

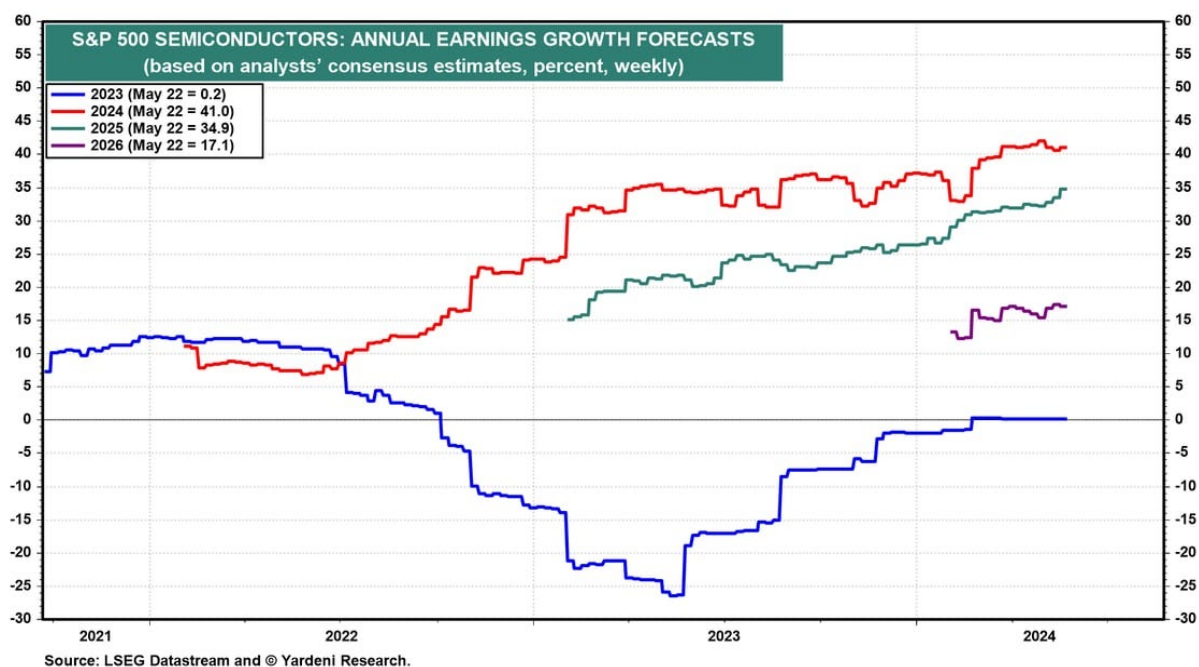
IN FOCUS – The Market Response to Lack of Fed Accommodation

This month's FOMC minutes confirmed that Fed officials are in no rush to lower the federal funds rate - and some are considering the possibility that they might have to raise them if inflation stalls above the Fed's 2.0% target. The 2-year Treasury yield is back up to 4.95%, implying one 25bps rate cut over the next 12 months. Earlier this month, stocks sold off on fears of "even-higher for longer" interest rates. This confirms our view that it is unlikely that the federal funds rate will be cut at all over the rest of this year, and could remain at current levels through the first half of next year.

In addition, the just-reported initial unemployment insurance claims of 215,000 confirm that the labor market remains fairly strong. In the past, the Fed has responded by lowering the federal funds rate when this weekly insured unemployment rate moved higher.

U.S. Technology Stock Valuations Revisited:

Some economists have suggested that the technology boom will continue to hold off a Fed response and bolster productivity, economic growth, and push the stock market higher. The Fed's monetary policy is just one of many drivers of the economy, and bolsters the position that the Fed will most likely not need to cut rates to fill the gaps in economic growth. We believe that productivity will continue to forge ahead, as it did last year, supporting the significant semiconductor rally that was coincident with raising growth forecast this year. Yardeni research has made the observation that semiconductors are the "oil of the high-tech revolution". The forward earnings of the S&P 500 Semiconductor industry have soared since the start of 2023. The forward P/E of the group currently trades at 29.9X.

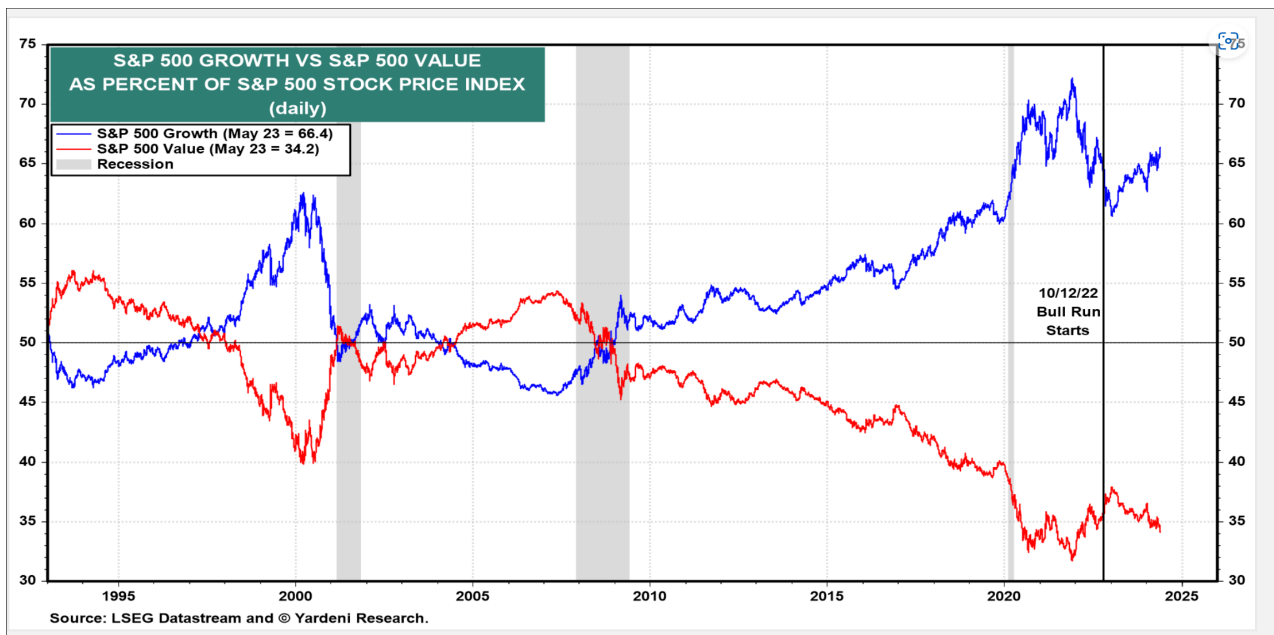


A number of investors and sell-side analysts have recently argued that U.S. tech stocks - the “Magnificent 7” - are either not expensive or are well supported by their fundamentals. While certainly debatable, on an objective basis or in the context of a historical framework, financial data on mega-cap tech and tech-related stocks indicate that they are richly priced based upon considerable optimism about future growth.

Value versus Growth:

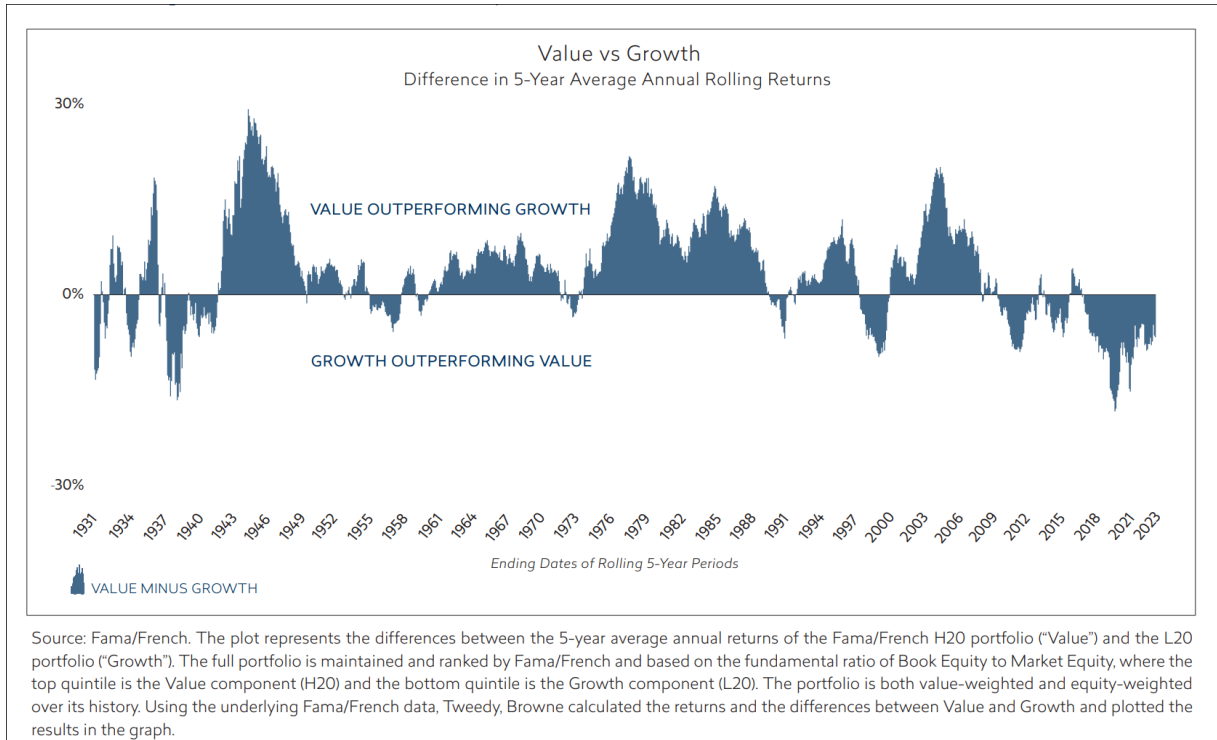
Today’s U.S. tech stocks may or may not be in a bubble. However, we have written on this subject for some time, and continue to believe that it will be increasingly difficult for them to outperform given their huge size, already rich valuations and elevated earnings, such that the relative risk-reward is tilted negative in our opinion. The key lesson from the 1990’s bubble was that it was largely a function of the “age of easy money.” Markets have again been bolstered by unprecedented amounts of monetary and fiscal stimulus by government and regulatory authorities all over the world. This has pushed inflation-adjusted interest rates near zero, and even into negative territory in many European countries.

For well over the past decade, investors have essentially been forced further out on the risk curve, in an effort to receive some yield on their investments. In an age of rapid technological change and innovation, it has become increasingly enticing to bid up the prices of longer-duration growth stocks whose earnings power is expected to endure long into the future. Even at high valuations, these types of securities have produced earnings yields that were superior to the nearly zero yield on bonds.



Conversely, investors accorded lower valuation multiples to the nearer-term earnings of value stocks, despite the earnings yield advantages associated with their lower valuations. As we have reiterated in past commentaries, we believe we are getting close to an inflection point following the excesses of the last decade. Investors now find themselves in an economic environment that consists of persistently higher inflation and interest rates that are likely to normalize at levels well above the interest rates that prevailed over the past decade. In such an environment, one has to wonder if investors will continue to bid up the prices of technology shares at what we believe are excessive valuations. If the last year is any indication, perhaps this can continue for a while longer.

In Summary:



The longer-term performance of value and growth indices since late 2020 suggests instead that we may be in the midst of a material shift in markets, largely driven by the prospect of a more normal interest rate environment. Less risky alternatives are now available in both bond and equity markets and provide investors with earnings yields superior to those provided by highly valued growth stocks. We continue to adhere to our time-tested investment principles focused on low price-to-earnings. Our discipline guides us in identifying companies with intrinsic values that trade at substantial discounts to the overall market, and provide a margin of safety in the event that markets come back down to earth.

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