Marco Investment Management

Investment Newsletter **September 2018**

Market Review

Introduction

The stock market has shown remarkable resilience in 2018 in the face of a less accommodating Federal Reserve, trade jitters, and mid-term election uncertainties. These concerns have been offset by a strengthening economy and double digit earnings growth for many companies. The question now is can the market continue to reach new highs or will a more cautious tone ensue? We will explore these and other issues in this edition of our Investment Newsletter.

Equity Markets

Through the first eight months of 2018 the stock market has been trending higher despite periodic setbacks. As of August 31st the S&P 500 index was up 9.9% for the year only slightly below its all-time high reached on August 29th.

Despite the market being near an all-time high, the valuation of the market is not at a peak level. That occurred during the dot com era in 1999. Currently the market trades at about a 17X 12 month forward P/E ratio which is actually down from close to 19X in January. The reason the P/E is lower now than at the first of the year despite near record high prices is that earnings have been growing faster than stock price appreciation. Earnings growth has benefitted from corporate tax reform that was passed in December of 2017. These lower corporate taxes combined with an improving economy have resulted in 20%+ earnings growth. Over the next 12 months earnings on the S&P 500 index are expected to grow by 22.3%.

While earnings are currently very strong, the comparisons will get tougher as we enter 2019 since we will anniversary the big tax cuts. Earnings should continue to grow in 2019 and 2020 but at a more typical rate than what we are currently experiencing. This deceleration in growth might present a headwind for the market, but we think the trend will remain positive.

So far in 2018 the market has been rewarding economically sensitive companies especially those in the technology and consumer discretionary sectors. Healthcare has also performed well. The worst sectors have been defensive and interest rate sensitive sectors although recently we have seen some sector rotation in that direction.

Technically speaking, the market appears sound with the 200 day moving average on the S&P 500 in a clear uptrend. As we have experienced periodic selloffs this trend line has provided support and has not been violated.

The big question for the stock market is whether the current P/E ratio can be maintained in the face of higher interest rates and a likely slowdown in earnings growth. Assuming a 17X P/E on 2019 S&P 500 consensus earnings of $178.15 would put the index at 3,029 compared to 2,902 at the end of August. This implies modest upside from here but 2020 consensus earnings are at $196.15 which represents 10% growth over 2019. Dividends could also boost stock returns by around 2% annually on average. Dividends are expected to grow around 10% this year.

Historically during a four year presidential cycle the mid-term election year is the weakest of the four (please see chart). Perhaps this year will prove atypical due to the tax cuts and accelerating GDP but we still expect volatility between now and year-end.

Fixed Income Markets

The bond market continues to struggle with higher interest rates but the rise in rates has not been uniform. Short term notes are up over a percentage point in the past year while the yield on the 30-year Treasury bond is only up about a quarter of a point. This non-parallel shift in the yield curve has resulted in a flattening phenomenon.

Because longer-term issues carry more price risk investors typically receive a steadily higher yield the further they extend maturity. Presently there is very little additional yield compensation in longer term issues versus short-term issues. While the yield curve is still positively sloped there is a distinct possibility of an inversion occurring which would mean that longer-term issues will yield less than shorter-term issues. While uncommon, previous yield curve inversions have signaled a coming recession and subsequently lower interest rates. At the moment though there is no sign of a recession on the horizon and the Fed is still telegraphing multiple rate hikes in the coming months.

We still think the trend in interest rates is higher, not lower, so we are concentrating purchases in short-to-intermediate maturities. However, if the curve inverts we would consider some longer maturities as a hedge against lower rates. Since the Fed started raising rates returns have been better in the shorter end of the curve than the longer end even though the absolute rise in rates has been more pronounced in the short end. For example, the ICE 1-3 year Treasury index is flat for the 12 months ending August 31st while the ICE 7-10 Treasury index is down 3.1%.

We expect the Federal Reserve to hike rates in September by a quarter point and then take a wait and see attitude before implementing a December hike. For all of 2018 the Fed will likely raise short-term rates by 3/4 to 1 percentage point.

Economic Outlook

Gross Domestic Product (GDP) has picked up substantially since the relatively weak first quarter report which was impacted by weather. Since then the second quarter came in at an annualized rate of 4.2% (best since September 2014) and economists are generally expecting the third quarter report to exceed 4%. For the full year the consensus is for 2.9% growth. This number has been trending higher and could top 3%. Inflation seems relatively contained with an expectation of 2.5% for 2018 and 2.3% in 2019. Wage growth has ticked up to 2.9% year-over-year and this could contribute to somewhat higher inflation down the road. The Fed seems content to let inflation move a little above their 2% long-range target.

Other indicators of economic growth are also favorable. The Institute for Supply Management composite index is at 61.3. Anything above 50 indicates expansion in economic activity. The Conference Board's Consumer Confidence Index stands at 133. This is a level consistent with GDP growth of 2.9% on average. This survey bottomed out at 26 back in 2009 during the recession

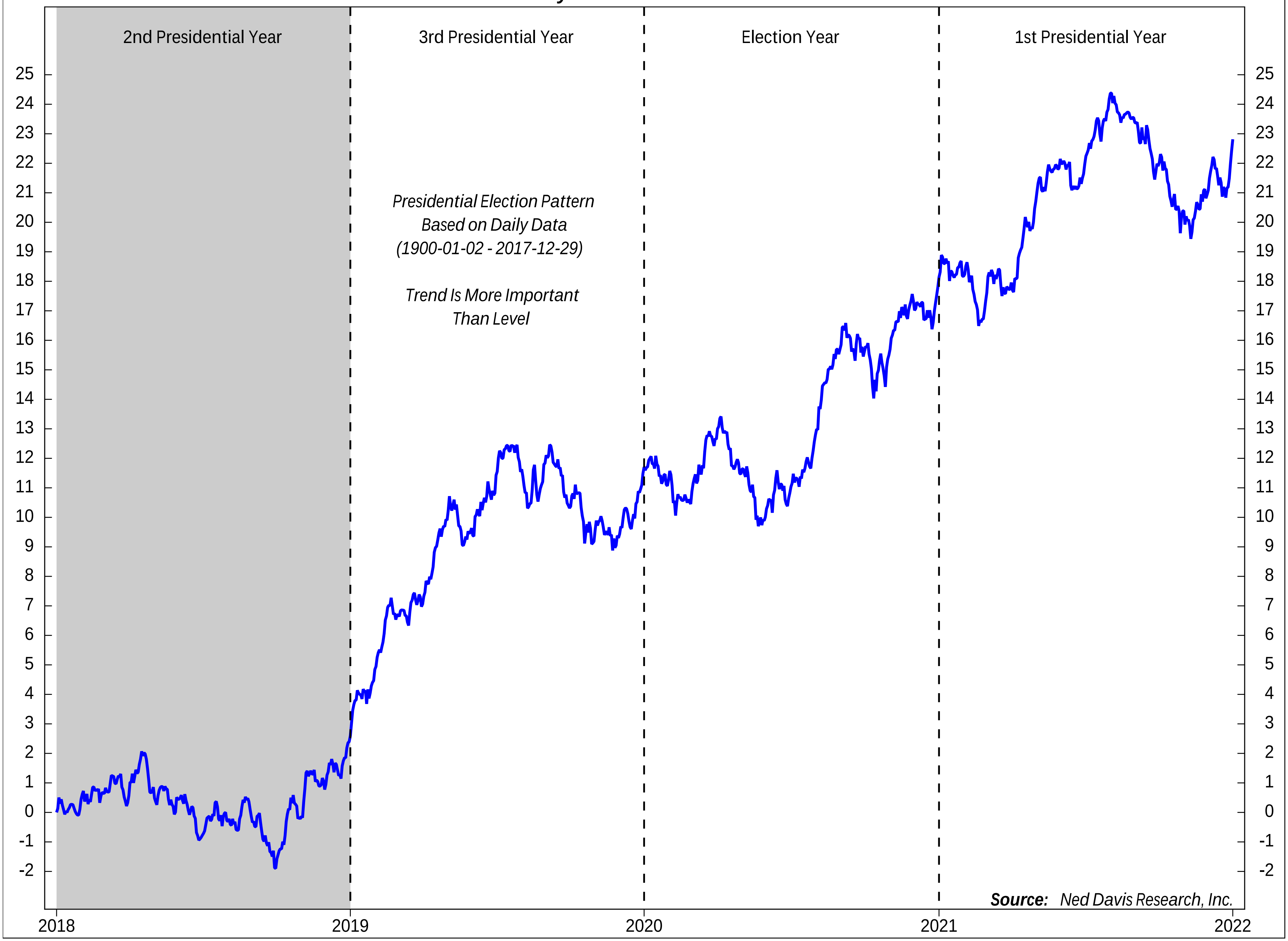
The U.S. economy is generally outperforming that of other industrialized nations. This along with higher interest rates and our "safe haven" status has lead to a strengthening in the dollar. Absent new tariffs, a strong dollar should have a deflationary impact as it puts downward pressure on import prices

Hiring remains brisk and the 3.9% unemployment rate is at a multi-year low and well below the 10.1% rate registered as the last recession was winding down.

Summary

Some observers have referred to the present situation as a Goldilocks' economy; not too hot and not too cold. We would not disagree but we are on the lookout for potential storm clouds on the horizon that could affect the stock market. These storm clouds could come in the form of significantly higher interest rates, slowing earnings growth, or significant policy changes out of Washington that are not viewed as business friendly. For now though we think the underlying trend remains positive. For fixed income we expect low single digit returns at best unless recession fears emerge. Absent an inverted yield curve we think keeping the bulk of fixed income investments in short-to-intermediate maturities is prudent and captures almost all of the yield available in longer-term issues.

Dow Industrials Four-Year Presidential Cycle



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