Tandem Investment Advisors

October 25, 2021 - Tandem Investment Advisors, Inc.

tandemadvisors.com/notes-from-the-trading-desk/october-25-2021

October 26, 2021

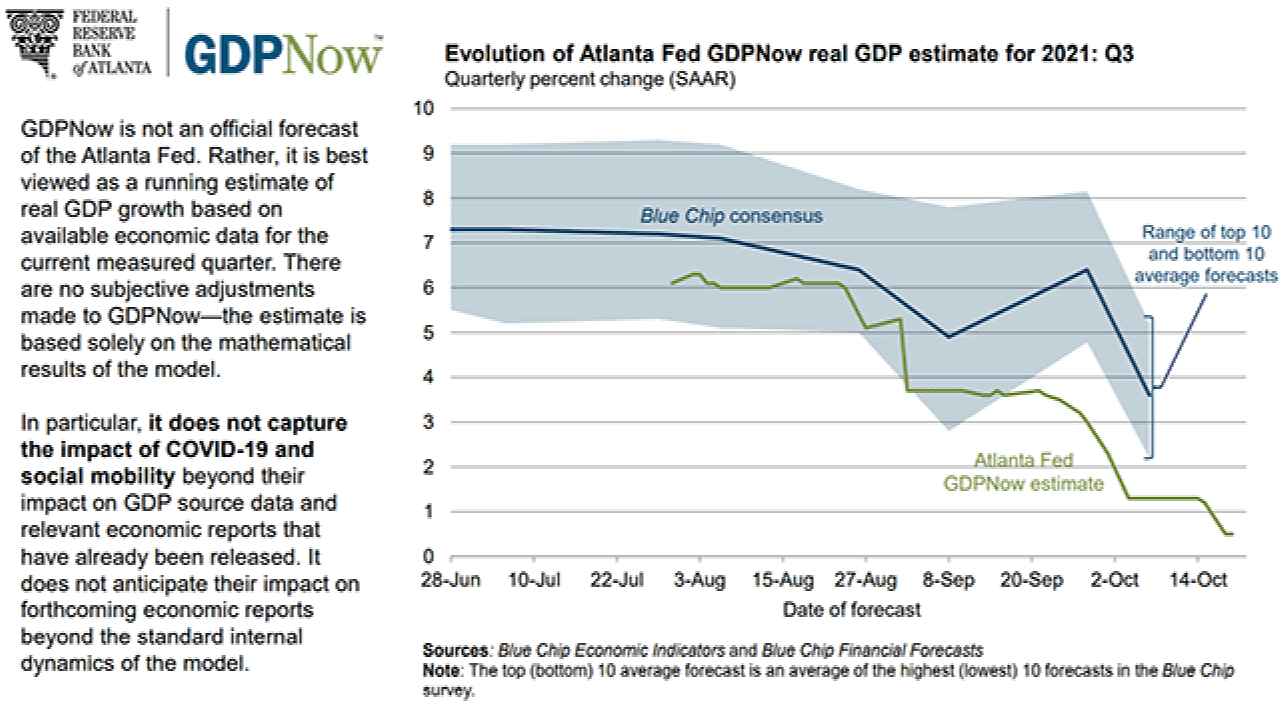
Notes from the Trading Desk
- October 25, 2021
by Benjamin “Ben” G. Carew, CFA

MARKET MOVERS & SHAKERS

U.S. stocks were up once more last week. It marked the third straight week of positive finishes for the S&P 500, the Nasdaq, and the Dow Jones. Perhaps more importantly, the S&P 500 closed at a new all-time high on Thursday – its first record close in seven weeks. Similarly, the Dow eclipsed its previous record close from mid-August. The Nasdaq has not yet regained its September 7th closing high and the Russell 2000 remains a bit further away, still, from its March 15th high. In terms of weekly drivers, regional banks seemed to lead the way higher. This came despite the flattening of the yield curve which typically spells trouble for banks. All in all, last week’s leaders had a defensive and interest-rate sensitive tilt. REITs, Utilities and Financials all outperformed the broader S&P 500, as did Healthcare and Industrial stocks. Elsewhere, the short end of the yield curve continued its steady march higher. The 2-year U.S. Treasury yield, which was just 0.22% a month ago, closed the week yielding 0.45%. The spread between 2s and 10s has tightened up these past few weeks, though it had previously steepened considerably throughout the summer.

Speaking of fixed income, according to Bank of America’s fund manager survey, allocation towards bonds has fallen to its lowest level in at least two decades. Over the past 20 years, bond exposure has neared these under-allocated levels just four times. Three of those times were met with a considerable drop in yield. The contrarian investor would expect the pain trade to manifest itself through a decline in yields. In the same vein, according to Goldman Sachs Global Investment Research, equity exposure amongst investors is at its highest level ever – surpassing both the Tech Bubble and the precursor to the Financial Crisis. From a sentiment standpoint, it seems investors are all on the same page – they can't get enough stocks!

One thing that could certainly spoil today's environment is the stall of our economic recovery. As seen below in the Federal Reserve Bank of Atlanta's GDPNow tracker, expectations for Q3 real GDP growth have dropped considerably thanks to weaker than expected economic data and rising inflation.



Not even three months ago, the regional Federal Reserve bank was estimating real third quarter GDP growth to be north of 6%. The current estimate, as of October 19th, is 0.5%. *The Wall Street Journal's* Economic Forecasting Survey tells a similar tale, reporting that expected Q3 GDP growth has been cut in half. Some of this drop may be attributed to supply chain disruptions as net exports have dropped considerably. Looking at the economic data though, it seems clear that the drop in expectations is more widespread than just exports. Sentiment has become increasingly light. New orders for goods, financials, tech, and communication services all peaked in Q2, and the Non-Manufacturing Index peaked in March. Despite the decreasing unemployment rate, the labor market remains tepid as industries nationwide are being hit with labor shortages. It was recently reported that a record number of Americans, 4.3 million, quit their jobs in August. A bit of this turnover can be attributed to people changing their jobs, while others are exiting the workforce all together. Some are blaming the need for businesses to be paying higher wages to entice people back into the workforce. However, wages are growing at one of the fastest clips in nearly two decades. Since the beginning of the pandemic, wages have risen more than 8% and they are up 4.6% year over year through the end of September. What seems like a healthy rise in wages for the working person actually amounts to a pay cut when adjusted for inflation as CPI was above 5% on a year over year basis in September. With an effective pay cut for the average U.S. worker, thanks to inflation, it is not hard to envision a scenario in which people have less money to spend on goods and services – which could contribute to lower growth.

Economic expectations are clearly less rosy today than they were even a month ago. Despite that, stocks have trudged higher. One explanation for this is the old TINA adage – There Is No Alternative. In other words, with yields so low and so much money in the system, one must be invested in stocks – there is nowhere else to invest. This line of thinking is also aligned with the "Don't fight the Fed" mentality. Since March of 2020, the Fed has been very accommodating through their insistence on lower rates for longer and continued asset purchases. However, taper talks, which began in earnest over the summer, are beginning to be bypassed by discussions of rate hikes to fend off inflation. On Friday, Fed Chair Jerome Powell commented that inflation will likely last well into 2022. It seems that the definition of transitory is changing once more and becoming a bit more synonymous with persistent. In response to these continuing inflationary concerns, Powell said "we need to make sure that our policy is positioned to adjust to a range of possible outcomes." Reading between the lines, it's evident that rate hikes could be necessary to stave off the damaging effects of continued inflation. Whether it was a misstep by the Federal Reserve Chairman, something he was prone to early on in his tenure, or a change in policy intention, only time will tell. However, the market picked up on his words quickly. The bond market is now pricing in a 56% chance that the Fed will have raised rates at least once by the June 2022 meeting. Just a week ago, this probability was closer to 39%. One month ago, it was hardly even given consideration with a less than 12% chance. The tides are changing. The short end of the curve is rising alongside the probabilities of a Federal Reserve rate hike. Meanwhile, the long end remains well below its late March peak in response to economic pressures stemming from inflation, supply chain disruptions, and decreasing economic growth expectations.

TRANSITION UPDATES & NEWS **

Earnings season is officially underway. Johnson & Johnson kicked the week off for us with a beat and raise. The shares of JNJ then responded favorably throughout the day. Not to be outdone, Abbott Labs also beat estimates and raised guidance. Abbott's positive results were largely driven by increases in COVID testing, specifically the success of their OTC COVID tests. Euronet also beat, and even raised the short-term guidance. However, the stock traded poorly after their results and analysts lowered the longer-term forecasts for the company.

Outside of earnings, Brown & Brown also announced that they will be increasing their quarterly dividend by 10.8% and J.M. Smucker announced a 5m share increase in their repurchase authorization. M&A activity also picked up as CBOE also announced the acquisition of ErisX, an operator of a digital asset spot market, and PayPal was reportedly contemplating an offer to acquire Pinterest for $70 per share, though they ruled this out early Monday morning.

***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.*

Share via:

- Share on LinkedIn
- Email this
- Print / PDF

Written By: Benjamin “Ben” G. Carew, CFA

Ben Carew is a shareholder and Portfolio Manager for Tandem Investment Advisors, Inc. Mr. Carew joined Tandem in 2013. His duties include quantitative and fundamental research and portfolio management. Mr. Carew also oversees Tandem’s internship program. 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.
Disclaimer: This writing is for informational purposes only and shall not constitute or be considered investment advice, or an offer to sell, or a solicitation of an offer to buy any product, service, or security. Please consult your financial advisor before making any investment decisions.

Past performance is no guarantee of future results. All past portfolio purchases and sales are available upon request.