Marco Investment Management

Investment Newsletter **November 2020**

Market Review

Introduction

The year 2020 continues to be an enigma. Few would have predicted that the stock market would hit an all-time high in November in the midst of a global pandemic. It remains to be seen whether recent moves in stocks reflect an overly optimistic view or are justified given the backdrop of promising vaccine developments, continued low interest rates, and strong economic numbers. We'll explore this and other topics in this edition of our Investment Newsletter.

Equity Markets

The stock market has been on a roller coaster ride in 2020. Monthly returns have varied dramatically but through October the S&P 500 index was up 2.8%. In early November we got news of a possible breakthrough coronavirus vaccine being made available by year-end. This resulted in a strong rally that took the market to new highs and a total return of 11.5% through November 10th. For context, at the March 23rd low the S&P 500 was down 30.4% for the year.

The recent rally has also seen a shift in leadership although it remains to be seen if this is the beginning of a new trend or just a short-term rotation. Companies that are viewed as pandemic winners (i.e. the "stay at home" stocks) have faltered a bit in favor of more cyclical value names. Since September 30th, the best S&P sectors have been Financials, Utilities, Energy and Industrials. In addition, the equal-weighted S&P 500 has been outperforming the capitalization-weighted S&P 500 indicating that small-to-midsized companies are doing relatively well.

While the broad economy is still trying to fully recover from the economic lockdowns earlier this year, corporate earnings have held up fairly well. The consensus of analysts is that the S&P 500 will have aggregate earnings growth in 2020 of 8.7% followed by 22.2% growth in 2021. If this proves correct that would help justify recent stock moves. Also, to date, Q3 earnings are coming in with a high percentage of positive surprises.

There has been some concern expressed that stocks have rebounded too much, especially with substantial uncertainty as to the timing of a return to normality. It is true that price earnings ratios have expanded and are well above historical averages. Some of this P/E expansion is justified by the extremely low level of interest rates which makes the present value of each dollar of earnings more valuable. In addition, 68% of S&P 500 companies have a dividend yield greater than that of the ten-year Treasury note. For many investors looking for income, stocks have replaced bonds as their preferred asset class. At last count, 134 S&P 500 companies had a dividend yield over 3%.

As we mentioned in our last newsletter, the stock market up to that point had been very bifurcated with only a handful of stocks doing well. The recent broadening out of the market is a welcome development in our view. While some stocks do look expensive, there are many others that had not participated in the rally until recently and still appear to offer good long-term value.

Fixed Income Markets

The Federal Reserve has indicated that short-term interest rates are not likely to move higher for at least another two years. The Fed is determined not to be an impediment to an economic recovery. They have also changed their target for inflation such that inflation over 2% will be tolerated for sustained periods of time before they take any action.

The implications of Fed policy is that high quality short-term bonds and money market instruments will likely be firmly grounded under 0.5% for the foreseeable future. This means one would have to either extend maturity or accept lower quality in order to get a yield comparable to the average stock dividend of 1.7%. That strategy comes with its own set of risks, chiefly principal risk in the event of a rise in rates or default risk if the company is unable to pay.

Optimism about economic growth in a post-pandemic environment has recently led to some expectation that inflation may begin to creep higher after being very subdued for years. This is being reflected in the ten-year Treasury yield moving up to almost 1% after touching 0.51% on August 4th.

This de-coupling of short and long-term rates has resulted in a steeper yield curve. Presently, the difference in yield between a two-year and ten-year Treasury note is 77 basis points (over three quarters of 1%). The average differential over the past two years is about 30 basis points.

While the steepening yield curve does provide some incentive to extend maturities, real interest rates (nominal minus inflation) remain negative so caution is still in order. As some commentators have quipped, the Treasury bond market is presently offering return free risk rather than a risk free return.

Economic Outlook

The trend in weekly initial jobless claims continues to improve as does the unemployment rate. The most recent weekly figure of 709,000 claims pales in comparison to the March peak of 6.9 million. The unemployment rate has also dropped to 6.9% down from a peak of 14.7%. While things are moving in the right direction, these are still elevated numbers and not back to pre-pandemic levels.

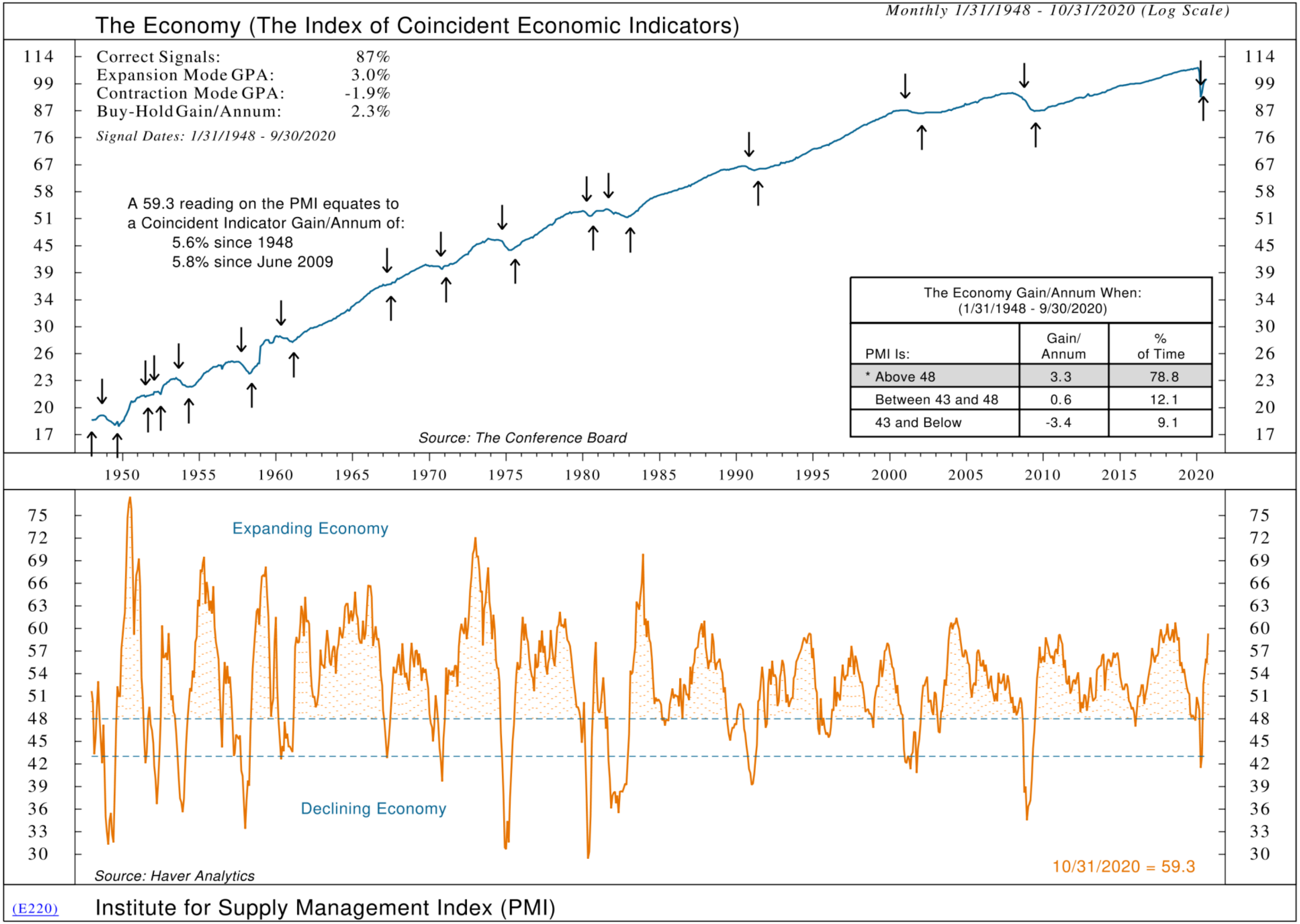
Gross Domestic Product ("GDP") came roaring back in the third quarter to a 33.1% rate. While this number was above forecast and clearly bodes well for future economic growth, it should be tempered by the fact that it is an annualized number. Economists are still expecting 2020 full year GDP to be down almost 4% compared to 2019. Next year the expectation is for full year GDP of 3.8% which would be a very good number but only gets us to about 2% above year-end 2018 levels.

Other economic reports have generally been coming in strong. The Institute for Supply Management's ("ISM") monthly Purchasing Manager's Index currently stands at 59.3. This is indicative of an expanding economy and historically a reading in this range coincides with about 3.3% GDP growth (please see chart). Residential real estate continues to show strength and Durable Goods orders increased 1.9% in September for the fifth straight month of gains. Consumer Confidence has also been showing gradual improvement.

Post-election there is optimism a bi-partisan stimulus bill can still be passed. There is a general consensus that some additional stimulus is needed, especially for vulnerable industries, but it is unclear whether anything will happen during the lame duck session. Even though the presidential election is still being contested, the market seems to be more focused on the possibility of divided government. Divided government has generally produced good investment returns. A recent study found that since 1950 a divided congress produced better stock market returns than when either Democrats or Republicans controlled both the House and Senate.

Summary

Considerable uncertainty still surrounds the outlook for the economy and the markets but the stock market is definitely taking a "glass half full" attitude. It is interesting that the "Roaring 20's", a strong decade for stock returns, followed the 1918 pandemic. That pandemic eventually ran its course with no vaccine. It is anyone's guess as to whether stocks will continue to respond favorably as we get on the other side of the current pandemic, but the virus has certainly been transformational for many aspects of the economy with long lasting implications. We are less enthused about the prospect for fixed income returns in the current environment but recognize that bonds can play a valuable diversification role for many investors. If real rates of return for bonds turn positive, we would be more inclined to increase exposure.



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