ALTMAN
INVESTMENT MANAGEMENT

EQUITY STRATEGY FOCUS

APRIL, 2023

IN VIEW: The Equity Landscape

With inflation running well above Fed target levels and economic growth slowing, the economy is presently in what is often characterized as its "late cycle" phase. Typically, in this phase, positive yet slower growth is accompanied by tighter employment trends which then leads to tighter monetary policies. As corporate profits come under pressure, stock market returns often soften into the mid-single digits. Uncertainty associated with the Fed's aggressive rate hikes on both the economy and corporate profits still lie ahead, in our view. Leading indicators such as housing, purchasing managers indexes (PMIs), and an inverted yield curve suggest that economic and market conditions could remain challenging for a while.

The rebound in stock price levels so far this year appear to be centered around short-term sentiment. The top mega cap growth stocks are soaring after a tumultuous 2022 as Fed policy raised key interest rates 7 times. This rebound reflects anticipation of a reversal in Fed policy towards lower rates coupled with a perceived increase in risk to global growth brought about by several banking failures. We are of the opinion, however that these idiosyncratic banking failures have stabilized and will not derail the banking system. Banks are now in stronger positions since the 2008 financial crisis, having rebuilt their balance sheets while maintaining higher liquidity standards. As the Fed continues to digest incoming data and assess broader implications of the banking failures on credit conditions and economic activity, the Fed may indeed pause.

Labor conditions are a large factor in future Fed policy direction. The March jobs report was healthy and reflected efforts from the Federal Reserve to slow labor demand. The report identified an increase of 236,000 jobs with unemployment falling modestly to 3.5%. Average hourly earnings grew at 4.2%. The healthy jobs market alongside stubbornly high inflation are in part behind the Fed acknowledgment of "some additional policy firming may be appropriate" and leads us to the conclusion that the Fed is unlikely to begin to lower interest rates just yet.

Consensus estimates for Q1 GDP remain in positive territory according to The Atlanta Fed. Tracking at 1.5% for Q1, down from a high of 3.5% in March. The largest detractors are coming from equipment, residential investment and private inventories. The remainder of the year is where we see a discrepancy amongst analysts as to the impact of past Fed policy moves, earnings growth potential, and the overall health of the economy. In our view, we are likely to see disinflation back to a level of around 3% by 2024, with the potential for more interest rate hikes before the Fed finds reason to ease.

CLOSE-UP: Equity Investment Overview

Market Performance & Earnings:

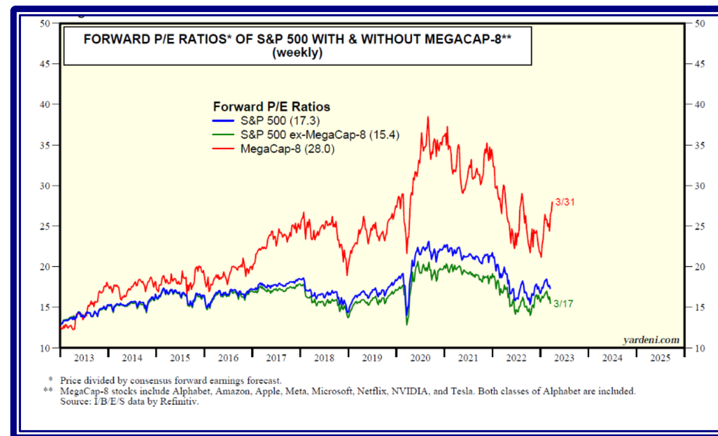
The S&P 500 benchmark index rebounded strongly in Q1 with a total return of 7.48%, regaining a portion of the loss during 2022 of -18.1%. Throughout last year, the FAANGM stocks sold off significantly, led by Meta, Netflix and Amazon which lost -64%, -51% and -49% respectively. At @ 21% of the benchmark market cap, the 6 FAANGM stocks contributed to nearly half the market's downturn for the year. In fact, the group lost approximately $4 trillion in market cap in a span of just under 12 months.

1st Qtr. S&P 500 Sector Performance

Info Tech	Comm Serv	Cons Disc	SPX Performance	Materials	Industrials	Real Estate	Cons Staples	Utilities	Financials	Health Care	Energy
24.1%	20.5%	16.8%	7.5%	4.3%	3.1%	2.0%	0.9%	-3.2%	-3.4%	-4.3%	-4.7%

The opposite appears to be occurring this year as the same sectors that were dragged lower by FAANGM, Communication Services, Consumer Discretionary and Information Technology, are now leading the market higher. This move, in our opinion is largely sentiment-driven as we see multiples expanding against declining estimates for a majority of the group. These companies contributed 4.49% of the 7.44% S&P 500 total return for the first quarter, and the rally will likely be short-lived.

Multiples Expand In FAANGM Stocks



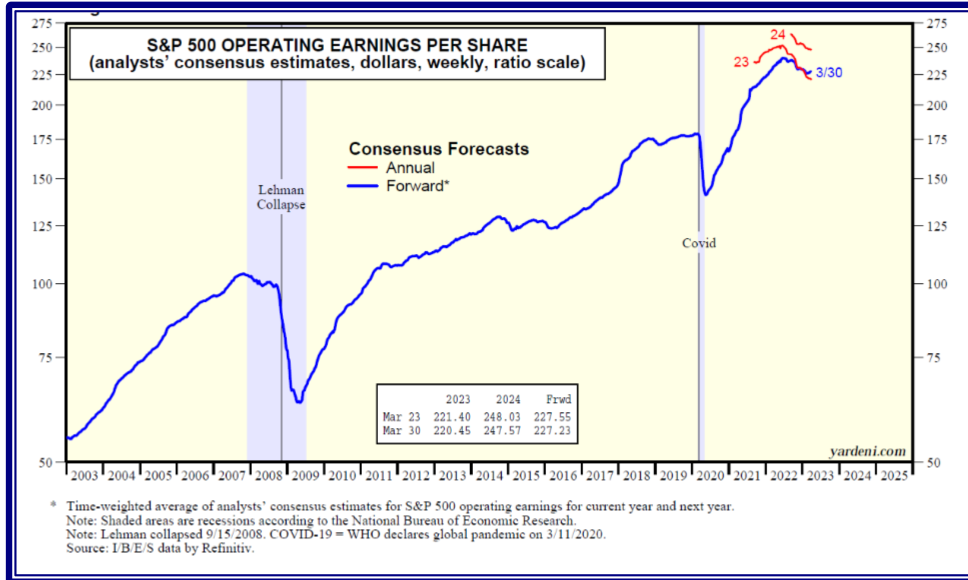
An extension of the mega cap growth stock theme throughout the year is based upon the anticipation of a reversal in Fed policy towards lower interest rates and a hard landing, a view of which we are more skeptical. Inflation has likely peaked; however, we believe it may stay elevated for some time keeping conditions tight with rates higher. The recent failures amongst an isolated group of banks also could contribute to additional tightening by way of more conservative lending practices. Even as Meta's price soared into the new year, it remains 40% below its high at the start of 2022. Similarly, performance of the major benchmarks tells us that despite a strong first quarter, large cap growth stocks still have a lot of ground to recover.

Index	Total Return 12/31/21 – 3/31/23
NYFANG Index	-16.4%
S&P 500 Index	-12.0%
Russell 1000 Value Index	-6.7%
Russell 1000 Growth Index	-19.0%

Source: AIM, LLC and Bloomberg Analytics

Yardeni Research conducts weekly studies on consensus S&P 500 earnings behavior. The downtrend in 2023 and 2024 consensus earnings (red) could reflect either typical estimate revisions off overly optimistic levels or it could indicate rising concerns of a recession**.** In contrast, forward earnings (blue) appear to be plateauing around the $227 level thus suggesting a recession is not imminent. With time, the forward rolling calculation engulfs more of higher 2024 data providing some support. The top 4 sectors in terms of year over year growth expectations for Q1 2023 are Consumer Discretionary (+36%), Industrials (+18%), Energy (+14%) and Financials (+5%). Overall consensus earnings for Q1 2023 are expected to decline -7.5% year over year. Consensus earnings growth for the full year is expected to rise 1% before climbing another 10-12% during 2024.

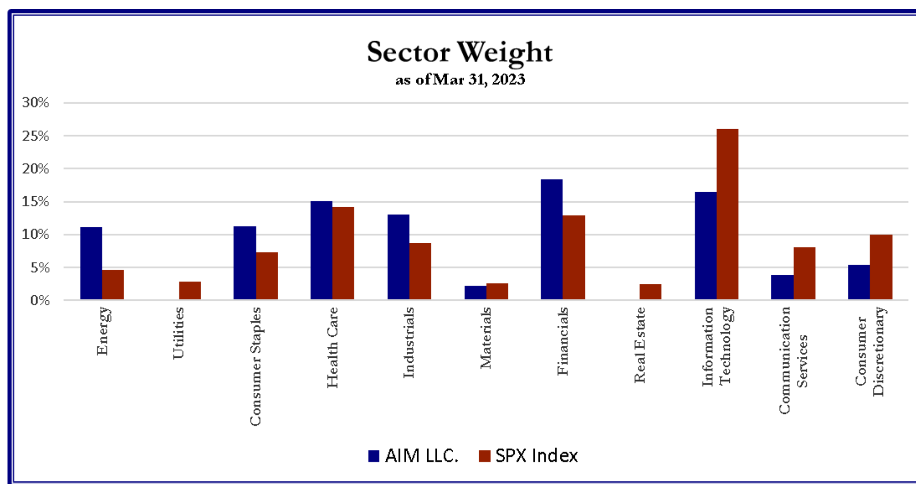
**Forward Consensus Earnings Estimates
Are Leveling OFF**



Forward revenues have held steady around $1,888 since the second half of last year. However, Yardeni suggests the flattening of revenues may indicate concern over unit sales for the later part of this year. The tight labor market and high inventory levels could weigh on new orders as consumer demand softens. A soft landing could cool growth just enough to ease these pressures and raise productivity levels.

Stock Spotlight and Strategy:

Overall, we favor market sectors that have the potential to outperform in a higher interest rate environment such as, Energy and Financials and some select Industrials over Information Technology or Communication Services stocks whose valuations remain elevated.



Source: AIM LLC., and Bloomberg Analytics

Financials (Overweight):

Earnings season kicked off with strong reports from some of the largest banks, aided by higher interest rates and a resilient consumer. With regards to the recent banking failures and the impacts on the economy as a whole, Jamie Dimon of JPM highlighted what he sees as a potential tightening in credit as opposed to a full out credit crunch. Developments will most certainly impact how the Fed proceeds from here.

Tighter conditions could do some of the work for the Fed, thus allowing space for a pause in rate hikes in order to gauge how inflation settles from current levels. The Federal Reserve Bank of San Francisco puts out a proxy rate that in essence captures the broader effect of the Fed's balance sheet. It then adjusts the Fed Funds rate to include the combined policy effect. The current proxy rate of 6% is telling us that quantitative tightening is having a 50-100 basis point impact on top of the current Fed Funds rate of 4.75-5%. So, one can argue we are already at a level high enough to be restrictive so it would not be unreasonable for the Fed to pause here.

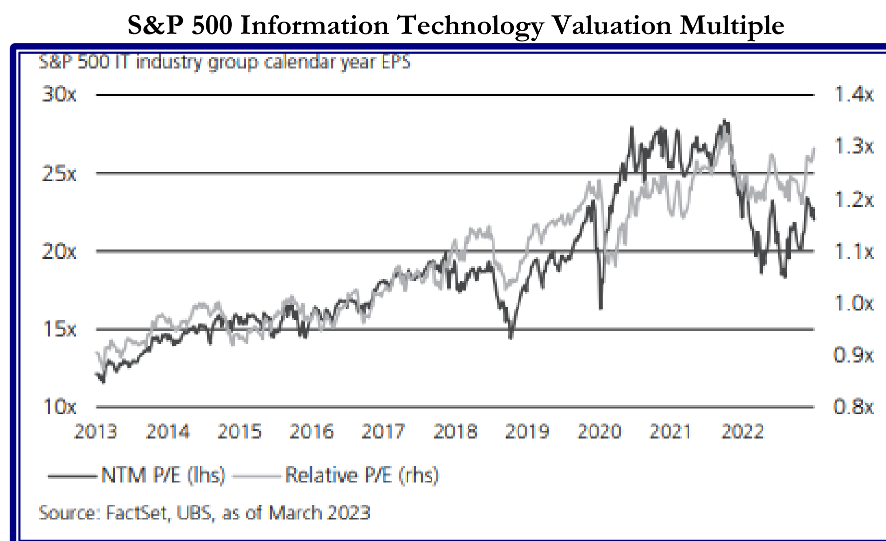
In an effectively neutral sector trade after banking stocks bottomed in late March, we let go of our position in Bank of New York - investing the proceeds to increase already established positions in US Bancorp and Bank of America. The net result increases the sector market cap, raises ROE and dividend, while lowering valuation. The moderately less defensive posture also positions the portfolio to perform better in a higher interest rate environment as net interest margins expand. But even as loan/deposit ratios are turning up, the level is much lower by historical standards and even more so amongst the larger cap banks.

We continue to view our financial holdings as being of the highest quality holdings of the Financial sector, due to their strong capital positions, diversified business models, and comparably sound investment portfolios.

Information Technology (Underweight):

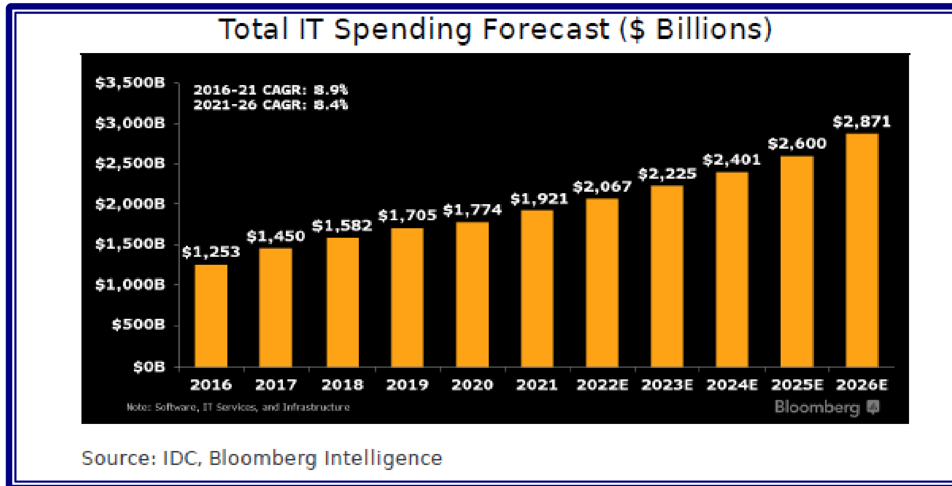
Led by Apple, Nvidia, Microsoft and Advanced Micro Devices, the Information Technology sector drove the market higher during Q1. Although the sector is -17% from its 15-month high, its 30% premium to the S&P 500 multiple tells us the sector is still overvalued.

S&P 500 Information Technology Valuation Multiple



Source: UBS and FactSet

The rally in the Technology sector so far is not accompanied by a rally in forward earnings. This opens the door for increased volatility should earnings not meet swelling expectations. In portfolio terms, this simply means to resist chasing these stocks higher, with stock selection within the space being the key. As a higher interest rate environment is likely to cap spending to some degree in the short run, IT spending is still expected to continue to grow at a compound annual growth rate in excess of 8%.



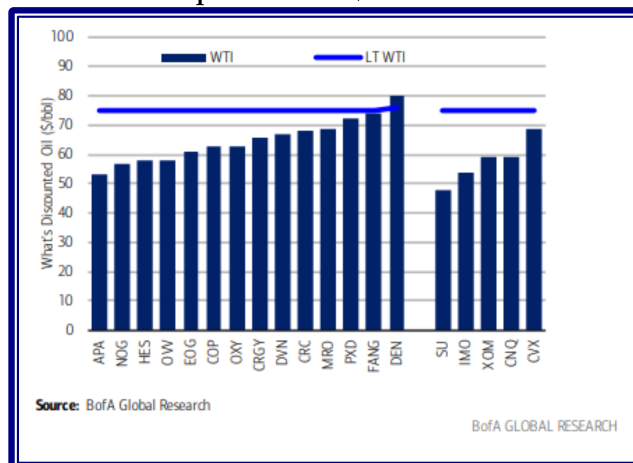
Rising interest rates have been a headwind against this sector, therefore the group benefited from the reversal in short rates during the quarter. Other drivers include the maintenance of legacy systems, cloud infrastructure builds, cybersecurity initiatives, and AI. But as long as valuations remain rich against a higher interest rate environment, an underweight in this sector is appropriate.

Energy (Overweight):

Energy stocks experienced a bit of a pullback during the first quarter, retreating -4% after excelling 65% last year. Brent crude reached a peak of $123.6 last year on supply disruptions, Russia/Ukraine War, and climbing inflation. Since then, oil prices fell to the low $70s on higher interest rates, a strong dollar and inflationary concerns. In response and in a preemptive move against a potential global recession, OPEC made a surprise announcement in early April to once again cut production. Oil prices shot up above $85 on the news.

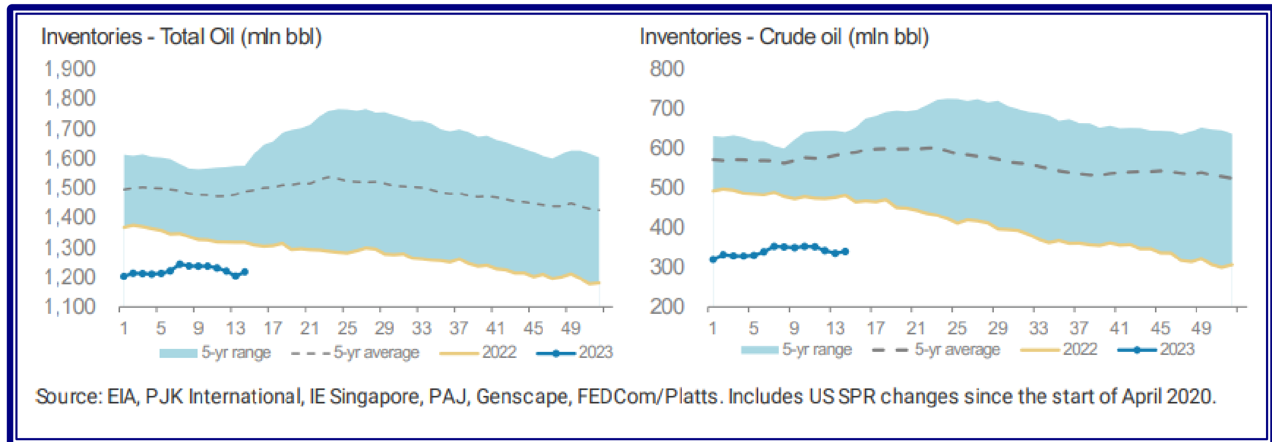
According to Bank of America Global Research, US oil companies are discounting ~$65 oil leaving plenty of room for upside surprises, particularly as we anticipate inflation to remain elevated for some time.

E&P's undervalued by -30%
compared to LT $80 Brent Oil



Low inventory levels imply demand strength coming out of the pandemic. Concern over demand softening is premature in our view - and with more risk to the upside given oil price support levels and our call for a soft landing.

Total Oil and Crude Stocks Remain Below 5y Averages



Entering 2023 with strong free cash flows, record breaking profits, low-cost production, improved debt ratios, and oil upwards of $80 bodes well for the Energy sector this year and provides the potential for further out-performance should a soft landing materialize.

IN CONCLUSION:

As the first quarter brought an about face to last year's performance, we are reminded of the noise that often distracts investors from pursing objectives within their intended risk/return profiles. Short term results can often be misleading and unsettling. Our outlook for the coming months is that inflation will likely stay elevated with the Fed possibly heading to the sidelines for a few quarters before resuming its rate hikes to combat sticky inflation. Technology multiples will likely compress alongside earnings surprises within the industrial and commodities sectors, so it's best not to chase after these mega cap FAANGM stocks.

We have not concluded that the recent bear market has ended, although the bottom appears to have been set in October of 2022. During the quarter, the narrative shifted from "soft landing" to "no landing" to "hard landing" to "how hard a landing." Focusing on the macroenvironment devoid of the underlying investment business models can obfuscate our longer-term investment objective and not based on concrete underlying fundamentals. While we're never happy with periods of underperformance, we think our focus on valuation and quality and underlying business models is especially appropriate right now. The cycle has entered its later stage - but we believe shifting towards a more defensive portfolio at this juncture would be premature. Staying the course by staying invested and maintaining some cyclicality within our sector exposure should prove beneficial for the remainder of the year.

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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.

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