Marco Investment Management

Investment Newsletter **November 2023**

Market Review

Introduction

While most stock and bond indexes are in the black so far this year, it has been a very narrow, uneven market. For equities, a handful of stocks have led the way, while bonds have been held captive to Federal Reserve policy. There are now signs that interest rates may have peaked, and in this edition of our investment newsletter we will explore the potential impact of lower rates and the outlook for the remainder of the year.

Equity Markets

The average stock in the S&P 500 Index is about flat on the year, but there have been a few pockets of strength. This narrow market has been led primarily by mega-cap technology and a few internet communications companies. Interestingly, these same companies were among the worst performers in 2022.

Relatively high interest rates and inflation have penalized some sectors. For example, Real Estate and Utilities are the worst sectors, year to date. Other sectors posting negative returns this year are Healthcare, Consumer Staples, Energy, and Financials. While diversification is generally acknowledged as the preferred method of reducing risk, in 2023 broadly diversified stock portfolios are trailing higher-risk portfolios concentrated in Technology and Communication Services.

We believe that the ingredients are in place to see a broadening out of stock market performance. Interest rates appear to have peaked. If they have, that should take pressure off Real Estate and Utilities, in particular, and will likely help Financials as well. Healthcare has pulled back after posting a strong performance during the pandemic, but demographic trends continue to bode well for this sector. Energy demand remains strong, and these stocks offer some of the highest dividend yields in the stock market and may also be helped by ongoing industry consolidation.

Currently the overall stock market valuation does not look inexpensive, with a forward P/E ratio of almost 19X. However, after removing the influence of some of the high P/E mega-cap stocks, the average stock in the S&P 500 (equal-weighted) has a much more reasonable forward P/E of about 15X. The market is expecting earnings growth in 2024 to be about 9% over 2023, and dividends are expected to grow about 8% over the next 12 months.

In 2023, rising interest rates created competition for stocks as the 2.2% dividend yield on the S&P 500 Index was less than half the yield available from government bonds. However, bond yields may have peaked, and most bonds pay fixed rates as opposed to stocks, where dividends should continue to grow at a mid-single-digit rate. Historically, dividends have provided a substantial percentage of the total return from stocks (see chart). Currently the dividend payout ratio is below the historical average (since 1926), at 36.9% versus 56.2%, indicating that companies may be able to grow dividends at a nice clip in the future.

We have now entered what is historically a strong seasonal period for stock market performance, but substantial uncertainties persist, including geopolitical conflicts, the possibility that the lag effects of higher interest rates are not yet apparent and could lead to a slowdown, consumer spending could slow as individuals are dipping into savings to maintain their standard of living, and inflation remains above the Fed's target. On the other hand, the economy has been very resilient and there remains a lot of money on the sidelines that could potentially send stocks higher.

Fixed-Income Markets

The Federal Reserve has paused their rate hikes while they assess the impact of the cumulative rate hikes to date. Many market prognosticators believe there is no need for further rate hikes and see potential for rate cuts in 2024.

The yield curve remains inverted but much less so than in recent months. The difference between the yield on a 10-year Treasury note and a 2-year is about 37 basis points. Earlier this year it was over 100 basis points. Most of the change has come from the 10-year declining in yield, which could be an indication that the market believes the Fed is finally getting inflation under control. Consensus expectations are for inflation to average 2.7% in 2024. While it is still above the Fed's 2% target, 2.7% would be much improved from the 9.1% peak experienced in 2022.

Currently the 10-year Treasury note is yielding 4.45% after briefly touching 5% in mid-October. If inflation can be contained in a 2-3% range, then the current level of interest rates should provide a positive real rate of return. However, we would not expect long-term interest rates to drop much further until we have additional confirmation that inflation is under control. The real rate of return for long-term bonds over the past 20 years has averaged about 1.3% over the inflation rate.

We believe the best risk/return in bonds comes from intermediate-term securities. These securities offer a similar yield to longer-term securities with less volatility (duration risk). They will also provide some protection if the Fed eventually starts reducing short-term interest rates. Although government bond yields from 2 to 30 years are under 5%, many investment-grade corporate bonds are still yielding over 5%.

Economic Outlook

The economy has been remarkably resilient, posting relatively strong job growth along with a 3.9% unemployment rate. Nonfarm payrolls have increased at a 239,000 average monthly rate in 2023, although the most recent report for October moderated to 150,000. Some of this drop may have reflected the United Auto Workers strike that has since been settled.

Despite overall growth in hiring, there has been a recent pickup in layoffs, which is reflected in the unemployment rate ticking up to 3.9% from 3.8%.

Rising labor costs will have to be passed along to consumers or absorbed by companies in the form of lower profits. For example, the upfront cost of the new Teamsters contract with United Parcel Service penalized their quarterly results. It is estimated that the new UAW contracts could push the average wage and benefits for the big three automakers to $75-$80 per hour, which could put them at a competitive disadvantage with non-union and foreign auto makers.

Mortgage rates for conventional 30-year mortgages are well over 7%, which has had a negative impact on entry-level buyers. Higher-priced homes have held up better due to lack of inventory and more cash transactions. Overall, a supply/demand imbalance has kept prices relatively high in most markets but on a reduced transaction volume.

The Federal deficit continues to grow at a rapid rate and ended fiscal 2023 with about a $2 trillion shortfall, which was almost double the level of the past fiscal year and reflected higher debt servicing costs, increased defense spending, cost-of-living increases, and lower tax receipts. Clearly this trend is troubling, although better-than-expected economic growth in 2024 would help ease concerns.

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 recovered a bit from very poor results in 2022. However, gains have been uneven, and many stocks have not participated in the rally. One potential catalyst could come in the form of a less restrictive Federal Reserve. The market would likely welcome stability as it relates to interest rate policy, which might draw more cash into stocks that is currently parked in short-term investments. A broadening trend may also develop where some of the cheaper valuation sectors play catch-up to the more expensive areas, such as mega-cap tech.

Fixed-income securities are now offering positive real rates of return based on projected inflation rates. We believe rates may now be in a trading range, but for income-oriented investors, having some allocation to bonds is more attractive than in many years.