Marco Investment Management

Investment Newsletter **May 2023**

Market Review

Introduction

The stock and bond markets have rebounded so far in 2023, although the move in stocks has been characterized by narrow leadership. Most interest rates are lower than where they began the year, as the bond market anticipates the end of the Fed rate-hiking cycle. Can the financial markets continue to rally? We will discuss this issue and others in this edition of our Investment Newsletter.

Equity Markets

During the first quarter the S&P 500 Index gained 7.5%, and through early May there has been some additional improvement to reach 7.9%. However, the average return of stocks in the index is only 1.7% year-to-date as a handful of stocks has driven most of the return. Mega cap technology stocks have been very strong this year. Two stocks, Apple and Microsoft, make up a record 14% weighting in the index and are responsible for 42% of the index return so far this year.

While some stock market sectors have done very well this year, including Technology and Communication Services, not all sectors are in the black. Energy, Finance, Healthcare, and Utilities are all down for the year. The financial sector has been extremely turbulent, with regional banks taking a pounding following several high-profile failures requiring government intervention. Many regional bank stocks are down 35-40% year-to-date. Some of the largest bank stocks have bucked this trend as the money center banks have picked up deposits from the regionals.

In general, stocks are rebounding following a miserable 2022, but returns are widely dispersed and we are not seeing a “rising tide lifts all boats” market. Currently the forward P/E ratio of the capitalization-weighted S&P 500 is about 18X, which is not cheap, but the equal-weighted S&P 500 trades at a much more reasonable 15X.

Despite the current divergences we are seeing in stock market returns by sector, we continue to believe that focusing over the long haul on good-quality dividend-paying stocks across all sectors will continue to reap significant rewards. While some non-dividend-paying growth stocks may be appropriate in a diversified portfolio, going back over fifty years dividends have made up a significant percentage of stock market investors’ total return, and dividend growth over time is a key reason (please see chart).

There are numerous uncertainties facing the stock market at this time, including Fed interest rate policy, recession risk, government debt ceiling, and stubborn inflation. In addition, we are entering a seasonal period (May through October) that is often characterized as the weakest months of the year. That said, there is an old saying that the stock market climbs a wall of worry, so the market may be able to power through the uncertainties and have a decent year. This development would be consistent with the strong tendency for pre-presidential election years to be positive, with only one down year (Dow Jones Industrials) going back to 1939.

Fixed Income Markets

The Federal Reserve appears to be near the end of the rate hiking path they have been on for over a year. The bond market is already anticipating this change in policy with a rally that has brought the 10-year Treasury note down about a half percentage point in yield since year end. In fact, all points along the yield curve from 2 to 30 years are trading at yield levels below the upper bound of the Fed Funds target rate, implying that the market expects the Fed to begin cutting rates in the not-too-distant future.

If the Fed does start cutting rates later this year it would likely be in response to either a victory in bringing inflation down to a manageable level or a Fed-induced recession (or both). There is a chance for a “soft landing” where we avoid recession, but the markets are presently predicting a 65% chance of some sort of a recession developing in the next few months.

The Fed is somewhat in a box right now in that they might like to raise rates at least one or two more times. However the risks may be too great, as we have already seen the damage done to the banking sector due to higher rates. At the end of the day, the Fed may have to settle for inflation closer to 3%, rather than their stated 2% target.

In 2023 we have seen some modest spread-widening in investment grade corporate bonds, but high-yield debt has actually seen tighter spreads, so the bond market doesn't appear excessively worried about credit risk, which perhaps signals a mild and brief recession as the most likely outcome.

Economic Outlook

The economy has definitely slowed. Real GDP expanded at a 1.1% annual rate in the first quarter, which was below expectations. Consumer confidence has also slipped in some surveys. The consensus of economists is calling for full-year GDP growth of 1.1% then slowing further to 0.8% in 2024, which contrasts with the top-down analysts' forecast of about 10% earnings growth in 2024. While stock market earnings can certainly outperform economic growth, there does appear to be some disconnect, and we should see a convergence over time.

Another tell-tale sign of a slowdown is weakness in the energy markets this year. West Texas Intermediate Crude Oil prices are now below $70 a barrel as the market anticipates slowing demand.

Housing is another area that has weakened due to Fed rate hikes, with conventional 30-year fixed-rate mortgages priced well over 6%. These relatively high rates are also keeping homeowners from "trading up," as many have current mortgages in the 2-3% range that they do not want to walk away from, which could be a plus for home improvement companies as homeowners instead focus on renovations to their existing homes. One bright spot for housing is that the inventory of homes for sale remains relatively low. In March there was a 2.6-month supply of existing homes, whereas 6 months is considered to be normal.

Inflation has come down steadily as the Fed rate hikes have taken hold. Currently the year-over-year Consumer Price Index is at 5%, which is down from a peak of 9.1% in June of last year. The expectation is for inflation to average 4.2% in 2023 and decline to 2.6% in 2024.

Average hourly earnings have been growing at a 4.2% annual rate, but these wage gains have not kept up with inflation.

Consumer sentiment has recently weakened, with the Conference Board's survey falling 2.7 points in April to 101.3, a six-month low. The reading was also 7.3 points lower than a year ago.

The Institute of Supply Management's survey of manufacturing purchasing managers is also deteriorating. This index is in a multi-month decline, and the present reading of 47.1 is the lowest since May of 2020 during the heart of the pandemic.

Overall, mixed signals persist for the economy. Inflation is coming down, but pent-up demand post-pandemic is waning and economic risks seem skewed to the downside given the lag effect of interest rate hikes. A mild recession a few months down the road is possible.

Summary

The stock and bond markets are producing positive returns so far in 2023. Both are registering in the low- to mid-single-digit range. Historically, pre-presidential election years are positive, and if the Fed stops hiking short-term rates soon, then markets may have another reason to continue the rally. However, valuations are not inexpensive for stocks, bond yields are generally running below the inflation rate, and both of these factors could be headwinds. We are cautiously optimistic that we will have a decent year in the financial markets, but we expect a good bit of volatility in the months ahead, especially as we face a possible debt ceiling showdown.

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.