Marco Investment Management

Investment Newsletter **August 2020**

Market Review

Introduction

The year 2020 is certainly one for the record books. Amid a global pandemic the stock market has been on a roller coaster ride but currently stands near a record high. Interest rates are near historic lows as the Federal Reserve continues to provide unprecedented liquidity to the financial markets. Can the dichotomy between stock prices and interest rates continue? We'll explore this and other topics in this edition of our Investment Newsletter.

Equity Markets

To a large extent, the stock market performance in 2020 can be characterized as bifurcated. The mega-cap technology stocks and other companies that have benefitted from changes in behavior due to the pandemic have done extremely well while the broad market has lagged. Through August, the capitalization weighted S&P 500 index was up 2.4% while the average stock in the index was down 6.5%.

Through August 31st, the S&P 500 top performing Technology sector was up 21.4% while Energy was the worst performing sector down 38.7%. Financials and Industrials were also weak. In additional to Tech stocks, the Consumer Discretionary sector has done very well this year. This may reflect optimism around the "re-opening" trade as well as pent up demand from the first quarter.

In recent weeks we have seen some early indications that the market may be broadening out. From June 30th through August 14th, Technology has fallen from the best of 11 sectors to the number 7 rank with Industrials taking the top spot. Materials have also surged. Over this same period, the average stock in the index has kept pace with the cap-weighted index. Both are up 9%. A broadening out of the market would be a welcome development since narrow markets are not considered healthy in the long-term.

Earnings reports this year have been somewhat schizophrenic as the economic shutdown in the spring caused earnings to plummet, only to snap back as economies began to re-open. Overall, the consensus expects earnings this year to be relatively flat compared to 2019 with an expected earnings surge in 2021. Flat earnings in 2020 would be much better than what was expected just a few weeks ago, but strong reports out of some very large companies have lifted overall expectations over previous dire forecasts. In our last Newsletter we noted that the consensus at that time was expecting 2020 earnings would be down 13% compared to 2019.

Because the stock market has rebounded strongly off the March lows and earnings have not yet caught up with the price move, the P/E ratio for the market has moved higher. The forward P/E multiple on forecasted earnings over the next 12 months is around 23X. This is elevated in relation to historical norms but if earnings do accelerate in 2021 the move in stocks we have seen to date could be justified. The other thing that is underpinning the market is that bonds are not providing much of an alternative to stocks with the ten-year Treasury note yielding under 0.7%. The average stock in the S&P 500 yields 1.8% with numerous companies in the 2-3% range. Currently 75% of stocks in the index yield more than the ten-year Treasury (please see chart).

While the stock market has generally been looking at the "glass half full", significant risks are still present. The Coronavirus has not faded away and some experts warn of a second wave of infections in the fall and winter months. Any move to shut the economy down as occurred in March would likely not be well received by the market. In addition, we are in the midst of a presidential election that will be decided in less than three months. This could add uncertainty and volatility to the market.

Fixed Income Markets

The Federal Reserve has flooded the markets with liquidity and has re-purchased a wide range of securities causing interest rates to decline. We are presently sitting near historically low levels with yields ranging from 0.1-1.4% depending on maturity.

Economists expect the Consumer Price Index to average about 1.0% in 2020 before picking up to about 1.7% in 2021 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. Already, we are seeing the core rate of inflation (ex food and energy) running above the stated rate. Eventually, we would expect to see higher inflation reflected in bond yields, but this may only be manifested in longer-term securities as the Fed appears to be "managing" the short-to-intermediate part of the curve. They have indicated that short-term rates, in particular, are not going to rise anytime soon. Because of this situation income oriented investors are forced to either look at lower quality bonds or stocks in order to maintain an acceptable income stream.

With the ten-year Treasury note under 0.7% the duration (measure of price volatility) has moved to levels more normally associated with zero coupon bonds. From a practical standpoint, this means that only a relatively small upward move in interest rates could result in price depreciation that would wipe out any income earned over that same period. So, the risks of holding bonds is greater than in the past since the income cushion isn't present for most bonds. Of course, if you hold the bond to maturity you will receive the stated yield over the life of the bond but on an inflation adjusted basis your real rate of return may be negative.

For investors that desire bonds for diversification we do see some pockets of relative value primarily in non-Treasury securities but even finding 2% in investment grade bonds is difficult at present. Some sectors like Energy and Finance offer above average yields as well as some taxable municipal bonds.

Economic Outlook

Weekly initial jobless claims have been steadily improving since peaking March 27th at 6.9 million. Since then all but one week has shown a decrease over the previous week and the most recent report on August 7th was under one million for the first time at 963 thousand. The continuing claims number has also been showing improvement. That number peaked at 24.9 million on May 8th and presently stands at 15.5 million. While the trends are moving in the right direction, these are still very elevated numbers and to see ongoing improvement we will need a continued pickup in economic growth with no further shutdowns.

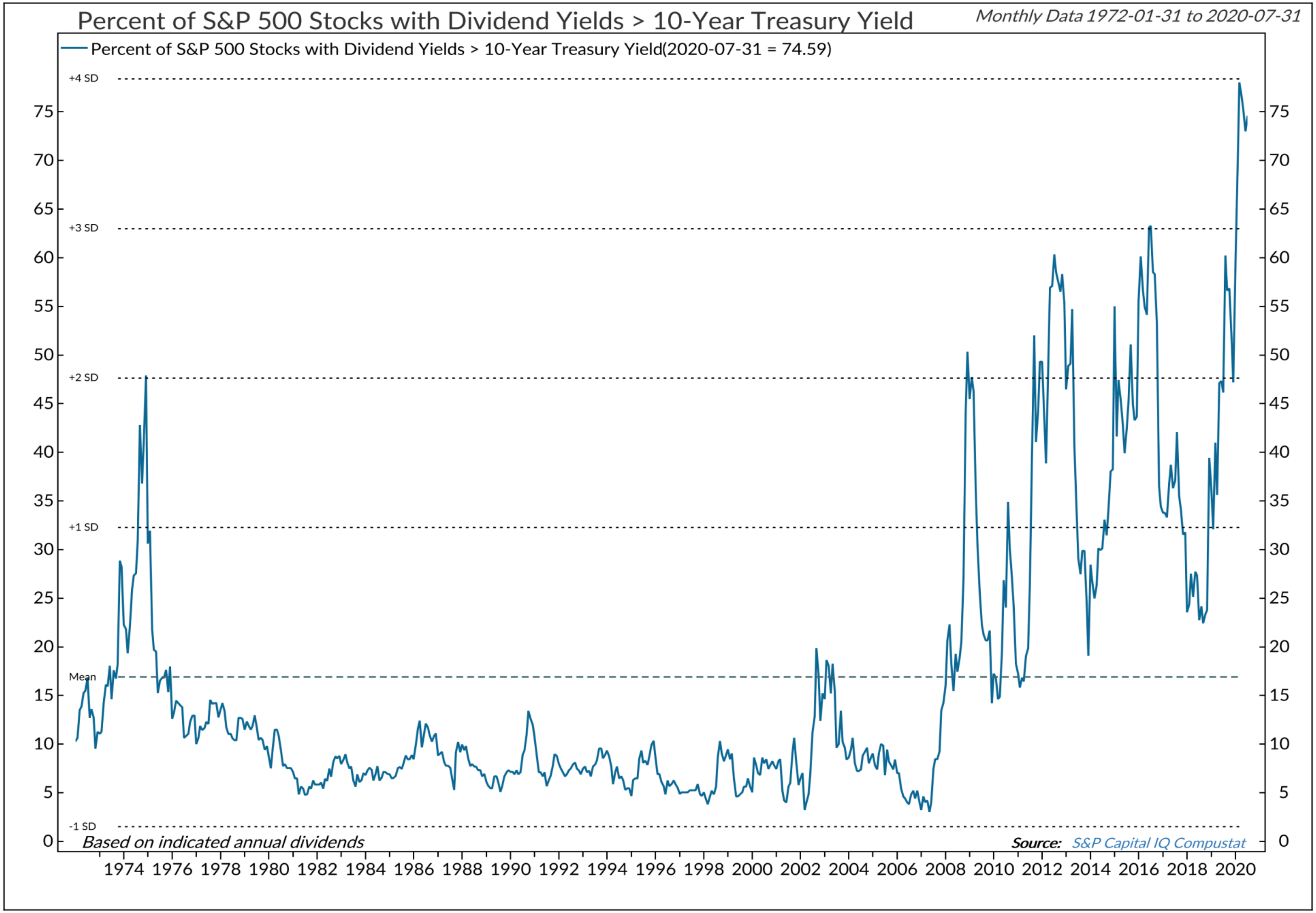
While Gross Domestic Product ("GDP") has been contracting and is almost 10% lower than a year ago, the expectation is that we will see a sharp snapback in the third quarter that will equate to a 20% annualized growth rate. If that comes to fruition followed by decent expected growth in the fourth quarter, full year GDP may be down about 5% in 2020 compared to 2019.

Recent economic statistics have generally come in stronger than expected. The Institute of Supply Management ("ISM") non-manufacturing index jumped to a relatively strong reading of 58.1 in July while the New Orders Index came in at 67.7. Both exceeded expectations. Industrial production grew a better than expected 3% in July while retail sales continued to trend higher, up 1.2%. Housing figures remain strong with both new and existing home sales surging. However, consumer sentiment remains cautious with the University of Michigan survey coming in at 72.8. The cautious consumer sentiment is not unexpected since there remains uncertainty about policies coming out of Washington regarding a payroll tax holiday, enhanced unemployment benefits, and loan and rent forbearance.

Summary

As long as the Federal Reserve is continuing to support the financial markets through various programs this could provide a backstop for stocks. There is an old saying "Don't Fight the Fed". We would agree and prefer to remain invested rather than on the sidelines. Fixed income yields are generally unattractive to us relative to inflation expectations although they can provide valuable diversification benefits.

Important disclosures regarding this newsletter: 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.



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