Marco Investment Management

Investment Newsletter **February 2026**

Market Review

Introduction

After another good year for stocks and bonds, the markets have begun 2026 a little bumpy with a good bit of sector rotation in the stock market and somewhat higher yields in the bond market. There are, however, reasons to be optimistic about the prospects for full year 2026. We will discuss some of these reasons and other topics in this edition of our Investment Newsletter.

Equity Markets

The year 2025 marked three years in a row of double-digit S&P 500 Index returns. Once again, the capitalization-weighted S&P 500 outperformed the equal-weighted S&P 500 as mega-cap Technology and Communications stocks did particularly well. Just seven stocks in the index provided over half of the index's return during the year. All but one of these stocks came from the Technology and Communications areas.

The narrow and concentrated performance in 2025 has shifted to a broader-based market in early 2026. Technology is registering a negative return year to date, while the top-performing sector is Energy. Through the first week of February, the equal-weighted S&P 500 is outperforming the capitalization-weighted S&P 500 by over four percentage points. We believe this broadening trend is healthy and is allowing many more stocks to participate in the rally.

Technology stocks have pulled back in 2026 partly on concerns that AI applications will be disruptive and could threaten the recurring revenues of many software companies. In addition, capital spending by Technology companies on data centers, etc., represents a huge dollar commitment with no assurance of a return on investment in the near term. While these are valid concerns, it appears that the spending is necessary for the U.S. to retain its technological lead in this area and will likely pay off in the long term.

Investors have rotated some funds away from mega-cap technology stocks, which has benefitted sectors that lagged in 2025. In addition to Energy, we have seen a nice move year to date in Consumer Staples and Materials stocks. Even with the recent broad market rally, the forward price earnings ratio of the equal-weighted S&P 500 remains below that of the capitalization-weighted S&P 500, at 18.2X versus 22.8X. We believe that the outsized gains we have seen in recent years from some mega-cap technology stocks pushed their valuations to levels that made them vulnerable to profit taking, but these fast-growing companies are still very important to the overall health of the stock market, and we expect them to do well in the future. However, they may not outperform the broad market as consistently as in the past.

Currently, the average stock in the S&P 500 Index carries a dividend yield of 1.2% (equal-weighted 1.9%). Dividends are expected to grow about 7% in 2026. While this 1.2% average yield is relatively low, many stocks still yield 3 to 4% or more, so stocks can still be viewed as a way to provide income in a portfolio, assuming higher-yielding sectors are emphasized. Also, the average dividend payout ratio is historically low, indicating that companies have the capacity to increase dividends at an above-average rate of growth if they choose to do so (please see chart).

Historically, when the S&P 500 Index registers a positive return in January, the tendency is for the full-year return to also be positive. This "January Barometer" has an 84% accuracy rate going back to 1950. The S&P 500 Index registered a positive return of 1.4% in January of 2026, which provides some further optimism for the rest of the year. The Dow Jones Industrial Average also recently hit an all-time high, implying investor confidence in stocks.

We expect choppiness from the stock market in 2026, but we believe that the uptrend remains intact and that there is a strong likelihood of positive returns this year.

Fixed Income Markets

Fixed-income securities have been trading in a fairly narrow yield range, but yields are a little higher (10-year Treasury) than where they began the year. The 10-year is currently 4.22% compared to 4.17% at year end, even with the market expecting further Fed Funds rate cuts in 2026. At present, the market expects two more rate cuts in 2026, taking the Fed Funds target rate to just over 3%. One sticking point is that the market also expects inflation to average 2.7% in 2026. While this inflation rate would continue the recent trend of lower inflation, it is hard to see the 10-year Treasury yielding much less than 4% with inflation at that projected level. Investors will likely demand some "inflation premium" in bond yields to insure a positive real rate of return. In addition, typical inflation hedges like gold are trading near all-time highs, indicating there is still some concern about long-term inflation trends. The yield curve is also positive, with the 10-year Treasury yielding about 72 basis points over the 2-Year Treasury, implying some inflation premium is embedded in longer-term securities.

Corporate bond spreads remain tight, indicating confidence in the U.S. economy and strong investor demand. However, these tight spreads reduce the attractiveness of corporate bonds relative to Treasury notes.

Compared to a few years ago when many bonds yielded 1-2%, today's yields of around 4% or more seem much more reasonable and provide needed cash flow for income-oriented investors. While we don't see yields declining too much from here, if the Fed is successful at lowering inflation to its 2% target, we could see lower yields. However, that 2% target has proved elusive, and the market is skeptical that we will reach that level anytime soon.

The term of Fed chair Jerome Powell ends in May, and the nominee to take his place is Kevin Warsh. He is a former Fed governor and is widely respected, but his confirmation may face some pushback. If confirmed, he is expected to push for lower short-term rates to help stimulate the economy.

Economic Outlook

The U.S. economy has been doing relatively well, with GDP presently running at a 4.4% quarterly annualized rate. It remains to be seen if this recent acceleration in growth can be maintained. The year-over-year growth rate is 2.3%, which basically mirrors the 2.4% market expectation for 2026.

The argument for faster growth is that the positive economic effects of the "One Big Beautiful Bill" are just now starting to be felt. Between lower tax withholding on individuals and accelerated write-offs for capital investments by corporations, as well as other provisions in the bill, the economy could be poised to post strong results.

Consumer sentiment (University of Michigan survey) has also been improving and is presently at a six-month high. While still below levels from a year ago, the trend is improving and lends credence to the argument that consumer spending will be supportive for the economy in 2026.

The Institute for Supply Management's Manufacturing survey also recently registered a well-above-consensus reading of 52.6. The expectation was for 48.5. Readings above 50 indicate expansion. The ISM New Orders index also showed a strong jump of almost 10 percentage points to 57.1.

One wild card for the economy could be the pending Supreme Court ruling on the legality of the Trump tariffs that have been negotiated or imposed on a wide variety of trading partners. To date, the tariffs are generating a lot of revenue for the government without an apparent negative impact on the inflation rate, so any reversal of the tariff policy could rattle the markets at least temporarily. The Trump administration claims they have a backup plan if the ruling goes against them, but it could still be a disruptive period.

Summary

The stock market appears relatively healthy at this time despite three years of double-digit returns pushing valuations to above-normal levels. The recent broadening trend is a welcome development and could extend the length of the bull market. Dividends should continue to rise at a healthy clip. Fixed-income yields are relatively attractive in comparison to inflation expectations, and 4+% yield levels are a good source of income for investors with cash flow needs. We expect yields to stay in a trading range for the time being with the possibility of somewhat lower rates down the road.