Marco Investment Management

Investment Newsletter **November 2022**

Market Review

Introduction

Both the stock and bond markets have been tough in 2022, with double-digit losses for most indexes. Despite a nice rally in October, the S&P 500 is still down about 15% on the year. Bonds have declined in value as interest rates have risen substantially. Even though headwinds persist, we do see some reason for optimism that the worst may be behind us. We will explore this possibility and other issues in this edition of our Investment Newsletter.

Equity Markets

The stock market rollercoaster has continued over the past few months. The late summer rally we were experiencing topped out and then took another leg down, hitting a new yearly low before bottoming in early October. Ultimately, October ended up as a big rally month with some of the best returns for that month in years. Since then, we have seen some further improvement.

Going back to 1928, the S&P 500 has averaged 3.4 pullbacks of 5% or more per year. This year has already seen seven. We also tend to average about one correction of 10% or more per year. This year we have already experienced three. In addition, declines of 15% or more happen, on average, every two years. In 2022 we have already seen two. Clearly this year has exhibited above-average volatility.

Some of the recent improvement seems tied to optimism that the Fed may reduce their pace of interest rate hikes in coming months given the recent easing in inflation. After peaking at a 9.1% annual rate, the Consumer Price Index has moderated a bit to a 7.7% annual rate. While still extremely high, it does show that the inflationary trend is improving.

There is also room for optimism that with the mid-term elections behind us, divided government may be a best-case scenario for the markets, since it implies gridlock. Historically, the market has favored divided government over one-party rule. Mid-term election years are typically the worst of the four-year Presidential cycle (please see chart), so we may be moving into a more favorable period. In addition, stock valuations are much more reasonable than they were at the beginning of 2022. However, today's market valuation is based on an expectation that earnings will continue to grow next year. A recession would likely trim earnings and pressure valuations further from current levels.

Energy stocks remain the big winners in 2022, as production constraints continue to pressure supply. The Russia-Ukraine war continues as a wild card for the energy markets. The United States has been drawing down the Strategic Petroleum Reserve to try to supplement supply, but the need to replenish the reserve will likely keep a floor under oil prices for the foreseeable future.

Big-cap Technology and Communication Services stocks continue to suffer due to a major valuation reset and ongoing concerns about a possible slowdown in consumer spending and corporate advertising budgets. These stocks are very sensitive to interest rate moves, as they typically don't pay dividends, so their valuation is partly a function of discounting expected future earnings into today's dollars, with the current interest rate serving as the discounting mechanism. Interest rates have pulled back a bit from recent highs, which could help valuations a bit.

S&P 500 earnings are expected to expand about 7.4% in 2023 over 2022. That number has come down, and a large chunk of the earnings is coming from the Energy sector, so that contribution may not be sustainable.

Fixed Income Markets

Like stocks, the bond market has also suffered in 2022 as the Federal Reserve has hiked short-term interest rates aggressively in an attempt to rein in inflation. Despite a recent rally in bond prices, through mid-November the 10-year Treasury Note is up 220 basis points in yield over the past twelve months and some shorter-term maturities are up over 400 basis points. The

2-year Treasury Note yields about 4.36%. One year ago, it was yielding 0.52%. The yield curve also remains inverted, with shorter maturities yielding more than longer-term bonds. In the past, an inverted yield curve has often been a precursor to a recession.

Over the past few weeks we have seen some improvement in the bond market, with the 10-year Treasury Note declining from a peak yield of 4.30% in late October to the present 3.79%. The rally was sparked by better news on inflation and hopes that the Fed will now have the latitude to reduce future rate hikes and perhaps pause to see if the rate hikes implemented to date have the desired effect.

The real rate of return on fixed income investments is still negative, since inflation exceeds the yield by several percentage points. However, economists are expecting inflation to settle in at around 2.5% in 2024, implying that bonds bought today will offer positive real rates of return in the not-too-distant future. Therefore, locking in today's yield levels could prove attractive.

Non-Treasury bonds provide higher returns, and yield spreads to Treasuries are not particularly wide compared to average levels, which signals that market participants are comfortable with taking some credit risk to lock in those higher yield levels.

Economic Outlook

Third quarter real GDP grew at a 2.6% annualized rate, which was above expectations. However, because the two prior quarters registered negative growth and the fourth quarter is only expected to be modestly positive, full-year GDP will likely come in well below 2%.

The economy added 261,000 new jobs in October, which was well above expectations of 193,000. The unemployment rate is 3.7%, which is not far off the 50-year low of 3.5%. Many believe this relatively strong job growth is inconsistent with an imminent recession. However, we are starting to see some layoff announcements, especially in the technology sector, and the pace of layoffs may pick up in coming months. Economists are looking for the unemployment rate to climb to 4.3% in 2023.

One reason the labor market remains tight is that the Labor Force Participation Rate continues to be stuck at just a little over 62%. The participation rate has been declining after peaking at 67.2% in 2001.

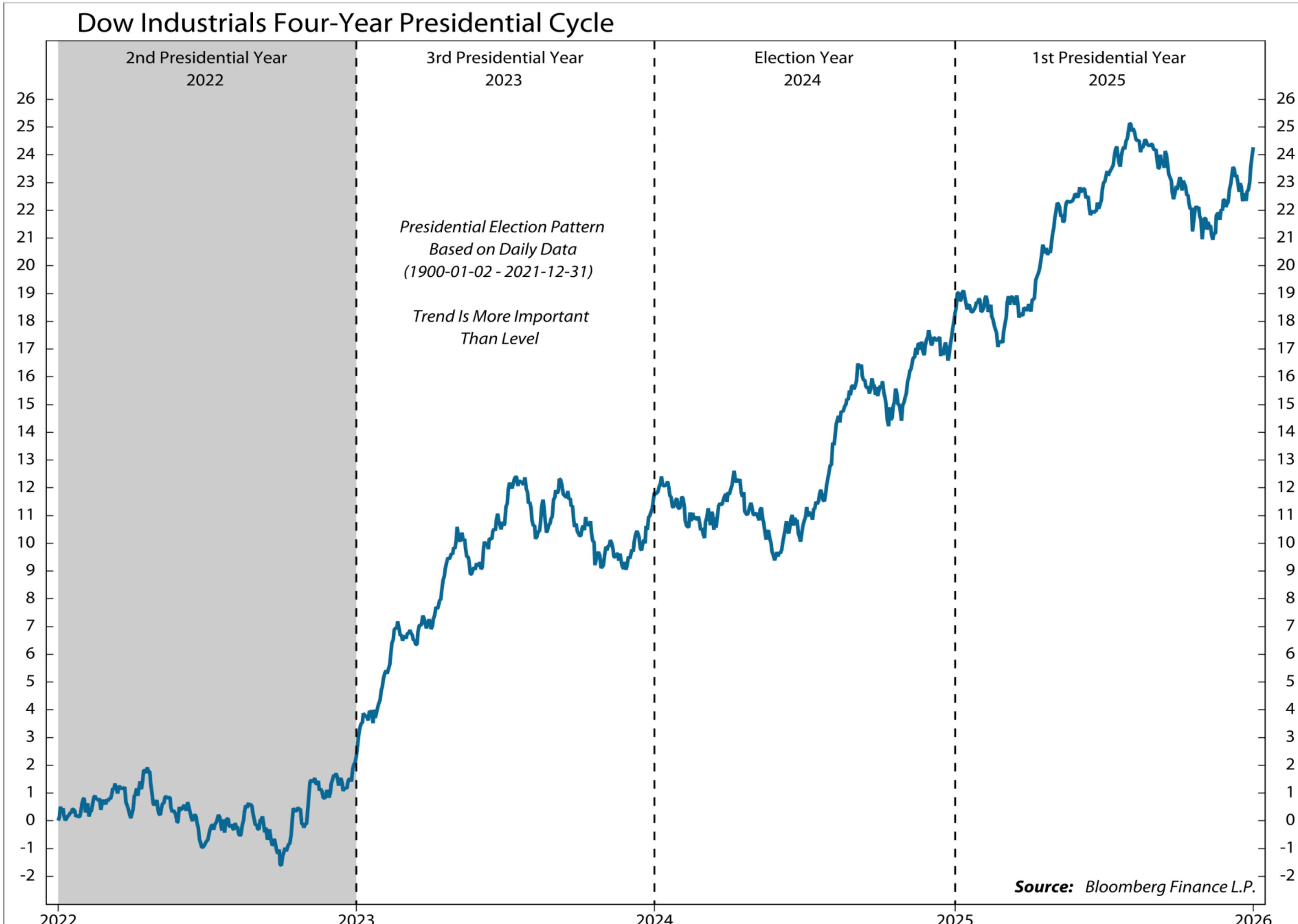
Average hourly earnings have been running at a 4.7% annual rate, but these wage gains have not kept up with inflation in 2022.

The U.S. dollar has been very strong the last couple of years, as our high interest rates and relative political stability have attracted capital. The Euro is currently worth $1.03, compared to about $1.23 in January of 2021. Much of Europe is in or near recession and is dealing with the repercussions of the war in Ukraine. The strong dollar relative to the Euro makes imports from this region cheaper and is a boon for European travel. On the other hand, the strong dollar makes our exports to Europe more expensive and hurts the earnings of U.S.-based multinational companies.

Consumer sentiment has been deteriorating, and the most recent University of Michigan survey came in at 54.7, a four-month low and well below consensus expectations of 59.5. The current reading is near levels not seen since 1980, another period of high inflation. On the other hand, the Institute of Supply Management surveys of manufacturing and services incidate that both, while moderating, are still in expansion mode.

Summary

This year has been challenging for both stock and bond investors. However, both markets have rallied recently, and we are now entering a historically strong seasonal period for stocks. In addition, the divided-government outcome of the mid-term elections could bode well for the markets in 2023. A 2023 recession is still on the table, but if it occurs, we believe it will likely be short and shallow. Inflation appears to have peaked, and stock market valuations are fairly reasonable. The stock market typically bounces back after big selloffs, and the third year of a presidential term has a positive bias. All these factors lead us to believe 2023 could be a decent year for both stocks and bonds.


Dow Industrials Four-Year Presidential Cycle
2nd Presidential Year
2022
3rd Presidential Year
2023
Election Year
2024
1st Presidential Year
2025
Presidential Election Pattern
Based on Daily Data
(1900-01-02 - 2021-12-31)
Trend Is More Important
Than Level
Source: Bloomberg Finance L.P.
26 25 24 23 22 21 20 19 18 17 16 15 14 13 12 11 10 9 8 7 6 5 4 3 2 1 0 -1 -2
2022 2023 2024 2025 2026

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