ALTMAN
INVESTMENT MANAGEMENT

EQUITY STRATEGY FOCUS

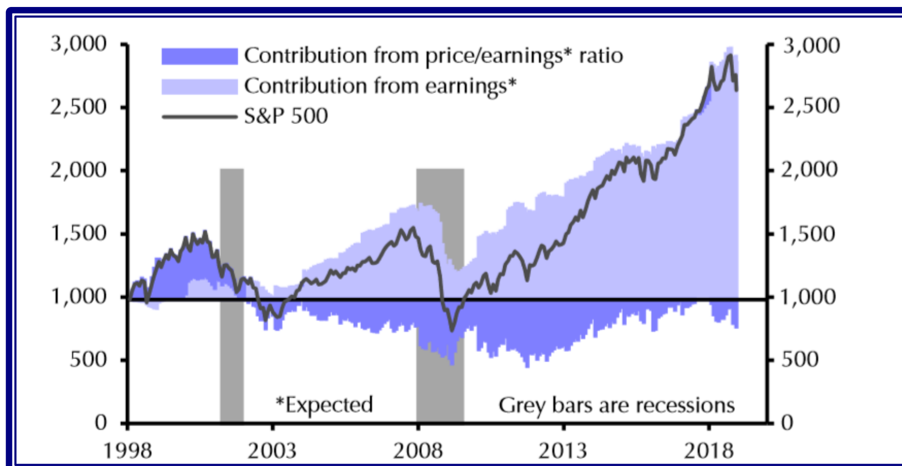
JANUARY, 2019

IN VIEW: The Equity Landscape

Equity prices are trading at levels that are more reflective of future expectations rather than current economic data. To date, U.S. consumer strength is evident, unemployment is low, wages are increasing and GDP has been rising. The recent fall in equity prices that began in October is mostly a reaction to the potential slowdown in GDP in response the unwinding of monetary accommodation, the ongoing/escalating trade war with China, and the diminishing impact from tax reform. Exacerbating the sell-off was the Fed's decision to raise rates as planned in December.

Contrary to multiples leading the markets higher during the tech bubble in the late 1990s, earnings have been a far more substantial contributor to S&P 500 returns in the current bull market. Prior sell offs have been accompanied by a drop in earnings and multiples, therefore these trends continue to be relevant indicators and are worth monitoring going forward.

Contribution to S&P 500 Performance



Source: Capital Economics and Bloomberg

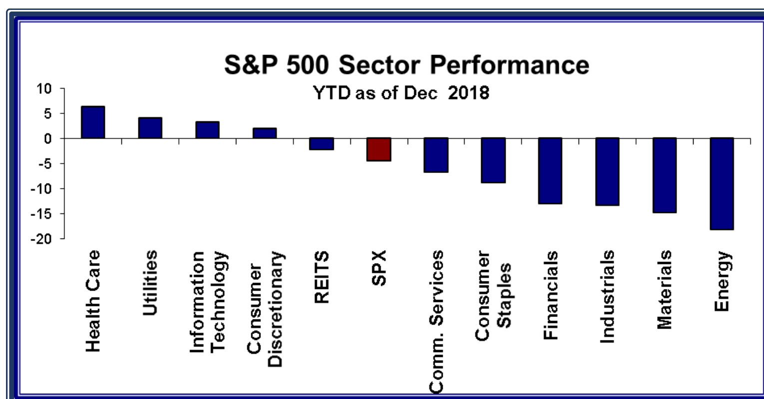
After oil sold off over 30% from the October peak of nearly $76, the Organization of the Petroleum Exporting Countries (OPEC) and its allies announced production cuts to help stabilize falling oil prices. In the months leading up to this decision, OPEC had agreed to bump up production in order to offset lower exports out of Iran due to sanctions. But more recently, the Trump administration granted 8 countries exemptions to these sanctions causing the cartel to reassess their initiatives. E&P company reports in Q3 are budgeting in $50-60 crude prices. Therefore, a likely surprise to the upside will provide companies with a surplus of funds that can be returned to investors. During 2018, the U.S. became the world's largest oil producer as per the Energy Information Administration. Lower oil prices no longer simply translate into tax cuts for consumers, they could also threaten cap ex and employment levels of U.S. oil producers.

In December, the Federal Reserve raised the Fed Funds rates to a range of 2.25%-2.50% while also stating they may slow the pace of rate hikes going forward due to softening growth expectations. While many Fed officials lowered their growth forecasts for 2019, they unanimously agreed to the December rate hike, the fourth one in 2018. At current levels, Fed officials believe interest rates are close to neutral and will not adversely impact or accelerate economic growth. In response, the yield on the 10-year Treasury bonds fell to only a 10-basis point spread against the 2-year yield. The bond market is telling us that investors are worried about slowing growth in the upcoming year and they are moving money into longer term investments. We are not forecasting a recession for 2019 but a slowdown in economic growth coupled with lower inflation could dissuade the Fed from hiking rates further in 2019.

CLOSE-UP: Equity Investment Overview

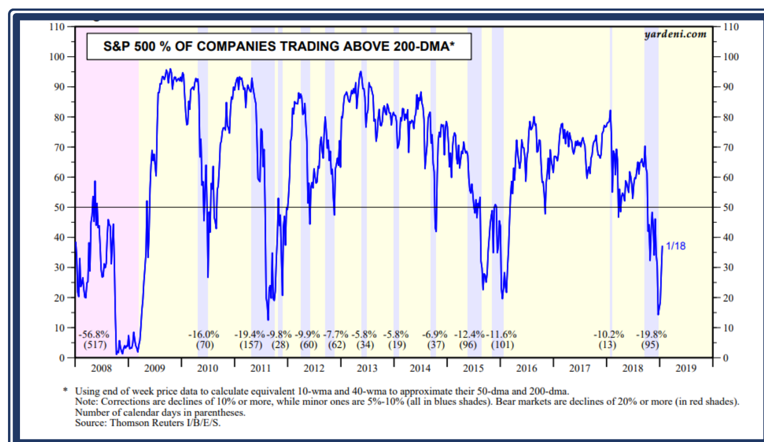
Market Performance Overview:

Bonds outperformed stocks during 2018 with the ML Domestic Master Index returning 0.92% against the S&P 500 of -4.4%. Large cap stocks beat smaller caps - and growth outperformed value. As the market sold off in Q4 however, it was value stocks that outperformed growth by 420 basis points. Only 4 of the 11 market sectors posted positive returns for the year - Healthcare, Utilities, Information Technology, and Consumer Discretionary.



Market breadth has improved some since its December lows of 10%. As of late January, the percentage of stocks now trading above their 200-day moving average (DMA) has reached the 35% level. Putting this into greater context, over the past 10 years market breadth has averaged 50%. The average is closer to 70% excluding the financial crisis.

We Would Still Like to See the 200 DMA Higher.



Earnings for 2018 are expected to grow approximately 20% with revenue growth of 8.9% according to FactSet Research Systems. The Energy sector is expected to report the strongest earnings growth. Despite the drop in oil prices to as low as $45 during the 4th quarter, the average price of oil in 2018 was near $65. This is significantly higher than 2017 levels which is contributing to earnings growth. The Materials sector is also anticipated to report strong growth, particularly in Metals & Mining and Containers & Packaging. Higher imposed tariffs, tax reform, and continued economic strength have all worked to support these industries. Additionally, the rise in short term rates for most of 2018 along with improved loan growth and credit should help prop up results within the Financials sector for the year.

2019 earnings growth estimates have been trimmed to roughly 5%. Downward revisions have been prompted by slowing growth expectations, U.S./ China tensions, and lower energy prices. The earnings estimate revision ratio (ERR) has fallen in the past 3 months and is now below 1, reflecting a majority of downward earnings revisions by analysts. The largest number of negative revisions are in the Technology, Financials, and Energy sectors. Utilities were the only sector to show a modest improvement in ERR. Purely domestic company ERRs are holding at about one upgrade for every downgrade, whereas multinationals are experiencing more downgrades.

During a turbulent 4th quarter, the AIM composite performed relatively well, as value stocks pulled ahead of growth stocks.

- The top 5 contributors to relative performance for the year were Keysight Technologies, Merck, Conoco Phillips, Express Scripts, and Cisco.
- The bottom 5 contributors to relative performance were Applied Materials, Halliburton, Conagra, Dollar tree, and Cardinal Health.

Portfolio Strategy:

Large cap bank stocks declined -16% in Q4 as compared to the S&P 500 index which was down -13.5%. Bank stocks typically underperform the broader market in periods of flattening yield curves. Forward multiples in the banking sector now stand at 8.5x earnings. This multiple reflects a bear case for banks by pricing in a recession. On the contrary, we are not forecasting a recession at this time and remain focused on what we see as accelerating loan growth and improving credit conditions. Externally, economic data continues to bode well for banks while improving internal factors are reflected in stronger balance sheets.

Potential headwinds include a flattening yield curve and slower economic growth. Q4 earnings kicked off with nearly all the banks and about ½ of the diversified financial stocks reporting in the first week. Results thus far have been weak leading analysts to continue to lower earnings expectations. Of those financial stocks reporting, about 50% beat on eps and approximately 30% on revenue. Should the shutdown resume, it has the potential to impact the overall level of interest rates, small business loan generation/approvals, and overall consumer confidence which will ultimately impact bank earnings.

Regions Financial's (RF) quarterly earnings came in at $0.37 a share, falling short of analyst expectations by $0.01. Q4 eps were a 42% increase from the same quarter last year. For the entire year, earnings were up 39% to $1.36 a share. The stock has already recovered 25% from its December low, double the pace of the market for the same time period. Loans across both corporate and consumer banking experienced broad-based growth with management anticipating its ability to keep pace with GDP growth.

Bank of America (BAC) is a high-quality bank with more than half of its deposits coming from the consumer side which benefit from higher short-term rates. BAC's strong credit quality has improved since the financial crisis due to enhanced underwriting standards. In Davos this month, BAC's CEO, Brian Moynihan, acknowledged slower economic growth but albeit from a faster pace. He continues to forecast 2.5% GDP growth in the U.S. and 3.5% globally, referring to the current rate as a "synchronized slowdown" as opposed to a "full stop". He attributes the success of the company which has improved its operating leverage for 16 straight quarters, to a strong core banking franchise, a large relative consumer banking business, and its continued investment in technology for better products and services.

After trading down 6% in 2018, the Semiconductor Index (SOX) started off the new year by outpacing the overall market by 236 basis points. While it is arguable whether weakness in wafer fab equipment is fully priced in, trading at a 17x forward multiple makes semis attractive at current levels. China remains a headwind with uncertainty surrounding trade tensions and its 5G adaptability. The street, however is forecasting a V shaped recovery with a sales recovering +11% in 2020 after a 2019 decline of 10%.

Intel (INTC) had a relatively strong year returning 4.21% as compared to a negative return for the benchmark SOX index of -6.05%. INTC reported Q3 results in October that beat expectations on both an earnings and revenue basis. Revenues were up 19% year over year and earnings up 39%. Record revenues were reported in cloud computing, data center management, and Internet of Things, all of which INTC is focused on for future growth. As semiconductor revenues are under pressure this year, INTC is guiding for 1% year over year growth as compared to flat to negative growth amongst many of its peers. INTC possesses a diverse set of products that should continue to meet heightened standards in computing demands. Risks/headwinds include the absence of a permanent CEO, delays in new generation chip technologies, and competition from Advanced Micro Devices.

Applied Materials (AMAT) was down nearly 35% last year on lower guidance for 2019. Management anticipates lower order volumes and a weakening foundry business as customers trim their cap spending plans. Memory markets (NAND and DRAM) are oversupplied or plateauing, although cash flow in this segment is strong and should help AMAT through this supply/demand imbalance. AMAT is trading at 58% of the SOX index P/E multiple as compared to an average of 88% during the last decade, highlighting the stock's attractive valuation level.

IN SUMMARY

The S&P benchmark index corrected during the last quarter of 2018 pulling back just shy of the 20% mark that defines a bear market. The last sell off of this significance was back in 2011 and some would argue that the recent one was long overdue. We view periodic corrections as healthy rebalancing that a portfolio of high-quality large cap stocks can withstand over the long run.

Looking ahead, we see economic data slowing as tax benefits and government spending taper off. Company guidance is warning that the outlook is likely to be more challenging and year-over-year comparisons should be tough on both revenues and earnings. This has tempered our 2019 profit growth from 15+% to a 10% level and a CPI of 2.5% and places a lower ceiling on market valuations. If the trade disputes are settled peacefully then the economy, after a pause, could reaccelerate back to a 3.0% growth rate.

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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.

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