Marco Investment Management

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Market Review

Introduction

The stock and bond markets remain volatile. Stocks have shown pockets of strength and weakness this year, with just a few sectors leading the way. Overall, the major averages are higher on the year. Bonds remain pressured by restrictive monetary policy and inflation above the Fed's target rate of 2%. In this edition of our investment newsletter, we will explore the outlook for the remainder of the year.

Equity Markets

Through mid-August the S&P 500 Index is up over 16%, but those results are skewed by a handful of stocks, with the average stock in the index up less than 7%. The average stock return is also consistent with the Dow Jones Industrial Average, up 6.8% so far this year.

This big divergence is attributable to the outperformance of megacap Technology and Communications Services stocks. The stocks that dominate these sectors are up around 40% on average this year, skewing the index return since these two sectors make up about 36% of the index. On the other side of the coin, there are five sectors with returns of 1% or less this year, including Utilities, down 8.8%, and Healthcare, down 0.2%.

Because of this year's megacap Technology and Communications Services outperformance, the price-to-earnings ratio for the overall index has risen to around 20X, which is high by historical standards. Virtually all this year's return has come from P/E multiple expansion, rather than from earnings growth. S&P 500 earnings are only expected to grow 0.6% in 2023.

The best-performing stocks this year share a common theme of enthusiasm about artificial intelligence (AI) applications. While we agree that AI will be a significant contributor to future earnings growth and may lead to productivity gains, the market seems to have already discounted a lot of the expected good news. We may now need a period of consolidation while we let earnings catch up with the stock price moves. In the meantime, we could see the overall market hold up relatively well as laggard stocks and sectors close the performance gap with Technology and Communications Services companies. Since the end of July we have seen some signs that this catchup may be occurring as this year's big winners have been subject to profit-taking.

The technology sector is currently trading at a near-record forward P/E ratio not seen since the dot-com era in the year 2000 (please see chart), so further P/E expansion may prove difficult.

The late summer and early fall are a seasonally weak period for stocks in most years, which could prove the case again in 2023. However, there is also a strong tendency for pre-presidential election years to be positive (Dow Jones Industrials), with only one down year going back to 1939, so if the economy continues to show growth, the setup for a year-end rally could be favorable.

Fixed-Income Markets

The Federal Reserve has signaled that it is nearing the end of the rate-hiking cycle, although the market expects one or two more hikes are possible. Inflation has been trending lower but remains above the Fed's 2% target. The most recent reading was 3.2% on a year-over-year basis.

The yield curve remains inverted, with about a 66-basis-point differential between the 2-year and 10-year Treasury note. However, this spread has narrowed from over 100 basis points earlier this year. An inverted yield curve has often signaled a looming recession, but the market seems to be getting more comfortable with the "soft landing" scenario. The consensus of economists still forecasts positive GDP growth in both 2023 and 2024.

While the yield curve inversion has narrowed, absolute yield levels have been on the rise with the 10-year Treasury note above 4.25% - a level not seen in about 15 years. The short end of the curve is very sensitive to Federal Reserve policy, and until the Fed begins cutting rates, short-term Treasuries will likely remain above 5%. Currently the 10-year Treasury note is yielding about 4.3%, which implies a real rate of return of about 1.1 percentage points over current inflation. However, if we assume the Fed will be successful in getting inflation down to 2.5% to 3%, that would imply a real rate of return of 1.8% to 1.3%. Over the past 20 years, long-term Treasury bonds have returned about 3.9% annualized. With inflation over the same period running 2.6%, the net result is a 1.3% annualized real rate of return. Therefore, the market could be telling us that the Fed may have to settle for something above its 2% stated inflation target rate. Otherwise, long-term rates will need to fall at some point.

Economic Outlook

The economy has held up better than expected, and talk of a recession keeps getting pushed farther out. The consensus expects 1.6% GDP growth in 2023, but recent surveys, including the Federal Reserve Bank of Atlanta's GDPNow forecast, are predicting an acceleration in growth this quarter to a 5.8% annualized rate, which may prove high, but we have seen a pickup in growth the past two quarters.

The unemployment rate remains near an historic low at 3.5%, and we continue to see gains in monthly nonfarm payroll numbers. The three-month average is 218,000.

Another area that has defied expectations is housing. With mortgage rates above 7%, it was widely expected that demand would slow and prices would level off. Instead demand remains high, especially from all cash buyers. There is a lack of inventory, possibly due to homeowners being reluctant to part with a 3% mortgage. In addition, new home construction isn't keeping pace with household formations. Affordability is a concern, and first-time homebuyers are being particularly hard-hit. If rates remain above 7% there could be a ripple effect into higher-priced categories. Already, the monthly mortgage cost for a $400,000 home is about $400 more than a year ago.

Inflation has come down steadily as the Fed rate hikes have taken hold. Currently the year-over-year Consumer Price Index is at 3.2%, which is down from a peak of 9.1% in June of last year. The expectation is for inflation to average 4.1% in 2023 and decline to 2.5% in 2024.

Average hourly earnings have been growing at a 4.4% annual rate, but these wage gains have been slowing and generally have not kept up with inflation.

The Institute of Supply Management's Manufacturing Purchasing Managers Index is also deteriorating. This index is in a multi-month decline, and the present reading of 46.4 is the lowest since May of 2020 during the heart of the pandemic.

Overall, while there are still mixed economic signals, the economy has outperformed expectations. Most observers were expecting the unprecedented rapid rate hikes from the Fed to take us into recession by now, but the economy remains resilient.

Summary

The stock and bond markets are producing positive returns so far in 2023. Bonds are barely in the black with intermediate-term indexes up around 1%. Stocks have fared better, but the gains have been uneven. Broadly diversified portfolios have lagged the tech-heavy indexes, and some widely held sectors such as Healthcare are negative on the year. Most S&P sectors have lagged the return of the S&P 500 cap-weighted index.

Stock market valuations are high by historical standards but are being skewed by a handful of large companies. The typical stock has a valuation nearly four multiple points lower than the 20X level of the cap-weighted index, which lends credence to the possibility of a broadening trend where lagging sectors outperform expensive sectors that are currently trading at very high relative valuations.