Marco Investment Management

Investment Newsletter **June 2019**

Market Review

Introduction

Sell in May and go away? This would be an understandable reaction based on the -6.4% return of the S&P 500 index in May but we have seen a sharp snapback since then and through the first seven trading days of June the S&P 500 index is up a strong 16.1% year-to-date. Are we likely to see more gains from here or is this as good as it gets? Another question is why bond yields have retreated significantly in recent months despite a fairly robust economic backdrop. We'll explore these and other topics in this edition of our investment newsletter.

Equity Markets

Despite the strong equity market so far in 2019, the S&P 500 index return is about flat compared with the high point in 2018. We experienced a dramatic selloff in the fourth quarter of 2018 and it has taken many months to recover from that weakness. In the fourth quarter of 2018 the main concern was the relentless hiking of short-term interest rates by the Federal Reserve. That concern has been totally reversed with many market participants expecting the Fed to cut interest rates soon. At the moment the market seems more fixated on trade negotiations and the threat of new tariffs being imposed on China, Mexico and other trading partners. The situation is fluid and headline driven but at the moment it appears that a favorable resolution could be reached in the coming months. That sense of optimism combined with a more dovish Fed has helped lift stock prices.

So far in 2019, Technology has been the standout S&P 500 stock market sector up almost 25%. Consumer Discretionary stocks have also outperformed the overall market so there has definitely been an economically sensitive theme at play for stocks. The two sectors that have lagged the most in 2019 are Healthcare and Energy. In the case of healthcare, that sector was the top performer in 2018 but now concerns over the pricing environment for prescription drugs, opioid pain killer lawsuits, and "Medicare for All" have all weighed negatively on sentiment. The good news is that relative valuations are now very cheap for the healthcare sector with a forward P/E of 93% of the overall index compared with a long-term average of about 120%. So, it wouldn't take much in the way of a sentiment shift to produce good returns going forward.

Overall stock market valuations remain somewhat elevated compared to historical averages but are not at extreme levels. The average dividend yield of stocks in the S&P 500 index is presently just under 2% which compares very favorably to the 2.1% yield of a ten-year Treasury note. Almost half the stocks in the S&P 500 index yield more than the ten-year treasury. Lack of competitive yield alternatives may keep money flowing into stocks.

Earnings growth will slow in 2019 compared to 2018 which benefitted from major tax reform but earnings are expected to reaccelerate in 2020.

Historically, the third year of a presidential term is very favorable for stock market returns. In the post World War II era (1948 forward) the third year of a presidential term is up 94.1% of the time for the Dow Jones Industrial Average with an average gain of 15.8% and 88.1% of the time for the S&P 500 index with an average gain of 16.1% (source: Ned Davis Research Inc.). The average gain for the third year is over double that of any of the other years in the four year cycle. Perhaps the reason for this strength is that politicians often pursue a pro-business, low tax agenda to keep the economy strong and enhance reelection prospects. Regardless of the reason, it is generally not a good idea to bet against stocks in the third year of a presidential term. It is true though that year-to-date the return for stocks in 2019 has already met the average for the full third year in the cycle so we could mark time from here and still have a typical year in terms of overall return.

Fixed Income Markets

The U.S. fixed income markets have been taking their cues from overseas markets, low inflation data, a recent softening in economic reports, and more dovish talk from the Federal Reserve. The combination of these factors has resulted in a big rally in bond prices as yields have dropped significantly.

The ten-year Treasury note currently yields 2.12%. As recently as March 1st it stood at 2.76%. While this yield seems very low given a above consensus first quarter GDP at 3.1%, the reality is that our yields are still high in relation to many other industrialized economies (please see chart). In addition, with inflation running below the Fed's 2% target and fears of a slowdown tied to ongoing trade issues it is not unreasonable that bonds prices have rallied.

Market participants expect that the Fed will reduce the Fed funds rate once or twice over the balance of the year. This is a complete reversal from their prior rate hike policy that was in effect as late as the fourth quarter of 2018. One way you can see that the market anticipates a cut is that yields across the entire maturity spectrum from one year to thirty years are higher than the Fed Funds rate. This is causing the front end of the yield curve to be inverted. The normal way this gets corrected is for the Fed to cut rates and drop the Fed Funds rate below what is available in longer dated maturities.

Despite the prospect that yields may remain low for the foreseeable future, we see very little value in most bonds at this time. Yields in the 2% range for Treasuries don't provide much cushion in case the economy surprises to the upside or inflation starts to percolate.

Economic Outlook

Real GDP growth came in at an above consensus 3.1% annualized rate in the first quarter of 2019. However, much of the growth in Q1 was driven by trade and increasing inventories while real final sales were sluggish at 1.4%. Because of trade concerns and other factors economists now expect 2.0% growth in Q2 down from a previously forecasted 2.5%. Calendar year 2019 growth is also forecasted at 2.5%. Weather has been a factor to some extent but concerns about a slowdown tied to already implemented, and newly threatened, tariffs has lead to a more cautious outlook.

Despite this more cautious tone, the economy still looks relatively strong. The Institute for Supply Management Purchasing Managers Index continues to point to expansion with a current reading of 52.1. The 3.6% unemployment rate stands at a 50 year low, and the Conference Board's Consumer Confidence Index remains at a very optimist level of 133. Labor conditions look fairly tight and yield spreads on corporate bonds are in a normal range that would not be indicative of a looming recession.

We continue to believe that for the full year GDP will exceed the current consensus outlook of 2.5% but acknowledge there are downside risks if trade negotiations bog down and punitive tariffs start to weigh on U.S. growth via higher prices that could lead to a reduction in consumer spending and confidence.

Summary

Although stocks have enjoyed a multi-year bull market, we still see an opportunity for further gains. If the current forward P/E ratio of around 17X can be maintained and earnings grow at a forecasted 9-10% this year and another 11%+ in 2020 then stocks should move higher. There is always a risk of P/E compression but low interest rates at just a little over 2% are generally more conducive to multiple expansion rather than contraction. Volatility seems to have become the norm rather than the exception so we do not expect a smooth ride. Headlines out of Washington will add another element of uncertainty but historically the third year of a presidential term is very favorable for the stock market.

Important disclosures regarding this newsletter: 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.

Weekly 6/13/1982 - 6/09/2019

10-Year Government Bond Yields (U.K., Eurozone, Switzerland)

Source: Federal Reserve Board, Bloomberg Finance L.P.

(IE915)

10-Year Government Bond Yields (U.S., Canada, Japan)

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