ALTMAN
INVESTMENT MANAGEMENT

EQUITY STRATEGY FOCUS

AUGUST, 2024

"In my own thinking, the concept of value … has always lain at the heart of true investment, while price expectations have been at the center of speculation"
-Benjamin Graham, 1974

IN VIEW: Market Performance & Earnings

Q2 stock performance represented by the S&P 500 index resumed its narrow leadership trading up 4.28% against a negative return of -3.63% for the same index on an equally weighted basis. The broad market rally at the beginning of the year was interrupted by Mega Cap 7 (Microsoft, Meta, Alphabet, Netflix, Nvidia, Amazon, and Apple) exuberance, as these stocks account for 31% of the index market cap. Not too soon after the 2nd quarter ended, however, the broad market rallied again outperforming the Mega Cap 7 by nearly 200 basis points. President Biden is considering new restrictions on exports to China and former President Trump is voicing his intentions to make Taiwan pay more for defense should he win reelection. This ongoing seesaw between the broad market and the Mega Cap 7 shows vulnerability in several sectors of the market, and reminds us that every leadership regime eventually comes to an end.

That being said, let's take a quick look at a similar period of exuberance when a large group of blue-chip stocks dominated the market. During the late '60s early '70s, a group of 50 stocks, known as the "Nifty Fifty", grew to comprise 40% of the market and traded at a combined price to earnings multiple of more than double that of the benchmark index. As they peaked, the group lost all of their gains from the early '70s, dropping to a mere 23% of the benchmark market cap. Afterwards, many Nifty Fifty stocks struggled to recover, some not recovering at all. Johnson & Johnson and Xerox took years to produce returns, while others filed for bankruptcy, became targets of acquisitions or went out of business altogether.

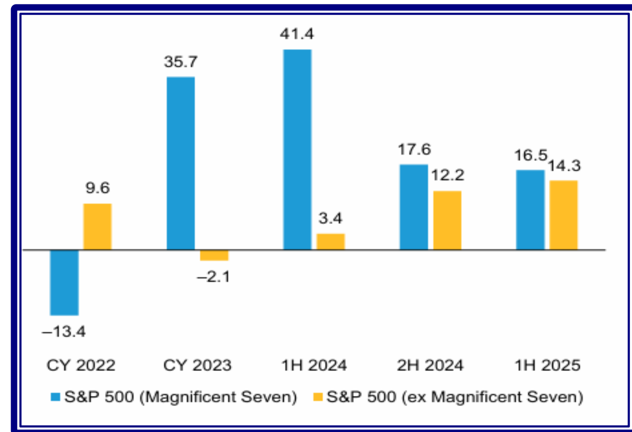
Market Cap of New Economy Stocks as % of S&P 500 Index

Similarly in the early 2000's, dotcom stocks peaked at over 40% market cap dropping to just about 20%. As the bubble burst and venture capital dried up, mass consolidation occurred in a sort of "survival of the fittest" mode. Of those that survived, many traded sideways for 10+ years. In each of these circumstances, valuations during peak years were often set aside as irrelevant, not unlike what we are seeing today with the Mega Cap 7.

Today's new economy includes the Technology, Communication Services, and Consumer Discretionary sectors and accounts for just under 50% of the benchmark market cap. Drilling down further, just 7 companies make up 31% of the market cap and have a combined forward multiple of 31x earnings, a 69% premium to the S&P 500 index excluding the Mega Cap 7. What history reminds us is that as growth rates begin to normalize, valuations inevitably normalize as well - reverting stocks in a direction towards the mean.

Overall, macroeconomic data supports earnings growth and a broadening market. The June CPI rate fell -0.1% for the first time in 4 years boosting investor confidence that the Fed may begin to ease as early as September. With the addition of a more balanced labor market, the Fed has room to begin pivoting from restrictive to accommodative policies. The markets reacted positively with a broad rally in stocks on the increased probability the Fed may be successful in cooling inflation without causing a recession. The broad uptick at the start of the second half also reflected a better -than-expected June retail sales report. Its resilience bodes well for consumer spending that makes up about two thirds of U.S. gross domestic product. Manufacturing PMIs and exports have also expanded over the past 3 months indicating optimism for GDP growth and in turn eps growth.

Closing the Gap
S&P 500 YOY Earnings Growth Consensus Est (%)



Source: Alliance Bernstein

Historically, earnings per share grow at an average rate of 8.8% per year. Looking ahead, growth rates can very well exceed this level if productivity continues to improve. Higher productivity translates into higher GDP that in turn would put downward pressure on unit labor costs, expanding profit margins and lifting earnings. So rather than an absolute stock market crash, it is more reasonable to anticipate a narrower correction where a highly concentrated market broadens into underappreciated sectors of the market (lower valuations) that are producing high earnings at sustainable growth rates.

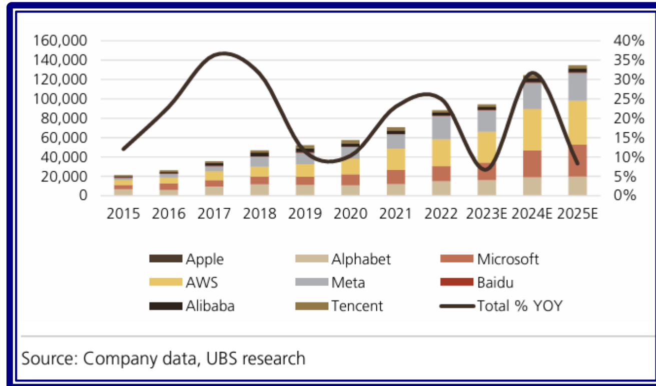
July's Employment Report and the Market Response:
The recent weak payroll employment report should have not materially changed Fed Chair Powell's assessment of the labor market - considering that inclement weather might explain most if not all the weakness. Nevertheless, he and his colleagues might be inclined to be more dovish than what we believe is warranted.

In conclusion, the markets seem to be leaning toward a 50bps cut in the federal funds rate in September and two more cuts of 25bps each in November and December. According to Yardeni Research, over the next 12 months, the federal funds rate futures market is anticipating eight rate cuts of 25bps each, or the equivalent of that many cuts. However, we are operating on the assumption that the Fed will cut rates once in September and done for the rest of this year.

CLOSE-UP: Equity Sector Overview

Designed to learn the patterns and the structure of data, Artificial Intelligence (AI) is set to revolutionize and commoditize intelligence, decision making, analysis and content creation. One challenge now is as corporations seek to leverage AI to enhance customer experience and operational efficiencies, is the time it takes to fully monetize these efforts. The payoff from this investment is not automatic, particularly due to the complications in monitoring customer usage of new AI tools and translating that into a billable product. Additionally, capex growth is largely driven by hyperscalers such as Microsoft, Amazon, Alphabet, and Meta, who require massive data centers to support their applications and websites. UBS estimates growth of 15-20% in the data center equipment market throughout this year and next year. The stress placed on the available power grids and manufacturing capacity is generating an indirect demand for data center infrastructure builds.

Hyperscale Data Center Capex, $m



While demand for AI continues to grow, its sustainability and its velocity is not guaranteed. That being said, there are a number of other sectors that are underappreciated and indirect AI beneficiaries. For example, demand for data centers by hyperscalers in turn is fueling growth in the heating, ventilation, & air conditioning (HVAC) industry. **Johnson Controls (JCI)** up 16.6% in the first half, manufactures products such as A/C units for computer rooms, chillers, and air handlers. In Q3, JCI announced a dedicated Global Data Center Solutions organization to meet the growing demands of data center expansions. Efficient and cost-effective cooling solutions are in high demand and the challenge will be to keep up with the evolving technologies required to meet increased scale. Shares of JCI are valued a price to earnings multiple of 17x, a 38% discount to the market index.

Additionally, industries such as transportation, building products, materials, and construction stand to benefit from reshoring efforts and infrastructure builds. The hard truth is that U.S. infrastructure is aging. In fact, the American Society of Civil Engineers rated U.S. infrastructure with a less than stellar rating citing a broad range of circumstances ranging from bridges to airports and water systems. The study found that between now and 2033 an additional $7.4 trillion in infrastructure is necessary to close the gap between needs and investment. This is in addition to the $580 billion in new infrastructure funding already baked into assumptions.

10 YR Gaps within "Continued to Act" Scenario

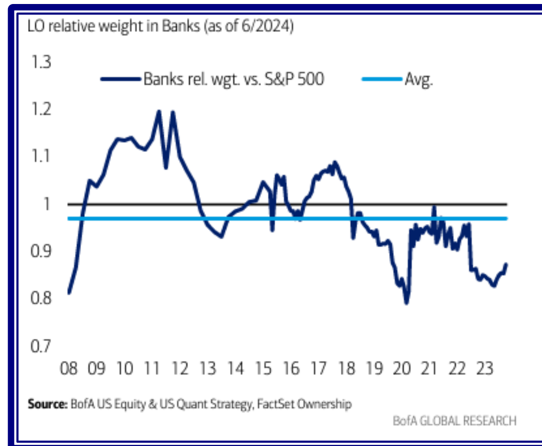
Source: American Society of Civil Engineers: 2021 Report

Honeywell's (HON) Infrastructure Renewal Program analyses and consults on building systems replacements and integration for operational efficiencies and reliability. The implementation of maintenance processes adds an additional layer of process optimization by extending the life expectancy of equipment. Shares of HON are valued a price to earnings multiple of 20x, a 27% discount to the market index.

The banking sector is another beneficiary of AI. Banks are working to integrate AI tools in data analytics to personalize and improve the overall customer experience. Additionally, AI can automate routine tasks, simplify processes and improve customer interactions. At the same time, AI can be utilized to enhance productivity, efficiencies and profitability. In fact, a study published by Citi Global Perspectives and Solutions, estimates 2028 global banking profits have a 9% upside based upon growing adoption of AI. This could equate to an additional $170 billion in profits as the industry aggressively embraces AI.

Bank of America (BAC) is an industry leader in AI advancement and has plans to spend $3.8 billion on technological initiatives in 2024 and is one of the major holders of AI banking patents. Erica, its virtual assistant gained 16% in customer usage last year while sign-ins into its corporate and commercial client interface, Cash Pro Chat, climbed more than 40%.

Banking Exposure is 1 Standard Deviation Below Average



Semiconductor consensus earnings are forecast to grow at a rate of 48% this year. However, excluding Nvidia, using an adjusted calculation by Yardeni Research, the forecast drops to 5.4%. This is because many companies in the space are experiencing an inventory correction, particularly those with exposure to PCs, cell phones, autos, and industrial products. This puts downward pressure on price levels within the semi-conductor and related devices market. After the correction is worked through, earnings growth is expected to resume a rate of 42% in 2025. A tailwind from AI is also behind next year's growth forecasts as data center and energy infrastructure builds along with the increased demand for premium processing sparks chip demand.

As a leading supplier of Dynamic Random Access Memory (DRAM), **Applied Materials** (AMAT) is in a strong position to benefit as the demand for generative AI fuels the need for faster, more efficient processing solutions. AMAT recently raised sales guidance for several of its AI silicon enablers. **Intel** (INTC) despite being the market leader in central processing units, has been suffering from stiff competition. A turn-around centers on their ability to keep pace with future chip generations and its success rate in the AI accelerator race. INTC gear up, is re-focusing on core businesses, pursuing cohesive partnerships, and has a diversified portfolio of solutions.

The current bull market continues to be fueled by economic growth, labor market strength, ample liquidity, and consumption. Excitement surrounding AI added a boost to the earnings recovery already underway. However, based upon difficult comps over last year coupled with a shift from cost savings to capex spend we can expect that the earnings growth in the Mega 7 stocks to decelerate. The equally weighted benchmark index has underperformed relatively against the S&P 500 index this year, but that has not been without interruption. The intermittent strength the broader market has demonstrated this year is becoming more persistent. In fact, the equally weighted index outperformed by 327 basis points during the month of July. From here, we expect market breadth to widen further, as earnings growth rates converge and normalize. Given the value style bias of our strategy, our portfolios are positioned to capitalize as this trend perseveres.

Final Thoughts:

The adjustment to a new world of structurally higher interest rates which we are expecting in the future will likely not be easy for investors, and may very well be accompanied by a further consternation in capital markets. We have certainly seen evidence of this anxiety since the markets began recovering from the last recession, as the overall direction of interest rates has been rising.

In our view, Benjamin Graham's helpful parable about Mr. Market is vital and relevant. As he explains in the *Intelligent Investor*, Mr. Market "is there to serve you, not to guide you". It offers the disciplined and wise investor the opportunity to take advantage when markets seem unanchored. It requires autonomous thought, disciplined analysis, and sound business judgment to market challenges.

We have found that this intelligent and time-tested guidance has served the interests of investors as opposed to speculators. Since the financial crisis of 2008, and lasting through 2021, we believe that relatively free money has mostly served the interests of speculators, not investors. We conclude that we are now in a phase that will be rooted in responsible monetary discipline and sound investment principles, and should serve the interests of intelligent investors.

We do recognize how long the broadening market process has taken to take hold and will continue to do our best to take advantage of the mispriced opportunities that become apparent to us. We are grateful for your trust and confidence in our disciplined investment process.

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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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