ALTMAN
INVESTMENT MANAGEMENT

EQUITY STRATEGY FOCUS

OCTOBER, 2021

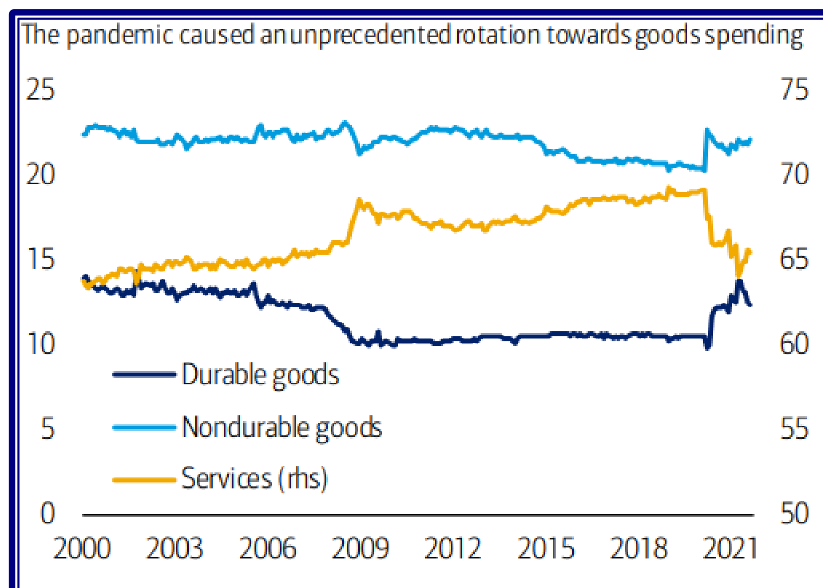
IN VIEW: The Economic Landscape

Personal Consumption Expenditures came in at a year/year growth rate of 4.3% in August. This figure has steadily increased since bottoming below 1% in mid-2020. To date, we hold the view that this elevated level of inflation is transitory, stemming from supply shortages as the economy emerges from the pandemic. Offsetting this trend into next year is the Fed's move to unwind bond purchases and the run off of fiscal stimuli. Longer term secular trends are also at work, such as aging demographics and technological enhancements which tend to be deflationary.

The risks to our thesis are that economic growth doesn't moderate quite as significantly as anticipated or that supply chain disruptions persist throughout next year. Consumer balance sheets are stronger than ever after years of deleveraging, but the recovery remains fragile and requires tactical fiscal and monetary policy as not to derail the progress that has been made thus far. Growing wage pressures as well as pricing power gains due to globalization could also work to lift inflation. That being said, we believe these risks will be limited by a normalization of activity after the initial surge in demand. We will keep our finger on the pulse and continue monitoring all angles as they develop.

GDP is on track to grow at a pace in excess of 5% for 2021 before moderating in 2022. The service sector is poised to take the reins, after the resurgence of demand on the product side.

<u>Goods vs Services Spending Share of Consumption (% share)</u>



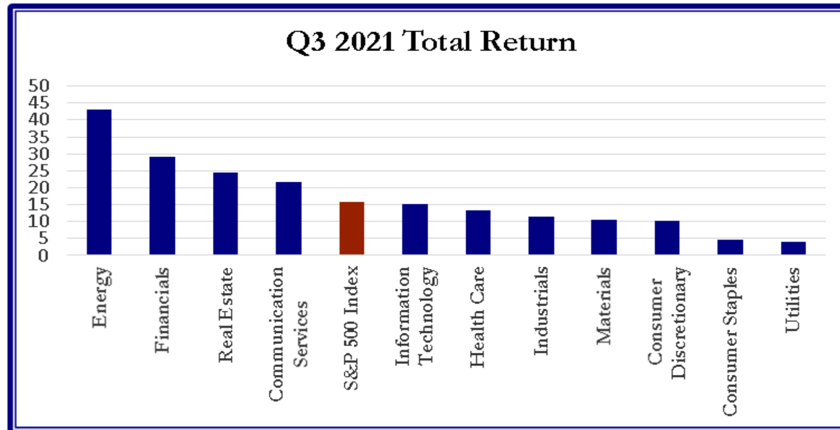
Source: BofA Global Research, Bureau of Economic Analysis

Air travel has improved but is still well below pre-pandemic levels. Restaurant spending has regained ground at a faster pace, as customers embraced outdoor dining. Lodging, like airlines has more ground to cover in its rebound. As the vaccination rate increases and/or we learn to take proper precautions to safely live with the virus, the service segment should be a beneficiary as activities resume.

CLOSE-UP: Equity Investment Overview

Market Performance & Earnings:

S&P Benchmark Return



Source: Bloomberg and Altman Investment Management, LLC

Equities enjoyed total returns of just over 15% during the first three quarters. Energy, Financials, and Real Estate lead the market higher. Drilling down further, particular strength came from Exploration and Production, Banking, Diversified Financials, and Media and Entertainment.

Record margins, higher capex, and overall optimistic guidance fueled earnings growth in the second quarter. Following eps growth of over 85% in Q2 consensus has second half expectations slowing somewhat to a rate of 27% and 21% in Q3 and Q4 respectively. Front end loaded earnings growth has consensus earnings estimates for 2021 at 44% then moderating to 9% next year. Mentions of inflation in corporate communications as third quarter results are released has increased significantly citing supply chain disruptions, rising wages, and higher transportation costs. Each are potential reasons for our anticipated slowdown in earnings growth for 2022.

The upward trajectory of positive earnings revisions relative to negative revisions has turned over. The elevated level is not surprising given the significant plummet in comparisons as a result of the pandemic. So naturally, we'd expect a healthy normalization to follow. The speed at which we get there depends upon the pace and stability of the economic recovery. Rising inflation is of growing concern amongst analysts, but we do not see this as a signal to dampen our bullish equity stance, but rather raises dependance upon stocks with pricing power and positive cash flow characteristics.

Source: FactSet, Bloomberg, Morgan Stanley Research

33 Witherspoon Street, 2nd Floor – Princeton, NJ 08540 – (609) 252-0048 – www.AltmanInvest.com

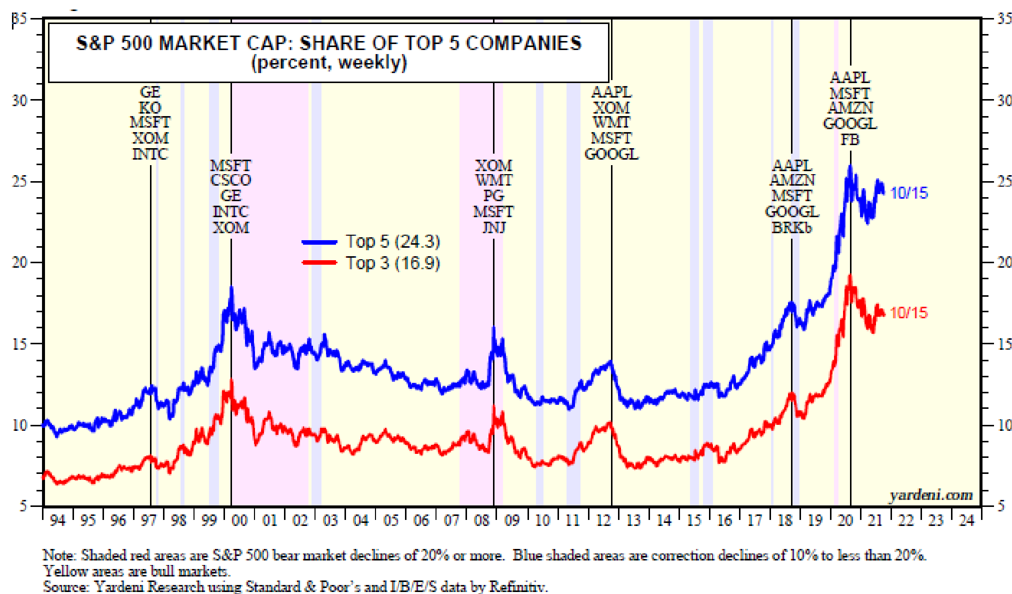
Inflationary pressure is manageable by firms with pricing power. Third-quarter earnings results appear to be separating the haves and the have-nots. The haves are companies that are successfully growing their bottom lines despite rising wages, escalating inflation, and disrupted supply chains that are pushing up costs. Some are enjoying sales growth and pricing power, which are offsetting cost increases. Others are employing technology to cut costs and improve productivity.

Since earnings season began, analysts have increased their Q3 earnings estimates by bringing the quarterly consensus up to as high as $50, or close to a 30% year-over-year gain. As of the time of this writing, according to Yardeni Research, 38% of the S&P 500 companies have reported and all 11 of the S&P 500 sectors are beating estimates.

A quick comment on FAANMG Performance (25% of the Standard and Poor's 500) Finally Stalling?

As we have discussed in previous commentaries, for a good part of the past decade, the stocks that make up FAANMG—Facebook, Amazon, Apple, Netflix, Microsoft, and Google (Alphabet)—have risen sharply, driven by expanding businesses and earnings growth. But that seems to have changed. Since it peaked at a record high in early September, the group's collective market cap has dropped 3.5%. Likewise, FAANMG's market-cap share of the S&P 500 is still lofty having moved sideways since peaking at a record-high 26.7% during August 2020. Looking back over the past three years, each of the FAANMG crowd's members easily trounced the S&P 500's performance. The same cannot be said over the past year or the past three months, when Facebook, Apple, and Amazon have sharply underperformed. YTD the picture is even less rosy for FAANMG with only three of the six members outperforming.

FAANMG Still Dominates the Standard and Poor's 500



The good news is that the forward P/E multiples for Facebook, Amazon, and Apple have declined this year, helping the FAANMG group's collective forward P/E to drop to 35.8 X from 44.7X at its peak in 2020 but still not at the valuation multiples we would be comfortable establishing positions.

FAANMG Stock Multiples Have Turned Over

Equity Strategy:

Comments on Potential Margin Pressure on Select Investment Holdings.

Conagra is facing inflationary pressures from vulnerable supply chains, as its costs from freight and logistics trend higher. Rising costs in its' frozen foods division is another pressure point. In order to help combat inflationary impacts, Conagra recently announced price increases citing limited impact on demand is anticipated. Its higher-end brand positioning and divestitures of non-core products somewhat insulates the company from private brand competition.

Overall, as a staple, its products tend to be more resistant to price increases. Conagra raised its full year sales growth target and raised its dividend by 8 cents a share during its most recent earnings call. The quarterly dividend has remained relatively stable as well with regular increases over the past decade.

Lowes is another company passing its higher costs through to consumers. There are several demand drivers that are allowing the company to lift prices without much impact on demand. Flexibility around working from home creates a need for home improvement as more time is spent there. Overall, consumer strength coupled with low borrowing costs and higher home prices enables home improvement investment. Demand is outpacing supply in the housing market and professional home improvement service backlogs are growing. Given these trends, Lowes is somewhat insulated from inflationary pressures in our view allowing room for earnings growth to continue. As long as supply chain disruptions are kept to a minimum, we'd expect margins to continue to improve as well.

Select Stock Review:

Fidelity National Information Services' (FIS) poor performance this year appears to be moving counter intuitively to upward earnings revisions. Earnings estimates are reflecting higher synergies from its 2019 merger with Worldpay, a global leader in eCommerce and payment technology, than initially projected. The combination created a significant presence in financial services and payments solutions by combining merchants, banks and financial markets. Stock performance however is reflecting modest merchant growth and disappointing margins that were pressured by incentive compensation and higher costs associated with initial ramp up in contracts. Looking ahead, we expect greater momentum in its merchant and banking businesses as the global recovery continues, more restrictions are lifted and demand continues to expand.

Dollar Tree (DLTR) has recently announced a change to its pricing model that will lift prices above $1 to combat higher costs. Its firm $1 price point was a major issue holding the stock back as compared to its competitors who were ahead of the game offering higher priced goods. DLTR also announced it will be offering more frozen foods and seasonal items to encourage more customer spending per trip. The company will continue to experiment to determine viability within the $3-$5 as well. The stock jumped 16% on the news. The next bump up could be when higher shipping container prices normalize as supply disruptions subside. In 2019, 85% of DLTR's containers were coming from China. Management's expectation is this number will be closer to 65% in 2021. Overall, we believe the stock, which compares favorably to its competitors on a fundamental basis, is oversold and should continue to lift into year end.

Select Sector Review:

- ### *Oil Stocks:*

Multiple factors have led to an oil price spike to $85 a barrel, its highest level since 2018-brent and some 60% since the start of the year. While some of this has been due to strong demand, it has mostly been driven by weaker supply, as OPEC has continued to fall short of its output targets and US production has been crimped by hurricane Ida. Other drivers that contributed to the price rise has been global coal shortages, power blackouts in India, as well as a power crisis in China.

While we recently pushed up our year-end forecast from $80-$85 a barrel, we still expect oil prices to stay elevated at this level through the end of 2022 and does not alter our inflation forecast for advanced economies in the near term. Without forecasting drop in oil prices next year, there shouldn't be any material effect on our inflation forecast by more than a couple tenths of a percentage-point more or less by the end of next year and into 2023. Our expectation is that inflation in 2022 will run at 2.5%.

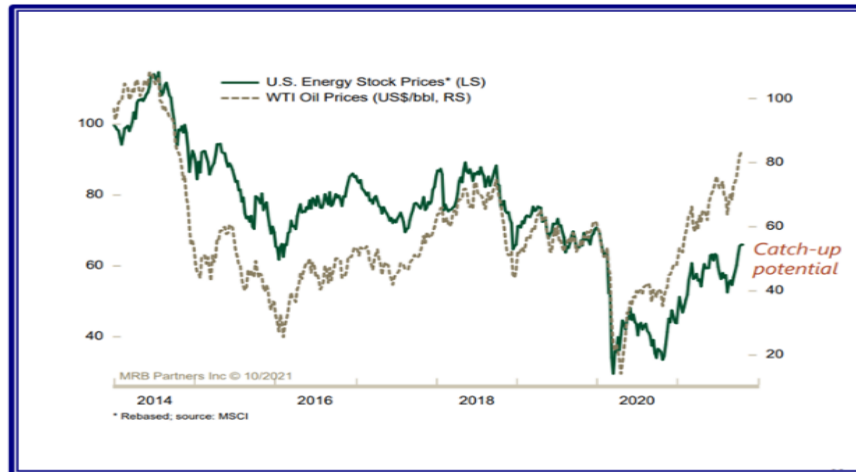
However, the risks to our oil price forecast are probably skewed to the upside. Oil prices would have to surge significantly from current levels if central banks were to stop energy inflation from dragging on headline rates next year. By the end of next year, we believe the energy contribution to inflation in the developed markets should still fall considerably as year-over-year comparisons work through the data. All else equal in terms of headline inflation rates, flat oil prices would help moderate inflation expectations. While higher oil prices wouldn't do much to change the outlook for inflation, there could be a significant impact to household consumption. Indeed, in virtue of the fact that oil prices have risen so much this year, base effects will do most of the heavy lifting in pulling down inflation next year, not so much the change in the oil price itself over the course of 2022.

However, the positive year-over-year comparisons will not disguise the fact that higher oil prices could mean households spending more on fuel, which could reduce other areas of spending. Some economists are now estimating that at the $85 per barrel scenario, households in advanced economies could end up spending in excess of $200 billion at an annualized rate on fuel by the end of next year. Without a rundown of savings to cushion the blow, this could drop annual consumption by 0.8% or roughly 0.4% of global GDP. Given that households are facing higher food prices at the same time, the impact of high fuel prices could aggravate consumer confidence. This has pushed our growth forecasts down for 2022 to reflect a potential squeeze on households' disposable incomes. As inflationary concerns grow amongst the central banks and investors, we would expect this will push interest rate policies higher over time.

In addition, support behind climate change pressures oil and gas companies to shift away from fossil fuels. E&P companies are not ramping up production as prices rise like they would have in the past. There is also pressure coming from shareholders who are pushing for share buy-backs and higher dividends as opposed to reinvestment. All this while demand is rebounding as the global economy emerges from pandemic restrictions. Additionally, the International Energy Agency set a goal of "net zero" emissions by 2050, calling instead for significant clean-energy investment.

The upward pressure on oil prices does not come in a vacuum. A reduction in fossil fuels does not entirely support the transition towards clean energy. The resulting higher price for liquid natural gas raises clean energy costs in areas such as wind and solar power backup and electoral grid maintenance. Having said that, OPEC maintains its heavy influence over prices and is currently limiting production of 4.6 m/b/d. This production cut however is gradually coming back online. All the while, OPEC is highly focused on maintaining a price level that doesn't invade its market share. If prices remain above $80 as we expect, the resulting surpluses for most producers could put downward pressure on break-even levels. Diversification away from fossil fuels, higher exports and lower overall spending levels also suggest lower break evens which would put some downward pressure on oil prices.

Energy Stocks Have Lagged the Oil Price Rally



Source: MRB Partners Inc.

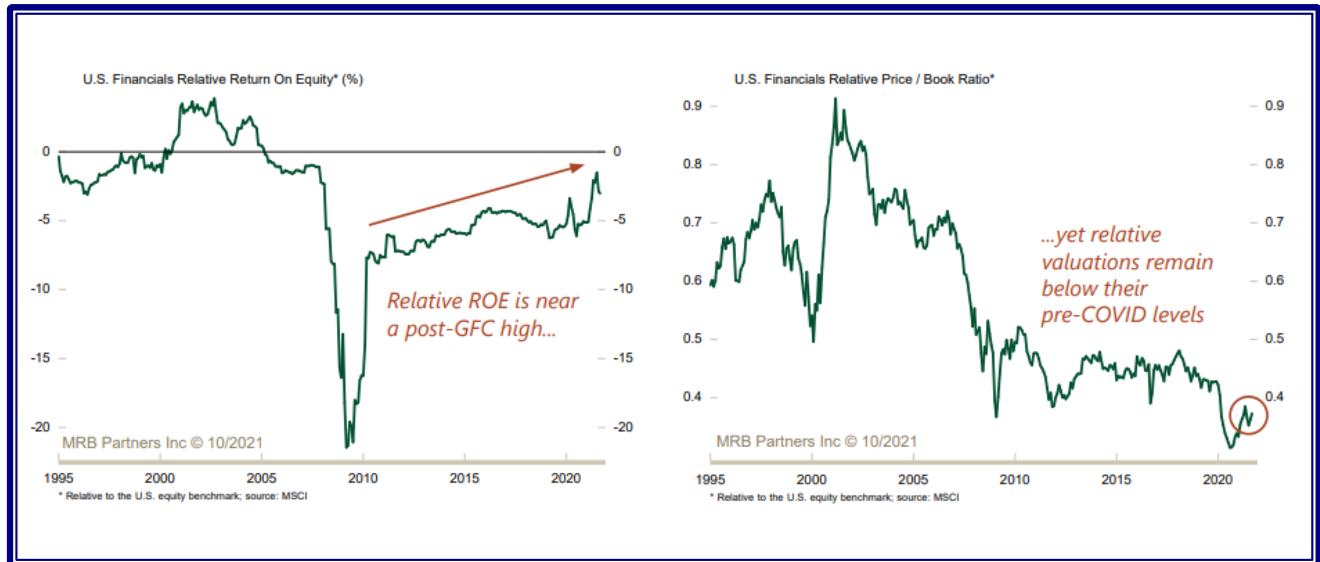
As we attempt to reconcile the recent uptick in oil prices with what we anticipate is a continued cyclical recovery amid lower break evens, we are cognizant that while Energy stocks outperformed, they lagged overall oil prices - leaving room for further upside in the sector. The previous chart shows the spread between the price of the commodity and the valuation multiples of the stocks.

Our net overweight stance on Energy stocks is predicated on the fact that US energy companies appear to continue to be committed to a conservative fiscal capital investment strategy. This should support higher free cash flow as oil prices remain elevated and alleviate the cash funding deficits accumulated in 2020. We expect dividends and buy-backs should continue to accelerate into 2022, as investors reward companies that have announced a preference to raising payouts over growth.

- ***Bank Stocks:***

Bank stocks in the S&P 500 index enjoyed strong year-to-date performance. A majority of the performance was boosted in Q1, up nearly 23%, but during the latest quarter they still managed to outpace the overall market by 411 bps. Looking ahead, we believe NII (net interest income) margins should expand along with rising interest rates. Growing demand coming out of the recovery along with loosening loan standards sets the stage for an uptick in loan growth. The new Stress Capital Buffer rules gives banks more room to make share buy-backs without seeking prior approval, as long as certain minimum requirements are in check. Loan growth is still negative primarily due to PPP loan growth run off and high payback rates fueled by stimulus checks, but it is declining at a slower pace.

Financials Still Have Lots of Room to Re-Rate



Source: MRB Partners Inc.

US Bancorp, a relatively new addition to the portfolio in late Q2, cited stronger trends in its payments business on the backs of improving volumes. Opportunities also exist to expand market share in the digital wallet space. Citigroup is selling over a dozen of its retail assets within its International Consumer business in order to focus on its higher growth wealth management business. As its Consumer business focuses on deposit generation, its M&A and Investment Banking segment growth were bright spots in its most recent earnings report.

Bank of America has cost controls in place enabling revenues growth to outpace expenses. Loan growth is improving and, like most banks, the company's NII stands to improve. Our view of rising long term interest rates is a tailwind for Banks and Financial Services. While lending remains challenging in the short term for the industry, we believe that our exposure (approximately 19.0%) at this point in the cycle is warranted.

IN CONCLUSION:

The Fed is focused on stabilizing prices beginning with a reduction in asset purchases. They are not looking to raise interest rates until the latter part of 2022 or early 2023. Corporate earnings are likely to surprise on the upside with continued re-openings and consumer strength providing opportunities for both broader market breadth and multiple expansions off current levels. We therefore continue to favor stocks over bonds with consensus earnings growth forecasts above 40% for 2021, before moderating to high single digit relative returns next year.

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.