Marco Investment Management

Investment Newsletter **May 2022**

Market Review

Introduction

The year 2022 has certainly tested investors, with both stocks and bonds negative for the year. High inflation, labor and product shortages, the war in Ukraine, and rising interest rates are all weighing on the markets. After this poor start to the year, can we expect improving market conditions? We will explore this topic and others in this edition of our Investment Newsletter.

Equity Markets

Through the third week of May, the S&P 500 Index is down 17.7%, and the technology-heavy NASDAQ index is down a whopping 27.2% year-to-date. While bonds can sometimes act as a safe haven during turbulent stock markets, the 10-year Treasury note (1.375% due 11/31) fell 10% (total return) during this same period as the price dropped from $98.75 to $88.29. So in this instance, bonds did not serve as a safe haven at all.

Energy is the only sector to produce strong positive returns this year, but its impact on the overall market has been small. Without the positive influence of Energy, the S&P 500 would have been down 16.5%. In addition to Energy, the market has rotated into more defensive stocks that provide steady earnings and dividend growth. Consumer Staples and Utilities have eked out fractionally positive returns in 2022.

The biggest negative impact to the market this year has come from Technology, Consumer Discretionary and Communications Services stocks. These are relatively large sectors, and together they account for about 80% of the decline in the S&P 500 Index.

With the selloff in stocks, valuations are down significantly. We began the year with the forward price-to-earnings ratio around 22X. It is now around 17X. Some stocks are just now back to levels not seen since before the pandemic despite overall earnings for the market being about 25% higher now than then.

Price-to-earnings ratios are sensitive to interest rate levels, and with rates up across the board, the increase has pressured P/E ratios, especially for growth stocks with minimal current earnings and dividends.

Technically speaking, there has been a lot of damage in the market, with many stocks now trading well below their 200-day moving averages and with widespread negative sentiment. However, stocks look very oversold on a short-term basis, which could lead to some sort of snapback rally. What would be the catalyst for this rally? We think an easing of inflation or a less aggressive Federal Reserve are two possibilities. We might also see a pickup in merger and acquisition activity as corporations take advantage of depressed prices.

As mentioned in our last newsletter, mid-term election years are generally the weakest of the four-year cycle, and the market seems to be following this pattern. We believe, however, that the market can stage a rally later this year, particularly if the flow of news affecting the market improves.

Fixed Income Markets

The bond market reacted swiftly to the Fed's change in policy from accommodative to restrictive. The market has already priced in multiple anticipated Fed rate hikes. For example, even though the Fed has so far only hiked the Fed Funds rate by 75 basis points this year, the yield for the bellwether 2-year Treasury note is up 185 basis points. The Fed has signaled that by this summer they may have hiked rates by close to this amount, but clearly the market is ahead of the Fed. As such, the bond market may be doing the Fed's work for them, which could lead to lower inflation rates sooner than if left to the Fed. If the Fed senses a lessening in inflationary pressures, they may be able to take more of a wait-and-see attitude rather than relentlessly raising rates. They also want to keep rates from getting out of hand, due to the high level of government indebtedness.

Because higher interest rates have a direct impact on bond prices, there really hasn't been anywhere to hide this year in the bond market, aside from

some floating-rate bonds, perhaps. However, money market yields are still extremely low, so locking in around 2.5% on a 2-year Treasury or a comparable security may prove to be a good alternative to cash.

The arch-enemy of bonds is inflation, and with the current year-over-year inflation rate of 8.3% (near a 40-year high) real returns on bonds are negative. Even so, bonds prices could rally if it appears that inflation is peaking. Already, the yield on the 10-year Treasury has declined about 35 basis points off the recent high.

One reason inflation currently appears so high is that we are comparing this month's CPI number to a relatively low level from a year ago. Because inflation was already picking up in mid-to-late 2021, the comparisons going forward should get easier. For example, if inflation doesn't get any worse this year from April to May, the year-over year comparison would drop from 8.3% to 7.1% just because the comparison to the prior-year month is more favorable.

Economic Outlook

The economy has clearly slowed, but economists still expect overall GDP growth in 2022 of 2.7%, which would be above the average of the last 25 years. Quarterly GDP was actually negative in Q1 due to multiple economic shocks as well as net export impacts and inventory drawdowns. Growth, however, is expected to rebound from the weak Q1 and not send the economy into recession. The big post-pandemic rebound in growth is behind us, though, so things should moderate from here.

Consumer spending remains relatively robust, and pent-up demand for travel and entertainment remains. Initial jobless claims and continuing claims continue to trend lower, and the labor market remains tight. Non-farm payrolls have expanded for two months in a row.

Factors that may contribute to a slowdown in growth from the strong 2021 numbers include ongoing shortages of goods and services as well as record-high gasoline prices. Because of high energy prices, consumers may have to cut back in certain areas as energy expenses take up a larger share of wallet. Food prices are also up significantly.

The unemployment rate is presently 3.6%, which is not far off the pre-pandemic low of 3.5% and which is a further indication of a tight labor market. However, the labor participation rate of 62.2% is still off the pre-pandemic peak.

We are also expecting to see a slowdown in the housing market from the torrid pace of the past couple of years. The increase in 30-year mortgage rates to over 5% will eliminate some buyers from the market. However, prices may remain high due to a shortage of inventory.

Summary

The year 2022 has gotten off to a thud for both stocks and bonds, but we could see some improvement as the year progresses.

With the P/E ratio around 17X in the cap-weighted S&P 500, valuations for stocks are no longer extreme, and the P/E ratio for the typical stock (as measured by the S&P Equal Weight Index) is even lower at around 15X. Further, dividend payout ratios are near all-time lows at 31.1% (please see chart). This means that companies have a lot of capacity to raise dividends if they so choose. Despite market turbulence, dividends continue to rise, which also serves as an inflation hedge.

The stock market has gotten a boost in recent years from easy-money Fed policies and massive government stimulus. Those tailwinds are being replaced by some headwinds, but we believe that if earnings continue to expand and the P/E ratio on the market stabilizes or, perhaps, climbs back up a bit, then we could get back on track to high single-digit or low double-digit stock returns in coming years. That type of returns would be near historical averages going back multiple decades.

Fixed income securities may have more difficulty posting strong returns as real rates of return (nominal less inflation) continue to deteriorate. However, the bond market often trades on anticipated policy moves, so if the Fed pauses its rate hikes later this year, the market would likely respond favorably. Also, bond yields are now high enough to provide income investors with a viable alternative to stocks.

Disclosures: PMI measures manufacturing activity based on a monthly survey 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. 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.