Marco Investment Management

Investment Newsletter **December 2018**

Market Review

Introduction

Although stocks have been on a roller coaster ride in 2018 the overall trend has remained positive. Fixed income, on the other hand, has struggled in the face of higher interest rates. Total returns for bond indexes are generally negative year-to-date. In this edition of our Investment Newsletter we will explore the outlook for each of these asset classes in 2019.

Equity Markets

Through the first eleven months of 2018 the stock market has registered eight positive months and three negative months while the S&P 500 index has returned 5.1% overall. October was a particularly harsh month, down 6.8%, living up to its reputation as being one of the more volatile months of the year. Jitters over the mid-term elections, higher interest rates, fears of a slowdown in global growth and trade tensions were all factors in the October sell-off. However, hope springs eternal and by late November a more optimistic tone had set in. Trade rhetoric was abating, the Fed chair announced that we are approaching a neutral range for interest rates, and a return to divided government was the new order of the day.

Alongside this year's volatility has been a steady improvement in corporate earnings growth. This strong growth backdrop combined with limited upward momentum in stock prices has left the forward price earnings ratio on the S&P 500 at a fairly reasonable 16.3X. This about 3 multiple points off the peak level of the past 12 months. Over the next twelve months, earnings are expected to grow in the high teens with dividends growing at about a 7% rate over this same period. So, the problem with the stock market this year has not been the current environment but, rather, a fear of what the next couple of years may bring.

While earnings are currently very strong, the comparisons will get tougher in 2019 as the market goes up against post tax cut results from 2018. So even if earnings continue to climb there will undoubtedly be a slowing in the rate of earnings growth. Inflation has been off most people's radar these past few years but a historically low unemployment rate and a shortage of skilled workers could be laying the ground work for higher wage growth that could feed inflation. Add to this the potential for higher interest rates, ongoing trade uncertainties, and higher deficits and the backdrop for stocks might look a good bit less compelling. However, as the saying goes, "The market climbs a wall of worry" and there is always something to worry about.

The glass half full argument would point to reasonable valuations, strong corporate cash flow, ongoing merger and acquisition activity, and our status as a safe haven that attracts overseas capital. Stock prices generally follow earnings and there is no sign of earnings growth turning negative at this time. In addition, the third year of a presidential term is generally very positive for the stock market (please see chart).

Technically speaking, the market did suffer some damage during October and early November with the S&P 500 index dropping below the 50 and 200 day moving average lines. But, by early December the market had clawed its way back above both of those trend lines. The slope of the 200 day moving average line has flattened out though. A resumption of the prior upward trend would be viewed as validation that the bull market remains intact.

Assuming a 17X P/E on 2019 S&P 500 consensus earnings of $178 would put the index at 3,026 compared to 2,760 at the end of November. That would mean the market could rise another 10% over the next year but of course the big question is whether the market can trade at a 17X P/E. We think this is very possible but if we traded at 16X the upside potential would only be about 3%. Another factor for 2019 is what will 2020 projections look like? We anticipate the market will start to look ahead by the middle of next year.

Fixed Income Markets

Yields on fixed income securities are up across the board in 2018 as the market has taken its cues from the Federal Reserve and its steady beat of rate hikes on the short-end of the yield curve. Although rates have risen for all maturities in 2018 the rise has not been uniform as short-term rates have risen faster than long-term rates. This has resulted in a flat yield curve. For example, in early December the difference between the yield of a ten-year Treasury note and a two-year Treasury note was only about 12 basis points and the difference between the five-year and the two-year was negative 2 basis points. This inversion in yield where short-term rates are higher than long-term rates is rare and may be signaling that the market believes the Fed's hiking cycle is getting close to the end. Federal Reserve chairman Jerome Powell recently stated that interest rate policy was approaching neutral.

The take-away from this is that if the Fed is winding down their rate hikes that could be signaling that economic growth may also slow over the next 12-24 months and raises the specter of a recession in the 2020 time frame (an election year). All of this is speculation though because current economic statistics show no signs of a contraction in economic growth. To the contrary, the most recent Institute for Supply Management Manufacturing survey accelerated to a high reading of 59.3 that is consistent with GDP growth of at least 3.6%.

Regardless of whether rates are peaking or not it is clear that from a risk perspective there is less risk in 2-5 year bonds compared to long-term bonds since one can get virtually the same yield in both. Only if rates actually decline from here will one be better off in long-term bonds on a total return basis (price change plus income). With rates higher year-to-date in 2018 that has not been the case though. Longer-term bonds have produced negative total returns and these returns are worse than those from shorter-term bonds. This can be seen in the returns from various bond indexes year-to-date. For example, the ICE 1-3 year Treasury index is up 0.8% year-to-date through November 30th while the ICE 7-10 Year Treasury index is down 1.8%.

We expect the Fed will raise rates a quarter point later this month then take a wait and see attitude based on forthcoming economic data. Our interest rates are already higher than those in many other industrialized nations so barring a spike in inflation the Fed may have the luxury of a go slow approach.

Economic Outlook

Real GDP growth came in at a strong 3.5% annualized rate in the third quarter and appear to be tracking at about 3% for the full calendar year. Third quarter GDP was boosted by inventory building some of which may have been businesses stockpiling ahead of possible tariffs.

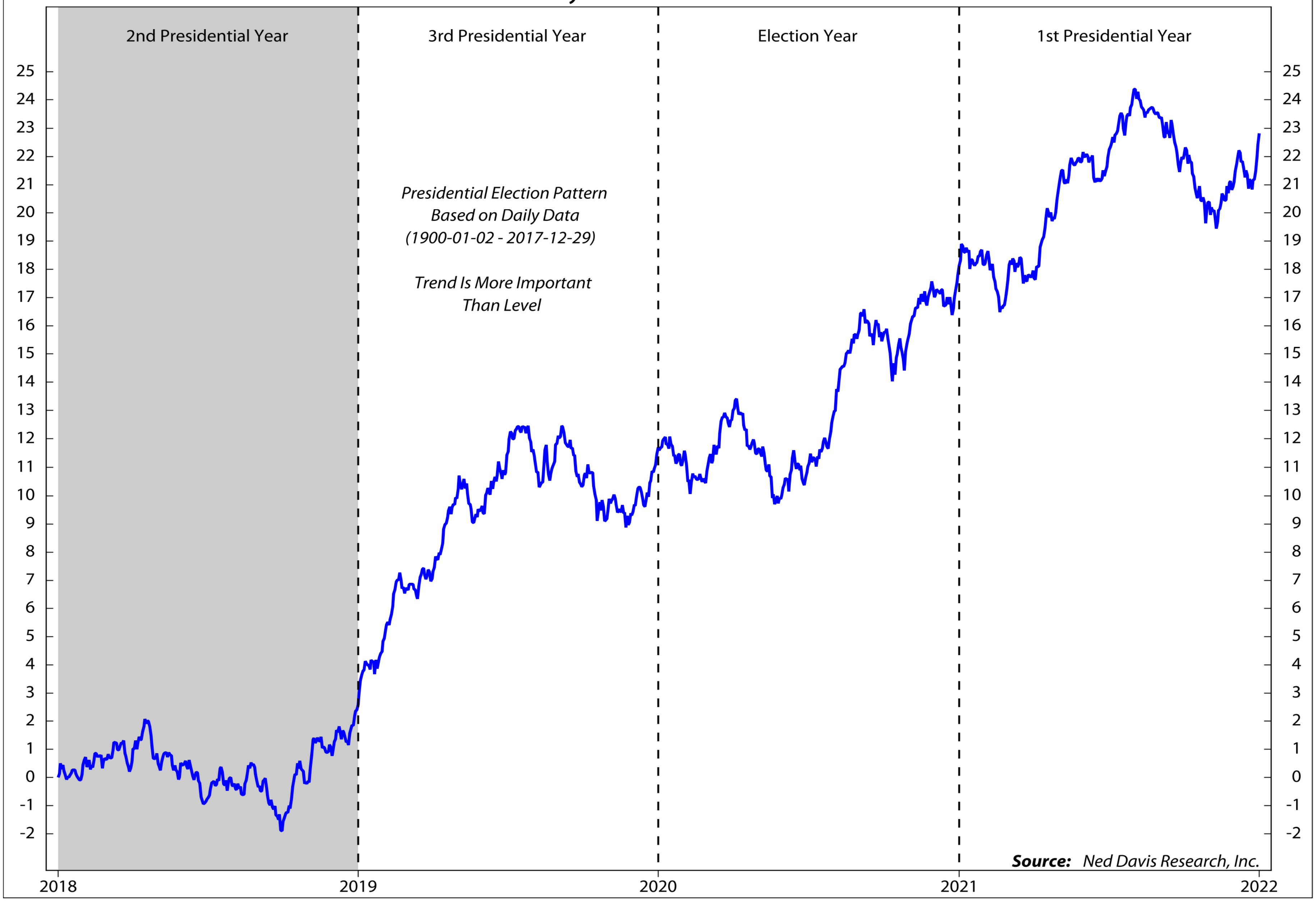
Tariffs remain a wild card for the economy. Despite some cooling of rhetoric with China, a deal will need to be worked out in the next 90 days or so to avoid new tariffs being slapped on Chinese imports. The Chinese would no doubt retaliate with tariffs of their own.

Unemployment stands at a historic low of 3.7%. This is the lowest since the late 1960's. The Labor Participation Rate stands at a multi-year high of 62.9%. Inflation is running at a 2.5% year-over-year rate but could moderate in light of the recent decline in energy prices.

Summary

2018 has been somewhat of a conundrum for investors as stock prices have not really followed the strong growth in corporate earnings. The market seems to have taken a "glass half empty" approach focusing on the prospect of slowing growth in late 2019 and 2020. Fixed income securities have also struggled as interest rates are up but that trend may be moderating. We are cautiously optimistic for 2019 and believe reasonable stock valuations leave room for more upside. Bonds could return low single digits if rates stabilize at current levels.

Dow Industrials Four-Year Presidential Cycle



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