

## Financial Markets Review

What a difference a year makes! At this time last year, we were writing about the S&P 500 Total Return Index and the MSCI All-Country Index rising for the 13<sup>th</sup> consecutive month, which at the time was the longest uninterrupted monthly streak on record. This streak continued for two more months before giving way to our first 10+% correction in over two years. Fast forward eight months and a second 10+% correction roils the stock market. In such a short time, we've gone from global synchronized growth to chatter of an impending recession. So, which is it? Unfortunately, it's not that black and white. The market is looking for clarity and all we've got right now is confusion, which breeds volatility and directionless markets. And, that is where we find ourselves today.

There was a glimmer of hope during Fed Chair Jerome Powell's speech at the Economic Club of New York on November 28th. Over the past two months, the market has been struggling to figure out how many more times the Fed plans on raising rates. Not long ago, they were criticized for being behind the curve regarding economic growth and now many believe they are behind the curve regarding an economic slowdown. For starters, the Fed has always been and always will be behind the curve in any economic environment. They are data dependent, which inherently makes them reactive rather than proactive. For this very reason, market participants really need to stop hanging on every word a Fed official may utter. All they tell you is what has happened, which doesn't help much when trying to figure out what may happen. Regardless of what I may think, the market still reacts to their every last breath. In the case of the Fed Chair's most recent speech, the stock market interpreted "just below" the neutral rate as the Fed potentially halting or limiting any future rate hikes. The S&P 500 soared 2.3%, which marked the second-best day of the year.

Shortly thereafter, President Trump headed down to Buenos Aires for the G20 meeting. The hope among market participants was that President Xi and President Trump's dinner meeting would finally bring an end in sight to their recent trade spat. Following the meeting, the President's administration announced they would temporarily hold off on implementing its newest round of 25% tariffs for 90 days. The possible truce between Trump and Xi sent markets rip-roaring overnight to start December off with a bang.

Since then, we have started to see that the truce was hardly little more than a pause. Nothing seems to have really changed. What's more, Fed Chair Powell's words were not that large of a deviation from his prior stance. The market seems to be overreacting on both counts. The headlines surrounding the Powell comments certainly emphasized the "just below" portion of quote. As James Mackintosh pointed out in *The Wall Street Journal*, "Fed policy makers estimate the neutral rate at 2.5% to 3.5%, with a median of 3%. Thus, it was true in October that current federal-funds rates of 2% to 2.25% are a "long way"—three or four more increases—from the median of 3%. It was also true on

Wednesday that 2% to 2.25% is “just below”—one or two increases—the bottom of the range.” And, just like that, what had for a very brief time looked like clearer skies ahead, quickly turned back to gray.

## **Tandem Strategy Update**

Our core holdings have fared well throughout much of this recent volatility. Throughout the month of November and into the first week of December, we've taken advantage of opportunities to buy and sell.

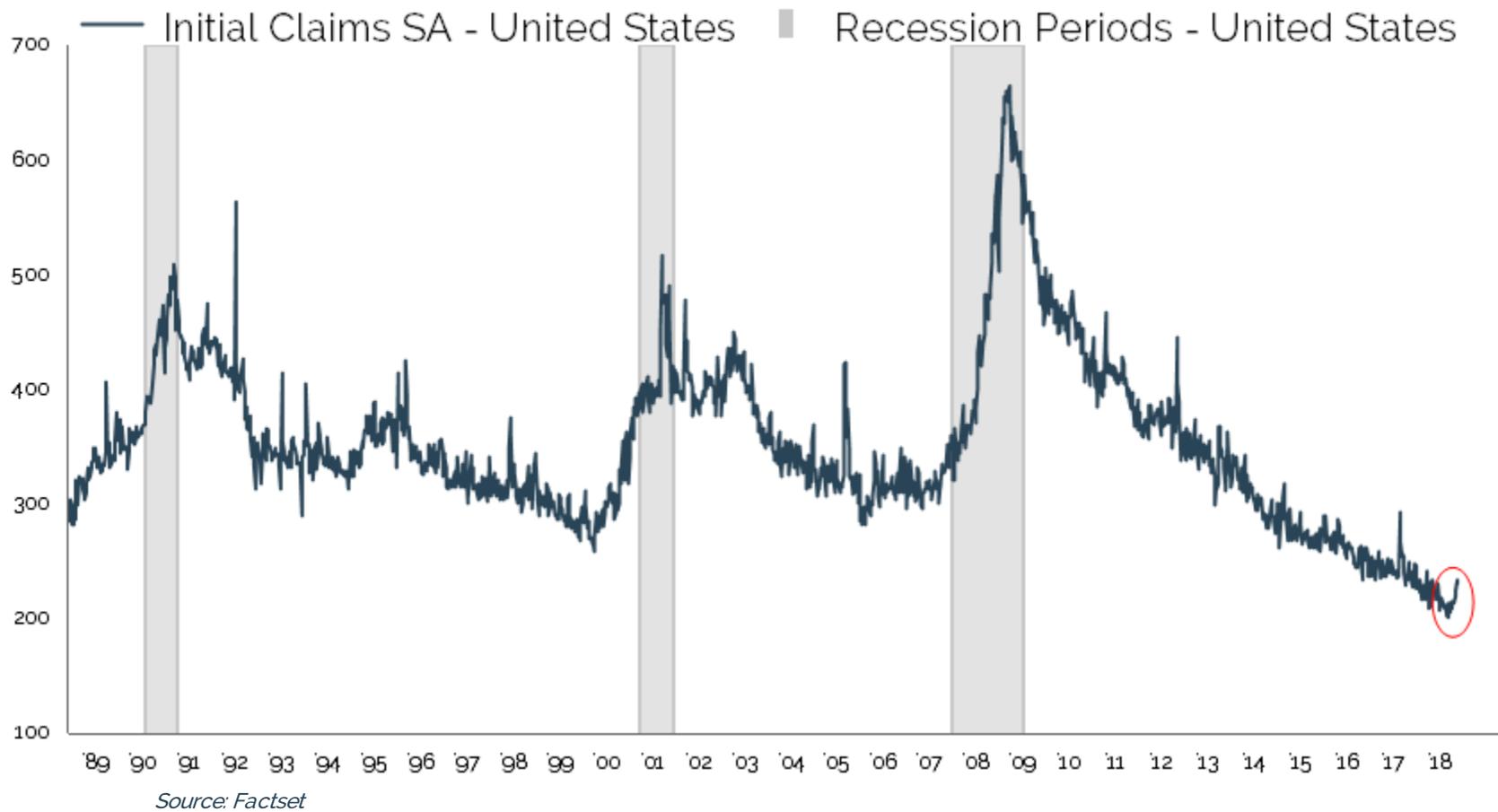
As the market climbed back during the first few weeks of November, to make up some of the losses in October, we were able to trim our position in Hormel Foods (HRL). HRL is the quintessential defensive company during market uncertainty. After all, HRL is the maker of SPAM. However, everything comes at a cost and HRL is no different. Our quantitative model identified HRL as a sell when its valuation far exceeded its growth prospects. In particular, HRL is trading at an historic price to sales ratio and one of the highest price to earnings ratios that the company has ever seen. I'm not quite sure they could ever sell the amount of SPAM necessary to justify those valuations! So, based on our sell discipline, it was prudent to reduce our position by 25%.

On the flip side, we took advantage of individual stock price volatility to take an initial position in Tyler Technologies (TYL) and ExlService Holdings (EXLS) within our Equity and Mid Cap Core strategies. TYL provides technology and services for local governments. If you've ever gone online to look up your property tax records, the software was likely a TYL product. TYL has consistently grown revenues, earnings and cash flow at a healthy clip and continues to do so. EXLS is also in the technology sector, but more so in the services and consulting industry. They are an operations management and analytics company that uses industry data to help businesses grow and run more efficiently. EXLS is one of the few companies in our universe that have recently exhibited accelerating fundamental growth. In addition to these new portfolio additions, we have more recently added to our holdings in JM Smucker (SJM) and Dollar General (DG).

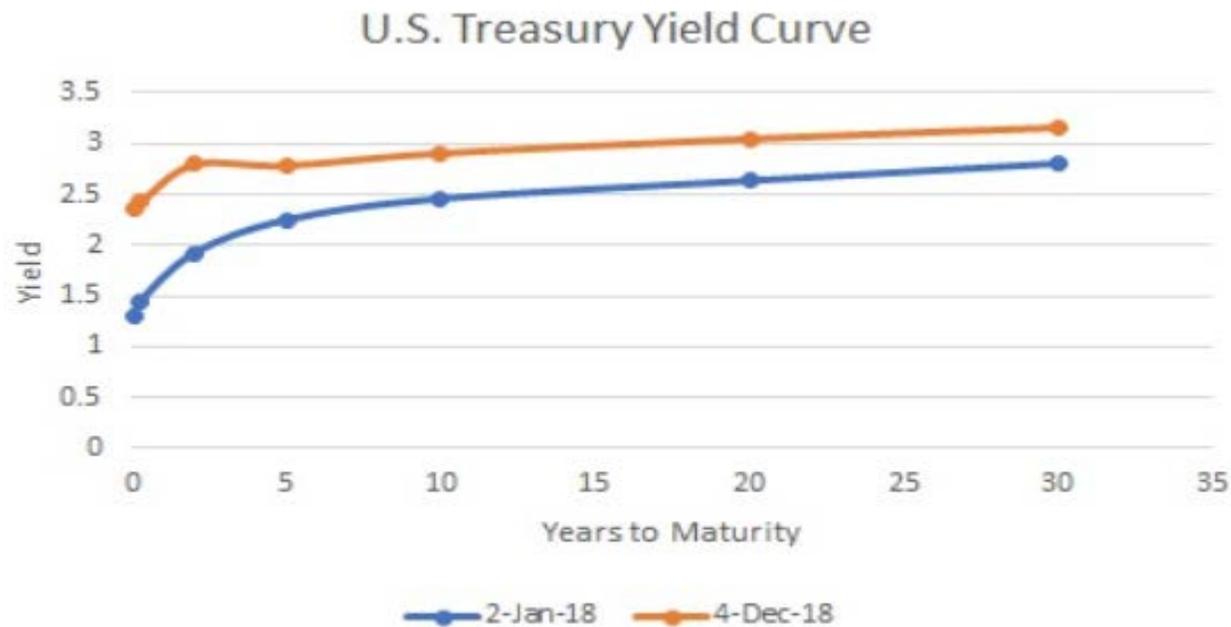
## **Trends to Watch**

There are a couple of trends in the economy and within fixed income markets that you may want to keep an eye on. None of these trends in and of themselves scream panic, but it is worth noting how each of them acted before recessionary periods.

First, the unemployment initial claims report is a data series that is released every week on Thursday morning. The data can be choppy from week to week, but you will notice how a reversal in the downward trend typically always precedes a recession. Just recently the initial claims data has started to move higher, which is a change from its previous downward trajectory. This change in trend is in the very early stages and could very well reverse to continue lower. Regardless, it is worth seeing how this data set plays out over the next several weeks and months.



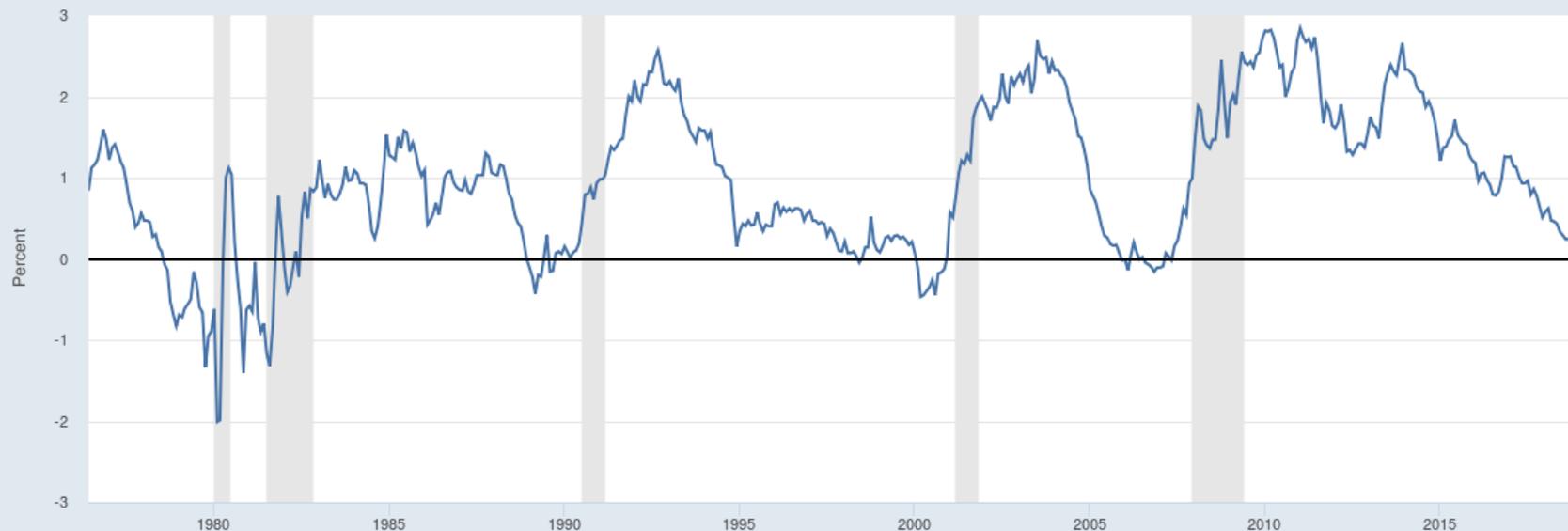
Second, the yield curve has inverted for the first time since 2007. Thus far, the inversion has been minimal and only on the front end of the curve. However, the back end of the curve has declined fairly dramatically in recent months and now sits at its flattest point since before the previous recession. As you'll see from the chart below, the 2-year U.S. Treasury Note and 3-year Treasury Note have inverted (i.e. higher yield) with the 5-year Treasury Note.



*Source: Morningstar and St. Louis Fed*

This is not the shape of a normal curve. One would expect to be compensated in the form of a higher interest rate for the risk of holding a bond with a longer maturity. When the curve inverts, the opposite happens and this change in shape has accurately predicted the past seven recessions. The following chart shows how a recession has followed every time the spread between the 10-year Treasury Bond and the 2-year Treasury Note has gone negative. Currently, that spread sits at 11 bps, which is down from 51 bps to start the year. You should also note that a negative spread doesn't signal an immediate recession, so there is no reason to panic. In some cases, a recession did not occur for over a year after the spread initially went negative. However, this is just another one of those trends to monitor as it is likely signaling that we are closer to the end than the beginning of an economic and market cycle.

FRED — 10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity



Shaded areas indicate U.S. recessions

Source: Federal Reserve Bank of St. Louis

myf.red/g/mmcM

-Billy Little, CFA

***"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***

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