Marco Investment Management

Investment Newsletter **February 2021**

Market Review

Introduction

Following a most unusual year to say the least, the stock market has continued to build on the gains registered in 2020. Fixed income, on the other hand, is showing some signs of weakness as the prospect of an uptick in inflation combined with large deficit spending is beginning to be noticed. Can 2021 deliver solid returns for stocks and bonds? We will explore this and other topics in this edition of our Investment Newsletter.

Equity Markets

The stock market performed well in 2020 despite a global pandemic and has built upon those gains so far in 2021. Significant monetary and fiscal stimulus, along with vaccines getting approved to protect against the novel Coronavirus, have allowed the stock market to move higher. Corporate earnings also held up better than expected, and the potential for very strong economic growth in 2021 continues to buoy the market.

Through early February, the S&P 500 index has moved about 4% higher this year. Value stocks are doing well and have been outpacing growth stocks since about June of last year. The Technology sector continues to do very well, but perhaps the most notable shift in performance has come from the Energy sector, which is up almost 16% this year after a multi-year period of underperformance. Financial stocks have also perked up on the potential for higher net interest margins and renewed loan demand.

The only S&P sector to post a negative return so far in 2021 is Consumer Staples. This is consistent with the rotation we've seen into cyclical companies that have earnings that are more sensitive to a strong reopening of the economy. Consensus forecasts are for S&P 500 earnings to be up almost 40% in 2021 over 2020, followed by another 15.6% growth in earnings in 2022.

Much of the strong performance of stocks in 2020 and early 2021 has been due to anticipation of earnings picking up substantially as well as a lack of good alternatives to stocks. Since much of the anticipated earnings rebound has yet to occur, the market P/E ratio has expanded well beyond historical norms. The 2021 estimated P/E is currently about 23X, but a case can be made that with interest rates below 1% for many bonds, stock valuations are not as stretched as they might otherwise appear.

While some stocks do look expensive, there are many others that appear reasonably valued, and while the average S&P 500 stock yields 1.5%, many stocks in the index still carry dividend yields of 3% or more.

Fixed Income Markets

The Federal Reserve continues to maintain that short-term interest rates will be anchored in a range of zero to 0.25% for the foreseeable future. Despite this stance, interest rates further out the curve have been creeping higher. In fact, the ten-year Treasury note yield has risen almost a half a point in yield since the end of September. That may not sound like much, but it equates to a 65% move in yield with little cash flow to cushion the downward price move. As a result, the total return on this security has been about -3.9% since September 30th with 4.1% in price depreciation.

The message here is that bonds can have significant price moves even with interest rates only moving a half a point or so. Because of the historically low interest rates we are experiencing, many bonds are behaving like zero coupon bonds with heightened duration risk. Older higher-coupon bonds can cushion somewhat on the downside due to higher cash flow, but these bonds command premium prices.

If the consensus estimate that inflation will rise from 1.2% in 2020 to 2.1% in 2021 proves correct, then this rise will likely put additional pressure on the longer end of the yield curve, prompting the Fed to perhaps adopt some sort of

yield curve control measures to slow the rise in yields.

The Fed has indicated that while inflation averaging 2% or less is desirable, they are willing to tolerate higher inflation for a period of time. However, a headline annualized CPI number of 3% might prompt action on the part of the Fed to stem any rise in longer-term yields.

Currently the bond market is not forecasting much chance of recession, as yield spreads on non-Treasury debt have tightened significantly. (Please see chart.) If spreads were to widen out over time, moving closer to historical norms, this shift would create additional risk for bond prices.

Economic Outlook

The economy has shown tremendous resilience during the pandemic, and while there are still some pockets of weakness, the overall trends look promising. Real Gross Domestic Product (GDP) is expected to average 4.1% in 2021 with most of the acceleration beginning in the second quarter. If the vaccine rollout results in far fewer virus infections and economic restrictions continue to be lifted, then we could begin to see a return to normalcy. There is large pent-up demand for travel and leisure activities that could be unleashed soon, which would help to fuel the rebound.

Recent economic reports have been impacted by a post-holiday spike in cases and deaths, but already these numbers are trending much lower. There are still risks like new variants of the virus, but so far it appears cases and deaths may have peaked.

The most recent report on non-farm payrolls showed an increase, but it was below forecast. Initial jobless claims, however, have declined to 793,000 from 927,000 one month ago. The unemployment rate has dipped to 6.3% from 6.7% and is well off the high from last April of 14.8%.

Other measures of economic activity are pointing to growth, including the Institute for Supply Management Purchasing Manager's Index. The latest reading of 58.7 is well above the neutral baseline of 50. Residential real estate also continues to do well with more demand than available supply driving prices higher.

Consumer confidence edged up in January but is still well off the pre-pandemic levels, indicating some ongoing concern about employment and the course of the virus.

Policies coming out of the new administration appear favorable for consumer spending but could have some long-term inflationary impacts. Tax policy going forward is unclear given a 50/50 Senate, although the new administration will likely attempt to roll back some of the previous reductions in tax rates.

It appears likely that we will see some sort of infrastructure bill that could boost construction as well as other industries. A hike in the minimum wage to $15 per hour would likely result in net job losses, but a compromise or a phased approach may be possible.

Summary

While considerable uncertainty still exists, it appears we may be close to turning the corner on the virus, which would bode well for economic growth in 2021.

The stock market will likely need to take a breather at some point this year as the "sugar high" from massive stimulus and low interest rates recedes. However, the underlying fundamentals point to a much better economic backdrop in 2021 than 2020, which could help justify the appreciation we have seen in equity prices during the pandemic.

Fixed income markets could have a hard time repeating last year's returns, which averaged around 6% for intermediate-term issues. We have a hard time seeing bonds appreciating much given the current low interest rate environment and the specter of higher inflation this year. Bonds can play a valuable role in portfolio diversification, but currently the risk/reward for most bonds looks mediocre, in our view.

Disclosures: GDP is the monetary value of all finished goods & services made within a country during a specific period & is used to estimate the size of an economy & growth rate. ISM measures manufacturing activity based on a monthly survey conducted of purchasing managers at more than 300 manufacturing firms. 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.

OAS on Agencies, Mortgages, Corporates, and High Yield

Weekly Data 1989-07-07 to 2021-02-12

U.S. Agencies (2021-02-12 = 6 bps)

Mean = 27

Source: *Bloomberg Barclays Indices*

Mortgage Backed Securities (2021-02-12 = 13 bps)

Mean = 57

Source: *Bloomberg Barclays Indices*

U.S. Investment-Grade Corporate Credit (2021-02-12 = 92 bps)

Mean = 132

Source: *Bloomberg Barclays Indices*

U.S. High Yield (2021-02-12 = 326 bps)

Mean = 545

Source: *Bloomberg Barclays Indices*

OAS = Option-Adjusted Spread

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