Marco Investment Management

Investment Newsletter September 2019

Market Review

Introduction

Stock and bond markets registered moderate gains in the third quarter of 2019 building on gains in the first half of the year. However, there could be some storm clouds on the horizon. We will examine the current outlook for financial markets and review recent developments in this edition of our Investment Newsletter.

Equity Markets

The S&P 500 stock index posted a 1.7% return in the third quarter of 2019. This return was moderate compared to the gains in the first two quarters of the year but cumulatively the market is up a strong 20.6% year-to-date.

During the third quarter, defensive sectors were the standout as formerly strong economically sensitive groups faded a bit in the face of slowing economic data here and abroad. The best sector in the third quarter was Utilities up 9.3% followed by Real Estate at 7.7% and Consumer Staples at 6.1%. The weakest sectors were Energy at -6.3%, Healthcare at -2.2% and Materials at -0.1%.

Stock market valuations remain somewhat above the long-term average with the 12 month forward price earnings ratio at 17.4X. However, this level doesn't seem out of line when considering the current level of interest rates. Low rates make the present value of a company's future earnings stream more valuable and companies continue to boost dividends and buy back shares which also helps to support the current valuation level.

Earnings growth has slowed when compared to 2018 which benefitted from major tax reform. This deceleration in growth may continue at least through the first quarter of next year but full year 2020 is expected to show some reacceleration over 2019. Currently the market is not expecting a recession to develop but any change in that outlook would likely create headwinds for stocks.

The conundrum for stocks at present is that current economic condition represented by low unemployment, economic growth above 2%, and strong cash flow generation by corporations does not jive with a 10-Year Treasury Note yield of around 1.63%. The bond market seems to be looking at the glass half empty while stock market participants have been looking at the glass half full. Only time will tell if this disconnect between stocks and bonds will be resolved by higher interest rates or lower stock prices.

Those bullish on stocks can point to the fact that over 62% of stocks in the S&P 500 index have a dividend yield higher than the 10-Year yield. This is near an all-time record (please see chart). They can also point to the fact that historically the third year of a presidential term is very favorable for stock market returns. In the post World War II era (1948 forward) the third year of a presidential term is up 94.1% of the time for the Dow Jones Industrial Average with an average gain of 15.8% and 88.1% of the time for the S&P 500 index with an average gain of 16.1% (source: Ned Davis Research Inc.).

Although stock returns have been strong so far in 2019, it is worth noting that we are not that much higher than a year ago prior to the sell-off that developed in the fourth quarter of 2018. The average price change in stock prices over the past year (through September 30th) is only 2.1%. The S&P 500 index closed last September 30th at 2,914 and this September 30th at 2,976.

Returns in the fourth quarter will no doubt be influenced by headlines relating to trade talks, impeachment proceedings, polling relating to the 2020 presidential election, Hong Kong unrest, etc. However, it is a well known fact that the market tends to climb a "wall of worry" so any setbacks may prove temporary.

Fixed Income Markets

Prices for U.S. fixed income securities have been grinding higher in 2019 and intermediate term bonds gained about 1.3% in the third quarter. This puts returns year-to-date around 6.4%.

The 10-year Treasury note currently yields 1.63%. A year ago the yield was 3.06% The plunge in yields has been driven by concerns about a slowing economy, the prevalence of negative interest rates in many overseas markets, and the Federal Reserve embarking on a new rate cutting cycle

Market participants expect that the Fed will continue to gradually reduce the Fed Funds rate in the coming months. That may eventually lead to a more positively sloped yield curve since the shape of the curve at present remains very flat with the difference between the 10-Year and 2-Year Treasuries at only 8 basis points.

Despite the prospect that yields may remain low for the foreseeable future, we see very little value in most bonds at this time. Low rates don't compensate for inflation that is expected to run about 1.8% this year and any move in rates from these low levels will have an outsized impact on bond prices making fixed income securities more risky in terms of the potential for fluctuations in principal value.

Economic Outlook

Real GDP growth is expected to run about 2.3% in 2019 down from 2.9% in 2018. The most recent quarter was reported at a 2% annualized rate. Trade woes and tariffs that have been imposed on many goods have certainly weighed on growth. Many overseas economies are performing at a lower level than here in the U.S. and that is affecting our exports to some extent. Year-over-year growth in exports is forecasted at only 0.1% compared to 3% in 2018. The strong dollar is also hurting exports.

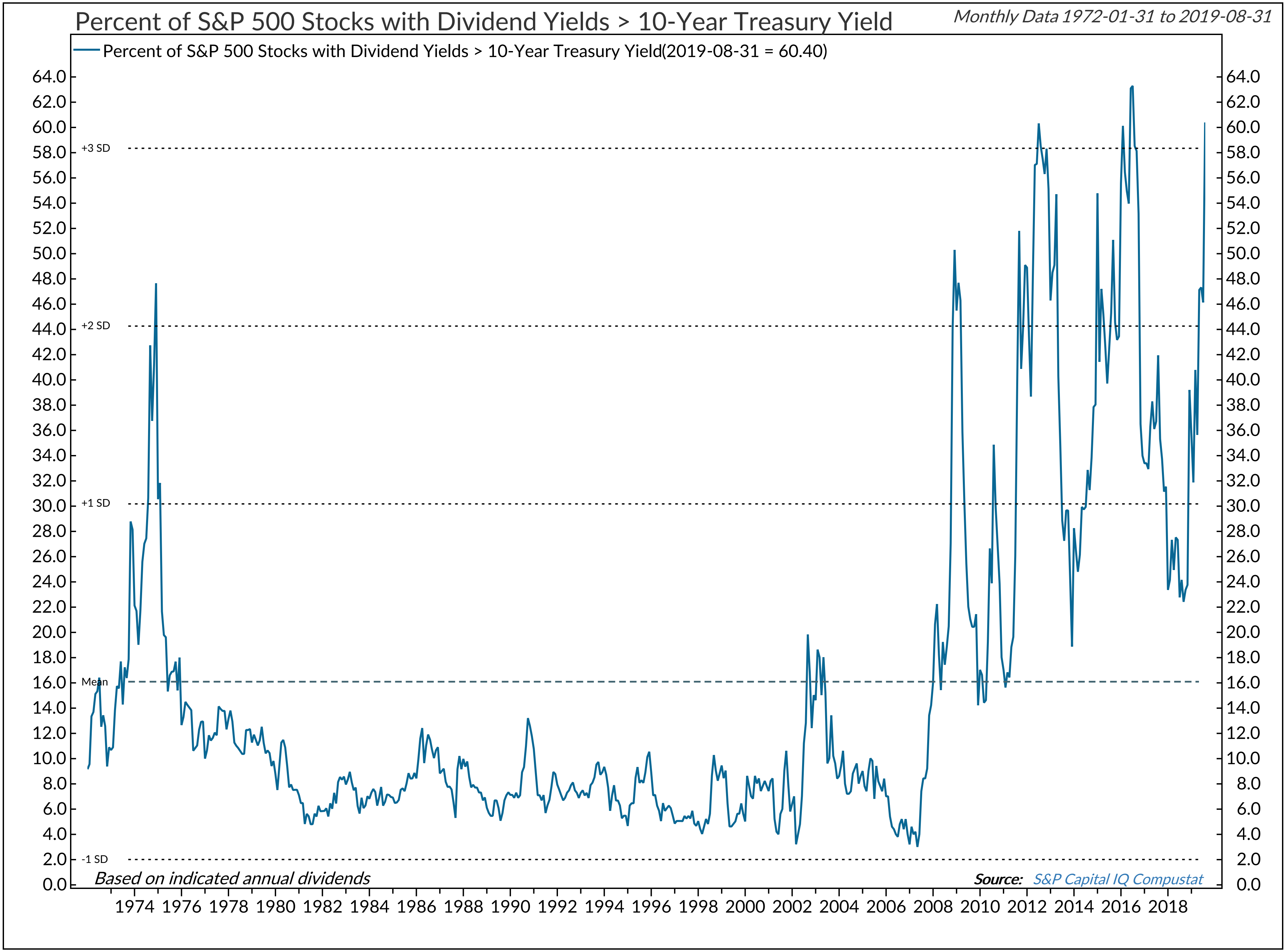
Adding to the concern about a slowdown was the recently reported Institute for Supply Management factory index which slipped to 47.8 in September. This was the lowest level since during the last recession (June of 2009) and was the second straight monthly reading below 50. Readings below 50 indicate contraction while readings above 50 indicate expansion.

For now, the U.S. economy looks to be relatively healthy with unemployment near a 50 year low but weakness in the industrial sector could spill over to other parts of the economy especially if negative headlines weigh on consumer sentiment.

Summary

Although the stock market has turned in a good year so far in 2019, there appears to be heightened risks in the near-term that could lead to more volatility. These include headlines relating to impeachment and trade, along with the chance that some companies may report slowing earnings due to the impact of tariffs and the strong dollar. However, if a correction develops we would likely view it as a buying opportunity as most U.S. corporations have healthy balance sheets with strong cash flow generation and the ability to continue raising dividend payouts. Historically, the best three month period to be invested in stocks is November through January so even if we saw a pullback in October there is a strong tendency for prices to rise later in the year.

We remain cautious towards bonds with yields below 2% implying no real rate of return over the inflation rate. Bonds could potentially offer some safe haven from volatile stock prices but it would not take much of a reversal in yields to produce negative returns on bonds making them more risky as an investment than in the past.



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