Notes from the Trading Desk

Ben Carew, CFA
Tandem Investment Advisors

March 23, 2020

Market Mover & Shakers

U.S. Equities were down sharply once more last week. The S&P 500 fell 14.98%, while the Dow dropped 17.30% and the Russell 2000 16.20%. The Nasdaq fared slightly better than its companions, as it only dropped 12.64%. It was the worst week for the S&P 500 since October 2008, and Monday's 11.98% drop was the third worst on record — only eclipsed by Black Monday of 1929 and 1987. Elsewhere, Treasuries remained exceptionally volatile. In terms of daily change, it was the most volatile week for the 10-year Treasury since October of 1987. The 10-year Treasury is back below 1% once more, after having briefly recovered that level during the middle of last week. Crude Oil traded down to $20 for the first time since 2002. Per FactSet, Crude fell 28.7% last week, despite a 27% gain on Thursday. All sectors were hit hard, though some were certainly hit harder than others. REITs led the way lower, down nearly 23%. They were followed closely by Energy, Industrials, Financials, and Utilities — all down between 17% and 20%. The selloff has also claimed its first major casualty as Ronin Capital — a clearing firm for the CME — failed following its inability to meet its capital requirements. The Federal Reserve remained extremely active. After cutting the Fed Funds rate effectively to 0%, they also announced $500 billion in Treasury purchases and $200 billion in mortgage-backed securities. The Fed also rolled out a plethora of programs not seen since the Financial Crisis. They are now supporting the commercial paper market, providing liquidity to dealers, and propping up money-market funds. Despite the sweeping action from the Fed, some are still calling for more action. The calls for support within the corporate bond market and the muni bond market have become increasingly louder — actions that have been undertaken elsewhere around the globe, but not in our own domestic markets. Finally, economists have become increasingly unsure of where Q2 GDP will land. Goldman Sachs forecasted a 24% drop in Q2 (the largest recorded drop in U.S. history was 10% in 1958 during a very quick recession). JPMorgan is currently forecasting a 14% drop in Q2, while Bank of America is forecasting a 12% drop. If any one of these numbers is correct, then we will be accelerating past the depths of the Financial Crisis, in which GDP dropped 8.4% in Q4 of 2008.

The market wrapped up its worst week in quite a while. In fact, the 14.98% loss on the S&P 500 was the fourth worst weekly drawdown since 1928. If the month ended today, it would be the fifth worst month on record, and only the seventh month in which the market dropped more than 20%. The destruction of capital has been rapid and rampant. Quality and Low Volatility are finally beginning to feel the wrath of the selloff as well. The S&P 500 Low Volatility Index's 18.06% weekly loss was its worst performance relative to the S&P 500 during a down week since 2001. In fact, it was only the third time in the last 30 years that Low Volatility trailed the S&P 500 to the downside by more than 3% — the other two incidences occurred during the Tech Bubble.

By and large historic safe havens have begun seeing massive outflows in an exodus to cash. Bank of America noted the largest outflows ever from credit, fixed income and money market funds over the course of the last three weeks in terms of percentage of AUM. Outflows for Investment Grade funds were 3.5% of AUM, 7.7% for high yield, 5.7% for Global Emerging Market Debt funds, and 4.1% for Money Market Funds. These enormous outflows have begun causing some noted disruptions in the bond market. The iShares Core U.S. Aggregate Bond ETF (ticker: AGG) is the largest of fixed income ETFs. Twice in the past two weeks the ETF closed at a 4.4% discount to its NAV. This has only occurred two other times — both in October of 2008. Meanwhile, the ICE BofA Global Corporate Bond Index has dropped 11.37% so far this month — more than double the decline in September 2008 following the collapse of Lehman. As a result of the quick and sharp moves, credit speads have widened to levels not seen since the depths of the Financial Crisis. Elsewhere in the bond market, *The Wall Street Journal* reported that some hedge funds have begun unwinding the "basis-trade". The basis trade looks to arbitrage the difference between Treasuries and Treasury futures. Per the article, some traders have attributed the unwinding of these trades to the large selloffs in off-the-run Treasuries.

In some ways, this selloff has more to do with market psychology and sentiment than any sort of fundamentals — though we would be remiss to not remember that markets were in fact overvalued and already slowing down prior to the selloff. However, to say that the virus has accelerated and exacerbated the previous slowdown would be a marked understatement. We are witnessing a true Black Swan event. It is as if a Category 5 hurricane is simultaneously hitting every single town, city, state, and country around the world — and it has certainly taken its toll on investors. Bank of America's Fund Manager Survey showed the steepest drop in global growth expectations on record. Furthermore, the survey showed that equity allocations recorded their largest drop on record as well. The widespread fear is also reflected in the VIX — often referred to as the market's fear gauge. The VIX closed at its highest levels ever last week, surpassing even its 2008 highs. However, there is actually a bright side to the market's current sentiment. New lows on the New York Stock Exchange have been steadily decelerating since the 12th. Similarly, new lows peaked prior to the Christmas Eve bottom in 2018, the February 11th low in 2016, the October 3rd low in 2011, the July low in 2010, the March low in 2009, the 2002 bottom, prior to the double bottom in 1998, and even the low during the recession in 1990. In other words, every major bottom in the last 30 years has coincided with a prior peak in new lows on the New York Stock Exchange. This is good news for investors so long as we do not exceed the new lows set on the 12th.

This week will mark the 20th Anniversary of the bursting of the Tech Bubble. Since that time, the S&P 500 has grown at a putrid annualized rate of 2.1%. For the sake of comparison, this 20-year return is well below the average annualized rate of 6.8% that spans the past 70 years. So, what does this mean moving forward? It seems likely that the future will be much brighter than the past twenty years. When analyzing 20-year returns over the better part of the past 70 years, it is apparent that the data has a tendency to not only revert back to its mean of 6.8%, but it actually has the propensity to overshoot its mean as well. The last time a 20-year period ended with a 2% annualized rate of return was in the early 1980s — which coincided with one of the greatest possible periods to invest in over the past century. A similar opportunity was found in the early 1960s and the late 1940s. In fact, the average annualized return for the 20-years following a 20-year period with an annualized rate of return less than 2.5% has been roughly 9%. In other words, if this data is in fact mean reverting, then above-average returns are in front of us. As we previously stated, if this month ended today, it would only be the 7th time that a month has closed down 20% for the S&P 500 and just the 11th time that a month has closed down 15%. The other ten instances have an average one-year return of more than 20%. Now, this is not to say that volatility and further downside will not persist in the short-term. However, one thing we are tasked with is being cautious when others are greedy — hence the rise in cash levels in the months leading up to this crash — and being acquisitive when others are panicked — hence the buying more recently. This virus has taken its toll on people, the economy, and global markets — but, this too shall pass.

*Transition Update***

The 2008 bear market happened more quickly than the 2000-2002 bear market. The Financial Crisis also regained its highs more quickly. Similarly, this bear market occurred much more quickly than either of the previous two. It would not be surprising to see this market bounce back quickly once new cases begin to slow. Similar to the past few weeks, we have continued to be quick to put new money to work. As a result, we once again purchased the majority of our names on the transition level last week.

***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.*

Upgrades/Downgrades & Dividends

CHKP — Upgraded to buy from hold at SunTrust Robinson Humphrey, target remains $115 (3/17).

CMCSA — Downgraded to market perform from outperform at Raymond James (3/16).

COST — Upgraded to overweight from equal-weigh at Morgan Stanley, price target increased to $330 from $315 (3/16).

COST — Upgraded to buy from accumulate at Gordon Haskett (3/17).

DLTR — Upgraded to hold from sell at Loop Capital Markets, target remains $74 (3/16).

DLTR — Initiated Catalyst Call Buy at Deutsche Bank (3/19).

DLTR — Upgraded to overweight from sector weight at KeyBanc, price target is $90 (3/20).

EBAY — Upgraded to outperform from neutral at Wedbush Securities, target increased to $38 from $34 (3/16).

ECL — Downgraded to underweight from neutral, price target cut to $152 from $200 (3/17).

FISV — Upgraded to outperform from market perform at Keefe, Bruyette & Woods, though the price target was decreased to $116 from $134 (3/19).

ORLY — Upgraded to buy from neutral at Goldman Sachs, though the price target was decreased to $357 from $430 (3/18).

ROST — Upgraded to buy from neutral at Citi, though the price target was cut to $90 from $120 (3/20).

SJM — Upgraded to market perform from underperform at Bernstein (3/18).

Earnings Calendar

Date	Time	Ticker
3/26	Pre-Market	FDS

Portfolio News & Notes

Over the past week we saw a few different strategy level actions occur. We added to CBOE, National Retail Properties, and Stryker in both Large Cap and Mid Cap. We also added to our position in Lab Corp in Mid Cap. We initiated a new position in ADP in LCC. We also added Ross Stores — a long time Mid Cap holding — to Large Cap, and added to our position in United Technologies in Large Cap as well. However, we also took advantage of a momentary pop in ResMed to trim the position across all strategies. Similarly, we sold a little bit of our position in Hormel Foods after it hit 52-week high.

Our cash level in Large Cap Core is currently around 15%. This is not too far off from where it was last summer as cash dwindled down into the high-teens at that time. Throughout the second half of 2019, as our model began signaling many more stocks to sell than to buy, we began raising cash in earnest and even liquidated a few names as cash rose to the high 20s. In essence, our more recent quantitative buy signals in certain names have returned cash levels to where they were just 9 months ago — which is right around our average cash levels for the past twenty years. A near 30% percent drop in the S&P 500 has brought Large Cap Core back to a, more or less, neutral position relative to where it has been for the past twenty years. Of course, our process is entirely independent of the broader market, as our investment process is done on a stock-by-stock basis.

	WTD	MTD	QTD	YTD
Dow Jones	-17.30%	-24.54%	-32.81%	-32.81%
S&P 500	-14.98%	-21.98%	-28.66%	-28.66%
Nasdaq	-12.64%	-19.70%	-23.33%	-23.33%
Russell Mid Cap	-18.16%	-29.43%	-36.20%	-36.20%
Russell 2000	-16.22%	-31.33%	-39.23%	-39.23%
Comm. Svcs	-12.25%	-19.24%	-23.86%	-23.86%
Con Disc	-12.53%	-22.32%	-27.88%	-27.88%
Con Staples	-11.32%	-13.26%	-20.20%	-20.20%
Energy	-19.63%	-43.55%	-57.51%	-57.51%
Financials	-17.98%	-29.06%	-38.86%	-38.86%
Health Care	-13.03%	-14.79%	-22.86%	-22.86%
Industrials	-18.38%	-30.23%	-37.25%	-37.25%
Info Tech	-15.25%	-19.21%	-22.31%	-22.31%
Materials	-12.60%	-23.14%	-34.13%	-34.13%
Utilities	-17.18%	-23.35%	-26.74%	-26.74%
REITs	-22.92%	-25.91%	-29.74%	-29.74%