Marco Investment Management

Investment Newsletter **November 2021**

Market Review

Introduction

Despite a brief correction in September of approximately 5%, the S&P 500 Index currently stands less than 2% away from all-time highs. The market has continued to march forward in 2021 on the heels of strong earnings growth and accommodative monetary policy. Returns have not been evenly distributed, but all sectors are solidly in the black. The market in recent months has generally favored economically sensitive companies as we continue to make progress with the pandemic. The question now is whether the upward trend can continue or must pause or correct. 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 over 24% year-to-date and up over 100% off the pandemic low in 2020. Year-to-date, the best sectors have been Energy, Financials, and Real Estate. Lagging sectors include defensive groups like Utilities, Consumer Staples and Healthcare.

Until recently the stock market had been generally favoring large and mega-cap stocks over small to mid-sized companies. Now the market seems to be broadening out to some degree, as evidenced by the equal-weighted S&P 500 overtaking the cap-weighted S&P year-to-date. The performance gap, however, is not extreme, and we could easily see larger companies regain the edge.

Perhaps the bigger question is one of market valuation and prospects over the next six to twelve months. Currently the forward P/E ratio on the S&P 500 is elevated at 22.1X (please see chart). The previous high was recorded in 1999 at 24.3X, so there doesn't appear to be much room for further improvement. On the other hand, interest rates in late 1999 were around 6.4% on the 10-year Treasury Note compared with about 1.6% today. P/E ratios are helped by low rates, as they make the discounted value of future earnings higher in today's dollars. So, a strong case can be made that P/E ratios are not as extreme as they appear.

If we assume that P/E ratios can remain stable at current levels then we can look at 2022 earnings projections for the S&P 500 and apply the current multiple to those earnings. Earnings are projected to grow about 7.7% in 2022 over 2021 and come in at $225.17 per index share. Applying 22.1X to those projected earnings results in a S&P Index value of 4,976. Presently the index stands at 4,618.

Obviously, there are a lot of factors that could affect the actual return of the market in 2022. The P/E ratio might contract or expand, earnings could come in stronger or weaker, inflation could improve or worsen, etc. Based though on what we currently know and expect, 2022 could be a moderately positive year for stocks. As usual, we would expect volatility and periodic corrections. However, the uptrend appears intact for now. The 50-day and 200-day moving average trend lines remain upward sloping.

Fixed Income Markets

The Federal Reserve has finally confirmed that they will begin to taper their stimulative monetary policies. The tapering will be in the form of the Fed buying fewer Treasury and mortgage-backed securities (MBS) per month. So, they will still be net buyers but at a diminished rate. We do not see an outright change in short-term interest rates before next summer. Despite the Fed laying out a framework for reducing monetary stimulus, interest rates have not moved significantly higher except on the short end of the curve where the Fed has the most influence. Because short rates have risen more than intermediate and longer-term rates, the yield curve has flattened a bit. The gap between the 10-year yield and the 2-year yield has narrowed in recent weeks by about two tenths of 1%.

Even though inflation has surged recently to a year-over-year rate of 6.2%, the bond market has generally taken it in stride, preferring to focus on the moderation in inflationary pressures that the

Fed is predicting. In our view, this attitude could be overly optimistic. Even if inflationary pressures moderate, we do not expect to see lower absolute prices. Instead, current price hikes will be embedded going forward. Also, while it is true that wages have been growing, they are not keeping pace with the current inflation rate. All of these factors could spell trouble for bond yields down the road. Inflation-adjusted bond yields are firmly negative, and even if inflation falls back to the Fed's long-range target of 2% they would still be negative. These low yields are to some extent a global phenomenon, and central bankers have a lot of incentive to keep borrowing costs low. However, market forces could still ultimately prevail.

Despite a less accommodative Fed and the recent surge in inflation, we don't expect a rapid rise in interest rates. A 10-year yield above 2% is certainly possible over the next few months, but in our view a move much higher than that level would require the Fed to become a net bond seller.

The bond market is currently not forecasting much chance of a recession. Yield spreads on non-Treasury debt are tight, indicating confidence in the economy and a market assessment that default risk remains low.

Economic Outlook

The economy continues to perform well and, in some instances, has reached or exceeded pre-pandemic levels. Following a surge as the economy reopened, growth is moderating but still solid and above average.

Weekly jobless claims have been inching lower in recent weeks and are well below the levels seen a year ago. Continuing claims are also trending lower. There is still an acute shortage of workers in some areas.

The Institute for Supply Management Purchasing Manager's Index (PMI) remains in expansion mode with the most recent reading near 60. Anything above 50 is considered expansionary.

Retail sales have been very strong, growing at an above consensus 1.7% in the recently reported month-over-month data. Some of this growth could be from consumers scrambling to buy Christmas presents while shelves are still stocked as holiday shortages have been predicted.

The Conference Board's Leading Economic Index (LEI) climbed 0.9% in October. This was the best showing in three months. Over the past six months the LEI has grown by 4.6%, the best pace since early 2010 (excluding the post-pandemic rebound).

The first infrastructure bill that was somewhat bipartisan was signed into law a few days ago. This $1.0 trillion bill will address areas such as roads, bridges, rural broadband, etc. The fate of the much larger reconciliation spending bill is still up in the air. This bill has no support from Republicans and will need 100% support from Democrats in the Senate to pass. It appears that some form of the bill may ultimately pass, but it will need to be scaled back from its present form to garner enough support.

Presently, the consensus view among economists is calling for 5.5% economic growth in 2021 followed by 3.9% in 2022, in contrast to the negative 3.4% registered in 2020. Inflation is forecast to run 4.5% in 2021 and 3.7% in 2022.

Summary

The upward trend for stock prices appears intact, although we have rebounded so strongly since March of 2020 that a consolidation phase could occur. Valuations are not cheap, but stocks still offer dividend yields that are very competitive with bonds, and unlike most bonds, stocks can offer some inflation hedge.

There are definitely areas in the market that look detached from reality, but overall we view quality companies that are consistently growing earnings and dividends as long-term winners. We are currently in what is normally a favorable seasonal period for stocks, but news on virus variants, etc., could influence near-term price action. Once we enter 2022 the market may become more fixated on the prospect of higher interest rates and slowing growth. However, we still believe that a mid-to-high single digit return for stocks in 2022 would be a reasonable expectation.

Disclosures: PMI measures manufacturing activity based on a monthly survey conducted of purchasing managers at more than 300 manufacturing firms. The S&P 500 Index is a capitalization-weighted index designed to measure changes in the aggregate value of 500 stocks representing all major industries. An investor cannot invest directly in any index. Moreover, index performance does not reflect the deduction of advisory fees, transaction charges and other expenses. Potential for profit is accompanied by possibility for loss. Performance results are for informational purposes only and are not indicative of future results.