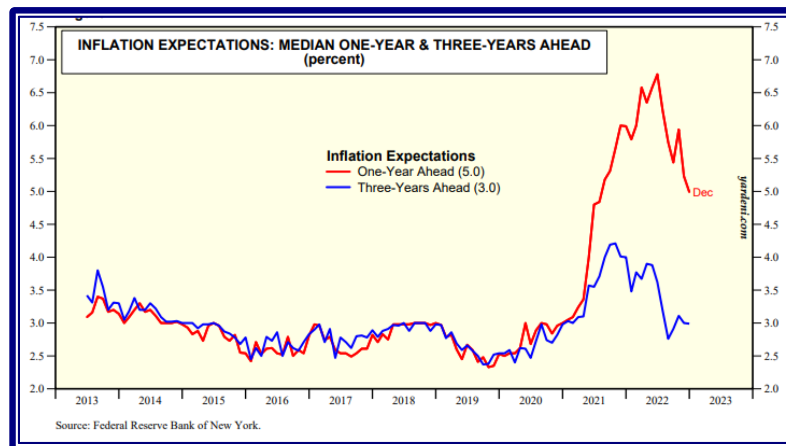
ALTMAN
INVESTMENT MANAGEMENT

EQUITY STRATEGY FOCUS

JANUARY, 2023

IN VIEW: The Economic Landscape

As the new year unfolds, what we are monitoring closely includes inflationary signals, GDP growth, Fed policy, corporate earnings, and the U.S. ability to meet its debt obligations past June. Inflation appears to be peaking on the back of improving labor conditions. Although wages are elevated, they have begun to surpass the rate of rising prices. Notable though, is as goods inflation is coming down service inflation is picking up providing some offset. This seems reasonable given consumers directed spending towards durables for several years and as economies opened up, services have attracted greater demand. Overall, we see inflation moderating during the year trending lower by 2025.



Source: Yardeni Research

GDP growth resumed reaching an annualized rate of 3.2% in the 3rd quarter of last year, after two prior quarters of negative growth. The U.S. economy is proving more resilient than pessimists expected, with the energy crisis less intense than feared a few months ago, and strong underlying fundamentals remain in place. We are forecasting a soft landing with support of consumer spending, improving labor market and moderating inflation. Resilient credit card spending accompanied by draw-downs to personal savings and falling gasoline prices are all propping up the consumer heading into the new year. However, these factors could moderate to some degree as rising interest rates temper consumption. A soft landing scenario is indeed possible if inflation continues to reign in throughout the year without significantly disrupting a normal deceleration in labor market activity.

The markets are discounting the Fed Funds rates will peak ~5% by mid-year. U.S. financial conditions are close to historical averages and fundamentals and spending power are in place to support a soft landing. The current yield on the 10-year treasury is 3.5% not nearly as restrictive as the 8% back in 1970s when the accompanying Fed Funds rate was pushing double digits. Keep in mind, the Federal Reserve initiated its aggressive tightening off an equally aggressive accommodative policy. A concern of course is that volatility in the equity markets this year will be accompanied by volatility in the bond markets as well.

A battle over the U.S. debt limit is unfolding in Congress as the Treasury department begins to use "extraordinary measures" to fund federal obligations. Past crises have been resolved with solutions ranging from raising or suspending the debt ceiling, spending caps, targeted tax increases, and/or sequestrations. The current size of the national debt of $31 trillion has tripled in size since 2001 to combat such forces as the Sept 11th attacks, The Great Recession, and the Coronavirus Pandemic. It will take concessions on both sides of the aisle within a Congress growing ever more divided, and may very well end up coming down to the 11th hour before a resolution is reached.

CLOSE-UP: Equity Investment Overview

Market Performance & Earnings:

The stock market had a rather strong 4th quarter (+7.6%) capping off an otherwise abysmal year (-18.1%). Performance over the last three months of the year was broad with 7 sectors outperforming the overall market. Energy, Industrials, Materials, Financials, Healthcare, Consumer Staples, and Utilities led the rally with only Communications Services and Consumer Discretionary posting negative returns.

4th Qtr. S&P 500 Sector Performance

Energy	Industrials	Materials	Financials	Health Care	Cons Staples	Utilities	SPX Performance	Info Tech	Real Estate	Comm Serv	Cons Disc
22.8%	19.2%	15.1%	13.6%	12.8%	12.7%	8.7%	7.6%	4.7%	3.8%	-1.4%	-10.2%

For the year, Energy outperformed the market by 8377 basis points. Rising demand out of the pandemic, and tight supplies from under-investment in production capacity, and geopolitical uncertainty continue to support the trajectory of oil stocks. The primary risk being a significant reduction in demand should a more severe recession materialize than anticipated. Due to their defensive nature, Consumer Staples and Healthcare outperformed by a respective 1743 and 1609 basis points. Defense and Aerospace stocks up 17% for the year supported the Industrial sector relative out-performance.

Historically, markets rarely have two consecutive years of decline. In fact, it has only happened twice in the past 50 years, during the recession in the early 70s and again during the late 90s bursting of the tech bubble. Going forward sector leadership should broaden. The 50 largest stocks in the S&P 500 under-performed during 2022 as the market cap weighted index lagged the equally weighted index by 6.7% in 2022. According to Bank of America Global Research, these mega caps trade at a full standard deviation premium to the bottom 450 stocks, while the five largest companies account for 20% of the overall index. High quality, high dividend-paying stocks should perform better in this late cycle, hence our overweight in Energy and Financials.

Q3 earnings came in up 4% year over year as capex accelerated 24%, with upticks in Energy, Communication Services, Technology, and Industrials. Capex in semis is expected to boost manufacturing spend as production moves back to domestic shores. Foreign exchange pressured earnings growth as the U.S. dollar strengthened. Only 4 of the 11 market sectors with Energy, Real Estate, Industrials, and Consumer Discretionary posted positive year over year eps growth.

At this point we do not believe that a major earnings recession is in the cards, however a partial reversion to the mean is likely. Consensus eps estimates for 2023 call for 5% growth. However, this could prove too optimistic when the average growth rate during recessionary times is closer to -19%, as reported by Bank of America Global Research. U.S. 12-month forward earnings are approximately 30% above their pre-pandemic peak less than three years ago. Extraordinary eps growth off the bottom into mid-2021 was both the strongest and quickest on record and has been further bolstered in the past year by the surge in inflation. The 12-month forward P/E ratio for the U.S. market is at a 7.3% premium to the historical average of 16.5x. Forward estimates have already been cut by over -4% for Q4 and -3.6% for 2023. Consumer Discretionary demand vulnerability, perpetuated by inflation, is being outpaced by demand in Consumer Staples. Another noticeable trend, is the margin for the demand for services over goods continues to widen.

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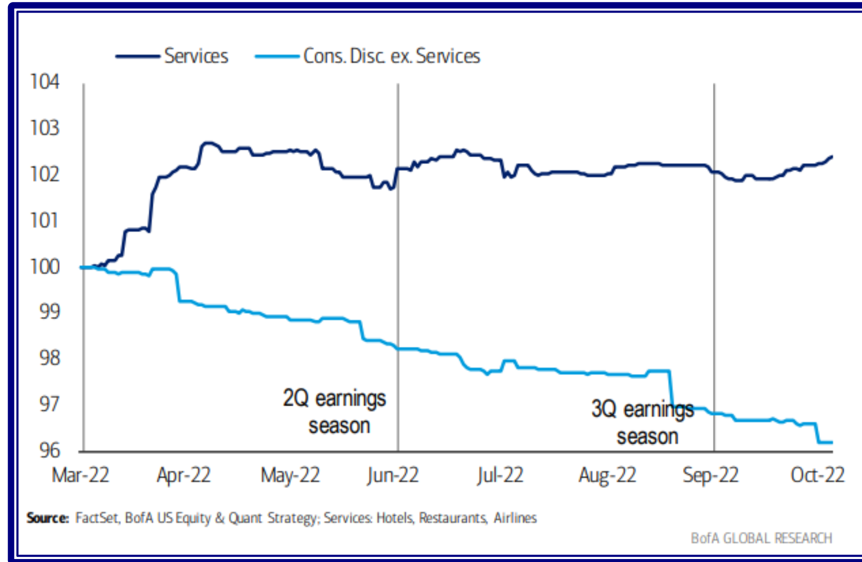
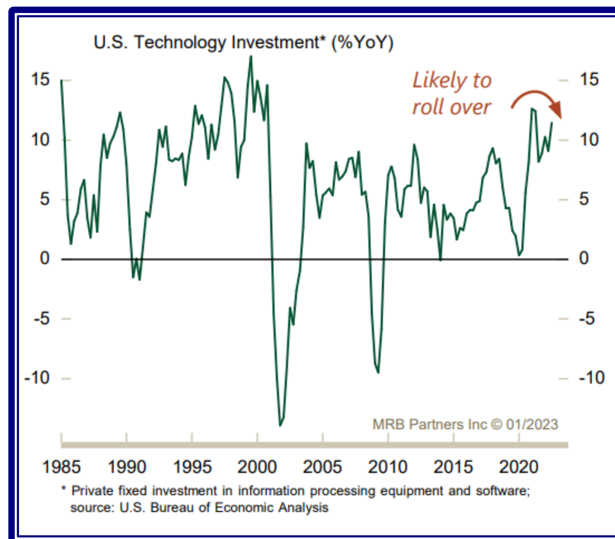
Consensus Sales for Services vs. Consumer Discretionary ex: Consumer Services
March 2022-Nov 2022



From a style perspective, value stocks are expected to outperform based upon expectations for higher interest rates, earnings uncertainty and relative valuation. With the 10-year trading at 3.5% up from 1.7% a year ago, the bond market can be classified as oversold. But any reversal on the backs of deceleration in the rates of inflation and economic growth are likely to be muted. Even as inflation may be peaking it remains well above the Fed 2.0% targeted levels. Alongside labor market tightness, these conditions may prevent the Fed from easing anytime soon and could lead towards another step up in bond yields later this year.

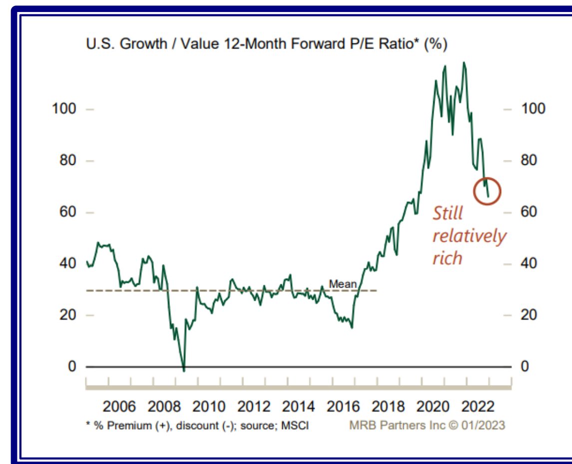
Slowing earnings growth trends within the tech sector also indicate a bias towards value. Technology spending trends skewed towards the upside during the pandemic to accommodate work from home solutions, improve the remote customer experience, and combat supply chain disruptions among many other initiatives. A reversion to the mean is likely, especially given tech capex has yet to roll over.

Tech Capex Growth is Due for Reversal



Source: MRB Partners

Even as growth stocks under-performed during 2022, valuations remain relatively high. On a trailing 12-month basis growth stocks are at a 90% premium against a 50% average. On a forward basis - growth stocks are trading at a 65% premium, leaving plenty of room for value stocks to continue to out-perform.



IN CONCLUSION:

The stock market appears to be working on forming a bottom since last September, with support established on June 16th with the Standard and Poor's hitting 3,666. We believe that support level should hold if real GDP grows between 0.5 and 1.5% through the first half of 2023 recovering to more normal levels during the second half of the year. In addition, the bottom should hold if the Fed pauses after two more rate hikes this year and moves to the sidelines early next year.

Markets should broaden out diminishing prospects for the narrow group of growth stocks that have been dominating the markets. We remain underweight commodities with the exception of energy, expecting soft demand conditions to outweigh supply constraints and the U.S. dollar to move lower in 2023. We continue to look for opportunities in Healthcare, Financials, and Communications Services, as well as select Technology sectors.

The U.S. economy is proving more resilient than pessimists expected, with the energy crisis less intense than feared a few months ago, and strong underlying fundamentals remain in place. Our outlook calls for a soft landing with odds of a recession at 55%. GDP is expected to grow at ~2% in 2023 with eps growth in the low single digits. Inflation should level off moving towards the Fed's target rate by 2024-2025. Corresponding S&P market performance will likely end the year in the low to mid-single digits.

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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.

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