Marco Investment Management

Investment Newsletter December 2019

Market Review

Introduction

Fear of heights? That is certainly on the minds of many investors as the S&P 500 index hovers near an all-time high. The question is whether the strong returns registered so far in 2019 are justified and sustainable. We will explore that topic as well as the outlook for bonds and the economy in this edition of our Investment Newsletter.

Equity Markets

Following a lackluster 2018 where most stocks declined in value, 2019 has been extremely strong with all S&P sectors registering positive returns. The standout performer in 2019 has been Technology with that sector up over 40% through early December. The laggard has been Energy up about 6% over the same time frame.

Because of the strong returns in 2019, the valuation of stocks has also increased with the forward price earnings ratio of the S&P 500 index now about 18X. This is above the long-term average of about 15X but remains below peak valuation levels. The current valuation may be justified given the current low level of interest rates. Low interest rates make the present value of a future earnings stream more valuable in today's dollars.

Even with the rise in stock prices this year, the average S&P 500 stock still has a dividend yield of about 2%. This compares favorably to the yield on the ten-year Treasury note of about 1.8%. Presently 52% of stocks in the S&P 500 index have dividend yields greater than that of the ten-year Treasury note. This is well above the long-term average of around 15% (please see chart). Dividends are expected to grow by about 7% in 2020.

Earnings growth will slow in 2019 compared to 2018 which benefitted from major tax reform but should still come in about 9% higher than last year. Consensus expectations are for about 10% earnings growth in earnings in 2020. This is notable since as recently as a few months ago there was widespread fear of a recession in 2020.

While returns have been uniformly positive in 2019, there has been a definite economically sensitive tilt to the market. As a result, some of the lagging sectors such as Healthcare are beginning to look more interesting on a valuation basis. Healthcare has suffered due to concerns about proposals such as "Medicare for All" and price caps on prescription drugs. While we think some reforms and expanded coverage are possible, it is very unlikely to be draconian in nature. Healthcare companies should benefit from an aging population and the sector presently carries the second lowest valuation in the S&P 500 index trading at 88% of the overall index valuation. Since 1992, that figure has been closer to 117% of the index indicating that the market may have already priced in most concerns.

Even though stocks are having a very good year, we see the potential for additional moderate gains from present levels. Historically, the third and fourth years of a presidential term are relatively strong for stocks. Now with recession fears fading and interest rates not providing much competition for stocks, the market could continue to grind higher. However, headlines relating to trade negotiations and impeachment could add to market volatility.

Fixed Income Markets

The U.S. fixed income markets have been doing well this year despite a generally good economic backdrop. The market seems to have responded more to a sub 2% inflation backdrop and overseas rates that are generally a good bit lower than here in the U.S.

The ten-year Treasury note currently yields about 1.8%. That is at the lower end of the 2019 range of 1.5% to 2.8%. The yield curve also remains fairly flat by historical standards, but due to recent Fed action the short-end of the curve is no longer inverted. Real interest rates are around zero to slightly negative depending on what inflation

measure is used. This would indicate a lack of long-term value in the bond market.

Fixed income prices have also been supported by an accommodative Federal Reserve that has lowered short-term interest rates a total of three times this year to stave off a potential economic slowdown. Since the economy is still growing at a 2% +/- rate the Fed may now be on hold for a while as they await further economic data that could dictate policy.

Even if rates remain low for an extended period of time, risks in the bond market are definitely higher now than in recent years. This is because the issuance of low coupon debt provides very little income cushion if rates rise at some point meaning prices will decline more so than in the past if rates rise. The average duration of the ten-year Treasury note is notably longer now than in periods when rates were higher. Longer duration bonds are inherently more risky than their shorter duration counterparts.

Economic Outlook

Real GDP growth came in at an above consensus 2.1% annualized rate in the third quarter of 2019. However, economists expect full year GDP to slow to 2.3% compared to 2.9% in 2018.

The labor market continues to show strength with 128,000 new jobs created in October. This was stronger than the forecast of 85,000. September was also revised upward to 180,000 from 136,000. The strength in the labor market in the third quarter was particularly surprising given that a strike was ongoing at General Motors which had resulted in temporary layoffs.

Escalating trade tensions between the U.S. and China are weighing on global economic growth, pressuring central banks around the world to continue easing monetary policy. The U.S. and China continue to move forward on securing a "phase one" trade deal. The U.S. congress also needs to ratify the already agreed upon USMCA trade agreement with Canada and Mexico. There seems to be bipartisan support to get this agreement ratified in the relatively near future which would ensure free trade between all three countries.

Even though inflation remains low with economists expecting the consumer price index to come in at 1.8% for all of 2019, we have seen a slight uptick recently. The October CPI reading was 0.4% but that may have been an outlier as the forecast for November is 0.2%. Regardless, it appears inflation should run a little north of 2% in 2020. The Fed's long-term target for inflation is 2% but they have indicated brief periods above that level are not problematic.

The Institute for Supply Management's Purchasing Manager's Index has slipped in recent months which is consistent with a moderate slowdown in economic growth, but consumer confidence remains relatively strong and labor markets are fairly tight. Unemployment at 3.6% is near a fifty year low.

Summary

Although stocks have enjoyed a multi-year bull market, we may still have opportunities for further gains. If the current forward P/E ratio of around 18X can be maintained and earnings grow at a forecasted 9-10% this year and next, then stocks should move higher. There is always a risk of P/E compression but low interest rates below 2% may help maintain stock valuations at present levels. Volatility will undoubtably continue so we do not expect a smooth ride. Long-term though, stocks generally follow the direction of earnings growth and we don't see an imminent recession on the horizon so the earnings trajectory should continue higher.

We don't see much value in the bond market at this time. Based on current and anticipated inflation levels we feel the ten-year Treasury note should be closer to 2.5% rather than 1.8%. The caveat is that our rates are still relatively high compared to much of Europe and Asia so we may not move higher without a similar move in those markets.

We would like to take this opportunity to wish you a joyful holiday season and a prosperous 2020.

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.

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

Monthly Data 1972-01-31 to 2019-11-30

Based on indicated annual dividends

Source: *S&P Capital IQ Compustat*

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