ALTMAN
INVESTMENT MANAGEMENT

BRIEF MARKET INSIGHTS

JANUARY, 2020

The Pause that Refreshes:

2019 was a great year for investors – so the long-anticipated correction cannot be a surprise, and serves as a healthy "pause" that could propel the market to new highs by yearend. Since the market top eight trading days ago (January 22nd), we are down 3.3% when the Standard and Poor's 500 hit 3335. The most obvious culprit was most likely fears that China's Coronavirus epidemic will go global. So was this just a mild panic attack or something more significant?

Let's first step back and review the difference between panic attacks in the stock market and outright bear markets. The former tends to be relatively short selloffs, of around 5% to less than 20% in the S&P 500. They turn out to be good buying opportunities. Corrections are the more severe versions of panic attacks amounting to selloffs of 10% to less than 20%. Bear markets are longer selloffs, typically lasting more than a year, with the S&P 500 down 20% or more.

Panic attacks tend to reflect widespread fears that a disturbing headline-grabbing event could trigger an economic recession. Relief rallies ensue once those fears dissipate. During panic attacks, the forward P/E of the S&P 500 declines while forward earnings continues to increase or, at worst, flattens out for a short while. During bear markets, both the forward P/E and forward earnings dive. This distinction is easy to see in the monthly and weekly data for the S&P 500 which we monitor on an ongoing basis.

In looking through a wider lens, the big unknown is whether or not the Coronavirus outbreak that started in the Chinese city of Wuhan, Hubei will turn out to be just the latest panic attack that provides yet another buying opportunity for stock investors. Fears that it could turn into a pandemic knocked stock prices down last week, especially on Friday the 31st. What's the difference between an epidemic and a pandemic? The former occurs when a disease either affects more people than usual within a locality or spreads beyond its usual locality. A pandemic is an epidemic of worldwide proportions. And the fear by investors is that the recent Coronavirus outbreak has the potential to turn into a pandemic since it has already spread beyond China's borders.

If the virus continues to spread rapidly, especially in China, the economic and political consequences could be bad news for China's rulers if it leads to social unrest. Admittedly, we are somewhat concerned about the potential global economic and financial implications as well. We've mentioned in the past that really only wars have had the capability to disrupt global commerce historically and have had negative consequences for the global economy. Pandemics can have similar negative consequences.

Bonds:

Certainly, bonds are signaling that the Fed is done with altering rates in the near term. On Friday, the 10-year U.S. Treasury bond yield fell to 1.50%, down 42 bps from the recent high of 1.93% in late December. Has the bond market been affected by the Coronavirus? Is the bond market signaling that a recession is coming? We don't believe so. Although the yield-curve spread between the 10-year bond yield and the federal funds rate turned slightly negative on Friday, the credit-quality spread between the nonfinancial corporate high-yield composite and the 10-year Treasury has remained relatively narrow so far (350+ bps).

In our opinion, the bond market is signaling that the Fed won't be raising interest rates this year, especially if the recent virus outbreak proves hard to contain and depresses global economic growth - which has been showing some faint signs of improvement over the weekend. Our contention is that there was nothing to fear but fear itself. As you may recall, that was the case with the SARS outbreak of 2003 in China. It was quickly contained. No known transmission has occurred since 2004.

Valuations:

Industry analysts estimated that S&P 500 earnings per share declined in the month of January by 1.7% y/y in Q4-2019. They currently estimate that earnings rose just 1.1% last year. That was mostly because the comparison with 2018 was tough, as earnings soared 23.8% that year, thanks to Trump's tax cut for corporations. Keep in mind that the S&P 500 revenues per share growth were remarkably strong during 2018, rising 8.9% according to Bloomberg. In other words, the S&P 500 profit margin jumped 14.9% during 2018. Although that may be a hard act to follow, this was why 2019 was a so-called "earnings growth recession."

The good news is that the outlook for 2020, is that industry analysts are calling for better earnings growth with forward revenues at another record high during January. Forward earnings ticked up to record high this month as well. Profit margin forecast are holding up surprisingly well around 12%. The resilience of the margin is impressive given rising labor costs and tariff-related costs. We are still expecting cost pressures may actually ease this year if productivity makes a rebound, as we expect, and the Trump administration deescalates its trade wars.

It is important to note that upside surprises for forward earnings tend to be a great year-ahead leading indicator of actual earnings - as long as there is no recession on the horizon. Our near-term strategy leans on the markets forward P/E. And of course, we seem to be at a cyclical high, though still well below the tech bubble high of 25.7x in April of 1999. Forward earnings rose to $178 per share during January. We estimate that earnings totaled $163 per share during 2019. That implies that earnings will grow above our earlier forecast of 7.6% in 2020. That would be a nice rebound from last year's near-zero growth rate. We are still projecting that S&P 500 earnings will rise to $175 per share this year, but we are considering revising our number higher. Of course, it's still early in the earnings season and we are monitoring actual results and expectations as February unfolds.

We believe that this too shall pass, though it could turn out to be the correction we anticipated as valuation multiples climbed late last year and early this year. The recent selling could also be a minor panic attack. We don't expect that the pandemic will last long enough or be severe enough to cause a global recession. So, we don't expect that this 'panic attack' (if that's what it is) will morph into a bear market. However, we aren't virologists and the details of transmission etc. will soon be clarified. We will be watching carefully to fully assess the short-term and long-term implications for our investors.

So, for now, we believe this correction is a healthy pause.

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