December 20, 2022 - Tandem Investment Advisors, Inc.

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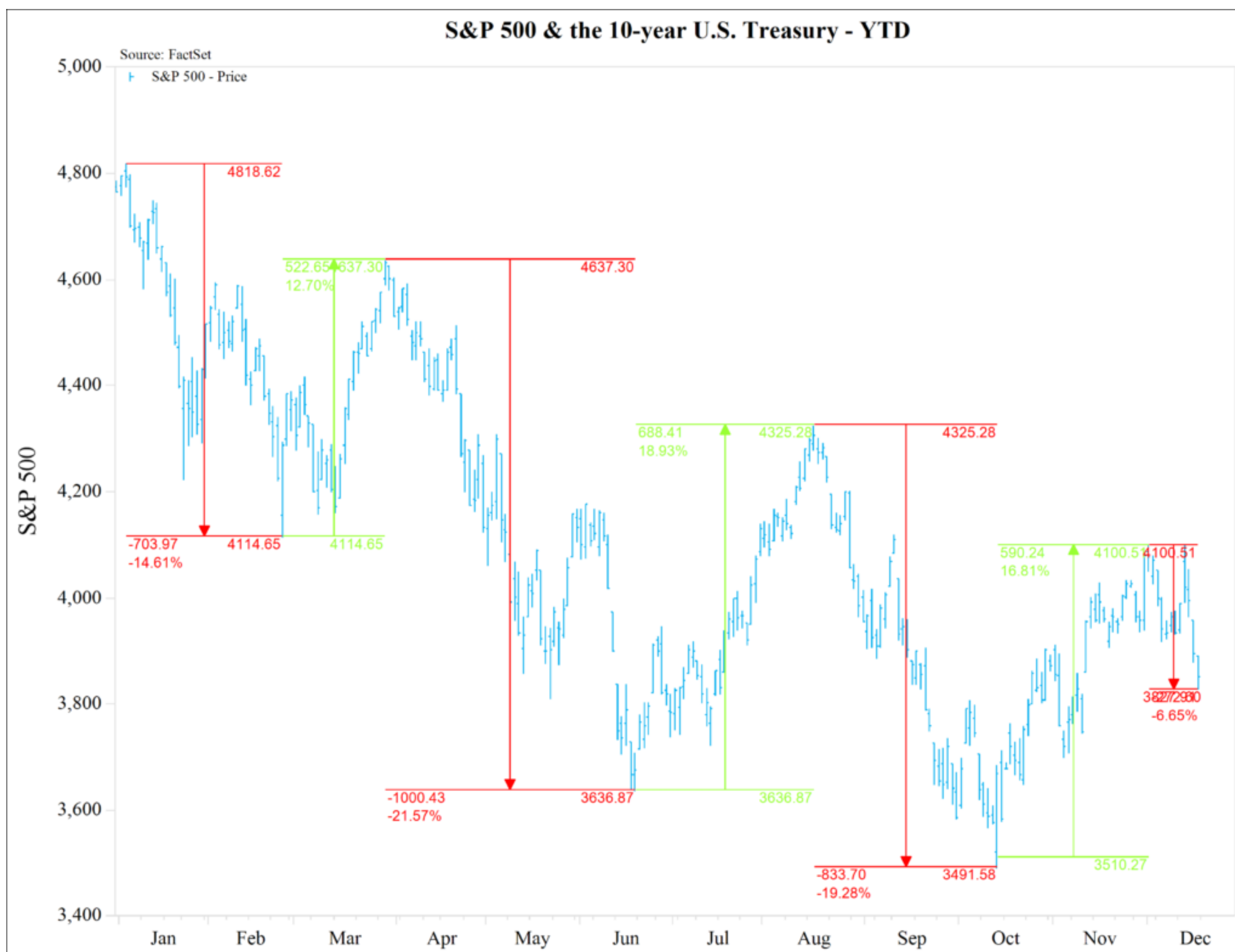
December 22, 2022

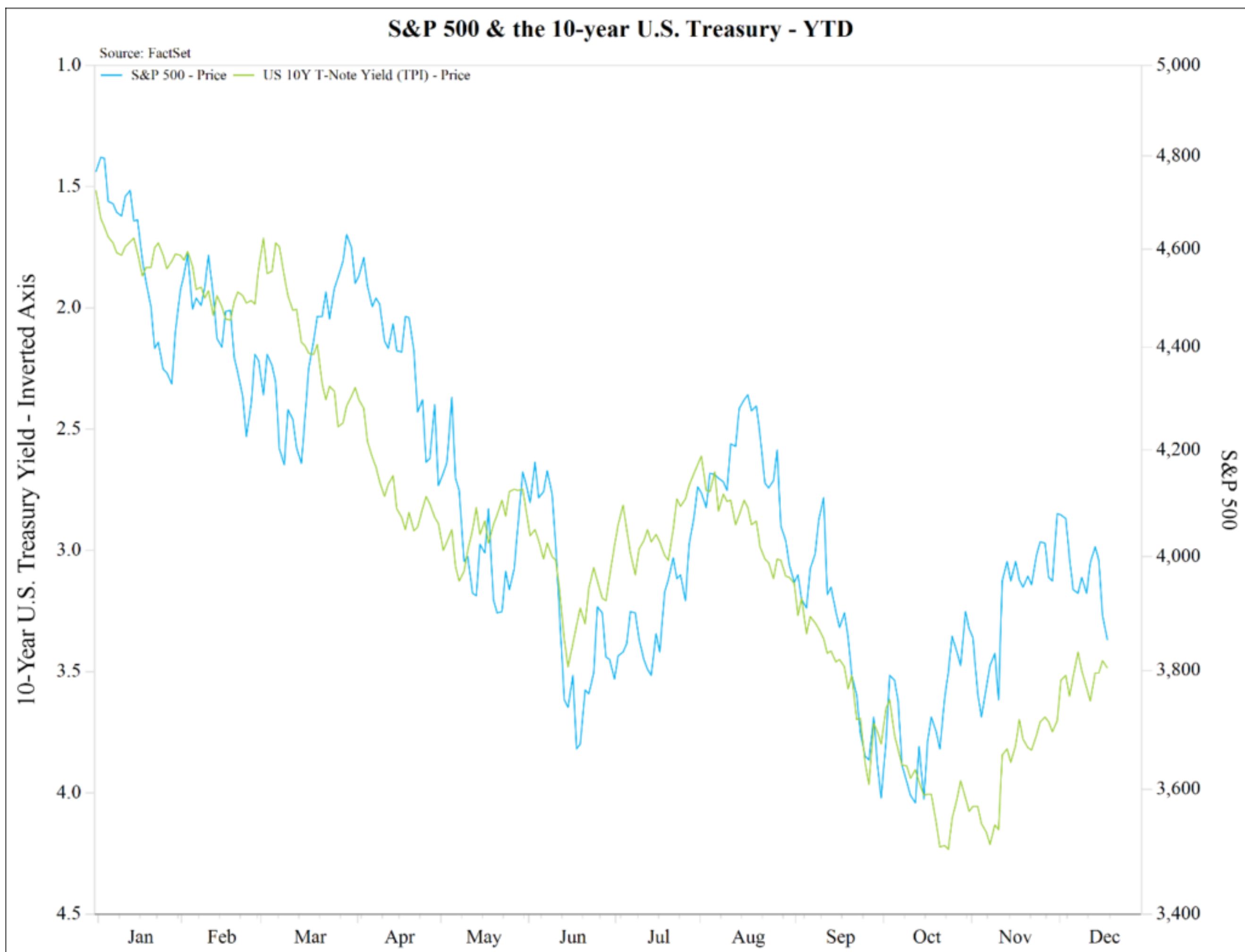
MARKET MOVERS & SHAKERS

With just a few more trading days left in 2022, this tumultuous year is finally coming to an end. Through December 16th, this year has seen 118 trading days in which the S&P 500 closed ±1%. Only twice has the market bested that in the previous 50 years; in 2008, there were 134 such days and 125 ±1% days occurred in 2002. Those daily swings have marked a more volatile and downcast year. Barring some sort of holiday miracle, the S&P 500 and the other major equity indices will close 2022 in the red, though their path lower has been anything but straight. After setting its last all-time high on January 4th, the S&P 500 proceeded to fall 15% by late February. Bouncing off its lows, the S&P 500 rose nearly 13% into the end of the first quarter. In Q2, the selling picked up swiftly as the S&P 500 slid more than 20% from late March into mid-June. Again, the market seemed to find its footing as the S&P gained 19% into mid-August. Just as people were starting to feel optimistic once more, the S&P 500 reversed course and dropped 19% by mid-October. A 17+% rally into the start of December gave us all a little bit of hope that this year might end on a slightly more optimistic note after all – that was until Jay Powell corrected markets and sent them lower for it's latest 7+% down move. I feel whiplashed just writing all of that, and investors surely felt the effects of that same whiplash all year long. There were headlines and reasons associated with each of those moves – the panic in Q1 was linked to the rising geopolitical tensions in Eastern Europe. Q2's pain was credited to peak inflation, while the third and fourth quarter selloffs were supposedly spurred by Fedspeak. Those headlines complicate matters more than necessary. In reality, those various headlines served more as a distraction from the main show – the rising King Dollar and Treasury Yields.



Declining yields can be a boon to the economy and for investors alike. For one, lower yields allow businesses and people to borrow more cheaply, which can spur more economic activity. And the lower cost of borrowing can even increase the profitability for businesses that need to borrow. Thinking back to my entry level finance course at the College of Charleston, one of the first things we learned was that the value of an asset is determined by discounted present value of future cash flows. Well, the discount mechanism used to calculate the present value of future cash flows is tied to interest rates – more specifically the future cash flows are divided by the discount rate. Thus, as interest rates fall, the value (or more accurately, the valuation) of an asset rises. This relationship is why valuations and interest rates share a strong inverse correlation throughout history. We all learned fairly early on that as the yield falls, the price of a bond will rise. Well, the same has been mostly true for equities. As yields fall, the discount rate drops, and equities, theoretically, should rise. Unlike the past 40 years, yields have been rising this year. So, the historic tailwinds from declining yields have reversed course. The cost of capital is rising, so businesses and consumers borrow less or incur more interest expense. Theoretically, the discount rate has also been rising which becomes a headwind for valuations. Sure enough, the forward P/E for the S&P 500 has fallen nearly 30% peak to trough this year.

Throughout the year, the rise in yields has been met with bouts of weakness in the major equity indices. Periods of strength this year have all seemingly coincided with declining yields. During the 19% rally from mid-June to mid-August, the 10-year U.S. Treasury fell from 3.5% to 2.6%. During the subsequent 19% drop into mid-October the 10-year climbed to 4.2%. The most recent rally saw the 10-year trace its way back to 3.5%. Time and time again this year, yields have seemingly been a key determining factor. During this most recent bout of weakness? Yields have been rising. Similar conclusions may be drawn from looking at the interaction between equities and the Dollar Index. The Greenback, which by and large has been strengthening relative to most currencies this year, saw periods of weakness in July and August, which coincided with the equity rally at that time. The Dollar Index experienced a decline from Mid-October to just earlier this month, which overlapped with the rally in stocks. For much of the year, one could guess what was happening in the stock market by just looking at the bond market and the U.S. Dollar Index.



> At the end of November, we stated in this column:
> *… a few things could splash cold water on the recent rally. First and foremost, yields and the dollar could reverse course. Significant dollar strengthening or a rise in yields has been met time and time again this year with weakness in the broader equity indices. There's no reason to think that this relationship has been broken yet. Second, we do have a Federal Reserve meeting in December which will give the Fed the chance to correct the markets perception of the Fed's future rate path should Jay Powell and company decide the market needs correcting.*

Those statements were not meant to serve as a prediction, rather just highlight some potential headwinds in the market. In hindsight, Jerome Powell did reset market expectations for future Fed action with a decidedly hawkish tone. We have also seen a rise in yields and a very slight strengthening of the Dollar Index. Ultimately, these developments have also coincided with weakness in the broader equity indices. When Powell took the stage on the 14th, he donned a hawkish cap to seemingly set the market straight. The market was anticipating the Fed to begin easing hawkish policies – hopefully saying the end of rate hikes was near. However, the Fed Chairman made it very clear that the Fed believes there is more work to do to shore up inflation. For now, there is a bit of a disconnect that will need to be resolved in 2023. The latest from the FOMC shows a projected Fed Funds rate greater than 5% by the end of 2023. Using CME Group's FedWatch Tool, it seems that the market believes that the Fed may get up to 5% in June, but that they will ultimately reverse course by the end of the year, cutting to a target rate of 4.25% – 4.50%.

If interest rates do stay higher for longer, there will be some readjustments for companies and investors to make. Whether the terminal rate is 5%, or somewhere between 4.25% and 4.50%, companies and entities are going to have to get used to servicing debt at a higher interest rate. This could hamper their ability to spend, which in turn could dampen economic activity. Higher interest rates further kill the trade that dominated the decade coming out of the Financial Crisis where yields were so low that investors followed the TINA moniker (There Is No Alternative). At the time of writing, the 1-year U.S. Treasury was the steepest part on the Treasury yield curve with a yield of 4.67%. That's an enticing alternative for some investors that have been crowded into the stock market over the past decade+.

Despite all of that, it does not need to be doom and gloom for Equity investors, instead it could just mean a return to normal. At the beginning of this article, we mentioned the 118 ±1% moves this year. That is unusually high, but much of the past decade was also unusually low. Most years see ~60 such days. In the past 10 years, we have been under 60 days seven times – including just eight 1% moves in 2017. That was abnormal. So, the pendulum swung a little bit too far in the other direction, that happens too. My bet is on a return to something a bit more inline with the historical norm – not the post-Financial Crisis norm, but the longer-term historical norm. That could mean a little more volatility than we

grew accustomed to from 2010 – 2019. Volatility, however, does not just mean downward pressure. Volatility simply means prices moving more quickly in either direction. That's okay! Volatility breeds opportunity after all.

TRANSITION UPDATES & NEWS **

With the recent uptick in volatility, activity at the transition level has picked up as well. The most recent weakness in stocks has presented numerous opportunities to begin transitioning into a handful of Tandem names. In fact, since the Fed met on the 14th, we've been able to transition into 26 different securities across the three strategies. In terms of actual news at the individual stock level, it has been pretty slow and tame. A few companies have announced dividend hikes – McCormick announced a 5.4% increase, MasterCard announced a 16.3% increase, while Stryker and Abbott announced quarterly increases of 7.9% and 8.5% respectively. Outside of that, FactSet reported a slightly disappointing quarter. Revenues and cash flow came in a little lighter than expected and the stock sold off throughout the day following its earnings release. Nike also reported their quarterly results, which came in above analysts' expectations.

***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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Ben Carew is a shareholder, Vice President, and Portfolio Manager for Tandem Investment Advisors, Inc. Mr. Carew joined Tandem in 2013. Mr. Carew manages Tandem's trading desk, overseeing day-to-day investment operations, including trading, quantitative and fundamental research, and portfolio management. Mr. Carew also oversees Tandem's internship program. Mr. Carew is a regular member of the CFA Institute and the CFA Society South Carolina. Mr. Carew currently serves as the Vice Chair for College of Charleston's School of Business Investment Program, a student program seeking to provide the opportunity for a select group of students to distinguish themselves academically, professionally, and personally. Mr. Carew is a graduate of the College of Charleston's School of Business, earning a Bachelor of Arts in Economics with a minor in Finance.

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