Marco Investment Management

Investment Newsletter **August 2021**

Market Review

Introduction

Despite concerns about the Delta variant of the coronavirus, a pickup in inflation, and mixed economic data, the market continues to focus on good earnings reports and continued stimulative actions. As a result, the S&P 500 Index sits near all-time highs. Is this upward move likely to continue, or can we expect a pullback? We will explore this topic and others in this edition of our Investment Newsletter.

Equity Markets

The stock market as measured by the S&P 500 Index is up almost 20% year-to-date and up almost 100% off the pandemic low in 2020. Year-to-date, the best sector has been Energy, followed by Real Estate and Financials. Lagging sectors include defensive groups like Utilities and Consumer Staples. All S&P sectors are positive year-to-date.

The stock market has benefitted from strength in Mega Cap stocks, particularly in the technology and communications areas. The top 10 stocks in the S&P 500 Index carry a 27.7% weight and are up an average of 28.3% year-to-date. Even though the skew towards the biggest stocks has helped the overall index return this year, the equal-weighted S&P 500 has also done well. By equal-weighting the index, the top performing Energy, Real Estate and Financials sectors represent 22.5% of the total index versus 16.3% using the cap-weighted method.

In 2021 we have seen a rotation between cyclical and defensive stocks, which seems to reflect the conflict between news about rebounding economic growth and periodic concerns about a virus resurgence. This tug of war has lead to rolling corrections in certain sectors, but the overall trend has remained firmly upward. The question now is whether we will see a late summer to early fall correction. Arguments in favor of a pullback include some paring of the growth outlook which could be virus related, the possibility of a less accommodative Fed, and P/E ratios that are at historically high levels. Arguments against a significant correction include above-trend growth, an expectation of continued low interest rates, and ongoing fiscal and monetary policy that should support the market. While we would not be surprised to see a 5%+ correction develop at any time, we would likely view that type of event as a buying opportunity.

While stock valuations remain elevated, the number of companies beating earnings expectations is on track for a new record and earnings revisions are moving higher. Both are bullish indicators.

One concern at the moment is the sharp drop in consumer confidence based on the University of Michigan survey. There is currently a disconnect between this survey and the equivalent Conference Board measure, which isn't far off its pre-pandemic peak. There is some evidence that the Michigan survey is more sensitive to inflation concerns, but regardless, the disconnect is notable.

Fixed Income Markets

All eyes remain on the Federal Reserve for any indication that they will begin to "taper" their stimulative monetary policies. The first sign of tapering would likely be the Fed buying fewer Treasury and mortgage-backed securities (MBS). Few expect to see an outright change in short-term interest rates for at least another year.

Even though inflation has surged at both the consumer and producer levels, the bond market has basically shrugged off inflation concerns, believing that the Fed is correct that the surge is transitory in nature as we deal with virus-related supply chain issues and labor shortages. Regardless of whether this belief turns out to be correct or not, the bond market doesn't appear to offer much value, as inflation-adjusted yields are firmly negative even if inflation falls back to the Fed's long-range target of 2%. This lack of value is evident with the ten-year Treasury yield presently at 1.27%. Currently, year-over-year CPI is running at a 5.4% rate with a full-year forecast of 4.2%. (Please see chart.)

So far in 2021, the ten-year yield has ranged from 0.91% to 1.74%. We believe that rates will eventually have to rise to get in line with the normalized inflation rate, which implies a move above 2% at some point, but the timing is very uncertain with the Fed currently in the driver's seat with policies that may be distorting the market at present.

The bond market is not forecasting much chance of a recession, as yield spreads on non-Treasury debt are tight, which indicates confidence in the economy and a market assessment that default risk is low.

Economic Outlook

The economy has rebounded strongly from the depths of the pandemic. Highly effective vaccines have boosted optimism that the worst is behind us. Economists are now forecasting 6.9% third-quarter GDP growth and 6.2% full-year growth.

The economy added a better-than-expected 943,000 new jobs in July, with positive revisions totaling 119,000 for the two-month May-June period. Unemployment has ticked down to 5.4%, and the labor participation rate has improved. Some of the increase in employment may be tied to numerous states ending the enhanced federal unemployment benefits earlier than the planned September 6th expiration.

The Institute for Supply Management Purchasing Manager's Index (PMI) remains in expansion mode with the most recent reading of 59.5, and the Services Index also posted a strong reading of 64.1.

Average hourly earnings have moved up to a 4% year-over-year rate, although this is not quite keeping up with the inflation rate at 5.4%.

One area that could be peaking is real estate, with new home sales dropping 6.6% in June, which may, however, be due to shortages in construction materials and labor. Also, the median new home price is up 16% year-over-year, leading to some affordability issues.

Retail sales growth may also be slowing, as comparable store sales are coming up against tough comparisons. Some states are also instituting restrictions on dining and other gatherings (proof of vaccination required), which could diminish activity.

It is appearing more likely that some form of infrastructure bill will pass both houses of Congress and be signed into law in the relatively near future. A $1.0 trillion bill has already passed the Senate with some bipartisan support, but a proposed $3.5 trillion spending bill faces a less certain future. If passed, it will likely be without any Republican support, instead using a technique known as budget reconciliation. The Senate Parliamentarian will likely have to rule on whether some of the spending items in the bill meet the test for inclusion in a reconciliation package.

Overall, it appears that the economy will continue to benefit from substantial fiscal spending, but questions remain about the long-term inflationary impact of these measures.

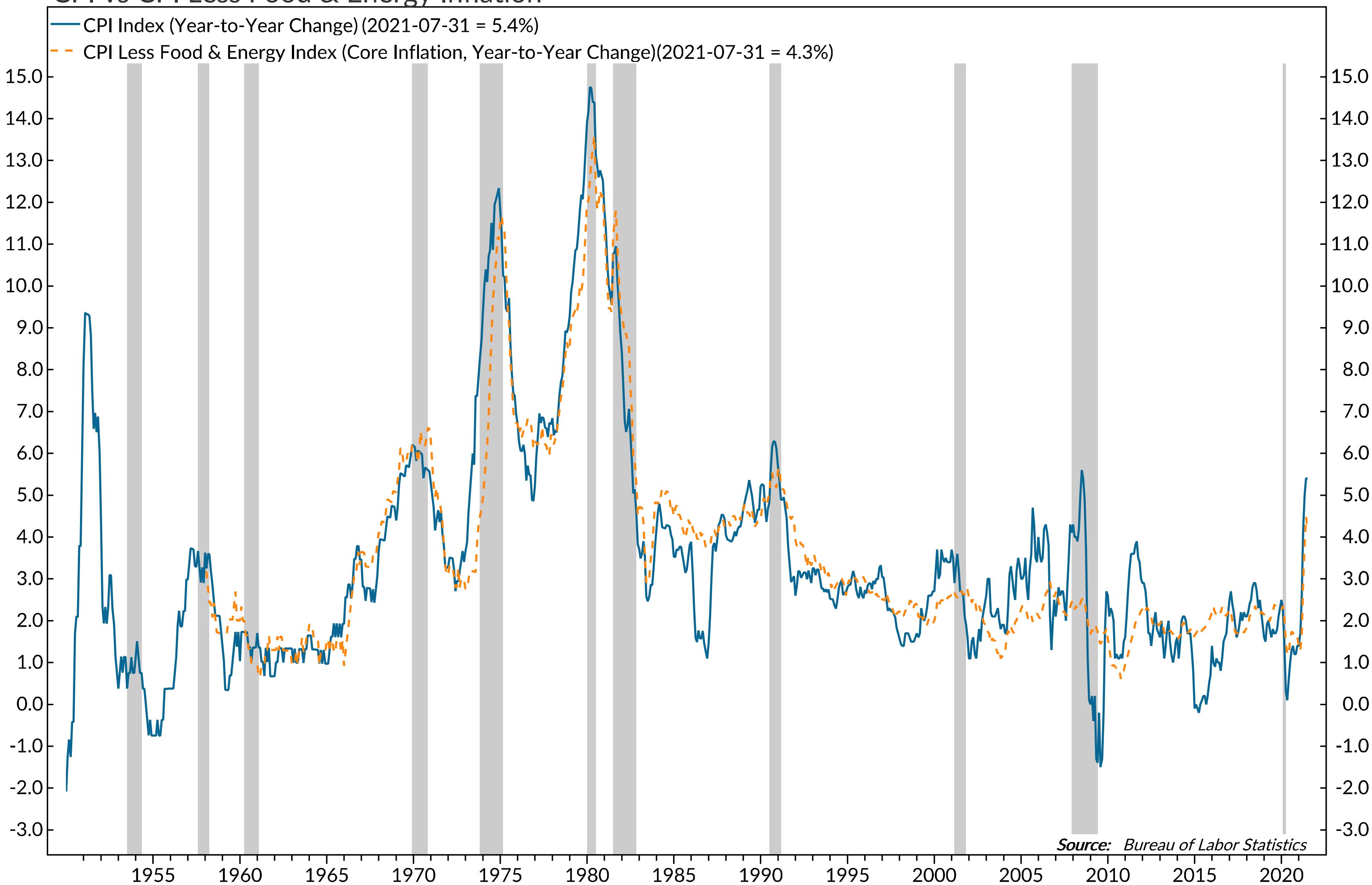
Summary

The long-term trend for stock prices appears higher, although we are in a typically seasonally weak period and possibly overdue for a pullback. The Delta variant has raised concerns that recent strong economic growth could taper off a bit, but the appetite for lockdowns seems low and growth is still running above trend. Inflation has surged in recent months, but it remains to be seen if this is a temporary condition. We believe recent price increases will be sticky and unlikely to decline significantly.

As long as earnings growth is strong and until we see the Federal government pulling back from fiscal and monetary stimulus, it still looks like the path of least resistance for stocks is higher. Fixed income does not appear to offer much relative value at this time but may still be appropriate from a diversification perspective.

CPI vs CPI Less Food & Energy Inflation

Monthly Data 1950-01-31 to 2021-07-31



Shaded areas represent
National Bureau of
Economic Research recessions

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