Marco Investment Management

Investment Newsletter **August 2022**

Market Review

Introduction

The stock market continues on its roller coaster ride with a big rally in July following the dismal showing in the first half of 2022, where the S&P 500 Index dropped 20%. Fixed income securities have also had a rough year but have recently rebounded a bit on hopes that the Federal Reserve may be able to pare back its planned rate increases in coming months. Is the recent rally in both stock and bond prices justified? And what may happen over the balance of 2022? We will explore these topics and other issues in this edition of our Investment Newsletter.

Equity Markets

The first half of 2022 was characterized by an extremely harsh market environment with investors focused on high inflation, higher interest rates, the war in Ukraine, and fears of a looming recession, even during a period of resilient corporate earnings, continued job growth, and fading virus concerns. This mix brought the worst first half for stocks since 1970 and interest rates about two percentage points higher than where they began the year. It also left the markets in a deeply oversold condition and positioned for a relief rally.

We got a relief rally in July as sentiment shifted and markets began to anticipate a "Fed pivot" and the potential for a "soft landing." Quarterly corporate earnings have also come in better than feared, and recent data indicates inflation may have peaked with a possible inflection point in the July numbers. Since the market low on June 16, the S&P 500 has rebounded 16.7% through the second week of August, with the battered NASDAQ up 22.7%. This increase doesn't erase the prior 2022 losses, and at this writing the S&P 500 Index is still down almost 10% on the year, but the rebound has been significant.

Because of the sell-off and subsequent rally in stocks, valuations are below the elevated levels where we began the year (around 22X forward P/E) but off the lows of around 16X. At this point it appears that valuations aren't holding back the rally, but earnings need to continue to come in at a decent clip to sustain it. The market consensus is for almost 11% earnings growth in 2022 versus 2021, which might prove to be a little optimistic. Corporations' ability to pass through higher input costs without demand destruction will be a key factor.

So far in 2022, there are only two S&P 500 sectors with positive returns: Energy and Utilities. Energy has benefitted from high commodity prices, although West Texas Intermediate Crude at $88 is well off the highs that were set in June at $117 per barrel. Energy has underperformed since that time. Utilities are a classic defensive sector and are now benefitting from the recent bond rally. The best sectors since the June low are those that were punished severely in the first half of the year. Consumer Discretionary is up 27.2%, and Technology is up 22.6%.

While mid-term election years tend to be the weakest of the four-year cycle, there is also a very strong tendency for the stock market to recover after a big sell-off. One study looked at quarters where the market dropped 15% or more to see how the S&P 500 performed in subsequent quarters. There have been nine such quarters since World War II, the most recent being Q2 of 2022. The study found that the market was higher over the next four quarters 100% of the time, with a mean return of 26.1%, (see table), indicating that the market tends to overshoot on its way down.

If we do achieve a soft landing and avoid a deep recession, with the Fed taking a more neutral stance on rate hikes while they await more data, then it is possible that the stock market can continue to recover. Seasonal market tendencies are generally favorable as well. However, there is a distinct risk of inflation remaining elevated, a weakening job market, and a cautious consumer. These factors could point to a difficult market environment or, at best, a trading range.

Fixed Income Markets

The arch-enemy of the bond market is inflation, and 2022 has delivered high inflation that has in turn pressured interest rates. However, rates never moved anywhere close to the actual inflation numbers, indicating that the market expects inflation to moderate. The Fed's goal is 2%, but the market seems to think something closer to 3% is more likely. After peaking at 3.48% on June 14, the 10-year Treasury Note has declined in yield to 2.78%. This yield is still well above the 1.51% where we began the year, but it indicates that the market thinks inflation may have peaked and the Fed may be able to take their foot off the gas pedal, in terms of rate hikes, before too long.

Another signal that the bond market can provide is the probability of a recession. Often before a recession, the yield curve inverts, where shorter-dated bonds yield more than longer-dated issues. That is exactly where we stand today, with the 2-year Treasury Note yielding 42 basis points more than the 10-year. The only reason an investor would prefer a lower-yielding Treasury to a higher-yielding issue of shorter duration is an expectation that rates are headed lower, and it is better to lock in for a longer term even if that means giving up some yield in the short term. One reason rates might be headed lower is if the Fed takes the economy into a recession to kill inflation. The bond market seems to think there is about a 50% probability of this happening. Recent action in the stock market seems to indicate otherwise, so we'll have to see which group of investors has the more correct view.

Even though short-term bonds do not allow one to lock in a rate for a long time, they are lower-risk instruments and are presently providing outsized returns. Considering that a 2-year Treasury was only yielding 0.73% at year end, today's 3.2% yield is attractive for risk-averse investors.

Non-Treasury bonds are providing even higher returns, often over 4%. Yield spreads have been widening on corporate bonds to reflect the higher risk of recession, but investment grade issues appear to offer good risk-adjusted returns. With inflation still running 8.5% year-over-year, we believe intermediate-term issues still offer the best risk/reward scenario for investors.

Economic Outlook

The economy has met the technical definition of recession, as we have experienced two consecutive quarters of negative GDP growth. However, this decline flies in the face of recently reported strong job growth and record-low unemployment. Some of the decline in GDP was due to inventory adjustments and decreases in government expenditures, which are not necessarily indicative of a decline in consumption.

The recent rally in consumer discretionary stocks like restaurants, travel, and retail is also an indicator that consumers are still likely to continue to spend and support economic growth. The recent decline in gasoline prices will also help consumers shift spending into more discretionary areas.

Real GDP is expected to be positive for the full year at 1.7%. However, this number has been steadily coming down and began the year at 4%.

The unemployment rate is presently 3.5%, which matches the pre-pandemic low. Also, all the jobs that were lost during the pandemic have now been restored. A labor shortage continues in many areas of the economy, although a few pockets of weakness exist. The labor participation rate is still a disappointingly low 62.2%, which is below pre-pandemic levels.

Summary

The year 2022 has been challenging for both stock and bond investors. After a dismal start, things have been improving, and the market is now looking at the glass as half full rather than half empty. Many stocks had gotten ahead of themselves, but now valuations have been reset to more normal levels and companies with good earnings outlooks could be positioned for further gains. The Federal Reserve has not been a friend to the markets this year, but the prospect of less need for tight monetary policy has given both the stock and bond markets reason for optimism.

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. 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.

After declines of more than 15% in a quarter, S&P 500 has tended to rebound

S&P 500 Performance After >15% Single Quarter Drops

Date	Previous Quarter % Change	Next 1Q % Change	Next 2Q % Change	Next 3Q % Change	Next 4Q % Change	Next 8Q % Change
12/31/29	-28.9	17.2	-4.6	-13.3	-28.5	-62.1
6/30/30	-18.6	-9.1	-25.0	-18.4	-27.5	-78.4
12/31/30	-17.5	8.8	-3.3	-36.7	-47.1	-55.1
9/30/31	-34.5	-16.4	-24.7	-54.4	-16.8	1.2
12/31/31	-16.4	-10.0	-45.4	-0.5	-15.2	24.4
6/30/32	-39.4	82.4	55.5	32.1	146.3	121.4
3/31/33	-15.1	86.5	68.0	72.7	83.8	44.8
12/31/37	-23.3	-19.4	9.6	16.0	25.2	18.4
3/31/38	-19.4	36.0	44.0	55.4	29.2	44.1
3/31/39	-16.9	-1.1	18.6	13.8	11.6	-9.3
6/30/40	-18.5	6.8	6.0	-0.2	-1.3	-16.8
9/30/46	-18.8	2.3	1.4	1.7	1.0	3.5
6/30/62	-21.3	2.8	15.3	21.6	26.7	49.2
6/30/70	-18.9	15.8	26.7	37.9	37.1	47.3
9/30/74	-26.1	7.9	31.2	49.8	32.0	65.6
12/31/87	-23.2	4.8	10.7	10.1	12.4	43.0
9/30/02	-17.6	7.9	4.0	19.5	22.2	36.7
12/31/08	-22.6	-11.7	1.8	17.0	23.5	39.2
3/31/20	-20.0	20.0	30.1	45.3	53.7	75.3
6/30/22	-16.5	??	??	??	??	??
All Cases						
Mean	**-22.0**	**12.2**	**11.6**	**14.2**	**19.4**	**20.7**
Median	**-19.4**	**6.8**	**9.6**	**16.0**	**22.2**	**36.7**
% Positive	**0.0**	**68.4**	**73.7**	**68.4**	**68.4**	**73.7**
Post WWII						
Mean	**-21.1**	**6.2**	**15.1**	**25.4**	**26.1**	**45.0**
Median	**-20.6**	**6.3**	**13.0**	**20.6**	**25.1**	**45.2**
% Positive	**0.0**	**87.5**	**100.0**	**100.0**	**100.0**	**100.0**
All Periods Mean	**2.0**	**2.0**	**3.9**	**5.9**	**8.1**	**16.0**

Source: S&P Dow Jones Indices

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