

## IN VIEW: The Economic Landscape

**Consumer sentiment for December read at a level of 70.6 overall.** Interestingly though, was the more significant increase in optimism amongst the lower income households, versus a relatively small decline in the upper tier. The uptick in sentiment was driven primarily by higher income expectations in the coming year. The report goes on to say that inflation was perceived as a much greater risk factor than unemployment. Rising wages would indeed set the stage for fueling inflationary pressures - thus focusing all eyes on the Fed's approach to monetary policy, as they attempt to temper inflation while supporting employment.

**Despite a pullback in December, the U.S. Purchasing Manager's Index (PMI) remains in expansionary territory.** Demand is driving the manufacturing sector, supported by strong (albeit slowing) new orders, inventories and backorders. Overall consumption remains elevated with some pullback in month-over-month production which offset employment gains. As supply constraints continue, supplier delivery rates appear to be improving. The Global Purchasing Manager's Index inched up in the latter part of Q4, after having weakened for most of 2021, suggesting that supply improvements have led to a resumption in the recovery. This is evidenced by the converging spread between supply and demand. The more recent report in January however, included more data from the impact of the Omicron variant and thus showed a modest downtick of 1.2% as expected.

**Global Manufacturing PMI  
Output & New Orders**



Sources: Capital Economics, CEIC, HIS Markit

**Employment has recovered by 18.8 million, but remains 3.6 million below the pre-pandemic level.** In December, employment rose by 199,000 supported by upticks in leisure and hospitality, professional and business services, manufacturing, construction, and transportation and warehousing. This report however, missed expectations for the second month in a row and came in well below the average monthly job gains for this year. This could be setting the stage for a moderation in job growth after a robust recovery off the bottom. The emergence of Omicron is set to exacerbate labor shortages as more employees call out sick. Although this should be temporary, it could contribute to more cancellations and even closings in some avenues. This comes during a time when employers are already struggling to fill jobs in an environment of rising demand. Wage growth is trending above pre-pandemic levels at 4.7%. Overall, the labor market is in a healthy position at the start of the year, however tightness in the market coupled with inflation will keep the Fed on course to begin raising rates.

In addition to rising employment, improving household wealth and increasing capex in conjunction with the continued release of pent-up demand are each poised to fuel economic growth throughout next year. With over \$2 trillion in cash on the books of S&P 500 companies, coupled with low-cost borrowing, corporations are in a position of strength to increase spending on fixed investments which have held in a “wait and see” pattern since the pandemic began. Deposits in all U.S. commercial banks climbed to \$18 trillion at year end, indicating access to capital is also available to help fuel future spending on the consumer side as well.

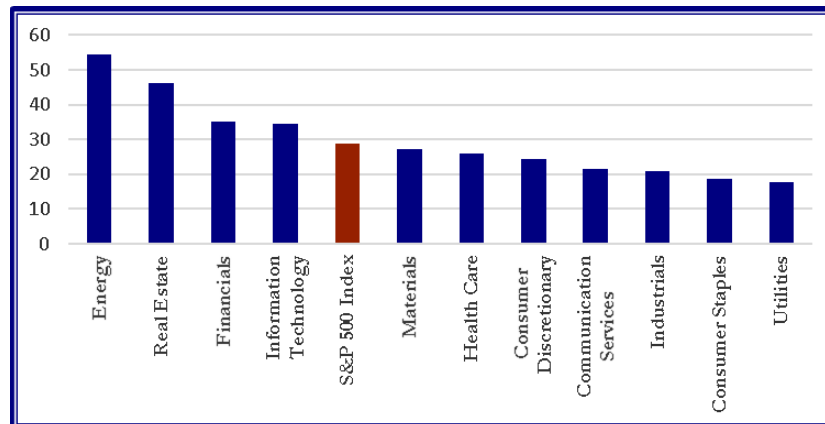
Inflation climbed yet again in December to an annualized rate of 7% mostly due to ongoing supply shortages and a rise in used autos and shelter costs. Excluding food and energy puts inflation around 5.5%. Stocks traded up on the news, as the uptick in inflation was widely anticipated. The Federal Reserve is keeping a close eye on the level and has recently targeted March as the end to its asset purchases, opening the door for interest rate hikes later this year in the neighborhood of 3-4x by year end.

## CLOSE-UP: Equity Investment Overview

### *Market Performance & Earnings:*

The S&P 500 benchmark index enjoyed another stellar year, recording a total return of 28.9%. High quality, large cap, and high dividend stocks out-performed during the year. Growth stocks out-performed Value for the full year, after lagging for most of the first half. Energy was the clear leader in total return, followed by Real Estate, Financials, and Technology. All sectors were positive for the year with Utilities and Consumer Staples trailing their peers.

**S&P Benchmark Return  
2021 YTD**



The top 5 performers in the AIM composite portfolio were Applied Materials, Lowe’s, Accenture, Microsoft and Bank of America. The weakest stocks in the portfolio were Koninklijke Philips, Fidelity National, Walt Disney, Conagra and Comcast.

**We uphold our preference for stocks heading into the new year.** Although lofty price levels may suggest markets are vulnerable for a short term pull back in the range of 5-10%, the likelihood of a lengthy or severe bear market is limited given the upward trajectory of the economic recovery. For one, profit margin reporting has been robust with 64% of companies reporting higher year-over-year profits, according to Goldman Sachs. Additionally, equity risk premiums are still very attractive supporting equity ownership over bonds. Also, when considering bond yields from a historical perspective, rates still have nearly 2% points to move up before they would adversely impact stock prices. Fund flows and balances further support equity investments, as well as corporate appetites for share repurchases.

**Q3 earnings beat analyst expectations with growth of 38.8% year-over-year.** Margins came in at record high levels, despite labor shortages and supply disruptions. Bottom-line earnings growth on a year-over-year basis was strongest in Energy followed by Materials and Industrials. The weakest sectors in the market were Consumer Staples and Consumer Discretionary. Top-line sales growth rankings mirrored that of earnings growth, while Financials lagged behind Consumer Staples and Discretionary.

**Inflation was the most recurring topic amongst earnings calls, particularly with respect to the rising cost of supply chains.** Supply disruptions are largely anticipated to ease in the new year, but to what extent and how fast is still to be seen. Wage pressures are the most risk to margins and account for nearly 40% of total costs, according to the U.S. Bureau of Economic Analysis. Productivity gains boosted by capex spend could work to ease these pressures somewhat. Additionally, companies cited pricing power as means to offset headwinds, particularly as demand continues to rise.

**Expectations for Q4 are for moderating growth, as consensus expectations call for some margin compression in Q1 due to heightened freight charges and seasonality.** With only 50% of earnings in as of this writing, net margins (ex: Financials) are indeed tracking with consensus estimates. But some analysts believe margin estimates may be too conservative given the vast pricing power and productivity potential. A number of factors will influence earnings growth in the coming quarters. Some areas include Covid-19 developments, viability of pricing power, labor cost pressures, and demand growth. The direction, timing and longevity of each of these factors will be significant and we will be monitoring these developments closely. It's worth mentioning that although only a small fraction of S&P 500 companies have reported capex guidance, the reported figures are up 38% year-over-year, indicating growing optimism.

## ***Equity Strategy:***

### ***Early Q1 Rebalance of Portfolio***

**We increased our banking exposure modestly by adding to US Bancorp (USB), a large cap banking and financial services company.** Taking profits from the Technology sector on the other side of the trade allowed us to modestly lower the portfolio multiple in preparation for a higher interest rate environment. Profit margins are expected to rise as banks can earn more from longer term borrowers. Banks and brokerage houses also benefit from rising rates that generate higher interest income and trading volumes. Specifically for USB, stronger trends in its payments business, improving volumes and opportunities in the digital wallet space should act as tailwinds. Our view of rising long term interest rates provides another potential boost for Banks and Financial Services. While lending remains challenging in the short term for the industry, we believe that our exposure of 20% (just shy of weighting in the Russell 1000 Value Index) at this point in the cycle is warranted.

### **Select Sector or Stock Review:**

**Oil prices rose during the first 3 quarters of the year, until the U.S., along with other oil consuming countries, began releasing reserves in an effort to stave off inflation.** Crude oil dropped from its peak of \$84.65 in October to the mid \$60s in early December. Additional downward pressure on oil prices was the result of renewed Covid-19 fears amid the emergence of the Omicron variant. Despite this late year decline, OPEC and Russia agreed to stick with prior output plans to gradually bring production back online by 400,000 mb/d each month. Since that dip in prices, crude oil has recovered to above \$80 as the overall fundamentals prevailed. Inventories are still 5% below 5-year averages and there is a 2 mb/d shortfall in supply.

**As more countries join forces to combat climate change, OPEC's influence will be impacted - but as far as to what extent, it's too early to tell.** For the short term, U.S. producers still provide competitive pressures as production continues to ramp up during the year. But over the longer term, as many oil supplying countries cut production in favor of other energy sources, this could open the door for OPEC to exert greater leverage over oil prices, depending upon longer term demand. OPEC is focused on what it believes to be ample demand to the extent it is spending more on production capacity. The IEA reports that OPEC's share of production could reach 49% and 58% by 2030 and 2050 respectively. To be successful, demand for oil must thrive and there needs to be a collective and cohesive partnership between the cartel and Russia, which has not always been the case.

### **Disconnect Between Oil Prices and Oil Stocks**



The oil price disconnect reveals investor concern over budgeting, executive incentives, and the impact climate change initiatives could have on oil demand. Adding to the complexity, growing interest in ESG compliance by investors creates challenges for oil companies to obtain capital.

### **Dollar Tree, Inc. (DLTR)**

In Q4, consumer discretionary sector contributed to relative performance. Discount retailer Dollar Tree, Inc. led the group with a gain of 46.8%. The company's shares benefited from news that activist investor Mantle Ridge had taken a \$1.8 billion position in Dollar Tree and was working with Dollar General's ex-CEO Richard Dreiling, with the expectation that he could help quicken the pace of improvements at the company. Dollar Tree's shares also got a boost after the company reported its quarterly earnings. While results were mixed, with freight costs still pressuring gross margins, Dollar Tree announced that it would be accelerating its multi-price initiative, targeting the roll-out to all core Dollar Tree stores by the end of the company's fiscal first quarter (April 2022).

### **Comcast Corporation (CMCSA)**

Another notable detractor was global media and technology company Comcast Corp., which declined -9.6%. In its quarterly earnings announcement, the company reported that all segments performed slightly ahead of expectations on earnings, although expectations for growth in the cable segment had been lowered by management. The company noted increased competition for low-income customers, as traditional wireless providers compete more heavily in new government programs. The company's shares remained under pressure during the quarter, as management updated its guidance in December for full-year broadband customer additions, which were below the consensus estimate (although in line with our modeling). Broadband remains a growth business for Comcast (and a profitable one) - although the rate of growth will likely be lower than management's earlier projections. Overall, we see Comcast's diverse business model as a strength for the company. Another positive, in our opinion, is that the company recently announced it had completed its debt reduction program.

### **Cardinal Health, Inc. (CAH)**

Cardinal is a major healthcare products distribution company that operates in two segments: Pharmaceutical and Medical. The Pharmaceutical segment distributes branded and generic pharmaceuticals and over-the-counter healthcare products. The Medical segment manufactures, sources, and distributes medical, surgical, and laboratory products. At the time of initial purchase, Cardinal had underperformed owing to a series of earnings misses, concern surrounding the renewal of its contract with CVS, and management's delay in providing long-term guidance. At the time, Cardinal was the cheapest of the three major distributors, was trading well below its historical price multiples and, in our view, looked compelling on a sum-of-the-parts basis, as investors appeared to be overly discounting the more valuable clinical products business, which Cardinal later spun off. By establishing a position in Cardinal, we added portfolio exposure to healthcare services, and we believed Cardinal would provide a diversification benefit. Furthermore, distributors were earning higher margins on generic drugs, which meant Cardinal offered an attractive way to offset some of the generic risk inherent in several pharmaceutical holdings we held. More recently, during the past several years, Cardinal faced several challenges, including a deflationary environment for generic drug prices, legislative risks related to potential healthcare policy changes, uncertainty around opioid liabilities for the company and its peers, and lower volumes in both the Pharmaceutical and Medical segments because of lower healthcare use related to COVID.

The persistence of some of these challenges have contributed to the shares languishing versus the market. Additionally, the company had a series of execution problems, primarily in the medical segment of its business, which has also contributed to an erosion in investor confidence. More broadly, Cardinal's strategic decision to prioritize growing its medical business over its specialty pharmaceutical business ended up being disadvantageous for the company. Specialty is crucial to future pharmaceutical distribution growth and margins, and Cardinal's small scale placed the company at a competitive disadvantage. Cardinal did not perform as expected over the past several years. We have revisited the longer-term fundamentals in determining whether the opportunity cost of continuing to hold the position makes sense. Cardinal has not been a successful investment, underperforming both the healthcare sector and the benchmark. The stock still trades at a low multiple and a discount to its peers, offering an attractive cash flow yield and dividend yield. In addition, in this market environment, it provides some defensive cover as multiples decline in a rising interest rate backdrop.

### **Fidelity National Information Services, Inc. (FIS)**

Another notable detractor was IT services provider Fidelity National Information Services Inc., down -13.9% on a total return basis compared to a decline of -2.3% for the sector in the benchmark. The company's shares came under pressure following disappointing guidance from competitor Global Payments, Inc. and the announced acquisition of Australian payments processor Afterpay Ltd. (a provider of buy now/pay later services) by Square, Inc. The following day, Fidelity National announced quarterly results that were ahead of expectations. The company raised quarterly and annual guidance; however, guidance for the third quarter of 2021 was slightly below the consensus estimate, sending the shares down further.

During the company's earnings call, management confirmed it does not want to pursue a buy now/pay later acquisition and the credit risk it would entail. Additionally, while the company will continue to do strategic acquisitions, management believes Fidelity National's shares are undervalued and will therefore primarily focus on share repurchases for now. Management also conveyed its confidence in the company's competitive position during the recent quarterly presentation announcing overall organic revenue growth of 10%.

On a segment basis, growth came in at 13%, 10%, and 8% for Banking Solutions, Merchant Solutions, and Capital Market Solutions respectively. They are expanding globally through eCommerce, developing innovation solutions to increase scale in their enterprise business, and offering differentiated vertically specific capabilities in its small to medium sized businesses. We believe investors are underestimating the growth potential of Fidelity National's platform. The stock remains attractively valued, in our opinion, trading at a P/E ratio of 18.8x, a 17% discount to its 5-year average relative to the S&P 500 Index.

## IN CONCLUSION:

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**Ongoing supply disruptions, alongside the uncertainty surrounding the pandemic as it relates to societal adaptations to new variants and vaccination progress, could result in some deferral of demand.**

However, we believe the expansion is not being undermined. Forward looking indicators in support of a global economic recovery remain intact. We do, however, expect the growth to moderate somewhat in coming quarters, as the initial post-lockdown rebound fades and policy support is reduced. At the same time, supply shortages are likely to persist into early next year coupled with rising inflation. We anticipate U.S. GDP to moderate at around 3.5% growth in 2022, after surging 5.7% in 2021.

**Earnings growth should prove resilient and support equity prices, although we would expect returns to be more muted than in the past 12 months.** Our pro-cyclical posture favors the Financial, Energy and Healthcare sectors. We remain convinced that staying fully invested, with a preference for stocks over bonds in balanced portfolios, remains a prudent course. We have encouraged this position consistently throughout the current bull market that has lasted nearly 13 years. Given the current high valuations in equities, stock selection, diversification, and valuations are of paramount importance in portfolio construction.

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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 17<sup>th</sup>, 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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