ALTMAN
INVESTMENT MANAGEMENT

EQUITY STRATEGY FOCUS

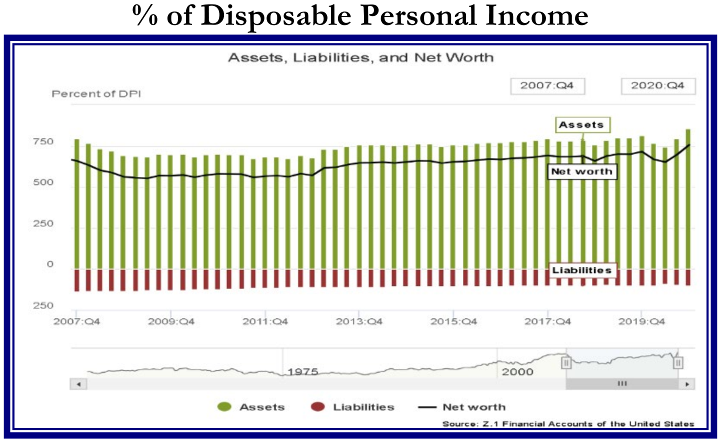
APRIL, 2021

IN VIEW: The Economic Landscape

It's worth taking a closer look at the economic trends and conditions surrounding the current recession to gain a perspective on its recovery potential as compared to history. Specifically, prior crises are often preceded by factors that support a level of economic growth that is unsustainable. Thus, the implosion of such factors leads to weaker economic growth in the wake of the crisis for a considerable period of time. This leads to supply vulnerabilities, as cutbacks hinder capacity and unemployment trends higher. Balance sheets both on a household and corporate level need time to rebuild and regain efficiencies. The resulting lost demand has the potential to stunt economic growth for months or even years afterwards depending on the circumstances.

On the other hand, before the current pandemic hit, we were operating in a world with a healthy overall jobs market, a resilient consumer, and relatively low interest rates. Growth was moderate, yet steady. Sustainability of that level of growth, only 2.3% for 2019, was not impractical and set an achievable benchmark for a return to normalcy. The unprecedented monetary and fiscal policy that we have written about at length have worked to support individuals and businesses throughout the crisis, and should only help to make a sustainable recovery that much more achievable. In addition to corporate balance sheets having already been shored up after the financial crisis, household balance sheets have strengthened as well. This empowers the consumer supporting future growth as the economy reopens releasing pent up demand.

Balance Sheet of Households and Non-Profits
% of Disposable Personal Income

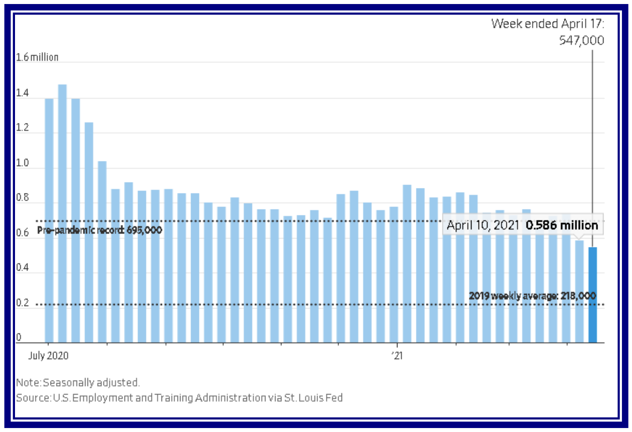


Source: Board of Governors of the Federal Reserve

The first estimate of Q1 GDP growth shows the economy grew at an annualized rate of 6.4%, following 4.3% growth in Q4. Consumption was fueled by low interest rates, stimulus checks, re-openings, increased personal savings, and vaccination availability. Strength in fixed investments along with federal, state and local government spending was partially offset by declines in exports and private inventory investments and higher imports. Personal Incomes continue to improve with Q1 estimates for disposable personal incomes and personal savings up $2.4 and $4.1 trillion respectively.

Jobless claims continue to decline, reaching their lowest point since the pandemic began. Although a significant improvement, current filings are more than double the 200,000 level before the shutdown. As the pace of hiring picks up with re-openings, 916,000 jobs were added in March. While the number of new unemployment claims appears to be stabilizing, the U.S. still has 8.4 million fewer jobs on payrolls at the start of the pandemic.

Filings for Jobless Benefits



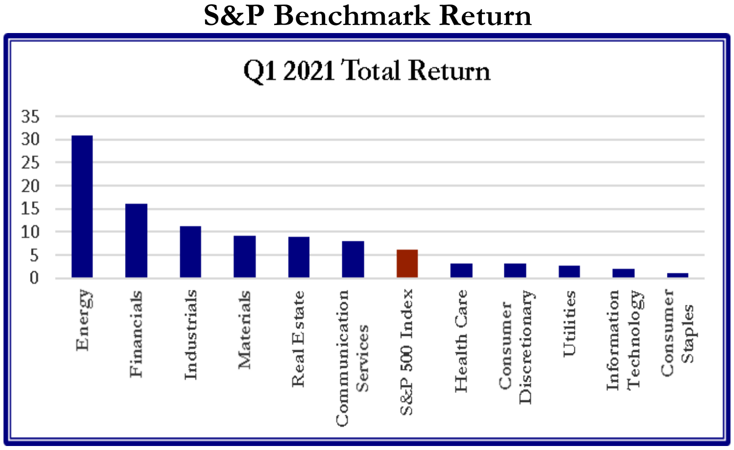
Source: Wall Street Journal April 29,2021

While we still have a way to go, the slack in the labor market is helping to keep a lid on wage inflation for now. While lower rates in conjunction with unprecedented stimulus does pose the potential for inflation in the long run, the Fed reiterated its intention to maintain its current policy until the labor market tightens and inflation reaches its target average of 2%. The Fed anticipates leaving rates near 0% at least through 2023, as any short term rise in inflation would likely be temporary. Economic activity is only just beginning to rebound as is the labor market. The Consumer Price Index (CPI) came in at an annualized 2.6% in March reflecting higher oil prices and rising demand for used cars and trucks. Ex food and energy the index climbed 1.6%. Factors to monitor that may indicate higher inflationary pressures in the long run are public debt levels, deglobalization, productivity weakness, and higher wage levels.

CLOSE-UP: Equity Investment Overview

Market Performance & Earnings:

S&P Benchmark Return



The total return of the S&P 500 index during the 1st quarter was 6.15%. Energy led the market with a total return of over 30%. Other cyclicals, namely financials and industrials, were also strong coming in above 10%. Apple, Qualcomm and Advanced Micro Devices led technology stocks lower during the quarter. The largest impact at over 6% of the index weight was Apple which fell -7.8%. Overall, defensive sectors waned as cyclicals took the stage with vaccination availability raising the prospect for a sustainable resumption in growth.

Our composite index, favoring value stocks, outpaced the benchmark index by an estimated net 575 basis points . Overweight positions in Energy, Financials, and Industrials helped returns to benefit from what we believe to be the beginning of both a secular and cyclical market rally. Our underweight in Communication Services partially offset our positive relative performance.

Into the 3rd week of the earnings season, nearly 78% of companies have reported thus far. On average, earnings growth expanded 48% year over year. The largest pop came from Consumer Discretionary stocks, followed by Financials and Communication Services. Top line sales increased 12% overall, with strength in Financials Technology and Consumer Discretionary stocks. Corporate guidance has returned as corporations begin to envision a future beyond the pandemic. In fact, the number of companies issuing guidance has reached a level not breached in over five years. The reemergence of earnings visibility also ignited the consensus earnings spread over guidance to reach its highest level in nearly a decade.

Concern over inflation has also become an underlying theme accompanying earnings results. The mention of inflation was most prevalent amongst material, consumer, and industrial companies. Management cited transportation and material costs, while labor costs remained benign. On the other side, with anticipated higher pricing alongside margin strength, corporations should find themselves in a better position to navigate a higher inflationary environment.

Consumer Discretionary Sector - Better than Headlines Suggest:

Just five months into 2021, there's a significant disparity between the S&P 500's best- and worst-performing sectors. The S&P 500 Energy sector's stock price index has soared 37.7% year-to-date through last week, while the S&P 500 Information Technology sector's stock price index has gained only 3.6%. Tech's poor performance leaves the index trailing the slow-growing Utilities and Consumer Staples sectors. We remain underweight the sector as market valuation disparities resolve themselves.

The surge in the Energy sector owes much to the 32% year-to- date jump in the price of Brent crude oil futures. Lower-than-expected loan losses and a steeper yield curve have boosted Financial sector stocks as well. Additionally, the 16% year-to- date gain in the CRB Raw Industrials spot price index has been a tailwind for the Basic Materials sector.

With the economy reopening and government payments continuing to flow, consumers are in good shape. Personal income was up 21.1% in March, helped by government benefits. Consumers spent some of their newfound wealth, sending March's retail sales up 9.8% during the month. Every retail category reported positive growth. The Consumer Discretionary sector also has a lot of exposure to home-related industries, which continue to be 'hot' with interest rates and housing inventories low. Most of the stock price indexes of industries in the Consumer Discretionary sector have demonstrated respectable returns through the first quarter.

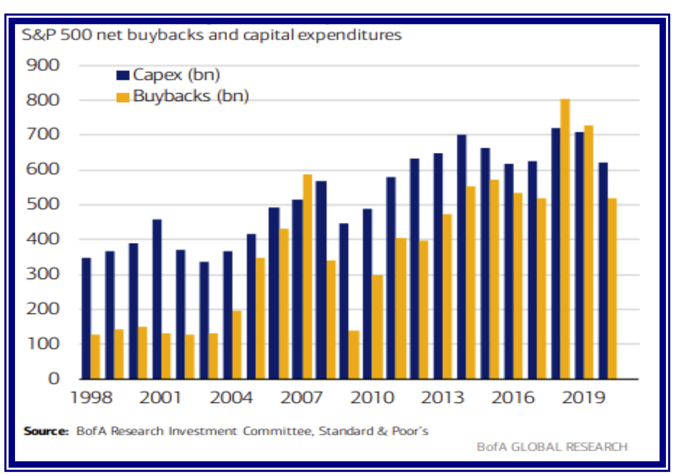
To understand the Consumer Discretionary sector's underperformance, one has to look no further than Amazon and Tesla. Despite Amazon shares climbing almost 70% in the first half of 2020, the shares have since treaded water. We calculate that the group would have only advanced about 10% in 2020 without Amazon's contribution. Amazon is in the Internet & Direct Marketing Retail industry, which is basically flat year-to-date. Of the industry's four component stocks in the Standard and Poor's 500, Amazon dominates the group's market capitalization with a 37.8% share, and has an outsized impact on the sectors results.

In Tesla's case, the stock (which has fallen 12.5% ytd) is a member of the S&P 500 Automobile Manufacturing stock price index. The drop in Tesla stock is even more dramatic—30.1%—when measured from its early January high through yesterday's close. Keep in mind that the shares are still up significantly from the end of January last year. The year -to date drop in Tesla's shares has been more than offset by the gain in General Motors shares and Ford Motor, leaving the S&P 500 Automobile Manufacturing index still down 6.2% year-to-date. Tesla's 13.8% market-cap weighting in the Consumer Discretionary index isn't quite as meaningful as Amazon's. Nonetheless, without Tesla, the Consumer Discretionary sector would be up 9.2% year-to date. Together, Amazon and Tesla make up 51.6% of the Consumer Discretionary sector's market capitalization. If Amazon and Tesla were excluded from the Consumer Discretionary sector, the sector's ytd return would be closer to 18% and more reasonable a return given the consumer's strength**.**

Equity Strategy:

Over the last four market cycles, dating back to the 1980s, CapEx (capital expenditures) growth has slowed across a majority of market sectors. A reduction in computer and electronic component production has been one of the main reasons for the overall decline in CapEx. Capacity expansion has also slowed as companies shifted focus away from equipment and structural builds toward spending on intellectual property. However, in recent weeks several leading semi companies have announced a collective increase in CapEx of nearly $50 billion giving the indication a secular shift in support of higher CapEx spending and capacity levels is on the horizon. Additionally, analysts are seeing signs of a re-shoring of supply chains as companies aim to avert impending tariffs, reduce disruptions, and support the surging "buy American" mentality. This anticipated pivot should provide a welcome boost to the cyclical rally already underway, as the economy re-opens with the vaccination roll-out and warmer weather allows for increased outdoor activity.

What we have also seen is an over reliance upon share buybacks in recent years. Although corporate buybacks are generally a positive signal to investors as show of managerial confidence or even temporary support for earnings during a downturn, investors need to see a corresponding investment in long term growth, i.e., CapEx growth.



Johnson Controls (JCI) is one such company that stands to benefit from developing trends. Capacity expansion and CapEx spending funnel investment towards the modernization of commercial buildings. The commercial HVAC segment stands to benefit from an anticipated upgrade cycle led by aging equipment, less expensive replacement systems, ESG trends, and economic stimulus. Management recently raised guidance on the backs of future growth expectations. Additionally, the new CFO has initiated SG&A (selling general and administrative) cost reductions and COGS (cost of goods sold) savings plans that should help expand margins.

Lowes (LOW) has had strong performance in 2020 that carried over into Q1 of the current year. "Do it yourself" (DIY) spending soared as consumers used quarantine to get projects done on the cheap, while working from home or having been laid off. As DIY spending begins to moderate to some extent this year, we expect spending on larger projects requiring professional contractors to pick up, offsetting the DIY market. Additionally, accrued household savings and stimulus payments should continue to fuel the market in the near term. Longer term, we see increased demand for energy efficiencies and "smart" homes as drivers of growth.

Profit-Taking Rationale in Semiconductor Stocks:

Business conditions for U.S. semiconductor & semi-equipment companies are unambiguously positive. The re-acceleration of global economic growth, coupled with tailwinds from ongoing digital transformation, growing semiconductor content in consumer goods, and the rollout of 5G networks and smartphones are supporting robust unit volume growth and pricing. In addition, expanding CapEx budgets by major chipmakers, such as Intel and Taiwan Semiconductor, bode well for semiconductor equipment manufacturers.

As strong as demand conditions are today, semiconductor supply shortages imply that much of the current unmet demand will have to be filled down the road. This has increased confidence among investors that the current cyclical upswing for chip companies has staying power. As a result, the forward earnings of semiconductor companies are likely to see further upgrades in the months ahead.

While the sales and earnings outlook for chip companies are bright, the prospects for their share prices could be challenging in the months ahead, which has encouraged us to reduce the portfolio's exposure to the group. Semiconductor share prices are up significantly versus their year-ago levels and have front-run a large acceleration in global semiconductor sales and underlying earnings momentum. The only time that semiconductor stocks have seen a meaningfully bigger run-up over a 12-month span was in the late-1990s during the dot-com bubble. We believe that the recent rally in share prices could limit further outsized gains. This could perhaps leave the group vulnerable, if sales unexpectedly weaken or supply constraints raise concerns that potential double ordering may have artificially boosted demand.

Valuations are full and reinforce our view to reduce exposure as the return prospects for chip stocks are muted. The sub-group trades at 21x 12-month forward earnings. Although the current forward P/E ratio does not look extended by historical standards or relative to the broad equity market, historical comparisons of valuations could be more problematic given the distortions caused by the build-up and subsequent unwinding of the dot-com bubble. The current forward P/E multiple is elevated within the context of the past decade and is 40% above the 10-year average.

The sub-group trades at a 10% discount to the broad equity market on a forward P/E ratio basis. The relative forward P/E ratio is in line with the average over the past decade. Still, absolute valuations reflect significant optimism about sales visibility and expectations for further large improvements in forward earnings, underscoring the fact that a lot of good news has been discounted. At the end of the day, the sub-group remains highly cyclical and current valuations will be more difficult to sustain as the year progresses.

IN CONCLUSION:

Improving labor markets, pent up demand and vaccination roll-outs are all working to provide a stable base for earnings and GDP growth in 2021. Earnings releases so far have exceeded analyst expectations by 18%, with net margins reaching record highs. Consensus estimates for 2021 as reported by both Yardeni Research and FactSet are at 32% growth for 2021, and 12% for 2022.

We expect the recovery to continue at sustainable levels, with GDP running upwards of 5% for 2021 before moderating somewhat in 2022. Slack in the labor market is working to temper inflation for now, giving the Fed room to maintain current interest rate levels for some time to come. The stock market is on track to follow the economy higher, favoring cyclical market sectors.

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