March 28, 2022 - Tandem Investment Advisors, Inc.

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March 29, 2022

MARKET MOVERS & SHAKERS

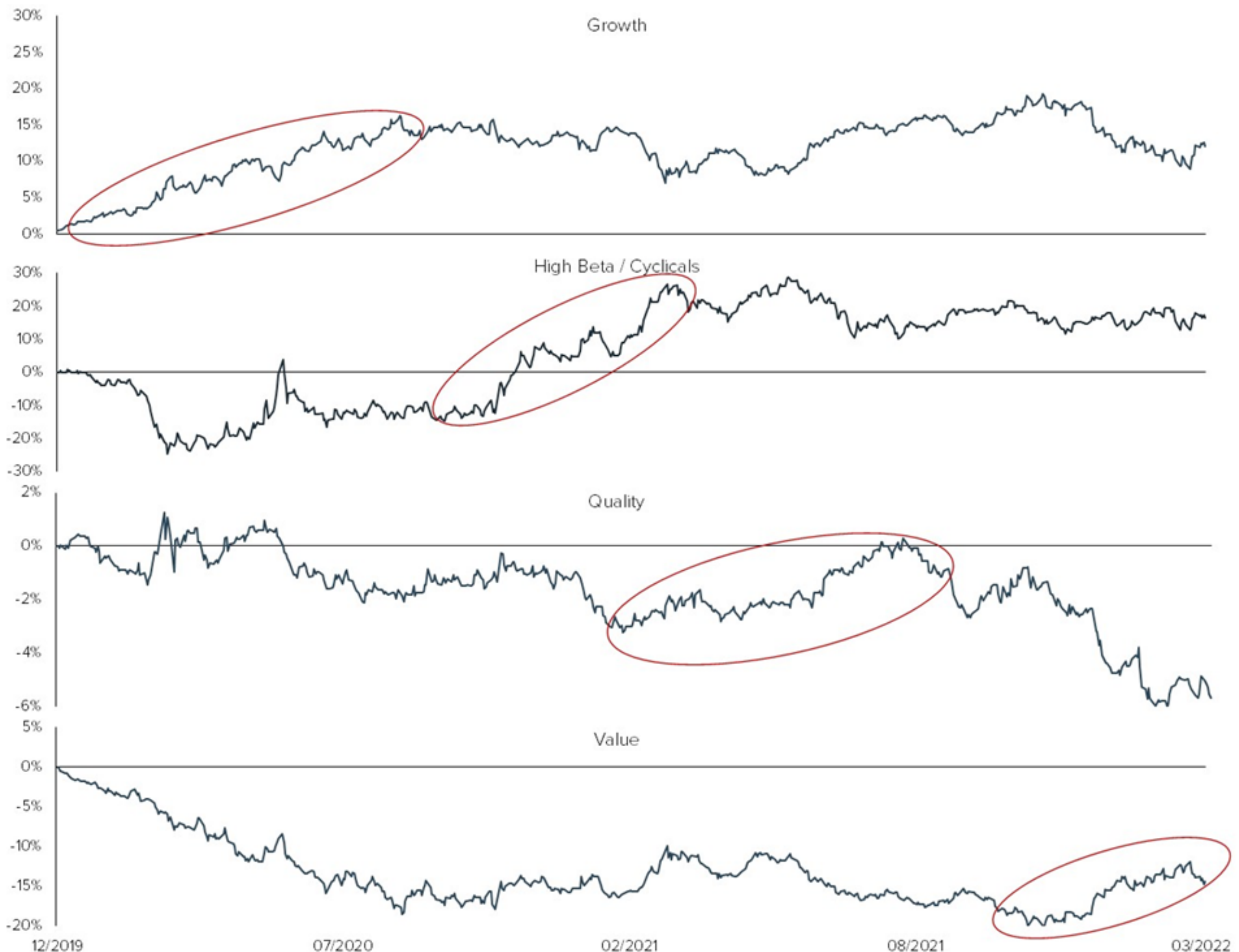
U.S. equities remained resilient last week in the face of rising yields, surging oil, and hawkish rhetoric coming out of the Federal Reserve. The Nasdaq Composite Index surged nearly 2% for the week – gaining 13% in total from its Mach 14th low. Small cap stocks were clearly out of favor as the Russell 2000 was down 39 basis points. The Dow gained just 31 basis points, while the S&P 500 was up 1.79%. Cyclicals remained in favor as the Energy sector soared more than 7.4% alongside the spike in oil. More defensive sectors like healthcare and staples were among those that underperformed. Perhaps the most attention grabbing move last week though was the continued sell off in treasuries. The 10-year tested 2.5% for the first time since April of 2019 as yields surged higher. The 2-year is also at its highest levels in nearly three years. Meanwhile, Crude oil continues to trade at its highest level in the past decade.

The flattening yield curve, and its potential inversion, is beginning to pick up a lot of traction in the media. At the time of writing, the spread between the 2-year U.S. Treasury and the 10-year U.S. Treasury was just 14 basis points – its narrowest since 2019 and early 2020. The uptick in media coverage might leave some asking, why does this matter to equity investors? Well, an inverted yield curve is often seen as an indication of an impending recession. In fact, according to Bank of America Securities, the inversion of the 2-year yield and the 10-year yield (meaning the 2-year yields more than the 10-year) has preceded the previous eight recessions and 10 of the last 13. Part of the recent surge in yields can be attributed to a combination of rising inflation expectations and the Federal Reserve's reaction to said inflation. The market has begun pricing in more aggressive action out of the Federal Reserve following Chairman Powell's statement last week that the Fed needs to move "expeditiously". Not only is a 50 basis point hike very much on the table for the Fed's next meeting, but the market is now placing a 75% chance of a Fed Funds rate between 2.25% and 2.50% by year-end. In other words, the market thinks it's very likely that the Fed will hike 9 times (counting each 25 basis points as one hike) before the end of the year. The need for more aggressive action out of the Federal Reserve makes sense. According to Bloomberg's John Authers, the bond market is beginning to signal that long-term inflation expectations are becoming unanchored and are on the rise. Up to this point, inflationary pressures had been expected to be largely contained to the next year, perhaps two years tops. Inflation is now

beginning to seep into the market's longer-term expectations. Were this to become reality, it would be terrible. As a result, it appears that the Fed is even willing to go past neutral and become restrictive to prevent the unanchoring of long-term inflation expectations.

The effect of the Federal Reserve's actions, and/or expected actions, are already beginning to make their way through the market. Financial conditions have been steadily tightening for months now. One of the most easily viewed effects, interest rates, have been rising steadily for a while. This is increasing the cost of borrowing for individuals and corporations alike. The 30-year mortgage rate is at its highest level in more than three years. For corporations, spreads for corporate borrowing have been widening throughout the year as well. In short, this means that the cost of borrowing for a corporation is going up in two ways. First, as yields rise, the absolute rate at which a company can borrow will rise as well. Second, as spreads widen, investors are now beginning to require an additional premium (or additional compensation) to hold corporate bonds. This also serves to increase the borrowing cost. The continuation of this trend could be bad news for corporate profits among debt laden companies, specifically those with floating-rate debt and those that need to issue more debt, or rollover their existing debt.

Enough with the fixed income and interest rate talk though. Now back to our regularly scheduled programming discussing equities. Since COVID, the market has been very rotational. In the depths of COVID and coming out of COVID, growth stocks were very clearly in favor. Towards the end of 2020 and throughout the first six months of 2021, the market clearly preferred high beta stocks, which tend to be more cyclical. Throughout last summer, Quality stocks were in vogue, before ceding that leadership spot to value stocks. In hindsight, and as



seen in the accompanying chart, the rotations were clear as day. The chart shows the relative performance of a few different ETFs against the SPY (IVW was used for growth, SPHB for high beta, QUAL for quality, and IVE for value). Growth, which outperformed for so long, has begun underperforming (as has quality) as interest rates have risen. If recessionary fears continue to rise, rotation back into these names and out of value or high beta would be unsurprising. If huge economic growth continues and the Fed engineers a soft landing for the economy throughout their hiking cycle, then the continued outperformance of the more cyclical names should be expected.

As an aside, it's worth mentioning that Tandem does not fit in any of those above categories or boxes. We think of all of our companies as being high quality, though there is very little overlap with the QUAL ETF used in the analysis above. QUAL is comprised of stocks like Apple, Nike, Meta, Nvidia, and Eli Lilly – stocks we do not own. Sure, it does have exposure to familiar names among its top holdings that we like such as JNJ, Costco, and Microsoft. However, we cannot be boxed into a factor like that so easily. One of the core tenets of a Tandem investment is the ability to grow through any sort of economic environment. That sounds a lot like something a growth company would do. However, we do not own any Apple, Amazon, Tesla or Alphabet in our strategies. We certainly aren't value with IVE's allocation towards JPMorgan, Exxon, Chevron and Coca Cola. Each of those companies fail

to meet our criteria. The same is true of the High Beta ETF used, SPHB. Instead, it's worth reiterating. A core tenet of a Tandem investment is a company's ability to grow its revenue, earnings and cash flow through any sort of economic environment. If a company can do that, and it chooses to pay a dividend, then it should naturally be able to grow that dividend in a consistent and sustainable manner. Companies that can do those things are hopefully better able to withstand the market's rotation. It doesn't mean that those companies will outperform the market, or that they will even go up! Instead, we hope that it means those companies can provide a consistent, repeatable, and less volatile investment experience.

TRANSITION UPDATES & NEWS **

As the quarter comes to an end, it seems like all news has dried up – and volatility with it. We did have one company, FactSet, report earnings last week. FactSet's reported revenue beat even the most optimistic analyst's estimate. Not only did they report a stellar quarter, but they raised their guidance as well for 2022. They previously guided their earnings for the fiscal year to be between $12-12.30. On Thursday, they guided that number to be between $12.75-13.15. Outside of FactSet, there was not much to report on the news front.

***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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