Marco Investment Management

Investment Newsletter **May 2024**

Market Review

Introduction

Since our last newsletter in mid-February, the S&P 500 Index is up about 5% despite dropping over 4% in the month of April. Bonds have been rangebound in recent months, posting slightly negative returns so far this year. Investors are now fixated on whether the Fed will lower rates this year and whether earnings will continue to grow despite weakening consumer confidence. We will discuss these and other topics in this edition of our Investment Newsletter.

Equity Markets

The stock market has bounced around a good bit so far in 2024, but the overall trend has remained positive. The broadening out in stock performance has faded a bit, with the cap-weighted S&P 500 performing better than the equal-weighted S&P 500 so far this year by about 5 percentage points. Large-cap Technology and Communications stocks continue to do well along with strong results from Energy and Utility stocks.

Weaker areas in the market this year include Consumer Discretionary, Real Estate, and Healthcare stocks.

First quarter earnings reports have come in above expectations in most cases. As of this writing, 76% of reporting companies in the S&P 500 have beaten expectations. Forward-looking guidance has generally been good, too. The bulk of the earnings growth is still concentrated in some of the mega-cap names, but there is some indication that earnings are picking up across a wider swath of companies. The consensus expectation is for 9.7% earnings growth for the S&P 500 in 2024, which would be a considerable improvement over 2023 when earnings growth was relatively flat.

The potential fly in the ointment is that stock valuations are elevated, with the S&P cap-weighted forward P/E ratio at 21.7X. There is little room for disappointment, as expectations are high that we will see continued growth and no recession.

Although the market P/E appears high by historical standards, this measure is skewed by mega-cap Tech and Communications companies. If all 500 stocks in the Index are given an equal weighting, the forward P/E ratio is a more reasonable 17.3X.

So far in 2024, six of eleven S&P sectors have outperformed the overall index return. One sector that has seen a notable turnaround from 2023 is Utilities. In 2023 the Utility sector was penalized by higher interest rates, but rates now appear to have peaked. 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. The challenge will be to meet this expected demand, as construction investments to expand capacity can be drawn out.

Fixed Income Markets

The bond market has struggled to make much headway in 2024. Year to date, the total returns of most intermediate-term fixed income indexes are slightly negative.

The 10-year Treasury note has fluctuated this year between 3.88% and 4.71%. It is currently around 4.41%. We started the year at the low end of the range, so the increase in yields since then has resulted in negative returns. Over this same period, improvement in the inflation statistics has stalled, prompting market participants to dial back their expectations for Federal Reserve rate cuts in 2024. Early this year the expectation was for 6 or 7 cuts, and now we are looking at perhaps 1 to 2 cuts. The Fed has not discouraged the new narrative of "higher for longer." For the Fed to cut rates, we will probably need to see a substantial slowdown in the economy or further progress towards the Fed's 2% inflation target. The attached chart shows the year-over-year inflation rate. While we are well off the recent 9.1% high, inflation has been stuck in the 3's since June of last year, which has kept the Fed on hold.

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 42 basis points. At one point last year the spread was over 100 basis points.

Because short-term interest rates are higher than longer-term rates, a lot of money remains parked in cash equivalents. When the Fed does embark on their next rate cutting cycle, it will likely spur a reallocation of some of this cash into longer-term bonds and/or stocks.

It is hard to predict if or when the Fed will achieve its 2% inflation target. There is some speculation that the Fed may be willing to accept a somewhat higher rate of long-term inflation, but so far they have dismissed this line of thought. If they are successful in achieving a sustainable 2% inflation run rate then we could reasonably expect to see the 10-year Treasury yield drop to somewhere in the 3.5% range.

Spreads on investment-grade corporate bonds remain relatively tight, which could be interpreted as a sign of confidence in the economy. We do have some concern about smaller companies with low-cost debt on their balance sheets being able to absorb higher refinancing costs as this debt matures.

Economic Outlook

While the economy has shown remarkable resilience, some leading economic indicators have deteriorated a bit. For example, the most recent University of Michigan Consumer Sentiment Index dropped to 67.4 from the previous month's 77.2 reading. The Conference Board Consumer Confidence Index dropped in April from 104.7 to 97. These surveys could be an indication that consumers are getting a bit stretched and may have depleted some of their reserves. Persistent inflation, which has been particularly noticeable in things like groceries and insurance, may be weighing on confidence. Also, the cost to carry credit card balances has ballooned to an average of 24.71%. The average rate has ticked up steadily for 27 months, now. According to the New York Fed, about 8.9% of credit card balances have been classified as delinquent, up from 4% at the end of 2022.

The Institute for Supply Management (ISM) surveys have also slipped. The Manufacturing Purchasing Managers' Index stands at 49.2 compared to 50.3 the previous month, while the Services Purchasing Managers' Index dropped from 51.4 to 49.4. Readings above 50 are indicative of economic expansion.

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 3.9% but is off the lowest level of 3.5%, recorded in January of 2023. There is some concern that a lot of the recent growth in jobs created has been in the form of lower-wage part-time jobs. The labor participation rate has been holding fairly steady at 62.7%.

Overall, while there are still mixed economic signals, the economy has done better than many expected, and so far, a recession has been avoided. The consensus of economists is that U.S. Gross Domestic Product (GDP) will grow 2.4% in 2024.

Summary

Despite restrictive Fed policy and a stretched consumer, the stock market continues to grind higher. Developments such as artificial intelligence are creating excitement and hope for future productivity gains. The buzz has sent shares of mega-cap technology and communications companies higher. The broad market continues to lag these mega-caps, but the large valuation gap could close over time, especially if the other sectors start to contribute more to overall S&P 500 profits.

2024 is a presidential election year, and historically those years are also positive stock market years. We think the market could mark time over the next few months, but as we get closer to the election seasonal factors should turn positive and could give stocks a lift. If the Fed does offer up at least one rate cut before the election, it would likely be well received by the market. Valuations are pretty full, though, so a continuation of recent positive earnings growth and positive earnings surprises will probably be necessary to keep the market momentum positive.

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.

CPI vs CPI Less Food & Energy Inflation

Monthly Data 1950-01-31 to 2024-04-30

Shaded areas represent National Bureau of Economic Research recessions

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