ALTMAN
INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

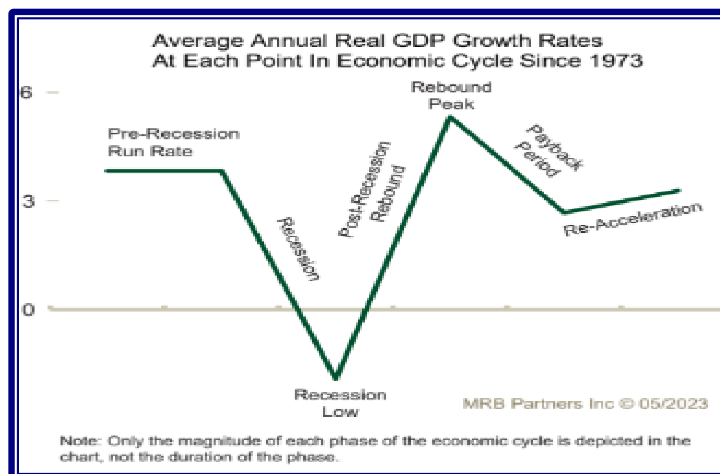
MAY, 2023

IN FOCUS:

Over the past several quarters we believe that softness in the U.S. economic data is best characterized as a slowdown or period of payback following the post-pandemic boom. It is our belief that the accommodative Fed policy resulting in a surge in economic activity following the pandemic was unsustainable, especially once morphed into a politically toxic spike in consumer price inflation. We remain in the camp that it is premature to call for a recession in the U.S., particularly one that would generate such an economic event as to completely unwind sticky inflationary pressures. The latest data continues to support the view that the U.S. economy is resilient and reaffirms a more constrictive non-recession outlook.

Economic pullbacks vary in magnitude. Historically, they have been sharp causing economic activity to slow to a sustainable rate that is below average levels. In other words, the economy reaccelerates modestly after the pullback and settles into a somewhat firmer underlying rate of expansion. The 2000's saw an exception to this phenomenon as economic growth continued to gradually erode below the average level. We have taken into account this post-recession slowdown or payback and the subsequent reacceleration as an integral part of analyzing the new expansion growth rate trend. Today investors appear to be overwhelmed by the fear that this slowdown will spill into a deep recession. Investors have been reticent to reverse this stance, until there is clear evidence of relief in the contractionary phase when the economy reaffirms its trendline growth trajectory.

Typical Cycle for the U.S. Economy
Over The Past Half Century



Source: MRB Partners

In order to make the determination of whether this is just a cyclical slowdown or an all-out recession, we emphasize that the "hard" economic data suggests a resilient economy - yet the "soft" data (surveys) points to a sharp decline in economic activity. Certainly, the deceleration from double-digit growth rates we experienced during this recent cycle was followed by an abrupt slow down. Significant uncertainty bolstered by negative press headlines has been fully discounted in the sentiment indicators.

We would be the first to acknowledge that during this decade there have been major shocks - a pandemic with widely varying policy responses (both fiscal and monetary, as well as health care) and a major war in Ukraine followed by a significant energy shock. No doubt these events were followed by periods of ultra negative sentiment data, consistent with a recessionary outcome, and has unnerved investors.

The Economic Landscape:

Our research shows that the U.S. economy has become increasingly resilient over the past 10-15 years, and a recession is now much harder to validate.

- **Unlike during the late-2000s, U.S. households now have solid balance sheets**, still ample excess savings, and solid wage/income gains. Dramatically reduced debt burdens have made households considerably less interest rate sensitive than in the 2000-2008 period.

- **Higher interest rates and a moderate tightening in bank credit conditions have had far less of a negative impact on economic growth than in past cycles**, given that this expansion has not been fueled by private sector borrowing.

- **The aggregate cost of capital is also not yet high enough to set a recession into motion,** in our opinion. Although Fed policy rates are elevated compared with recent years (when it had been pushed to absurdly low levels), they are not considered restrictive when seen from the perspective of the Taylor Rule[1], especially if one takes into account more realistic structural assumptions. For example, the current inversion of the yield curve is helping to support economic growth, since much of the private sector borrowing is done with longer maturities.

- **Another new wildcard to consider is the vastly publicized appearance of current stress in the banking system. However, U.S. bank balance sheets have improved dramatically over the past 10-15 years.** The overall sector is well capitalized and flush with deposits. The problems are isolated within a select group of poorly managed banks, rather than something widespread or systemic in our opinion. Thus, there likely will not be a dramatic tightening in credit conditions that would materially deteriorate aggregate growth conditions. Although commercial mortgages have been raised as an issue, these are only 15% of GDP (and only a portion of these are in the most vulnerable office space), compared with close to 80% for single family home mortgages at the peak of the household boom in the mid-2000s.

- **Outside of the U.S., the other two major economies (China and the Euro-zone) are reaccelerating**, following significant softness in 2022. Specifically, China's economy is benefiting from a post-COVID economic reopening, while the eurozone is receiving a boost as the energy crisis unwinds. This provides direct support to the global economy and indirect support for the U.S., further reducing the likelihood of a recessionary outcome.

Stock/Bond Allocation and Investment Strategy Outlook:

It has become increasingly evident that the Fed will soon pause its rate-hiking cycle. The resultant elevation of recession fears should all but eliminate the chances of the significant rate cuts, despite already being priced into the bond markets. While core consumer price inflation is easing, it will remain stickier than the consensus expects in the absence of a recession or prolonged period of below trend growth that significantly weakens employment. Neither of these are imminent. Rather, we believe shelter, an important driver of inflation, should provide some inflationary relief ahead, but the pandemic-related surge in CPI goods inflation has already begun to unwind. Core services excluding shelter (which accounts for 30% of the core

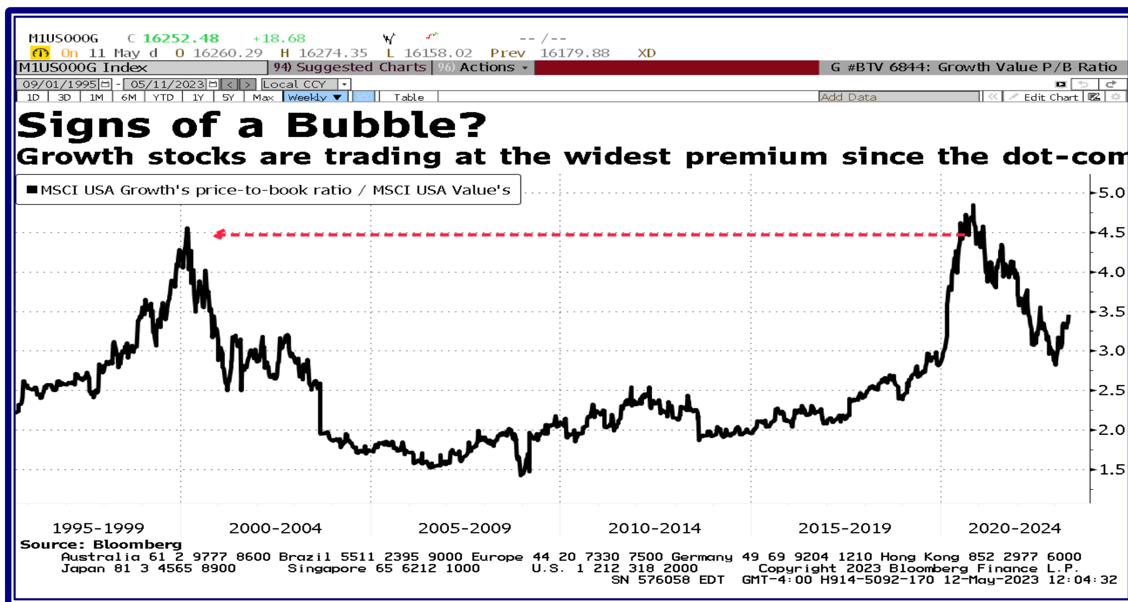
(1). The Taylor Rule is an interest rate forecasting model introduced by the economist in 1992 in a study called "Discretion Versus Policy Rules in Practice." It suggests how central banks should change interest rates to account for inflation and other economic conditions. The rule suggests that the Federal Reserve raise rates when inflation is above target or when gross domestic product (GDP) growth is too high and above potential. It also suggests that the Fed should lower rates when inflation is below the target level or when GDP growth is too slow and below potential.

CPI and as much as 55% of core PCE) has moderated and correlates with wage gains. So, without the latter softening materially, the Fed's hopes that core PCE inflation will return to near 2% is unrealistic.

In terms of our fixed-income strategy, bond yields may continue to consolidate in the near term, as the Fed moves to the sidelines and inflation edges lower. It is our position that U.S. Treasury rates are likely to resume an upward bias later this year if our macro view materializes. Therefore, we are maintaining a short duration emphasis and favoring higher quality corporate credit in fixed income portfolios. Given the dramatic inversion in the yield curve, we are staying away from the belly of the curve (2–3-year maturities) and emphasizing either very short-term maturities or purchases beyond 5 years.

Our outlook for equities reflects that the U.S. may be late in the economic expansion, but that the economic growth could surprise to the upside in the coming months with some volatility. Although earnings are somewhat desynchronized in aggregate, we expect they will be firmer than forecasted and should potentially support equity prices later this year. In this macro environment, we maintain a pro-cyclical bias favoring equities to bonds, and companies with valuation support and/or the ability to expand earnings to offset higher-for-longer interest rates. This reinforces our preference for low price to earnings - and presents a potential headwind for the comparatively expensive FAANGM stocks that have a concentrated weight in the S&P 500 index. Instead, we favor large-cap Financials, Health Care, Communication Services and Energy. We would not chase the momentum bounce in tech stocks that has transpired so far this year.

Growth Socks Trading at 2001 Dot-com Valuations



Source: Bloomberg, AIM, LLC Research

Energy Stocks Revisited:

With oil and natural gas prices down sharply from their 2022 highs, investors and industry analysts have differing opinions about the future. Stock investors have bid up the shares, despite analysts' dour earnings projections. Despite S&P 500 Oil and Gas sector earnings climbing 60% year over year in the first quarter of 2023, they dropped off 20.6% below the prior quarter. The decline from Q4 earnings is not surprising given the drop in the price of West Texas crude which has fallen 27.4% through April of this year, after peaking in June 2022. Additionally, the price of natural gas is 75.1% below its August 2022 peak.

The overall profitability of this group cannot be understated and is reflected in the year over year advance in average earnings of our composite holdings of +180%, trouncing the S&P 500's earnings of 12.1% one-year gain, according to Bloomberg. Despite the shares extraordinary earnings record, analysts turned decidedly negative following Fed tightening, and the possibility that the global economy will drop into a severe recession dousing the group's earnings prospects for 2024. Analysts are now forecasting that earnings per share for our aggregate holdings will decline this year by 19%, but remain relatively optimistic that profitability will resume in 2024 with an estimated year over year comparisons of 15.6% growth in 2024.

The industry's stock price index is near its 5-year peak, even though analysts collectively are not very optimistic about the industry's earnings power this year. These forecasts are in sharp contrast to a number of oil CEOs comments during the quarterly conferences who believe oil demand will continue to increase this year, predicting crude oil prices will approach $80-100 a barrel later in the year, according to Bloomberg Research. We believe that Energy companies have done a terrific job remaining profitable, even when oil prices fell, in part because they've been able to produce far more energy using far fewer rigs than in the past. In October 2014, there were 1,609 rigs in operation industrywide at the peak. Oil production peaked shortly thereafter at 9.6 million barrels/day. Today, there are only 591 rigs employed, but 12.2 million barrels/day of oil are being produced.

AIM, LLC Characteristics versus The Standard and Poor's 500

Portfolio: AIM MODEL | Benchmark: ISHARES CORE S&P 500 ETF | As Of: 5/12/2023

Equity	Port	Bench	+\-
Beta	0.88	1.00	
P/B	2.34	3.99	-1.65
P/E	13.50	20.27	-6.77
BEst P/E	12.674	18.072	-5.398
P/S	1.65	2.31	-0.66
Div Yld	2.48	2.01	0.47
P/CF	9.41	14.16	-4.75
Market Cap	6512380	38192160	-31679780
BEst ROE	14.746	46.570	-31.823
BEst PEG	2.647	2.064	0.584

Source: Bloomberg, AIM, LLC Research

IN SUMMARY:

The Fed's monetary policy is helping dampen activity from what otherwise would be the case, but is not yet restrictive, or providing a recession catalyst. This is partially because U.S. households have strong balance sheets and are less interest-rate sensitive, which provides increased resilience for the aggregate U.S. economy. Looking ahead, we expect the U.S. economy to reaccelerate modestly as housing and manufacturing improve, while consumer spending and the service sector strengthen. In addition, the other two major economies China and the Euro-zone have shifted from being a drag on the global growth in 2022 to reaccelerating and supporting aggregate growth conditions.

We think that although the Fed and other central banks may pause their tightening policy/rhetoric in the next few months, further rate hikes may still be on the table before the cycle ends. We are maintaining a pro-growth investment bias. This backdrop continues to support our view that cyclical stocks offer better relative valuation and earnings upside. We are emphasizing Financials, Industrials, and Energy, while hedging portfolios with the defensive Healthcare group to balance our late-cycle bias.

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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.