Marco Investment Management

Investment Newsletter **March 2019**

Market Review

Introduction

On November 30, 2018 the S&P 500 stood at 2,760. At the end of February 2019 it stood at 2,784. So, sort of boring three months, right? Well, not exactly. The past three months were a true roller coaster ride with extreme volatility as the market took on a manic depressive persona. In this edition of our investment newsletter we will discuss what drove the markets from depression to euphoria and where we might go from here.

Equity Markets

So far in 2019 the S&P 500 is up a strong 11.5% and up almost 19% since the Christmas Eve low. However, when all of December is included the market is up less than 2% since that time. December was a very weak month at -9.0% and the weakness in December pulled the 2018 yearly return into the red.

Back in December the market was fixated on a number of negatives including talk of an economic slowdown that could lead to a recession, a seemingly tone deaf Federal Reserve intent on ratcheting interest rates ever higher, the ongoing Mueller investigation, and fears that the Chinese trade dispute could escalate with additional tariffs. All of these concerns weighed on stocks. Sentiment turned decidedly negative culminating in a low volume shortened trading session on Christmas Eve when the S&P 500 closed at 2,351. That was almost 20% lower than the September 20th high water mark.

Fast forward to the end of February 2019. The Federal Reserve got the message and is now officially taking a wait and see attitude towards further rate hikes, there is a lot of optimism that we are close to a breakthrough on a Chinese trade deal and fourth quarter GDP came in at a very respectable 2.6% annualized rate alleviating recession fears. The Mueller investigation is still ongoing but to date there is no information to report about any Russian collusion that might have impacted the 2016 elections. So, the stock market is back in rally mode. The takeaway from all this is that sometimes it is better to step back and take a long view of the markets rather than get caught up in every headline

So, where do we go from here? In the short-term the market looks a little extended and overbought but that condition can be rectified by a consolidation phase where the market digests recent gains. While valuations are no longer "cheap" the forward P/E ratio on the S&P 500 index is not extreme at 16.4X. This is above the 14.9X long-term average but still well off the year-end 2017 level of about 19X. Dividend hikes and stock buybacks continue while merger and acquisition activity remains relatively brisk. As long as the economic data remains in the 2.5%-3% range earnings should continue to expand at least at a high single digit rate providing some support for stocks and possibly allowing for the forward P/E to move to 17X or higher. Consensus estimates put 2019 S&P earnings at $167 (+10%) implying limited near-term upside but by mid-year market participants will likely be focused on the 2020 estimate which is currently about $186 (+11.2%). If $186 is accurate that would imply about 13.5% upside potential using a 17X P/E.

Of course it is rarely a smooth ride for stocks as the market always has to "climb a wall of worry". If attention turns toward ballooning deficits, a global economic slowdown (perhaps excluding the U.S.), or renewed geopolitical tensions then we could easily give back some of the recent gains

Recently the market has been favoring economically sensitive stocks at the expense of more defensive issues. After finishing 2018 as the top performing sector, Healthcare has weakened on concerns about pricing pressures. We still think this sector is attractive due to our aging population and that innovative companies with strong patent portfolios can continue to do well. We also think the recent rebound in energy stocks could have some staying power after being the worst sector four of the past five years.

In general, we are favoring companies with above average growth potential selling at reasonable valuations. This often leads us into the mid-capitalization category although there are many large cap stocks that qualify as well. Companies generating free cash flow that can be used for dividends increases and share repurchases are also of continued interest.

Fixed Income Markets

Over the past three months interest rates have generally fallen. With the exception of T-Bills, most rates are about a quarter of a point lower than at the end of October. Initially, the drop in yields was attributed to money moving out of stocks into bonds during the December selloff but now stocks have roared back and yields are still on the lower end of the trading range. Some of this may be attributed to very modest inflation as well as the anchoring effect of global interest rates that are lower than here in the U.S. (please see chart).

The other bond market phenomenon that continues is the relatively flat yield curve. Interest rates on maturities from 1-5 years are almost identical and going from 5 to 10 years only provides about 20 basis point in additional yield. This flat curve is unusual. For example, going back to 1979 the difference between the yield of a two year and a ten year Treasury has been almost a full percentage point on average compared to the current 18 basis points. Given the flat curve and the rally in bond prices over the past few months we see little reason right now to aggressively extend maturities. The risk/reward doesn't seem favorable. At some point when it is clear the Fed is no longer biased towards raising rates we may want to lock in some longer-term yields but for now we are content to stay in intermediate term maturies ranging from about 2-7 years. Yield spreads have widened on some corporate securities making that sector relatively attractive in our view.

With very little in additional yield available on longer-term bonds only if rates continue to decline from here will one be better off extending into these securities on a total return basis (price change plus income) compared to shorter-term issues. We expect the Fed will raise rates at some point in 2019 if the economy continues to expand but we think they are on hold for now.

Economic Outlook

Real GDP growth came in at an above consensus 2.6% annualized rate in the fourth quarter of 2018. That put the full year at a solid 3.1%. There was some inventory building in Q4 so any drawdown in early 2019 could present a headwind. Overall though, we still think 2019 GDP could come in above the current consensus of 2.5% although Q1 will be negatively impacted by severe winter weather and the government shutdown with a likely sharp snapback in Q2.

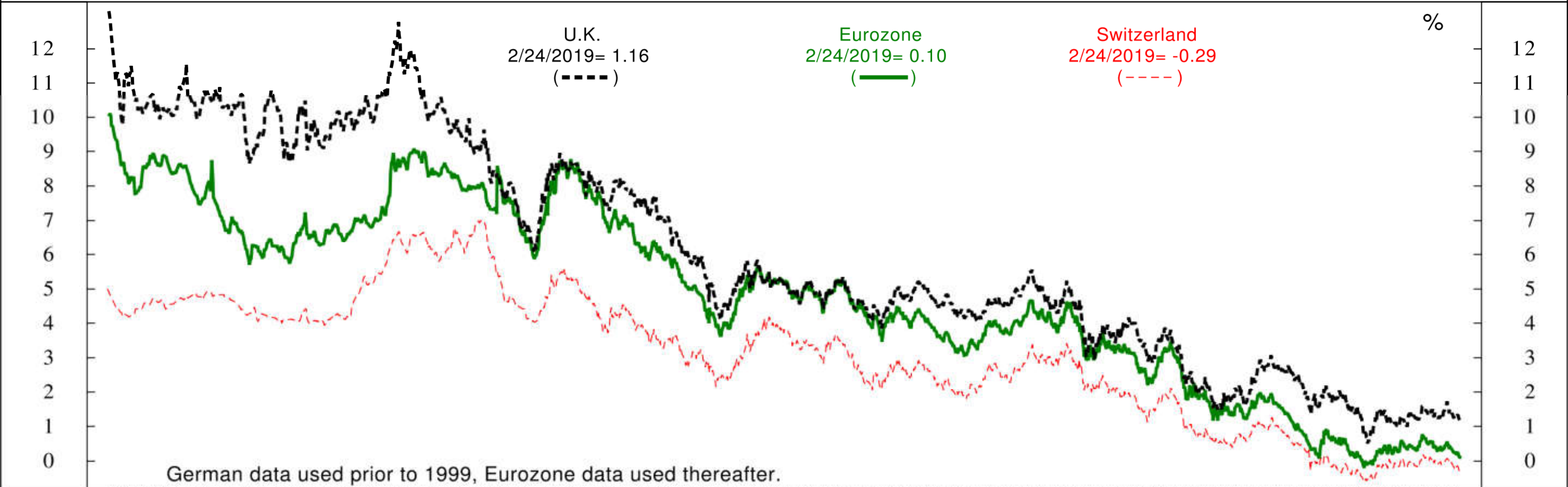
Other measures of economic activity also point to continued growth. For example, the most recent Institute for Supply Management Purchasing Managers Index reading of 54.2 is still solidly in the expansion zone. The Conference Board's Consumer Confidence Index also points to optimism with a recent above consensus reading of 131.4.

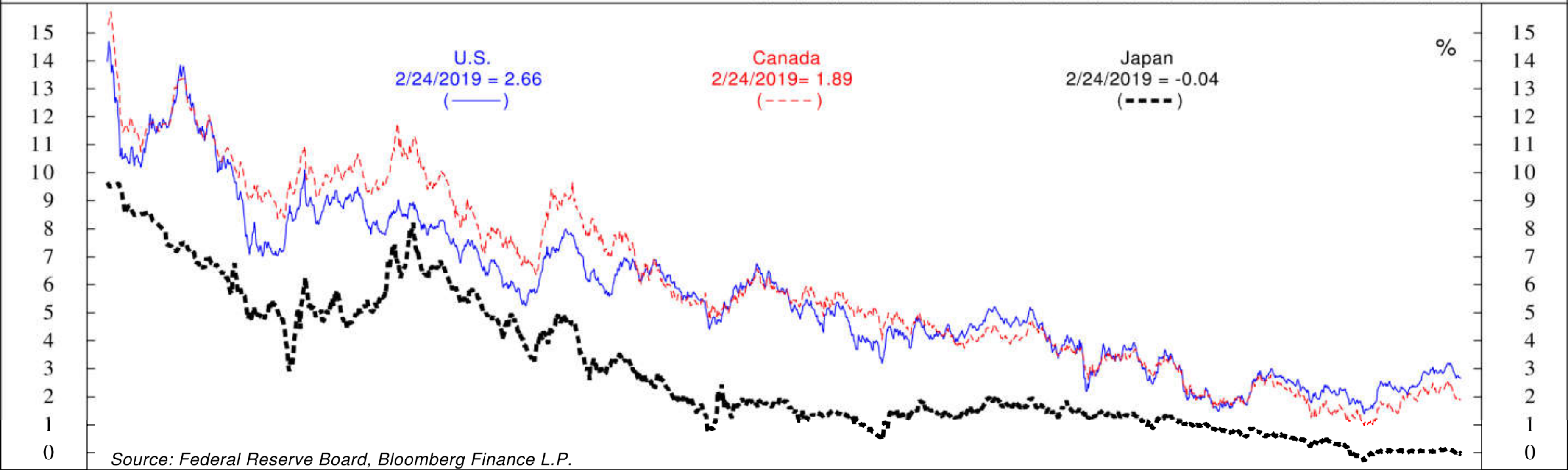
Unemployment remains low at 4.0%. While this is off the 3.7% historic low, some of this is attributable to a higher labor participation rate. Unemployment peaked at 10.1% just after the Great Recession of 2008-2009. The Labor Participation Rate stands at a multi-year high of 63.1% (up from 62.9%). Inflation is running at a 1.6% year-over-year rate but we would expect it to move closer to the Fed's 2% target over time.

Summary

The stock market remains volatile over short periods of time but we remain bullish for the intermediate-to-longer term horizon. Valuations are not stretched and interest rates remain relatively low and possibly range bound. Eventually we will have another recession but it does not appear imminent.

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.





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