Marco Investment Management

Investment Newsletter **February 2024**

Market Review

Introduction

The stock market has rallied significantly since the low point in October of last year. Seasonally, November through January is often a strong period, but now the question is "Where do we go from here?" There are both bullish and bearish influences currently at play, and we will discuss these and other topics in this edition of our Investment Newsletter.

Equity Markets

The recent rally in stocks kicked off in late October when interest rates started to decline after nearly reaching the 5% level on the 10-year Treasury note. It was becoming clear around that time that the Federal Reserve was shifting policy to neutral from restrictive, and the anticipated policy change set off both stock and bond market rallies.

From November through January the S&P 500 Index rallied over 15%, and we also saw some broadening out with better participation outside of the mega-cap tech stocks. However, in recent weeks the market has narrowed again.

Earnings growth in 2024 is expected to be fairly strong, with analysts forecasting that earnings in 2024 will be about 10% better than 2023. This increase is notable since the final tally on earnings in 2023 should be fairly level with 2022, which means that stock market gains last year were primarily due to P/E multiple expansion rather than being earnings driven.

Currently the overall stock market valuation is rich, with the forward P/E edging above 20X. The long-term average is 15.4X. However, the S&P 500 Index is capitalization-weighted, so the current P/E ratio is being skewed by several highly valued mega-cap stocks. If we take the same 500 stocks and give them an equal weight, the P/E ratio becomes a more reasonable 16.8X.

The performance of the various S&P sectors has been uneven. Several bellwether sectors, such as Healthcare, Energy, and Utilities, lagged badly in 2023 but may present some opportunities in 2024. In addition, these sectors offer very attractive dividend yields.

Even with relatively high stock market valuations, there are reasons to believe that the rally can continue in 2024. The market is forecasting that the Fed will start cutting interest rates later this year, and an accommodative Fed is typically positive for the market. In addition, the economy has been stronger than predicted and consumers are still in a spending mood, which could help earnings of consumer cyclical companies. From a technical perspective, the major indexes have been posting record highs, which tends to be a bullish sign for the year. The Dow Jones Industrial Index has already posted 9 new highs in 2024. Going back to 1904, years with over 7 record highs have a median gain for the year of 17.9%. (Please see chart).

The year 2024 is a presidential election year. These years tend to be positive for stocks, with most of the strength coming in the latter half of the year. However, there are other factors that could influence the market in unpredictable ways. Geo-political tensions and unrest come to mind. Also, an unexpected reversal in recent inflation trends could cause the Fed to stay "higher for longer," putting the rally at risk.

Fixed-Income Markets

The bond market has been closely watching economic data and comments from Federal Reserve members as it tries to discern the path of interest rates in 2024. After 10-year Treasury rates almost touched 5% in October, a strong rally developed, taking the yield all the way down to 3.8% late in December. Since then, rates have crept up a bit as Federal Reserve Chairman Jerome Powell hinted that the Fed was in no rush to start cutting rates. The market had been expecting rates to be cut as soon as March, but now that timeline has slipped. The market forecast is still for multiple interest rate cuts this year but likely none before May or June. The strong jobs report in January is a contributing factor to this delayed timeline, as 353,000 new jobs were created, the highest monthly total in a year.

The yield curve remains inverted but much less so than in the recent past. The difference between the yield on a 10-year Treasury note and a 2-year is about 30 basis points. At one point last year the spread was over 100 basis points. Yields have dropped more on the 2-year Treasury than the 10-year Treasury.

Currently the gap between the upper bound of the Fed Funds Target Rate (5.5%) and the 2-year Treasury note is historically wide. In the past when the Fed Funds rate was very high relative to the 2-year Treasury yield, it was followed by one or more rate cuts.

The Fed is still targeting an inflation rate of 2%. While substantial progress has been made, we are still looking at year-over-year CPI growth of 3.4%. If the Fed is able to get CPI inflation down to 2%, we could see the 10-year Treasury yield declining from over 4% to 3.25% or 3.5%.

Spreads on investment grade corporate bonds have narrowed relative to Treasury yields, which could be interpreted as a sign that the bond market expects continued economic growth with no recession.

Economic Outlook

The economy has continued to grow and add jobs, confounding many prognosticators. The widely held belief was that 11 hikes in the Fed Funds rate would not only slow inflation but likely send the economy into recession. However, a recession has not occurred, and consumer confidence has been improving. The University of Michigan Consumer Sentiment survey jumped in January to its highest level since July of 2021, and the monthly jump was the biggest improvement since 2005.

One area that continues to languish in the wake of 11 rate hikes is home sales. Inventory remains low, which is keeping prices high, but overall volume is depressed. First-time home buyers are particularly affected by the lack of affordable housing. Sales of existing homes have declined in 20 of the past 24 months. On an annual basis, sales are at their lowest level since 1995. The recent downtick in mortgage rates may reverse this trend to some degree.

While consumers continue to spend, they are also getting deeper in debt. Consumer debt stands at $17.5 trillion, and delinquencies are on the rise. About 6.4% of credit card debt is in a seriously delinquent status, up from 4% at the end of 2022.

The typical rate on credit card balances has risen from 14.5% pre-pandemic to the current 21.5%. However, because income has been rising, the amount of total credit card debt relative to income is still below pre-pandemic levels even though servicing costs are up.

Given that consumers appear stretched, we will need to see above-average real wage gains and continued job growth to sustain or increase spending.

Unemployment remains low at 3.7%, and the Institute for Supply Management's surveys of both manufacturing and services are improving. The manufacturing survey is at a 15-month high.

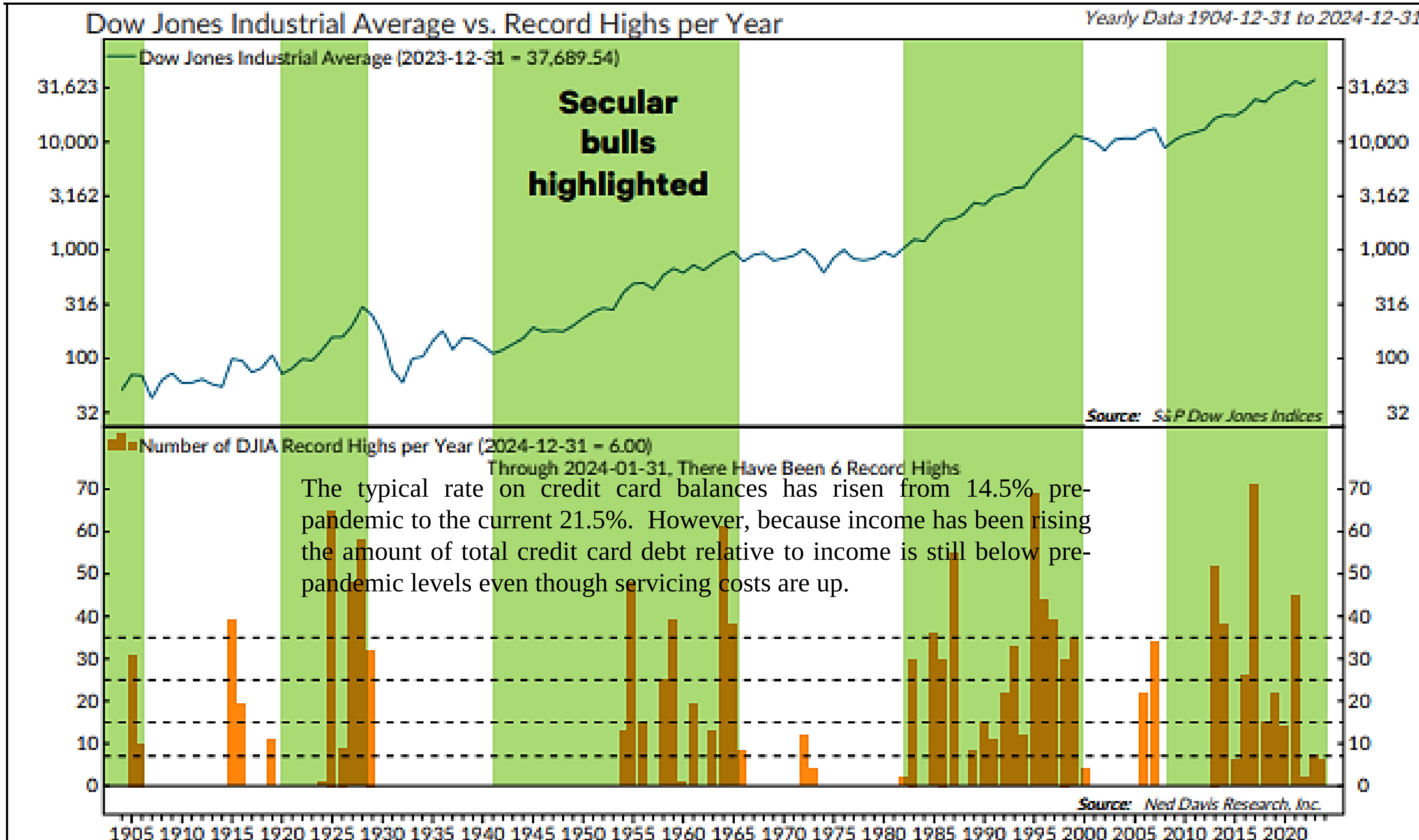
Overall, while there are still mixed economic signals, the economy has done better than many expected and, so far, a recession has been avoided.

Summary

The stock and bond markets have both rallied in recent months, sending stock market indexes to new highs and registering solid bond market returns. For stocks to continue to rally, we will likely need to see continued economic growth and a more accommodative Federal Reserve. Once the Fed begins cutting rates, money flowing into the market from other areas, such as money-market funds and short-term bonds, could be a catalyst for further gains.

Presently, stocks overall appear fully valued on a price/earnings ratio basis, but that ratio is skewed by a handful of stocks. The vast majority of stocks do not appear overvalued. Rather, they have suffered as investor attention has been focused on emerging areas, such as artificial intelligence. We expect some catch-up from these neglected stocks/sectors. If rates continue to decline, we could also see more interest develop in yield-oriented stocks. It appears S&P 500 dividend growth should be around 6% in 2024 adding further appeal.

We expect a good bit of market volatility in 2024 but remain optimistic for the full year.



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DJIA Performance Stats (1904 - 2023)	Records per Year					
	= 0	> 0	> 7	> 15	> 25	> 35
Year's Median % Gain	4.2	16.3	17.9	20.5	21.7	25.1
Next Year's Med. % Gain	10.8	6.4	3.2	2.2	1.2	2.3
# of Cases	66	54	46	32	26	17

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