Tandem Investment Advisors

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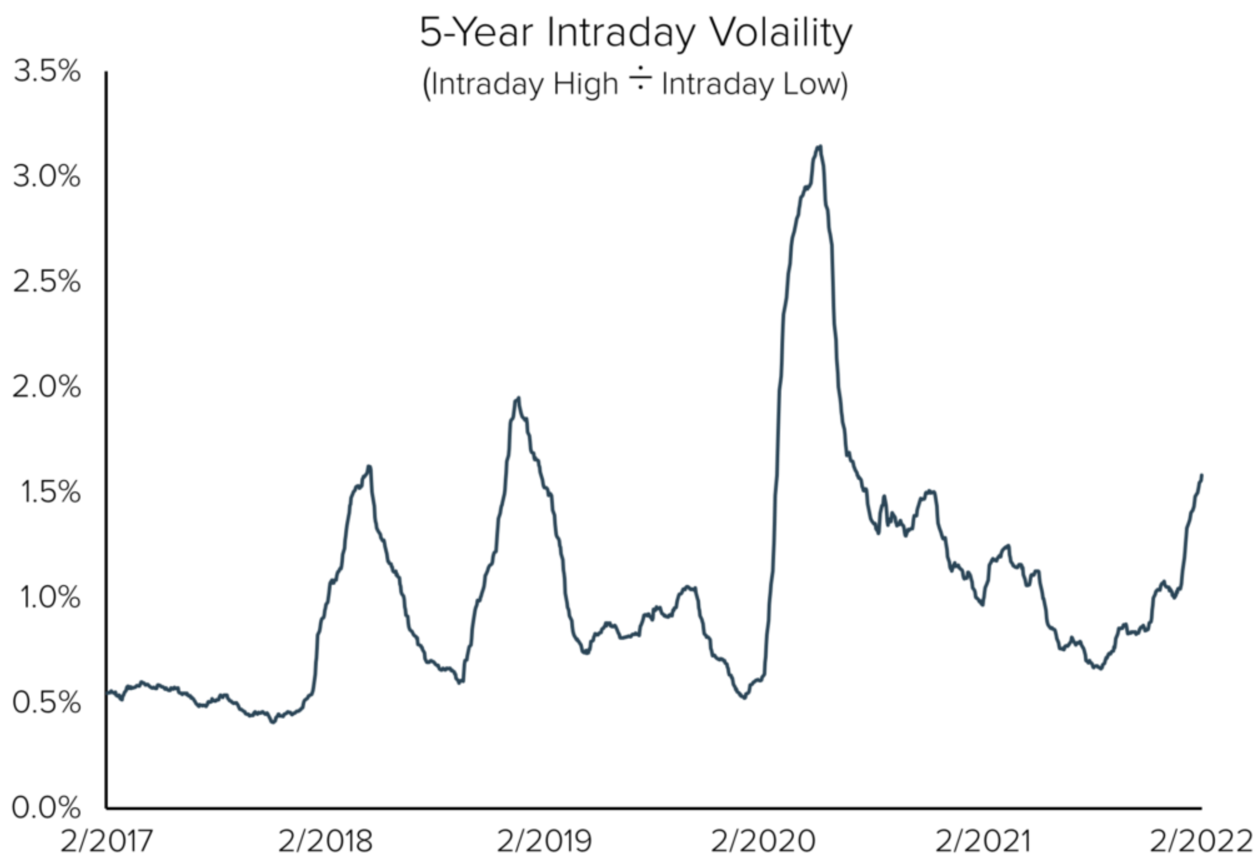
Notes from the Trading Desk -
February 23, 2022
by Benjamin "Ben" Carew, CFA

MARKET MOVERS & SHAKERS

Since the last edition of Notes, volatility has remained the topic du jour as the major indices have all dropped. At the time of writing, the Nasdaq has dropped nearly 4.5% over the past two weeks, while the Dow and the S&P 500 have both fallen right around 4%. Small caps have fared better as the Russell 2000 was only down ~1.5% over that two-week time frame. The source of this year's volatility has been any number of things. The causes have been inflation and rising rates, a hawkish Fed, weak consumer sentiment, a rise in negative guidance coming out of earnings, and most recently, Vladimir Putin. Regardless of the cause, heightened volatility has been a consistent factor for the past 3 and a half months or so – a noticeable change from the prior 12-15 months.

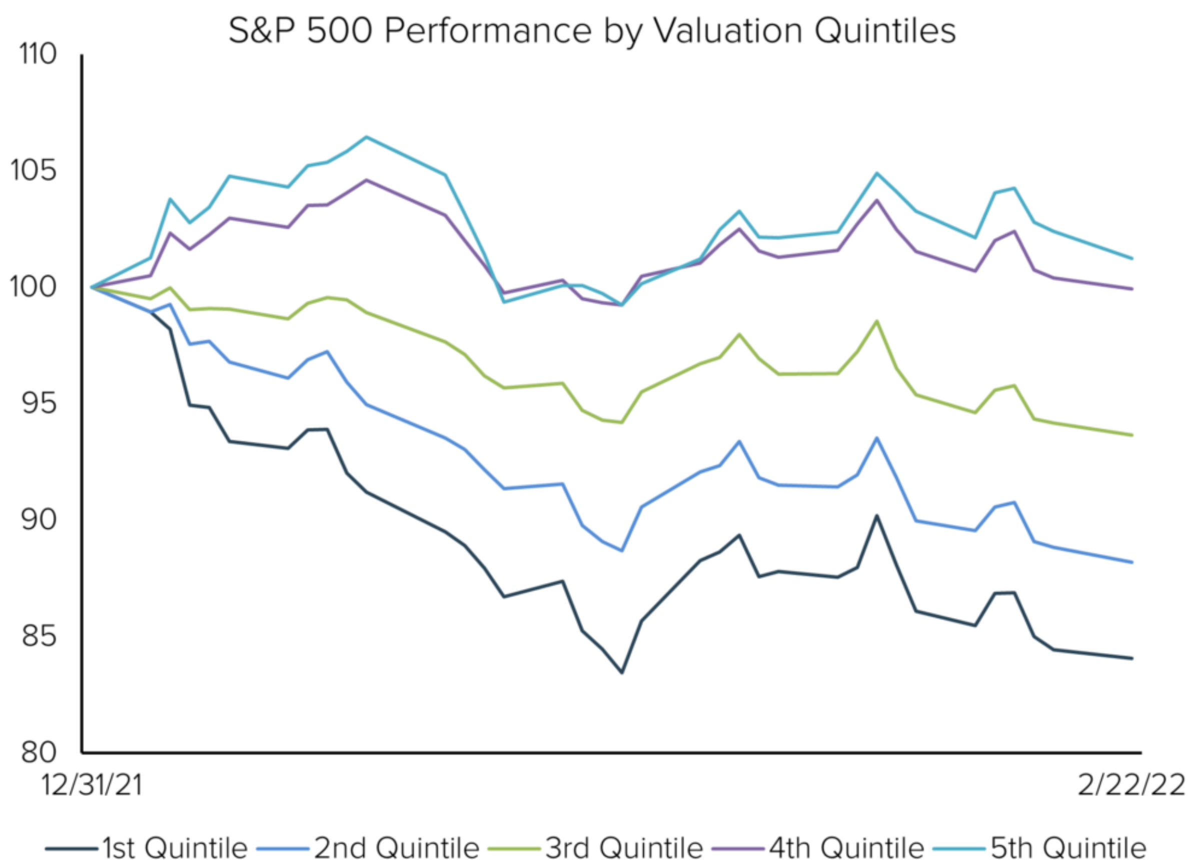
As seen in the chart below, volatility, when measured by the degree of intraday swings, has really been accelerating since early September. However, it wasn't until November that we started seeing consistent intraday moves that were greater than 1%. The intraday volatility from lows to highs has been surpassed only three times in the last five years: the Pandemic, the Q4 2018 drawdown, and the aptly named "Volmageddon" in February of 2018 that saw the implosion of a few volatility structured products. Those three time periods were met with drawdowns of 34%, 20%, and 10%, respectively. Volatility has not just been limited to stocks though – it's been apparent in bonds for some time now as well. In fact, the ICE BofAML MOVE index, which serves as a volatility gauge for the bond market, is also at post pandemic highs.



We touched on a lot of separate issues that are weighing on markets in the opening paragraph. Domestically, inflation remains the primary concern. The Federal Reserve is openly alarmed by the recent inflation data and has stated that accommodation will be removed more quickly should inflation persist. The market, at this time, has backed off the notion that a 50 bps hike in March is a sure thing. At one point, the market was placing a greater than 90% chance of 50 bps in March, but, according to FactSet, that has since retreated to a ~40% probability. Still, the market is pricing in steady rate hikes going forward with at least 6 hikes being shown as likely by the end of the year. However, it's a very tight rope that the Fed must walk. The term "transitory" has been bandied about again and again by the Federal Reserve over the past year and half, but it actually looks like the market is beginning to see the light at the end of the tunnel. Looking at the 5-year, 5-year forward inflation expectation rate and it has actually come down to less than 2%. In other words, five years down the road, market participants believe that future inflation will be below the Fed's 2% objective. According to the University of Michigan Consumer Survey, the consumer still expects large price increases over the next year – but very little change over the next five years relative to the historical 5-year expectation. The New York Federal Reserve's own Survey of Consumer Expectations tells a very similar story. The median one-year expected inflation rate and median three-year expected inflation rate have both peaked. The three-year number peaked in October and the one-year number peaked in November. However, despite the market seeing the light at the end of the inflationary tunnel, prices have clearly

weighed on the consumer. In fact, the aforementioned University of Michigan Consumer Survey shows that consumer sentiment is at a decade low. Sentiment has only been worse following the downgrade of the US Federal Government in 2011, the Financial Crisis in 2008, the Savings and Loans crisis of the late 80s and early 90s, and the inflationary environment of the early 80s. Only one of those time periods was not met with a recession. Hence, the Fed really is needing to walk a tight rope. They need to combat and control inflation, but in doing so, might further choke economic growth and further dampen already tepid sentiment.

So, what has all of this meant for markets? Well, the combination of rising interest rates and rising inflation has been a boon for cyclicals and commodities. The Russell 1000 Value Index has easily outpaced the Russell 1000 Growth Index since Thanksgiving – when both volatility and interest rates began accelerating in earnest. The 10-year U.S. Treasury yield bottomed at 1.34% on December 3rd. Since then, the 10-year has soared towards 2%, the Russell 1000 Value Index was up 0.5%, while the Russell 1000 Growth Index fell 10.7%. The outperformance of value relative to growth is very different than what the market has grown accustomed to over the past decade with the proliferation of the old FAANG complex. The large cap growth names that led the market higher in recent years have clearly fallen, at least temporarily, out of favor. Part of that is due to the rise in interest rates. We've touched on the correlation between rates and growth names many times in the past here at Tandem, but generally speaking growth names and interest rates share an inverse correlation. That is to say, when rates rise, it is usual to see growth underperform. As rates fall, growth typically has outperformed. Valuations and interest rates have also historically enjoyed an inverse relationship. As interest rates fall, valuations have typically expanded. As interest rates rise, one would expect valuations to contract. The historically low level of interest rates over the past few years led to valuations rarely seen outside of the Tech Bubble. As interest rates have risen recently, these high valuation names have been among the worst performing stocks, while the stocks with the lowest valuations have held up much better. In fact, the story year-to-date has almost entirely been one of valuation – the Fed, Putin, inflation, and everything else could have just been ignored. In the chart below, we broke the S&P 500 in five quintiles sorted by their P/E ratio on 12/31/2021. The most expensive names are in the 1st quintile with the cheapest names in the 5th quintile. In terms of performance this year, the quintiles are in perfect order. The 1st quintile, with the most expensive names, has been the worst performer, while the performance of the cheapest names (5th quintile) has been the best. This year, above all else, valuation has mattered. This is why the Russell 1000 Value Index (comprised of typically cheaper cyclical names like financials, energy, and materials) has outperformed, while the Russell 1000 Growth Index (comprised mostly of more expensive Tech names) has underperformed.



TRANSITION UPDATES & NEWS **

The recent pullback in the market has also coincided with more opportunities to add to names in unrestricted transition accounts. The implementation of Tandem's strategy typically takes 3-6 months. Recently, the increasing number of opportunities has allowed us to put money to work a bit more quickly. Accounts that have been with us for just a few weeks are already ~50% of the way through the implementation process while accounts that have been with us for a month or two are closer to 70-80% of the way through the implementation process. That does not mean that 50% of the cash (or 70-80% of the cash) has been spent, it just means that close to 50% (or 70-80%) of the strategy has been implemented. Just a quick reminder – a fully transitioned portfolio does not mean a fully invested portfolio! Tandem's cash levels have fluctuated over time, and none of the strategies are currently fully invested.

***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 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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