THE TANDEM REPORT

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"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it."

~ Ralph Waldo Emerson

Dear Clients,

Tandem is committed to the preservation of your wealth by minimizing risk while adding value through superior investment performance. This issue of *The TANDEM Report* provides a summary of our views pertaining to the investment landscape and subjects that influence our decision making. More information about our firm, including our investment style and process, is available at www.tandemadvisors.com or upon request. We hope you find this report useful.

Respectfully,

John B. Carew
President,
Chief Investment Officer

In This Issue

MARKET COMMENTARY:
IT'S BEEN A QUIET SUMMER IN LAKE WOBEGON

On the surface the second quarter of 2013 was relatively mild. The S&P 500 returned a respectable 2.91%, much tamer than its 10.61% surge in the first quarter. Beneath the surface lies some degree of entertainment, if not drama.

A May 29th *USA Today* headline read: "*Bull run gets solid footing*". Those looking for an excuse to lock in gains and head to the beach for the summer had found one. Dating back to the 1979 *Businessweek* article entitled "The Death of Equities", the media has earned a reputation as a contrary indicator. The *USA Today* proclamation was viewed by many as a market top.

And indeed it was, at least for a time. The day the article ran the S&P closed down 0.7%. A week later it was 3.1% lower. In reality the market had begun a correction a week earlier on May 22nd. From its historic closing high the previous day, the S&P would lose 5.8% of its value by June 24th before regaining the solid footing that *USA Today* had written of.

In the midst of the stock market's correction something else, something far more important than press headlines, was brewing. Interest rates were rising with a vengeance. Mortgage rates went from 3.5% to 4.5% in a month. Would this derail the long-anticipated yet still fragile housing recovery? The rate of the 10-year Treasury, an important benchmark yield, rose from 1.86% at the beginning of the quarter to

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COMMENTARY:
A 32 YEAR BULL MARKET NEARS ITS END. NOW WHAT?

Like a pendulum reaching its full amplitude before forces return it toward equilibrium, 1981 witnessed the end of a massive run higher for interest rates and a reversal of fortune for bond investors that would last more than three decades. Then-Federal Reserve Chairman Paul Volker had broken the back of inflation and rates would head steadily lower for the next 32 years.

Those old enough to remember the late 1970's and early 1980's will recall interest-bearing checking accounts with yields in the high teens. On July 26, 1981, a 30-year U.S. Treasury bond provided a yield of 15.21%. Any investor lucky enough to buy that bond and hold it to maturity would have realized a 15.21% annual return for 30 years with zero risk. No wonder no one was buying stocks at the time. Who needed them? Rates that high can paralyze an economy, make mortgages unaffordable and cripple a stock market. They can also put an end to persistent inflation. And they did.

Many say the pendulum is reversing course again as interest rates have finally started heading higher. To some extent we have been here before. The Fed shocked the market by raising rates temporarily in 1994. The Fed again raised rates in the years after the recovery from the tech bubble and 9-11, only to cut them to zero in the aftermath of the financial crisis. Each of these hikes produced very different results for the stock market.

To be clear, the Fed is maintaining its zero interest rate policy for the foreseeable fu-

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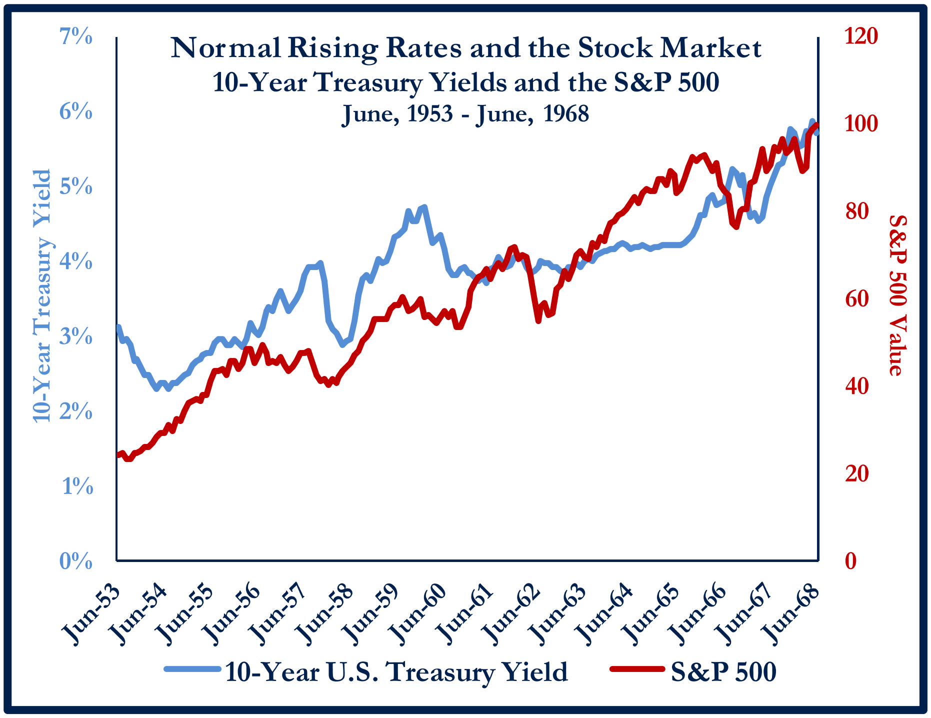
ture. Sometimes the market gets ahead of the Fed and forces rates higher despite Fed policy. This is why some say the Great Bull Market for bonds is nearing its end. The Fed may not be ready to call an end, but many investors believe it is inevitable. Suffice it to say that the end of a 32 year run is at least near, if not at hand. Now what?

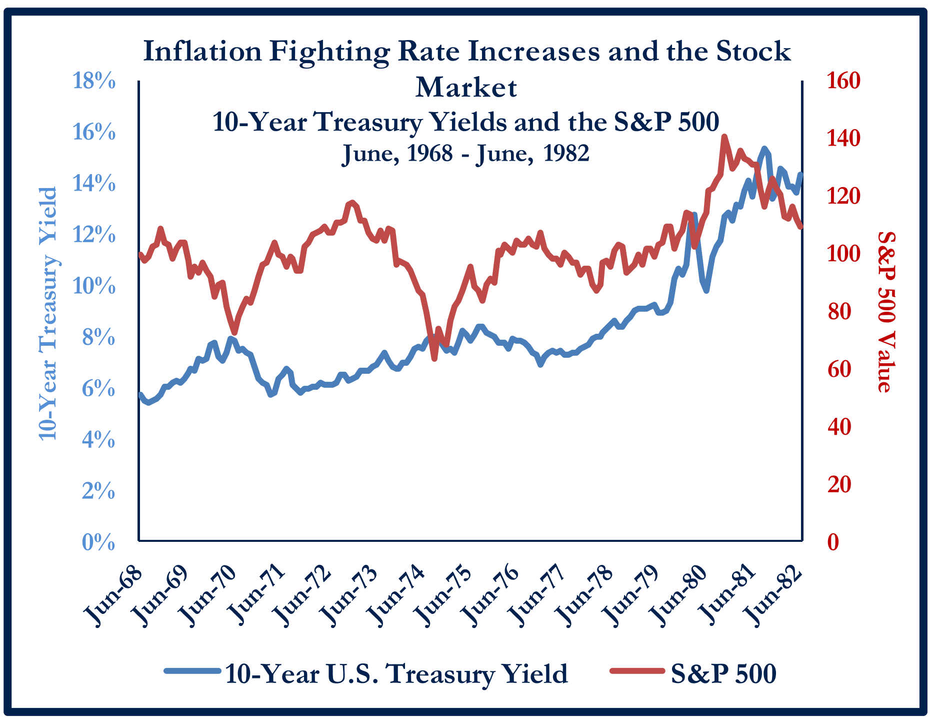
Stock market reaction to rising rates is dependant upon why rates are rising. We referenced the differing responses to rate hikes in 1994 and after the tech bubble. In 1994, the hikes were unanticipated, dramatic and in response to inflation concerns. The market reacted poorly. The hikes from 2003 - 2007 were anticipated, gradual and in response to economic growth. The market took the increases in stride and continued to rise to an all-time high.

The two charts below clearly illustrate the different types of responses. World War II was in a sense a financial crisis. Government debt ballooned to finance the war effort while industry produced tanks and planes instead of automobiles and other consumer products. It took years to regain solid economic footing. By 1953, America was healing and interest rates began to rise naturally in response to the economy's expansion. For a period of 15 years, rates rose fairly steadily from 3.11% to 5.72% and the market responded with a gain of 312.51%. By 1968, inflation was becoming a concern. Half-hearted and half-witted measures were offered to combat it but inflation marched onward. Finally Mr. Volker put the hammer down and drove rates to levels so high that few had previously contemplated the new levels. And the market's response? From June of 1968 until rates were in descent in June of 1982, the S&P changed in value by only 10.07%. It had many severe dips during this 14 year period.

Hopefully lessons were learned from this period so that our economy never again will be forced to endure such dramatic rate increases. Inflation must be viewed as being contained by the Fed. It is critical that the present Federal Reserve raise rates at some point to stay ahead of the public's perception of inflation. With no sign of inflation on the horizon, that time is likely not yet here. But it surely will come.

So if in fact we are at the end of an amazing bull run for bonds, bad times await bond investors. But this not need be so for stock investors. If rates rise naturally in response to economic growth, stocks will perceive this as good news and react accordingly. If rates remain low too long and inflation takes hold, the market will become quite volatile until the Fed contains the threat. Either way, stocks appear poised to respond well when the interest rate pendulum returns toward its natural equilibrium.





Data sources for above charts: www.federalreserve.gov and www.finance.yahoo.com

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2.52% by the end. Speculation was rampant that the Federal Reserve would soon end its $85 Billion/month bond buying program and send rates even higher.

The Fed's termination of what is known as QE, or Quantitative Easing, remains a hot topic. Yet in the midst of a dramatic rise in rates the stock market held firm. After finding bottom on June 24th, the S&P rallied 2.1% to close the quarter. Perhaps *USA Today* just printed their story a month too soon.

The question the market has yet to satisfactorily answer is whether can stocks go higher with rising rates and less help from the Federal Reserve. The fact that the market shook off the rate spike is encouraging. However, the market's confidence was given a boost by several assurances from the Fed that QE's end was not imminent. With $85 Billion/month flooding our economy, much of it naturally finds it way to the stock market, providing the liquidity necessary to keep driving stock prices higher.

According to the Federal Reserve, QE's endpoint will be data driven. In other words, they are there to help until the economy no longer requires assistance. The exit, whenever it does arrive, will likely be messy. In the meantime, it is difficult to argue against the power of $85 Billion/month!

In the past we have pictorially illustrated the market's dependence on QE. Every previous time the Fed has attempted to ease off the gas the stock market has responded with a tantrum. The next time will likely be no different unless the economic data proves definitively strong enough to be self-sustaining. The economy is not there yet, but the Fed isn't at the end of QE yet either. So stocks still find the wind at their backs. The old Wall Street adage remains good counsel - "*Don't fight the Fed*".

Although interest rates are likely to remain at historically low levels for a very long time, they will continue to rise incrementally if economic growth is believed to be taking hold. So can stocks move higher if interest rates do? Of course they can - at least some can. At the bottom of this page is a table of the ten industry sectors that comprise the S&P 500. During the second quarter, while rates were rising, three industry sectors outperformed the S&P. They were Consumer Discretionary, Financials and Health Care.

Financials are not a sector that Tandem clients have much exposure to. Recall that we only invest in companies that grow their earnings (and dividends) in any economic cycle. Few financial institutions can make this claim after the financial crisis. Tandem's financial sector holdings include HCP, T. Rowe Price and National Retail Properties (none are banks). Tandem exposure to the Consumer Discretionary sector includes TJX, Tractor Supply and McDonalds, while Tandem's holdings in the Health Care sector include Stryker, Abbvie and Abbott.

Share price reaction to rising rates will differ among companies and industry sectors, both immediately and over the long run. The immediate impact will be to favor those companies that are perceived to be most leveraged to economic expansion. Cyclical companies that do well as the economy expands come to mind. The longer-term impact, and the more lasting, will be to favor those businesses that borrow less and have the ability to pass on price increases to their customers. Consumer Staples, Health Care and certain Consumer Discretionary and Industrial companies come to mind.

S&P 500 Industry Sector	Quarter ended June 30	Year-to-date
S&P 500	**2.4%**	**12.6%**
Consumer Discretionary	6.4%	18.9%
Consumer Staples	-0.2%	13.6%
Energy	-0.9%	8.6%
Financials	6.8%	18.4%
Health Care	3.3%	19.1%
Industrials	2.2%	12.5%
Information Technology	1.2%	5.5%
Materials	-2.4%	1.7%
Telecommunications Services	-0.1%	8.1%
Utilities	-3.7%	7.7%
Source: www.standardandpoors.com		

The Federal Reserve will eventually stop buying $85 Billion/month of U.S. debt and this will allow interest rates to move higher. Further, when economic expansion is evident, the Federal Reserve will begin to raise interest rates directly. However, we are moving from such historically low levels that slightly higher rates will have little impact on the economy. As long as the Fed provides support, stocks will most likely continue their broad ascent.

Higher rates do not have to derail a rising stock market. Some stocks will still thrive. maybe *USA Today* had it right.

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MARKET REPORT CARD

YIELD TABLE			
	Current	3 months ago	1 year ago
3-month Treasury Bill	0.05%	0.09%	0.09%
5-year Treasury Note	1.20%	0.82%	0.71%
10-year Treasury Bond	2.30%	1.96%	1.62%
30-year Treasury Bond	3.40%	3.16%	2.70%
Prime Rate	3.25%	3.25%	3.25%
Federal Funds Rate	0.09%	0.14%	0.16%
Discount Rate	0.75%	0.75%	0.75%
30 year Mortgage	4.07%	3.57%	3.68%

The data used to compile the above tables come from publicly available sources. Tandem believes it to be reliable, but makes no such assertions. Such data is not meant to imply past or future performance for Tandem or any securities market.

KEY MARKET DATA				
	6/30/13 Close	% Change 1 Year	% Change 3 Years	% Change 5 Years
S&P 500	1,606.28	17.92%	55.84%	25.49%
Dow Jones Industrial	14,909.60	15.76%	52.54%	31.36%
NASDAQ	3,403.25	15.95%	61.35%	48.42%
Russell 2000	977.48	22.42%	60.38%	41.73%
German Xetra DAX	7,959.22	24.05%	33.42%	24.01%
London FTSE 100	6,215.47	11.57%	26.41%	10.48%
Shanghai Composite	1,979.21	-11.06%	-17.48%	-27.66%
Crude Oil	96.56	13.65%	27.67%	-31.03%
Gold	1,192.00	-25.43%	-4.18%	28.14%
CRB Index	275.62	-3.02%	6.61%	-40.44%
U.S. Dollar Index	85.14	4.34%	-1.05%	17.50%
Euro/Dollar*	130.11	2.79%	6.47%	-17.42%

** Negative return represents dollar strength, positive return represents dollar weakness. Returns are cumulative, not annualized.*

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