Marco Investment Management

Investment Newsletter **February 2020**

Market Review

Introduction

Two steps forward and one step back? That's the current question for the markets. After a strong 2019 for both stocks and bonds we got off to a good start in 2020 as well until the Coronavirus took center stage in investor eyes. We will explore current issues as well as the outlook for the economy in this edition of our Investment Newsletter.

Equity Markets

Following a very strong 2019, the S&P 500 stock index moved up almost 5% in the first few weeks of 2020 before giving it all back with news that the Coronavirus had spread to Italy, Iran, South Korea, and other nations.

The strong performance of the stock indexes during the first few weeks of the year didn't really tell the full story though as performance has been influenced heavily by a handful of mega-cap stocks primarily in the technology and communications space. For example, through February 13th four stocks made up 50% of the return of the S&P 500 index. These stocks have been coined the MAGA stocks since that is the acronym for Microsoft, Amazon, Google, and Apple (to be precise, Google's parent is Alphabet).

Over the past twelve months these same stocks made up about a third of the index return so their influence has grown in recent weeks. All four of these companies have trillion dollar plus market capitalizations. For context, the largest of these companies, Apple, has a market capitalization almost six times that of Exxon Mobil. All things being equal, we would prefer to see a more broad based market where the other 496 companies in the index were contributing at a rate equal to or better than these MAGA companies. For that to happen we'll need to see the equal-weighted S&P 500 catch up to the capitalization weighted S&P 500.

Even with the relatively narrow market and Coronavirus fears, there is still a case to be made for the current bull market to continue. Perhaps the best argument for stocks is that the average dividend yield is about the same, or higher, than what is available from high grade bonds. This is not typical. In addition, dividends have been growing at a high single digit rate and stocks also have the opportunity for capital appreciation greater than what has been historically available from bonds.

While price earnings ratios are a bit elevated at 17.9X forward estimates, P/E ratios tend to expand when interest rates are low. Therefore, if rates stay low, the market may be able to maintain the current P/E ratio allowing stocks to move higher in price based on earnings growth and dividend increases. The recent selloff reduced the forward P/E by almost a full multiple point making stocks more attractive for long-term investors.

Perhaps the biggest near-term challenge for the stock market is the unknown impact of the Coronavirus. This viral outbreak will likely slow global growth in 2020, especially in the Asian economies. There will definitely be a spillover effect to the U.S. economy especially if the virus cases continue to grow. Already, some supply chains are being disrupted. If the virus is contained soon then the market may be able to look beyond the near-term disruptions. The SARS virus proved to be a temporary setback for stocks in 2003. For now though Coronavirus is a wildcard and could continue to pressure the market.

Generally, presidential election years are positive for the stock market. However, there is also a tendency for the tenth year of decades to be the worst of the decade. A notable exception though was 2010 when the S&P 500 was up about 15%.

Overall, we think the recent market pullback is a result of extended valuations leaving the market vulnerable to concerns about global growth. We have not had many corrections within the current uptrend so we were overdue for a pullback. The question is whether the current pullback will be contained at around 10% or so. If so, it could be a buying opportunity within an established uptrend once fears about the Coronavirus settle down. Relatively speaking, stocks still appear to be the asset class of choice for long-term appreciation and income.

Fixed Income Markets

Following a strong 2019, bond prices have moved higher in 2020 as the yield on the ten-year has dropped from 1.91% at year-end to the present 1.31%. This is an historic low level for the ten-year. Most of this drop in yields seems to be based on a belief that the Federal Reserve is on hold in terms of interest rate policy and that they might even consider another cut in the Fed Funds rate if economic growth decelerates. Right now, economists are looking for growth of about 1.8% in 2020 which is a definite slowdown from 2018 and 2019. The other factor is a "flight to safety" as investors park money in Treasuries to ride out the virus concerns.

In our view, the problem with a 1.3% Treasury note is that it is below the expected 2.1% rate of inflation leading to a negative real rate of return. Yields in the U.S. have been pulled lower by the even lower yields in many other industrialized countries. There is also a lot of money in the system due to central bank policies and that money is looking for a home. Treasury notes offer liquidity and no credit risk so money is often allocated to Treasuries despite the very low yields.

In the days when interest rates were in the 3-5% range bonds could legitimately be viewed as a less volatile alternative to stocks. However, at current levels there isn't much yield support to cushion the blow of rising rates. In fact, we would expect the ten-year Treasury note to drop about 9% in value if rates quickly rose by one percentage point to a still historically low 2.3%.

At the moment there appears to be some relative value in the mortgage-backed securities market as the yield spread between mortgages and other fixed income securities has widened. This widening is likely a result of concerns about a pick-up in refinancing activity that would result in more principal pre-payments. However, we think the extra yield spread compensates for this risk.

Economic Outlook

Real GDP growth came in at an above consensus 2.1% annualized rate in the fourth quarter of 2019. Economists were expecting 1.8% which is also the consensus expectation for full year 2020. However, that number could be at risk if the global economy slows.

The labor market continues to show strength with 225,000 new jobs created in January. Figures for November and December were also revised higher. The unemployment rate ticked up to a still historically low 3.6% from 3.5% but this was due to an increase in the labor participation rate.

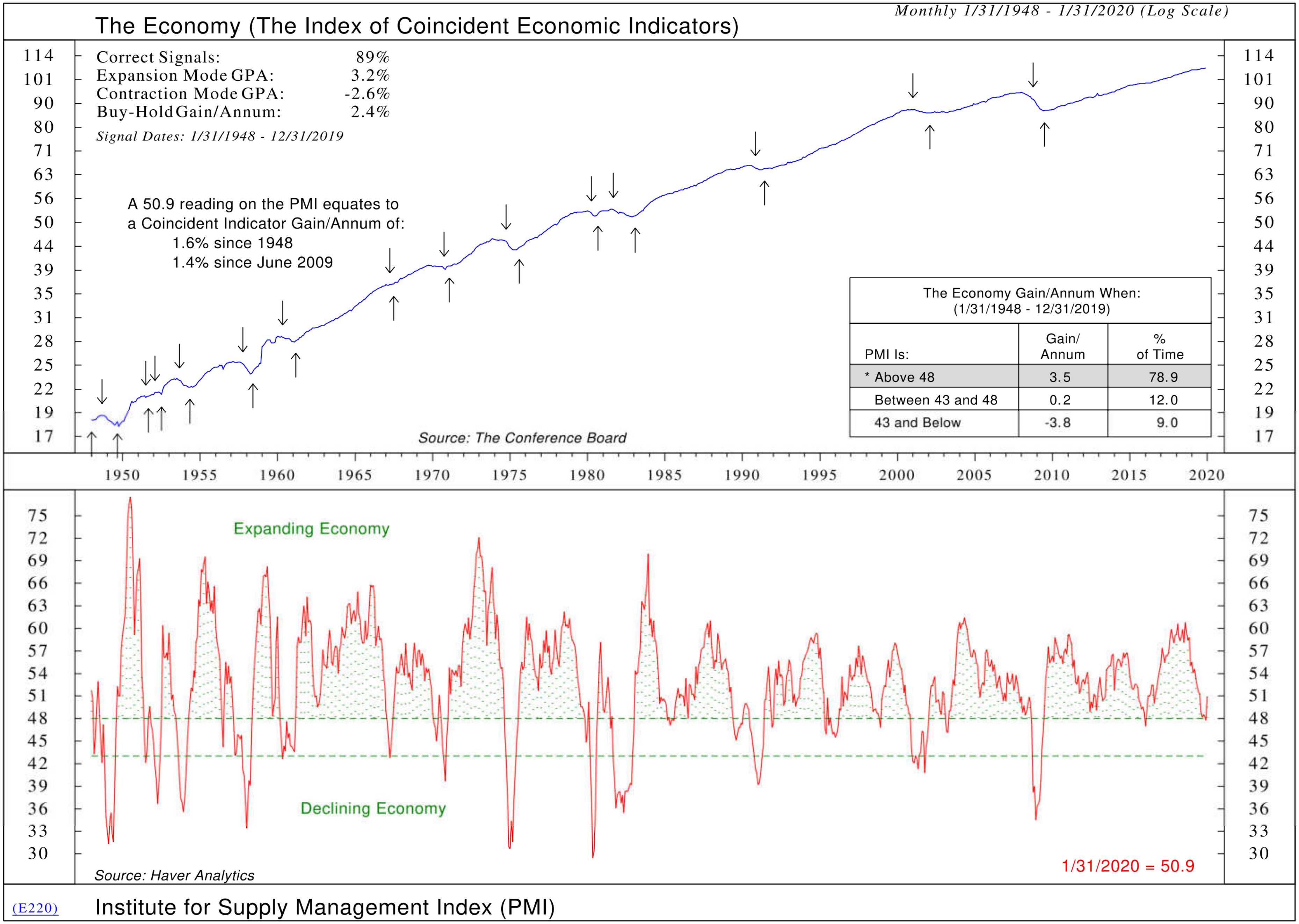
Trade tensions between the U.S. and China appear to have eased with the signing of the "Phase One" trade deal. However, the current Coronavirus outbreak could also diminish China's ability to fulfill their commitments especially in regards to agricultural purchases.

Inflation came in at 1.8% in 2019 but has shown some recent acceleration with economists expecting 2.1% inflation in 2020. The Fed's long-term target for inflation is 2% but they have indicated brief periods above that level are not problematic. As mentioned though, sustained inflation over 2% could be problematic for bonds yielding sub-2%. On a year-over-year basis inflation is presently running at a 2.5% rate.

The manufacturing sector is showing signs of a pick up after a multi-month contraction. The most recent Institute for Supply Management survey came in at 50.9 (please see chart) which indicates expanding manufacturing activity. With new trade deals in place with China, Canada, and Mexico we could see more exports as well.

Summary

Once things settle down we think that the bull market still has some room to run. Most bonds look overvalued to us but they could possibly provide some diversification benefits for those not wanting to be 100% in stocks.



The Economy Gain/Annum When:
(1/31/1948 - 12/31/2019)

PMI Is:	Gain/ Annum	% of Time
* Above 48	3.5	78.9
Between 43 and 48	0.2	12.0
43 and Below	-3.8	9.0

Please see important disclosures on previous page.