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tandemadvisors.com/notes-from-the-trading-desk/february-20-2023

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MARKET MOVERS & SHAKERS

On paper, February has been a dull month – the antithesis of January's exciting surge in asset prices. The S&P 500, through Friday's close, has gained a whopping six basis points. The Dow is down ¾ of a percent, while the Russell Mid Cap and Russell 2000 are both up 26 and 75 basis points, respectively. The Nasdaq has outperformed the major U.S. equity indices so far in February as it has gained 1.75%. All of that is a far cry from the surge higher that equity investors enjoyed in January. The flattish performance amongst U.S. equities has been surprising. Over the past 12-15 months, equities have disliked higher yields, a stronger dollar, and a rising VIX. So far in February, yields are largely higher, the dollar has strengthened, and the VIX has been steadily rising. Check. Check. Check. The outperformers this month have been tech and small caps, which again is surprising given the backdrop of rising yields and a stronger greenback. We've also seen some continued strength in growth relative to value. However, value turned that around Wednesday morning through the end of last week. Similarly, small caps, which have outperformed large caps for most of the month, saw that flip on Wednesday morning as well. Elsewhere, commodities have been largely lower so far in February. Oil, gold, copper, silver, lumber, sugar, corn, hogs, and cotton have all been falling. This is good news for deflationary hopes.

Despite the recent weakness in the commodity complex, recent economic data should confirm the Fed's need to continue its crusade against inflation. A triad of surprisingly resilient economic data in February should give the Fed enough ammo to continue to hike. Just last week, the retail sales release pointed toward stronger than anticipated growth. In fact, the retail sales number was the hottest since March of '21. Moving on to the labor market, the 3.4% unemployment rate that came out earlier this month was the lowest since 1969. The participation rate, which is still below pre-pandemic levels, is currently at post-pandemic highs – a step in the right direction. As more folks return to the labor force, it would not have been surprising to see upticks in unemployment that naturally coincided with more people looking for jobs. The labor market has had no problem soaking up additional workers. In fact, JOLTs, which measure the total number of nonfarm job openings, is well above its pre-pandemic levels and is accelerating higher once more. In terms of inflation, the January CPI number released at the start of the month was also hotter than expected. The 6.3% year-over-year increase in CPI is still a deceleration from the 8.9% peak from last June – so

the deflationary trend continues to be in the right direction. However, 6.3% is still much too high and it was higher than the consensus estimates. The seasonally adjusted month-over-month number began reaccelerating higher as well. All of these data points point toward a stronger economy – one that the Fed should be able to continue to hike into. All of these data points could also point towards a potential reacceleration of inflation.

Consumers are clearly continuing to spend. Their spending behavior is beginning to shift though. BofA recently reported that the usage of credit/debit is spiking. January saw a 5.1% year-over-year increase in credit/debit usage, versus just 2% growth in December. The increase in credit usage can be seen flowing through to some of the major credit card companies. Capital One reported that net charge-offs are on the rise. And, Discover surprised analysts as management recently noted the company was anticipating much higher charge-offs in 2023 than analysts were expecting.

Even though consumer spending habits may be deteriorating, all of the resilient economic data should beget further rate hikes from the FOMC. The Fed will likely look to keep rates higher for longer as they continue to combat inflation. The belief that there are more rate hikes to come is clearly making its way through the market. Just one month ago, the market implied Fed Funds rate for the end of 2023 was somewhere between 4% and 4.5%. Today, that implied rate is somewhere between 5% and 5.5%. The market has gone from pricing in one to two cuts, to pricing in an additional one to three hikes. This has led to a rising 2-year U.S. Treasury, which has been climbing toward its cycle high once more. Meanwhile, the 1-year U.S. Treasury has breached 5% for the first time since February of 2007. Given this shift in yields, the resiliency in equities, specifically within growth, has been quite surprising. We are either entering a new regime, where growth is more tolerant of rising yields, or growth will become coupled to rates once more. If the relationship should become coupled again, then a rise in yields should translate to weakness in the growth trade and vice versa.

TRANSITION UPDATES & NEWS **

With more than 80% of the S&P 500 having now reported their quarterly results, earnings seasons is coming to an end. According to FactSet, earnings are currently set to decline nearly 5% year-over-year. Some of the worst earnings contractions have been occurring in what are typically more cyclical sectors like consumer discretionary, materials, and even communication services. At the end of Q3, growth was predicted to be slightly more than 3% in the quarter.

Clearly earnings have deteriorated for the broader market. For the average Tandem holding, growth is still expected to be positive, albeit, at a lower rate. Companies that were clear beneficiaries during COVID, like Expeditors International, Abbott Labs, or Lab Corp have all seen expected and anticipated declines in their earnings as they have begun to return to a more normalized level. Companies like those listed above received a one-time boost from COVID era changes. Abbott and Lab Corp both benefitted from COVID testing. Chances are

that most folks that have taken a rapid COVID test have probably taken Abbott's test. That rate of growth was always going to slow for Abbott. As the need for rapid tests diminished, Abbott was destined to return to its normal earnings level. This isn't a traditional contraction in growth that is commonly seen in cyclical companies, nor is it a lack of consistency in Abbott's growth which can occur when a company is unable to sustain its fundamental growth. Instead, Abbott, as an example, received a one-time boost in profitability and cash flow thanks to its rapid diagnostic tests. The company is arguably stronger today as a result of that temporary boost.

***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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