Tandem Investment Advisors

Notes from the Trading Desk - April 29, 2021

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by Benjamin “Ben” G. Carew, CFA

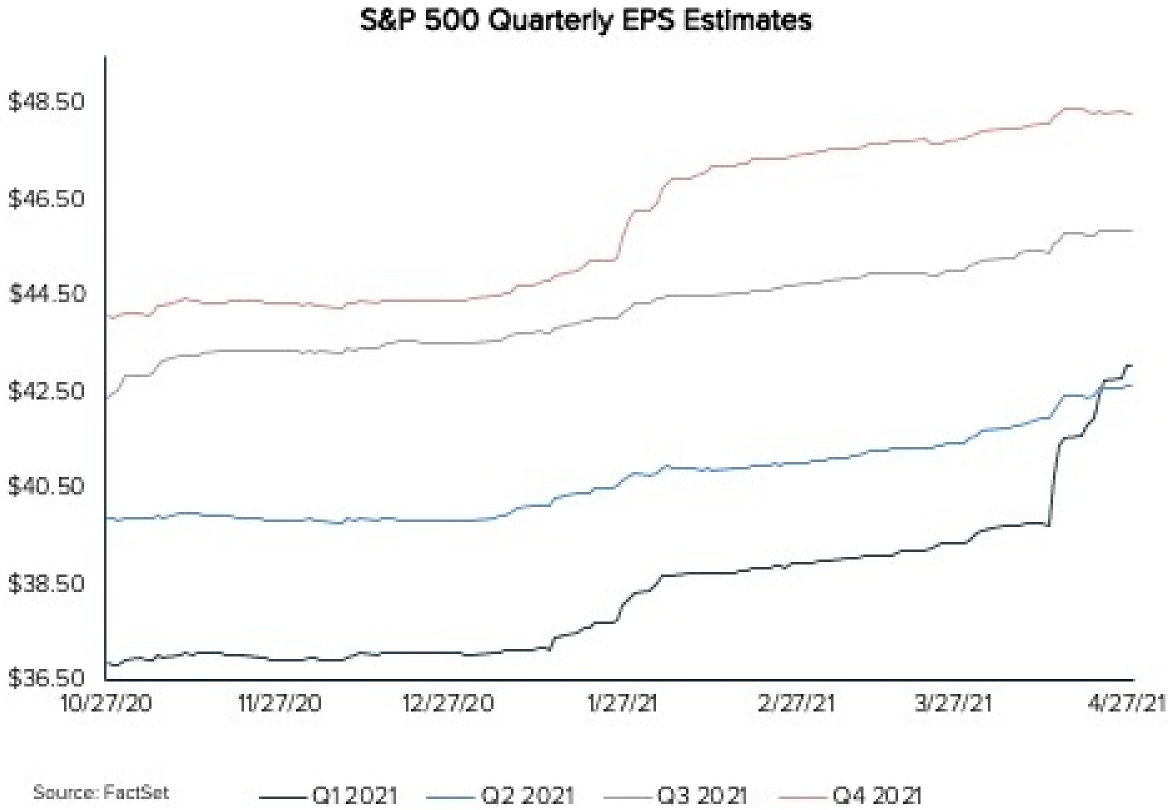
MARKET MOVERS & SHAKERS

Compared to the start of the quarter, it feels like stocks have stalled out over the last two weeks. The S&P 500 is up 1% since the previous edition of *Notes*. The Nasdaq and the Dow Jones Industrial Average are up even less than that, while the Russell Mid Cap and Russell 2000 have fared slightly better. The mid-cap index is up nearly 2.5%, while the Russell 2000 is up nearly 3.4%. Meanwhile, many commodities have continued rising at their torrid pace. Lumber is on fire, now up 41% for the quarter. Sugar, corn, wheat, cotton, and copper futures are all up double digits quarter-to-date as well. While many commodities have continued to point towards potential inflationary pressures, yields have continued to trade in a tight range with little news or movement to report. However, the long end of the curve has been trending higher over the past few sessions.

A couple of weeks ago, we emphasized the importance of the inflationary insight we would gain from earnings calls. According to a recent FactSet report, “more S&P 500 companies have cited the term ‘inflation’ on their earnings calls for Q1 2021 through this point in time in the earnings season in more than 10 years.” Despite the continued pickup in inflationary chatter within the various C-Suites, the Fed remains unperturbed. On Wednesday afternoon, Federal Reserve Chairman Jerome Powell repeated his now common refrain that any sort of inflationary pressures would be transitory and unlikely to be sustained.

Some of the year-over-year changes in inflationary measures were bound to happen. The rapid decline in economic activity last March, April, May, and June undoubtedly lowered the base number for year-over-year comparisons. Any sort of return to normal was bound to look inflationary if one only looked at the headline numbers. It is easy to put an attention-grabbing number out there and say lumber futures are up nearly 450% from their April 2020 lows, so inflation is here! However, that number does ignore the fact that lumber futures had already fallen 45% in the 6 weeks preceding that low. It is a valid argument and a fair point to assert that the base number is misleadingly low. However, lumber is still up more than 300% from its April 2019 levels. Similarly, copper, up 114% from its April 2020 low, is still up 55% over the last two years. Corn is up 108% since August, but it is also up 77% from its level two years ago. Clearly, some of these eye-popping inflationary pressures are attributable to an easy comparative period stemming from the heart of the pandemic's economic shutdown. However, it would be untenable to completely dismiss inflationary concerns. Only time will tell if these inflationary concerns are legitimate, or merely a head fake. Either way, given the evidence from companies themselves, it would seem foolhardy to not be paying attention to such metrics.

Another clear takeaway from the earnings season so far is that analysts woefully underestimated what many companies would earn in the first quarter. As seen in the chart below, the ramp higher in Q1 estimates has been relentless. Typically, analysts begin the quarter too optimistic and must temper their estimates as the quarter progresses. This quarter is clearly bucking that trend. In fact, estimates are up nearly 8% since April 13th alone. During that time, however, the S&P 500 has only gained 1%. The index, as measured by a price-to-earnings ratio, is becoming cheaper because earnings (the E in a P/E ratio) is currently growing more quickly than price (the P in the aforementioned ratio). Coming out of the pandemic, valuations have become quite rich, as most measures are only surpassed by the peak of the Tech Bubble. However, price does not have to correct for valuations to come down. A company, or in this case the companies that make up the S&P 500, could just as well grow into their valuation.



TRANSITION UPDATES & NEWS **

Earnings season typically presents opportunities on the transition level as volatility within individual names will often pick up. So far, we have been pleasantly surprised with our holdings' results. So far, 42% of Tandem's holdings have announced 1st quarter earnings results, and they have reported an average growth rate of 23% – well above the 9.5% growth rate that was estimated by analysts at the start of the year. Despite the nice upward surprise in earnings, we have been able to add to a few names on pullbacks at the transition level. Most recently, we were able to purchase Abbott Labs (ABT), Automatic Data Processing (ADP), NextEra Energy (NEE), and Fiserv (FISV).

***The transition update describes activity taken by Tandem on the transition level, not the composite or firm-wide level. The transition update is applicable to new accounts and new money. New accounts and new money are not automatically invested on the first day. Rather, they are transitioned into our strategy over a longer time period that is dependent upon market conditions. This update describes that transition.*

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