Marco Investment Management

Investment Newsletter **March 2018**

Market Review

Introduction

The trend is your friend. This old adage has certainly held true in recent years as the stock market has marched to new heights with only periodic pullbacks. The question now is whether the sharp pullback experienced in early February marked a change in trend or just a correction in the established uptrend. Similarly, is the recent rise in interest rates a change in trend following many years of steadily lower interest rates? We will explore these and other topics in this edition of our Investment Newsletter.

Equity Markets

Through the first two months of 2018 the stock market has been on a roller coaster ride. January was strong right out of the gate helped, in part, by the tax reform bill passed in December that dramatically lowered corporate tax rates. The strong January return of 5.72% (S&P 500 index*) was unsustainable, however, creating an extreme short-term overbought condition. This set the market up for a pullback on any negative headline. That headline came in the form of a 2.9% average hourly earnings number for January. This "hot" number created fears of inflation which could lead to a faster pace of Federal Reserve rate hikes. The stock market quickly retreated 8.55% in the first eight days of February wiping out all of the January gains.

During the selloff many individual stocks declined more than 10% which is the typical definition of a correction. However, the selloff was short lived as the market staged a strong comeback bringing the S&P 500 back into the black through February.

In dissecting the selloff, it is clear that the overbought technical condition was a factor, along with computer generated selling that was tied to increasing volatility and the violation of key technical support levels. Higher interest rates also were a concern. In addition, the forward P/E ratio of the market had moved to about 19X compared to a long-term average of closer to 15X so there was minimal valuation support. At the low on February 8th the forward P/E on the S&P 500 was a much more reasonable 16.4X prompting some buying. Presently the forward P/E is 17.7X. We believe the market P/E is actually overstated because many companies have not yet issued updated earnings guidance resulting from the lower corporate tax rate.

We are still constructive on the prospects for stocks in 2018. Earnings growth is expanding at a double digit pace and should continue to accelerate for at least 2-3 more quarters. Dividends are still growing and the average corporate payout ratio is below the long-term average indicating there is still room for increasing payouts. Merger and acquisition activity continues at a healthy clip and the repatriation of overseas cash by U.S. corporations may be redeployed in a more productive manner.

In terms of trend, the recent pullback does not appear to violate the overall uptrend. The slope of the 200 day moving average trend line has been generally positive since July of 2009 and while the index has breached this line a few times over this period those violations were relatively short lived.

Sector-wise, the market has been favoring economically sensitive groups and we see no reason for this to change anytime soon. Technology and Consumer Discretionary have been standout sectors in part because of the contribution of the "FANG" stocks like Amazon, Facebook, and Netflix. While these companies continue to deliver above average revenue growth, valuations are stretched in some cases. For example both Amazon and Netflix have forward P/E ratios in the 84X range. Interest rate sensitive sectors such as Utilities, Telecommunications, and Real Estate have lagged along with Energy. Later this year changes are coming to the constituents of several sectors. The Telecommunications sector, for example, is being renamed Communication Services and will now include companies such as Alphabet, Facebook, Twitter, and Netflix.

Fixed Income Markets

While stocks have generally been in an uptrend, bond prices have been trending lower as a result of higher interest rates. The Federal Reserve has made it clear that the era of easy money is ending and interest rates are set to move higher through balance sheet shrinking and increases in the Fed Funds rate. The Fed has already hiked the Fed Funds rate five times since December of 2015 and another 2-3 increases are possible in 2018. If this path comes to fruition the Fed Funds rate will end the year around 2-2.25%.

Initially increases in the Fed Funds rate were met with a yawn in that longer term rates did not respond proportionately. More recently though, longer term rates have been moving a good bit higher with the ten-year Treasury note going from around 2.1% in September of 2017 to about 2.9% at present. It is widely expected, and we would concur, that the ten-year will move above 3% in the not too distant future. We do not believe that a 3% ten-year will stifle economic growth. It is just a reflection of an economy that is picking up steam and with perhaps a tad bit more inflation. The Fed would like to see inflation around 2% and they will be vigilant in responding to any indication of sustained accelerating inflation.

The new tax law will likely have a positive effect on economic growth but it may also have a negative effect on the deficit, at least in the first year or two. Borrowing costs to finance the deficit are likely to increase creating a non-virtuous cycle unless tax receipts surge. Surging receipts would negate the concern that lower tax rates mean higher deficits. While the ultimate impact on the deficit is unknown we do believe that rates are headed somewhat higher and that the long-term trend towards lower rates that had been in place for at least ten years has been reversed.

Economic Outlook

Despite the fourth quarter Gross Domestic Product (GDP) registering an annualized 2.6%, it appears that the economy may be on track for 3% growth in 2018. Both Q2 and Q3 in 2017 registered 3%, or better, annualized growth and current labor market conditions and double digit corporate earnings growth should be supportive of acceleration in GDP this year. It is possible that unusually cold weather could impact Q1 negatively but we would view that as an aberration. Fatter paychecks could boost consumer spending and the consumer is still the driving force behind our economy.

Other indicators of the economy are also pointing towards expansion including the Institute for Supply Management Purchasing Managers Index (please see chart), the Conference Board's Leading Economic Index, Initial claims for unemployment insurance, and the Bloomberg Consumer Comfort Index. In the case of the Leading Economic Index (LEI), it jumped 1.0% in January, the second most since November of 2013. Over the past six months the LEI is up 3.8% which is the biggest surge since April 2011. The Bloomberg Consumer Comfort Index stands at 56.6 which is the second highest level since March of 2001. This index is a good proxy for consumer spending.

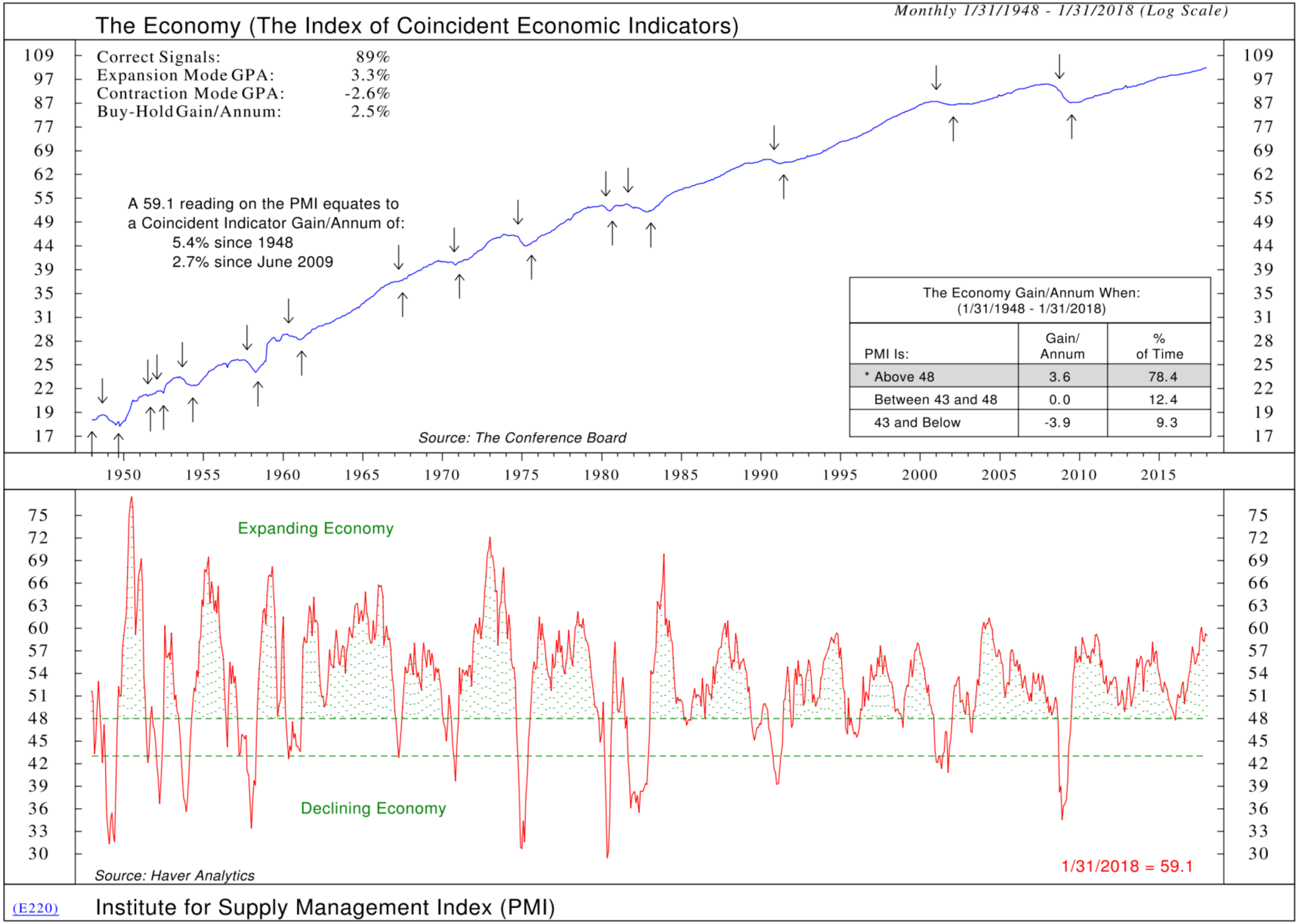
Inflation is expected to average about 2.3% in 2018. That would be a small increase from 2017. We believe the risk to inflation is skewed to the upside but we do not believe we will see a surge in inflation especially with the deflationary forces such pricing transparency of e-commerce keeping many prices in check.

Summary

As we said at the beginning of this newsletter "The trend is your friend". We believe the trend for stock prices remains up while the trend for fixed income prices remains down as interest rates creep higher.

Volatility is definitely back in 2018 following a very subdued period of volatility in 2017. This is not necessarily a bad thing and it may create additional opportunities to buy stocks as periodic corrections occur.

While the rise in the S&P 500 index has been dominated this year by a handful of stocks we think the market will likely broaden out and that economically sensitive sectors will continue to do well.



The Economy Gain/Annum When: (1/31/1948 - 1/31/2018)

PMI Is:	Gain/ Annum	% of Time
* Above 48	3.6	78.4
Between 43 and 48	0.0	12.4
43 and Below	-3.9	9.3

** 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.*