ALTMAN
INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

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"An investment in knowledge pays the best interest."

Benjamin Franklin

IN FOCUS:

The U.S. economy expanded 2.1% in the fourth quarter of 2019, at a seasonally adjusted annual rate, according to U.S. Commerce Department data on real gross domestic product (GDP). This followed increases of over 2% in the third quarter, 2% in the second quarter and 3% in the first quarter. Consumer spending was a bright spot, up 3.2% at an annual rate, while capital expenditures fell -2.3%, down for the second quarter in a row. Meanwhile, the Conference Board Leading Economic Index (LEI) was unchanged in November following, three consecutive monthly declines, suggesting modest growth for the U.S. economy going into 2020. Inflation pressures remained muted, as measured by the Personal Consumption Expenditures Price Index (PCE), the Fed's preferred gauge at 1.6%. Nonfarm payrolls softened in December as compared to the last two years. We expect payrolls to bounce back in the first quarter. Meanwhile, the unemployment rate ended the year at 3.5%.

The U.S. economic backdrop also includes some uncertainty surrounding slowing global growth as the U.S.-China trade dispute lingers. In addition, high-profile civil unrest in places such as Chile, France, Hong Kong, and Spain, and a more aggressive stance on Brexit in the United Kingdom, persisted throughout the year.

In October, Federal Reserve Chair Jerome Powell encouraged investors to take on greater risk when he said during in his post-meeting press conference: "so I think we would need to see a really significant move up in inflation that's persistent, before we would consider raising rates to address inflation concerns." Powell was encouraged that inflation had remained persistently below the 2.0% Fed's official target for the personal consumption expenditures deflator (PCED) measure since January 2012. Apparently, with Powell's supportive position on the economic backdrop, investors have been convinced that the federal funds rate could remain unchanged through at least the end of the current decade. During this past year the Federal Open Market Committee (FOMC) cut the federal funds rate three times, the most recent being in December by 0.25%, leaving the rate within a target range of 1.50% to 1.75%.

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

Global economic indicators show some pickup in global economic activity. The positive tone might reflect easing trade tensions between the U.S. and China - starting late last year and culminating in their signing a Phase 1 trade agreement in early January. The tone of future data may be materially affected by the perceived course of the novel coronavirus outbreak.

However, in understanding our view on the overall economic landscape we have outlined below the economic and financial market indicators that we believe help support our overall confidence in where we are in the current business cycle. We have concluded that examining the available BEA data at this juncture gives us the confidence that we are nowhere near the tipping point that would trigger a recession.

Major Economic Indicators Remain Constructive:

- *Commodity prices:* The Commodities Research Bureau (CRB) raw industrials spot price index rebounded nicely since its recent lows experienced in December, and suggest the global economy is in expansionary mode. However, we have observed that the price of oil also appears very sensitive to the fear of a global slowdown associated with the coronavirus continuing to spread around the world.

- *Purchasing Managers' Indexes (PMIs):* The good news is that manufacturing PMI for the U.S. remained above 50.0 (expansionary) during January, though it edged down slightly from a recent high during November. The Eurozone's manufacturing PMI edged up from December to 47.8 in January. Weighing on the region's index has been Germany's PMI, which rose to 45.2 this month from a low of 41.7 at the end of the third quarter. Japan's PMI edged up to 49.3 and the Eurozone's PMI has been expansionary (52.2) since late 2018.

- *U.S. business surveys:* New York, Philadelphia, and Kansas City surveys were strong during January. The average employment index for the composite rose from a recent low of zero during August 2019 to well over 10.8 during January.

- *U.S. housing market:* The U.S. housing market has been relatively positive as 2020 unfolds. The mortgage applications index for new purchases jumped in the first two weeks of January to the highest readings since October 2009. Single-family housing starts climbed during December. Single-family building permits rose as well to a new cyclical high at the end of last year. It may be that the Millennials, who turned 24–38 years old last year, may finally be buying houses. That would be a very big positive for the U.S. economy.

- *U.S. leading indicators:* The Index of Coincident Economic Indicators rose to a new record high during December. It is important to note that the Index of Leading Economic Indicators (LEI) appears to have stalled for the past year and a half, though at a record high. However, we have concluded that the cyclical components of the LEI may have outlived their usefulness, because the current economic expansion has lasted for so long. It becomes increasingly difficult to believe there is much more room for improvement in initial unemployment claims at this rate.

- *The Industrial sector:* Although a significant smaller contributor to GDP, the manufacturing indicators remain sluggish. A lead indicator of U.S. manufacturing sector is exemplified in U.S. transportation indicators. The statistic that best describes this weakness is the freight train and railcar data that has declined close to 6% y/y during January. This series has been highly correlated with the comparable growth rate in industrial production, which also declined 1% during December.

- *Forward revenues & earnings:* Lastly, forward revenues and forward earnings through January for the MSCI U.S., Developed World ex-U.S., and Emerging Markets seemed to be holding near these record highs, with the U.S. showing a bit more resilience than the other two international indices. There's neither a global boom nor a bust in these indicators.

The Bull Market Lives to See Another Day:

This past year produced remarkable global financial asset returns, as the 4th quarter in the U.S. stock market produced the largest gains of the year. With a total return of 9% for the quarter and over 30% total return for the year, the broad market S&P 500 Index achieved a new all-time high. International equities as measured by the MSCI All Country World Index ex-U.S. posted a 22% return.

The U.S. stock market rally in the latter months of the year encouraged investors to reemphasize non-cyclical stocks, fearing the tenuous nature of the economic and political uncertainties that continued to plague markets. This economic uncertainty was most evident in the disparity in stock market returns, as the domestic technology-heavy NASDAQ Composite Index advanced 14.0% in the 4th quarter and finished the year up 38.5%. The enthusiasm was almost entirely based on price advances with little earnings growth to support these hefty market gains. Note that in three of the four quarters of the year, aggregate earnings for the S&P 500 Index were actually down year-over-year, and are expected to be under continued pressure as the 4th quarter results are reported.

Already, markets are off to the races in 2020. The S&P 500 as of mid-January was up another 3%. Keep in mind that since the start of the current bull market in March of 2009, this benchmark index is up close to 500%.

It's hard to get too excited about the stock market's likely returns over the next decade. That's because the S&P 500 scored average gains of 11.8% per year during the previous decade - and often times strong 10-year returns tend to revert back to the mean. Then again, perhaps the stock market is discounting a significant rebound in productivity growth. The 10-year average percent change in the S&P 500 tends to lead the comparable growth rate in nonfarm productivity by a few years. We attribute this productivity cycle to technological innovations.

Bond Rally Temporarily Offsets Coronavirus Fears:

The fixed income markets generally benefitted from falling rates, as the 10-year U.S. Treasury Note ended the year at 1.92% down some 77 basis points for the year. The Bloomberg Barclays U.S. Aggregate Bond Index returned 8.7%, its strongest calendar year since 2002, while the Global Aggregate Bond Index returned 6.84% driven by price appreciation coupled with declining yields globally. Yields on longer-dated U.S. Treasury securities moved higher during the quarter as investors became more constructive on trade and the economy.

As January unfolded, coincident with the news on the novel coronavirus, 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 new 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 the same day the credit-quality spread between the nonfinancial corporate high-yield composite and the 10-year Treasury has remained relatively narrow at only 400 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 temporarily depresses global economic growth - which has been showing some faint signs of improvement with each day. Remember that the 2003 SARS outbreak in China was quickly contained. No known transmission has occurred since 2004. We don't expect that the pandemic will last long enough or be severe enough to cause a global recession. And we don't expect that this will morph into a bear market. We hope to gain further clarity as details of transmission, containment, and/or treatment are identified.

Global Policy Extends the Economic Cycle:

We expect the global economy to bottom out around the first quarter of 2020, with growth recovering thereafter. However, the pace of this recovery will be relatively slow and sporadically spread unevenly across regions.

We still expect the U.S. will lead the way among developed markets, as the lagged effect of looser financial conditions continues to feed through into more interest rate-sensitive parts of the economy. At the other end of the spectrum, however, we expect the Eurozone to lag behind other advanced economies with China's economy slowing in 2020 to as low as 4.5%. Our forecast takes into account that a modest improvement in external demand is more than offset by domestic headwinds from a weaker property sector and the new coronavirus.

We expect inflation will stay low in most major economies - and so monetary policy is likely to remain supportive. Most analysts expect interest rates in the U.S. to remain at their current level throughout the year. We are expecting that weak growth and low inflation will cause the ECB and the People's Bank of China to loosen policy further in the second half of the year.

The three geopolitical issues that are likely to shape markets this year are: trade wars, the U.S. presidential election and (in the UK at least) Brexit. The scale of the Conservative election victory has increased the likelihood of a "negotiated" Brexit, but there is still a risk of a disorderly outcome if a comprehensive trade deal isn't reached by the end of 2020. Lingering uncertainty is likely to cap any upside for the pound - and one could conclude that while GDP growth should pick up next year, the pace of recovery will most likely be modest.

Recent news that the U.S. and China have agreed to a deal - that will see Washington scale back tariffs in exchange for Beijing buying more U.S. agricultural and other products - has raised hopes of a lasting breakthrough to end the trade war. But while this sets the stage for a truce, we fear that the deal might not hold. In any case, our view remains that the trade conflict is likely to move to a new phase over the course of this year, in which the focus shifts away from tariffs and towards a broader set of issues like technology, industrial policy and security.

Finally, while the outcome of the U.S. election is expected to have a significant bearing on the equity market, it is unlikely to have a major effect on the performance of the U.S. economy over the next couple of years. We will cover all of these issues, plus key risks to the view, during the course of this year.

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Valuations Bolster Asset Allocation Preference:

Industry analysts estimated that S&P 500 earnings per share declined 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 mostly due to the tax cut. 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 industry analysts are calling for better earnings growth with forward revenues at another record high during this month. Forward earnings ticked up to a record high as well. Profit margin forecasts are holding up surprisingly well around 12%.

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 25.7 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. Our positive bias for 2020 for better earnings growth is based on the resiliency of profit margins, despite rising labor costs and tariff-related costs. We expect cost pressures may ease this year as productivity makes a rebound, coupled with a de-escalation in the trade wars. Of course, it's still early in the earnings season and we are monitoring actual results and expectations as February unfolds.

Life after Brexit:

After years of debate and drama concerning how and when the United Kingdom should exit the European Union, the nation has finally gone ahead with the separation. The UK stock market has still lagged many other countries' stock markets, since 52% of voters opted to exit the EU in 2016. The UK MSCI has returned 36.0+% in local currency and 19.4+% in U.S. dollars from the day before the Brexit vote through January 31st, 2020.

The UK's local-currency stock market return since the Brexit vote is below the local currency returns of all the other European countries' MSCI indexes - and far behind the returns for the European Economic and Monetary Union (EMU) MSCI (23.3%), the World MSCI (56.3%), and the S&P 500 (66.2%).

There's still much to be decided about the relationship between the UK and the EU. In addition to trade agreements, the UK and EU have to hammer out how to handle law enforcement, data sharing, immigration and security to name just a few.

In the meantime, UK analysts have been lowering their expectations for UK companies' earnings for the past two years. According to our sources, analysts are forecasting a drop in revenue of 1.4% in 2019 and only a slight increase in 2020 of 1.2%. Earnings, however, are also expected to turn positive this year, up 6.8% in 2020 compared to a 4.5% drop in 2019. The end result makes the country's 2020 earnings growth among the slowest in global markets. This compares to companies in the EMU that are forecasted to grow earnings 9.7% and in the U.S. 9.0%.

U.K. valuations have been under pressure as well. The forward P/E for companies in the UK's stock index has declined quite a bit from a high of 16.4 in early 2016 to a low of 11.2 in late 2018. The forward P/E currently stands at 13.3. That's lower than the forward P/E of the EMU (14.6) and the U.S. (19.2).

IN SUMMARY:

The market valuation multiple has pushed the forward P/E to new highs for the current bull market, and ever closer to the previous record high of 25.7 during the last market cycle in 1999. If the market index (S&P 500) climbed 7% in 2020, that would put us at 3500 for the year - and could very well happen in the first half of the year rather than the back half. Nevertheless, we would rather see the market's fundamentals catch up with the P/E. So far, S&P 500 forward revenues remain on an upward trajectory and are near a record high during the first weeks in January. This however hasn't materialized in the forward earnings so far during the current earnings season. It's also hard to believe that the stock market is likely to keep up the annualized rate of return we have experienced over the past 10 years (with 11.8% average annual gain) over the next decade.

Economic activity has picked up and is evident in the latest global economic indicators. The next set of data should confirm our positive bias and better clarify the impact of the coronavirus worldwide outbreak. We remain optimistic that any material drop in the broad indices for the time being represents a buying opportunity. While we remain vigilant concerning the broad range of risks that could undermine this recovery and the bull market, we continue to recommend staying overweight equities against the risk of underweighting equities too early in this business cycle.