ALTMAN
INVESTMENT MANAGEMENT

# MARKET PERSPECTIVE

**NOVEMBER, 2023**

## IN FOCUS:

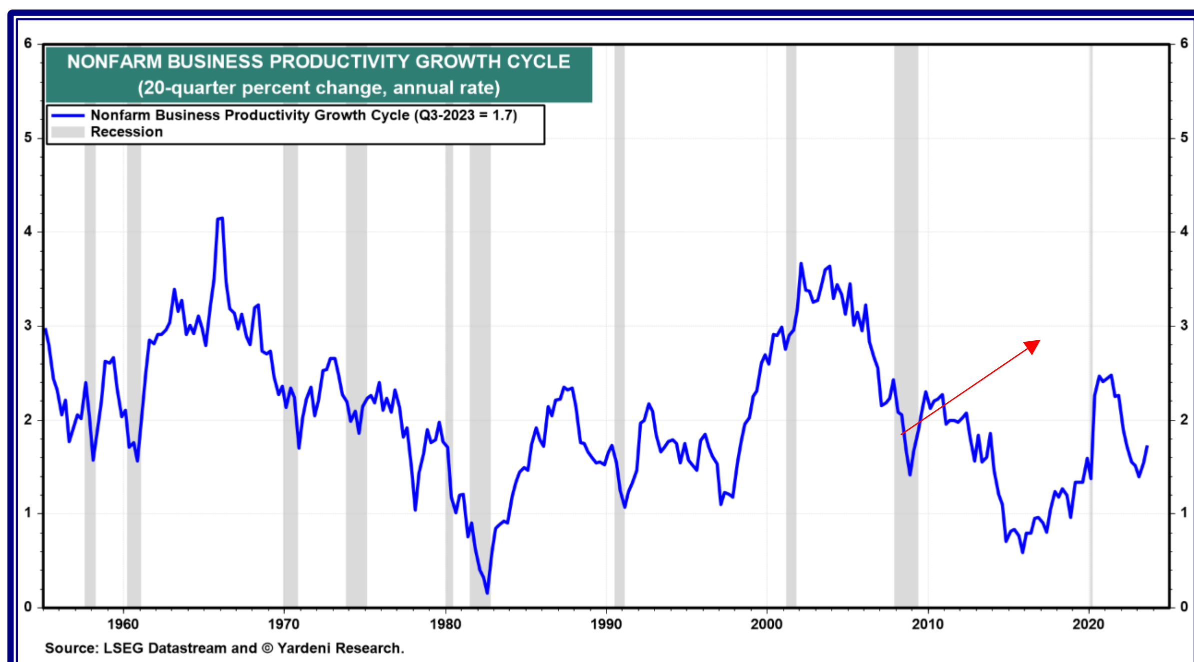
### *Inflation now vs. the Great Inflation of the 70s:*

**Taking a historical look at CPI, it peaked 2x during the Great Inflation of the 1970s, reaching levels of 12.3% and 14.8% respectively.** Inflation back then was fueled by a deficit funded war and a depreciating dollar upon the abandonment of the gold window. Oil prices surged as a result, well above 150-200% each time, adding to pressures already in place. The Fed lifted its key interest rate aggressively to 20% ultimately triggering a recession to bring inflation under control.

**It wasn't until the pandemic hit that inflation once again soared, peaking at 9% in June of 2022.** But unlike the 70s, a recession does not appear imminent. This time around, inflationary pressures resulted from aggressive fiscal and monetary policy intended to inflate demand in order to recover from the economic shutdown. This resulted in significant supply disruptions that struggled to meet rising demand. In efforts to reign in the resulting pent-up demand, the Fed raised its key interest rate to 5.4% - the highest level in several decades - triggering a significant sell off in bonds. The CPI has since fallen to 3.2% at its latest reading.

**As compared to the 1970s, despite tighter credit conditions, liquidity within the financial system remains fluid.** The Fed was able to quickly contain this year's potentially wide spread banking crisis after several isolated banking failures. Additionally, the inflation rate of durable goods was not only far less than levels reached in the 70s, but it has already sunk back to deflationary levels. The services inflation rate is also relatively lower than those reached in the 70s. Another key difference between then and now is dollar strength that has been supported by tight monetary policies and a healthy relative GDP growth rate.

**Productivity is Regaining its Upward Momentum**



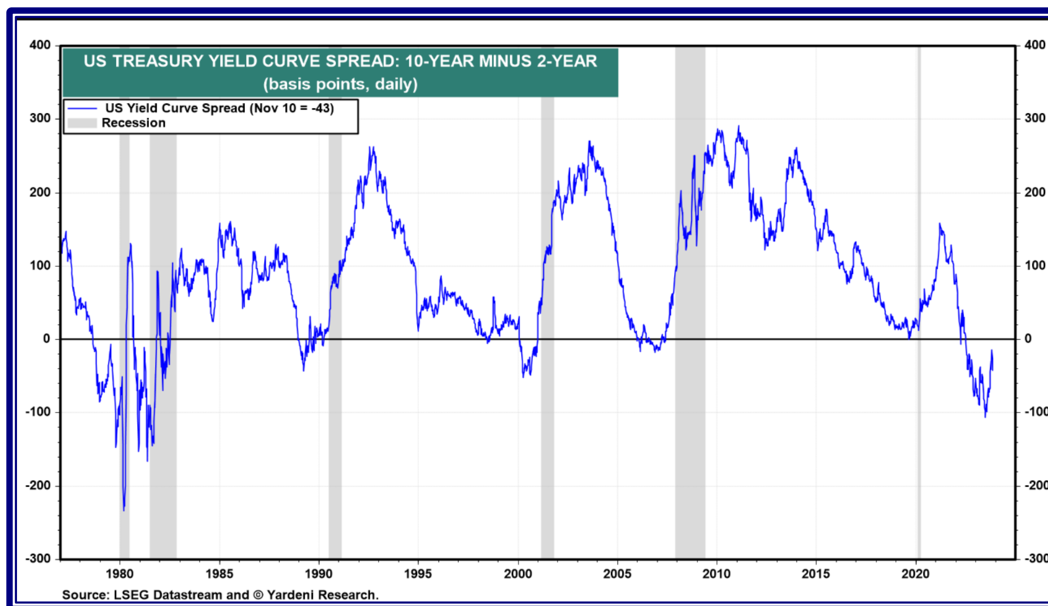

Source: Yardeni Research

**Another point of differential between today and the 1970s is that productivity is proving more resilient, having regained positive momentum, resuming its upward trend that began nearly 8 years ago.** The chart above shows a 20-month average growth rate, smoothing out any short-term volatility which is typical for this statistic. The recent reversal is due in part to continued technological advancement which is showing no signs of abatement. Therefore, if the trajectory of productivity continues to climb as we expect, it should lift real wages along with it, providing further support for consumer spending in the coming months.

## *Bond Yields Bode Well for Economic Growth:*

**As inflation moderated, bond yields on the 10-year Treasury reached a high of 4.99% in October.** Although yields have retreated ~60 basis points or so off the peak, relatively higher bond yield levels are reflecting lofty treasury supplies in the wake after several years of aggressive fiscal policy. Concerns over the ballooning U.S. deficit from swelling Federal debt levels in conjunction with declining y/y individual income tax revenues is pressuring yields higher as well. The opposing forces of moderating inflation and a swelling deficit could contain the 10-year Treasury within a range of 4.5-5% through yearend and into 2024.

**Treasury Spread Narrowing in Positive Direction**




Source: Yardeni Research

**Interestingly, the yield spread between the 10yr and 2yr Treasury has narrowed to -43 basis points, trending ever closer towards positive territory.** A negative spread, or inverted yield curve, is generally a precursor to a recession, so the narrower the spread becomes the better the outlook is for economic growth.

## *Narrow Market Performance and Valuations:*

**The current leadership within the U.S. equity market is remarkably narrow and close to the record setting period of the late-1990s Technology Bubble, when the NASDAQ demonstrably outperformed, but was followed by roughly 9 years of underperformance.** The current period of extreme outperformance of the Mega 8 makes the Tech bubble look relatively mild. The recent run up in these 8 securities is contrary to the reality when overall profits for the average company in the S&P 500 have decelerated - thus, bidding up the prices of these selective secular growth stories. The historically narrow market suggests not only a deep profits recession but also brings into question the corporate survivability of the broader global economy.

**Another great example of this phenomenon is the high-flying Nifty 50 during the 70s.** These stocks ultimately collapsed in the '73/'74 bear market with many of them losing in excess of 40% of their values, according to FactSet data. Like the Tech bubble, the lessons learned from investing in highly valued securities lasts only so long. As the market inevitably broadens, investors once again look for the next "big thing".

**Admittedly, many of the high flying Mega 8 stocks have good financials and growth prospects, however it's the question of how much of a premium is justified.** Unfortunately, many investors learned how costly it can be as they collapsed in 2022. This year's recovery of the Mega 8 demonstrates how the pain endured the prior year was quickly forgotten. Like prior bubbles, valuations are often rationalized if not put aside all together.

**With each bubble we learn that leadership is not indefinite and its overall duration is unknown.** It's because of this that valuations at times can reach extraordinary levels making the prospect of investing in such stocks successfully appear too easy. We believe this time is no different and would expect today's "Nifty 20" to ultimately underperform. It's hard for us to imagine that there are no other growth opportunities in the markets here or abroad.

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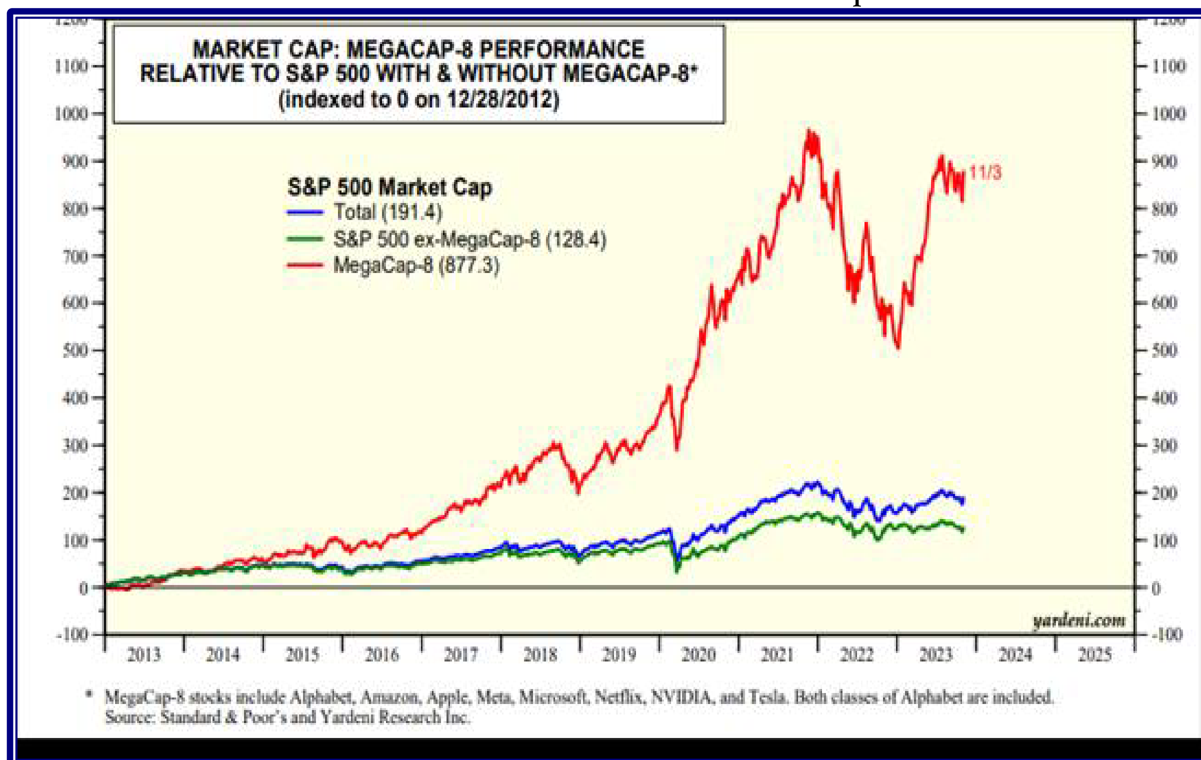
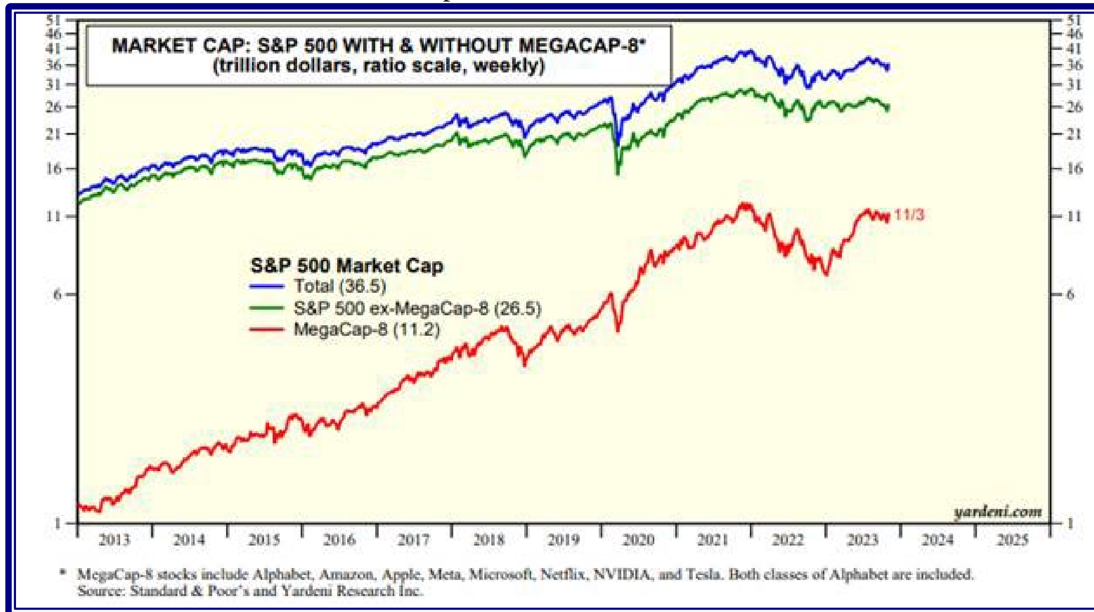
**The Melt Up in a Concentrated Group of Stocks**
**Is Unsustainable – 2022 is a Good Example**




Source: Yardeni Research

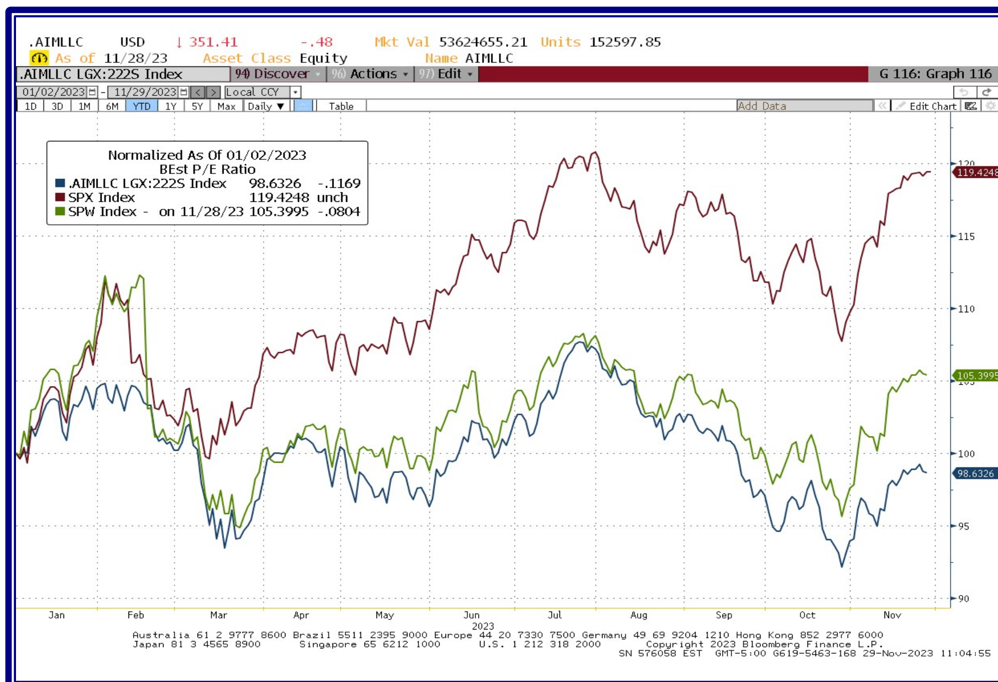
**Mega Cap 8 Stocks Are Over Bought**
Significant Momentum into Mega Cap 8 Stocks (Red Line)
As compared to S&P 500 Benchmarks




Source: Yardeni Research

**As a result, valuations remain extraordinarily high - inflated by the Mega 8 stocks.** When, on the contrary, many stocks are relatively undervalued presenting investors with considerable upside from current levels. This same opportunity was evident last year as value multiples surged ahead of the overall market off the October bottom. This year so far, the weighted forward multiple of the S&P 500 index has surged by 19% against a more modest increase for the equal weighted index of 5%. The forward multiple of the AIM composite this year has compressed by ~2% creating another path for outperformance ahead.

**S&P 500 Valuations Look Extended Throughout 2023**




Source: AIM, LLC and Bloomberg

**We continue to believe that we are in the midst of a significant shift in the drivers of financial markets.** To date, catalysts have been in part the war in Ukraine, pandemic related supply shocks, a stubbornly persistent level of core inflation, and rising interest rates. As these trends began to take hold this year investors were bailed out as a slower recovery in the Eurozone and weakness in overall growth in China materialized. This provided some respite on core inflation. In late October, Fed officials gave markets the less hawkish pause they needed, reaffirming that technology shares remain the "only game in town".

**In the new year, we believe that yields on six-month to two-year treasuries will again resume the 5.0% and 5.6% levels, while the 10-year treasuries again move above 4.5%.** With low-risk treasuries now presenting a meaningful alternative to previously yield-starved investors, incentives to take equity risk, particularly in technology shares where valuations appear to be stretched, may taper off.

## IN SUMMARY:

**The investment behavior of a diversified portfolio of undervalued stocks tends to be correlated to the investment behavior of a broad index** - when the index is up, probably more than one half of the stocks in the entire universe of public companies will be up, albeit in greater or lesser percentages than the index. Similarly, when the index declines, probably more than one-half of the stocks of the entire universe of public companies that are included in the index will be down in greater or lesser percentages than the index.

**The dominance of the Mega 8 has been so significant that even value benchmarks took opportunities to incorporate some of these highly valued stocks during rebalancing efforts.** This demonstrates the power of momentum and how easy it can be to chase market leaders higher, ignoring or justifying their valuations. It is important to note that most stocks are not participating in the rally this year. We continue to believe that over time mean reversion is inevitable and volatility can be greatly reduced by focusing on appropriately valued stocks within the market place.

**As we have stressed in past commentaries, in such an environment price *matters*.** We believe over time should augur well for active equity investment.

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