ALTMAN
INVESTMENT MANAGEMENT

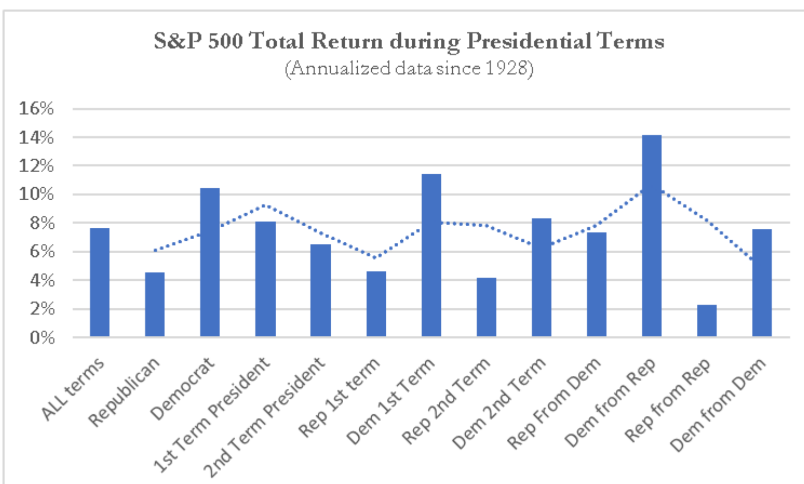
EQUITY STRATEGY FOCUS

JULY, 2020

IN VIEW: The Economic Landscape

The political uncertainty surrounding the upcoming election could cause the market to be range-bound through November. No matter the results, an expanding deficit is likely to continue if not for COVID-19 but from general policies on either side. If Republicans win, there will likely be another round of tax cuts without much to offset on the spending side. If Democrats win, taxes will likely increase but so will spending on healthcare and infrastructure. Different approaches, but both resulting in higher deficits. However, other issues such as healthcare, immigration, and foreign relations may have vastly different outcomes depending on who resides in the White House next year. While it's not in the scope of this paper to list all of their policy differences, in key issues such as jobs, healthcare, and a plan to handle the current pandemic, the two candidates could not be more at odds. Therefore, the level of uncertainty may lead to range-bound markets throughout the remainder of the year.

We took a look at returns during presidential cycles under various scenarios and found that markets appear to perform better under Democratic leadership. The overall moving average settles in around 7-9% annualized returns. The COVID-19 pandemic however changes the game significantly. It comes down to the timing/availability of a vaccine - and whether or not we lapse into a second wave in the fall, thereby pushing the recovery timeline back indefinitely.



Source: BofA Global Research and Altman Investment Management

Off the bottom in March, as we discussed in our last quarterly commentary, the optimistic outlook on the part of investors has created a disconnect between the performance in the stock market and economic performance. A recovery in the stock market will not necessarily rely upon a simultaneous resumption of the economy, but rather the expectation that a recovery is on the horizon. The second quarter has demonstrated this point, as the market has recovered 39.3% off the March bottom through June 30th, with the backdrop of 11.1% unemployment totaling 17.8 million people out of work paired with the latest GDP report of -4.8% for Q1.

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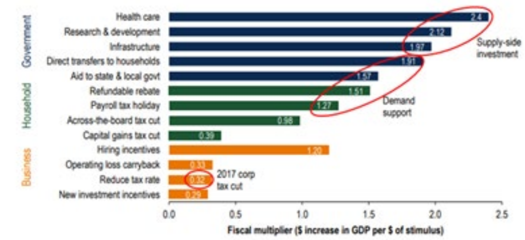
It was initially thought that economic activity may have troughed in April or May. However, since then there have been pauses and even back tracking in re-opening initiatives in several states. PMIs are still stuck around 50 in between expansion and contraction territories. But even as some activity is picking up, such as traffic and gasoline purchases, overall it remains below pre-pandemic levels. Plus, we still need to determine whether consumers feel safe to spend or feel the need to save in this environment. It's too early to tell yet, but we can look at China who is ahead of us in recovery by a few weeks. According to analysis by Capital Economics, data out of China shows that the consumer is still reluctant to spend even as production picks up. For the time being, we await policy guidance on bringing employees back to work safely. Additional questions are floating around such as whether consumers can shop with confidence not only financially but feel safe while out and about.

Consumer spending in a BofA credit card study shows U.S. purchasing picking up as states reopen, particularly in online retail and electronics. This growth however is partially offset by softening spending in states that are experiencing a resurgence in Covid-19 infections. We expect markets to remain volatile as the failure to contain the virus overshadows any progress made of the economic data side.

Fiscal Support was Significant in Swiftness and Severity

Source: BofA Research Investment Committee, Global Financial Data

Impact on GDP from Fiscal Stimulus



Source: BofA Research Investment, Committee, Congressional Budget Office, Moody's, Reeves et al. (2013), Deleidi et al. (2019)

Fiscal response to support the crisis has thus far aided in keeping businesses afloat during the shutdown, and a 2nd round of fiscal stimulus is possible in the coming weeks. That being said, the aggressive influx of liquidity into the system is not without its risks. Some economists are beginning to caution on the potential impact the excess liquidity will have on inflation and debt burdens. With regards to inflation, all else equal, the general level of money supply is generally correlated with price levels. However, the current low interest rate environment combined with a strong U.S. dollar appears to be keeping inflation in check. Pressures caused by the current downturn, i.e. high unemployment and consumer reluctance to spend, are at least for now, working to offset inflationary pressures from increased liquidity. This environment is likely to continue for the next couple of years as economies ramp up to pre-COVID levels.

An increase in the debt burden by both the private and public sector is another concern. Stimulus programs are working to temporarily lend solvency to firms in order to weather the shutdown. The real test comes once support is pared back and firms have to regain independent solvency on the backs of increased debt burdens. On the public side, global debt is rising to combat recessions which could lead to concerns over the ability to some to repay some of those debts. Interest rates would then rise, in turn increasing borrowing costs. But right now, as a second fiscal stimulus is anticipated and the Fed has committed to "do what we can to provide stability, to ensure that the recovery will be as strong as possible, and to limit lasting damage to the economy," there is a low probability for the liquidity spigot shutting off for some time (anytime soon?).

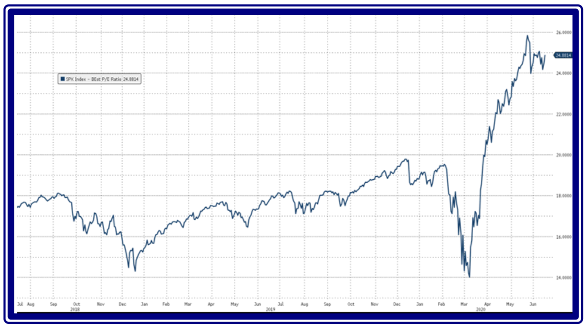
CLOSE-UP: Equity Investment Overview

Market Performance & Earnings:

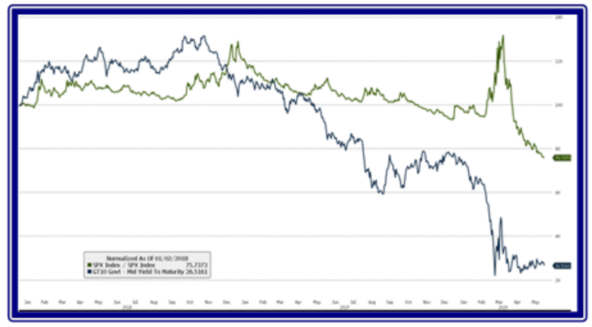
Stock market performance as represented by the S&P 500 benchmark index rebounded strongly in Q2 with a total return of 20.5%. Cyclicals led the way with Technology, Consumer Discretionary and Energy stocks each up over 30%. Defensive sectors such as Healthcare, Consumer Staples and Utilities underperformed the overall market. Performance results underscore investors' interpretation of economic weakness as transitory as they look towards a recovery in 2021.

As the economy shut down in Q1, the multiple of the S&P 500 contracted as earnings expectations plummeted along with prices. Investor sentiment was reflective of weakening expected income levels and an overall lower appetite for risk. As we entered Q2, investor focus shifted longer term towards optimism in 2021. Even as earnings expectations waned, prices soared expanding forward multiples that surpassed pre-crisis levels. The renewed appetite for risk is also evident in the spread between the S&P 500 earnings yield and the 10-year treasury. The relatively widening spread indicates the risk premium required to hold corporate equity securities has remained elevated.

S&P 500 Forward P/E



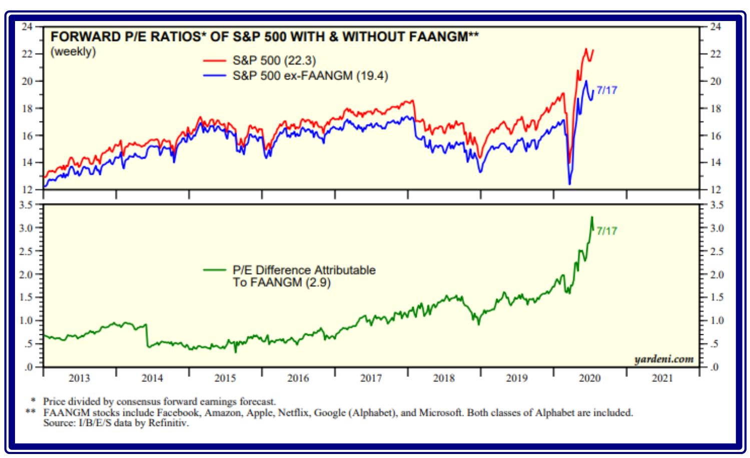
S&P 500 Earnings Yield Spread over 10 YR Treasury



Source: Bloomberg and Altman Investment Management, LLC

At such an elevated level, the market is expensive overall and it's telling us that it has already fully priced in a large premium for liquidity and hopes of a vaccine. Before Q1, markets benefited from tax cuts and extensive stock buyback programs even as GDP was expected to slow globally. Going forward, support for current market levels is now highly reliant upon a recovery in earnings. The difficulty here is that depressed capacity utilization rates, coinciding with negative GDP growth, have created substantial headwinds for earnings.

FAANGM stocks (Facebook, Apple, Amazon, Netflix, Alphabet, and Microsoft), account for nearly 25% of the S&P 500 market cap. With valuations in the 40x range, Facebook and Amazon weigh heavily on the average FAANGM multiple which is currently over 27x earnings. But even excluding FAANGM, stocks market valuations are still trending above historical averages. When markets trade at such lofty levels, fundamentals become even more important in stock selection as not to overpay for expectations that may already be fully priced in.



Consensus earnings for the 2nd quarter are -43% y/y with indications of future job cuts in order to balance out margin pressures. Incidentally, we are early in the earnings season with only ¼ of companies reporting thus far, therefore any conclusions would not be fully representative at this time. However, the tone of management remains cautious against the background of continued economic weakness. Capital expenditures are down and buybacks seem to be a thing of the past. Understandably, Energy and Retail companies have been hit hardest by margin pressures so far and we expect similar indications from the broader discretionary group, along with Industrials and Technology.

The good news is economies have begun to reopen, admittedly with some setbacks, but the worst may be behind us. Only 13% of companies announced dividend cuts since the market bottom, with the numbers tapering off as the weeks go by. Guidance remains thin but a growing level of cautious optimism about future profit growth is evident in managerial reporting.

Expanding on the point we made earlier with regards to the FAANGM stocks inflating valuations, this same group significantly influenced the overall rebound in the market. Excluding these 6 mega cap FAANGM stocks drops the Q2 total return of the broad market to only 13.81%.

- The best performing stocks in the composite were mostly within the Energy and Basic Materials sectors; Halliburton, Marathon Oil, Occidental Petroleum, Lowes, and DuPont.
- The weakest performers in the composite were Wells Fargo, Pfizer, Merck, Northrop Grumman, and Mondelez.

Close-up on Banking:

The banking sector recovered some of its losses in Q2, as cyclicals took the lead. Regions Financial (RF) faces greater headwinds from its reserve build requirements as it combats the decline in economic conditions alongside other regional banks. Whereas, the big money center banks are further along in the credit card cycle and personal loan space and thus carry lower relative valuations. Since its recent earnings release, RF has outpaced other regional banks while trading in line with money centers. This is most likely due to investor confidence in the stability of its dividend going forward by way of aggressive cost cutting initiatives. Likewise, heightened expense levels at Wells Fargo (WFC) provide an opportunity for improvement, leaving open the potential for upside surprises in coming quarters. Since releasing earnings this month, WFC's performance has been relatively strong indicating investor sentiment is improving. WFC maintains a strong underwriting business, and has announced new CEO and CFO changes over the past year to address pressures. We believe the worst is already priced into the stock and long-term holders will be rewarded for their patience.

Regarding banking in general, consumer credit is holding up as most unemployed persons don't expect to be out of work for longer than 6 months, according to Morgan Stanley bank analyst Betsy Graseck. What is key to banking in the weeks and months ahead are delinquency rates, not only in absolute levels but by how much or how quickly forbearances turn into delinquencies. We already mentioned the impact reserve builds have had on RF and WFC, but overall, the ability to continue to pay dividends across the sector is highly reliant upon intensifying reserve builds. This is another gauge we will continue to watch. Lastly, net operating leverage is anticipated to decline as a result of top line weakness in most areas due to higher COVID-19 related costs. This highlights the importance of efficiency controls as not just specific to RF and WFC, but the sector in general.

Overall Equity Strategy:

We continue to exercise caution in portfolio construction, as we search for opportunities in companies that are best positioned given the uncertainty associated with COVID-19, including the aggressive countermeasures being taken to support the economy until the pandemic can be contained. Our goal is consistent, in that we maintain exposure to companies that are high quality, relatively low in valuation and have an opportunistic risk/reward profile. Our portfolios are fully diversified with exposure across most market sectors. While we interpret Technology as overbought, we are able to find strong representation within our investment criteria. Our strategy includes a defensive/cyclical barbell approach with Healthcare and Energy as our largest over-weights. We remain cautious on Basic Materials and are underweight Consumer Discretionary and Communication Services.

Comcast Purchase Rationale:

The purchase of Comcast Corporation raised our composite weight in the Communication Services sector by adding what we believe to be a high-quality company with an attractive long-term risk-reward profile. The global media company's leadership positions in broadband, broadcast TV, filmed entertainment, Sky, and video could provide a strong, predictable recurring cash flow, in our view. The fastest growing of these segments, broadband, is also one of the most defensive and has been a share gainer despite its large size.

We believe any subscriber losses in paid cable TV subscriptions will be more than offset by growing penetration in broadband, a market that carries superior earnings before interest, tax, depreciation, and amortization (EBITDA) margin for Comcast (nearly double). Comcast is now trading at a discount to its long-term intrinsic value and offers a dividend yield of 2.46%. We believe the company's debt reduction plans are realistic given its free cash flow generation and should give Comcast more flexibility with its shareholder return programs.

IN CONCLUSION:

We believe that the U.S. economy will expand next year, but at a more moderate pace with significant challenges to overcome. The obstacles we face in this particular recovery argue in favor of a more cautious, or value-oriented approach, in sector, industry and security selection. Our preference for equities over bonds is dependent upon a recovery in earnings in 2021, and we remain fully invested at current levels.
