Marco Investment Management

Investment Newsletter **February 2023**

Market Review

Introduction

After a tough 2022 for both stocks and bonds, financial markets have improved in early 2023. While challenges remain, there are some reasons for optimism. We will discuss the outlook for financial markets in the coming months along with other issues in this edition of our Investment Newsletter.

Equity Markets

Last year was one of the worst in recent memory for stocks and bonds. Rising interest rates, high inflation, the war in Ukraine, and a slowing economy all contributed to weak markets. The good news is that some of those headwinds appear to be receding. We began 2023 with reasonable valuations for stocks and attractive yield levels for bonds, so the setup for this year appears more favorable for both markets than what we experienced last year.

So far in the first few weeks of the year, we are seeing a nice rebound in some of the most beaten-up stocks and sectors. Consumer Discretionary, Technology, and Communication Services stocks have been particularly strong. As of mid-February, these three sectors have each rebounded by over 14%. Defensive sectors such as Consumer Staples, Healthcare, and Utilities are lagging the broad market.

The stock market has rallied in 2023 despite the Federal Reserve continuing to raise short-term interest rates. It appears that the Fed will continue to raise rates during the first half of the year, but the market remains optimistic that we are nearing the end of the rate-hiking cycle. This optimism is also reflected in lower yields on intermediate and longer-term bonds.

While mid-term election years are typically weak, there is a strong tendency for the pre-election year (third year of a presidential term) to produce positive returns. In fact, the Dow Jones Industrial Average has only registered one negative return in a pre-election year since 1939.

In addition, the six months following the mid-term elections are typically strong, with the S&P 500 Index averaging 15.2% over these spans since 1950.

Although the setup for stocks appears favorable following a very poor 2022, there are potential challenges ahead for stocks. One concern is negative earnings revisions. Analysts seem to be a little too optimistic in their aggregate earnings projections for the S&P 500. That number is starting to come down, and further negative revisions will make valuations less attractive unless prices also decline. It now appears likely that 2023 aggregate earnings will be lower than in 2022.

Another concern is competition from bonds. Until recently the S&P 500 Index had a dividend yield that was very competitive with the yields available from investment grade bonds, and it was not uncommon to find half the stocks in the Index yielding more than the 10-year Treasury Note. Today that figure is down to 18.5% (please see chart). While dividends have continued to grow, they have not grown fast enough to keep up with rising interest rates. As a result, income-oriented investors now have a viable alternative to stocks.

While we have strong seasonal and cyclical tendencies pointing to a market rally in 2023, we also have continued headwinds to overcome. We believe this tug of war will likely be won by the bulls, but we expect volatility throughout the year.

Fixed Income Markets

Sub-1% bond yields are quickly becoming a distant memory even though they existed as recently as 2021. Today, bond investors are enjoying the opportunity to lock in yields of 4% or more, and the inverted yield curve means that the highest yields are in low-risk short-term securities.

Yields have shot up in response to high inflation and ongoing monetary tightening by the Federal Reserve. Because inflation is running over 6% on a year-over-year basis, real yields remain negative. However, bond market participants expect inflation will subside and eventually reach the Fed's target of 2%, making real yields positive again. This expectation supports the argument for accepting a lower yield on a 5- or 10-year security rather than a higher yield on a 1-year security. The high yield on the 1-year security will likely prove "transitory," to use a Fed term, and will eventually drop below what is currently available on longer-term securities.

The current inversion in the Treasury yield curve between 10-year and 2-year securities is 87 basis points. You would have to go back to 1980 to find a deeper inversion. Inverted yield curves often precede recessions, but the accuracy rate as a predictor is not 100%. While a recession this year is looking increasingly likely, perhaps the strongest argument against recession in 2023 is the historically low 3.4% unemployment rate.

Non-Treasury bonds continue to provide incremental excess return opportunities over Treasuries, and yield spreads to Treasuries are not particularly wide compared to average levels, which signals that market participants are comfortable taking some credit risk to lock in higher yield levels.

Economic Outlook

Fourth quarter real GDP grew at a 2.9% annualized rate, which was above expectations. However, trade and inventory adjustments accounted for more than two-thirds of the growth, and most of the data measuring consumption has been trending lower. For 2023, the consensus among economists is for anemic GDP growth of 0.6%.

The economy added a much-better-than-expected 517,000 new jobs in January, which was well above expectations and was accompanied by a drop in the unemployment rate to 3.4%, the lowest in over 50 years. The labor participation rate also improved. One concern is that the recent layoff announcements we have seen, primarily in the technology sector, will spread to the broader economy. Economists are looking for the unemployment rate to climb to 4.2% in 2023.

Housing has taken the brunt of the Fed's interest rate hikes, and the 30-year conventional mortgage rate has ticked back up recently, now approaching 6.5%, which could further suppress demand even while the inventory of homes for sale remains relatively low.

Average hourly earnings have been growing at a 4.4% annual rate, but these wage gains have not kept up with inflation.

During the pandemic, demand soared for goods while services suffered. That has since reversed, and demand for services, especially for travel and other experiences, has been very strong. CEOs of hotels and airlines are continuing to forecast robust demand despite economic uncertainties.

Consumer sentiment has recently improved, with the University of Michigan survey coming in at 66.4, which was the highest level in over a year and above consensus expectations. Continued strength in the labor market and signs that inflation may have peaked are likely contributing to this improvement. While the trend in sentiment looks favorable, the actual reading is still well below the pre-pandemic peak of 101 and the historical average of 86.1.

The Institute for Supply Management's manufacturing index, a survey of purchasing managers, is running in the opposite direction from consumer sentiment. This index has been contracting, and the present reading of 47.4 is the lowest since May of 2020, which was in the heart of the pandemic.

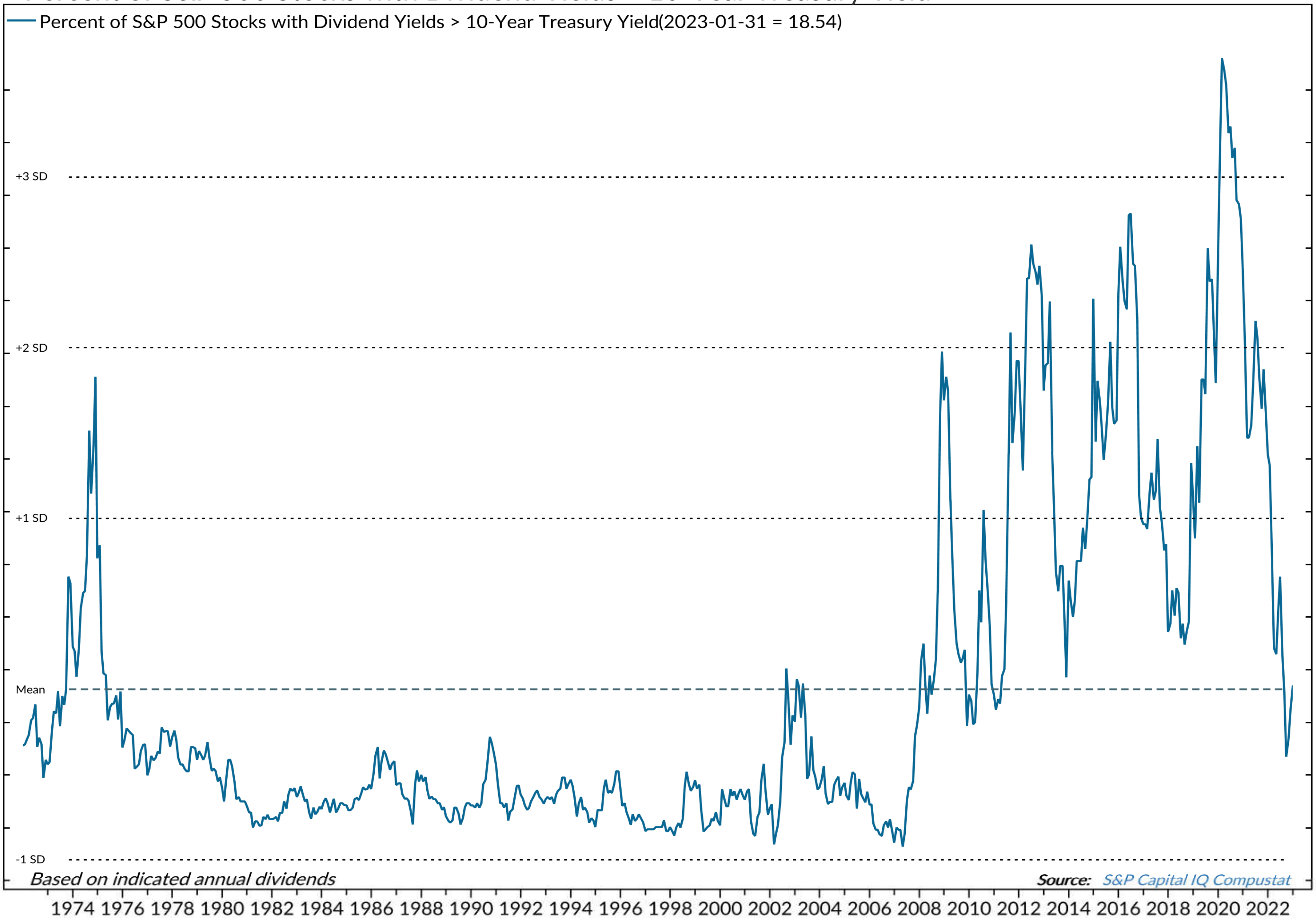
Overall, mixed signals persist for the economy, but the risks seem skewed to the downside given the lag in the effect of interest rate hikes. We could be looking at a mild recession a few months down the road.

Summary

We enter 2023 with cautious optimism about prospects for the stock and bond markets. Pre-election years are typically positive for stocks, and there are still many stocks trading at attractive valuations. Bond yields are now at levels that look relatively attractive, and we therefore expect money to flow into both markets. Any sign that the Fed is nearing the end of its rate-hiking cycle will likely be met with enthusiasm, but we still expect at least a couple more hikes this year. Even though a mild recession is possible, the market seems to be looking ahead to better days.

Percent of S&P 500 Stocks with Dividend Yields > 10-Year Treasury Yield

Monthly Data 1972-01-31 to 2023-01-31



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