Marco Investment Management

Investment Newsletter **February 2025**

Market Review

Introduction

After closing out a strong 2024, the stock market has improved further in the early weeks of 2025. The bond market has also posted modest gains. Despite these good results, markets remain nervous about interest rate policy, inflation trends, tariffs, and stock market valuations. We will discuss these and other topics in this edition of our Investment Newsletter.

Equity Markets

The stock market has continued to rally following the presidential election in November. Enthusiasm over pro-growth initiatives and the promise of artificial intelligence have buoyed stocks. As is usually the case, sector performance has varied with both winners and losers year to date.

The best-performing S&P sectors year to date are Communication Services, Finance, and Healthcare. The resurgence in Healthcare is notable since it was one of the worst-performing sectors in 2024. Also notable is that the only sector with a negative return so far in 2025 is Technology. Tech stocks have been consistently among the best performers over the past two years. It remains to be seen if the relative weakness in the technology sector is just a short-term rotation or something more. In the equal-weighted S&P 500 Index, technology is doing well year to date, which implies the weakness we've seen in the cap-weighted index is confined to just a handful of mega-cap tech stocks.

The stock market seems to be very thematic- and momentum-driven at the moment, with certain companies and industries that are at the forefront of emerging technologies doing very well and with very little consideration given to valuations. At the other end of the spectrum, there is a large number of mature, dividend-paying companies that are languishing since their earnings growth prospects pale in comparison to some of the "hot" stocks that have captured the fancy of the investing public. Generally speaking, we would expect many of these lagging companies to do better if the market takes on a more defensive tone in the future. In that scenario, cash flow generation and dividend growth would become more rewarded. We believe having a diversified portfolio exposed to both growth sectors and defensive sectors is a good strategy that limits risk without ignoring exciting areas such as artificial intelligence and other new technologies.

The S&P 500 Index currently carries a forward price-earnings ratio of 23.1X compared to the equal-weighted S&P 500 Index at 17.9X. When looking at these indexes, there are some large differences in valuation for various sectors, including Consumer Discretionary at 28.3X vs. 16.3X, Consumer Staples at 21.7X vs. 14.9X, and Technology at 28.0X vs 21.7X. Clearly the market is assigning much higher valuations for the larger companies in these sectors over the smaller-to-mid-sized companies. These valuation gaps could narrow over time, as they are currently historically large.

As mentioned, the Healthcare sector has rebounded in 2025. Healthcare is one of the more reasonably valued sectors in the S&P 500 at 17.7X. Only Energy carries a significantly lower P/E ratio (14.1X). The market expects long-term annualized earnings growth of about 13% for Healthcare, meaning the P/E-to-growth ratio is around 1.36. For reference, Technology carries a 1.42 ratio. While these ratios are similar, overall expectations for Technology are more elevated, which leaves less room for error.

Fixed Income Markets

When the Federal Reserve cut short-term interest rates last year by a total of 100 basis points (one percentage point), there was a general expectation that the longer-term maturities would follow suit and drop in yield by a similar amount. Instead, those rates rose, with the 10-year Treasury note rising almost a full percentage point between the first Fed rate cut in September and the most recent cut in December. The bond market was signaling that it was skeptical of the need for the

Fed rate cuts since the economy was continuing to expand and progress on inflation was becoming less dramatic, with the CPI seemingly stuck around 3%. Now the narrative is shifting to whether the Fed will follow through with additional cuts this year or the current rate cut pause will persist. The consensus expects at least one more cut in 2025, but recent economic data brings that into doubt.

The 10-year Treasury note is currently trading around 4.5%, which we believe is appropriate given where inflation is presently (2.9%). The consensus of economists is expecting inflation to average about 2.6% in 2025, but without further improvement additional Fed rate cuts seem at risk.

Relative value in the bond market is difficult to find at the moment since yield spreads are tight, but some investment grade corporate bonds on the lower end of the spectrum still can provide an additional percentage point in yield in some categories. Lower-coupon bonds also appear to offer relative value as investors are favoring full coupons. Some asset-backed bonds also look attractive.

Economic Outlook

Last year the U.S. economy grew at a 2.8% rate. The market has been expecting some moderation in 2025, but recent data shows continued strength.

The Institute for Supply Management's Manufacturing and Services surveys are both above 50, meaning expansionary conditions should continue.

Nonfarm payrolls expanded by 143,000 in January, and the prior two months were revised up by 100,000, indicating that employment growth was strong at the end of 2024. This indication probably keeps the Fed on the sidelines for now. The unemployment rate also dipped from 4.1% to 4%, and the labor force participation rate remained steady at 62.6%.

One concern is the possible impact on inflation from tariffs. In the most recent University of Michigan Consumer Sentiment Survey, the expectation for inflation a year out jumped a full percentage point to 4.3%, which is the highest level since November of 2023. It remains to be seen whether this expectation by consumers will be fulfilled, but it may give the Fed another reason to defer future interest rate reductions.

The question of tariffs' impacts is very difficult to assess, since many that have been announced or floated may never come to pass or could be absorbed before reaching consumers. In the previous Trump administration, inflation was very low despite some tariffs being implemented. However, the number and magnitude of announced tariffs would be greater than in the 2017-2020 period if they all came to pass. It is also possible that revenue from tariffs could stimulate the economy and have a net positive impact.

Another wild card is the effort by the Department of Government Efficiency to streamline government and reduce inefficiencies and wasteful spending. While this is likely an economic positive in the long term, there could be some near-term negative impacts if laid-off employees, for example, reduced their expenditures. Also, cancelled or reduced government spending on domestic projects could depress growth that might have resulted from those projects.

Summary

The stock market remains in an uptrend (please see chart) and has generally responded well to companies benefitting from and/or offering technological innovations. These innovations could raise productivity and quality of life for many Americans. The prospect of stimulative, business-friendly policies coming out of Washington, D.C., has also been a plus.

Some policy changes may have positive long-term effects but could be disruptive in the near term. The changes could include reduced government spending, revised immigration policy, and tariffs. To date, the market has taken these uncertainties in stride.

Valuations for stocks are somewhat extended, but the broad market looks more reasonably valued than some sectors that are riding a momentum wave. Inflation remains a concern and may keep interest rates in a trading range of perhaps 4-5% on the 10-year Treasury note.

January was positive for stocks. Of the past 18 post-presidential election years, 14 followed the direction that was set in January.

Disclosures: 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. Index performance does not reflect the deduction of advisory fees, transaction charges and other expenses. Potential for profit is accompanied by possibility for loss, including loss of principal.

S&P 500 Index vs. 200-Day Moving Average

Daily Data 2023-02-06 to 2025-02-06

Moving average direction based on reversals of 0.5% or greater.

S&P 500 Index Performance **Full History:** 1929-11-11 to 2025-02-06		
200-Day Moving Average is	% Gain/ Annum	% of Time
Rising	7.77	69.58
Falling	2.66	30.42
Buy/Hold = 6.19% Gain/Annum		

S&P 500 Index Performance **Chart View:** 2023-02-06 to 2025-02-06		
200-Day Moving Average is	% Gain/ Annum	% of Time
Rising	23.49	90.42
Falling	0.98*	9.58
Buy/Hold = 21.61% Gain/Annum		
** Cases less than one year are not annualized*		

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