Marco Investment Management

Investment Newsletter May 2025

Market Review

Introduction

The first few months of 2025 have been a roller coaster for markets. Initial strength in the stock market gave way to tariff and interest rate anxiety followed by renewed optimism. Fixed-income securities have also fluctuated with uncertainty regarding the outlook for inflation and the economy. The direction markets take, over the balance of the year, will be highly dependent on all these factors. We will discuss these and other topics in this edition of our Investment Newsletter.

Equity Markets

At the end of April the year-to-date return for the S&P 500 was -4.9%. Looking at this one data point would indicate some normal profit taking after strong returns in both 2023 and 2024. However, this limited view does not tell the full story.

The market peaked on February 19th and then began pulling back on nervousness about upcoming tariff announcements and their implications for economic growth, not only in the U.S. but globally. Concerns about growth also contributed to interest rates dropping about half a point over the same time frame. The actual "Liberation Day" tariff announcements on April 2nd were not well received, as they were much higher than expected. The low for stocks was registered on April 8th. At that time, the S&P 500 Index was off 18.8% from the February high and the tech-heavy NASDAQ Composite Index was off 23.8%.

Since then, we have seen a strong stock market recovery. Some of the tariffs have been postponed or rolled back, and economic data continues to come in relatively strong. Reports on inflation have also been fairly muted. The market seems to be getting more comfortable with the tariff situation and the possibility that the tariffs will have the desired long-term effect and that any short-term pain will be manageable.

Because the market has been so volatile, there has been a move toward companies with stable outlooks and attractive dividends. Year to date through April, the best-performing sector has been Consumer Staples followed by Utilities and Healthcare. All three are classic defensive sectors. On the flip side, the worst sectors year to date are Consumer Discretionary, Technology, and Communication Services. These sectors have done very well in the past but are characterized more as "risk on" than "risk off". In recent days we have seen some movement back into these sectors.

The S&P 500 Index currently carries a forward price-earnings ratio of 21.3X, which is down from 23.1X in February. This level is still historically high, and the fact that we went into the initial tariff announcements at a high valuation probably made the selloff more pronounced.

Historically when the market suffers a sharp sell-off, it takes some time to resume the uptrend. During the most recent sell-off, the trend lines for both the 50- and 200-day moving averages were crossed and investor sentiment turned very negative, which caused the market to go from a short-term overbought condition to oversold. The oversold condition led to a strong upward bounce that was followed by another sell-off. That sell-off did not reach beyond the prior low. It remains to be seen whether another successful re-test of the prior low will occur, but we are currently trading above the 50-day moving average and quarterly earnings reports have generally been good, so we are hopeful the April 8th low will hold.

Fixed Income Markets

Despite a lot of economic uncertainty at present, the bond market continues to trade in a broad range of roughly 4% to 4.5% on the 10-year Treasury note. It is unknown whether tariffs will cause a one-time increase in the inflation rate, but longer-term inflation expectations seem to be settling at around 2.3% (please see chart), which means that the 10-year Treasury yield is trading about 2 full percentage points above inflation expectations. To us, that yield spread seems like fair compensation.

The 2-year Treasury note is trading below the Fed Funds rate, which is a signal that the market feels short-term rates are too high and that the Federal

Reserve will begin cutting the Fed Funds rate this summer, with more cuts later in the year. Currently the expectation is for around 3 or 4 cuts that will bring the rate down by three-quarters to one percentage point. The Fed has been very data-dependent, so they will likely want another data point or two on inflation and hiring before taking action.

Yield spreads on corporate bonds and municipal bonds have widened a bit, given the economic uncertainty, but they remain within historical norms. Many investment-grade corporate bonds are yielding about a percentage point higher than the comparable-maturity Treasury note. The widest spreads are in Finance-related bonds, with high-grade industrial bonds trading with the narrowest spreads.

Economic Outlook

The outlook for the U.S. economy is mixed, but growth is still expected for the full year. Most recently, GDP was reported to have contracted in the first quarter to an annualized rate of -0.3% (down from 2.4%); however, the contraction in the reported number was mainly attributable to a surge of imported goods that were purchased in an attempt to front-run upcoming tariffs. Imports subtract from GDP, while exports are additive. The consensus among economists expects overall real GDP growth in 2025 of 1.4%.

The Institute for Supply Management's Manufacturing and Services surveys are giving mixed signals, with the Services survey indicating expansion while the Manufacturing survey is indicating contraction. Consumer sentiment surveys have weakened. The Conference Board survey came in at 86 versus the prior month at 92.9.

April nonfarm payrolls surprised on the upside at 177,000 compared to an expectation of 130,000. However, the prior month was revised downward to 185,000.

Despite market participants expecting inflation to stay relatively mild, consumers have a different view with a 5- to 10-year average inflation estimate at 4.4%. It is likely that all the media talk about the impact of tariffs is skewing this survey. The actual impact of tariffs would probably be a one-time event and should not continue to drive the number higher over 5 to 10 years.

First-quarter corporate earnings reports have generally been good, with an average increase of 12.8%. So far, 76% of companies that have reported to date have beaten the consensus expectation for earnings per share and 62% have reported a positive surprise on revenues.

Although the earnings have been fairly strong in the first quarter, many companies have pulled or lowered their forward guidance due to economic uncertainty tied to tariff policy. If the tariffs are maintained at current levels, we would expect earnings growth in the second quarter to suffer. Currently the consensus expects a small contraction compared to the first quarter, but it is a fluid situation. However, an offsetting factor would be the revenue generated by the tariffs, which could be applied to deficit reduction.

There is a strong probability that Congress will extend the 2017 Trump tax cuts this summer. They may also add further tax cuts, which could spur economic growth and serve as a market catalyst in the second half of the year.

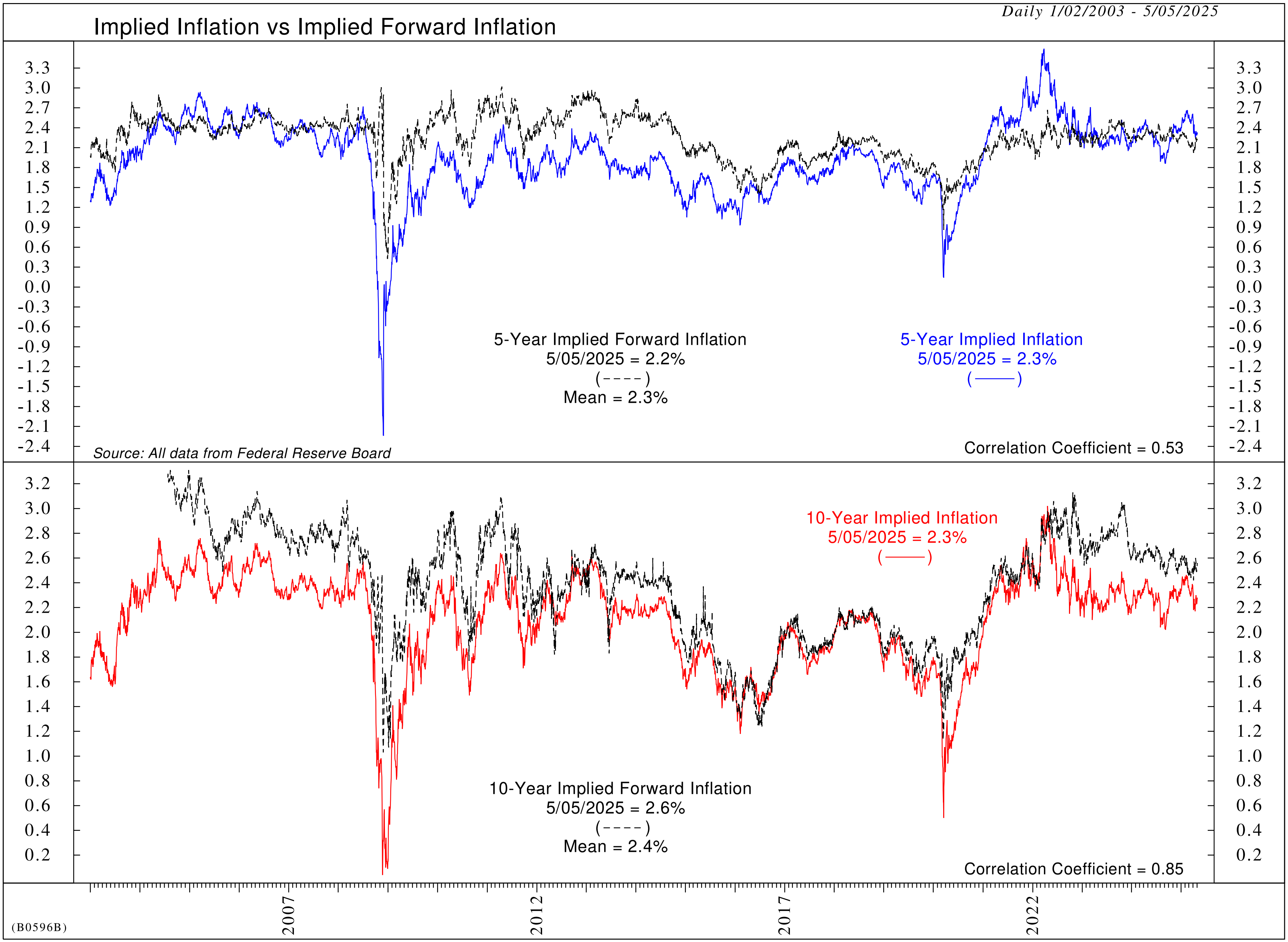
Summary

We have seen extreme volatility in stock prices so far in 2025, and the market remains very headline driven. Certainly tariff policy will result in both winners and losers in the short term, but the overall objectives of reshoring manufacturing and lessening our dependence on foreign countries for critical materials and products are worthy goals.

On a capitalization-weighted basis, valuations for stocks remain elevated, but on an equal-weighted basis the market looks reasonably valued at about 17X. Highly-valued stocks have lagged year to date, and the gap between these stocks and the broad market may continue to narrow.

We expect fixed-income securities to continue to trade in a range but feel that these securities offer good value relative to expected inflation.

Despite the negative returns registered by most stock indexes year to date, we see a good chance of a better news flow in the coming months that could lead to positive stock market returns in 2025.


Daily 1/02/2003 - 5/05/2025
Implied Inflation vs Implied Forward Inflation
5-Year Implied Forward Inflation
5/05/2025 = 2.2%
(- - - -)
Mean = 2.3%
5-Year Implied Inflation
5/05/2025 = 2.3%
(——)
Source: All data from Federal Reserve Board
Correlation Coefficient = 0.53
10-Year Implied Inflation
5/05/2025 = 2.3%
(——)
10-Year Implied Forward Inflation
5/05/2025 = 2.6%
(- - - -)
Mean = 2.4%
Correlation Coefficient = 0.85
2007
2012
2017
2022
(B0596B)