Marco Investment Management

Investment Newsletter **February 2022**

Market Review

Introduction

After nearly two years of above-average returns, stocks have definitely taken a breather in early 2022 with many stocks down 10% or more. This pullback has been triggered by a confluence of factors including fear of the upcoming Fed tightening cycle, surging inflation, and geopolitical turmoil. To some degree, positives like strong economic growth and rising dividends are an offset. Has the pullback created a buying opportunity? We will explore this topic and others in this edition of our Investment Newsletter.

Equity Markets

The stock market, as measured by the S&P 500 Index, was up over 28% in 2021 but has declined about 8% so far this year. The tech-heavy NASDAQ index has dropped over 12% year to date. Former winners with rich valuations have been subject to profit-taking, and the fear of rising interest rates has pressured P/E ratios, especially for growth stocks that provide little, if any, dividend yield.

The market has rotated into more defensive stocks that provide steady earnings and dividend growth. Financials have also held up as potential beneficiaries of higher interest rates. So far in 2022 the best sectors have been Energy, Financials, and Consumer Staples while the worst include Communication Services and Real Estate. Stocks that have issued disappointing results or outlooks have been severely punished. Downward moves of 20%+ are not uncommon.

Due to the sell-off, valuations have moved into a somewhat more reasonable zone. Over the past 12 months the forward P/E on the S&P 500 Index averaged 22.2X (range 19.6X – 23.8X). Currently it stands at 19.7X. In addition, many stocks have entered "oversold" territory making a near-term bounce more likely.

The contraction in P/E ratios has been price-driven rather than due to both price and earnings estimates falling. Currently the consensus is calling for earnings growth in 2022 of over 15%, compared to 2021, followed by another 10% in 2023. Obviously, these estimates could slip if economic headwinds materialize but if they are close to the mark and P/E ratios don't fall further, we should see some price recovery.

Currently the dividend yield on the S&P 500 Index is about 1.3% with 45% of the stocks in the index yielding more than the 10-year Treasury Note yield of just under 2%.

It remains to be seen if the shift from growth stocks to more defensive issues with higher dividends will be sustained. Generally, when fear envelops the market you get a move into stable, mature companies, but as sentiment improves, higher growth companies come back into favor.

In general, the second year of a presidential term is the worst for stocks (please see chart). That doesn't necessarily mean negative returns, just lower than average returns. Since WWII the percentage of up years for the S&P 500 in a mid-term election year is about 61% with an average gain of 6%.

Fixed Income Markets

The bond market has also struggled in the face of higher interest rates. The Federal Reserve has made it clear that accommodative monetary policy is coming to an end soon. Fed watchers are generally in agreement that the fed funds rate will be hiked multiple times in 2022 to rein in inflation and keep the economy from overheating. This could mean that the fed funds rate might be well over 1% by year end. The pace of rate hikes is still being debated, but it appears near certain that the first hike will come in March.

The bond market has already adjusted yield levels to reflect the anticipated rate hikes on the short end of the yield curve. Just last October the 2-year Treasury Note was yielding 0.27%. It is now about 1.47%. This rise basically implies that the Fed will hike rates at least 5 times in 25 basis point increments. If it turns out that the market is overly bearish and the Fed backs off and takes a wait-and-see attitude after the first two to three hikes, then the 2-year Treasury could be offering a generous yield. This could make it a good short-term alternative to park funds. Beyond the 2-year, yields flatten out with the pick-up from 2's to 10's only around 47 basis points.

With inflation running hot at almost 8% on the Consumer Price Index, all bond yields are currently negative on a real, inflation adjusted, basis. If the Fed is successful at bringing inflation back down, then bonds may be able to provide stable returns in the low single digits, but we are not expecting current bond market headwinds to ease anytime soon. In 2021 most bond indexes posted negative returns and they have started 2022 in negative territory as well.

The bond market is currently not forecasting much chance of a recession. Yield spreads on non-Treasury debt have widened a bit but are still in a zone that indicates confidence in economic growth, which also implies default risk remains low.

Economic Outlook

The economy continues to perform well. Job growth has been solid although labor shortages persist. Economists are forecasting that GDP will be 3.7% in 2022 which would represent some moderation from last year's strong 5.7% growth but still above trend.

Inflation is expected to moderate a bit from the extremely high levels registered in recent months but could still average 5% this year. This is well above the Fed's 2% long-range target for inflation, and this development has forced their hand in terms of changes to interest rate policy.

The Institute for Supply Management Purchasing Managers Index (PMI) remains in expansion mode with the most recent reading near 58. Anything above 50 is considered expansionary.

The unemployment rate is presently 4% which is not far off the pre-pandemic low of 3.5%. indicating a tight labor market. However, the labor participation rate of 62.2% is still 1.2 points off the pre-pandemic peak.

Non-farm payrolls expanded by 467,000 in January which was well above the consensus estimate of 250,000. The prior two months were also revised higher. Average hourly earnings jumped 5.7% year-over-year but this was still below the inflation rate, meaning no net gain in purchasing power.

Persons choosing to leave the workforce for various reasons jumped to 952,000. This was the highest number since October 2016. Also, the Omicron variant caused some temporary disruptions to the labor force although that factor seems to have eased significantly in recent weeks.

Retail sales jumped 3.8% in January which was above expectations of 2.0% and the best showing since March 2021. Some of the sales growth was likely due to inflationary impacts.

Overall, the economy is performing well but consumer confidence surveys have been trending lower, indicating that factors such as surging inflation are starting to weigh on consumers and future spending could be curtailed.

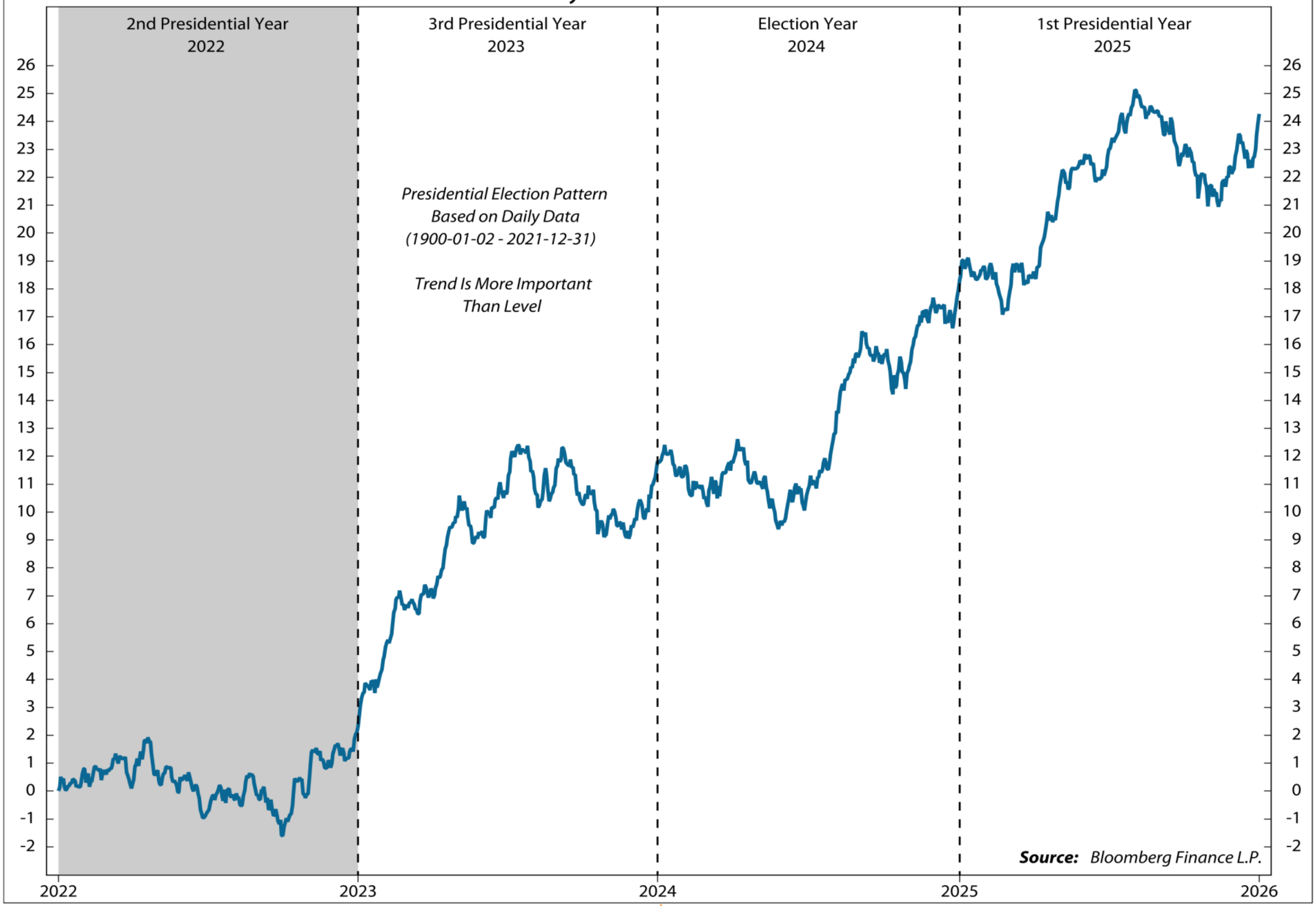
Summary

The upward trend for stock prices appears intact, although it is currently being tested, especially in former high flyers with expensive valuations and little to no dividend support.

The pullback in stocks in 2022 has made the valuation backdrop more reasonable, and it is certainly possible that we will register positive returns for the full year despite the weak start. We were overdue for a pullback and conditions came together to make that possible. Now, many stocks and sectors look oversold and could bounce on any positive change in sentiment.

Fixed income securities are facing continued headwinds from rising inflation and a change in monetary policy. This will likely make it difficult for most bond indexes to register positive returns in the near term. However, the rapid rise in short-term interest rates in the shorter maturities could present an opportunity for positive returns going forward in that sector.

Dow Industrials Four-Year Presidential Cycle



Source: *Bloomberg Finance L.P.*

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