THE TANDEM REPORT

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TANDEM Investment Advisors

"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

In This Issue

MARKET COMMENTARY

This quarter's *Market Commentary* is brief for two reasons. First, most of the pages were needed by other articles. Second, we are running out of ways to marvel at this bull market. So enjoy the brevity, and enjoy the bull market. Neither will last forever.

For the quarter just ended, both the Dow and the S&P reached new milestones. The Dow crossed 22,000 and the S&P passed 2,500. It is remarkable to think that just 8 1/2 years ago the Dow touched 6,443 and the S&P hit 666. Quite a comeback. Both indices continue to set new highs regularly.

Also during the quarter, the Federal Reserve announced its plan for unwinding its balance sheet after it grew from about $900 Billion to roughly $4.5 Trillion post-crisis *(see Commentary)*. Combine that with the escalating tensions with North Korea and Congress's failure to pass anything and one might have thought the markets would pause. But one would be wrong to think that.

For the quarter, the Dow was up 4.94% and the S&P was up 3.96%. Year-to-date the Dow is up 13.37% and the S&P is up 12.53%. This year is on pace to be the best for U.S. stocks since 2013.

On the portfolio front, things at Tandem were busier than normal. On the buy side in various strategies we added to our positions in FactSet, National Retail Properties, Dollar General, JM Smucker, O'Reilly Automotive, TJX and Ross Stores. We also were able to establish a new position in CVS.

On the sell side, we took some profit in a few names. ResMed, NextEra and Republic Services all have reached valuation levels that prompted us to take some money off the table, reducing the size of these holdings in our portfolios.

We also liquidated a few holdings because they violated our fundamental tenets. Aptar, Thermo Fisher Scientific and Bank of the Ozarks are no longer in our holdings.

A few of our holdings made news during the quarter. First the bad—Scana. The utility appears to be in all sorts of trouble over a failed nuclear project, and the stock is down. On the positive front, Scripps Networks has agreed to be acquired (up over 70% from Tandem's first purchase) and Abbvie had a big court victory that has caused its stock to soar as well.

If you would like to read more about any of these developments, please visit our website to read *Observations*.

COMMENTARY:
One Heck of a Party

This is one heck of a party! It's already been going on for awhile, but somehow it feels like it's just getting started. The Dow is certainly rocking, making more than 50 all-time highs just this year. That's got to be some sort of record. The S&P and all the other stock indices don't seem to be suffering either. Even the European and Asian markets are partying. It seems like nearly everyone is on board. This has to be the party of the decade. Maybe of the century!

Let's be sure to thank our hosts before we leave. The Federal Reserve and their central bank brethren have kindly

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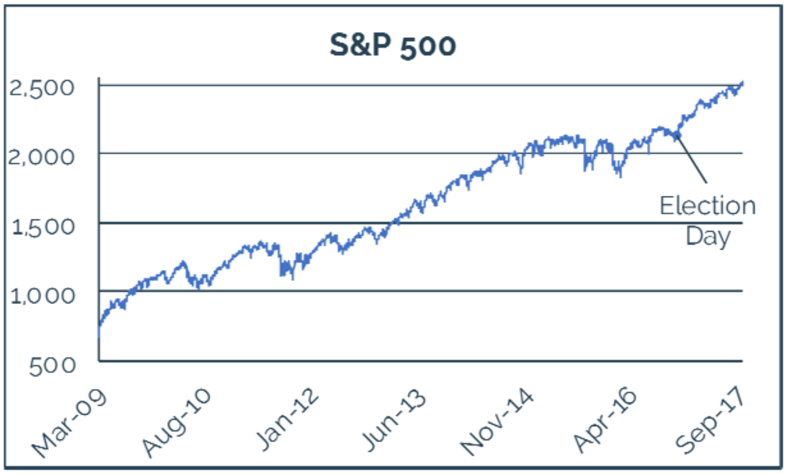
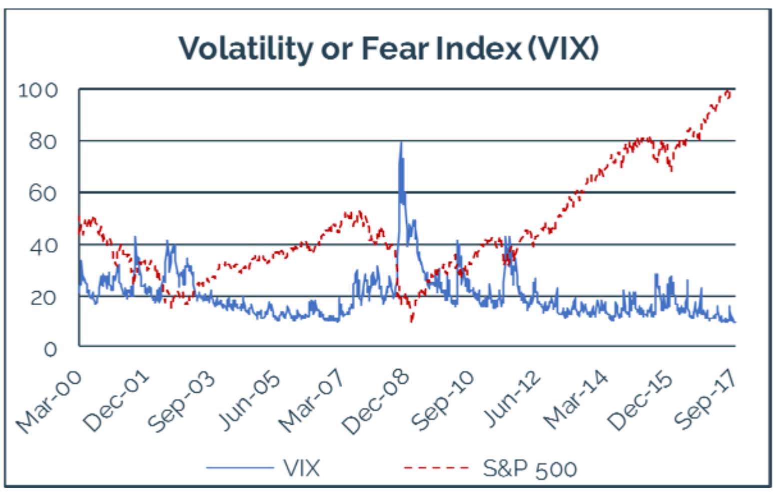
agreed to pick up the tab. They sure know how to show investors a good time! So good, in fact, that no one wants to talk about leaving. We will get back to this later.

This party started back in 2009. At the time, it didn't seem all that fun. People were still feeling the ill effects of the last big party. This new party was sparsely attended for awhile. At first is was mostly the sophisticated crowd. The average folk remained leery. Many elected to stay home. Others decided to go, but they promised themselves they wouldn't have too much fun and they would leave at a responsible hour.



Then the 2016 Presidential election changed everything. The party was ready to rock and the average folk were suddenly in a partying mood. Now no one wants to miss this party.



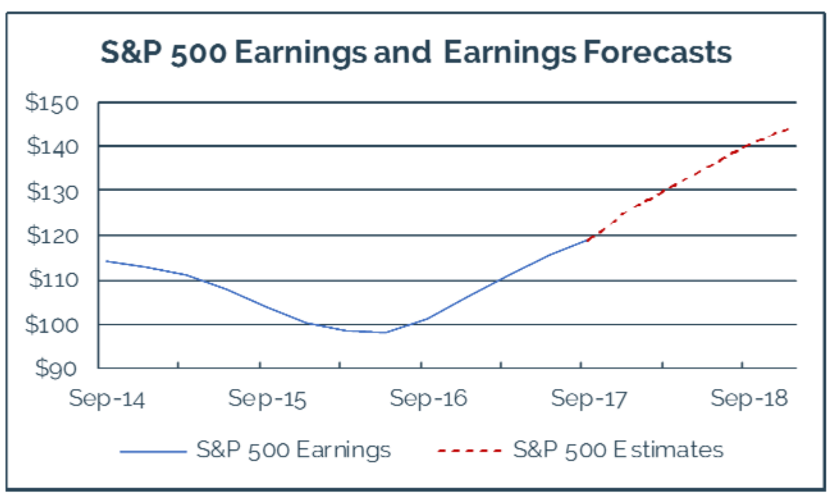
The election promised to deliver tax cuts for corporations and individuals alike, rollbacks of regulations and the end of ObamaCare. This was manna for corporate profits and stock prices. With the Federal Reserve still promising to pick up the tab, these were all the ingredients any investor could ever hope for in order to make a successful economic throw down.

The partying hasn't stopped since. Hasn't even taken a breather. There are new records set nearly every day somewhere around the globe. All without even a hint of concern. Volatility hasn't been this low since the last big party. You may recall the Volatility Index is considered a fear gauge, called the VIX. When the VIX is high, investor fear is said to be high as well. When the VIX is low, like now, investor fear is said to be minimal.

Here's an interesting aside about the VIX. If you look closely at the chart below, you might notice that the VIX is at its lowest when the market is at its highest, and vice versa. Seems investors are most scared when prices are the cheapest, and least scared when prices are the highest. Hmmm.

Enough of the serious talk. Let's get back to the party. As stated above, the VIX hasn't indicated this little concern by investors since 2007. Why should investors be concerned? Corporate earnings have finally recovered the ground they last claimed in 2014, and are projected to go ever higher. The S&P earnings chart below clearly shows that earnings growth seems to be back. Since earrings were last at this level, the S&P 500 has increased in price by nearly 28%. Of course, S&P earnings have only grown 3.82% over the same period, but who cares? Let's don't get picky. The important thing that keeps fear down and the party going is that earnings are now growing for the foreseeable future.

Nearly all closely watched economic indicators seem to be pointing to smooth sailing and good



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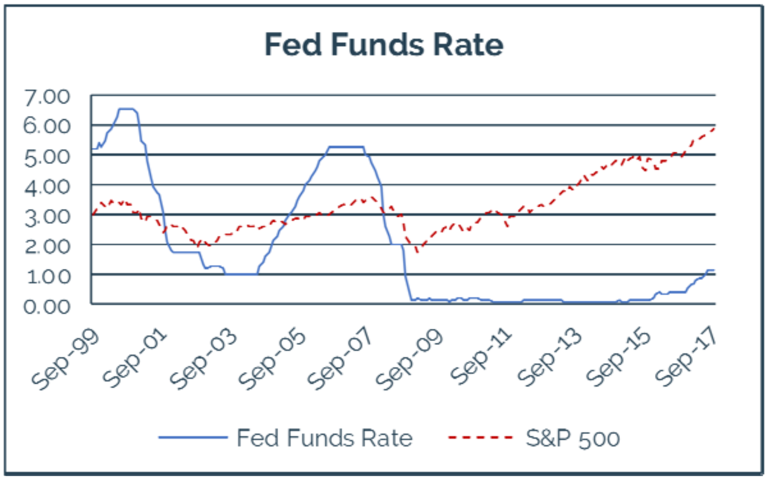
times ahead. In addition to the corporate earnings revival, GDP (economic growth) is accelerating, unemployment continues to fall, inflation is nowhere to be seen, the real estate market is humming, oil prices are stable, the dollar is weakening and interest rates will remain low for the rest of all time. What more could investors possibly hope for? Everything is perfect and nothing can derail this market.



In 2017, there have been numerous events that might give a market reason to at least pause:

- North Korea has launched 14 ballistic missiles and tested a hydrogen bomb
- 3 successive hurricanes wreaked human and fiscal havoc on Texas, Florida and Puerto Rico
- Congress failed 3 times to repeal and replace ObamaCare and made no apparent progress on tax reform
- More than 140 million Americans had their credit compromised through no fault of their own when Equifax was hacked

What was the stock market's response to these significant events? New all-time highs.

Party metaphors aside now, no one seems to want to talk about the elephant in the room - the Federal Reserve. The are at least three concerns regarding the Fed that will eventually play out, whether markets care now or not.

The first concern is the direction of interest rates. In December of 2015, after almost 7 years of holding the Fed Funds Rate at or near zero, the Federal Reserve began to raise rates, albeit ever so slowly. By the end of September of this year, the Fed Funds Rate had increased to 1.15%, a very low rate to be sure, but higher nonetheless. Another hike is expected in December.

Stock prices can absolutely go higher as interest rates rise. After all, the Fed typically hikes rates precisely because the economy is improving and the Fed doesn't want it to overheat. Rising rates, in a vacuum, should not be a cause for concern to stock investors.

The problem with rising rates, however, is that historically, the Fed has been behind the curve. They have waited too long to raise rates, and then once they begin, they have tended to raise rates for too long. This can create sort of a boom-bust cycle. By waiting too long to raise rates, the economy gets going too fast. Once the Fed decides to try to slow things down, their policies generally not only temper the overheating, but actually lead to recession.

Maybe this Fed will get it right. Investors sure seem to think Janet Yellen's Fed will err on the side of caution, which is to say it will keep rates lower longer. At least in the short run, this would be good news for stocks, as the market prefers this low rate environment.

This brings us to the second concern that will eventually have to play out. Janet Yellen may not be the Fed Chair much longer. Her term expires in February. She may be reappointed, or the President could appoint someone with similar views on monetary policy. Or he may not. To its credit, the financial media hasn't ignored this concern. But the market sure has.

In fact, this market takes notice of very little. The uncertainty of rate hikes and Fed leadership are staring the market directly in the face. When the Fed initiated rate hikes in 2015, the response from the market was what we might have expected. The market stumbled. In fact, from its high in November of 2015, the S&P fell over 13% through February of 2016.

That response proved to be temporary, as if only a minor hiccup. Investors quickly forgot their concerns, placed their trust in the Fed to get it right, and carried on. The S&P recovered all its lost ground and then some as it went on to set more and more all-time highs. The market is seemingly taking it on faith that Fed policy will get it right, no matter who the new Fed Chair might be.

Which brings us to the third, and largest concern. The Federal Reserve, along with every other major central bank on the planet, has been conducting an experiment in monetary policy since the depths of the financial crisis. Investors have given them high marks thus far for the execution of their bold experiment called

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Quantitative Easing. Since 2008, the balance sheets of the 5 major central banks (U.S., England, Europe, Japan and China) have risen from approximately $5 Trillion combined to over $20 Trillion combined today. They have all created money to buy financial assets. The Bank of Japan is now the largest owner of Japanese equities, holding 75% of all Japanese ETFs. As much as anything, this explains why asset prices have risen. Central banks created $15 Trillion to pump into financial markets around the globe. Why prices haven't risen even more is actually a bit puzzling.

Most central banks are continuing to hold steady or expand their balance sheets. The notable exception is our own Federal Reserve. After its September meeting it announced its widely anticipated plan to reduce the size of its balance sheet.

First some history. Before the financial crisis, the Fed's balance sheet was a little over $800 Billion. Today it stands at approximately $4.6 Trillion, with a T. This represents a more than fivefold increase since 2008.

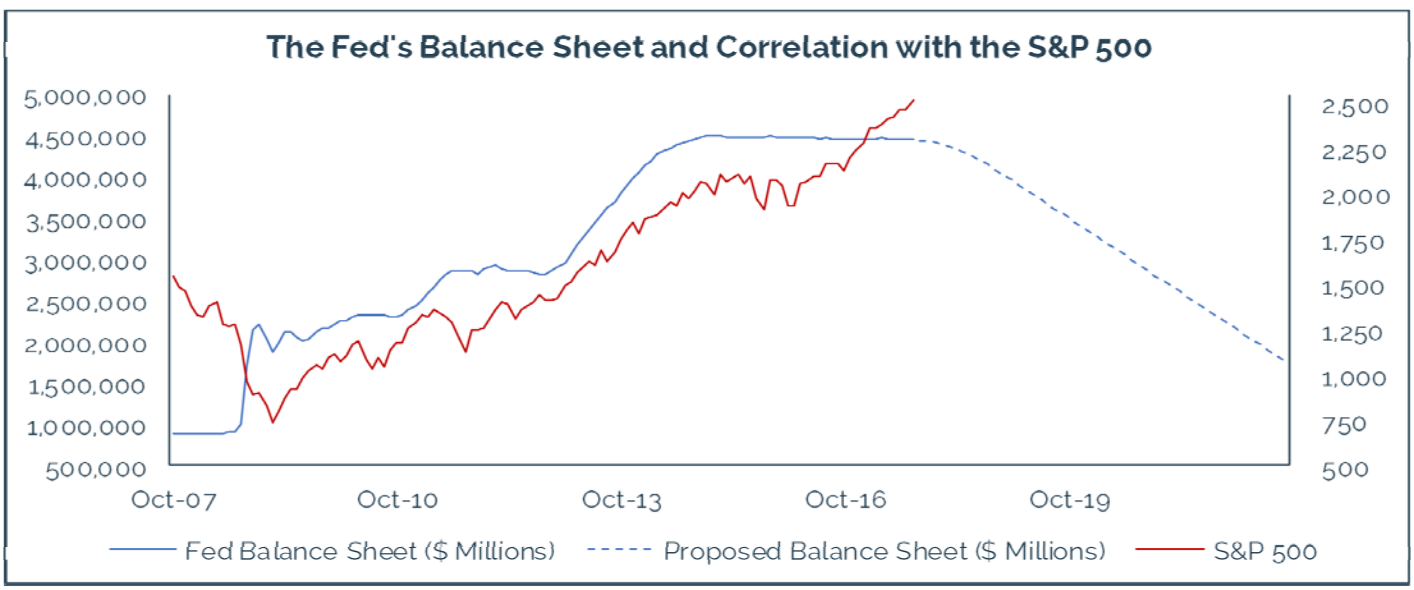
And now the Fed has unveiled its plan to unwind this great experiment called Quantitative Easing, or QE. For every month of the 4th quarter the Fed will allow $10 billion of assets to roll of its balance sheet. To be sure, $10 Billion is a lot of money. But it barely makes a dent in a $4.6 Trillion balance sheet. This amount will increase by $10 Billion every 3 months until it next October. At that time $50 Billion per month will be allowed to roll off until 2022. Of course, this policy can be altered at any time.

The problem is that this is not news. The Fed has been very open and transparent about its intentions. Yet the market doesn't seem to believe what the Fed is telling it. On what basis should the market place this much confidence in a Federal Reserve that has almost never gotten it right?

The chart on this page shows a very strong correlation between the size of the Fed's balance sheet and stock prices, right up until the Fed stopped expanding its balance sheet in 2015. For a brief time, around the time of the Fed's first rate hike since 2006, the market stumbled and leveled off as the balance sheet size plateaued. And then, around the time of the election, the market broke this correlation and took off to the upside.

Maybe the market has it right. Maybe a lack of government action had actually been holding the market back. Maybe now that the market expects lower tax rates and less regulation, the fuel that the Fed provided is no longer necessary and the market can run on its own. And maybe it can even do so as the Fed seeks to unwind its great experiment. Or maybe the Fed will abandon the unwind and just leave its balance sheet inflated.

The balance sheet unwind is the biggest concern because it could derail this bull market. Divining what the Fed may or may not do, depending on who the President chooses to appoint as Chair, is no longer investing. It is guessing, or even gambling. Excess speculation is the fuel of the last stages of a bull market.



A quote from Seth Klarman of Baupost Group seems an appropriate close: *"When share prices are low, as they were in the fall of 2008 into early 2009, actual risk is usually quite muted while perception of risk is very high. By contrast, when prices are high, as they are today, the perception of risk is muted, but the risks to investors are quite elevated."* Until next time.

Is History Rhyming Again?

Tandem turned 27 years old this month, and I have had the unbelievable good fortune to be around for every single day of those 27 years. I have seen a lot. Which is why I am pretty certain I have seen this before, about 18 years ago.

On February 24, 1999, the stock price of Walgreens closed at $25.93, which was a new high. Of course, most stocks in 1999 were closing regularly at new highs. It was near the end of a bull market. But on that particular day in February, Walgreens was about to face an existential threat, or so it would soon seem.

A new business called drugstore.com launched its web operations that fateful day. At the time, investor sentiment was so overwhelmingly pro-all-things-internet that it was widely believed that Walgreens days would be numbered. It could not possibly hope to compete with an entity known as drugstore.com. The stock market's reaction bears this out.

On July 28, 1999, drugstore.com sold its first shares to the public. During its first day of trading, shares more than tripled in price. Walgreens shares closed that day at $23.10, down nearly 11% from its February high.

Walgreens shares would continue to struggle for a bit, losing nearly $15 Billion in market value as drugstore.com, a company with little revenue, no earnings and no dividend, saw its value soar to more than $3 Billion. It was clear that investors feared Walgreens couldn't compete in the new paradigm of the internet.

We all know how the story actually turned out. Has anyone ever shopped at drugstore.com? Has anyone even heard of it in the last 17 years? Walgreens never blinked. They continued to operate their core business with the same proficiency they always had, while working on the proper solution for their customers that preferred to shop online - a solution they had already been working on before drugstore.com's arrival. In the end, drugstore.com was never able to pry Walgreens' loyal customers away. In fact, if you were to visit www.drugstore.com today, you would be redirected to walgreens.com. Walgreens owns the site.

Today, history may not be repeating itself, but it sure is rhyming. Born in the late '90s was a remarkable company called Amazon. Amazon was one of the few of the dot.com era to make it out of the bubble alive, and today it can be counted among the most successful and highly valued companies on the planet.

Amazon began as an online book seller. Because it was not burdened by the costs associated with owning or leasing real estate for stores, Amazon was able to undercut the prices its competitors charged. Remember Borders Books? And Barnes & Noble, while still around, isn't nearly as fashionable as it once was. It has had to close many of its stores to survive.

You see, Amazon had no stores. Just a website. And soon they began selling just about everything from that website. Amazon has become so mind-bogglingly successful as a retailer that it has turned the retail world on its head. Malls are actually closing. Many retailers have been unable to compete and the landscape has forever changed. In fact, in an ironic twist, having caused many retailers to shutter their stores, Amazon has decided to begin to open stores. Its first physical book store opened in Manhattan, in a site previously occupied by Barnes & Noble.

As Amazon's empire expands, the company continues to set its sights on new business to enter and disrupt with lower prices and online convenience. Amazon has entered the entertainment business, the grocery business and now is considering entering the pharmacy business. With every new entry or announcement or deal that Amazon makes, the shares of would-be competitors tumble in price.

Amazon is an amazing business, and the intent here is not to denigrate Amazon in any way. Amazon has done nothing to merit criticism here. But in my view, the market has responded to Amazon's encroachments in much the same way the market responded to drugstore.com and others of that ilk in the 1990's.

Amazon is a for more worthy competitor that drugstore.com ever was. It is to be taken seriously and with respect when it takes on a new competitor. But within its recent past, Amazon has either taken on or contemplated taking on an impressive list of businesses as competitors. A partial list includes TJ Maxx, Macy's, Wal-Mart, Target, Advanced Auto Parts, O'Reilly Automotive, Dollar Tree, Dollar General, Costco, Kroger, Home Depot, Lowes, Google, Lionsgate, Netflix, CVS and Walgreens. I repeat, this is a partial list only.

The stock market considers Amazon to be such a threat to these businesses that hundreds of billions of dollars have been shed from their collective market values. Amazon has a proven history of being able to disrupt business. Capitalism is based in part on the notion of creative destruction, where, much like a forest, the old falls away, permitting the new to emerge.

I would never bet against Amazon, but I will bet on many of its competitors. Amazon has become a de facto conglomerate. Most of these other businesses are fixed on a much narrower scope with perhaps fewer distractions. Yet the market seems to anticipate that Amazon will negatively impact all of them. I think I have seen this before. Is the market rocking a rhyme? In the words of Rev. Run and DMC, it's tricky. ***~ JBC***

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Past performance is no guarantee of future results. Indices are unmanaged and not available for direct investment. They are shown or referred to for illustrative purposes only and do not represent the performance of any specific investment.

Yield Table

	Current	3 months ago	1 year ago
3-month Treasury Bill	1.03%	0.98%	0.29%
2-year Treasury Note	1.38%	1.34%	0.77%
5-year Treasury Note	1.80%	1.77%	1.18%
10-year Treasury Bond	2.20%	2.19%	1.63%
30-year Treasury Bond	2.78%	2.80%	2.35%
Prime Rate	4.25%	4.13%	3.50%
Federal Funds Rate	1.15%	1.04%	0.40%
Discount Rate	1.75%	1.63%	1.00%

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

	9/30/17 Close	% Change 1 Year	% Change 3 Years	% Change 5 Years
S&P 500	2,519.36	16.19%	27.74%	74.87%
Dow Jones Industrial	22,405.09	22.38%	31.46%	66.74%
NASDAQ	6,495.96	22.29%	44.57%	108.46%
Russell 2000	1,490.86	19.11%	35.33%	78.02%
German Xetra DAX	12,828.86	22.05%	35.41%	77.78%
London FTSE 100	7,556.20	8.66%	15.42%	30.67%
Shanghai Composite	3,348.94	11.46%	41.67%	60.53%
Crude Oil	$ 51.67	7.11%	-43.32%	-43.95%
Gold	$ 1,284.80	-2.17%	6.14%	-27.46%
CRB Index	183.09	-1.73%	-34.27%	-40.81%
U.S. Dollar Index	92.88	-2.63%	7.94%	16.06%
Euro/Dollar*	1.18	5.10%	-6.48%	-8.12%

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

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