THE TANDEM REPORT

Volume XVI, Issue 4 October 2015

"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:
THE STOCK MARKET FINALLY CORRECTED, SORT OF

The technical definition of a stock market correction is a decline of at least 10%. The U.S. stock market corrected this summer, for the first time since 2011. From an all-time high of 2,130.82 on May 21st, the S&P fell to a low of 1,867.61 on August 25th. This represents a decline of 12.35%. The stock market finally corrected, sort of.

The S&P ended the quarter down 6.44% and it is down 5.29% year-to-date through the end of September. For one year, the S&P is down 0.61%. If the trend holds, 2015 is on pace to be the first down year since 2008.

Although the correction lasted three months from high to low, most of the correction came in the six trading days between August 17th and August 25th, when the S&P dropped 11.17%. The correction was more like a temper tantrum, lasting only a week or so before returning to previous levels. Further, the low wasn't some level not seen in years. Not at all. One only need go back ten months to find the last time the S&P saw similar levels. As corrections go, this wasn't much of one.

The previous correction, in 2011, was a real one. On April 29th of that year the S&P closed at a then all-time high of 1,363.61 (56% lower than the 2015 record high). By October 3rd, the S&P had finally bottomed at 1,099.23 - a 19.4% decline. The old adage "sell in May and go away" certainly would have worked well. Four times in August and September the S&P tried to rally off a low, only to fail all four times before settling at the October 3rd bottom and recovering from there.

The 2015 correction seems more like a brief return of volatility than it does a statement from the market. Oil dipped to new lows on weak demand. China's growth slowed more than expected. And the Fed was due to meet in September when they likely would announce an interest rate increase. The market indeed had a tantrum.

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COMMENTARY: LET'S TALK ABOUT CASH

A vocal minority of our clients have taken issue with the level of cash we presently hold in their portfolios. They see the market going up and want that cash put to work! And given the market's recent correction, why wouldn't we put more of that cash to work?

As you know, we do not allocate to cash. That is to say we do not make a conscious decision that we should become defensive and raise cash or become more aggressive and deploy cash. Instead, when stock prices are high or fundamentals are deteriorating, we sell more stocks than we buy and cash levels increase. When prices are low or fundamentals are improving, we buy more than we sell and cash levels decrease. This investment approach historically has tended to result in a defensive posture at market tops and a more aggressive posture at market bottoms.

Stocks were cheap in 2008 and 2009, and we had plenty of cash on hand to take advantage of that. Now, after

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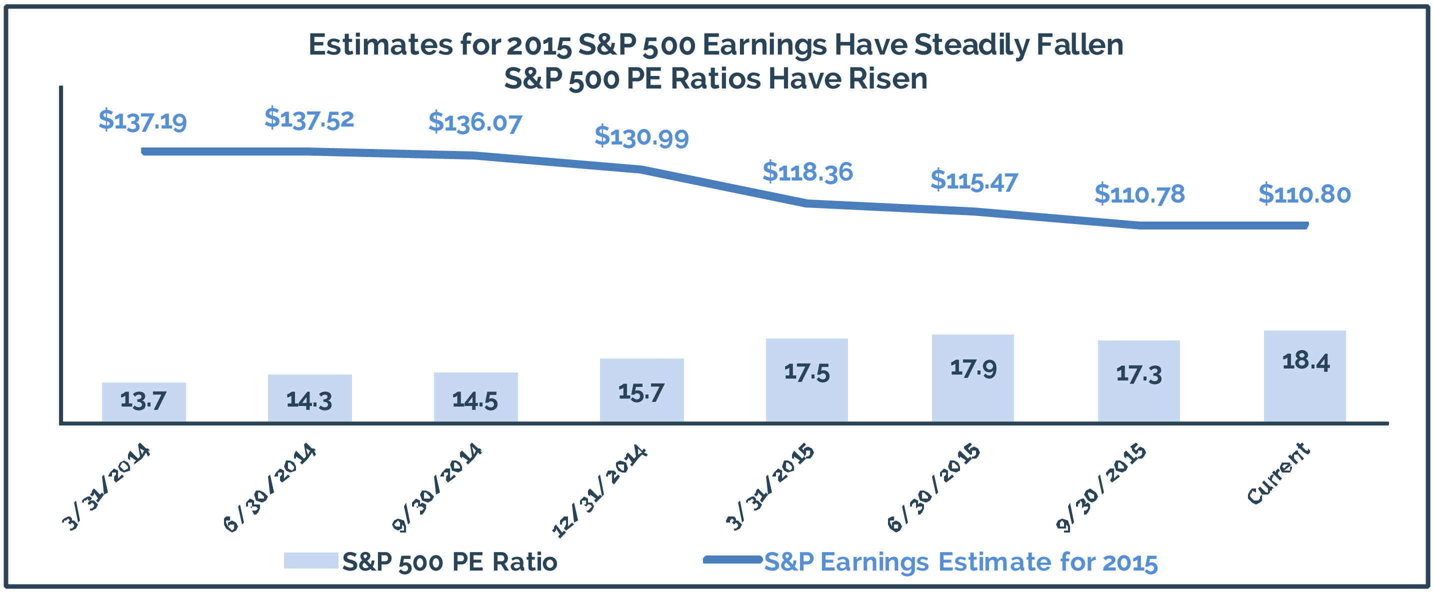
seven years of a bull market, stocks are no longer cheap. In fact, many of them are downright expensive. Global economic growth is slowing and corporate earnings expectations reflect this. The chart immediately below shows the decline in earnings expectations for calendar year 2015 for the S&P 500. A year-and-a-half ago, in March, 2014, the S&P 500 companies were expected to earn $137.19 in 2015. Today, that number has been revised downward to $110.80.

Amazingly , as earnings expectations have steadily declined, prices have continued to rise. So have PE ratios, as illustrated below. The PE in 2014 for the S&P based on 2015 earnings was 13.7. Today it is 18.4.

Our job is to buy low and sell high. By definition, those two things can't happen at the same time. We believe that this has become a seller's market and a good time to have taken some profit. And so we have.



Source: www.standardandpoors.com

It is clear to us that we have entered an earnings recession. The chart below depicts rolling 12 month S&P earnings from December, 1988 through September, 2015. Currently, earnings are in decline. This is the fourth period of earnings decline since 1988. The previ-

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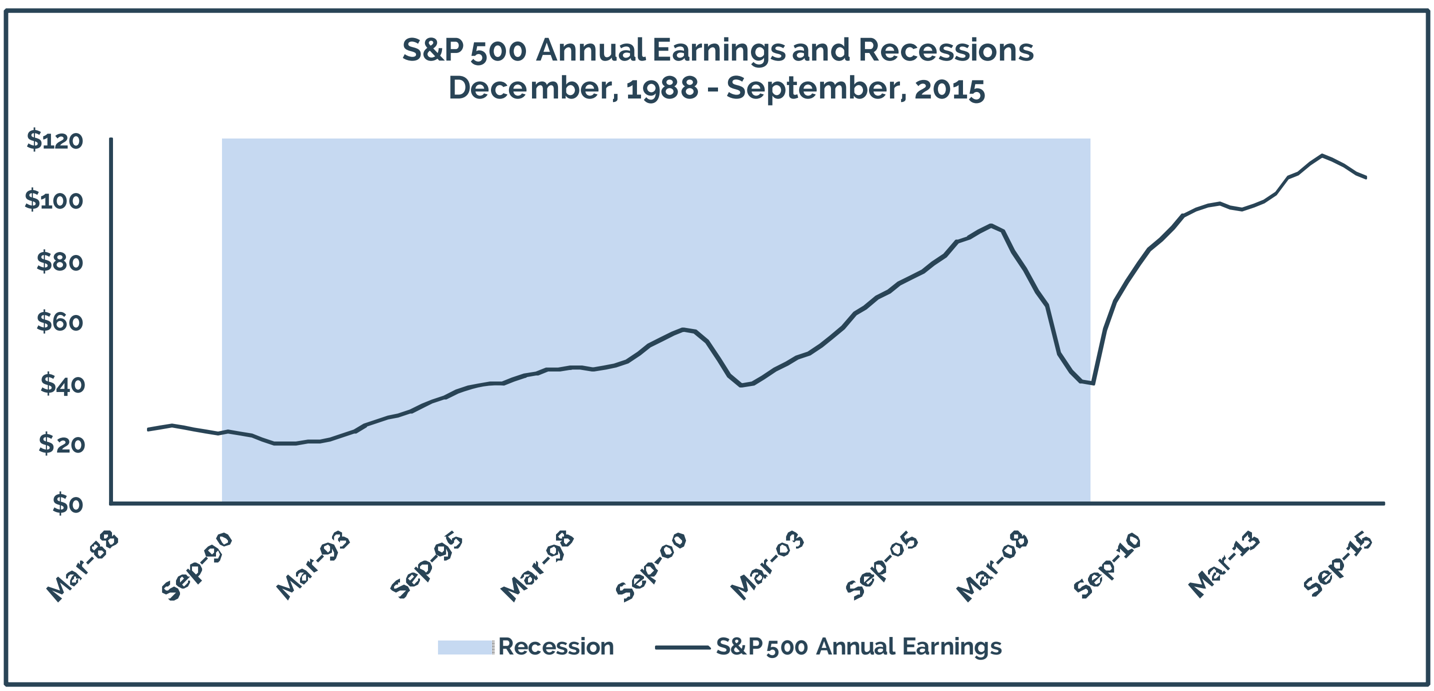

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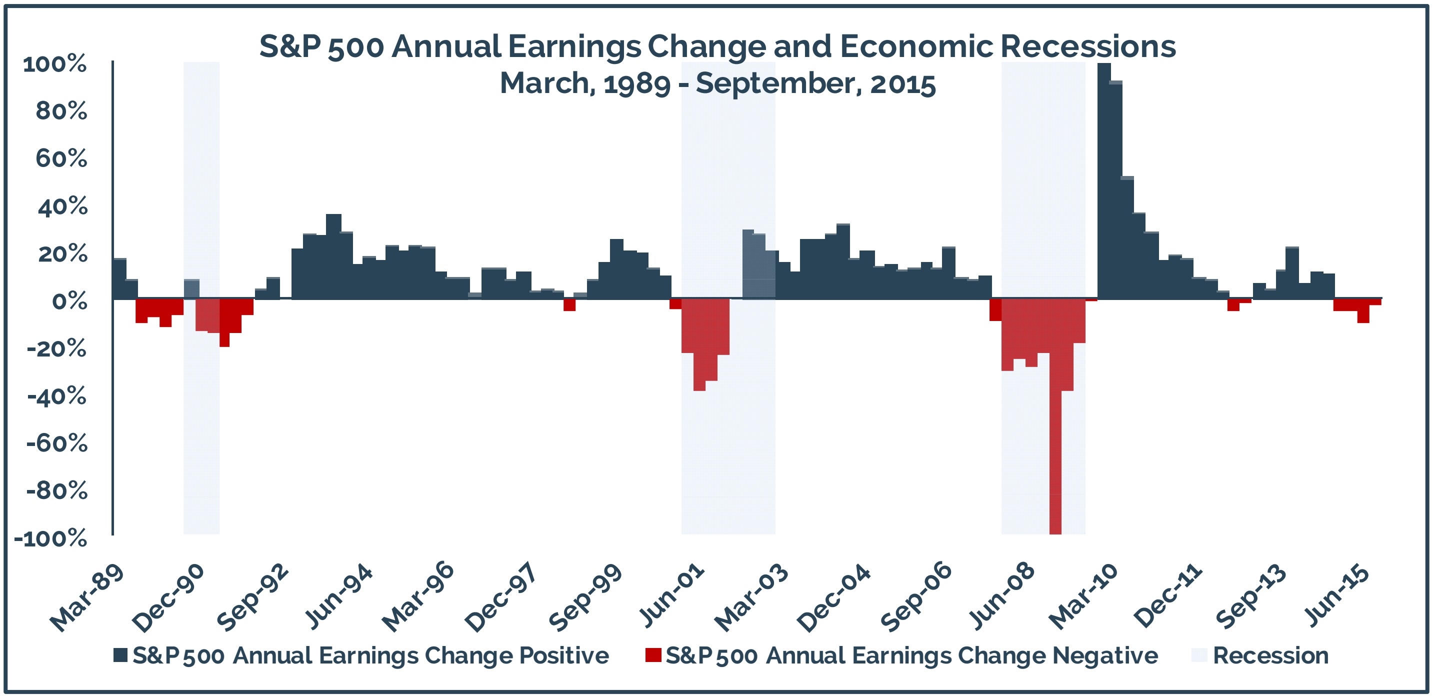

Source: www.standardandpoors.com

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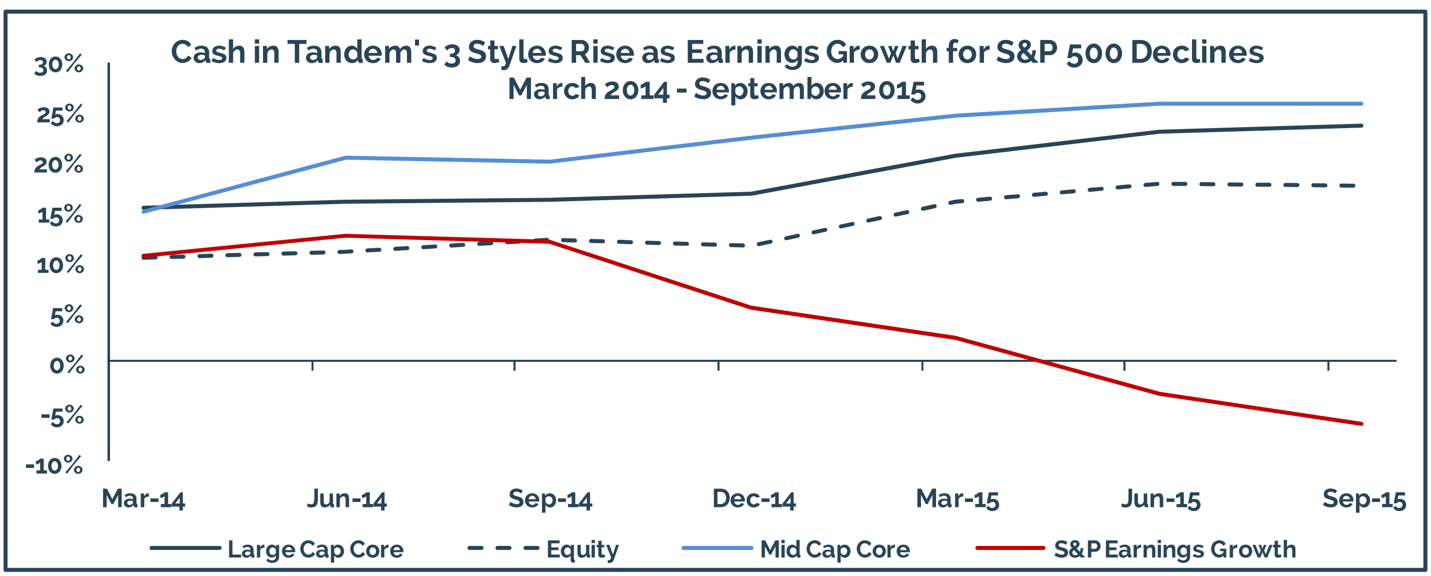
ous three were accompanied by economic recessions. Could we be headed for another?

Possibly, but earnings recessions don't *always* result in economic recessions. When we look at earnings declines differently in the chart above, we see that there have been a few times that earnings declined (red bars) without coinciding with an economic recession. However, if a recession does not follow the current state of earnings, it will mark the first instance during this time period that four consecutive quarters of decline did not presage a recession.

The vocal minority opposed to cash says yes, we have heard all about the economic and earnings slowdown. But the market corrected and you didn't buy! Tandem says that lower prices don't always make good prices.

Cash is an important component of what we do. It affords us the opportunity to take profits when warranted and redeploy the proceeds when fundamentals improve. If you want to know when more of your cash will be invested, follow the corporate earnings trend. We expect that prices will decline again to reflect the earnings recession. When earnings eventually improve, we have cash available because we sold high, allowing us to buy low. Sometimes patience is hard to come by, but this is how cash is supposed to be used.



Source: www.standardandpoors.com and Informais

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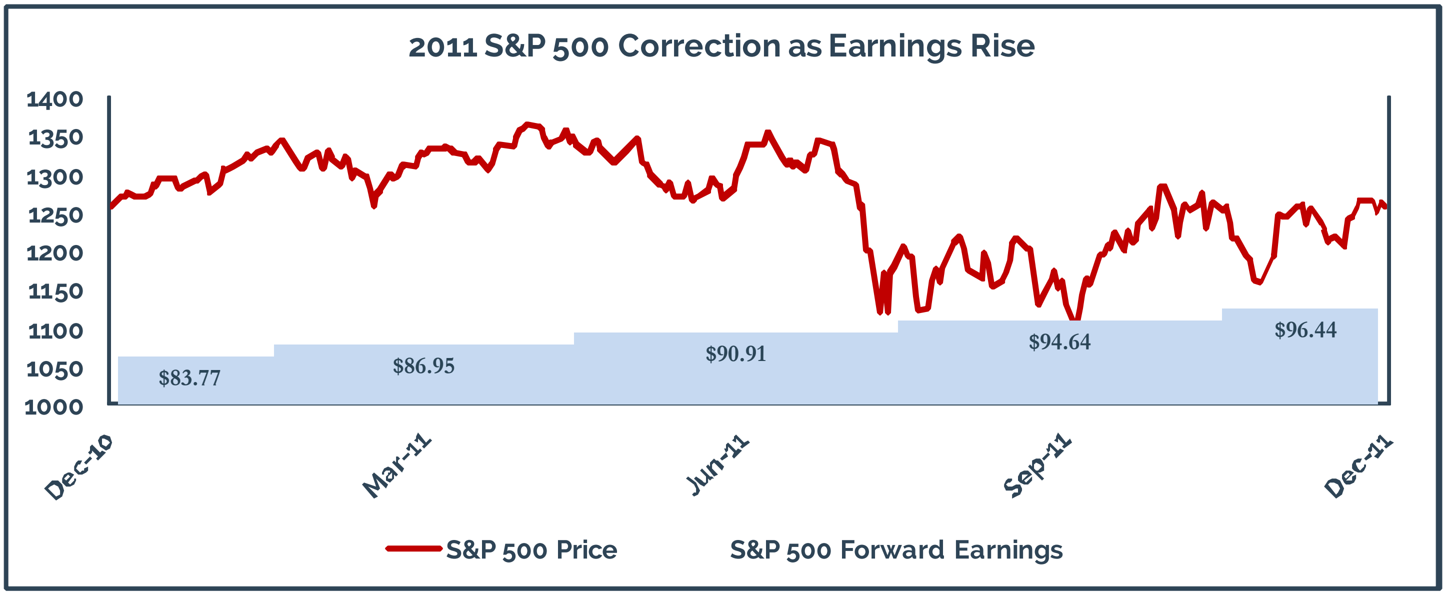
Ultimately the Fed caved, citing an inability to raise rates in the midst of global uncertainty. In our view, the window to raise rates has now closed and no rate hike will likely occur until 2017 at the earliest. The market won the standoff and normalcy returned in fairly short order. Yes the market finally corrected, sort of.

In 2011, corporate earnings were improving. While the stock market was correcting by nearly 20%, S&P earnings were growing from $83.77 to $96.44, an increase of 15%. However, during the 12% decline of 2015, earnings were deteriorating. A year ago, the S&P was expected to earn $114.51. Now, earnings expectations have sunk to $107.47. That is a decrease in forward earnings of 6%. That is quite a dichotomy.



Source: www.standardandpoors.com

Interesting to us is the fundamental circumstances surrounding the corrections of 2011 and 2015. In 2011, the Fed threatened to end Quantitative Easing and the market reacted violently. Similarly in 2015, when it appeared as though interest rates would finally rise, the market reacted with a large sell-off. However, the fundamentals were very different.

The 2011 correction occurred while earnings continued to rise. That is a normal correction. Sometimes prices just get ahead of fundamentals and need to correct. But in 2015, fundamentals actually changed. We went from expansion to contraction in corporate earnings and the market just shrugged.

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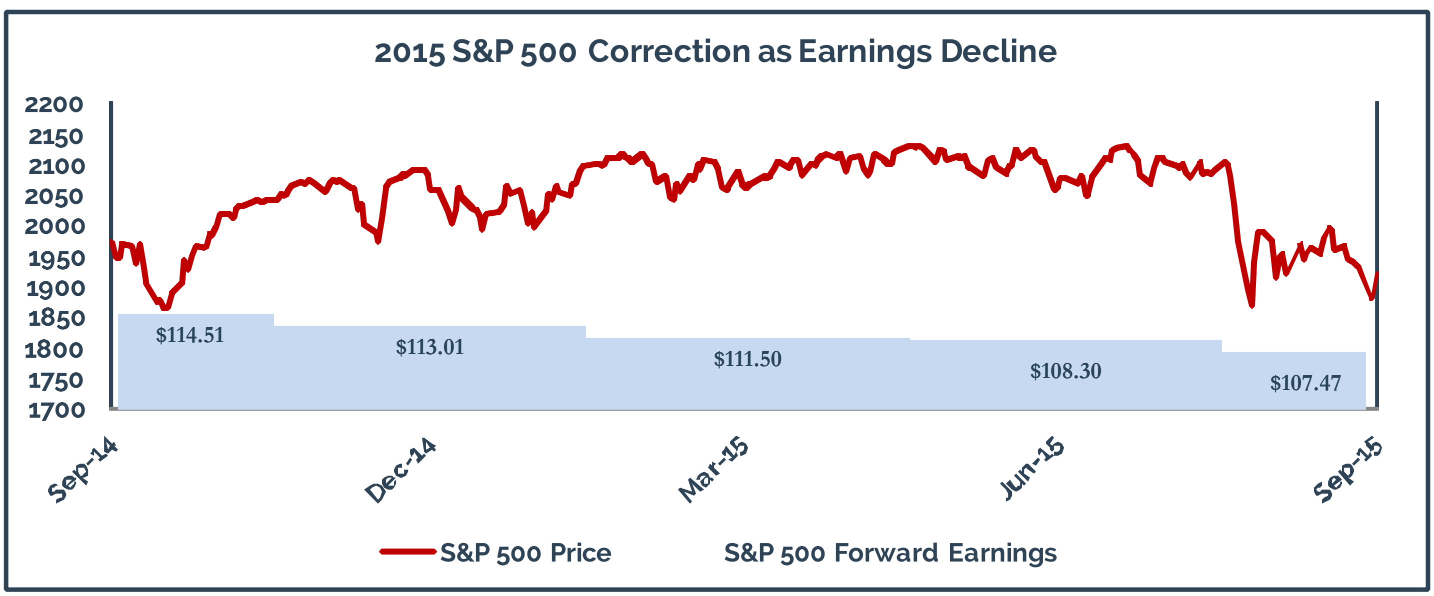

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Market Commentary (Continued)

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Maybe earnings will ultimately return to a growth trajectory. However, prices remain way ahead of earnings. There is a significant amount of catching up for fundamentals to do before prices accurately reflect realistic earnings growth. Don't forget that the S&P rose 32% in 2013 while earnings only grew 11%. Earnings indeed have some catching up to do, but right now they are going in the wrong direction.

We have devoted our *Commentary* in this issue to our view of the current earnings recession and how we have positioned ourselves. We have limited our *Market Commentary* discussion to the market's behavior. To that end, the quarter just ended showed signs of weakness that the market's recovery from correction belies.

According to Standard and Poor's, at the start of 2015 the S&P 500 was expected to earn $33.35 for the 3rd quarter just ended. By the end of September, that number had declined over 14% to $28.55. Over the same time period, 4th quarter earnings expectations declined by 13%. In fact, the 3rd quarter of 2014 was the last time quarterly earnings *grew* year over year.

Despite these obvious signs of earnings erosion, the market seems content to bury its proverbial head in the sand and ignore the obvious. Analysts forecast that earnings in 2016 will increase from 2015 by nearly 17%. One year ago, it was predicted that 2015 earnings would grow 20% over the previous year. It now appears they will decline by 2%.

Why the optimistic outlook for earnings growth? Your guess is as good as ours. Some say the impact from the decline in energy related earnings will be mitigated. Others point to the recent strength in the dollar as having a negative impact on the earnings of those companies doing business overseas. Maybe.

Ultimately it is the consumer that drives the U.S. economy and corporate earnings. There is a reason that interest rates remain near zero. In our view, it makes the consumer a less likely savior than she might appear.

We do not forecast anything remotely catastrophic. There is not another 2008 in our near future. The market corrected this year and that is a good and healthy thing. It simply undid all that good by rallying on Fed news and ignoring the fundamentals. Ultimately, it is always about the fundamentals. And when they improve, we will be prepared. If you want to know how, read our *Commentary*!

We Offer Our Thanks:

For your Good Wishes After the Rain and Floods and for Allowing us to Serve you for Twenty-Five Years!

First, we would like to thank all of those that checked on us during South Carolina's recent weather challenges. Many of you have called or emailed to check on our safety and how we survived the rains and subsequent flooding. We can report that Downtown spent a few days under water and was closed to most traffic. Other than that, and a few other road closures that made commutes more challenging, we all escaped unscathed and only slightly inconvenienced. Our neighbors to the north in the Georgetown area and those in and around Columbia were not nearly as fortunate. Our thoughts remain with them as they face a long and arduous path to normalcy.

Second, October 5th marked Tandem's 25th anniversary. It has been a gift and an honor to be able to come to work every morning to serve you and do what we love doing. From very humble beginnings we now manage nearly a quarter billion dollars and serve over 500 clients. Some of you have been with us from Day 1. Others, in fact most, have not. It doesn't matter. We humbly and sincerely thank you for a remarkable (and remarkably fast!) twenty-five years, and we look forward to many more years in your service. Thank you.

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YIELD TABLE			
	Current	3 months ago	1 year ago
3-month Treasury Bill	0.02%	0.01%	0.02%
2-year Treasury Note	0.63%	0.65%	0.57%
5-year Treasury Note	1.36%	1.65%	1.76%
10-year Treasury Bond	2.04%	2.35%	2.49%
30-year Treasury Bond	2.85%	3.12%	3.20%
Prime Rate	3.25%	3.25%	3.25%
Federal Funds Rate	0.05%	0.04%	3.00%
Discount Rate	0.75%	0.75%	0.75%
30 yr Fixed Mortgage	3.43%	3.66%	3.78%

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				
	9/30/15 Close	% Change 1 Year	% Change 3 Years	% Change 5 Years
S&P 500	1,920.03	-2.65%	33.27%	68.25%
Dow Jones Industrial	16,284.70	-4.45%	21.19%	50.95%
NASDAQ	4,620.17	2.82%	48.26%	74.16%
Russell 2000	1,100.69	-0.09%	31.43%	62.79%
German Xetra DAX	9,660.44	1.96%	33.87%	39.72%
London FTSE 100	6,061.61	-8.47%	5.56%	9.25%
Shanghai Composite	3,205.99	35.62%	53.68%	20.72%
Crude Oil	45.15	-50.47%	-51.03%	-43.54%
Gold	1,114.00	-8.43%	-37.27%	-14.77%
CRB Index	193.76	-30.44%	-37.36%	-32.45%
U.S. Dollar Index	96.29	12.06%	20.47%	24.99%
Euro/Dollar*	111.7	-11.53%	-13.10%	-18.01%

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