ALTMAN INVESTMENT MANAGEMENT

EQUITY STRATEGY FOCUS

JANUARY, 2024

IN VIEW: Valuation Matters

The biggest challenge facing tech stocks in 2024 will be living up to the lofty earnings growth expectations that have built up as a result of the optimism surrounding A.I. Last year's huge rally in the sector was mostly driven by multiple expansion, despite lackluster underlying earnings and revenue growth. It is our view that the tech companies will have to deliver significantly better financial performance to avoid potential profit-taking in their shares. The tech sector will also need to show tangible evidence that A.I. is being monetized, with the benefits broadening beyond a small handful of companies. Expectations are very high, implying that the bar for positive surprises has been substantially raised. Accordingly, analysts are forecasting that the tech sector will continue to generate earnings growth of 15% and 17% in 2024 and 2025 respectively.

These consensus expectations for long-term earnings growth have surged since mid-2023, led by the semiconductor sub-group where profit estimates have soared for companies such as NVIDIA. Analysts are projecting earnings growth of more than 20% per annum for the broader tech sector over the next 5 years. It is important to remember that long-term earnings growth forecasts for tech companies have only been higher during the dot-com bubble years in the late-1990s/early-2000s, when they ultimately proved to be overly optimistic despite the revolutionary nature of the internet. The result was a prolonged period of underperformance for tech stocks. Of course, the absolute earnings level of the tech sector is much higher today such that growing as rapidly as in the late-1990s will prove more difficult. However, we still expect the earnings growth of the broad tech sector to improve in 2024 as global semiconductor sales recover, the PC market exits its post-COVID hangover, and tailwinds from digital transformation persist. Parts of the sector should also benefit from positive operating leverage as revenues pick up due to cost-cutting in the past year. However, in order for tech stocks to deliver the type of earnings growth projected by the Wall Street consensus, two outcomes must materialize, neither of which is assured: 1) Global semiconductor sales will have to validate the strong upswing in demand that has been anticipated by the chip stocks; and 2) Business investment in technology will have to accelerate from its current pace of flat growth in the 3rd quarter of 2023.

Valuations in the aggregate tech sector provide no margin of safety with forward price to earnings ratio at a 35% premium to the broad market. Price to sales ratio of 6.3 has increased significantly from 4.7 at the beginning of 2023. This premium is at a 20-year high and has materially expanded since the period immediately preceding the pandemic. This leaves limited room for multiple expansion and little cushion against adverse developments or earnings disappointments. Furthermore, if expectations for Fed rate cuts are unwound, this will leave the tech sector especially vulnerable.

As a result, we remain underweight the sector. We prefer cyclicals that have been priced for bad economic outcomes, such as the financial and energy sectors. We also favor the oversold defensives with growth characteristics, such as the health care industry. Productivity growth will likely be the driver of economic resiliency in the coming year and there is greater probability that the U.S. economy will avert a recession. We believe that it is premature to run for cover by raising cash and lowering equity exposure. Our diversity across the market, with an emphasis on select sectors in conjunction with our long-term investment perspective, warrants staying the course.

CLOSE-UP: Equity Investment Overview

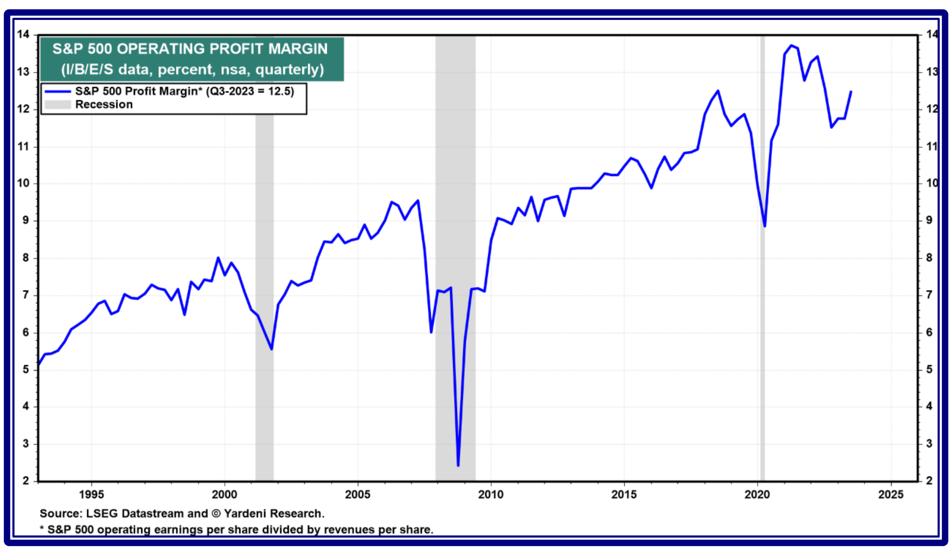
Market Performance & Earnings:

Real Estate	Info Tech	Financials	Industrials	Cons Disc	S&P 500 Index	Comm Serv	Materials	Utilities	Health Care	Cons Staples	Energy
18.8%	17.2%	14.0%	13.1%	12.4%	11.7%	11.0%	9.7%	8.6%	6.4%	5.5%	-6.9%

The market broadened in Q4 with 5 sectors outperforming the overall market. Propped up by the possibility that the Fed may conclude quantitative tightening, the real estate market took the lead. Technology maintained a close second followed by Financials, Industrials and Consumer Discretionary. Energy stocks felt the pressure of bearish concerns of oversupply in the market, despite numerous geopolitical risk that could disrupt supplies.

Q3 earnings, up 4.6% y/y, marked an end to the mild earnings recession that began in the final quarter of 2022. Declining inflation and improving productivity are behind the revival in earnings, bringing them back to a new record high. The earnings recession was relatively short lived as revenues pushed to new highs offsetting some of the margin pressure from higher input costs. Companies are now running leaner and margins recovered off the 2022 bottom. Even a small surprise to the upside in revenues could help Q4 earnings come in ahead of consensus 3% growth estimates.

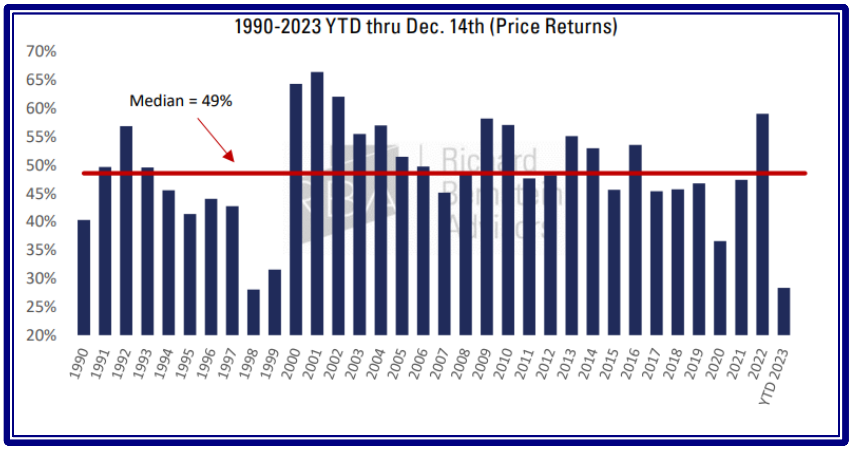
Profit Margins Likely Troughed in 2022



Productivity and consumer strength are bullish signals for the outlook. As labor shortages persist, companies are intent on boosting productivity through increased technology spend. This resulting rise in productivity is offsetting some of the growth in hourly compensation, suppressing overall unit labor costs. On the consumption side, at over $150 trillion, consumer net worth is at an all-time high. The accumulation of assets to this level gives baby boomers who have reached retirement age a solid base of excess savings from which to spend. Subsequent generations have adopted the "live/spend for today" attitude and are spending more money on experiences as opposed to saving for a rainy day.

The percentage of stocks out-performing the overall market is at its lowest point since the peak of the tech bubble in the late 1990s.

% of Stocks Outperforming in the S&P 500 Index

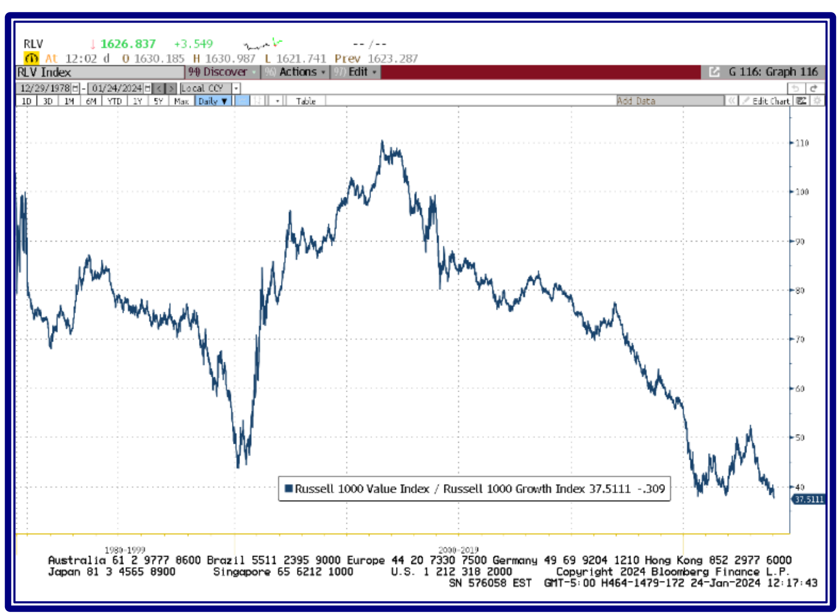


Source: Richard Bernstein Advisors LLC, BofA ML US Strategy

We have seen this this type of narrow market leadership before and we believe this time is no different. These cycles tend to repeat themselves when a specific set of stocks through a transition of discovery and underrepresentation to total dominance and extreme concentration which leads to extreme overvaluations. When these bubbles burst, the time period that tends to follow is one with broader market participation that brings investors back to earth demanding high-quality earnings at reasonable valuations. This pattern is not new and our portfolios should continue to seek diversification amongst market sectors that are set to lead in the new market cycle.

To further cement this view, the chart below demonstrates the marketplace is well overdue for a shift towards value stocks. This theme was briefly reaffirmed in 2022 exposing the vulnerability of the Mega 8 stocks.

<u>Russell 1000 Value vs Russell 1000 Growth</u>



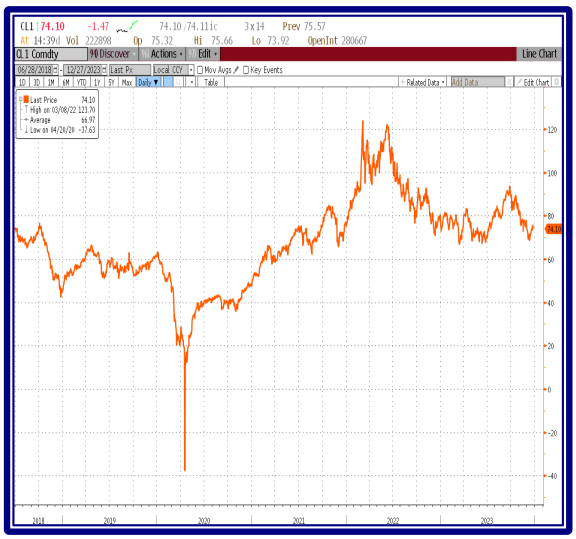
Source: Bloomberg and AIM, LLC

Stock Spotlight and Strategy:

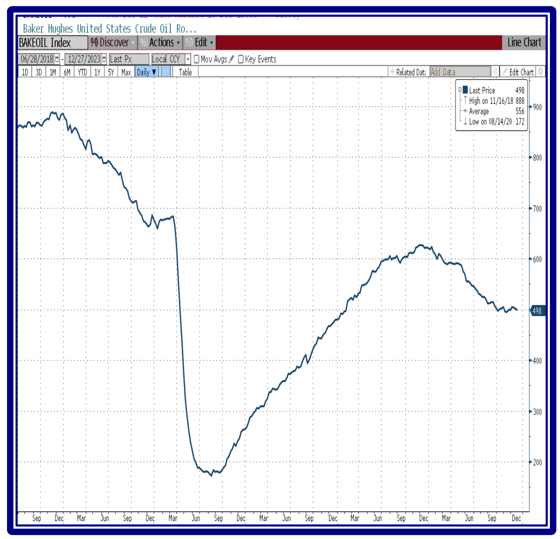
In Q3, Halliburton (oil services) was sold from the composite portfolio. The overall impact modestly reduced our exposure to the energy sector. At the same time, consolidation in the industry affords integrated energy stocks like Occidental and Chevron better capital discipline as they cut costs and manage risk. The resulting boost to profitability should increase their leverage to the commodity, thereby offsetting the impact from the reduction in sector exposure as we remain bullish on oil.

The current price of West Texas oil in the mid $70s, is down ~30% from peak levels reach in 2022. According to the U.S. Energy Information Association, this suggest that capital expenditures could be constrained in the coming quarters, and once oil prices begin to recover, rig counts could lag by ~4 months. This lends to reason that the integrated energy stocks may be better positioned for this phase in the oil cycle as opposed to oil services.

West Texas Crude Oil Price



U.S. Rig Count



Source: Bloomberg Research and AIM, LLC

On the other side of the trade, in TJX Companies, Inc (TJX) was purchased in the Consumer Discretionary Distribution & Retail sector. TJX is a leading global discount retailer of brand name apparel and home décor. TJX operates under names such as T.J. Maxx, Marshalls, HomeGoods, and HomeSense. Price hike initiatives are taking hold as the TJX brand exudes strength over competitors. Strong inventory management has helped TJX capitalize on inventory opportunities as full priced retailers unload products pinched by inflation. Management is optimistic about what it considers to be a sizeable addressable market within the home business and anticipates expanding its footprint within the segment. This position further underscores our belief that cyclicals are mis-priced based upon a perceived poor economic outcome.

IN CONCLUSION:

As investors adjust to a new world of structurally higher interest rates, it will likely not be an easy transition and may very well be accompanied by a lot of fits and starts in our capital market leadership. We have certainly seen evidence of that over the last two years. During times like these, we're reminded of the late Benjamin Graham, legendary investor, who would advocate that markets are there to serve you, not to guide you. Wide swings in stock prices offer the disciplined and intelligent investor an opportunity to take advantage when markets become unanchored – and look for high-quality earnings at reasonable valuations. It requires independent thought, rigorous analysis, and the mindset of a shareholder who has partial ownership of a business. This will serve the interests of investors as opposed to speculators. Conversely, following the financial crisis in 2008 through 2021, relatively free money primarily served the interests of risk-takers in our opinion, not investors. If we are now indeed entering the alternative of that period, a sound investment approach should once again serve the interests of intelligent investors and we will continue to do our very best to capitalize on the pricing opportunities that are presented to us.
