ALTMAN
INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

OCTOBER, 2019

"It would not be foolish to contemplate the possibility of a far greater progress still."

John Maynard Keynes

IN FOCUS:

During the third quarter, the broad market S&P 500® Index advanced 1.7% on a total return basis, pushing overall returns up to 20.6% year to date. This was the strongest performance through the first three quarters since 1997, according to Bloomberg Research. Q3 was characterized by considerable volatility. A range of assets – including stocks, bonds, crude oil, and industrial and agricultural commodities – experienced large price swings as investors responded to central bank actions, geopolitical events, and trade war developments, among other things. It appears that geopolitical and Federal bank policy considerations, rather than company fundamentals, have been the driving force behind current financial market returns.

During the quarter, the Federal Open Market Committee (FOMC) cut the federal funds rate twice, by 0.25 percentage points each time, leaving its target range at 1.75% to 2.00%. These were the first interest rate cuts since 2008, following a series of nine quarter-point increases that began in late 2015 and ended in December 2018. The Federal Reserve cited "the implications of global developments for the economic outlook as well as muted inflation pressures" as part of its justification for these moves. The European Central Bank (ECB) also turned to new rounds of stimulus, lowering its key interest rate by 0.1 percentage points to -0.5% and restarting its government bond-buying program with monthly purchases of €20 billion. The ECB had only recently ended its bond-buying program in December 2018.

The U.S. economy expanded 2.1% in the third quarter of 2019, at a seasonally adjusted annual rate, according to data from the U.S. Department of Commerce on real gross domestic product (GDP). Personal consumption expenditures were up 2.9% from the second quarter. This was offset, in part, by weak capital expenditures. In the 19-country euro-zone area, GDP growth expanded below 1.0%, the lowest level in five years and just below the 1.2% figure recorded for the first quarter of 2019. Japan's economy grew 1.3% in the second quarter. In September, the Organization for Economic Cooperation and Development (OECD) lowered its 2019 global growth forecast to 2.9% from 3.6%. In November, the global manufacturing PMI picked up slightly from 49.8 to 50.3. This means that the PMI has now increased for four consecutive months, which is the longest spell of improvement since the current downturn began at the start of 2018, according to Capital Economics

Yields on U.S. Treasury securities headed lower during the third quarter, as investors gravitated toward the relative quality, safety, and liquidity of U.S. government bonds (bond yields and prices move in opposite directions). The yield on the benchmark 10-year Treasury note sank to 1.46% (a three-year low) before settling at 1.68% at quarter end. The yield was 2.63% at the beginning of 2019. Negative yielding global debt hit a new high of $17 trillion at the end of August. (Source: Bloomberg)

CLOSE-UP: The Economic Landscape as the Fourth Quarter Unfolds

Beginning in the 2nd quarter, the U.S. and global economies hit another soft patch, partly attributable to Trump's escalating trade wars. This was confirmed by the growth rate of aggregate S&P 500 sales that weakened to an estimated 3.0% from last year's peak of close to 8.0%. The Energy sector again dragged down the results similar to the same period in 2015. However, for much of last year energy revenues were growing at double-digit rates. We expect this soft patch in energy to continue into the fourth quarter with growth in revenues closer to flat year-over-year.

The key question is whether current global growth forecasts for next year are too optimistic with U.S. revenue growth expectations at 5%. The good news about revenue forecasts is that analysts have been moving forward revenues up all year. Although analysts tend to be optimistic with their revenue assumptions, they tend to be more accurate than their earnings forecasts which have been holding up fairly well all year.

The IMF World Economic Outlook just confirmed that: "The global economy is in a synchronized slowdown", with growth for 2019 downgraded again - to 3 percent - its slowest pace since the global financial crisis. This is a significant revision from 3.8 percent in 2017, when the world was in a synchronized upswing. This subdued growth is a consequence of rising trade barriers; elevated uncertainty surrounding trade and geopolitics; idiosyncratic factors causing macroeconomic strain in several emerging market economies; and structural factors, such as low productivity growth and aging demographics in advanced economies.

Global growth in 2020 is projected to improve modestly to 3.4 percent. However, unlike the synchronized slowdown, this recovery is not broad based and is precarious. Growth for advanced economies is projected to slow to 1.7 percent in 2019 and 2020, while emerging market and developing economies are projected to experience a growth pick up from 3.9 percent in 2019 to 4.6 percent in 2020.

Available data suggest that world GDP growth was stable at around 3% annualized in the third quarter, which is below the ten-year average of 3.5% but stronger than the 2.5% pace recorded in the second half of last year. Growth looks to have accelerated in emerging economies, mainly thanks to a policy-driven rebound in India. But there appears to have been a slowdown in the developed. There are some signs that industrial production and exports, which have been the weakest parts of the global economy in recent months, may be bottoming out. But at the same time, the latest surveys of hiring intentions have implied that labor markets will weaken further. This, together with sharp price increases in China, will weigh on real incomes and household spending growth, keeping the global economy growing at a subdued rate for a bit longer.

Although this won't get investors too excited, we do concur with the IMF projection that global growth should pick up next year. We expect that Trump will continue to deescalate America's trade tensions with the rest of the world as the 2020 presidential election approaches. We've been expecting a soft Brexit deal, which has now been extended through January 31st. We believe that Germany's manufacturing output is bottoming along with the country's car production. Recent Chinese data including the M-PMI, rail freight traffic, and bank loans are all modestly improving. The latest rounds of easing by the Fed and ECB should provide some policy stimulus for the global economy.

The U.S. Outlook

The U.S. economy has grown at 2.1%, as measured by real GDP, for the twelve months through September. Overall however, the economy is slowing from the 2.9% growth attained in 2018, particularly in the manufacturing sector that is about 12% of the economy. The main culprit is export sales that is being hurt by tariffs imposed because of the trade war with China. The services sector however, continues to grow at a healthy rate and that explains the strong employment levels with unemployment of 3.7%, close to a 50-year low. The particular statistics that are important in measuring the changes in the economy are reflected in the Institute for Supply Management's Purchasing Managers Indices (PMI) for manufacturing and non-manufacturing or services.

In September, the Manufacturing PMI was 48.1% versus 49.1% in August, the second time since the financial crisis in 2008 that the number dropped below 50% which represents a potential contracting economy. The main culprit was new orders that declined from 49.1% in October from 50.8% in August. Production was down below 49.1% while employment hovered at 46.6%. With regard to services, the PMI in September was 47.8% versus 56.4% in August after four declines in the prior months. New orders increased to 47.3 from 47.2% in August while employment decreased to 46.3 from 47.4%. Business managers being interviewed suggest that the uncertainty regarding the tariffs and supply chains are having an effect on their investment plans. Investors should therefore follow closely the trade talks with China in the fourth quarter.

There are many moving parts to the economy and most statistics are reported with time lags of one or two months. The Conference Board Leading Economic Index is therefore important to follow and at 111.7 in October, a decline of 0.1% from September. The weakness came from manufacturing and the interest rate spread whereas strength emanated from strong consumer spending and robust job growth. The conclusion from the above index is that the economy is still expanding but at a slower rate. Durable goods orders for September were reported following a rise in July up 2.1% driven by transportation equipment. The series is extremely volatile but has increased in 8 of the last 12 months. Non-defense capital goods orders, ex-transportation, an important index of capital spending has been in a slow descent since September of 2017 and is now on a flat line but not yet negative. In summary, most Economists are taking the view that the latest improvements are against the background of a recession in manufacturing led by the trade dispute. We conclude that the overall U.S. economy is slowing due to slower widespread global growth. Both the World Bank and OECD are forecasting global growth of 2.9% this year.

One area of the economy currently improving after many months of sluggish growth is residential construction. The fall in 30-year fixed mortgage rates to 3.5% is credited with the improvement. In August, housing starts reached a seasonally adjusted annual rate of 1.375 million units, the highest level since June of 2007. More recently, the figure has dropped back to 1.314 but remains robust. Shortages of land and labor have been blamed for the dismal growth in homebuilding to date. One should mention that historically, housing has often thrived during recessions when interest rates fall. The Federal Reserve's recent action to lower the Federal Funds rate by 25 basis points to 1.75%-2.00% will have a continuing positive impact on housing investment.

There is a growing dispute among Federal Reserve officials as to how weak the economy is and how far to lower rates. One of the issues rarely mentioned is the structural harm that extremely low interest rates can do to an economy. For example, borrowing is in effect subsidized while saving is discouraged. Excessively high rates of borrowing can lead to uneconomic investments while excessively low interest rates can negatively impact the return on investment, thereby hurting retirees and the institutions that provide pensions. Another example is the harm done to life insurance companies. At present, we believe that the U.S. economy, as measured by real GDP, will grow at 2.5 % in 2019, with a CPI of 2.0% and a growth in corporate profits estimated at 5.8%.

The Federal Reserve

Since Chairman Powell's recent speech, stock prices have responded positively as he reassured markets stating: "While not everyone fully shares economic opportunities, and the economy faces some risks, overall it is - as I like to say - in a good place. Our job is to keep it there as long as possible."

The latest batch of PMIs and employment reports in October suggested to many investors that the Fed may need to cut the federal funds rate for a third time this year at the next FOMC meeting, to keep the economy in a good place. Those expectations were clearly reflected in interest rates early in the 3rd quarter - Federal funds rate futures fell sharply in the end of the third quarter. The Federal funds rate range moved to 1.75%-2.00% and futures rates fell to 1.64% for the nearby contract, 1.56% for the 3-month, 1.30% for the 6-month, and 1.06% for the 12-month. That implies three to four rate cuts of 25bps over the next 12 months.

Given the latest weak PMIs, a 25 bp cut seems most likely and in accordance with Powell's commitment to keep the economy in a "good place". The only question remains is whether there is another rate cut in the cards this year. FRBNY President John Williams believes that the Fed needs to act more aggressively to lower the Federal funds rate when it is so close to zero, to get ahead of deflationary pressures. He said so in a July speech - "when you only have so much stimulus at your disposal, it pays to act quickly to lower rates at the first sign of economic distress." coincident trends in macroeconomic and trade relations will become more evident as the 4th quarter unfolds.

At present, the 3-month Treasury bill yields 1.56%, an appreciable decline from 1.9% a month ago. 10-year Treasury bonds yield 1.7% while long-term high-quality corporate bonds yield 3.1%. Long-term municipal bonds (1-10 year) yield 1.68% and 30-year mortgage bonds 3.25%. While the Federal Reserve has lowered interest rates, some interest rates have increased because of stronger industrial production and the services PMI reports. Also, the recent attack on Saudi Arabian oil facilities, that strengthened oil prices while taking out 5.0% of global oil capacity, affected credit markets. The Bloomberg Commodity Index (164.7) was flat from beginning of October with oil ($56.07) per barrel.

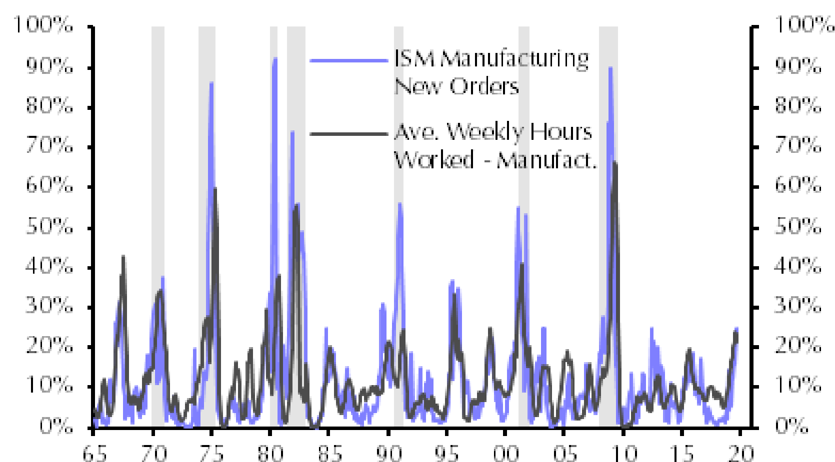
Gold at $1479 per ounce has remained relatively flat since August. The U.S. Dollar Index (97.6) was also unchanged from October, but down 1.7% from September 30th. While a commodity rise would suggest stronger economic conditions, most economists seem to take the view that the economy is slowing unless the trade concerns abate. The S&P 500 Stock Index at the end of September (2976) is up slightly from last month and currently sells at 18.1 times our $164 per share estimate of earnings for 2019. The valuation is little changed from the consensus estimates. Earnings estimates have come down as the trade dispute has worsened and the year has progressed. The decline in global forecasts has also affected valuations as foreign earnings are about 40% of the S&P 500 Index.

A major milestone was reached in Q3, as assets of index funds reached $4.27 trillion versus $4.25 trillion in stock-picking funds, or managed money, according to Morningstar, Inc. This is one of the more dramatic transformations in the history of financial markets. Over the past decade, while fund indices and ETFs grew by $1.36 trillion, managed fee-based funds lost $1.32 trillion in flows. The change lowered the price of investing for investors and has given the managers of indexed products much more influence over the activities of corporate managers. Nevertheless, according to the Investment Company Institute, U.S.-focused equity funds make up about 14.0% of the U.S. stock market, up from 7.0% in 2010. Economists believe that they account for about 5.0% of trading activity. The above phenomenon accelerated after the stock market crash of 2008-9 when many investors felt that their managers had failed to adequately protect them. Passive investing continued to grow in the decade following the financial crisis, as many managed funds could not keep up with the S&P 500 Index through 2018. It would seem to us however, that given the inevitability of periodic falling equity values over time, investors would want an experienced investor at the controls.

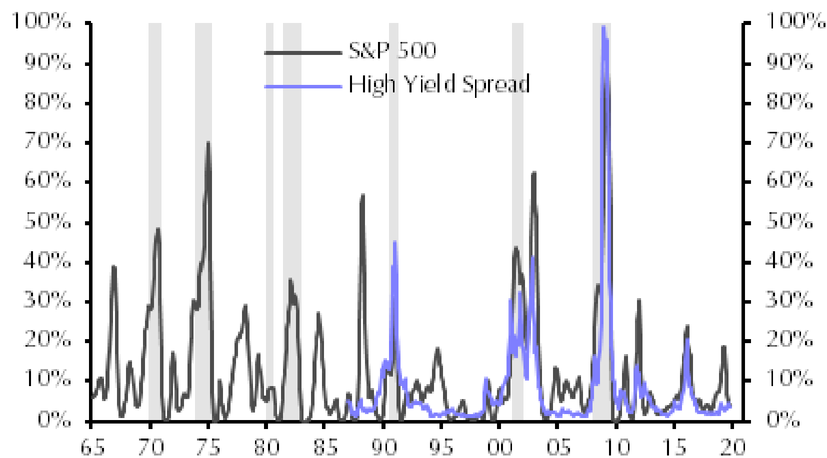
The Yield Curve Reversal

The reversal of the yield curve inversion indicates that the probability of a recession in 12 months' time has fallen considerably since the second quarter. Nevertheless, we shouldn't make the mistake of concluding that the threat has passed completely – the yield curve did occasionally un-invert ahead of historical recessionary experiences. It is relatively rare when the yield curve inverts without a recession following within the next year or two. We recognize that there are structural declines in the term premium on long-dated bonds. This means that the yield curve might not be as reliable as a recession indicator in the current environment.

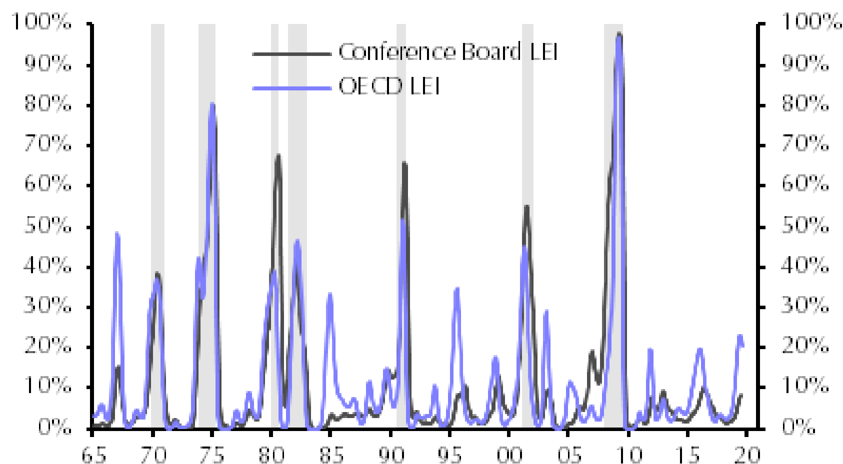
But the bottom line is that, aside from the yield curve, there is a lot of evidence that economic growth has slowed, but not enough to result in an outright contraction. At shorter time horizons, the weak manufacturing sector is close to recessionary levels – particularly with the further slump in the ISM manufacturing index to well below the 50 mark in September. That said, while the key manufacturing recession indicators – the ISM new orders and average weekly hours worked – do point to a slightly elevated risk, neither is high enough to rule out another false positive. Furthermore, there is a possibility of a partial rebound now that the GM strike has ended.



Aside from the yield curve, other financial indicators – including the S&P 500 and credit spreads – still suggest the risk of a recession within the next few months is quite low.



Finally, although the Conference Board's leading indicators index declined in month-on-month terms in both August and September, the six-month annualized growth rate remains positive and, consequently, it still suggests the recession risk is low. The alternative OECD index does point to a higher risk, but that index has signaled a number of false positives in recent years.



Here in brief is why the bond yield has been rising lately:

(1) *Reversing the self-fulfilling prophecy.* The U.S. bond yield fell to this year's low and inverted the yield curve on recession fears. The yield curve reversal in recent weeks has since reduced those fears.

(2) *De-escalating the trade war.* Also stoking recession fears was Trump's escalating trade war with China. It has been deescalated in recent weeks, as trade negotiators work on completing a Phase One deal.

(3) *Postponing Brexit.* The possibility of a hard Brexit also raised fears of a global recession. The deadline has been postponed until 1/31/20, providing time to complete a soft Brexit.

(4) *Showing better survey data.* As we discussed yesterday, the business surveys conducted by four Fed district banks (New York, Philadelphia, Richmond, and Kansas City) show that new orders and employment improved during October, suggesting that the national PMIs might have bottomed during September. Yesterday we learned that the Dallas Fed survey was disappointing. However, the averages of the five surveys still suggest that economic activity bottomed during the summer.

(5) *Heating up CPI inflation.* It's important to note that the core CPI (consumer price index) inflation rate jumped to 2.4% y/y during September. It was 2.7% at an annual rate during the three months through September. We aren't concerned because the core PCE (personal consumption expenditure) inflation rate remained subdued at 1.8% y/y during August. However, we are adding the CPI inflation concern to our bearish bias for bonds.

Valuation- Is the Market Overvalued?

In order to gain a better perspective on where securities are priced in terms of broader market valuations, we thought that after 10 years of rising markets it would be helpful to focus on a number of useful models. As investors recognize that inflation and interest rate levels appear to have materially changed from historic levels, previous correlations may have altered more traditional methods of projecting over and undervalued markets. We believe these characteristics have shifted valuation metrics higher and have had a net positive influence on stock market pricing. Whereas, more traditional standards emphasize reversion-to-the-mean P/E models, especially the ones based on trailing earnings. This is sometimes referred to as the real earnings yield ratio - and when compared to the 10-year Treasury, it is a helpful lead indicator of an under or overvalued stock market. The ratio currently suggests that stocks are not overvalued.

Another useful indicator is called the Misery-Adjusted P/E (MAPE) ratio. The Misery Index is the sum of the unemployment rate and the yearly percent change in the CPI inflation rate. The Misery Index tends to fall during bull markets and to bottom before bear markets. It was down to 5.4% during October, almost matching the most recent low of 5.0% during September 2015; and according to our research sources was the lowest reading since April 1956. That conclusion suggests that most Americans have never been less miserable at least in terms of how they're affected by the performance of the macro-economy.

According to Yardeni Research there is a reasonably good inverse correlation between the forward P/E of the S&P 500 and the Misery Index. This ratio suggests that when we are miserable, we aren't in the mood to drive up the valuation multiple. When we are happy, we tend to become exuberant, driving up the P/E. However, a high P/E, by historical standards, may not necessarily reflect irrational exuberance if interest rates are historically low because inflation is subdued. In other words, the current readings of the Misery Index are historically low and may justify P/Es that exceed the historical average. The Index averaged 23.8x from September 1978 through October 2019. Readings above (below) the average suggest stocks are overvalued (undervalued). It was 22.6x during October, i.e., below average. MAPE correctly warned that stocks were overvalued prior to the bear markets of the early 1980s and 2000s. It did not anticipate the last bear market, but that could be because the overvaluation back then was in real estate, not stocks.

The 1.9% average dividend yield of the S&P 500's for Q3 currently matches the 10-year Treasury bond yield. We conclude that as long as there is no recession, there's probably more upside in dividend-yielding stocks than in bonds.

How Is P/E Measured? As you may know, our process for arriving at sector strategy drills deeper into the S&P 500 forward P/E via individual companies and market sectors. We combine the research of several broker dealers along with independent research that uses data provided by I/B/E/S (formerly Thomson Reuters) for the weekly forward operating earnings of each S&P 500 company. These are the time-weighted averages of industry analysts' consensus earnings expectations, which change weekly, for the current and coming years. For each of the S&P 500 companies, the forward P/E is simply the company's stock price divided by the latest weekly reading of its forward earnings.

Broad Indexes and Sectors*:* The forward P/E of the overall S&P 500 stock price index is measured by dividing the total market capitalization of all the companies in the index (derived by adding up each company's market cap, i.e., the number of its shares outstanding multiplied by its share price) by aggregate forward earnings (derived by adding up each company's forward earnings, i.e., its number of shares outstanding multiplied by its forward earnings per share). The same methodology is used to calculate the forward P/Es of all the S&P 500 industries and sectors.

Mean vs Median: The forward P/Es of the industries, sectors, and broad indexes are market-cap weighted and are not equal weighted averages of the P/Es of individual companies that make up the index. According to Yardeni Research, the median market-cap weighted P/E is 17.7x. This is close to the actual forward P/E of the S&P 500, of 17.1x. Often when the market is overvalued, there are a number of outliers that skew the market-cap weighted index higher. The fact that these two statistics are tracking very closely suggests that the market is not currently overvalued.

IN SUMMARY:

In summary, the S&P 500 Index sells at 18.5 times our revised earnings estimate of $164 per share, or an eps growth rate of 5.8% over 2018. The current yield on the S&P 500 Stock Index is close to 2.0%. P/E ratios are usually used by investors in comparison to interest rates for valuation purposes. When monetary policy brings interest rates down, it is reasonable to conclude that stocks should sell at higher multiples of earnings. We use a number of valuation methods to gain a better understanding of stock prices from a historical context. Given the present market turbulence and the political aspects of the China-U.S. trade war, we believe that it is prudent to be a bit more cautious than at the outset of 2019.

Since corporate profits peaked in the third quarter of 2018, earnings continue to be under modest pressure in the first half of 2019. As a result, we lowered our GDP growth rate for 2019 to 2.5%, leaving the CPI forecast at 2.0% and reducing corporate profits this year to 7.5%.

The current economic expansion, at 120 months, is the longest in the post-war era. It is also the weakest in terms of real GDP growth at a 2.3% annualized rate. This has occurred even as the U.S. and other countries have applied unprecedented amounts of stimulus. We think economic growth could remain at modest levels in the coming years owing, in part, to aging demographics as well as high and rising debt levels (as a percentage of GDP, nonfinancial corporate debt, and U.S. federal government debt).

While several central banks have concluded that new rounds of stimulus are needed to combat slowing global growth, these successive programs will have diminishing returns, according to the National Bureau of Economic Research. William Dudley, former President of the Federal Reserve Bank of New York, has raised the issue that the amount of corporate BBB rated debt will dampen investor enthusiasm as the economic cycle matures. Hence, our expectations for equity market returns in 2020 are more modest than what we experienced this year. However, overall the market valuation appears reasonable today despite the fact that the broad-market S&P 500 Index has delivered a significantly high annualized return of 13.2% during the expansion. We continue to emphasize our discipline of concentrating on higher quality and attractive relative value in our selection process.

The opinions expressed in this commentary are those of Altman Investment Management, LLC as of the date appearing on this material only and are subject to change. The material is based upon information we consider reliable but we do not represent that it is accurate or complete and should be relied upon as such. This material does not take into account the particular investment objectives, financial situation or needs of the individual client and should not be viewed as an endorsement of any particular investment. Certain investments give rise to substantial risk and are not suitable for all investors.