Marco Investment Management

Investment Newsletter May 2021

Market Review

Introduction

According to the lyrics of a popular song, "what a long, strange trip it's been." The past 14+ months of the pandemic have indeed created a long, strange trip for investors, ranging from a massive sell-off in stocks to hitting new highs on the major averages. Now that we appear to have turned the corner on the pandemic, the question is: "Where do markets go from here?" We will explore this topic and others in this edition of our Investment Newsletter.

Equity Markets

The stock market has continued to build on the gains of 2020, with the S&P 500 index up over 11% year-to-date. Enthusiasm about declining virus case counts and deaths, as well as widespread vaccine adoption, have pushed many states to reopen their economies and relax restrictions, which has led to optimism that the economy will be very strong in 2021 and 2022. Year-over-year earnings growth in 2021 is currently forecast at 32.3%.

Strong earnings growth, monetary and fiscal stimulus, and continued low interest rates have created a favorable backdrop for the stock market. Year-to-date, the best sectors have been economically sensitive, such as Energy, Financials, Industrials, and Materials. Laggards include Technology, Consumer Staples, and Utilities. All S&P sectors are positive year-to-date.

In 2020, defensive "stay-at-home" stocks did extremely well, as did most anything connected to e-commerce. With the economy reopening, groups such as travel and leisure, restaurants, and transportation stocks have shined. Another shift has been away from growth stocks into value stocks. The valuation gap between the two had grown quite large, and so there has been some profit-taking in the large growth companies in order to buy into areas of the market that had previously lagged. While we think this shift may still have some room to run, we also believe that quality growth stocks that are extremely profitable and typically carry little debt will continue to offer long-term opportunities. The technology sector represents 27% of the S&P 500 (38% including communication services), so it is difficult to imagine a continuation of the bull market without the participation of these stocks.

Stock valuations, as measured by forward price-earnings ratios, look a bit stretched at the moment but may be justified given the strong earnings backdrop and continued accommodative fiscal and monetary policy. Investor sentiment is very optimistic at this time, and that can be seen as a contrary indicator. We would not be surprised to see some pullback and/or consolidation over the next few months, but we remain overall bullish.

Currently all major stock indexes remain in uptrends as measured by their 200-day moving averages. (Please see chart.) Unless this trendline reverses and rolls over, the bulls should be given the benefit of the doubt over the bears.

Fixed Income Markets

The Federal Reserve continues to maintain that short-term interest rates will be anchored in a range of zero to 0.25% for the foreseeable future. The market, however, is beginning to question this policy as inflation has been rekindled and is currently running much higher than the Fed's 2% target. Even though the Fed has indicated that the current bump in inflation is "transitory," we have seen interest rates rise this year for intermediate and longer-term securities. Rates are still low on an absolute basis, but if higher inflation becomes imbedded, rates will likely have to rise further and the Fed may have to adjust their very accommodative monetary policy. Most government bonds yield less than the current inflation rate, so real rates of return are negative. We could see the ten-year treasury note moving into the 2-2.5% range over the next year.

Returns for broad fixed income indexes this year are generally negative as the meager interest rates offered by many bonds have been offset by price declines. Floating-rate bonds and inflationprotected securities have done better. Tax-free municipal bonds have also done relatively well in response to talk of higher income tax rates.

Over the past year, the yield on the ten-year treasury note has increased by a full percentage point, with most of that move coming in 2021.

Currently the bond market is not forecasting much chance of recession as yield spreads on non-Treasury debt are fairly tight, which indicates confidence in the economy and a market assessment that default risk is low.

Economic Outlook

The economy has been on a roller coaster ride since last March. The unemployment rate went from a 50-year low to almost 15% virtually overnight. Annualized GDP has swung from -31.4% to +33.4%. Currently it is running at a 6.4% rate with expectations that full-year 2021 real GDP will be in the 6-7% range.

The current strong economic growth is leading to overheating in some areas. Residential real estate, for example, is extremely hot, and automobile sales are also very strong. Because of supply/demand imbalances, prices are rising in many areas. Labor is also in short supply. Some sectors, such as restaurants, cannot keep staffing at adequate levels and are having to raise wages and offer hiring bonuses. Some of the lack of labor may be attributable to the enhanced government unemployment benefits. This extra money with no work requirement is, in some cases, providing more income than would result from full time employment. These enhanced benefits are scheduled to expire in September, and some states are ending them before that date.

The most recent report on non-farm payrolls showed an increase, but it was well below forecast. Some of the shortfall may be attributable to potential workers choosing instead to collect benefits but may also be partially due to workers having to stay home due to childcare issues. There may also be some skill mismatch issues. Even with these factors, payroll growth has averaged over 500,000 in each of the past three months.

Other measures of economic activity are pointing to growth, including the Institute for Supply Management Purchasing Manager's Index. The latest reading of 60.7 is well above the neutral baseline of 50. In addition, durable goods orders exceeded expectations, and initial jobless claims came in lower, or slightly better, than forecast.

Supply chain issues are still causing disruptions, especially in areas like semiconductors. The inventory of new vehicles is shrinking as automobile makers are forced to curtail production due to chip shortages despite robust demand. This disruption will hurt future sales and profits until bottlenecks ease. We may also see some diminished demand for new construction since lumber prices are up over 250% from 2020 lows.

The most recent consumer price index report was much higher than expected at a 4.2% year-over-year rate. CPI expectations for 2021 are currently at 3.0%, so we will need to see some moderation in prices for this year-end result to occur.

It is unclear at this time whether the infrastructure bill in Congress will look more like the Republican or Democratic proposal. Both sides are far apart on the size of the respective packages, but it does appear there is some effort being made at a bipartisan compromise. Whatever bill passes should add further stimulus to the economy, although the potential long-term inflationary impact is still up for debate.

Likewise, there are numerous proposals being floated to raise individual and corporate taxes. The extent of any such increases could be a potential drag on future economic growth.

Summary

The overall trend for stock prices appears higher, although some short-term indicators are overbought and we are entering what is often a seasonally weak period. Fixed income may continue to struggle as higher inflation puts pressure on yields.

New policies coming out of Washington and any negative virus-related news could also influence markets over the balance of 2021.

Disclosures: GDP is the monetary value of all finished goods & services made within a country during a specific period and is used to estimate the size of an economy and growth rate. ISM 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.

U.S. Market Indexes 50-Day & 200-Day Moving Average Trend Indicators