Marco Investment Management

Investment Newsletter **August 2024**

Market Review

Introduction

Since our last newsletter, the stock market has moved higher, although in an uneven fashion with the bulk of the return coming from a handful of sectors. Anticipation of possible interest rate cuts and cooling inflation are driving prices higher. Fixed income markets are also benefiting from these developments. We will discuss these and other topics in this edition of our Investment Newsletter.

Equity Markets

The stock market in 2024 has benefitted from strong corporate profits, lessening fears of recession, and a belief that the Federal Reserve is about to embark on an interest-rate-easing cycle. In addition, investor enthusiasm for the promise of Artificial Intelligence has expanded the price earnings multiples for large technology companies that are expected to benefit, which has led to their outperformance.

The best-performing sectors this year are Technology and Communications Services. Both have 20%+ returns. At the other end of the spectrum, Consumer Discretionary, Real Estate, and Materials have lagged. Only 3 of 11 sectors have exceeded the overall index return.

Because of the narrowness of the market, the equal-weighted S&P 500 is lagging the capitalization-weighted S&P by almost half. The equal-weighted index is the more balanced of the two, with no single sector exceeding a weight of 16%. Meanwhile, Technology represents an outsized 32% of the capitalization-weighted index.

Because of P/E expansion, particularly in Technology and Communications Services, the forward P/E of the S&P 500 Index is currently 22.3X, which is high by historical standards. On the other hand, the equal-weighted index trades at a more reasonable 16.9X.

The market continues to be fairly volatile. We recently experienced an 8.4% drop in just 3 weeks, followed by a 7.2% gain in less than 2 weeks. The drop was primarily due to recession fears, but those were quickly dismissed by strong retail sales and continued hiring, albeit at a slower pace. Nevertheless, the market remains nervous and easily spooked by any unexpected data point.

Historically, presidential election years are positive for the stock market, and so far this year that tendency is on track. Interestingly, 2024 is not a typical presidential election year since the incumbent has chosen late in the race not to seek reelection. There have been a few other instances where the incumbent chose to step aside and did not seek reelection. Fortunately, this development did not derail the historical pattern of positive stock market returns (please see chart).

As mentioned in our last newsletter, one non-tech area that has done very well in 2024 is Utilities. After underperforming in a rising interest rate environment, the recent drop in interest rates has helped reverse that trend. Year to date, the sector is up almost 20%. Utilities are also being viewed as potential growth plays as the demand for electricity is expected to increase significantly due to the high demands placed on the grid from artificial intelligence applications and electric vehicles. Meeting this expected demand could be difficult, as construction investments to expand capacity can be drawn out.

Fixed Income Markets

Since our last update, fixed income returns have picked up and have gone from slightly negative to over 3% for investment-grade intermediate indexes. The rally in bond prices has occurred across the maturity spectrum except for very short-term issues where yields are tied directly to Fed action. If the Fed does lower interest rates in September, as widely expected, then the yield curve could return to a normal positively sloped shape where longer term bonds yield more than short-term bonds. We would also expect this Fed action to dislodge some of the money parked in short-term money market funds and send it into longer-term bonds and/or stocks.

The 10-year Treasury Note has fluctuated this year between 3.79% and 4.71%. It is currently at the low end of the trading range at 3.79%. Yields are not all that different from the beginning of the year, so most of the return has come from coupon income rather than price appreciation.

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 19 basis points. At one time last year the spread was over 100 basis points.

It is hard to predict if or when the Fed will achieve its 2% inflation target, but the recent 2.9% year-over-year number points to significant progress. If the Fed achieves a sustainable 2% inflation rate, we could reasonably expect to see the 10-year Treasury yield drop further, perhaps to somewhere in the 3.25-3.50% range. The consensus among economists is that inflation will average 2.3% in 2025.

Spreads on investment-grade corporate bonds remain relatively tight, which could be interpreted as a sign of confidence in the economy. The Fed has also waited longer than usual between the last rate hike and the first rate cut, which may also indicate that the economy has been more resilient than many observers predicted, meaning less need for stimulative monetary policy.

Economic Outlook

The economy has defied expectations and, to this point, has avoided recession, but there are signs of a slowdown. Manufacturing activity has eased a bit, and consumers appear to be pulling in the reins with less spending on travel. Consumer credit outstanding has increased relative to cash assets, and delinquency rates are on the rise. Consumer confidence remains subdued and has been hovering near the low end of its range since the summer of 2022. In the most recent Conference Board survey, the share of consumers who said it was hard to find a job increased to 16%, the most since March 2021. It appears that pandemic era government cash has pretty much been exhausted.

Although there are some signs of cooling, there isn't enough evidence to make a recession call. The economy is giving mixed signals, and pockets of strength remain. Economists on average peg the chance of recession around 30%.

If the Federal Reserve begins to lower short-term interest rates, it could provide enough fiscal stimulus to cause growth to rebound. At the moment, the consensus is calling for real GDP growth in 2025 of only 1.7%, but that could prove low if the Fed is successful in its drive for sustainable growth with only moderate inflation.

One key will be job growth. While the numbers have been fairly strong in recent months, with July being an exception, revisions to the numbers have generally been downward, rather than higher. A recent 12-month revision sent the job number lower by a significant 818,000 jobs. On the other hand, layoffs remain relatively low, which is an indication that while hiring may have moderated a bit, companies are hanging on to their full-time existing staff. The July employment report was weaker than expected, but some are blaming weather-related impacts. The unemployment rate did tick up to 4.3%, and labor force participation edged higher to 62.7%.

Overall, economic data is mixed, but the chance of recession in 2024 appears slim. Interest rate cuts may prove key to avoiding recession in 2025.

Summary

Although the U.S. economy is not gaining momentum, it continues to grow, and the stock market likes an environment of "not too hot, not too cold." That said, valuations appear stretched in some sectors, but the average S&P 500 stock trades at a P/E of under 17X, so pockets of value remain. We would welcome a broadening of the market so performance is not skewed just in the direction of mega-cap tech stocks. However, the market rewards consistency and strong earnings growth, and those stocks have generally delivered.

Volatility will likely continue, and some stocks are priced for perfection, meaning that any missteps will be punished severely. Outside of tech, we think good values exist in healthcare, energy, and some industrials. These stocks also tend to pay higher-than-average dividends, and over the long haul, dividends have proved to be a significant component of overall stock market returns. Fixed income securities could be range-bound with a downward yield bias over time.

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. Index performance does not reflect the deduction of advisory fees, transaction charges and other expenses. Potential for profit is accompanied by possibility for loss, including loss of principal.

Dow Industrials in Election Years - Incumbent Chose Not to Seek Reelection

Average (1904, 1920, 1928, 1952, 1968) = 13.95%
2024 YTD (2024-07-23) = 7.08%

116 115 114 113 112 111 110 109 108 107 106 105 104 103 102 101 100 99 98 97 96 95 94 93

YTD 2024

Incumbent not running for reelection

Jan Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec Jan

Source: *Bloomberg Finance L.P.*

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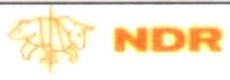

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