ALTMAN INVESTMENT MANAGEMENT

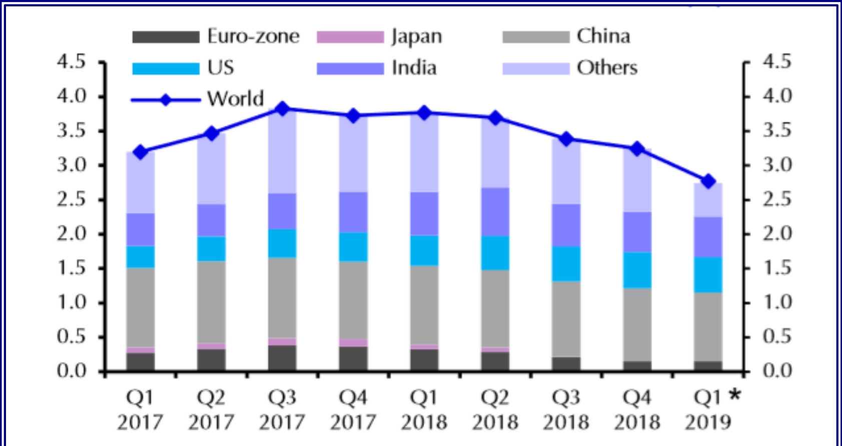
EQUITY STRATEGY FOCUS

APRIL, 2019

IN VIEW: The Equity Landscape

As anticipated, the global expansion has been weakening with the International Monetary Fund (IMF) estimating 3.5% growth for 2019. This is down from 3.8% and 3.7% (est.) in 2017 and 2018 respectively. Global PMI came in at 52.1 in April, down from 52.8 in March. The downward trend that began in early 2018 is mostly attributable to the manufacturing side within advanced economies. As one of the leading indicators for global GDP, it is not surprising that the forecasts for economic growth have been reined in. The global slowdown is due in part to deceleration in Japan and the Eurozone, as well as slower growth in China. There does not appear to be one single culprit but rather several factors such as new automobile emission standards in Germany, increased tariffs on China, political uncertainty surrounding Brexit, and demand weakness in Italy. Trade tensions are not anticipated to subside any time soon - adding to the longevity of the slowdown.

World GDP & Contributions (% y/y)



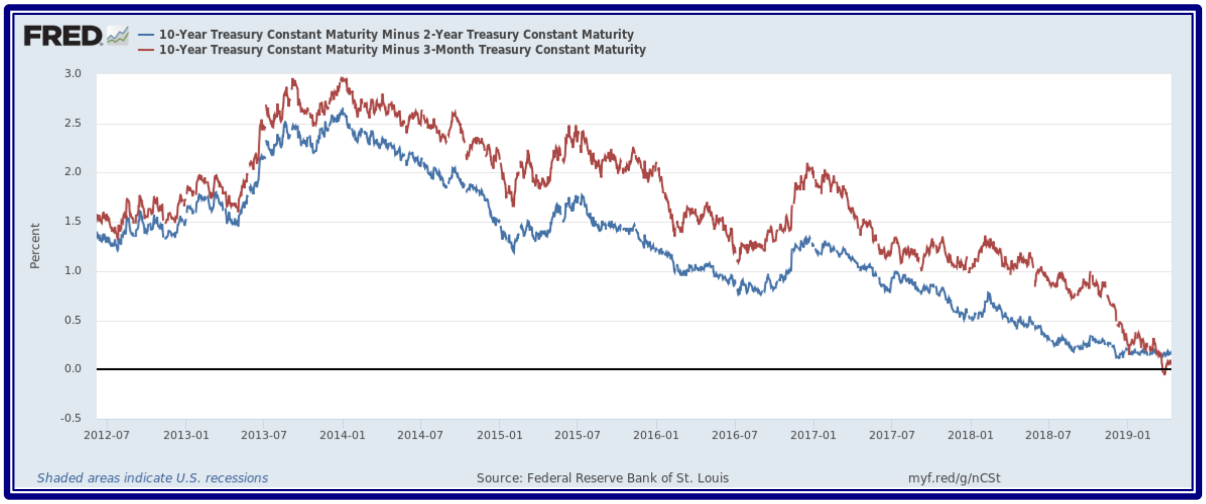
Sources: Refinitiv, Capital Economics *CE estimate

The first release of Q1 2019 U.S. GDP came in at 3.2% exceeding analyst expectations. Net exports provided the largest contribution followed by gross private investment. The growth in private non-farm inventories in conjunction with slowing personal consumption expenditures gives us some pause against the backdrop of a global slowdown and the roll off of tax cut benefits. Several large tech companies have already announced capital spending cuts this quarter in anticipation of slower growth and consumer confidence at near peak levels.

On an annual basis, the U.S. economy has held up at an estimated rate of 2.9% growth in 2018, up from 2.2% in 2017. While non-residential fixed investment and exports have held up year-over-year, both were stronger in the first half of last year. Personal consumption expenditures (PCE) and federal government spending have weakened over the last several quarters. Looking ahead, we anticipate domestic demand to strengthen against a framework of low unemployment and rising wages, which should help offset potential reductions in inventory builds.

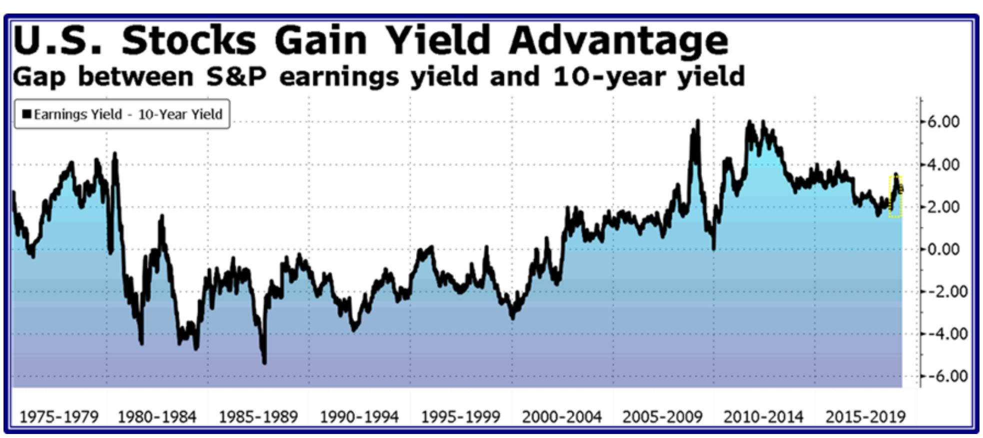
The spread of the 2-year against the 10-year Treasury continues to narrow but remains above inversion levels. However, the spread between the 3-month and 10-year has inverted. This atmosphere makes it difficult for businesses to justify funding new investments. Some of this shift is due in part to a weakening economic landscape and is impacting natural levels of supply and demand in the bond market. But it is important to note that there are also some other influential factors to consider such as European yield levels. Lower yields in Germany, for example, have brought investors to the U.S. pushing bond yields down. Additionally, we have just come off a multi-year quantitative easing program in which the Fed worked to unwind its balance sheet by selling bonds. These two factors are impacting the data in addition to natural supply and demand and could potentially lead to a false recessionary indicator.

3-Month Treasury Spread Briefly Dipped Below Zero
2-Year Treasury Spread Remains Above Zero



Since 1955, recessions have been preceded by inverted yield curves but not every yield curve has been followed by a recession. Therefore, we need to consider additional recessionary factors to get a more accurate temperature for the economy.

The earnings yield (reciprocal of price-to-earnings ratio) for the S&P 500 index of 5.25% is 2.8% above the current 10-year treasury yield, indicating investors continue to get paid for the extra level of risk taken by holding stocks (see chart below). It is worth mentioning that the gap has indeed narrowed from nearly 6% eight years ago. If this continues, investors may begin to reassess their tolerance for risk and what level of reward is warranted to continue to hold stocks over bonds.



Source: Bloomberg

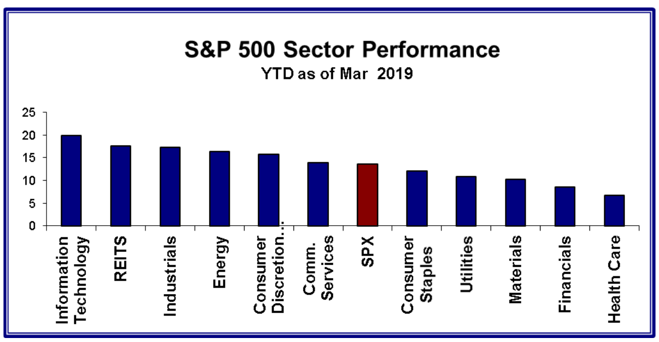
Broadening the scope into equities further, earnings for the S&P 500 came in 0.7% above analyst estimates in Q4 or 14% year-over-year. Earnings growth is expected to be flat for Q1 this year with top line sales up 5%. Capital expenditure growth is trending around 11.5% year-over-year which too is slowing but remains in the healthy double digits. Company guidance remains key this upcoming quarter, but for now investors are still getting paid for the extra risk taken via stocks versus bonds, and earnings are still growing albeit at a slower pace. Our current estimate for 2019 earnings-per-share growth still exceeds 5%.

Additionally, the housing market is showing signs of strength on better home builder sentiment and higher prices. Lower unemployment levels coupled with a stronger housing market add to the wealth factor lifting consumer sentiment and thus could lead to continued spending. However, we should point out that consumer sentiment is already elevated, consequently not leaving much room for expansion from current levels. Additionally, rising commodity prices could put a pinch on economic growth if they rise too quickly.

CLOSE-UP: Equity Investment Overview

Market Performance Overview:

- In Q1, the stock market came back strong - up over 13% - indicating the selling which occurred during Q4 of 2018 was overdone.
- This recent rally was the strongest quarter since the stock market trough in 2009. Midcap stocks led the markets this quarter and growth outperformed value. WTI Crude Oil rebounded 32% in Q1 after falling nearly 25% last year.
- Six sectors outperformed the overall market, led by Technology and REITs. Five sectors, primarily defensive in nature, lagged the overall market.



Growth stocks outperformed value stocks by 417 basis points (as measured by the Russell 1000 Growth Index and the Russell 1000 Value Index).

The best performing stocks in the AIM composite were: Keysight Technologies, Conagra, Cisco Systems, Johnson Controls and Mondelez. The weakest performing stocks in the portfolio were Cigna, Pfizer, DowDuPont, Disney and MetLife.

Equity Strategy:

The percentage of the market invested in the Energy sector has fallen to 5.5%, down from over 10% five years ago. By comparison, the weight of the Energy sector within the Russell 1000 Value index is 9.7%. The intrinsic value of energy stocks as hard asset beneficiaries certainly correlates closer to their book values as compared to companies with a higher percentage of soft assets (service companies) on their balance sheet. Value investors appreciate this relationship when evaluating new investment opportunities. The price relationship to tangible book value can provide a safety net to businesses that are faced with a tougher macroeconomic environment and allow greater financial flexibility. This enhances their relative attractiveness.

Energy Representation in the S&P 500 is at 5.5%

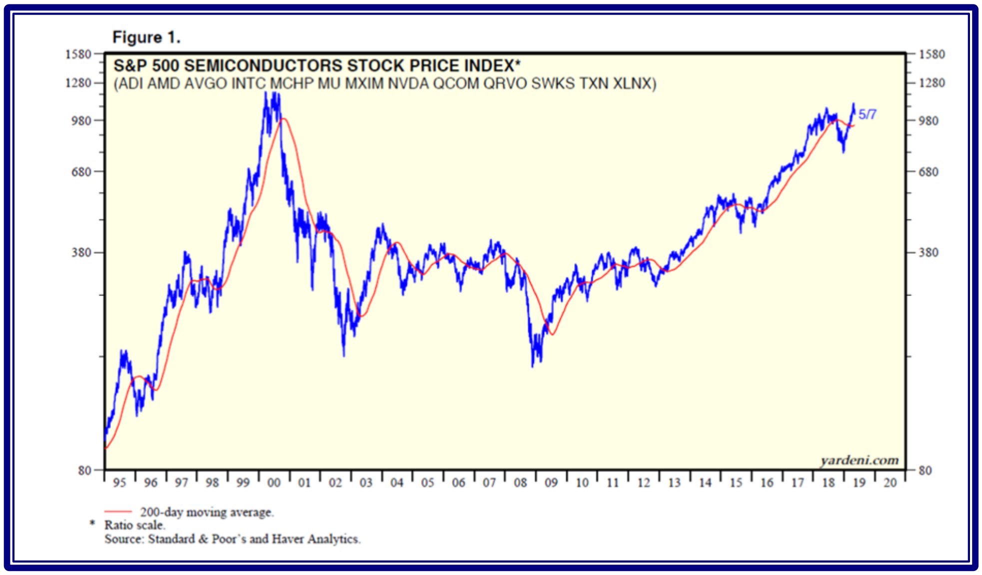
Source: Bloomberg

After selling off 38% in Q4, oil rebounded 32% during Q1 2019. Most likely, concerns over slowing global growth are impacting demand expectations for oil, hence the spike in early 2019. The volatility has altered managerial strategies which have moved away from unbridled production growth during times of higher prices towards an environment that favors maintaining free cash flow. More simply, the focus is more on returning cash to investors rather than growth at all costs. Some consolidation at current levels could occur, as companies take advantage of lower valuations to expand inorganically.

Large cap banks were major beneficiaries of the tax overhaul last year. Many banks reported an annual tax rate that was 30% below rates from prior years. Bank of America paid a rate of 18.6% which was even lower than the anticipated overhaul rate. Adding to bank strength is strong economic growth, moderate inflation, consumer and business confidence and lower unemployment. While the economy is expected to slow to some degree this year, the other anchors are holding steady and support continued bank ownership.

Healthcare stocks are trading at 5% discount to their 30-year average price-to-earnings multiple. Earnings growth in the sector is improving with nearly ¾ of the sector beating on both top and bottom-line growth in Q4 2018. While fundamentals remain strong, the uncertainty surrounding drug pricing going forward could pose some risks. However, Healthcare stocks are defensive in nature and provide attractive dividends adding to the overall balance of the portfolio.

In March, the Semiconductor Industry Association (SIA) reported semi sales were down 15.5% from Q4 and 13% from the same period a year ago. Weakness in cloud capex, memory pricing, and auto production are some factors behind reduced near term estimates. The SIA President categorizes this down turn in the semi industry as "consistent with the cyclical trend the global market has experienced recently." Analysts are now forecasting a decline of -4.2% in revenues and -11.5% in earnings for 2019. But even after reducing estimates, analysts remain optimistic for next year. Revenue estimates for 2020 are as high as 6.6% and earnings are expected to rise 9.2%.



The rally in semiconductors in Q1 of this year, up 19.8% against the backdrop of declining near-term earnings, highlights the fact that investors are focused beyond 2019. Analysts appear to be anticipating a short-term trade war with China, 5G opportunities in emerging markets, and potential consolidation. Representation in the sector is light when compared to the last peak period in semiconductors, indicating there is further upside potential.

IN SUMMARY:

During 2019, stocks rallied back to September peak levels confirming the market was oversold. At a recent press conference, Fed Chairman Powell highlighted accommodative financial conditions, strong employment data, and rising wages when identifying fundamental support within the economy. The Fed views the recent slowdown in consumption and business fixed investment as temporary. After running close to target levels, inflation pulled back temporarily in March reflecting lower Q4 oil prices. The latest report calculates inflation at 1.9%, as oil prices continue to recover. Main concerns include global growth, trade relations with China, and Brexit negotiations. All these considerations taken together; the data supports the Fed's continued patience in monetary policy.

The stock market is set to become the longest post-depression era expansionary period, breaking the record currently held by the 1991-2001 expansion. The length of time of a secular trend, in and of itself, is not enough to call an end to a bull market run. We are encouraged by economic activity in conjunction with supportive monetary and fiscal policy and continue to prefer stocks over bonds. Our target allocation in balanced portfolios continues to lean towards higher than average stock participation, especially in a low-yield environment. Our diversified and disciplined approach to investing enables us to maintain stock market exposure that provides superior long-term performance with below market risk.
