ALTMAN
INVESTMENT MANAGEMENT

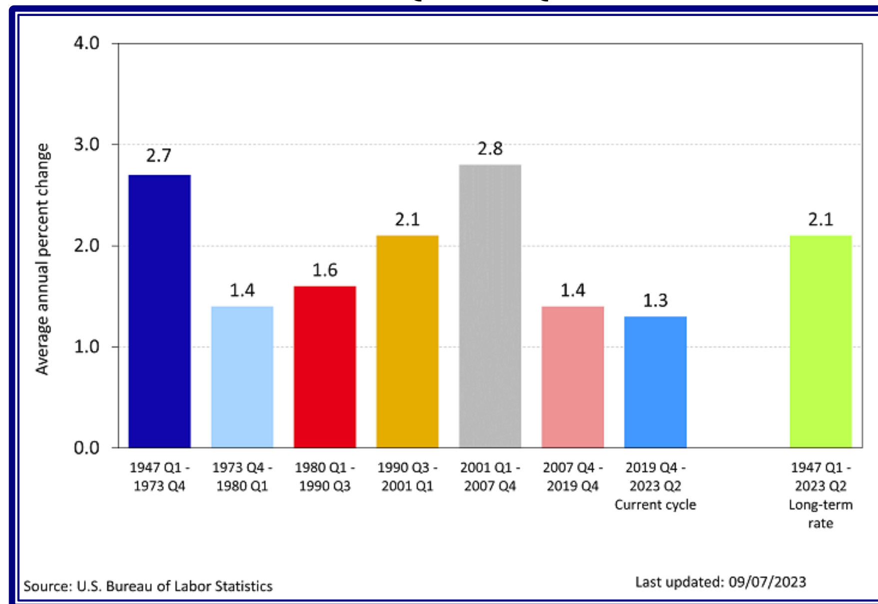
EQUITY STRATEGY FOCUS

OCTOBER, 2023

IN VIEW: The Equity Landscape

Consumer strength has its thumb on the scale - lifting Q3 GDP growth to 4.9% on the heels of Q2's lackluster GDP rate of 2.1%. Consensus estimates ranged from 3.5-4.7%% real growth and the "Atlanta Fed GDPNow" was a bit higher with estimates calling for 5.4% growth. Consumer strength is evident in core retail sales, initial unemployment claims, job cut trends and the unemployment rate. Overall labor market growth has been a source of support for the economy along with built up excess savings. As productivity continues to improve it has the potential to rein in inflation and as opposed to Fed tightening policies that could lead to a recession to combat inflation. Non-farm productivity jumped 3.5% in Q2 as output advanced and hours worked fell. The current annualized rate of productivity is just shy of the pre pandemic level however it still has a way to go to reach its long-term average of 2.1%.

Productivity Change in the Non-Farm Business Sector
1947 Q1 – 2023 Q2



Industrial production advanced 0.3% in September beating expectations, with gains in most major market groups. Despite union strikes, manufacturing experienced gains of 0.4% and utilities declined. Largest gains were in computers and peripherals as well as communication equipment. Meanwhile, manufacturing PMI clocked in at 49 in September, up 3 points from mid-year, just shy of the crucial 50-point level indicating an expansion.

Housing starts disappointed, with permits dropping 4% from the prior month. Housing starts saw an uptick in September, however remains 7% below last year's level. Higher mortgage rates are clearly pressuring the housing market, as home builder sentiment dropped in October in addition to a downward revision on the prior month.

Fed Chairman Powell, while speaking to The Economic Club of New York, expressed his view that inflation is still too high. The current level of 3.7%, although down significantly from last year's high of 9%, is not low enough to ensure its sustainability. In his remarks he indicated current rates are not too high but a rate hike is not likely for November. He would like to see the labor market and economy slow from current growth rates to help bring inflation closer to its mandate.

Under new house leadership, the work has only just begun to regain confidence in Congress. In addition, the uncertainty over the duration of union strikes and the possibility of a government shutdown, along with ongoing geopolitical risks, could contribute to economic headwinds. We will continue to monitor any developments closely, determining severity and duration, to help us measure the impact each could have on economic growth. At this time, however, we view these factors as transitory in nature and as underscoring the resiliency of the economy thus far. The consumer remains strong, inflation continues to moderate, and the labor market is reflecting strength. To date in this cycle, a broad-based economic recession has yet to materialize - but rather a rolling recession took place and looks to be losing momentum. We continue to anticipate a soft landing, while improving productivity provides a buffer to a deeper recession and inflation is brought back in line with target levels.

CLOSE-UP: Equity Investment Overview

Market Performance & Earnings:

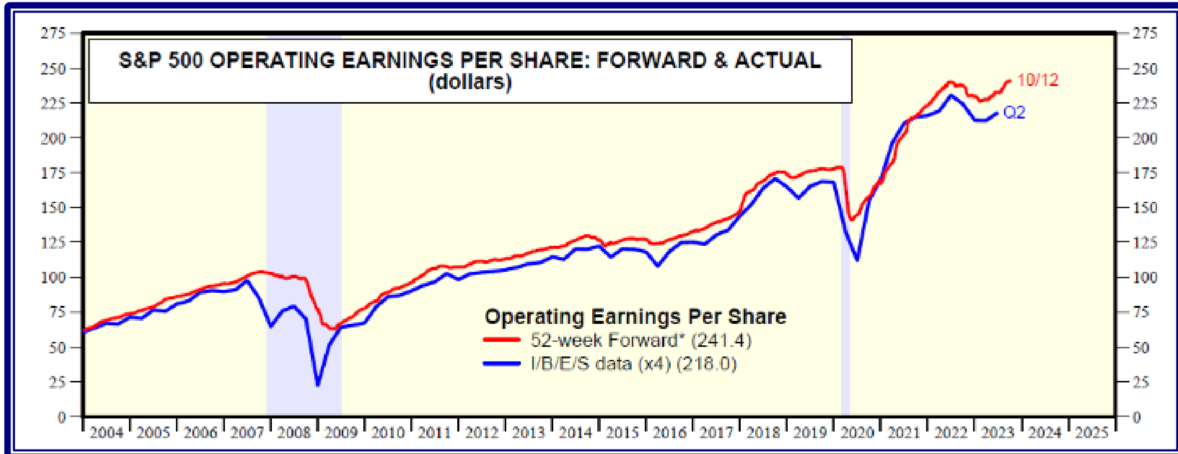
S&P 500 Sector Performance
Q3 2023

Energy	Comm Serv	Financials	Health Care	SPX Performance	Materials	Cons Disc	Industrials	Info Tech	Cons Staples	Real Estate	Utilities
12.2%	3.1%	-1.1%	-2.7%	-3.2%	-4.8%	-4.8%	-5.2%	-5.6%	-6.0%	-8.9%	-9.3%

The S&P 500 traded down -3.2% in Q3. September is seasonally a weak month for stocks and likewise, this past month erased all gains from the prior two months. The Energy sector led the market, followed by Communication Services and Financials. Real estate and Utilities were adversely impacted by the higher interest rate environment.

Q3 may mark the end of the latest earnings recession as consensus estimates call for flat earnings growth in Q3 following negative growth in the prior two quarters. The recent earnings recession was relatively minor and a result of narrowing margins as the spike in inflation caused costs to rise at a pace faster than revenues. But now as inflation eases, two spending bills (the Inflation Reduction Act along with the Infrastructure Investment and Jobs Act) in place, and contributions from AI advancements, all are working to support positive margins and thus earnings trends going forward.

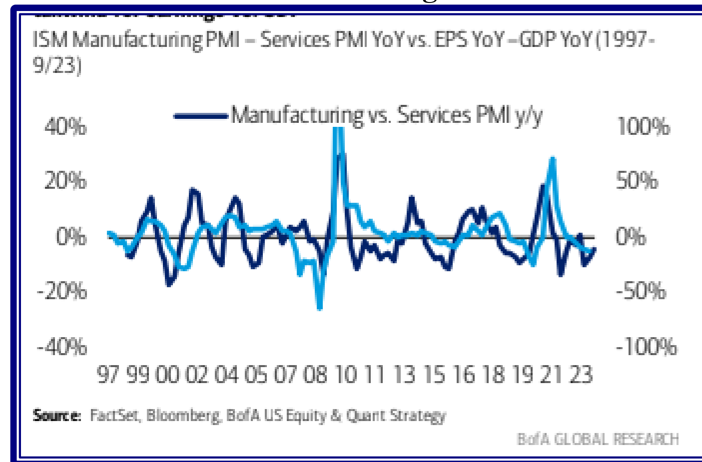
The trajectory of improving productivity is also good for profit margins as well as future earnings. According to Yardeni Research, productivity is normalizing and is back to pre-covid levels. Average hourly earnings, measured on a production and non-supervisory basis, are also regaining momentum alongside productivity.



Source: Bloomberg and Altman Investment Research

The shift aways from goods to services appears to be nearing an end as well. Manufacturing PMIs, although still below trend, are now pulling ahead of PMIs for Services indicating a better outlook for earnings trends. Historically, earnings growth outpaces GDP growth when manufacturing PMI are stronger, and this has not been the case for several quarters.

Manufacturing Outpacing Services Has Generally Been a Tailwind for Earnings vs GDP



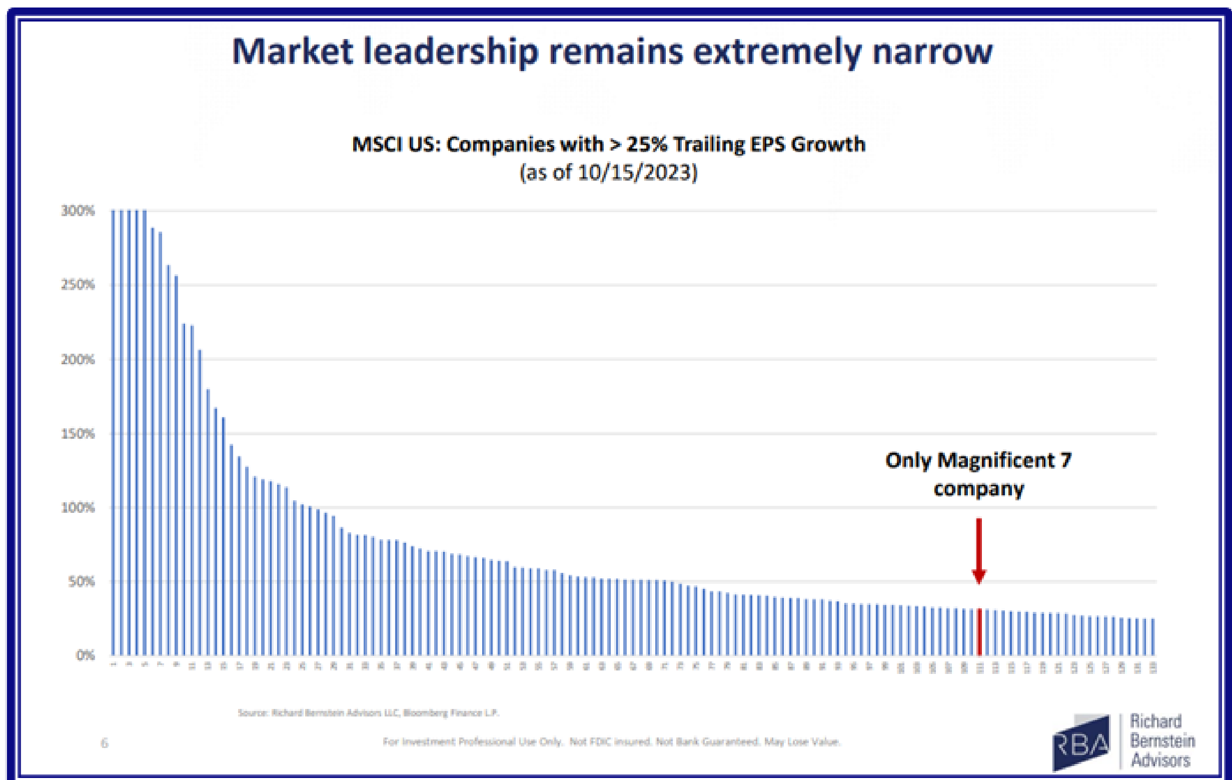
Large Cap banks started off the quarter results with most beating on both top and bottom lines. Citigroup revenues were up 9% over the prior quarter, with strong cash management services, investment banking, personal banking and wealth management. After a multi effort of streamlining and divestitures it is nearly two-thirds complete with the process and has announced additional upcoming reorganizations are on deck, although little specifics have been given at this time.

Bank of America topped analyst expectations with better-than-expected net interest income. Profits jumped 10% and revenues rose 2.9%. Results were strong in its sales and trading business along with investment banking. Holding back shares this year has been the perception of BAC's held to maturity portfolio that was long in nature and amassed unrealized losses as the yields on the 10 yr. Treasury spiked. As these short durations roll off, this should mark a trough in Net Interest Income (NII), rising the outlook of the year ahead.

Stock Spotlight and Strategy:

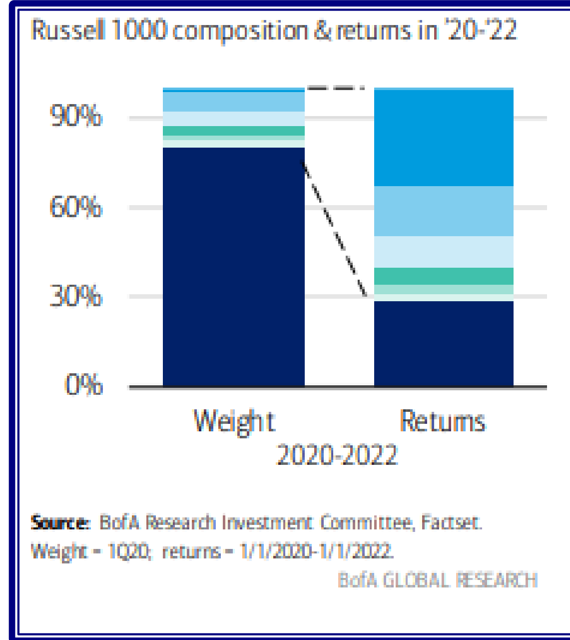
The AIM composite lost ground against the S&P 500 and Russell 1000 Value index this year. This comparison comes after a year of significant outperformance against these same benchmarks throughout 2022. Despite the reversal this year, the AIM composite maintains its lead since the Fed initially spooked markets by raising its key rate to over 5% to fight inflation. Last year's sell-off exposed the vulnerability of the Mega Cap 8 stocks, while also reinforcing the magnitude of impact these stocks can have on benchmarks on both the upside and downside.

This year's rally in the narrowly based Mega Cap 8 underscores the unsubstantiated perception that these stocks have better quality earnings or above average historical growth rates. So much so that the significant pain inflicted from the undue risk exposure suffered during the prior year's sell off was quickly forgotten. Richard Bernstein Advisors conducted a study that exposes this widely held misconception. Their study showed that in fact, only 1 of the Magnificent 7 stocks (Mega Cap 8 excluding Netflix) actually has a trailing 12 -month eps growth rate of over 25%.



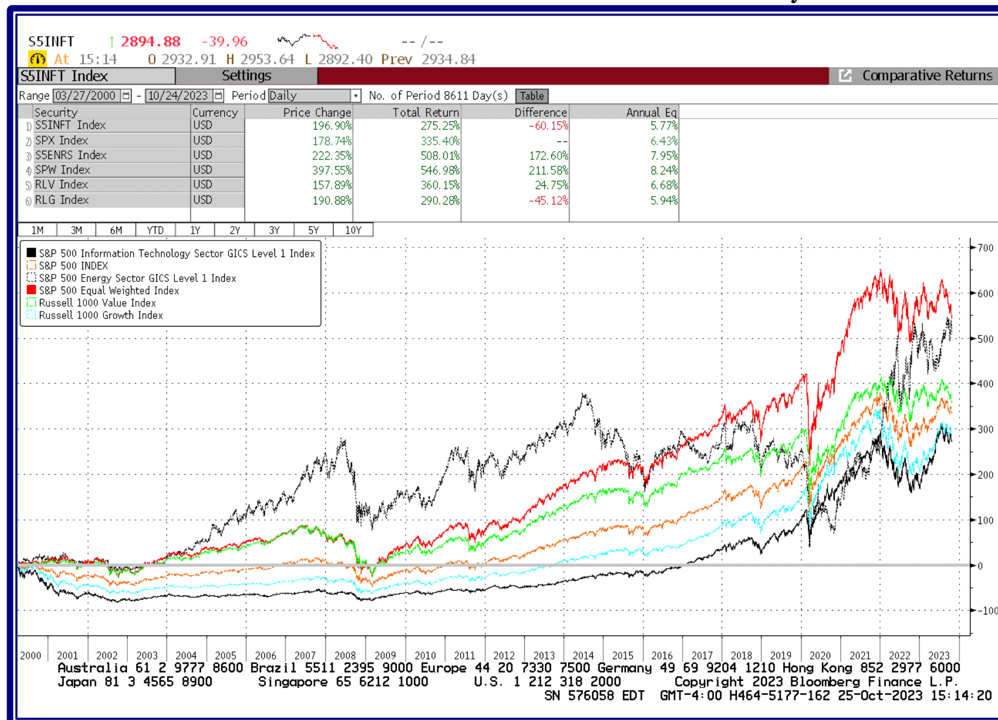
Even so, anticipated long term eps growth rates are driving prices of these companies to an average of 26x earnings, as compared to the average forward multiple for the S&P 500 stocks (ex: Mega Cap 8) of 16.2x. This narrow market leadership not only makes these stocks highly vulnerable, as most already experienced, but overshadows the great many opportunities in the marketplace which likely will have better performance in the long run. Unfortunately, participation has narrowed to such an extent that just 20% of the Russell 1000 Index accounted for 71% of returns during 2021 -2022. Last year's sell off with the index trading down -19% demonstrates the risk exposure of these over-owned stocks, particularly in market reversals.

Fewer Stocks Driving Benchmark Returns



The Mega Cap 8 stocks command so much attention, that the reality that Energy stocks outperformed Technology since the tech bubble peak nearly 23 years ago is lost. Not only that, but value has outperformed growth, while the equal weighted S&P 500 outperformed the weighted benchmark during this same time period. We believe the current outperformance of value stocks that is evident since 2021 will continue as the market is primed to broaden. Even if this takes some time, patience is well rewarded during market sell offs. This translates into less volatile long-term results with below market risk, justifying our position to stay the course and not chase highly-valued securities higher.

Energy, Value, and Equal Weighted Indexes Performed Better Since the Start of this Century



	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	S5INFT Index	USD	196.90%	275.25%	-60.15%	5.77%
2)	SPX Index	USD	178.74%	335.40%	--	6.43%
3)	S5ENRS Index	USD	222.35%	508.01%	172.60%	7.95%
4)	SPW Index	USD	397.55%	546.98%	211.58%	8.24%
5)	RLV Index	USD	157.89%	360.15%	24.75%	6.68%
6)	RLG Index	USD	190.88%	290.28%	-45.12%	5.94%

IN CONCLUSION:

Value stocks tend to outperform when inflation is high. This is because the present value of the future expected earnings for growth companies are lower in this environment, making yields on Treasuries more attractive by comparison. But right now, investors are more focused on the potential for a Fed policy reversal. This year's unsubstantiated reversal in markets in favor of growth stocks creates an opportunity for value stocks where valuations are comparatively depressed presenting significant upside from current levels.

We recognize short term periods of value strategy's relative underperformance can be frustrating. But it is important to recognize that periodic shifts in strategy leadership are a natural occurrence - and requires consistency and conviction in an investment strategy to achieve long term superior risk-adjusted returns. The outlook for a soft landing, as Fed policy alongside increased productivity work towards averting a recession, supports the case for value stocks from here.

Strong Q3 GDP growth underscores the resiliency of the economy. This is despite the Fed's tightening policy, difficult and copious budget negotiations with the overhang of a potential government shutdown, the auto workers strikes and more. A continuation of status quo into Q4 could potentially reduce the rate of growth in the quarter, but should not derail the U.S. economy that is currently on track to avoid a recession.

Consensus estimates call for moderating earnings growth in Q3, following negative growth the prior two quarters, thus marking an end to the relatively minor earnings recession. Improving profit margins along with two spending bills already underway, in tandem with technological advancements, are working to support corporation margins and bottom lines.

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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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