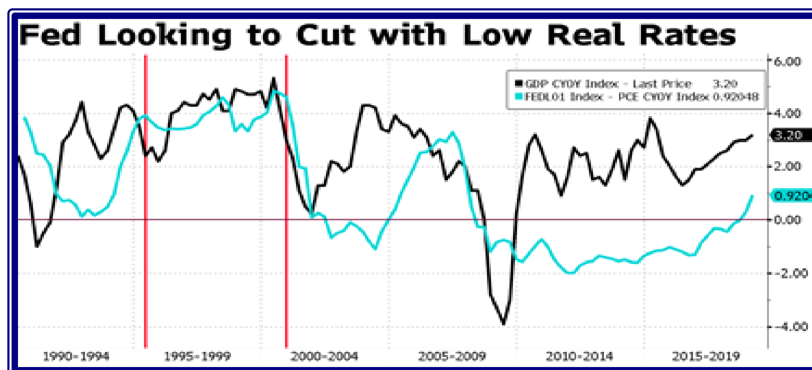
ALTMAN
INVESTMENT MANAGEMENT

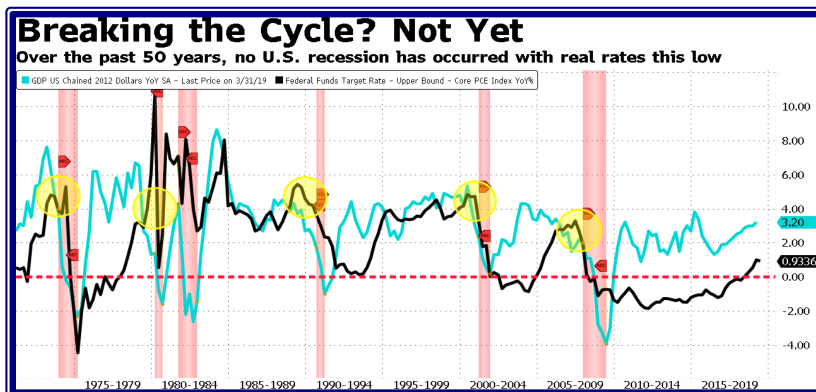
EQUITY STRATEGY FOCUS

JULY, 2019

IN VIEW: The Equity Landscape

The S&P 500 recorded solid gains in the second quarter of 2019, largely driven by a shift in the Federal Reserve's outlook for interest rate cuts, extending a rally that began in the equity and bond markets in mid-February. The S&P 500 has risen 18.5% on a total return basis since the start of the year and one of the best first halves since 1997. The majority of bond returns came from principal appreciation as rates declined. The recent bond market rally has been bolstered by global monetary accommodation. The FOMC also continued the narrative into the second quarter by altering their expectations for interest rate hikes from several to none in 2019 and perhaps only one hike next year. The Fed kept its target interest rate range at 2.25%-2.50% in its June Meeting citing sustained expansion of economic activity, strong labor market conditions, and inflation near 2%.





Source: Bloomberg

Overall consumer confidence remains high with the Conference Board's index exceeding analyst estimates in May. Lower interest rates and wage gains boosted consumer spending. This environment is currently offsetting fears from the ongoing trade war which has the potential to tighten consumer spending should tensions escalate while negotiations continue. Business confidence, however, is waning on pricing power concerns, capital expenditures, and hiring gauges. Weaker commodity prices in conjunction with trade war uncertainties is keeping a lid on manufacturers as they delay major decisions until the outlook is clearer.

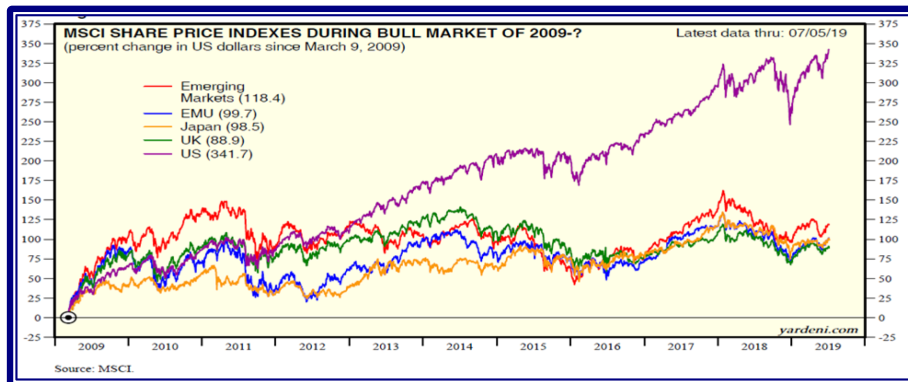
GDP came in at an annualized rate of 3.1% in Q1 up from 2.2% in Q4 of last year. Personal Consumption Expenditures, Gross Private Domestic Investment, Net Exports, Government Spending were all additive to GDP growth. However, there was weakness in areas such as motor vehicles and parts, non-residential fixed equipment investment, and residential fixed investments. Preliminary estimates for Q2 came in at 2.1% beating estimates of 1.8-2% as polled by Reuters and Dow Jones. The lower Q2 report, as result of slowing global economic growth, was partially offset by higher than expected consumer and government spending. Gross private domestic investment and falling inventories were the largest detraction from Q3 GDP growth.

Upon closer look - both absolutely and comparatively to past recessionary periods - we gain a sense of support for stocks at current levels. Since Q1, commodity prices have fallen, job sentiment has declined, and ISM new orders continue to trend downwards. However, recessionary indicators that remain positive outweigh negative data points, while a few suggest caution. Some of the positive indicators are credit spreads, jobless claims, and retail sales. Others are more cautious, such as money supply and ISM new orders. But predominantly, corporate profit growth remains positive, interest rates are low, and GDP is still growing; each in support of economic growth, albeit at a slower pace.

CLOSE-UP: Equity Investment Overview

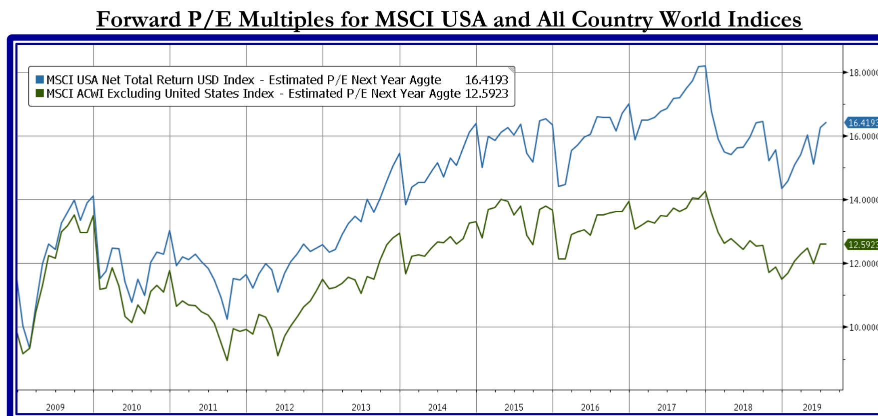
Market Performance Overview:

U.S. equities have been on a tear since bottoming in March of 2009. This momentum has carried stocks into the 11th year of the bull market.



The U.S. stock market continued outperforming international markets year-to-date with MSCI USA Equities Index coming in 444 basis points ahead of the MSCI All Country World Index ex-U.S. This is especially impressive given that the forward P/E of the U.S. MSCI has consistently exceeded the comparable valuation multiple for the MSCI All Country World Index.

Forward P/E Multiples for MSCI USA and All Country World Indices



Source: Bloomberg & Altman Investment Management, LLC

What is perhaps even more interesting is that the surge in U.S. stocks occurred after a -13.5% sell off in the S&P 500 index during Q4, and despite a December interest rate cut by the Fed, slowing economic growth forecasts, the looming trade war with China, and splintering U.S. international relations.

The strong equity market has been driven in part by corporate earnings growth and lower interest rates. In the years subsequent to the financial crisis, the Federal Reserve managed to maintain an overall accommodative approach while keeping interest rates in positive territory. Fed action helped lower borrowing costs in an effort to stimulate economic growth. Even after 9 interest rate hikes by the Federal Reserve since 2015, interest rates remain relatively low at 2.50% with inflation in check.

Even as earnings growth has been slowing relative to prior years, it seemingly remains strong enough to support stocks at current levels. Earnings during the 1st quarter grew at a rate of 1.1% year over year. That compares to earnings per share (EPS) growth rate of 3%. This implies growth was driven by share buybacks and not margin improvements alone.

Year over year growth in earnings was strongest in Healthcare, Communication Services, and Real Estate sectors. Energy, Technology, Materials, and Consumer Staples all exhibited a year over year decline in earnings. On top line sales growth, Healthcare was once again the leading sector, followed by Consumer Services, and Financials. Energy and Technology posted declines in sales growth.

Looking forward, pressures on volume sales and pricing power may materialize into lower margins. Consensus EPS growth is tracking at 0.4% growth so far for Q2. Analyst estimates, as reported by First Call, are tracking at 0% and 7% growth respectively for the subsequent quarters of this year, or an annualized rate of 4% growth for the year. U.S. corporations have been reserved in their guidance as it relates to capex and profits given slowing growth and uncertainties concerning trade and Fed policy.

Growth stocks outpaced value stocks by 525 basis points, calculated using the Russell 1000 Value Index against the Russell 1000 Growth Index. Even as growth stocks led the markets, the value stocks captured 90% of the S&P 500 benchmark return.

The strongest stocks in the AIM composite during the first half of the year were Keysight Technologies, Johnson Controls, Applied Materials, Mondelez, and Honeywell. Walt Disney Company, MetLife, and Microsoft popped up significantly in Q2, up 26%, 18% and 14% respectively.

The weakest stocks in the AIM composite during the first half of the year were Cigna, Occidental Petroleum, Halliburton, Dow, and Bank of New York.

The Second Quarter S&P 500 Results: Earnings, Revenues, Valuation & Margins

Consensus S&P 500 forward revenues and earnings dropped from their record highs last month. Analysts expect forward revenues growth to approach 5.3%, and forward earnings growth of 8.0% as the season winds down. This marks a full percentage point revision for revenue expectations from a seven-year high of 6.3% in February 2018, but still better than the mid-February lows. Consensus forward earnings growth is also down to mid- 8.0% levels from a six-year high of 16.9% last February, but improving late February 2019.

Prior to the passage of the Tax Cuts and Jobs Act (TCJA), revenues growth was expected at 5.5% and forward earnings growth was 11.1%. Turning to the annual growth expectations, analysts expect revenues growth to slow from 8.5% in 2018 to 4.5% in 2019 and 5.3% in 2020. They're calling for earnings growth to slow sharply in 2019, before improving to 10.4% in 2020.

The forward profit margin closed the quarter at 12.1%, and is down from a record high of 12.4% in mid-September. That compares to 11.1% prior to the passage of the TCJA in December 2017, and a 24-month low of 10.4% in March 2016, according to our research resources. Analysts are expecting the profit margin to fall from 12.0% in 2018 to 11.7% in 2019 before rising to 12.2% in 2020.

The S&P 500's forward P/E was down to a low of 16.5 and from an 18-month high of 17.4 in late July. That's up from 14.3 during December, which was the lowest reading since October 2013, and down 23% from the 16-year high of 18.6 at the market's valuation peak in January 2018. Similarly, the S&P 500 price-to-sales ratio was down 1.99 from an 11-month high of 2.10 in late July. That's up from December, when it was the lowest since November 2016, and down 19% from its then-record high of 2.16 in January 2018.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins: Consensus forward revenues was somewhat disappointing rising only for three of the 11 S&P 500 sectors and forward earnings did so for just one sector. Real Estate was the only sector to have both measures rise. Forward revenues and earnings are at or around record highs for 4/11 sectors: Consumer Discretionary, Health Care, Industrials, and Tech. Forward P/S and P/E ratios have declined from recent multi-year or record highs for four of the sectors: Communication Services, Real Estate, Tech, and Utilities. According to Bloomberg, all sectors remain well above their multi-year lows during December 2018. Due to the TCJA, the profit margin for 2018 was higher for most all sectors except Real Estate. The outlook for 2019 shows higher margins are expected y/y now for just one sector: Financials.

Portfolio Strategy:

A deeper dive into equity performance may be telling a story of continued equity strength, but with the potential for leadership change. Year to date, we have seen broad strength across all equity sectors. But in recent months we saw strength emanating from defensive areas of the market. The expectation of a July interest rate cut to offset slowing economic growth is keeping growth stocks charging full steam ahead, but the build-up of defensive stocks may be an indication that the Fed's insurance rate cut may not have a long-lasting impact to counteract slowing economic growth, especially as the U.S. trade war with China, on a temporary truce, has not been resolved. In this environment, defensive stocks could outperform for a while longer.

Source: Morgan Stanley & Co

The AIM composite portfolio is positioned with its largest over-weights against the S&P 500 Index in the Energy, Healthcare and Financial sectors. The price of WTI oil got as high as $66 in April and is now trading in the mid $50s. Strong upstream earnings in integrated oils worked to offset downstream and chemical businesses. Companies with better cost controls to help navigate through lower oil prices are preferred.

Global Inflationary Implications: Oil Prices

By the start of third quarter, the price of oil has been falling amid US-China escalating trade tensions and increased fears about global economic growth. Looking ahead, we expect consumption growth to slow, in part because we think that Chinese manufacturing activity will remain weak in the near term. Meanwhile, we think that U.S. output will keep growing as more pipeline capacity comes on stream. Collectively, these could push the market into a temporary surplus.

The major upside risk to our price forecast is an escalation in U.S.-Iran tensions. Iran could attempt to close the Strait of Hormuz, a shipping chokepoint through which 20% of global supply flows. If the Strait was to close, then we would expect the price of oil to surge well over $100 per barrel.

On the trade front, oil imports by India and South Korea slumped in y/y terms in June probably because Iran was forced to cut its crude exports to a reported 300,000 barrels per day, because of the end of U.S. waivers in May. Admittedly, Japanese import growth increased, but this was from an unusually low base a year earlier. Meanwhile, U.S. crude exports dipped in July due in part to the recent narrowing of the Brent-WTI price spread, as well as lower production as a result of Hurricane Barry. Looking ahead, we think that the spread will continue to narrow as additional pipeline capacity should allow the U.S. to export more.

Elsewhere, implied gasoline demand in the U.S. looks weak on a seasonal basis. We expect gasoline demand to be under pressure in the near term as the U.S. economy temporarily slows, and could lead to a drop in U.S. employment growth. Investors are likely to stay somewhat bearish through the next several months. Oil prices have fallen below our yearend forecast and should put downward pressure on inflation during the third and fourth quarters of 2019. The risks to this oil price forecast is certainly skewed to the upside. But even a surge in oil prices would have small effects on core inflation and would unlikely stop central banks accommodative monetary policy. The price of Brent crude got caught up in the broad sell-off in risky assets over the past month and, at $59 per barrel, remains 15% lower than in the middle of May. While supply constraints might push the oil price up a little in the near term, we expect it to end the year at $65 per barrel amid weakness in demand. This could knock a little under half a percentage-point off headline inflation in OECD economies in the coming months. But the direct effect on core inflation is likely to be modest and our view that central banks will cut interest rates is premised on more fundamental economic factors.

In fact, as highlighted by the latest increase in response to attacks on two tankers in the Gulf of Oman, there is a bigger risk of a sharp rise in oil prices than of a further fall. If Brent jumped to over $100bp (by 50% y/y), this would have a significant impact on headline inflation via its direct effect on consumer energy prices. On the basis of past economic stats, our sources believe that this could add about 0.7% points to inflation in the OECD. An oil price shock could push up the average headline inflation rate in the G4 advanced economies by about 0.8% points but a more modest increase (.15%) in the core rate. While much smaller than the effect on the headline rate, the estimated effect of a jump in oil prices on core inflation takes much longer for oil price moves to feed through to the prices of all sorts of non-energy consumer goods and (especially) services.

An oil shock would also have indirect, second-round effects on consumer prices by boosting energy costs for firms throughout the economy, some of whom would pass them on to consumers. As well as transport services, producers of materials used widely in industry are most exposed to higher oil prices. However, given global competitive factors diminishing pricing power and technological innovations impacting labor bargaining power, any sharp rise in oil prices would have largely transitory effects on inflation.

On the macro-economic front, our overweight in energy suggests that even an abrupt reversal of the recent drop in oil prices would be unlikely to sway the world's major central banks away from a path of policy loosening - especially given the likely backdrop of underlying economic weakness.

The Energy Sector:

Investments in the Energy sector caused the largest drag on relative returns in the second quarter. As a group, the portfolio's energy stocks took 150 basis points off the portfolio results partly attributed to the overweight position versus the benchmark. In a general sense, investor concerns about slowing global growth and the potential for weaker crude oil demand have hit the Energy sector. West Texas Intermediate (WTI) crude oil, the domestic benchmark, declined -2.8% during the quarter. Halliburton Co., an energy services provider, and Occidental Petroleum Corp., an exploration and production company, were down the most, falling -21.8% and -22.8%, respectively.

Halliburton sold off in response to several issues beyond those related to global economic growth. One issue was the constraint on takeaway capacity in the Permian Basin, which surfaced in headlines during the second half of 2018 and has persisted through July. We believe this is a temporary phenomenon that affects rig counts and should ease in the second half of 2019. Of course, investors compounded the negative effects on the sector by focusing on the levered companies. Although the overall debt for Halliburton is high relative to past cycles, it's important to note that less than 20% of the debt is due in the next five years. We believe the company offers an attractive upside-downside risk reward ratio over a three- to five-year time horizon, barring a collapse in oil demand. Current valuation levels - price-to-earnings (P/E) multiple of 10, price-to-book multiple of 2, price-to-sales multiple of 0.8, and a dividend yield of 3.25% - appear to be fully discounted in the current price.

Occidental Petroleum shares came under some pressure as well, following its decision to acquire Anadarko Petroleum Corp. which, like Occidental, has a substantial presence in the Permian Basin. We understand the market's near-term frustration with the offering price, which advanced as Occidental (OXY) and Chevron embarked on a bidding war for Anadarko, as well as with the terms of the financing, which included $10 billion from Berkshire Hathaway in exchange for shares of a newly issued 8% preferred stock. However, we still remain positive on the final terms and believe that the combination supports the original conclusion that OXY is still an attractive long-term investment. The combination appears to be highly accretive with cash-flow synergies in the $3 billion range. This gives OXY the ability to grow its production footprint in the highly sought-after Permian Basin which has the lowest break-even costs and an impressive operating leverage. We should emphasize that there is also significant overlap between Occidental and Anadarko within the Permian's Basin that allows Occidental to expand lateral drilling and enhance profitably in the region.

The Information Technology Sector:

Among the portfolio's seven holdings in the IT sector, two underperformed the market but the average results +4.3% exceeded the benchmark sector results, a gain of 3.2% during the quarter. Semiconductor manufacturer Intel Corp., the laggard in the group, was down -10.3%. The company's shares traded lower following its first quarter earnings report, in which revenue and earnings per share (EPS) met expectations, but gross margin came under pressure. The company expressed a more cautious view during the earnings conference call and lowered its full-year guidance, citing pricing pressures in memory chips, rising costs associated with its 10-nanometer offering, and a more challenging IT spending environment. At its investor day a few weeks later, Intel provided longer term guidance with conservative assumptions for revenue and EPS growth and a gross margin range that was lower than its previous projections. Additionally, the company's shares fell in response to the Trump administration's ban on technology sales to Huawei, a Chinese communications equipment provider, despite the fact that semiconductor sales to Huawei comprise less than 1% of Intel's revenues. In light of the current competitive challenges and pricing pressures, the longer-term outlook for Intel remains in our judgement attractive based on a number of attributes including its discounted valuation, diversified business model, improving operational efficiency, balance-sheet strength, and cash-flow generation.

The S&P 500 Semiconductor and Semiconductor Equipment stock price indices were battered in the quarter, primarily on renewed fears of a global economic slowdown, along with news that some of the U.S. tariffs on Chinese goods would be postponed until December. Semiconductor sales worldwide have been under pressure all year. The Semiconductor Industry Association that worldwide semiconductor sales in June were down 0.9% m/m and down 16.8% y/y. Using a three-month moving average, the drop-in industry sales measures 22.3% from the $42.1 billion peak last October.

Until recently, investors seemed to be anticipating the end of the downturn. The S&P 500 Semiconductor Equipment industry index is up 44.4% year-to-date through July 31st. A bit further behind is the S&P 500 Semiconductors stock price index, up 13.5% ytd and narrowly beating the S&P 500 over the same period. Until the recent selloff, perhaps investors were focusing on the improved earnings analysts are forecasting for both industries next year. Analysts expect the Semiconductor Equipment industry's revenue to drop 11.3% this year and rise 6.3% in 2020. Likewise, earnings are forecast to drop 22.2% this year and to bounce by 9.8% next year. This projected rebound in earnings gives us a greater degree of confidence to stay the course with our portfolio exposure.

The Financial Sector:

Another notable detractor from the portfolio results during the second quarter was global financial services provider Bank of New York Mellon Corp., which declined -12.0%. The shares sold off after the company reported its quarterly results. Revenues were 7% lower from a year earlier, due to weakness in both net interest income and fee income. Contributing to lower interest income were declines in both average earning assets and net interest margin. On the fee side, there was pressure on the bank's foreign exchange, investment management, and issuer services businesses. Additionally, deposit balances fell as more of the company's clients moved to interest-bearing deposits with higher yields. The bank continues to make progress in reducing expenses – lower by 1% last quarter – and, despite near-term challenges, seems to be positioned well, the result of the increasing trend toward outsourcing, the bank's substantial investment in technology, and its considerable scale across its businesses. Meanwhile, the company's shares are trading near five-year lows on multiples of earnings and book value.

The Industrial Sector:

The industrials sector made the largest contributions to relative performance. Three of the portfolio's four stocks rose with the average gain of 10.1% versus 6.6% for the sector in the benchmark. Shares of defense contractor Northrop Grumman Corp. led the group higher, gaining 20.4%. The company reported solid results across its major business segments for the first quarter of 2019, although total revenues were below Wall Street expectations. Nonetheless, operating margins were better than expected. Northrop Grumman also modestly increased its full-year guidance for EPS. We continue to believe the company is attractively positioned – its businesses are well aligned with U.S. Department of Defense priorities, including manned and unmanned aircraft and space and satellite systems. The company has a strong and growing backlog and has been focused on operational improvements. Overall, the business tends to be less economically sensitive relative to the broader Industrial sector.

A Note on a Corporate Restructuring:

In Q2, DowDuPont completed its spinoff into 3 entities; Dow Inc. (commodity chemicals), DuPont de Nemours, Inc. (specialty chemicals), and Corteva (agriculture business). We sold off our position in Dow Inc, investing the proceeds into DuPont de Nemours (DD). The new standalone company stands to benefit from a rebound in the auto and electronics market, improved R&D, unrealized merger synergies, and targeted non-core divestitures. DD currently trades at a 33% discount EPS multiple to the S&P 500 and a 15% to the materials index with a dividend yield of approximately 1.8%.

The Electronics & Imaging unit benefits from the increasing need for semiconductors to support the growth in 5G wireless and artificial intelligence (AI) technologies. In the Safety & Construction segment, the company's water business is exposed to the growing need for purified water. Additionally, the company's products in the Nutrition & Biosciences segment are increasingly needed to support the global push towards better health and nutrition, as well as cleaner energy. Other attributes include cost synergies across DuPont's businesses estimated to be around $1 billion and expected to be achieved by the third quarter of 2019. DuPont is a shareholder-friendly company, planning on returning 30%-40% of net income to shareholders as dividends and has received board approval for a $2 billion share repurchase.

Corteva was formed from the legacy agricultural businesses of both Dow and DuPont. The company is number 2 in global seed sales (number 1 in the United States for corn and soybeans), and number 4 in global pesticide sales. Seeds comprise 57% of revenue; crop protection 43%. Some of the notable decision points for selling Corteva included: 1) the level of existing exposure to agricultural commodities in the portfolio through our ownership of Archer-Daniels-Midland Co., 2) our sense that Corteva's results could be relatively volatile and that its shares could remain depressed because of where we are in the agricultural cycle, and 3) the company's higher level of direct exposure to the trade war and tariffs, particularly as they relate to the soybean market.

Final Note on Healthcare:

Healthcare will be front and center in the upcoming election next year as coverage and drug pricing debates heat up. Both the Healthcare and the Financial stocks, which are over weighted in the portfolio as compared to our benchmark, are positioned well benefiting from tax reform and are not directly tied to the negative impacts of an ongoing trade war with China.

IN SUMMARY:

We believe that a recession is unlikely over the next 12 months, given low interest rates and earnings growth, albeit at a slower pace. The strength in forward earnings suggests that industry analysts believe that their companies can continue to grow earnings, despite the headline news about weaker global economic activity. In the current environment, GDP continues to grow around 2.8% on a y/y basis. Inflation is around 2%, and the 10-year U.S. Treasury bond yield is also around 2%. This seems to be a very supportive combination for U.S. stocks.

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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.

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.