Marco Investment Management

Investment Newsletter **June 2018**

Market Review

Introduction

The stock market in 2018 could be characterized as manic depressive. The market goes from periods of euphoria to deep depression even though underlying economic conditions remain strong. Is the yo-yo nature of the market in 2018 justified? We will explore these and other topics in this edition of our Investment Newsletter.

Equity Markets

Through the first five months of 2018 the stock market has been on a roller coaster ride. Overall the S&P 500 is up 2% through May but two of the five months posted negative returns and as recently as April 2nd the market was down 3% for the year. So, it hasn't been a smooth ride despite generally good economic news.

There are several things that have worried the market in 2018. Chief among them is the threat that higher interest rates will choke off the recovery while also signaling higher inflation. So far this threat seems premature since inflation remains under control and the Federal Reserve seems comfortable with the inflationary outlook. The economy itself is hitting on all cylinders and aside from a tightening labor market does not appear to be showing signs of overheating. Therefore, we look for the Fed to continue to hike short-term interest rates but at a measured pace that is commensurate with 2-2.5% inflation and 2.5-3.5% GDP growth.

While the S&P 500 index is up a modest 2% year-to-date, individual sector returns have varied widely. Technology has been the standout up 11.3% YTD while the Consumer Staples sector has been hammered; down 12.9% this year. Since Technology makes up almost 25% of the capitalization weighted S&P 500, this strong outperformance has been the main reason the overall index is positive this year. Other sectors making notable moves include Consumer Discretionary +7.7% and Telecommunications down 10.5%. In general, the theme this year has been economically sensitive sectors doing better and defensive and/or interest rate sensitive sectors doing worse. The poor performance from Consumer Staples is a reflection of relentless price competition combined with higher input and transportation costs. However, the sell-off in this sector is beginning to look a bit overdone as the sector now sports an average dividend yield of over 3.1% and a price/earnings valuation below that of the index itself. Historically this sector has traded at a premium P/E valuation. The overall market P/E has also come down from a recent peak of almost 19X. Presently the forward P/E for the S&P 500 is 16.7X.

The reason the market P/E has moved back to a 16.7X is strong earnings growth that has outstripped the modest 2% return year-to-date. Some of the strong earnings growth can be attributed to the benefits of tax reform but even without this tailwind earnings growth would be outpacing stock market returns.

Another sector that has come back to life after years of underperformance is Energy. This sector saw poor performance and outflows when it appeared we had a glut of oil and gas relative to demand. Now, with the global economy picking up, supply and demand are more in equilibrium and the price of a barrel of West Texas Intermediate crude is about $67 up from a low of around $45 a year ago. So far this year the Energy sector has returned 6.1%, outpacing the overall market. In addition, the average dividend yield of the sector is an attractive 3.2%.

Another factor holding back stock returns this year has been the potential threat of a trade war with tariffs raising costs for everyone involved. Tariffs always create both winners and losers but overall the net effect on the economy tends to be negative. Some of the tough trade talk may just be a negotiating tactic that will ultimately result in a more level playing field for U.S. companies. However, if the limited tariff announcements we have seen to date begin to rapidly expand into other categories this would be a cause for concern.

Fixed Income Markets

While stocks have eked out a positive return year-to date, most bond indexes are negative for the year. Intermediate-term indexes are generally down around 1%. It is hard for all but the shortest bonds to post positive returns in the face of a Federal Reserve that is on a clear path to raise short-term rates. The bond market has been a little skeptical of this policy and that is seen in the flatter yield curve where longer-term rates have not risen at the same pace as short-term rates. Flattening, or inverted, yield curves are often associated with recessions so this has caused some alarm. Right now the difference between the yield of a ten-year Treasury note and a two-year Treasury note is only 42 basis points. We don't see any other early warning signs of a recession looming so we would expect longer-term rates to eventually move more in lockstep with Fed rate action avoiding a curve inversion.

Because short-term rates have risen faster than long-term rates this has created some attractive opportunities in short-to-intermediate term issues. It is now possible to get 3% or more on 2-3 year investment grade corporate bonds. Even if the Fed continues to push short-term rates higher we would expect the overall return of these securities to exceed the return one might receive in money market instruments over a 2-3 year time horizon. Longer-term issues, however, will likely be more susceptible to the headwinds of higher rates.

It is still too early to know whether the positive impact on economic growth from tax reform and reduced regulations can eventually offset the lower tax receipts that are a result of dropping the corporate tax rate from 35% to 21%. If not, then the deficit will expand and the bond market may react negatively. Higher rates would also drive up the cost of refinancing and issuing new government debt to help fund deficit spending. In the first quarter of this year tax receipts declined by $117 billion with most of that drop directly attributed to lower corporate taxes.

Economic Outlook

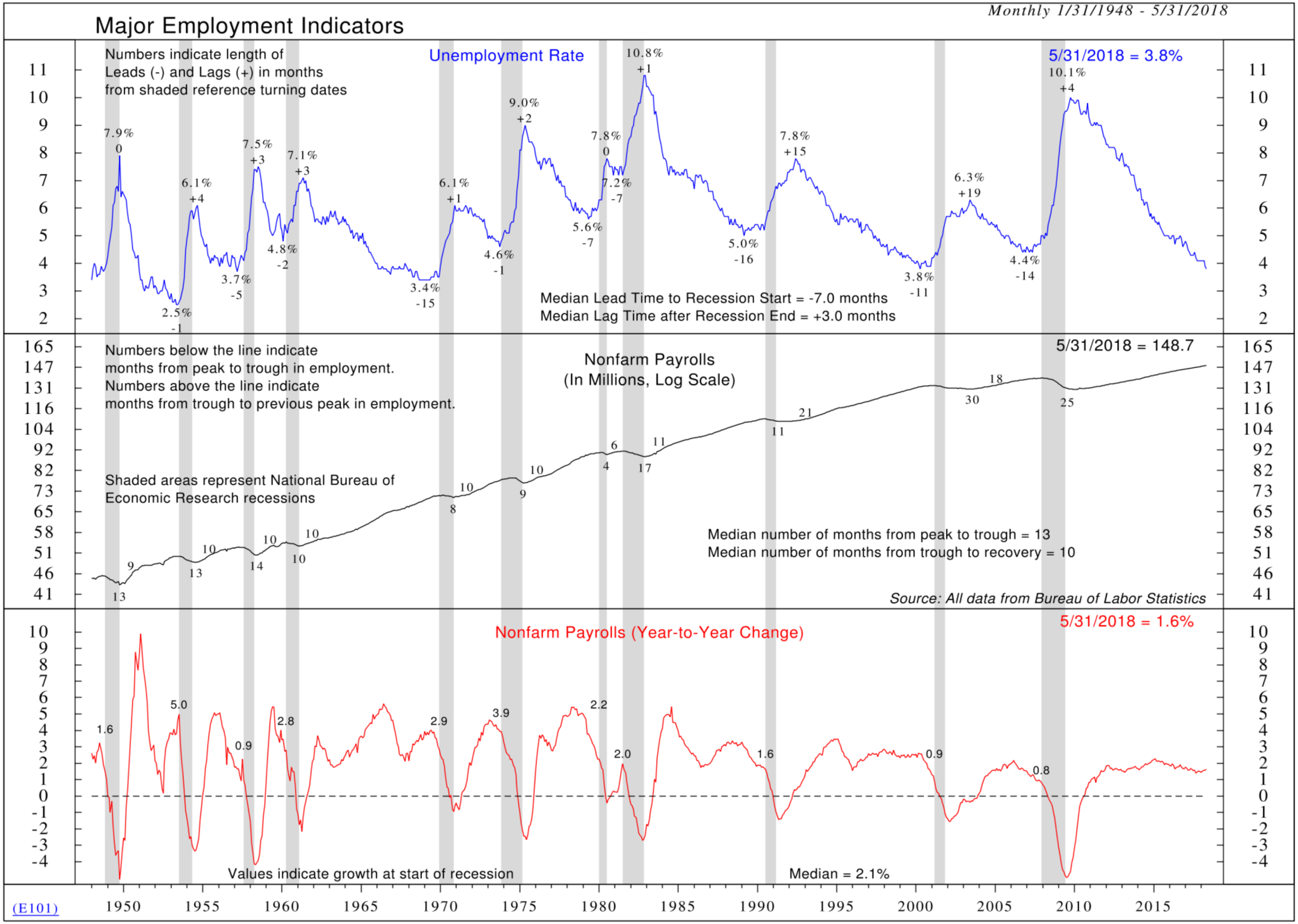
Gross Domestic Product (GDP) is forecasted to come in at 2.8% in 2018 which would be an improvement from 2.3% in 2017 and 1.5% in 2016. Despite an annualized rate of only 2.2% in the seasonally weak first quarter we should see a nice acceleration over the balance of the year. Economists are looking for an annualized second quarter growth rate of 3.4%. Strong jobs reports, a 3.8% unemployment rate (lowest since 1969, please see chart), and positive consumer sentiment all bode well for this pick-up in growth. The U.S. economy is doing better than many other industrialized nations and this seems to be attracting overseas investment driving the value of the dollar higher. Political instability in other areas such as Italy also make the U.S. stand out as a relative safe haven.

Other indicators of a strengthening economy would include a tight housing market, strong data from the Institute for Supply Management (ISM) manufacturing survey, increasing construction spending, and an increase in average hourly earnings.

Inflation is expected to average about 2.5% in 2018. That would be an increase from 2017 at 2.1% but still probably not enough to cause the Fed to deviate from their current path of gradual interest rate hikes. We expect a total of three rate hikes in 2018, although if we see more signs of tightening labor market conditions along with robust growth then four hikes could be possible.

Summary

While the stock market has been a little schizophrenic this year we still think the backdrop is favorable for further gains. Day to day price action will continue to be headline driven but if one can step back and take a 30,000 foot view of things, the investing environment appears attractive for stocks. Periodic sharp sell-offs should probably be viewed as buying opportunities. Fixed income securities are continuing to face some headwinds but with the ability to now lock in 3% returns over a 2-3 year time frame this could prove attractive for some investors.



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