Marco Investment Management

Investment Newsletter **November 2024**

Market Review

Introduction

The financial markets are shaping up to have a strong year in 2024. In particular, the stock market has done extremely well. A recent shift toward easing in Federal Reserve monetary policy, increasing enthusiasm for new technologies like Artificial Intelligence, and the potential for pro-growth policies out of Washington have all contributed to the rally. Fixed income has lagged stocks but appears poised to deliver low single-digit returns. We will discuss these and other topics in this edition of our Investment Newsletter.

Equity Markets

Equity investors have embraced the "Goldilocks" economy of not too hot and not too cold. Earnings growth has been solid, and inflation has moderated to below 3%. Valuations look expensive for some stocks, but the average stock carries a forward price-earnings ratio a little below 18X, which isn't extreme. If the proposal to lower the corporate tax rate is enacted, then more earnings would flow to the bottom line, making the P/E lower than its current level.

The best-performing S&P sectors this year are Technology and Communication Services, followed closely by Financials. All have returned over 30% year to date. Lagging sectors include Healthcare, Real Estate, and Energy. Only 4 of 11 sectors have exceeded the overall Index return.

Even though the market has begun to broaden a bit, the equal-weighted S&P 500 is still lagging the capitalization-weighted S&P 500 by a large amount (eight percentage points). The equal-weighted index is the more balanced of the two. For example, Technology is weighted at 13.8% in the equal-weighted index, whereas Technology represents an outsized 33% of the capitalization-weighted index.

The market has staged a nice post-election rally, with the S&P 500 up about 2% in the two weeks since November 5th. However, the initial euphoria that took the S&P up 3.8% in the first few days following the election gave way to some profit-taking. Historically, November through January is the best three-month period for the stock market, so it is possible that the recent strength could have some further follow-through (please see chart). However, we do expect choppiness as there may be more short-term profit-taking given the meaningful gains we have seen year to date.

Since the election, we have seen some changes in sector performance, with the Finance, Consumer Discretionary and Energy sectors doing best. All are economically sensitive. Technology and Communication Services have moved higher but only moderately so. Healthcare has continued to lag.

One reason that Consumer Discretionary stocks have rallied is that consumer spending continues to come in stronger than expected. In October, retail sales rose by a bigger-than-expected 0.4%, and the prior month also saw a big upward revision, which bodes well for GDP growth since consumer spending is a big component.

Fixed Income Markets

Although the Federal Reserve has changed policy from restrictive to gradual easing, the fixed-income markets have been more focused on whether we will see continued progress in moderating inflation and what the implications might be for the future pace of rate cuts.

The 10-year Treasury note has fluctuated this year between 3.62% and 4.71%. At 4.45%, it is currently at the higher end of the trading range. Interestingly, the yield bottomed around the time of the Fed's 50-basis-point rate cut in mid-September and has risen about 83 basis points since then, even with another Fed Funds rate cut in early November (25 basis points). The yield curve seems to be moving back to a more normal slope, where short-term rates are lower than longer-term rates. Prior to the Fed's action the yield curve was inverted.

We believe the 10-year Treasury should trade at about 1.5 to 2 percentage points above the inflation rate. Currently the year-over-year Consumer Price Index is 2.6%, so a 4.45% yield on the 10-year Treasury note seems reasonable. If the Fed is successful in getting inflation to their 2% target, then we can expect the 10-year to rally to a yield of 4% or less. Core CPI (excluding food and energy) has been sticky and is currently 3.3% on a year-over-year basis. Progress on bringing down inflation has stalled a bit, which may lead the Fed to slow the pace of future rate cuts.

Presently, the consensus among economists is that inflation will average 2.9% for the full year in 2024 and then moderate to 2.3% in 2025. Many factors will be at work. An expected increase in energy production could be disinflationary, while other government policies, such as imposing tariffs on some imported goods, could push inflation higher. As far as talk of tariffs goes, it may just prove to be a negotiating ploy to achieve fairer trade with other nations.

Economic Outlook

The economy continues to do relatively well, with growth in 2024 expected to come in around 2.7%. The question for 2025 is whether policies coming out of Washington will lead to acceleration in growth. Currently, economists expect growth to average around 2% in each of the next two years. Excluding the Covid-induced recession in 2020, 2% growth would be considered subpar.

At present, the probability of the U.S. entering a near-term recession seems slim. Economists peg the chances at only about 25%, and that might require an unexpected shock to the system.

The October jobs report was possibly distorted by two hurricanes and a strike at Boeing. Even so, the 12,000 nonfarm payrolls number was well off the estimate of 100,000 and was the smallest gain since December of 2020. In addition, the past two months' payrolls were revised downward by 112,000.

On a positive note, the Conference Board's Consumer Confidence Index rebounded 9.5 points in October to an above-consensus 108.7, the highest level this year. The forecast for November is for further improvement to 113.5.

This result would imply a possible pickup in economic activity. The unemployment rate is currently 4.1%, and the labor force participation rate remains steady at 62.6%.

The ISM Services PMI increased 1.1 points to 56.0 in October, which was the highest level since July 2022. This measure is historically consistent with above-trend economic growth. While the Manufacturing PMI remains below 50 and in contraction territory, service sector strength implies that the economy is in decent shape as we head into the final stretch of this year.

Overall, the economy seems to be on a firm footing and consistent with the "not too hot, not too cold" narrative.

Summary

Although stock market valuations appear stretched in some sectors, the prospect of pro-growth policies out of Washington and lower corporate tax rates makes the case for further upside in the market. We are also entering what has historically been a seasonally strong period for stocks. Rising interest rates could be problematic, but we believe that we are near the high end of the trading range for bond yields, with the potential to see rates drift lower over time.

We have recently seen some broadening in sector performance, which we view as a positive sign. Mega-cap technology and communication services stocks have led the market in 2024 as the market has paid up for consistency and financial strength, but we see potential for the rest of the market to begin closing the performance gap, especially if the economy reaccelerates and earnings gains are not just concentrated in the biggest companies.