ALTMAN
INVESTMENT MANAGEMENT

EQUITY STRATEGY FOCUS

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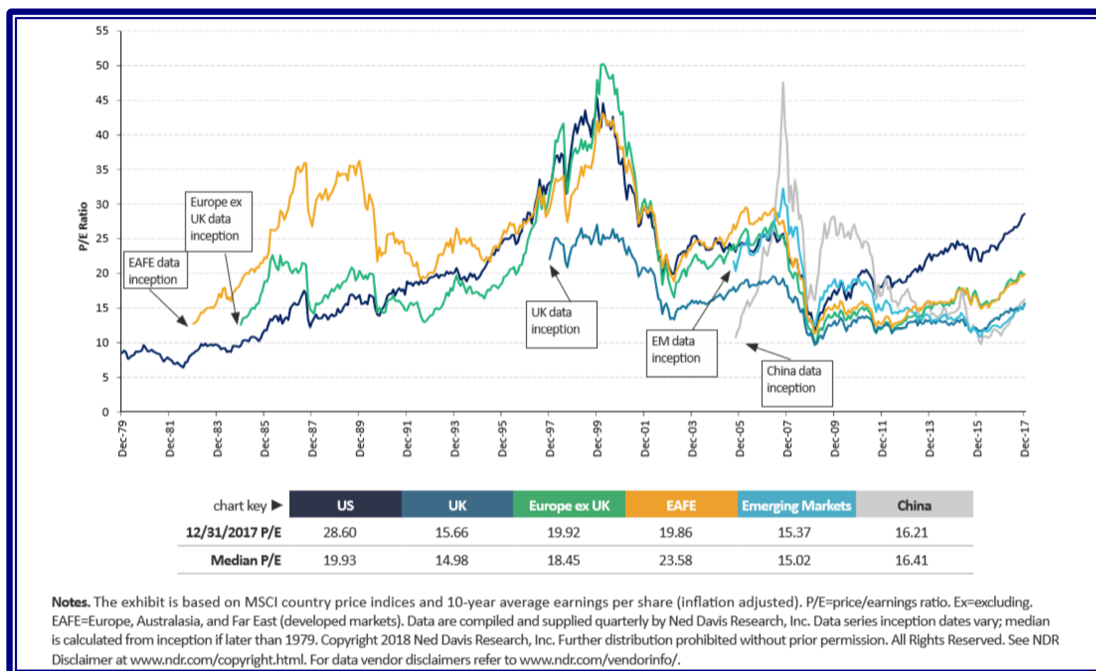
IN VIEW: The Equity Landscape

Since the financial crisis, when the S&P 500 index bottomed in March of 2009, the U.S. equity market has significantly outpaced all developed and emerging markets by over 170%. More recently though, after the lows in early 2016, Emerging Markets have pulled ahead surpassing our domestic benchmark by 17%. While the Emerging Market resurgence has not nearly closed the gap, it marks a turning point with opportunity for continued outperformance. Supporting a continuing uptrend are accelerating earnings, global growth, and an 8-9% pullback in the U.S. dollar after peaking in December 2016.

Likewise, the MSCI World Index excluding the United States has enjoyed more recent success, outpacing the S&P 500 index this past year by 3%. Europe suffered not only in unison with the U.S. financial crisis but again in 2011-2012 as a result of its sovereign debt crisis. Since then, Europe has undergone structural reforms strengthening its banking system via consolidations and the selling off of non-performing Assets (NPAs). The European Central Bank continues to provide various forms of QE (quantitative easing) in support of its banking capital structures, making them stronger and better capitalized than before the crisis began. Euro area demand for loans has continued to grow, while credit standards on household loans have eased, both lending support to further loan growth.

The CAPE Ratio (cyclically adjusted P/E) illustrates the value opportunity that exists in the global market place relative to the U.S., paving the way for multinational investors.

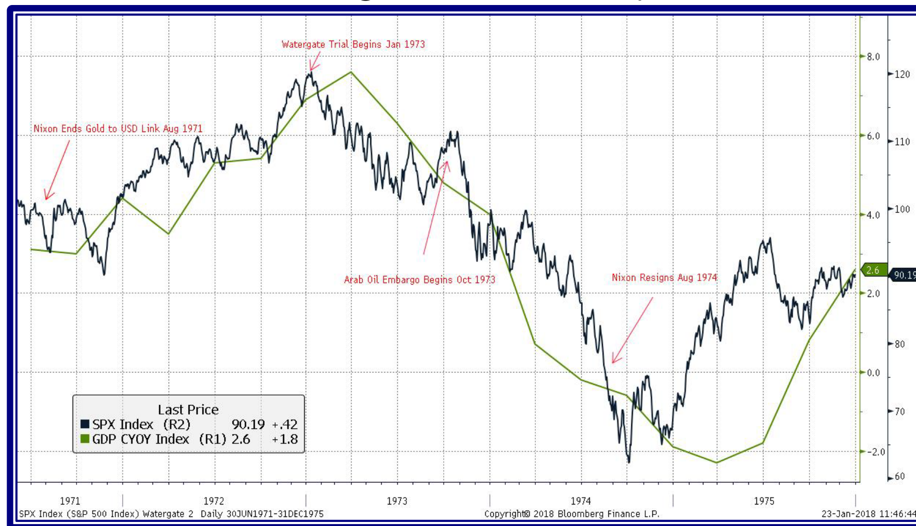
CAPE Ratio



Source: Ned Davis Research

Since President Trump's election, the stock market has traded up nearly 28% through yearend of 2017. The market has responded positively to his conservative agenda focused on tax reform, reducing regulatory oversight, and building out infrastructure. The ongoing investigation into Russian meddling in the U.S. elections has raised concerns over possible collusion and/or obstruction of justice. We believe therefore, while reserving judgment, it is prudent to review the market environment surrounding the Nixon impeachment era. In comparing our findings to today, hopefully we can help shed light on the possible impact on U.S. markets should impeachment proceedings become a reality as they did in the mid '70s.

Stock Market and GDP Growth
During the Nixon Presidency



By comparison, during the Nixon presidency when the stock market sold off over 44%, inflation was soaring, economic growth fell to -2.3%, and unemployment was on the rise reaching as high as 8%. To combat inflation, Nixon ended the U.S. dollar's convertibility into gold. This weakened the U.S. dollar compounding inflationary conditions already underway. Separately, the Arab Oil Embargo began in response to the U.S. backing of the Israeli military. Oil prices consequently soared putting more weight behind inflationary pressures.

Contrasting an aerial view of the economy during the Watergate period with today - under circumstances that could potentially bring similar turmoil into the current administration - gives us insight into the viability of a severe market correction. Today, the U.S. economy is running at 2.6% GDP growth, 2.1% inflation, and 4.1% unemployment. We are anticipating continued strength supported by accelerating earnings, a measured reduction of monetary accommodation, along with global growth. Heading into the 9th year of a bull market, following the 2007-2008 financial crisis, we anticipate heightened short-term volatility with the potential for additional corrections. Forecasting a longer-term bear market would require wider spread pessimism. Forecasting a recession would require the emergence of a bubble, a reversal in GDP growth, and/or a substantial rise in inflation.

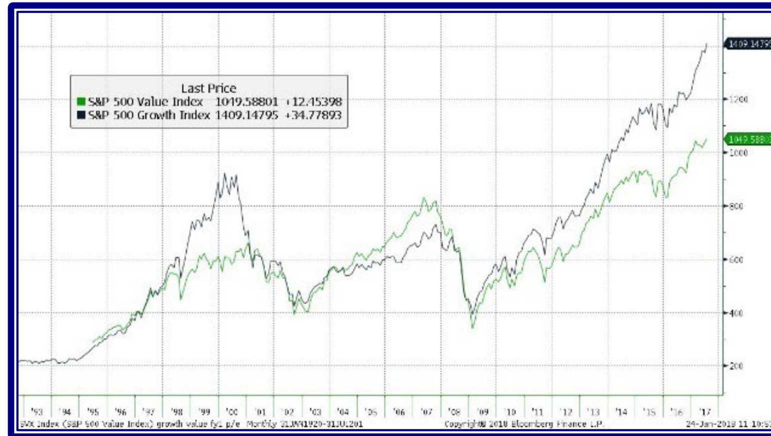
CLOSE-UP: Equity Investment Overview

Performance/Earnings Overview:

The total return for the benchmark S&P 500 index during 2017 was 21.8%. The technology-heavy Nasdaq and the Dow Jones Industrial Average which is also well represented in technology came in ahead of the S&P 500 benchmark by over 600 bps. Globally, these returns compare to the MSCI Emerging Market Index total return of 31%, the MSCI World Ex-US of 18.8% and the MSCI EAFE 15.8%.

The S&P Citigroup Growth Index out-performed its Value counterpart by over 1200 basis points this year. However, in the second half of Q4, Value once again began to take the lead. If the market normalizes and continues to broaden out, which we believe it can, Value stocks could play catch up in 2018 as they did in the latter part of last quarter.

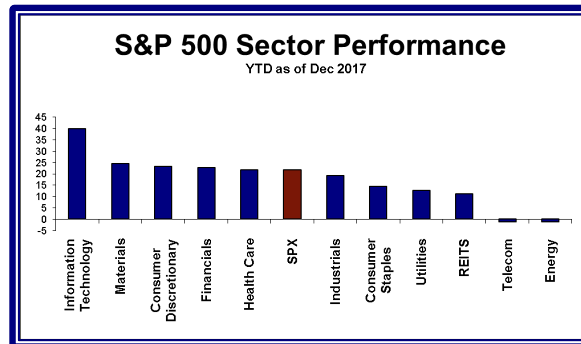
Growth Has Been Out-Performing Value
Since the Market Bottom in March of 2009



Source: Bloomberg and Altman Investment Management, LLC

The out-performance of Growth was expected given the performance of the FAANG stocks (Facebook, Apple, Amazon, Netflix, and Google), which accounted for nearly 20% of the market's return throughout 2017. We have exhibited restraint in our composite when it comes to owning FAANG stocks, due to their lofty valuations. The overall divergence in sector weightings coupled with stock specific index membership, particularly within Technology and Consumer Discretionary, account for the majority of performance dispersion between the Growth and Value style indices.

Let us now focus more intently on the performance of the S&P 500 index, the U.S. domestic benchmark. Within the Technology sector, semiconductors, home entertainment software, and application software took the lead. All other technology industries fared well with the exception of IT consulting which failed to keep pace with the overall market.

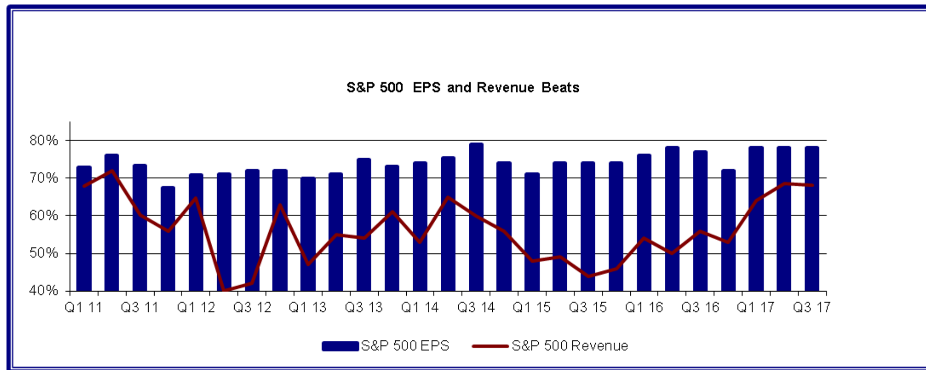


Materials stocks came in second place, leading the overall market index by 270 basis points. Encouraging performance from Copper, Specialty & Diversified Chemicals, and Industrial Gases were additive to out-performance. It was not surprising that Consumer Discretionary finished the year in third place, given its 10% gain in Q4. The internet and direct marketing industries comprise 23% of the Consumer Discretionary sector, and include Netflix and Amazon. Performance in this sector was strong across both the growth and value spectrums.

Energy stocks benefited as WTI oil prices climbed nearly 20% in Q4, breaking through the $60 level. This comes as OPEC continues to cut production into 2018. Ahead of the next OPEC meeting in June, items to watch include oil production and demand trends, along with cues from Russia with regards to involvement with the cartel. The 10% pullback in oil prices this year was not surprising, given the runup in prices during the second half of 2017. However, current demand trends along with OPEC production discipline offer support for oil prices at or above current levels.

Q3 Earnings wrapped up in mid-December and beat expectations. Earnings and sales growth rates came in at 7.1% and 5.3% respectively. Year over year growth in earnings was strongest in Energy, followed by Technology. Negative earnings growth in the Financial sector was the weakest.

Percentage of S&P 500 "Beating" on Both Sales and EPS



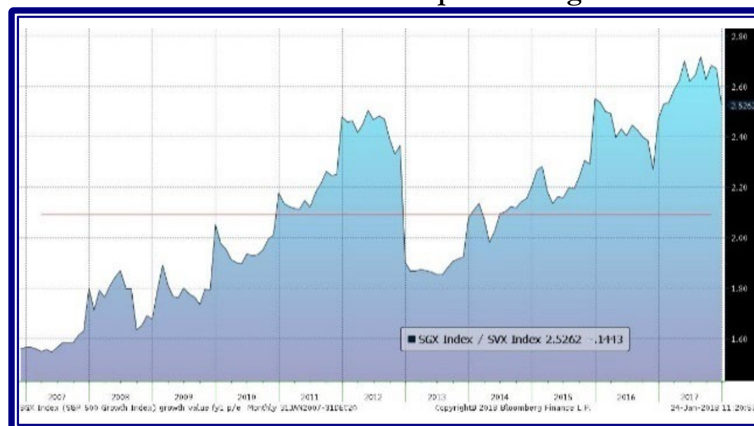
Source: Bloomberg and Altman Investment Management. LLC

The earnings guidance ratio, above vs. below consensus guidance, is nearly double the historical average. This is indicative of a maturing expansionary phase. The growth rate in capex has been waning since 2011, contrary to the improvement measured in the capex guidance ratios. The corporate reform legislation incorporates the full expensing of capex going forward, which could help stabilize the trend. A weaker dollar and higher oil prices supports higher sales growth figures for Q4 as well. Looking ahead, items we continue to monitor are company communications with regard to tax reform, wages, and capex.

Through week 4 of the Q4 earnings season, earnings growth is running at a rate of 13% year/year coupled with sales growth of 8%. A weaker U.S. dollar contributed to the higher level of earnings beats this quarter. The largest year/year growth was in Energy, followed by Materials then Technology. The new tax cuts are having a positive impact on earnings expectations for 2018, as consensus estimates reach $155, up from earlier estimates of $147-148 before the legislation was passed.

The AIM composite performed on par with the S&P 500 benchmark index in the final quarter of 2017. For the entirety of the year, the composite trailed. Value stocks began to take the lead in the last two months of the year. While Value has lagged growth for most of the current bull market, it is about time for the tide to change favoring Value stocks.

Growth to Value Gap Widening



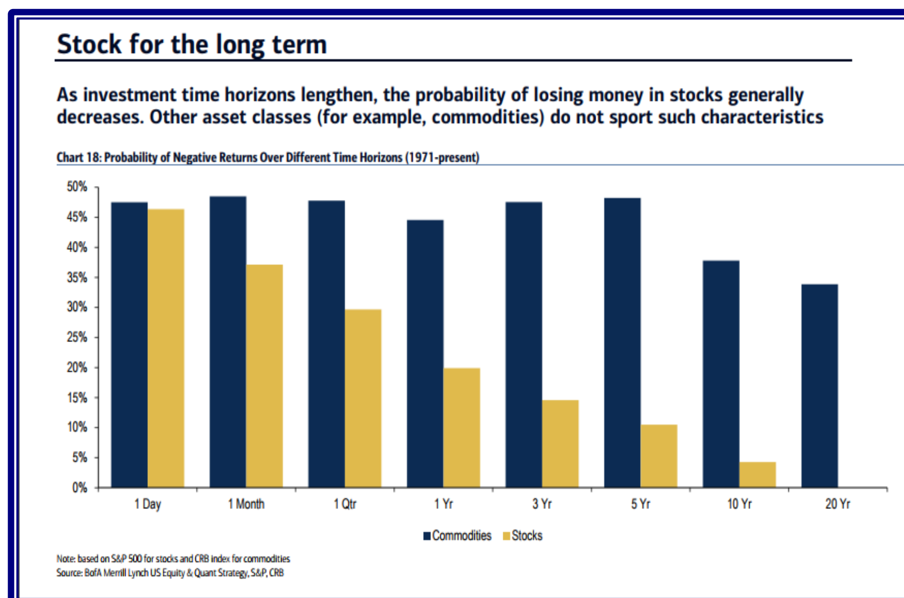
Source: Bloomberg and Altman Investment Management, LLC

- For the entirely of 2017, Consumer Discretionary was the most additive to our relative performance against the benchmark. McDonalds and Lowes nearly doubled the market this year while Dollar Tree has been strong as well since added to the composite in October.
- Our Energy exposure in the composite lagged for the year, but beat the market by nearly 500 bps in Q4 adding to relative performance.
- The top 5 contributors to our composite performance for the year were Applied Materials, Microsoft, Bank of America, Northrop Grumman, and Honeywell.
- The bottom 5 contributors to our composite performance for the year were Cardinal Health, Halliburton, Archer-Daniels Midland, Kraft Heinz, and Edison International.

Portfolio Strategy:

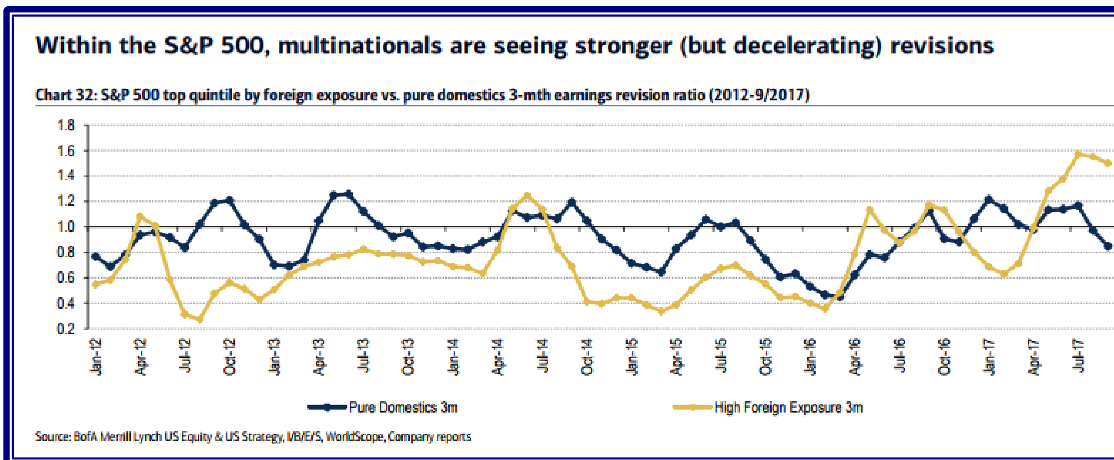
We recognize that stocks are looking expensive on many metrics, including trailing and forward price/earnings as well as price/book. Notably, the price/free cash flow is one of the few metrics remaining below historical averages. But it's not only multiples that have driven recent market performance; earnings have supported the rally on a comparable level. Analyst revision ratios and company guidance ratios are trending upwards and supporting stock momentum. We are indeed in the mid/late expansionary phase of the business cycle, with characteristics such as strengthening economic activity, earnings growth, and a not yet hawkish fed policy. The current conditions bode well for another leg up in stocks this year, as the initial fears of a hawkish Fed settle down. We are emphasizing high quality large cap stocks with low relative risk and coincident valuations.

In previous commentaries, we have discussed the risks to market timing and the benefits to owning stocks for the long run. To briefly recap, historically, the stock market experiences a 5% correction 3-4 times per year. Admittedly, it has been over a year since the last one and this is one of the longest stretches of time in between minor market corrections since the late 20s. Additionally, we are in the 9th year of a bull market which in itself has some questioning its' longevity. It is an impossibility to time markets perfectly, and therefore investors who attempt to do so have the potential to miss out on some of the best trading days in any cycle. Missing out on some of the best trading days can be costly. Consider the market return since the 1930s of over 11,000% - if an investor missed out of the best 10 trading days per decade, the return drops significantly to just 49%. Returns can vary dramatically when timing markets, which is why staying invested whenever possible is strongly advised. In fact, risk is mitigated the longer the time horizon.



Healthcare seems to be near the low end of its historical forward P/E valuation, offering yield at a reasonable price. Not only is this sector defensive in nature, but also a beneficiary of an aging population. As a result of new tax laws encompassing repatriated cash, we would expect to see an increase in M&A activity as well as dividend growth. We appreciate Merck's (MRK) diversified portfolio and leading market position. Its focus on advancing its stake within immuno-oncology is promising for its ambitions in lung cancer treatment. Pfizer's (PFE) leadership in breast cancer and rheumatoid arthritis treatments, along with the potential to unlock value in its consumer business (via spin-off), make it an attractive opportunity as well. We are currently market weight the Healthcare sector. Large cap manager over-weight exposure to Healthcare is at a multi-year low and appears to have formed a bottom, creating an opportunity. We anticipate investor posturing toward healthcare to intensify as the business cycle matures.

60% of Multinational stocks beat expectations on both earnings and sales, aided by a weaker dollar in Q4 and global growth. Our international strategy is implemented via multinational companies or companies that are domiciled in the U.S. with facilities and assets outside of the U.S. Globalization has given way to increased opportunities for better client service, lowering production costs, procurement processes, and sales initiatives. As a result, domestic companies have an increasing amount of revenues coming from sources outside of the U.S., and therefore stand to benefit should the European and Emerging Markets continue to outperform. Currently, the stocks in our composite portfolio generate approximately 40% of revenues from outside the U.S. The largest exposure coming from Applied Materials, Intel, and Mondelez, each with over 75% of their revenues coming from foreign sources. Our international strategy allows us to invest globally, while limiting governance and accounting issues as well as currency risk exposed to through direct foreign exposure.



IN SUMMARY

Our forecast for 2018 primarily incorporates faster economic growth, higher inflation, and significantly higher corporate profits. We are expecting 3.5%+ GDP growth, 2.7% CPI inflation, and corporate profit gains of 15%+ or better. In terms of the S&P 500 index, earnings could increase to $155 per share, versus our estimate of $130 per share in 2017, subject to the implementation of new tax laws. We will of course be monitoring the rate of inflation, as wage gains are beginning to materialize which have the potential to raise the risk of a recession. Up to this point, we have been pleased with the Fed's diligently measured pace in raising interest rates as not to upset the current positive trend.

Our investment strategy continues to emphasis stocks over bonds in anticipation of moderate but positive stock returns this year, supported by the continuing expansion and earnings growth. Reasons for recent improvement in economic statistics include a significant reduction in regulations, gains in individual and corporate sentiment that are driving consumption, and increased capital investment. The improvement in many foreign economies, after a lagged recovery from the Great Recession, also aided the U.S. economy. Looking ahead, we believe that in 2018 a continuation in growth will be fueled by new tax legislation, infrastructure spending, and continued strong economic growth from abroad.

The opinions expressed in this commentary are those of Altman Investment Management, LLC as of the date appearing on this material only and are subject to change. The material is based upon information we consider reliable, but we do not represent that it is accurate or complete and should be relied upon as such. This document is intended for informational purposes, and the material presented does not take into account the particular investment objectives, financial situation or needs of the individual client, and should not be viewed as an offer or endorsement of any particular investment. Certain investments give rise to substantial risk and are not suitable for all investors. There is no guarantee that these views will come to pass. Any tax information contained herein is general and for informational purposes only. Altman Investment Management, LLC does not provide legal or tax advice, and the information contained herein should only be used in consultation with your legal, accounting and tax advisers.

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.