ALTMAN
INVESTMENT MANAGEMENT

EQUITY STRATEGY FOCUS

OCTOBER, 2020

IN VIEW: The Economic Landscape

The amount and timing of additional federal aid and the plan for combating COVID-19 are perhaps the two most important factors coming out of election results. Still in a recession, the economy is vulnerable should a second virus wave evolve or unemployment gains stall. Some elements of the current relief package have expired with the remaining trailing off in the coming months. The current pace of economic growth is vulnerable, should negotiations fail to bear fruit. As of September, the unemployment rate stands at 7.9% with 12 million unemployed. Weekly unemployment insurance claims came in at a seasonally adjusted 837,000. Although claims have plateaued since June, in recent weeks that level is rising somewhat sparking concerns, particularly in the wake of new layoff announcements at United Airlines and Allstate.

Personal incomes fell in August by -2.7% due to a decline in unemployment insurance benefits which expired in July. In contrast, consumer spending rose by 1% on new motor vehicle sales, food services and healthcare. The baseline CPI came in at an annualized rate of 1.4%. Energy products and services remain weak but have been improving since bottoming in June. Excluding food and energy the rate climbed 1.7% with strength in used cars and medical services. This was partially offset by declines in apparel and transportation. Despite recent strength, we expect that core CPI inflation will remain close to 2% YoY at the end of next year. Core inflation is likely to gradually move higher beyond a 12 to18 month horizon, with potential for a moderate medium-term upside surprise. The key downside risk to the growth outlook stems from COVID-19's trajectory; not so much from its real-time hit to growth, as from its medium-term repercussions for the economy's supply side - which will accumulate damage if waves of cases continue to rise every few months until a medical solution becomes widely available.

In September, the Federal Reserve pledged to keep interest rates near 0-0.25% through 2023. The extended time frame is deemed appropriate by officials in order to meet its dual goals of maximum employment and a long run average inflation running modestly above 2%. Although the unemployment rate has improved somewhat since the economic shutdown began, it is still nearly double the rate recorded in March. For now, lower energy prices, elevated unemployment, and waning consumer spending are keeping inflation in check leaving plenty of room for continued accommodation. In his remarks, Fed Chairman Powell also stated that accompanying fiscal policy was necessary to combat the fallout from the pandemic that faces uncertain longevity.

House Democrats and Treasury Secretary Mnuchin remain hung up in negotiations for another stimulus package. In an effort to compromise, the House put forth a new scaled back piece of legislation that reduces the total relief package to $2.2 trillion. After his initial rejection of the offer, the Trump administration returned with a $1.8 proposal which Speaker Pelosi said was not enough. However, Senate Republicans remain firm on a $1.5 trillion limit to any package indicating further reductions are necessary before an agreement is possible. The stakes are high, not only with an election around the corner, but also the recovery is at risk without additional fiscal stimulus.

U.S. economic activity bounced back solidly in Q3 (real GDP likely rose by over 30% Q/Q annualized after contracting 5% and 31.4% annualized in Q1 and Q2 respectively). The rebound in Q3 represents "easy growth" achieved by the lifting of official activity shutdowns, thereby allowing pent-up demand to be released (especially for goods). Growth was inherently primed for a slowdown in Q4 and beyond, facing the tougher slog of normalizing service sector activity amid a pandemic. The intensification of the COVID-19 pandemic in recent weeks, and the still-uncertain fate for the provision of additional fiscal stimulus, have fueled fears of a deeper slowdown in growth heading into 2021.

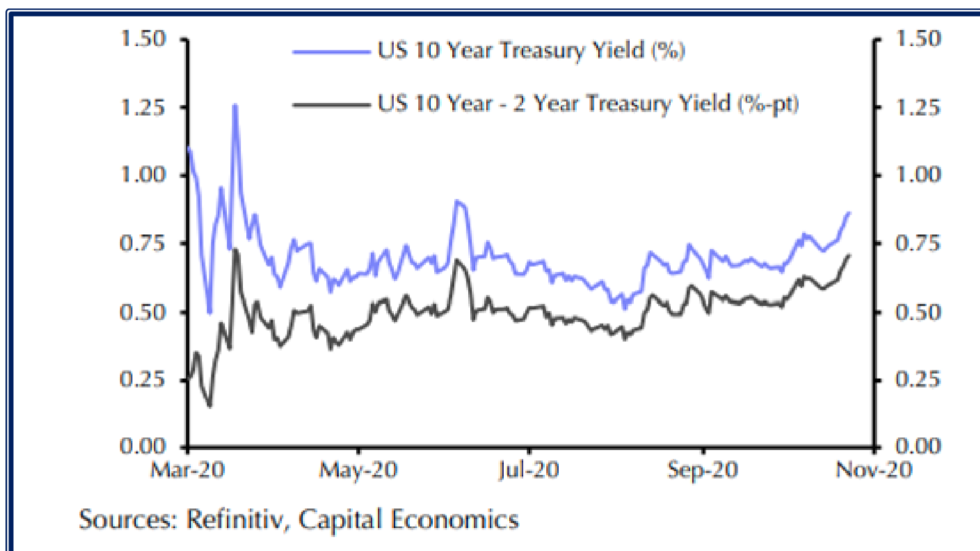
We expect that real GDP growth will moderate to around 3%annualized inQ4, assuming that there will be no fiscal deal by year-end. If there is a last-minute yearend deal, growth would be closer to 6% or higher, especially if unemployment compensation is provided retroactively. Provided Congress delivers close to $2 trillion in stimulus by Q1 including unemployment compensation, aid to small businesses, aid to state and local governments and support for some vulnerable sectors of the economy, the economy is likely to expand close to 5% next year. This outlook additionally assumes that a medical solution to COVID-19 will be approved by mid-2021, and its mass availability will broaden meaningfully by the end of next year. Under this growth trajectory, the level of real GDP should return to its Q4 2019 level by Q3 next year.

A Note on Treasury Yields:

The latest U.S. Presidential debate didn't appear to have any material effect on shifting the Democratic momentum leading into the final days of the upcoming election. Optimistic comments on the fiscal negotiations by House Speaker Nancy Pelosi had prematurely elevated the 10-year U.S. Treasury yield over the last week - but the sell-off in U.S. Treasuries faded as the negotiations on the stimulus package stalled and the COVID -19 cases surged. The ten-year U.S. Treasury yield has settled at .77 basis points, about the same level it was in early April. Because short-term yields have not changed much, the U.S. yield curve has also steepened significantly, as reflected in the increase of the gap between the ten-year and two-year Treasury yields. These moves appear to have been driven mainly by a growing expectation of a large fiscal stimulus in the U.S. either this year, in the form of a bi-partisan agreement, or next year, following a possible Democratic sweep at the upcoming U.S. Presidential election. Betting odds suggest that the chances of a Democratic sweep have increased from ~50% to around 60% over the past two months or so.

Exhibit I

U.S. 10-year Treasury Yield vs the 10-Year/2-Year Yield Gap

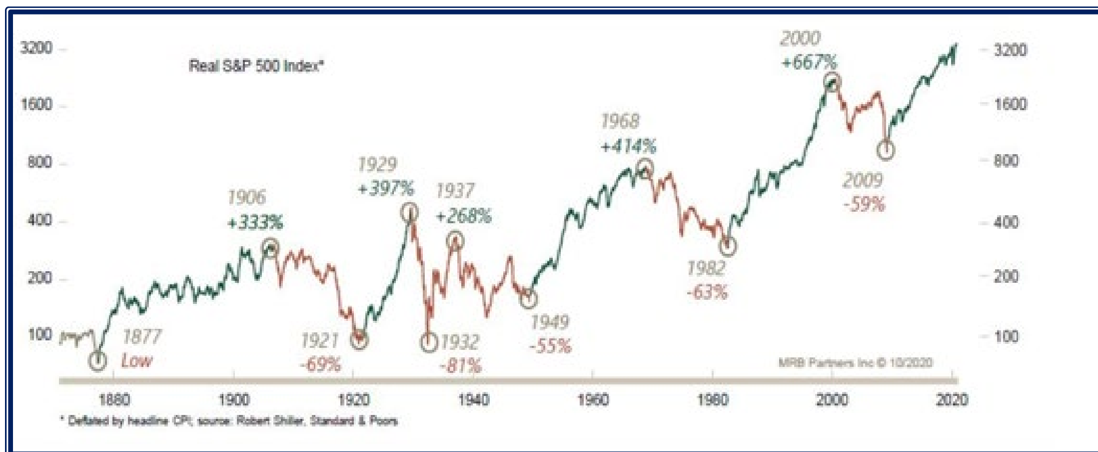


We don't however expect the 10-year Treasury yield to rise much further than the recent rally to .85 basis points last week for three key reasons. First, we think the chances of a bipartisan fiscal stimulus being passed this year are slim. We concur that a Democratic sweep would result in a larger fiscal stimulus than under any other election outcome. But we suspect that any package passed by the Democrats would be smaller and take more time to be approved than is widely anticipated. Second, even if a substantial fiscal stimulus were passed, we doubt that the Fed would allow monetary conditions to tighten much. Its response to fiscal stimulus now would probably be quite different from its reaction to President Trump's plans to cut taxes at the end of 2017, after which the Fed hiked interest rates four times in 2018. Fed chair Jerome Powell and several FOMC members have repeatedly emphasized the need for further fiscal stimulus to avoid an uneven recovery. This also suggests to us that if Treasury yields were to rise much further, the Fed would intervene. This could involve tweaks to its forward guidance or an increase in government bond purchases. Third, the global backdrop is unlikely to be conducive to further rises in Treasury yields.

Investors generally view the sovereign bonds of major advanced economies as fairly close substitutes, which is why the yields of these bonds tend to track each other. But over the past month, ten-year government bond yields in other developed markets have not risen as much as in the U.S., or at all, and we expect them to remain close to their current lows for the foreseeable future. Accordingly, a further rise in Treasury yields would probably generate an increase in foreign demand for U.S. government bonds, which would push down on their yields. We maintain the position that any further increase in Treasury yields is not likely to come close to matching the one that followed the global financial crisis, or even the one after Trump's tax reform. And it might even be reversed, depending on how aggressively the Fed decides to react.

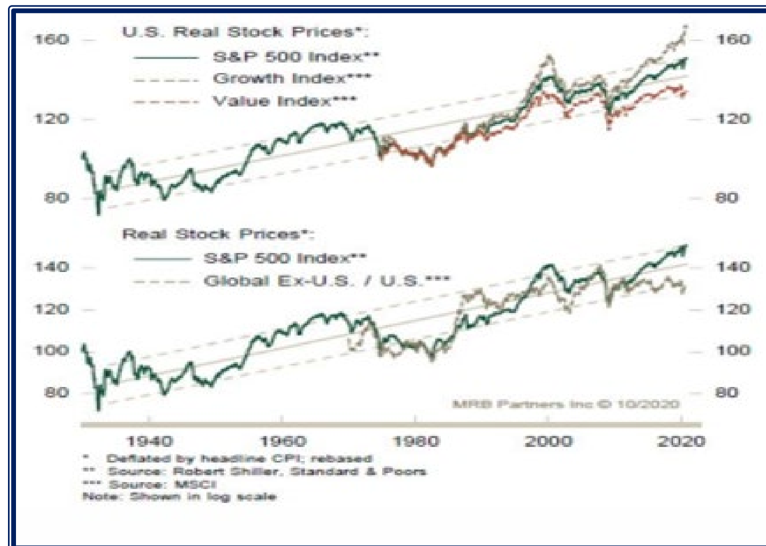
Exhibit II

U.S. Secular Equity Bull & Bear Markets Over the Past 150 Years



- The secular bull run in U.S. equities that began in 2009 appears a bit extended at first glance. This does not necessarily mean that a new secular bear market is imminent, but it does suggest a more challenging decade with the possibility of more subdued real returns for the U.S. benchmarks.
- Policymakers are aggressively trying to reflate cyclical economic conditions, which has benefited equities dramatically this year. However, this most likely comes at the expense of longer-term growth and asset returns.
- Profit margins have benefited from powerful secular tailwinds including greater labor flexibility, globalization, and technology, as well as reduced regulations and taxes. Several of these trends could quite possibly be challenged over the next several years.
- A more constructive outlook on our strategic bias is that the U.S. value index and global ex-U.S. stocks have materially lagged U.S. growth stocks over the past decade. These stocks offer a greater valuation cushion and could also help extend the secular bull market in global equities provided a major rotation occurs over the next several years and benefit our relative results against the S&P 500 benchmark.

Exhibit III
Major Divergence Between U.S. Growth Stocks and Everything Else



Conclusion: Growth stocks have enjoyed yet another banner year, despite the turbulence in the global economy. This sector has once again outperformed all other domestic and international benchmarks, continuing the trend from last decade. As proponents of reversion to the mean theory, we surmise that the bulk of the gains in U.S. growth stocks has already been materialized and that further equity gains in the years ahead by equities will require a broadening out of market breadth driven by laggard sectors and markets.

Candidate Policy Proposals and Objectives:

For the fiscal year ending in September, the federal budget deficit has reached an astounding $3.1 trillion. At 15.2% of GDP, the federal deficit is now the largest it's been since World War II. The level reached was due to the massive infusion of stimulus to combat the fallout from Coronavirus that was compounded by a reduction in tax revenues. With both candidates proposing fiscal stimuli in the coming year, the debt level is expected to continue to expand. The Congressional Budget Office projects the deficit as a % of GDP to fall to 5% by 2030 then rising steadily towards 12% by 2050. Projections are based upon mandatory spending levels, population and healthcare costs, among other items.

The concern over rising deficits is an anticipated rise in the level of interest rates, as the government provides incentives for the private sector to purchase government debt. If there is not enough interest from the private sector this could lead to a crowding out as the government is forced to seek alternative financing at the expense of private investment. Higher rates can also directly weaken demand for capital which leads to lower levels of commercial and retail borrowing, having a negative effect on credit sensitive markets in the long run.

Whether a Republican or Democratic victory, our stance on staying fully invested remains. Although Biden's fiscal proposals imply higher risks for equities, bonds and the U.S. dollar compared with Trump's, Biden provides greater policy predictability and has the potential to achieve greater political consensus than President Trump.

Trump's de-regulation policy in the Energy sector would benefit oil companies with the increase of fossil fuel production and limits on imports. His *America First* initiative takes the stance that the U.S. has an abundance of affordable oil to produce and has even opened up drilling on Federal land. In contrast, a Biden victory would mean reinstatement of past regulations upon energy companies to promote clean energy. Investments would be made in climate change initiatives, with limits placed on fossil fuel emissions and subsidies ended. By investing in clean energy, Biden believes he can bring back jobs to America that he believes were incentivized to move abroad as a result of Trump tax cuts.

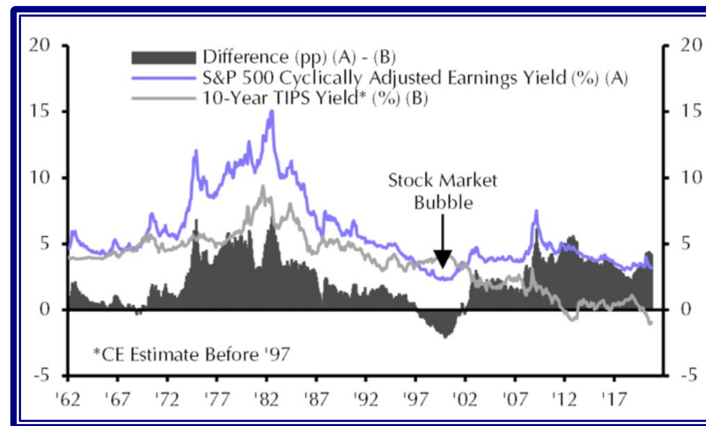
CLOSE-UP: Equity Investment Overview

Market Performance & Earnings:

The stock market returned 5.6% through the 3rd quarter as measured by the S&P 500 benchmark. When considered in isolation, the earnings yield on the stock market appears low causing concern over valuations. However, relative to Treasury Inflation Protected Securities (TIPS) the spread is currently quite wide. Unlike the bubble that occurred during the late 1990s when the yield on TIPS exceeded that of the stock market earnings yield, the reverse is now true.

Exhibit IV

Relative Valuations of U.S. Equity and TIPS



Source: Capital Economics, Shiller, Rifinitiv, Bloomberg

We do not believe we are in the midst of a market bubble, especially when you consider other indices. During this same time period, the Russell 1000 Value index was down -11.6%. This widening spread continues to emphasize the disparity in returns between FAANGM stocks and the broader market that we have written extensively about over the year. Our composite portfolio did somewhat better than our performance benchmark (Russell 1000 Value) by declining -8.9% through the first nine months. The New York Composite Index, which measures (capital weight) every stock on the NYSE, was down -6.9% over the same period.

Q2 earnings wrapped up in mid-August, with overall earnings growth down -32% year over year (down -20% excluding Financials and Energy). Top line sales were down -8% and -6% respectively. Earnings growth was strongest in Utilities, Healthcare, and Technology. Top line sales were positive in Financials, Healthcare and Technology. Margins were hit hard as the economy shut down and capex was cut to the lowest levels in a decade. Nearly a quarter of companies cut dividends. All the while, investors remained optimistic that the impact was transitory and markets trended up after bottoming in March.

Consensus earnings for Q3 are running at $32.91, down -22% year over year. For the full year, analysts expect $131 (down -20%) for 2020 and $166 (up 27%) for 2021. We are not anticipating another full-blown shutdown. As the economy continues to recover, capital expenditures should follow and spark a cyclical rotation. Large cap banks reported during week one of earnings season with a majority of them, including Citigroup, beating on both top and bottom-line results. However, Financials continue to underperform as investors remain focused on lackluster job growth and uncertainty surrounding stimulus talks.

The performance spread between growth and value stocks has continued to widen throughout the year, and suggests a major shift in leadership is long overdue. Inflation is running at an annual rate of 1.4% which makes the current environment less favorable towards value stocks due to their dividend paying nature. In general, low inflation coupled with slow growth reduces the value of dividends paid in today's dollars and thus leads to underperformance. At this point in the recovery, we believe we are at an inflection point where value stocks begin to unwind underperformance, as the growth trade has become crowded.

Over-weight Financials:

Significant accommodative Fed monetary policies, by both lowering rates and a bond purchasing program, have kept interest rates near historic lows. Likewise, due to quantitative easing, interest rates have not recovered in step with the V-shaped stock market recovery. Generally, a united party outcome in an election sends rates higher. This would be particularly so if either candidate wins with a united party, as additional fiscal stimulus is likely on both accounts. A divided outcome, which would likely diminish optimism of any legislation getting passed easily, would likely send rates lower. This environment has put pressure on the banking industry net interest margins causing the sector to underperform. We believe this is fully priced into stocks and are positioning for a recovery in earnings.

Throughout this recession, banks have remained profitable as federal aid packages helped to lower loan losses and fee-based services are once again beginning to regain some momentum. This should help offset any headwinds that may impact robust trading and mortgage businesses. As credit provisions peak, we believe banks may be at or near trough net interest income levels. A reversal to the mean in both areas would be beneficial to the industry. We are overweight banking in regional, diversified financial and custody banking, all of which have worked to improve balance sheets steadily over the past decade. We believe a cyclical rotation is upon us and, absent any major setback in the recovery, it will benefit Financials.

Citigroup Purchase Rationale:

We recently lowered our Technology exposure and added to Financials by establishing a position in Citigroup. Citi is a higher beta stock with a diversified portfolio that stands to benefit longer term from an improving credit cycle, a resurgence in growth, and rising interest rates.

As banks struggle to emerge from the current cycle, Citi's diversified business helps dilute its exposure to consumer and credit card businesses. Citi also has relatively lower exposure to small businesses and real estate, both industries under enormous pressure in the wake of the economic shut down. On the other side, Citi has greater exposure to emerging markets, foreign exchange, and cash management, all areas that are expected to be relatively less volatile in this cycle. Citi announced it will continue to build reserves in the current quarter to align with their revised forecast for slower growth. This conservative stance should pave the way for greater reserve releases in 2021.

Citigroup just announced Jane Fraser will be stepping up in February as the bank's newest CEO, making her the first woman to run a major U.S. financial company. Jane's current role as Citi's President and CEO of the Global Consumer Banking division made her promotion one that was highly anticipated, leaving only the timing of such a move as uncertain. Ms. Fraser has vast experience at the company having previously been charged with revamping Citi's mortgage business. Prior to that she ran Citi's Latin American division. Her experience in steering high-level strategic initiatives will be invaluable going forward as Citi continues to navigate the recession through cost-cutting initiatives and operational efficiencies.

Following a price decline of 36% since the start of the year, we established our initial position in Citibank. The price level has declined another 14% as regulators prepare to force Citi to ramp up its risk management system. As a result, management raised its expense guidance for 2020 and acknowledged the need to continue to improve internal infrastructure and control systems. The stock was already the cheapest amongst its peer group and the recent sell off now brings Citi further into oversold territory. According to analysis by Betsy Graseck of Morgan Stanley, at 7.7x 2021 earnings the stock is discounting an excessive drop in ROE and an over abundant rise in expenses is more than reflected in the current stock price.

A Closer Look at our Energy Strategy:

There are few times when problematic issues can be boiled down to one simple explanation. For the market in crude oil, the current problem is simply too much supply and not enough demand. U.S. crude production has soared, and a sluggish world economy has led to below trend consumption. Our view on oil has not changed significantly since the end of the second quarter. We recognized the mounting headwinds to oil prices as they approached shale breakeven (approximately US50/bbl). We believe the worst of oversupply appears to be over, demand recovery is being met with recovering output in both the U.S. and parts of the OPEC block.

What could go right for oil?

- If the U.S. and China can strike a trade deal, there's a chance that the worst has passed for the Energy markets for a while. A deal should cause consumers and businesses to use more oil, at the same time as U.S. fracking production growth may be slowing down.
- Industry analysts' consensus is optimistic that the Energy business has solid fundamentals ahead. The Energy sector's earnings are expected to drop 25.7% this year, but are expected to experience a solid rebound next year.
- The EIA forecasts production will rise by close to 2.0 million barrels a day and possibly surpass world consumption again. The agency assumes world real GDP (weighted by oil consumption) picks up to 2.4% growth in 2021 compared to 2.0% this year. However, it is forecasting that the average price of Brent crude oil per barrel will decline to $59.93 next year, down from $63.37 this year.
- With respect to the bullish argument on a "coming oil crisis", we are sympathetic in principle but may be somewhat skeptical about the timing of such an opportunity, based on our framework for understanding commodity cycles. Periods of low commodity prices pressure producers' margins and eventually deter further capital expenditures. When coupled with a rising demand backdrop, this "capital discipline" will eventually trigger fears of resource exhaustion and strong upward price momentum.
- Geopolitical stress in the Middle East has the potential to adversely impact supplies and thus lift oil prices.

The steep discount on oil companies remains one of the main reasons for holding them. At this point, the negatives have been fully discounted, and there remain enough positives to stay with our holdings as the global economies recover. Our strategy in portfolios targets a price of $45 near-term - and based on the level of economic activity next year warrants a price of $50-55 in our estimation. The market is adapting to the reality of slow oil market rebalancing. Although there are risks to crude prices in the short term, we conclude that maintaining an overweight position in portfolios is consistent with the fundamental drivers of the sector in the longer term and depressed valuations against this backdrop.

Over-weight Industrials:

A formal infrastructure package in the amount of $1 trillion did not materialize over the last 3 ½ years, limiting expectations that it will become a major priority should Trump win a second term. Biden's proposal, which he touts as a priority, is a bit heftier, at $1.3 trillion, vs Trump's suggested $1 trillion, with emphasis on greener gas emissions. The reality is that the success of either would rest on which party holds power in Congress. Regardless, any infrastructure plan from either side would bode well for the industrial sector.

Being cyclical in nature, cap ex spending within the industrial sector is highly reliant upon a continued economic recovery. According to the September Manufacturing Business Outlook Survey, business leaders are collectively becoming more optimistic about economic growth over the next six months. As a result, more companies expect employment increases and higher production for Q4. This bodes well for the outlook in the industrial sector which underscores our overweight position.

IN CONCLUSION:

With the election on the horizon, coupled with the potential for delayed results, we expect short term volatility. Additionally, a failure to compromise on a relief package could derail or delay the economic recovery. Top Republicans are urging for the postponement of any aid package until after the election, for fear of splitting the party - and in its place, prioritized the appointment of a Supreme Court Justice. Therefore, any compromise on a relief package in the next few weeks seems unlikely.

We expect the economy to continue to recover, but several sectors will be slow to normalize, depending upon the availability of a COVID-19 vaccine and/or other medical treatments. Containing and ultimately eliminating the threat of the pandemic and restoring corporate and consumer confidence will likely be more important contributors to the economic and capital market outlook over the next 1-2 years than the direct monetary impact of either candidate's proposals. Beyond the 1-2-year horizon, the biggest driver of capital markets will be the underlying growth of the economy and related productivity, and inflation.

We believe that the U.S. economy will continue to 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.

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.