Marco Investment Management

Investment Newsletter **May 2020**

Market Review

Introduction

We are only four months into 2020 but this will certainly be a year to remember. The Covid-19 coronavirus has turned the world on end, disrupting financial markets while also dealing a serious medical toll. In this edition of our investment newsletter we will look at the impact the virus is having on stock and bond markets and how they may respond over the course of 2020.

Equity Markets

So far in 2020 we have witnessed the most severe "waterfall" sell-off in stocks ever with the Dow Jones Industrials Average declining 37.1% in 40 days. That was followed by the third best retracement rally on record up 30.4% in just 25 days. That retracement rally erased over 50% of the sell-off. Through April, the Dow is off a little over 14% this year with the broader S&P 500 index down 9.3%. However, the market has been very narrow, led by handful of stocks. Over 40% of S&P 500 stocks are down 20% or more.

There have been a handful of winners since the pandemic led to a virtual shutdown of the economy. These are primarily companies that benefit from "stay at home" mandates like those involved in movie streaming, video games and conferencing, cleaning and household supplies, etc. However, the tailwind these companies are currently enjoying may diminish over time and beaten up economically sensitive companies may have the best bounce as the economy gradually re-opens.

The worst sectors this year are Energy, Financials, and Industrials. The energy sector has been hit by both a collapse in demand and oversupply. Financial companies are struggling with low interest rates and decreased loan demand. Industrials have also seen a drop off in demand as the economy contracted. Only time will tell if these sectors will reverse this underperformance but in April the best performing sector was Energy.

Because of the economic shutdown, many companies are reporting poor first quarter earnings and the second quarter will be even worse. As a result, companies are reluctant to issue earnings guidance for the balance of the year and analysts are reducing their aggregate earnings projections. It is still very much a moving target though and because of this, current P/E ratios aren't very meaningful. If things normalize and we have a nice snapback in 2021 then the present level of the market looks reasonable.

Currently, the consensus of Wall Street analysts is that 2020 S&P 500 earnings will be down about 13% compared to 2019 followed by a 28% rebound in 2021. This implies that over this two year period earnings will grow by about 11%. Admittedly though these numbers are based on a lot of assumptions that may not pan out. The market always looks ahead so if we see a strong rebound in economic activity later this year that would likely result in greater confidence in the 2021 forecast.

There are several scenarios that could play out with the coronavirus ranging from a rapid second half economic recovery to a second wave of infections that delays the recovery. Based on recent news concerning promising treatments like Remdesivir and declining mortality rates, we are optimistic that the worst may be behind us, but we are also mindful that there is some risk of another setback.

Typically, when the market stages a very strong retracement rally like we saw in April, subsequent re-tests are less severe. If this proves to be the case in 2020 then we may be laying the groundwork now for a better market environment over the balance of the year.

While over 80% of stocks in the S&P 500 are currently yielding more than the ten-year Treasury note, we have seen numerous companies cautiously reduce or suspend dividend payments. While these situations are troubling, the overall dividend yield is still a very attractive 2.1%.

Fixed Income Markets

With the Federal Reserve flooding the markets with liquidity and re-purchasing securities, interest rates have continued to decline and are presently sitting near historically low levels. The ten-year Treasury note is trading around 0.7% after touching 0.57% in late April. Yields are meager across the entire Treasury curve ranging from 0.2 -1.4% depending on maturity.

While inflation is not currently a concern, economists still expect the Consumer Price Index to average about 1.0% in 2020 meaning that all Treasury securities less than ten years in maturity are yielding below the projected inflation rate. This implies a negative real rate of return for investors.

As yields on bonds have steadily dropped, investors have enjoyed price appreciation on their securities but at current levels the probability of further capital gains is greatly diminished and only a small rise in rates would lead to capital losses. Massive monetary and fiscal stimulus could eventually lead to higher inflation, especially if the economic rebound is stronger than expected. This could drive interest rates higher.

During the month of March, before the Fed stepped in to provide liquidity, there were some temporary dislocations within the bond market that lead to a spike in yields. The corporate bond market had one of its worst months since data began being compiled in 1973. However, April roared back and now corporate bonds and other non-Treasury securities are no longer offering large spreads to Treasuries. For example, the spread to Treasuries on investment grade corporate bonds is only about 1/3 of a percentage point more than the one-year average.

In terms of relative value, some issues in areas such as subordinated finance, energy, and consumer discretionary still offer yields of 3% or more. However, there is a wide difference in yields among companies. Those suffering from credit downgrades tend to offer the highest yields.

Economic Outlook

Cumulative weekly initial jobless claims at 33.5 million over seven weeks is a staggering number but the trend is improving as each week has seen fewer initial claims than the prior week. We are hopeful that as the economy gradually reopens, the numbers in May will continue to improve week to week. As workers are rehired the continuing claims number should hit an inflection point and begin to subside.

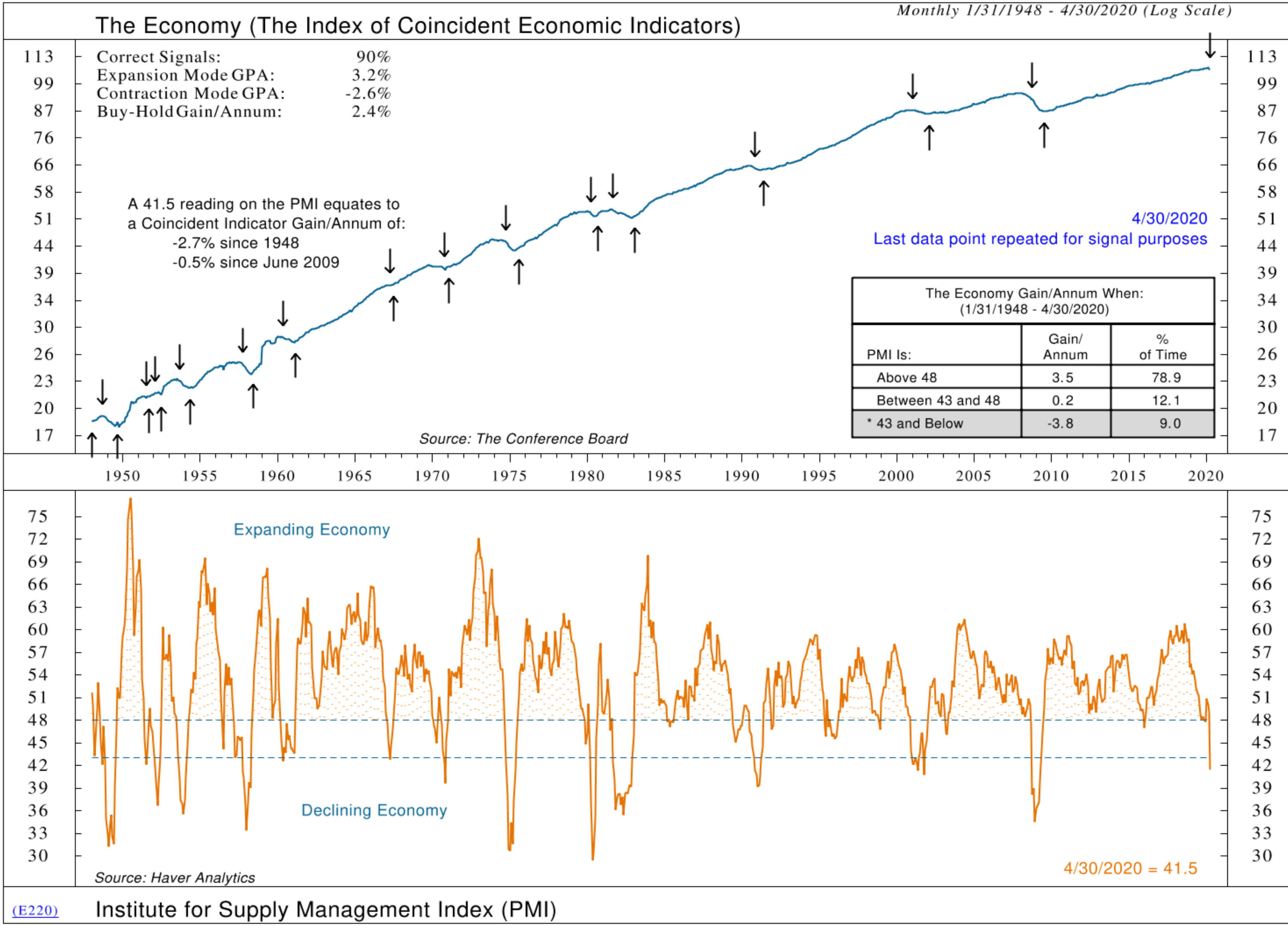
First quarter GDP contracted at a 4.8% annual rate but we expect the second quarter numbers to be even worse as the first quarter only had a partial coronavirus impact. Economists are expecting GDP to contract at about a 28% annualized rate in the second quarter before rebounding sharply in subsequent quarters. If these estimates are on the mark, full year 2020 GDP would be down about 4.2%.

Because of the impact of the coronavirus, we are now experiencing a full-blown recession ending about 11 years of economic growth. The unemployment rate is surging after touching a 50 year low earlier this year. As a result, the federal government has pulled out all the stops to try and mitigate the negative effects of the recession including direct cash payments to individuals, enhanced unemployment benefits, and grants and loans to businesses. While all of these actions will no doubt prove helpful, there is no substitute for actual demand driven economic activity which is why it is so important that the economy safely reopen as soon as possible.

The ISM Purchasing Managers Index contracted sharply in April to the lowest level since the Great Recession of 2008-09. The current reading is 41.3 and since 1948 readings below 43 have signaled an average decline in annual GDP of about 3.8% (please see chart). Fortunately, data points below 43 have only occurred about 9% of the time.

Summary

The coronavirus situation has impacted the economy and markets in ways that would have been hard to imagine just a few months ago. However, we don't want to bet against America and we look forward to better days ahead.



The Economy Gain/Annum When: (1/31/1948 - 4/30/2020)

PMI Is:	Gain/ Annum	% of Time
Above 48	3.5	78.9
Between 43 and 48	0.2	12.1
* 43 and Below	-3.8	9.0

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