avoided based on expensive valuations. This approach gives us confidence that our portfolios should benefit from this discipline and reduce excessive risk associated with market corrections. In this type of environment, the possibility of over-optimism reaffirms this "value" approach, emphasizing low price-to-earnings ratios, above-average dividend yields and low corporate leverage.

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