ALTMAN
INVESTMENT MANAGEMENT

EQUITY STRATEGY FOCUS

JULY, 2022

IN VIEW: The Economic Landscape

The Great Inflation of the 1970s is a hot topic this year, as economists reference the period to draw comparisons to today's rising price levels. Back then, import prices were soaring from a weakening dollar while the Arab oil embargo sent oil prices up exponentially. Inflation was already running in the mid-single digits leading into the early 70s, as demand was trending higher on the back of heightened government spending after the Vietnam War. Political pressures in favor of low interest rates in order to fuel economic growth coerced the Fed to prioritize unemployment over rising inflation. The combination of fiscal and monetary policies further complicated by the oil crisis caused a period known as stagflation, slowing economic growth amid rising prices and unemployment.

Some similarities exist today as expansionary policies are coming to an end, core inflation is rising, and there is pent up demand against supply constraints. However, as compared to the 70s the Fed maintains a greater level of independence and is willing to use the tools at its disposal to combat inflation. To date, it is unwinding its asset purchasing program and has raised the Fed Funds rate by 225 basis points in a series of four rate hikes since March of this year and more are expected. There are already signs that financial conditions are tightening and inflation may be peaking. Used car prices are coming down, housing starts and permits are softening, retailers are discounting, commodity prices are declining, and break-even inflation is starting to turn over. The strong dollar lifted by a flight to safety may also be helping the Fed's efforts to control inflation. For now, leading economic indicators are weakening but coincident indicators recently topped record highs, even as inflation weighs on several contributing factors. As tighter financial conditions work to temper overall growth it should also help bring demand into better balance with supply. Even so, the Fed's target of 2% inflation is most likely not achievable any time soon, but the market seems confident the Fed can keep it under control and reach that target within the next 1-2 years.

CLOSE-UP: Equity Investment Overview

Market Performance & Earnings:

U.S. earnings expectations for both this year and next year have been downgraded modestly over the past month, which is consistent with slowing economic growth, albeit not with a recession. According to Yardeni Research, the majority of U.S. sectors saw earnings downgrades last month, although again they were generally small. On the surface, U.S. earnings forecast appear optimistic: revenue growth is projected to slow sharply next year, but profit margins are projected to rise after a blip down this year. The extent of the revenue growth slowdown likely holds the key to U.S. profit and margin performance in the next year. U.S. 12-month forward earnings growth correlates closely with U.S. business sales growth, with both slowing from historically-elevated levels. Business sales growth, in turn, is closely correlated with S&P 500 revenue growth but offers the advantage of being more timely and seasonally adjusted, and thus useful for macro analysis.

As would be expected, earnings have greater volatility than sales growth. However, in recent decades U.S. forward earnings growth has only been negative when sales growth has also been negative. Business sales growth has also significant beta to nominal GDP growth, in part because it is weighted toward industrial rather than service activity, as is the U.S. equity market. Note that business sales growth has been negative even in periods when nominal GDP growth is still positive. Yet given current and projected inflation, it is highly improbable that nominal business sales growth will slide into negative territory over the next year.

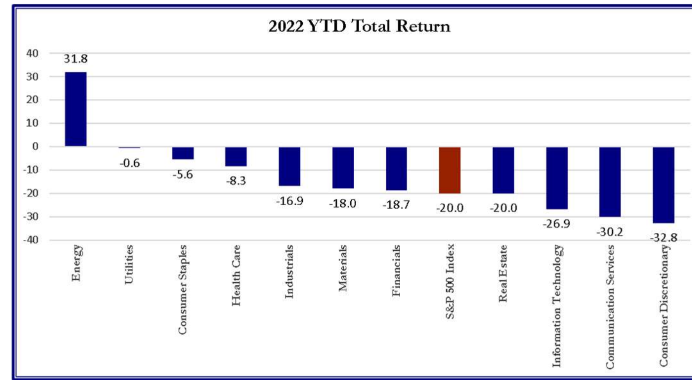
U.S. corporate revenue growth will slow in the year ahead, but we expect it to remain comfortably positive, which should provide support for earnings. In recent months we have highlighted the unique nature of the current cycle and its ramifications for equity prices. Typically, Fed policy becomes less accommodative or more aggressive only during periods in which global earnings growth is accelerating. However, the Fed rate hikes this year have coincided with a sharp slowdown in global earnings growth. In short, stocks have de-rated as the Fed has hiked even as worries about earnings growth were inevitably going to intensify.

It is important to stress that forward earnings are not a leading equity market indicator, but they are linked to underlying economic conditions. Even during the two main mid-cycle slowdowns in the last economic expansion, global 12-month forward earnings growth slipped into negative territory. Yardeni Research points out that as with the U.S. case, currently elevated inflation likely provides some support for nominal revenue and earnings growth in the year ahead. Yet it is likely too soon to expect investors to forecast an upturn in forward earnings growth that would be associated with a sustained equity market advance. A shift in Fed policy is still a ways off, but investors are already discounting rate cuts in mid-2023, which would provide support for global equity valuations. Even a less-hawkish Fed could end the vicious cycle of simultaneous de-rating and increasing earnings uncertainty that has weighed so heavily on stock prices year-to-date. Such a Fed pivot would improve the 6–12-month outlook for stocks, which already discounts a moderate decline in corporate earnings in the months ahead. Our overweighted stance on stocks in balanced accounts would necessitate being able to look through the near-term earnings valley to an eventual broad-based upturn down the road. Keep in mind that the depth of the earnings valley remains uncertain until growth headwinds in Europe and China begin to clear.

The recent renewed U.S. equity outperformance highlights the still bifurcated global equity backdrop. U.S. stocks have rebounded more sharply than global ex-U.S. stocks (in U.S. dollar terms), aided by the bounce in tech and tech-related stocks and continuing strong support from relative 12-month forward earnings. The U.S. market appears to be providing global equity market leadership in the near term, but a sustained and healthy global advance awaits widespread participation from non-U.S. markets. The commitment to the COVID-zero policy and the adverse economic impact have caused us to remain cautious overall as China and emerging markets (EM) gain control of their economies. Without the leadership of China, and with headwinds to both the semiconductor and resource sector earnings that dominate EM Ex-China, we remain cautious on the timing of broader global participation until the global economic landscape is clearer. However, our overall view longer term is constructive on the economic outlook and implies that equity prices should move decisively higher on a 6–12-month horizon.

A Closer look at the U.S. Market

After a difficult first half when markets sank into bear market territory, the S&P 500 delivered a total return of 9.22% during July, the best performance since 2020. Cyclicals were strongest during the month as Consumer Discretionary, Technology and Industrials regained the lead. Investors appear to be gaining confidence that inflation may in fact be peaking. This is perhaps an indication the markets are forming a bottom.



Source: Bloomberg and Altman Investment Management, LLC

Just as they had led the market higher, the Mega 8 stocks, as defined by Yardeni Research as Amazon, Alphabet, Apple, Meta, Netflix, Microsoft, Nvidia, and Tesla led the markets down, accounting for approximately 40% of the market's decline during the first half. Energy was the only sector that produced positive performance, up over 30%. Oil supply shortages resulting from under investment were exacerbated by disruptions stemming from the pandemic. As the economy re-opened pent-up demand added to higher pricing pressures. Then came the Russian invasion of Ukraine. The oil shock understandably led to cash windfalls for oil companies who used the cash to repay debt, raise dividends, and repurchase shares. Even highly regarded investors like Warren Buffett took advantage of the secular move by boosting his stake in Chevron. The consensus at least for now seems to be favoring a tighter market supporting oil prices at current levels or higher. The outcome and timing of the Russian/Ukrainian war along with the depth and longevity of a recession will of course be critical determinants and ones we will be monitoring closely.

As we monitor Q2 earnings releases, analysts' expectations are calling for just about a 5% increase over the same quarter a year ago, following earnings growth of 11.6 and 26.9% the prior 2 quarters. Earnings for the full year 2022 are expected to be up 9.5% and come in at approximately $228.27, although we would not be surprised to see these numbers come down as analysts react to continued demand weakness in the second quarter. Inflation is of course a growing concern and the stronger U.S. dollar will put pressure on foreign earnings. Consumption, industrial activity, and corporate guidance are all slowing. Additionally, the tightening policies by the Fed are expected to continue to put downward pressures on demand. Even so, with nearly 279 companies in the S&P 500 having reported so far, 67% have beaten earnings expectations.

Stock Spotlight and Strategy:

Energy

As quickly as oil prices reached $120 in March, they sank below current levels in April only to whip saw through the same pattern again during June and July. Despite this volatility, Brent crude oil at $95 per barrel today compares to an average of $71 for 2021, resulting in a windfall of free cashflow supporting our overweight position. During Q1, unhedged companies such as ConocoPhillips enjoyed the payoff it received from its unhedged position realizing a substantially higher average price per barrel.

Banks

We remain overweight U.S. bank stocks given their leverage to rising interest rates and attractive relative valuations. After sharply outperforming in January, bank stocks have lagged since the Russian invasion of Ukraine amid rising recession concerns, although their relative performance has recently stabilized. The foundations under the U.S. economy remain solid. As such, barring a negative shock, it is premature to worry about a recession until the Fed raises rates to restrictive levels, which is unlikely in the next 12 months. Accordingly, we expect another up leg in the relative performance of bank stocks as underlying relative earnings improve.

Besides economic concerns, weak relative 12-month forward earnings have made investors skeptical in owning bank stocks. As we have outlined in previous commentaries, much of this "weakness" has stemmed from a cessation of loan loss reserve releases. The latter materially boosted bank earnings in 2021, thus making for very tough year-over-year (YoY) comparisons this year. To a lesser extent, earnings estimates have also been negatively impacted by the unwinding of the IPO and stock trading booms, which have meaningfully slowed investment banking and capital markets-related revenues for the large, diversified banks. We have been anticipating a rebound in the earnings of the sub-group, driven by traditional banking activities. There are some early signs that our optimism on the profit outlook is beginning to show some green shoots. The forward earnings of banks have resumed climbing in recent months and have started to drive an upturn in earnings on a relative basis. As we move through the second half of the year, both absolute and relative performance should begin recovering along with improving earnings. They should continue to improve as banks benefit from the combination of higher interest rates and expanding loan balances, and tough YoY comparisons wash out of 12-month forward estimates.

Traditional Bank Revenues Have Yet to Materialize

The earnings volatility caused by accounting for expected credit losses during the COVID-induced downturn in 2020 has generated a lot of confusion about the financial performance of banks. This has led to misplaced pessimism about the industry's earnings prospects. This pessimism misses that traditional banking revenues have only started to fire up and have significant room to improve if the economic expansion continues, as we expect. The upside potential for earnings is evident when looking at banks' pre-provision net revenues (i.e., non-interest plus net interest income) less non-interest expenses, which are a better gauge of true underlying operating momentum of the industry according to Goldman Sachs Research.

MRB Investment Research validated that the historic performance of this metric was still 11% below their pre-COVID peak due to the slow recovery in net interest income. The latter has been crimped by historically low interest rates and tepid loan demand. As a result, it has become evident that there is still lots of underappreciated upside for bank earnings as Fed rate hikes drive up benchmark lending rates such as 3-month LIBOR, to the benefit of the industry's net interest income. The last Fed rate-hiking cycle in 2016-2018 resulted in a significant boost to banks' net interest income. We expect a similar outcome over the next 1-2 years, reinforced by the likelihood that the cost of deposits will be slow to adjust to higher interest rates given the abundance of deposits held by banks. Importantly, loan growth has been picking up, which also bodes well for the net interest income of banks. According to data from the Fed, total loans outstanding at large domestically chartered U.S. banks have increased by 5% year-to-date, led by commercial & industrial and consumer loans. This represents a marked revival in loan demand after two years of negative/tepid growth. The rebound in loan demand could soften if economic growth moderates. However, credit demand responds to changes in economic activity with a long lag. Banks continue to indicate that their loan pipelines remain strong and are willing to supply credit to the economy. As such, loan balances should continue to expand at a solid pace over the next 6-12 months

Given the tailwinds to net interest income, further upgrades to bank earnings are likely in the next year. The guidance raise for net interest income issued by JP Morgan at its recent investor day will likely be the first of many across the banking sector. As a result, we expect bank earnings will be re-accelerating at a time when overall corporate earnings growth will be slowing. The implication is that bank earnings on a relative basis should improve, thus supporting the outperformance of the sub-group

The CECL Accounting Wild Card

Since 2020, banks have changed how they recognize impairment losses on loans due to the adoption of new accounting rules known as Current Expected Credit Losses (CECL). The new accounting standards require banks to estimate the losses on loans that they are likely to incur based on economic forecasts, rather than booking losses as they occur under the old method. The change forces banks to increase their loan loss reserves much earlier than in prior cycles. As a result, CECL accounting has become somewhat of a wild card in forecasting the earnings of the sub-group.

However, the credit quality of the banking industry remains exceptionally strong, as demonstrated by the noncurrent loan and the quarterly charge-off rates for FDIC-insured institutions, which were near their multi-year lows at the end of Q1. Furthermore, measures of early-stage delinquencies such as the percentage of loans outstanding that are 30-90 days past due also remain subdued. Credit losses are likely to modestly increase if economic growth moderates and the cost of capital rises, but loan performance should remain solid in the year ahead, supported by strong corporate liquidity and low unemployment. With the reserve coverage ratio of banks still well above pre-COVID levels, banks appear to be well reserved against a normalization of credit losses. Consequently, any reserve builds in the next year should not meaningfully detract from bank earnings and warrant a continued emphasis on the group in portfolios.

Valuations Create Favorable Intrinsic Values

Bank stocks are relatively undervalued, which adds to their attractiveness. The broad sub-group trades at a forward P/E multiple of 10 versus an average of 11.5 over the past decade. The current forward P/E ratio is at a slightly more than 40% discount to the broad equity market, which is larger than the 10-year average discount of 30%. The sub-group's trailing price/book (P/B) ratio of 1.2 is roughly at the midpoint of the 10-year range of 0.8 to 1.5 despite the near-decade high in the ROE of banks. On a trailing P/B basis, bank stocks trade at a 70% discount to the market, which is large by the standards of the post-Great Financial Crisis (GFC) period and greater than the 60% discount that prevailed immediately prior to the pandemic.

While the trailing ROE of banks is well below the equity benchmark, the discount on a P/B ratio basis is much larger than is warranted by relative profitability. At roughly 13%, the ROE of the sub-group is only 35% below the equity benchmark's ROE of 20%. The relative trailing P/B multiple implies that the market expects a significant erosion in relative profitability. However, the opposite outcome is more likely given that banks will be relative beneficiaries of rising interest rates and the ongoing economic expansion. As their relative ROE improves, the valuation gap between the sub-group and the broad equity market should close, thereby benefiting the relative performance of bank stocks. Depressed relative valuations imply that bank stocks offer significant relative upside as they deliver superior earnings growth in the coming year. The 12-month forward earnings of U.S. bank stocks are beginning to rebound after a period of sluggishness in the past year, much of which was related to non-operating issues. Additional upgrades to earnings are likely over the coming months as the combination of Fed rate hikes and expanding loan balances spurs a recovery in the banking industry's net interest income. These developments will occur at a time when overall corporate earnings growth is poised to slow, implying that bank earnings will also strengthen on a relative basis.

Although a normalization/modest increase in credit losses from exceptionally low levels is possible, credit quality should remain benign if economic growth proves resilient, as we expect. As a result, reserve builds should not be a significant drag on bank earnings over the coming year according to Morgan Stanley Research. The large valuation discount of bank stocks should narrow as their relative earnings and ROE improve, thus driving another leg of outperformance for the sub-group. Accordingly, we are maintaining an overweight stance.

As Go Industrials, So Go Equities

Investor attention in recent months has largely been focused on tech stocks, but industrials bear watching as a crucial signal for overall market direction and relative upside potential if the global economic expansion begins to unfold. Global industrial stocks have modestly underperformed year-to-date relative to the global benchmarks, continuing a trend that began in early-2018. In the past two decades, industrial sector relative performance has typically been highly sensitive to overall equity markets, and often a leading signal. Indeed, last year's peak in the sector's relative performance could be interpreted as a harbinger of the weakness in the global equities since the start of the year.

The sector's relative performance has also been sensitive to swings in the global industrial activity, as proxied by the U.S. ISM manufacturing index. The post-pandemic peak in the relative performance of industrials coincided with the peak in the U.S. ISM manufacturing index. At the same time, it is noteworthy that industrials' relative performance is close to the lows experienced in the past economic recessions, implying that a lot of bad news has already been discounted. The sharp underperformance of industrial stocks is in stark contrast to the strong upturn in the sector's relative 12-month forward earnings.

Despite the current upturn, the sector's relative earnings remain far below their pre-pandemic levels experienced in 2019. The strong uptrend in the industrial sector's 12-month forward earnings is expected to be sensitized to downgrades in the coming months as global economic growth continues to slow. However, that also is consistent for the overall market as well as other cyclical sectors. In absolute terms, industrial sector earnings have tended to move in tandem with those of the broader market, making them a constructive overall indicator of aggregate earnings trends. We believe there is a compelling argument to be made that the industrial sector's relative earnings may be more resilient to weaker global economic growth than in the past. 12-month forward earnings for some of the sector's major industry groups are still depressed in absolute terms, with aerospace & defense earnings, for example, more than 20% below their pre-pandemic level and well below the underlying rising trend of the past two decades. Airlines as a subgroup in the sector for example show passenger demand recovering steadily, the industry sub group's order books and earnings are positioned to hold up or climb in the next year.

It is important to note that the earnings of euro area industrials are threatened by the potential cut-off of Russian gas supplies in the coming months, as well as extremely elevated gas prices. This overhang in the Euro area will weigh negatively on the sector in the near term as industrials represent approximately 12% of global industrial market cap, with German industrials about a quarter of that. The sector is highly diversified. Ultimately, the outlook for industrial sector earnings and stock prices will be driven by the global economy, which we expect to slow further in the months ahead but to avoid an outright recession. Historically, it has been consistent to underweight the industrial stocks as global growth slows, despite the already depressed level of relative stock prices. Our macro view and sector analysis support a more constructive stance on industrials, while acknowledging that investor caution will likely persist in the near term both domestically and globally.

The global sector is trading close to the post-2000 lower-end of the valuation range versus the benchmarks based on the forward P/E ratio. This is appealing given that relative earnings are also still well below their prior cyclical peaks. We are overweight industrials in the investment portfolio, albeit selectively (we favor the aerospace & defense and air freight & logistics sub-groups), and would gradually accumulate positions on relative weakness. The ongoing underperformance of industrial stocks versus overall markets, if the global economic recession is avoidable, implies that any downgrades in industrial sector relative earnings will be limited and there is scope for positive relative surprises. The sector also has a valuation cushion, with the relative 12-month forward P/E ratio at the low-end of its range over the past two decades. We continue to look for investment opportunities in the sector to gradually add exposure in an equity portfolio, with a focus on longer-cycle businesses where order backlogs can support earnings forecasts.

Portfolio Highlighted Holdings

Bank of America reported results that beat analyst expectations. Profits declined 32% from a year earlier after provisions for credit losses. Revenues were up 5.6% on rising interest rates and loan growth. After rebounding some since its earnings release the stock remains down nearly 25% since the beginning of the year. Competition and technological advancements within mobile banking are robust but we believe BAC has the scale and scope necessary to remain a market leader. Its cost advantage and recurring fee income alongside its stronger balance sheet positions the money center with a formidable advantage to navigate the next business cycle.

Microsoft shares bounced nearly 5% off the bottom upon its earnings. Revenues came in a modest 12% year over year with earnings up 2% missing estimates. Foreign exchange rates weighed on earnings by 4 cents per share according to management. Supply disruptions from factory shutdowns and weakening PC demand were also headwinds this past quarter. Microsoft has transitioned its cloud business to represent 65% of revenues. Azure and other cloud services are growing at a 40% rate, albeit down from 50% in 2021. LinkedIn and Office are also experiencing healthy growth levels. As its cloud-based businesses continue to gain efficiencies, it should help offset segments with slowing hardware exposure such as Xbox. Guidance for fiscal Q1 calls for low double digit revenue growth, slightly below consensus. Management cited commercial business and share gains as revenue drivers while operating expenses moderate with the rate of hiring.

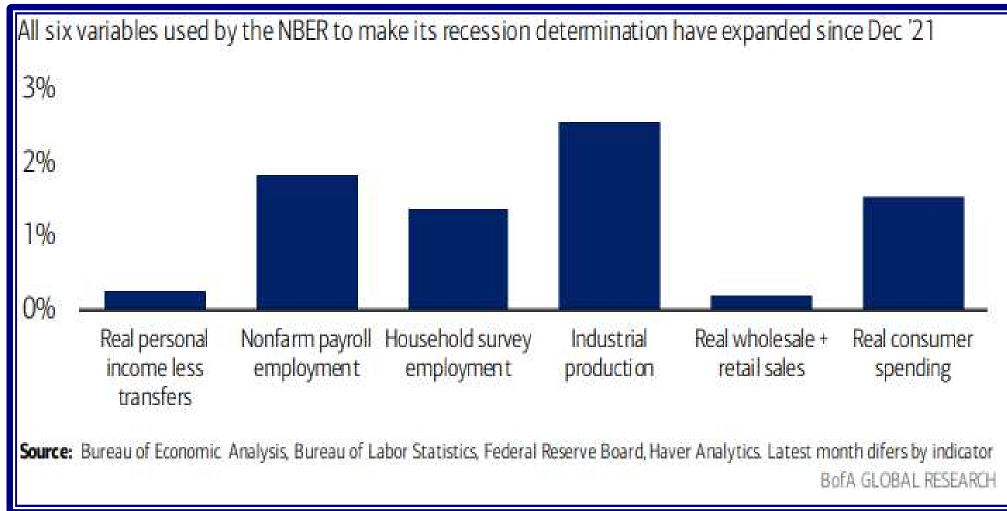
Defense contractor Northrop Grumman Corp. was the strongest performer in the sector during the quarter, up 7.4%. The company reported mixed results for the most recent quarter. Earnings per share (EPS) were above the consensus estimate, while sales were below. Northrop's guidance for the fiscal year remained unchanged. Generally, defense company stocks have performed relatively well given the lower economic sensitivity of their business models and a geopolitical environment that is more supportive of defense spending. In our view, Northrop has an attractive portfolio of businesses that are well aligned with U.S Department of Defense spending priorities, particularly in the areas of manned and unmanned aircraft and space and satellite systems. The company raised its quarterly dividend by 10% during the quarter.

Another notable contributor was pharmaceutical maker Merck & Co., Inc., which gained 12.0% for the quarter. Merck's shares moved higher after the company reported results for the first quarter that appeared to benefit from a further reopening of the economy. Revenue and EPS were both ahead of consensus estimates, and the company raised its guidance for the full fiscal year. Sales of Merck's cancer therapy Keytruda® and HPV vaccine Gardasil® came in ahead of expectations, as did sales of the company's anti-viral medication for treating COVID-19.

A notable detractor in the portfolio, as diversified entertainment and media company The Walt Disney Co., was down -31.2% for the quarter. In sympathy, Disney's shares traded lower after streaming competitor Netflix experienced a -30% share price decline following its earnings announcement. Netflix reported a modest loss of subscribers and slowing revenue growth for the most recent quarter. (Disney+ ended up adding 7.9 million subscribers' last quarter.) In addition, Disney's shares remained under pressure in response to a bill passed by the State of Florida to dissolve the independent special district that Disney World has operated for more than 50 years. In our view, Disney's long-term prospects remain strong. We think the company can be a leader in streaming services, given its extensive content library and the fact that the rollout in Europe is in its early stages. To us, the long-term potential of Disney's parks and travel-related businesses is being overlooked by investors in the current environment. We concluded that the potential dissolution of Disney World's independent special district will not have a meaningful impact on its overall business model.

IN CONCLUSION:

An official recession has yet to be determined - even as the latest GDP report came in -.9%, the second negative report this year, technically a recession. However, the National Bureau of Economic Research (NBER) defines a recession as "a significant decline in economic activity that is spread across the economy and that lasts more than a few months." NBER accesses several data points when defining recession. And since December, each of these variables has expanded. While still positive, the data collectively underscores a loss in momentum.



At its latest meeting, the Federal Reserve reiterated its 2% target inflation rate in order to cultivate a "sustained period of strong labor market conditions that benefit all". A tight labor market coupled with rising inflation are indications the Fed will continue to raise rates at each of its next three meetings this year, not ruling out the possibility of another 75 basis move at the upcoming meeting in September. Chairman Powell acknowledged that below trend market growth and some softening in labor market conditions may be necessary to restore pricing stability.

We remain upbeat despite the bear market sell off through June. A mild recession is mostly priced in with what looks to be a soft landing on the horizon. Evidence of tightening is already apparent in multiple areas of the economy and the Fed is willing to do whatever it takes to control inflation which may already be peaking.

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.