ALTMAN
INVESTMENT MANAGEMENT

EQUITY STRATEGY FOCUS

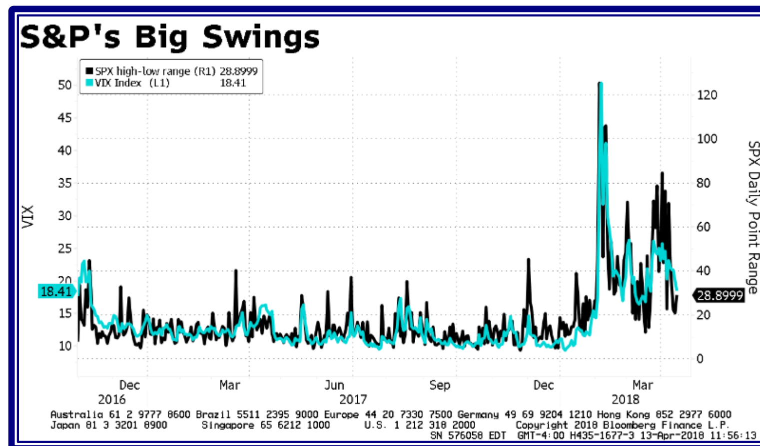
APRIL, 2018

IN VIEW: The Equity Landscape

Towards the end of the first quarter, President Trump announced tariffs totaling approximately $50 billion on select Chinese imports, to make good on a campaign promise of taking a tougher stance on trade. China was quick to retaliate with $50 billion in tariffs on U.S. products such as soybeans, chemicals, cars, and tobacco. The risks ahead revolve around negotiations between the two countries amid potentially escalating tensions. Trump has already requested an additional $100 billion in tariffs on Chinese products. For now, this could be interpreted simply as posturing for negotiations given that tariffs on both sides have yet to be implemented. However, China is likely to respond in kind and tensions could indeed escalate into a full out trade war.

Growing uncertainty has intensified market gyrations and is setting the stage for continued volatility. Capital Economics estimates the impact to the U.S. economy in conjunction with recent tax reform would be marginal at best. The import tariff would have the effect of a minor tax on certain consumer products, but much of that would be offset by the benefits of tax reform. While we remain confident that negotiations move forward averting a full out trade war, the possibility cannot be fully discounted. As we wait out the suspense, the market will continue to trade in response to rising/falling tensions.

The Volatility Index Has Not Been This High Since the 2016 Election.

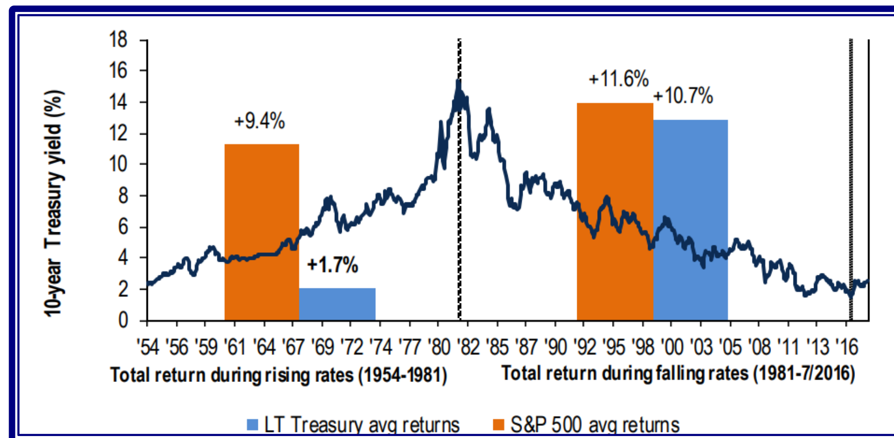


Source: Bloomberg

As interest rates climbed from just above 2% in September to now over 2.7%, it is a good time to revisit the relationship between stocks and bonds in a rising rate environment. Although it's a general principle that stock and bond prices move in opposite directions, the correlation is not always consistent. The level and speed of rates is important as well as the surrounding economic data. We will be monitoring the strength of economic growth as well as the level of funding required to support the recently expanded government budget.

The chart below takes a look at two distinct interest rate trends over the past 60+ years. When interest rates moved up into the mid-teens in early 1980, stocks on average outperformed bonds by over 7%. Subsequently when interest rates reversed, stocks outperformed bonds by a much smaller margin of less than 1%. This historical analysis shows that over longer periods of time, rising interest rates bode well for stocks over bonds. Pressure on stock returns could become most apparent as 10-year yields reach the 3.5% level but can begin to cause concern in terms of the speed that these interest rates are achieved. Of course, capitalizing on such dynamics involves a coordinated effort between stock selection and macroeconomic analysis, but the general theories apply.

Take a Look at Stocks vs Treasuries in Rising and Falling Rate Environments.



Source: Bank of America Merrill Lynch

A NOTE ON THE ECONOMY:

There has been quite a bit of concern as the second quarter unfolded about a slowdown in the global economy. The evidence seems to be mostly based on Purchasing Managers Index (PMI) surveys. Keep in mind that these indexes are cyclical indicators and are trendless. They typically rise when the economy is improving. However, at some point, more of the purchasing managers who respond to the surveys are bound to say that their business is strong but no stronger than the month before, which tends to push the PMI back toward 50. The indices have been solidly above 50 since late 2017, after showing some weakness during 2015 and early 2016. The outperformance of the PMIs of the advanced economies relative to the emerging ones has been noticeable in both the manufacturing and non-manufacturing sectors.

Another economic indicator that has been some cause for concern is the overall Commodity Research Bureau (CRB) U.S. Spot Raw Industrials Index. The data has stalled in recent weeks but remains on the uptrend since late 2015, after plunging in the second half of 2014. It is nearly back to the best levels of early 2014. Its metals component - which includes copper, lead and steel - remains on a solid uptrend registering the highest reading since the summer of 2011.

Let's take a closer look at oil as an inflation indicator. Keep in mind that the CRB index we use does not include the prices of any petroleum or lumber commodities. The price of a barrel of Brent crude oil has rebounded remarkably from its low of $27.88 in early 2016 to low $70's as of the first month of the 2nd quarter. That's especially impressive since U.S. oil field production has soared through April. Production also has been soaring in Iran and Iraq, with both near recent highs despite Venezuelan production plummeting. In any event, the rebound in the price of oil, despite ample global supplies, strongly suggests that global economic activity remains strong. While U.S. imports of crude and petroleum products have stabilized around 10 million barrels a day over the past couple of years, U.S. crude and petroleum exports have climbed considerably almost twice the levels in mid-2014.

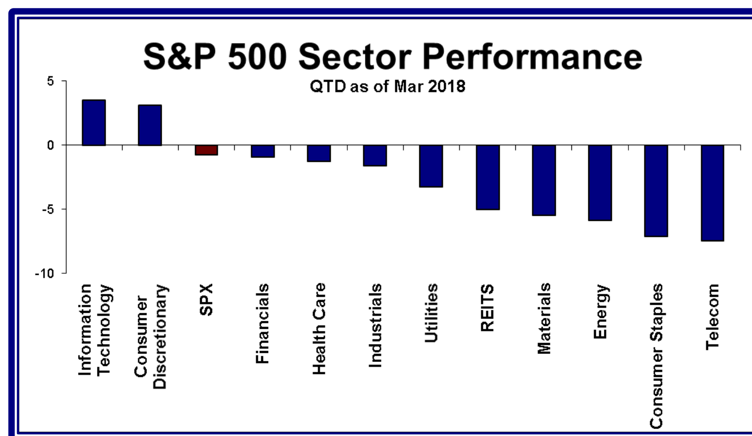
We are also seeing evidence that forward revenues are confirming a pickup in global growth as industry analysts are predicting that global revenues will rise 6.2% this year and 4.5% next year, according to Bloomberg. This top line growth is also supported by expectations of accelerating earnings and accompanied by higher margins at home and abroad.

Wages continue to outpace prices. The U.S. unemployment rate, currently at 3.9%, continues to drop and is the lowest since early 1973. Wage inflation is holding below 3.0% on a y/y basis. This has surprised Federal Reserve economists who expected that wages would rise to 3.0%-4.0% by now as the labor market tightened. The conventional view was that the shortage of workers would push up wages at a faster pace, which would boost prices. It appears that the typical Phillips curve phenomenon has not fully accounted for the secular forces of price disinflation, i.e., globalization, technological innovation, and demographics that has kept a lid on wage inflation.

In any event, the widespread notion that real wages have been stagnating for years is not entirely accurate. According to Morgan Stanley economists, wage gains have been outpacing price increases in recent years and have been taking the pressure off of worker compensation. The result is Baby Boomers have been staying in the work force longer with little pay increases over the past decade. Apparently, they are simply happy to be working. And of course, those who are retiring are being replaced by cheaper Millennials.

CLOSE-UP: Equity Investment Overview

Performance/Earnings Overview:



Source: Altman Investment Management, LLC. and Bloomberg

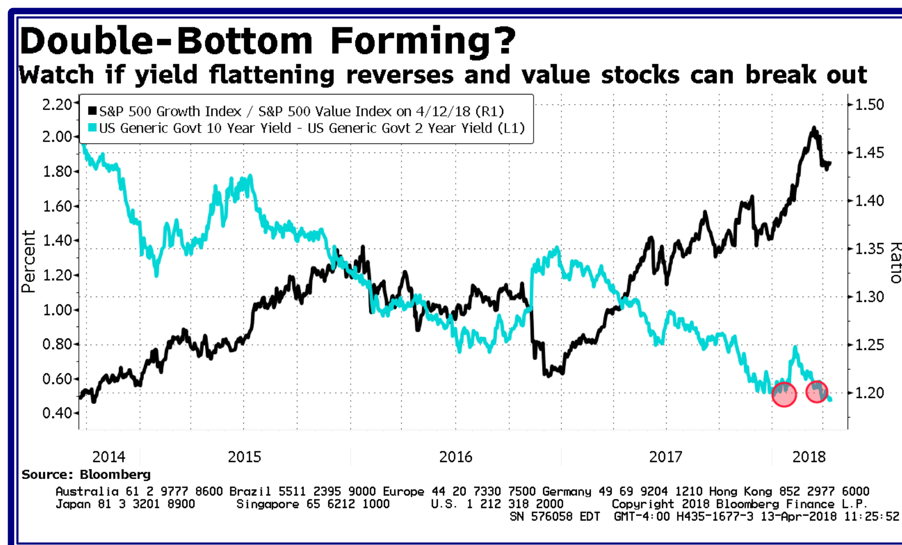
The benchmark S&P 500 index started the year with weak performance, trading down -0.76%. Only 2 sectors posted positive returns against the majority of negative sector returns. The market gained back most of its loss after falling as much as 10% earlier in the quarter. Markets sold off as higher interest rates and fear of inflation raised concern over the longevity of the current robust market cycle. The last time we experienced a 10% correction was back in early 2016 when oil prices tumbled and investors feared a hiccup in global growth. Large cap stocks under-performed smaller caps, while growth stocks outperformed value. In March however, value stocks have once again taken the lead as market volatility picked up.

This pull back in the market put an end to the lengthy streak of positive market performance during quarterly earnings seasons going back to 2013. It is our view that select equities should hold up as rates rise, given the strength in the economy and corporate earnings.

Source: Bloomberg

Q4 earnings wrapped up in March, running at 14% earnings growth overall. Consensus earnings for 2018 have risen nearly 7% to $157 on account of tax reform and higher oil prices. Buyback announcements have increased significantly this past quarter, yet companies have been somewhat vague in crediting growth or the impact of anticipated repatriated cash. Additionally, a significant portion of companies have announced spending plans that encapsulate investing in employees, R&D, raising cap-ex, or paying down debt. Multinational corporations continue to release earnings that exceed expectations at a higher rate than those with less foreign exposure, as strength in global growth continues. On a sector basis, earnings and sales growth were dominated by Energy, Materials, and Information Technology. No sector reported negative overall earnings growth, however, Real Estate and Consumer Discretionary were the weakest. On top line sales, Utilities and Financials were weakest.

The expectations for higher interest rates bodes well for value stocks. Value companies pay out earnings to investors earlier than growth companies which tend to reinvest their earnings back into the company. As interest rates rise, the future earnings of these growth companies are worth less in the eyes of investors as investors anticipate higher cost of capital and/or expenses. Therefore, value companies should experience less head winds in a rising interest rate environment.



Source: Bloomberg

The AIM composite outpaced the benchmark S&P 500 index. Off the bottom through quarter end, the composite gained over the benchmark.

- Information Technology, Consumer Staples, and Industrials were most additive to relative performance.
- The top 5 performers in the composite were Keysight Technologies, Northrop Grumman, Intel Corp., Cisco Systems, and Archer Daniels Midland.
- Consumer Discretionary, Financials, Healthcare, and Energy detracted from relative performance.
- The bottom 5 performers in the composite were Devon Energy, Wells Fargo, Dollar Tree, Occidental Petroleum, and DowDupont.

Portfolio Strategy:

We recently took gains in the Technology sector trimming Applied Materials, Microsoft, and Cisco, who's one-year total returns were up 44%, 41%, and 30% respectively. Proceeds were used to modestly reduce the cyclicality of the portfolio by buying into Healthcare and Telecom.

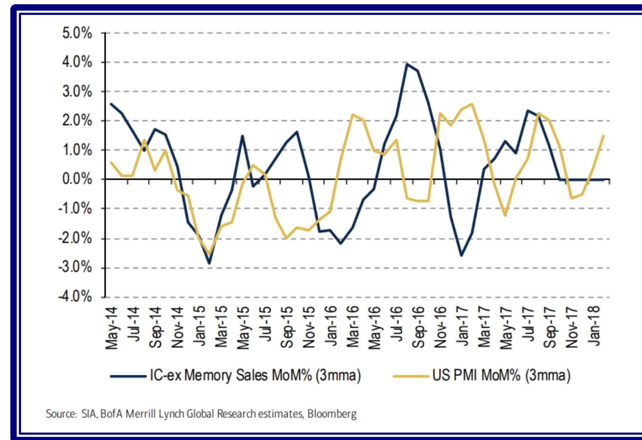
Merck reported Q4 results that beat expectations and grew earnings by 10% year over year primarily on lower taxes. In a recent data release, Merck's Keytruda beat out Bristol Myers' Opdivo, setting the stage for Keytruda to maintain its lead in the lung cancer market. Prospects for Keytruda are anticipated to forge ahead in 2018 into early stage therapy and in combination with chemotherapy. Merck's pipeline also includes opportunities in vaccine and HIV treatment arenas. We believe the company's shares represent an attractive long-term investment opportunity. We like Merck for its good relative value, strong balance sheet, above-average dividend yield of 3.3%, strengths in faster-growing therapeutic areas such as immuno-oncology and vaccines, and historically strong research and development.

AT&T beat expectations in Q4 by 20%, with top line revenues coming in ahead of consensus as well. The headlines currently are highlighting AT&T's intended merger with Time Warner that is currently undergoing court proceedings to determine the viability of the large-scale combination. AT&T is arguing the marriage would improve efficiencies that could be passed along to its subscriber base in terms of lower prices. The opposition is citing antitrust concerns that warn of higher content charges or the potential withholding of content to lower cost providers. But with or without the merger, AT&T is trading at a discount to its historical valuation and its dividend yield should prove beneficial throughout the anticipated market volatility.

Although the Energy sector detracted from portfolio's relative performance in the quarter, we maintained our relatively over weighted position expecting a rise in crude oil prices as global growth accelerates in the second half of the year. We continue to focus on exploration and production companies highlighting Marathon Oil, with its high oil-price sensitivity and significant U.S. shale exposure. Over the past two years, the company has taken steps to upgrade its balance sheet, production assets, and execution. In addition, the company has improved its flexibility and competitive position and lowered its breakeven costs. This rationale supported our recent increase in the investment.

Semiconductor stocks started the year strong, up 6.5% in Q1 as measured by the Semiconductor Sector Index (SOX). Sales growth for the industry is tracking up 10% year/year as of February reporting. Dynamic random-access memory (DRAM) revenues were strongest in contrast to weak sales in microprocessors (MPU) and microcontrollers (MCU). Anticipated drivers throughout the 1st half include lower inventory levels, new model launches, and high-performance computing (HPC) demand. PMI data, which is currently in an uptrend, has also proven to be a leading indicator for integrated circuit (IC) demand.

PMI vs. Core IC Sales



After taking some gains in the Technology sector, semiconductor stocks represent approximately 9% of our composite portfolio and roughly half of our Technology sector.

IN SUMMARY:

We are expecting 3.5%+ GDP growth and 2.7% CPI inflation. Consensus forecasts earnings for the benchmark S&P 500 to increase 18.9% in 2018 over the prior year report of $132. The inflation rate is contingent upon materializing wage gains which we will continue to monitor. Although we may experience continued market volatility in response to headline news, and perhaps experience an additional market correction, a recession is not in our forecast. Improving sentiment and a looser regulatory environment are driving consumption and capital investment. Faster economic growth, higher inflation, and significantly higher corporate profits support our preference for stocks over bonds, and we recommend portfolios remain fully invested.

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Any performance reference represents a hypothetical composite compiled from actual equity, fixed income or balanced client portfolios and includes cash. These three composites reflect aggregated returns that address differing objectives. As such, the performance of each composite does not reflect the actual total portfolio returns earned by our clients. The investment performance records are compiled from a capital weighted average of the equity, bond and cash components of a broadly representative group of discretionary accounts that meet certain minimum size thresholds.

No gross performance returns that are referenced that are calculated after brokerage commissions but before investment counsel fees are presented without the comparable net performance figures after both commissions, investment counseling fees and other custodial charges. The net counseling fees are the actual average counseling fee calculated across all the portfolios included in the composite. All performance figures are presented on a time-weighted total return basis and assume all income is reinvested. The investment advisory fees are disclosed in Part II-A of the Investment Form ADV. Some clients may benefit from available discounting in the management fee schedule associated with the overall size of the portfolio. Management fees will reduce overall returns to the client.

The composites were created in 2001 and the inception dates start on August 17th, 2001.The composites include only discretionary fee-paying accounts managed in the strategies, and additional information associated with the composites are available such as: dispersion in individual portfolio results as well as the % of the firms AUM in the strategy. All performance calculations are presented within the GIPS® guidelines of the CFA Institute. The CFA institute does not endorse or promote this organization nor does it warrant the accuracy of the content herein.

Investing entails inherent risks and results may be altered by material market or economic conditions. Investment returns and principal values may fluctuate, and losses are possible. Past results are not a guarantee of future comparable results or trends. Our process benchmark is the S&P 500 Index with dividend reinvestment, and our performance benchmark is the Russell 1000 Value Index with dividends reinvestment.