August 9, 2021 - Tandem Investment Advisors, Inc.

August 10, 2021

Notes from the Trading Desk
- August 9, 2021
by Benjamin “Ben” G. Carew, CFA

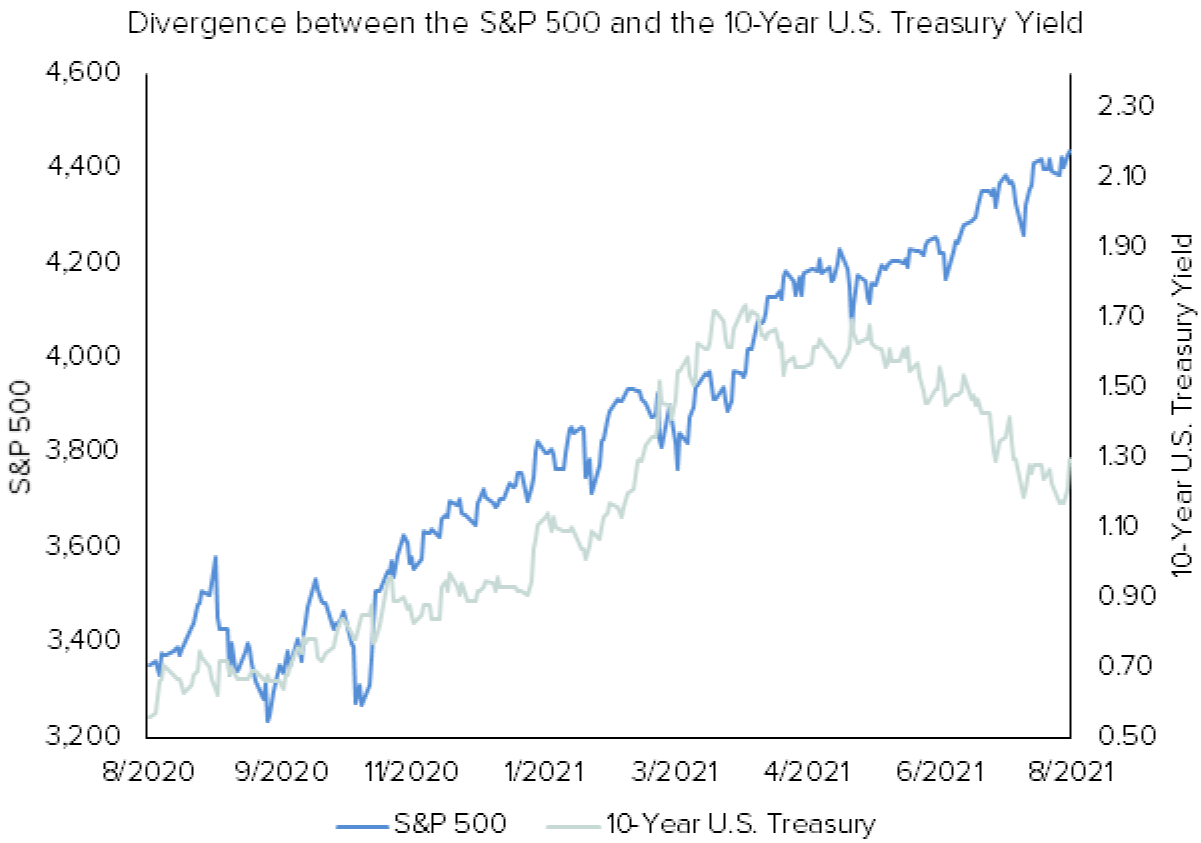
MARKET MOVERS & SHAKERS

In terms of getting from point A to point B, not a lot has happened since I last wrote here on July 12th. The S&P 500 is up 1.8%, ditto for the Russell Mid Cap. The Nasdaq, which has trailed the S&P 500, is only 1.4% higher than it was on the 12th. Likewise, the Dow Jones has gained just 1.2%. Small caps have fared less well, as the Russell 2000 is only up 0.6% over the same time frame. However, the action was a bit more interesting than the percentage moves would suggest. The S&P 500 fell 3.7% peak to trough, a garden variety pullback to be sure. However, the VIX (often called Wall Street’s fear gauge) spiked more than 60% during that time. Similarly, volatility within the bond market has picked up precipitously. The yield on the 10-year Treasury, which was around 1.4% when I last wrote, fell sharply and bounced off 1.13% twice before steadying itself around 1.3% towards the end of last week. Yields seem to have found a floor, temporarily at least for now. Recent action within the bond market has been curious to say the least. Chatter around Fed tapering or potential hikes to stymie inflation has been plentiful these last few months. However, the bond market seems torn. The probability of a rate hike and the probability of a rate cut over the next year or so have actually both been rising over the past month. Something has to give between those two! Thematically, defensive stocks have continued to rule the day. Health Care, Utilities, and REITs are all the best performing sectors quarter-to-date. Given the sharp drop in yields we have seen this quarter, it is not surprising to see the outperformance from REITs and Utilities. Generally speaking, as yields fall, those sectors tend to do well.

In Billy Little's recent *Observations* he mentioned the surprisingly positive correlation between the VIX and the S&P 500 these last few weeks. Typically, the two share a negative correlation – markets rise as the VIX falls and markets tend to fall as the VIX rises. Since the start of July, the pair have traded higher together for the most part. We saw a similar positive relationship prior to the February 2020 top, the January 2018 top, the then temporary tops in both '14 and '15, and throughout the summer of 2007. Does every positive relationship between the VIX and the S&P 500 mark a market top? No. However, it has been a trait that commonly precedes choppier waters. Luckily, this relationship has deteriorated a bit these last few days as it reverted to its more normal negative correlation with the VIX falling as the S&P 500 traded to all-time highs.

Continuing along the topic du jour of volatility, we had already mentioned in the first paragraph that volatility within the bond market has been on the rise. The ICE BofAML MOVE Index, which measures similar sentiment to that of the VIX only within the bond market, has been marching higher for months now. The Federal Reserve, which has kept yields low and the monetary policy pump primed, has been unable to stamp out volatility within the bond market. It's almost a bit like a reverse taper tantrum. In 2013, volatility within the bond market surged as yields shot higher in response to the Fed's initial announcement of future tapering. The media dubbed this event the "taper tantrum". This time, volatility once again picked up, except yields fell sharply.

Billy also touched on recent market divergences as cause for concern. As he pointed out, emerging markets have been trading lower, as have international developed markets, while our own large cap domestic indices have continued to trudge higher. The VIX has been rising, and credit spreads have widened. Another clear divergence though has been the deviation between yields and stocks. As seen in the chart below, stocks and Treasury yields have traded in lockstep for the last year or so. The relationship has become decoupled in the past few months and has really picked up steam since the start of July.



Similar divergences can be seen between our markets and the Shanghai Composite, the Hang Seng, breakeven yields, and the Dow Jones Transportation Average. These little cracks have been popping up left and right in broader markets. Markets on our shores though, have mostly remained calm and have just kept marching higher. Hopefully that trend can continue, and the decoupled marketplaces will just begin moving higher in lockstep with our own equity indices. However, China is worth keeping an eye on. In 2015, the Shanghai Composite fell 28% in just two months. Our markets remained unperturbed. Domestic equities kept shrugging off the turmoil in Chinese markets until they couldn't any longer. The S&P 500 then fell more than 11% in just five trading sessions. The action was worse in the Nasdaq 100, which fell close to 17% over the same time. If the CCP continues to wreak havoc on their own stocks (just look at Chinese education stocks and Chinese internet stocks) then the issues could easily spread into other indices. Chinese stocks can often be viewed as a proxy for broader risk appetite. Historically, it is not unusual to see selloffs in Chinese stocks have repercussions in less defensive domestic pockets of the market.

TRANSITION UPDATES & NEWS **

With the brunt of earnings season behind us, it has been an eventful few weeks. To date, all but two of our companies beat their earnings estimates to the upside. Verisk Analytics and Euronet were the two to disappoint. The reported year over year earnings growth rate for the average Tandem name this quarter has been a remarkable 40.5%. This is nearly twice the growth rate that was expected at the end of March for the second quarter, 23%, and up nicely from the 26% growth that was being estimated on June 30th. Outside of earnings season keeping us all busy at Tandem, it has been a calm few weeks in terms of other news.

**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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