ALTMAN
INVESTMENT MANAGEMENT

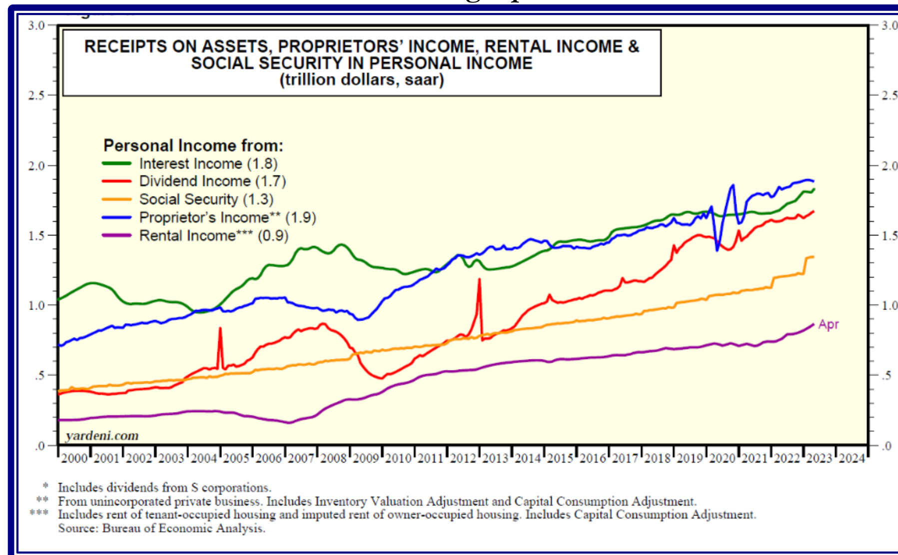
EQUITY STRATEGY FOCUS

JULY, 2023

IN VIEW: The Equity Landscape

As interest rates rose during 2022 to stave off an overheating economy, so did calls for a U.S. recession. Initially, consensus targeted the recession to begin in the first half of 2023, but consumers have access to excess savings accumulated throughout the pandemic which can help maintain a healthy trend in spending. Now, a growing number of economists believe the recession is likely pushed back until 2024. That's when consumers are expected to run through most of their excess cash. However, analysis by Yardeni Research sheds some light on additional income sources available to consumers that should support spending.

Sources of Consumer Income are Trending Upwards



Another phenomenon is the growing source of spending coming from retirees that have amassed a combined net worth of nearly $75 trillion. Not only does this provide spending support for the Baby Boomer generation, but also younger generations who stand to inherit much of this wealth don't have much incentive to save right now.

Additionally, the term rolling recession, is becoming more common terminology when categorizing current conditions. This occurs when some areas of the economy are in decline while others exhibit relative strength. For example, the leisure and travel industries are growing whereas the commercial real estate market is already in a recession. Retail sales are holding near record levels as spending gravitates towards services. Industrial production was mixed, with motor vehicles and parts exhibiting strength - while utilities remain nearly 4% below this time last year. This helps illustrate that an economy wide recession does not appear to be materializing with support from a strong jobs market and consumer confidence. Additionally, households and businesses took advantage of cheaper borrowing costs to lock in low interest rates. Three spending bills, including the Infrastructure Investment and Jobs Act, contributed to unprecedented fiscal stimulus which impacts are yet to be fully realized. There has also been a boom in travel spending alongside an 8.7% annual cost of living increase in social security benefits driving consumption.

That being said, the outlook is not without headwinds. The inversion of the yield curve is generally a precursor to a recession. Inflation is still above its target rate, interest rates are high, government debt has skyrocketed to 129% of GDP, and there remains the aforementioned concern over the sustainability of consumer incomes. But all considered, a soft landing remains a strong possibility if a full-on recession is not averted all together. The June CPI report, although 1% above its target rate, is down sharply from the 9.1% level just last year. The housing market has remained relatively tight and unemployment continues to improve. Even as the Fed chairman expressed concern over tight credit conditions which are expected to weigh on economic activity, hiring, and inflation, the end of the tightening cycle is likely near.

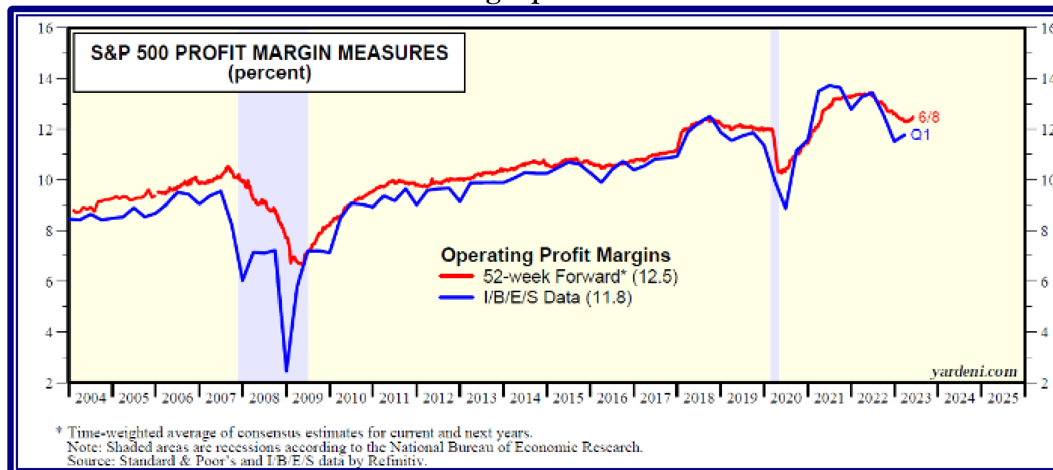
CLOSE-UP: Equity Investment Overview

Market Performance & Earnings:

According to Yardeni Research, analysts are still lowering their earnings estimates for the year and next, but the pace of the downward revisions is slowing. With a majority of Q2 earnings reported thus far, earnings have declined for the 3rd straight quarter, down -5% year-over-year. Annualized earnings growth was strongest in Consumer Discretionary, Communications Services, and Industrials. Declines in Energy, Materials and Healthcare were the largest year-over-year. Resilient economic data along with continued strength from consumers is working to stabilize earnings expectations for Q3. Sentiment amongst corporations has turned up, indicating a positive earnings trend. Top line sales grew 0.6% year-over-year led by Consumer Discretionary, Financials and Healthcare.

While inflation has indeed boosted revenues the past several quarters, it has also eroded profit margins as costs continue to rise at a faster pace. In this same vein, easing inflation should work to relieve pressures on profit margins as implied by an upward shift in forward estimates.

Forward Profit Margins (Red)
Are Turning Up as Inflation Eases



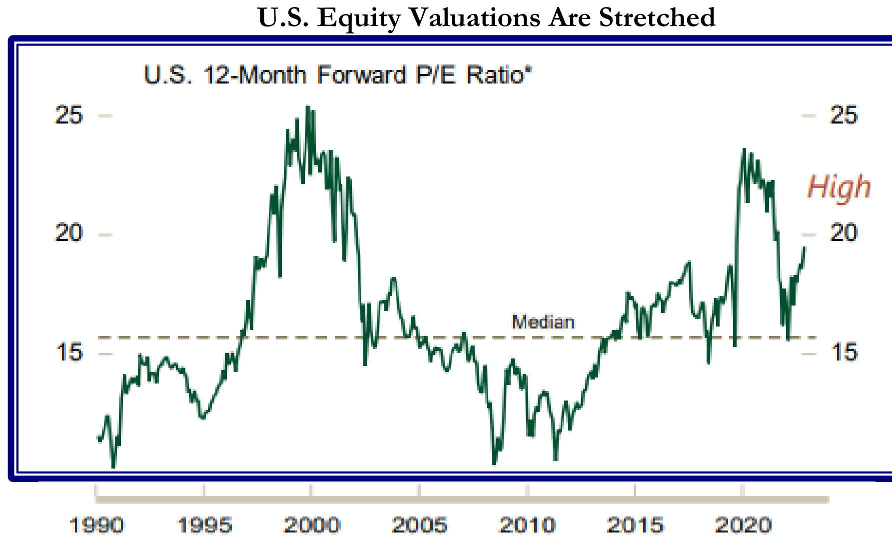
Source: Yardeni Research

S&P 500 Sector Performance
2nd Qtr 2023

Info Tech	Cons Disc	Comm Serv	SPX Performance	Industrials	Financials	Materials	Health Care	Real Estate	Cons Staples	Energy	Utilities
17.2%	14.6%	13.1%	8.7%	6.3%	5.3%	3.3%	3.0%	2.5%	0.5%	-0.9%	-2.5%

The S&P 500 climbed 8.74% in Q2 with nearly 67% of the contribution coming from the Mega Cap 8 stocks (Alphabet, Amazon, Apple, Meta, Netflix, Nvidia, Microsoft, and Tesla). Due to their hefty combined representation in the S&P 500 index of ~26%, their combined forward P/E of 28x is inflating the overall market multiple to over 19x earnings.

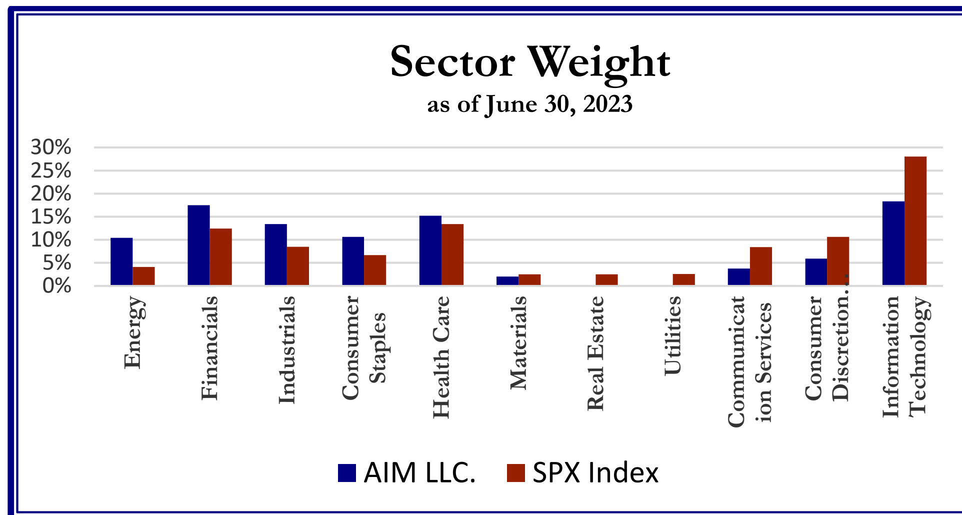
U.S. Equity Valuations Are Stretched



Source: MRB Partners and MSCI

Sector Spotlight and Strategy:

The AIM composite portfolio is overweight Energy, Financials, Industrials, Consumer Staples, and Healthcare. Its largest underweights are in Technology and Consumer Discretionary. This positioning emphasizes our focus on lower valuations as we navigate a late cycle economy.



Source: Bloomberg & Altman Investment Management Research

Industrial Sector

A rebound in industrials was notable during June, as evidenced by upticks across machinery, transportation, components, equipment and conglomerate segments. Increased spending on infrastructure from the bipartisan Infrastructure Investment and Jobs Act plan should funnel about $550 billion of new Federal Investment into roads, bridges, water resources, etc. Onshoring efforts are also focusing investors on growth potential within the industrial sector.

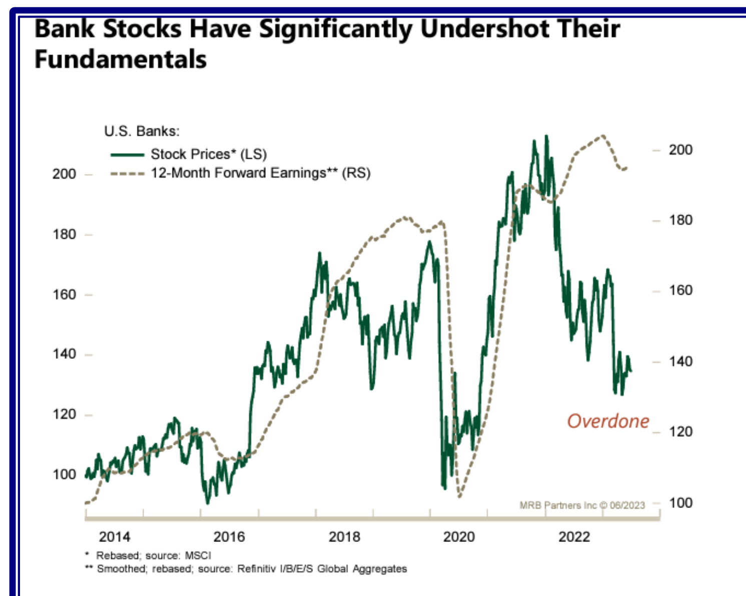
After significantly outperforming the market last year, defense stocks gave back a portion of that gain this year on rising defense budget concerns throughout adversarial debt ceiling negotiations. While the defense budget increased modestly, it lags the pace of inflation and thus pressures from higher costs remain. Defense departments purchasing power declines as inflation rises, while fixed price arrangements made before the spike in inflation pressure contractor margins. But rising international defense budgets along with diminishing supply chain disruptions should provide a catalyst for defense stocks going forward.

Northrop Grumman (NOC) sees continued opportunities internationally with escalating geopolitical tensions. Management is calling for double digit international revenue growth over the next several years. To meet this demand requires investment on the part of NOC to build out capacity across their range of weapons and missile components. Several years ago, NOC acquired Orbital ATK, a company that designs, builds, and distributes defense, aviation and space related systems. NOC also boosted capacity at its ballistic and hypersonic missile laboratories to meet growing missile demand. According to Morgan Stanley missile defense accounts for about 10% of NOC's portfolio.

Furthermore, NOC is in a position of strength having acquired two of what's called the nuclear triad capabilities with its B-21 bomber (air to land) and its Sentinel ground-based strategic bomber. The company is also a key player in the space-based missile defense program providing tracking sensors. It's also pursing production of an integrated air and missile defense battle command system.

Banking Sector

Bank stocks rebounded off March lows as the market digested what turned out to be isolated banking failures. Stock prices relative to forward 12 months earnings remain significantly below 10- year averages as a result of the sell-off, presenting investors with a buying opportunity.



Concern within this sector stems from net interest margin pressures, alongside slowing loan growth and higher funding costs. Additionally, as a result of the failures, higher costs from increased regulations are likely. Despite these headwinds, pre-provision new revenues remain elevated in the high interest rate environment. Banks are also closely managing credit losses as they continue to build loan loss reserves. As reserve ratios have reached historically high levels. Banks also have room to raise asset yields to some degree, helping to offset higher deposit costs.

Banking valuations offer significant upside from current levels. An overweight with a focus on large money center banks and super regionals is appropriate in our opinion. As earnings prove to be firmer than what is currently being discounted, valuations should rise offering considerable upside.

IN CONCLUSION:

Mega cap technology multiples will likely compress alongside earnings surprises within the industrial and commodities sectors. In positioning portfolios, we find it more appropriate to focus on valuations, earnings quality, and underlying business fundamentals. Shifting to a more defensive portfolio in our opinion is 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.

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