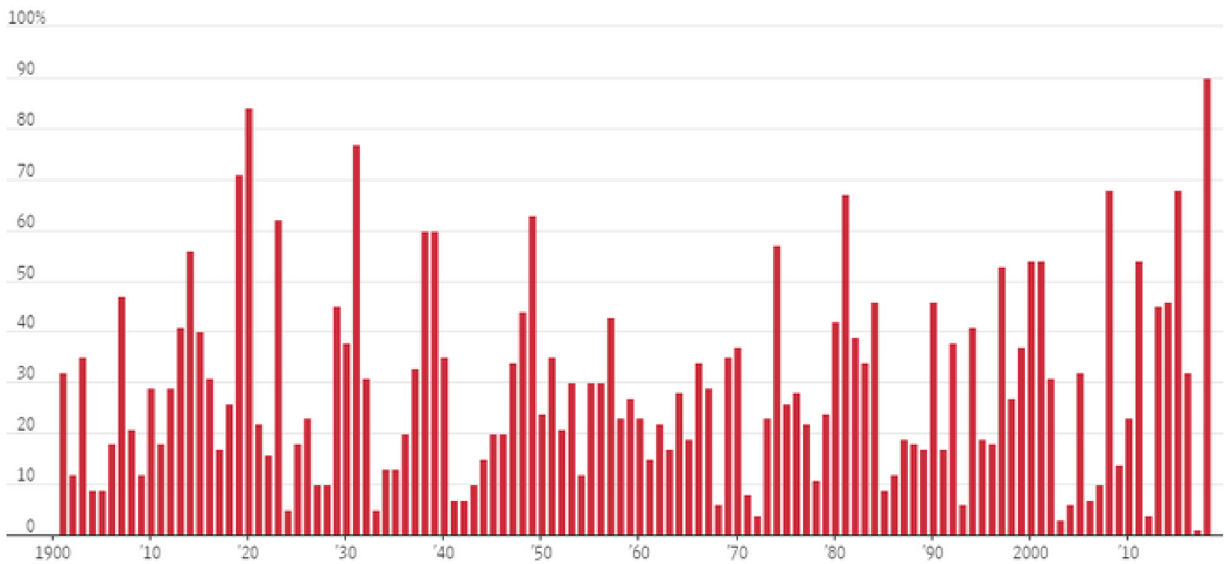
Financial Markets Review

2018 started and ended the same way – volatile. After the first 18 trading days of 2018, the S&P 500 had climbed 7.45%. In the last 18 trading days of the year, the S&P 500 fell 7.16%, and that was pretty much the end of the similarities between the two time periods. We entered 2018 full of hope on the back of global synchronized growth. And twelve months later, we find ourselves stumbling into 2019 fearing a global recession.

Nearly every major asset class around the world ended up posting a negative return in 2018. There was almost nowhere to hide. According to Deutsche Bank, through mid-November, 90+% of the 70 asset classes they track were down on the year.

Under Pressure

A record share of asset classes have posted negative total returns this year, according to Deutsche Bank data going back to 1901.



Note: Returns are in U.S. dollars. Data for 2018 are as of mid-November.
Sources: Deutsche Bank; Bloomberg Finance LP; GFD

It didn't get any better in December with nearly all asset classes continuing to decline, except for U.S. Treasuries and cash. In fact, when the bell rung on December 31st to close the year, cash ended up being the last asset class standing.

Asset Class Returns

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
REIT 31.6%	EM 34.5%	REIT 35.1%	EM 39.8%	HG Bnd 5.2%	EM 79.0%	REIT 28.0%	REIT 8.3%	REIT 19.7%	Sm Cap 38.8%	REIT 28.0%	REIT 2.8%	Sm Cap 21.3%	EM 37.8%	Cash 2.0%
EM 26.0%	Int'l Stk 14.0%	EM 32.6%	Int'l Stk 11.6%	Cash 1.4%	HY Bnd 57.5%	Sm Cap 26.9%	HG Bnd 7.8%	EM 18.6%	Lg Cap 32.4%	Lg Cap 13.7%	Lg Cap 1.4%	HY Bnd 17.5%	Int'l 25.6%	HG Bnd 0.0%
Int'l Stk 20.7%	REIT 12.2%	Int'l Stk 26.9%	AA 7.6%	AA -22.4%	Int'l Stk 32.5%	EM 19.2%	HY Bnd 4.4%	Int'l Stk 17.9%	Int'l Stk 23.3%	AA 6.9%	HG Bnd 0.6%	Lg Cap 12.0%	Lg Cap 21.8%	HY Bnd -2.3%
Sm Cap 18.3%	AA 8.9%	Sm Cap 18.4%	HG Bnd 7.0%	HY Bnd -26.4%	REIT 28.0%	HY Bnd 15.2%	Lg Cap 2.1%	Sm Cap 16.4%	AA 11.5%	HG Bnd 6.0%	Cash 0.1%	EM 11.6%	Sm Cap 14.7%	REIT -4.0%
AA 14.1%	Lg Cap 4.9%	AA 16.7%	Lg Cap 5.5%	Sm Cap -33.8%	Sm Cap 27.2%	Lg Cap 15.1%	AA 0.3%	Lg Cap 16.0%	HY Bnd 7.4%	Sm Cap 4.9%	Int'l Stk -0.4%	REIT 8.6%	AA 14.6%	Lg Cap -4.4%
Lg Cap 10.9%	Sm Cap 4.6%	Lg Cap 15.8%	Cash 4.4%	Lg Cap -37.0%	Lg Cap 26.5%	AA 13.5%	Cash 0.1%	HY Bnd 15.6%	REIT 2.9%	HY Bnd 2.5%	AA -1.3%	AA 7.2%	REIT 8.7%	AA -5.6%
HY Bnd 10.9%	Cash 3.2%	HY Bnd 11.8%	HY Bnd 2.2%	REIT -37.7%	AA 24.6%	Int'l Stk 8.2%	Sm Cap -4.2%	AA 12.2%	Cash 0.1%	Cash 0.0%	Sm Cap -4.4%	HG Bnd 2.7%	HY Bnd 7.5%	Sm Cap -11.0%
HG Bnd 4.3%	HY Bnd 2.7%	Cash 4.7%	Sm Cap -1.6%	Int'l Stk -43.1%	HG Bnd 5.9%	HG Bnd 6.5%	Int'l Stk -11.7%	HG Bnd 4.2%	HG Bnd -2.0%	EM -1.8%	HY Bnd -4.6%	Int'l Stk 1.5%	HG Bnd 3.5%	Int'l Stk -13.4%
Cash 1.4%	HG Bnd 2.4%	HG Bnd 4.3%	REIT -15.7%	EM -53.2%	Cash 0.2%	Cash 0.2%	EM -18.2%	Cash 0.1%	EM -2.3%	Int'l Stk -4.5%	EM -14.6%	Cash 0.3%	Cash 1.0%	EM -14.3%

Source: https://novelinvestor.com/download-returns-tables/

Earnings Update

For several months now, we've written extensively on the deceleration in earnings growth for 2019. After the explosion in 2018 earnings growth on the back of corporate tax reform, there was little possibility of an encore performance. According to Factset, 2019 S&P 500 earnings are expected to grow 7.29% with sales growth of 6.10%. Over the past three months, 2019 expectations for earnings growth has come down 2.5%, whereas sales expectations have increased by 1.24%. These numbers would imply further margin expansion, which I find highly unlikely based on what companies have been saying. Countless companies reported margin contraction in the last quarter and they don't see it improving going forward. Therefore, it is very likely we see 2019 earnings expectations continue to get revised down over the coming months.

In the more near-term, I think Q1 2019 estimates are what the market is trying to figure out. We know companies should report decent Q4 growth over the next few weeks, but Q1 is where it might get a little dicey. Currently, Q1 2019 earnings expectations are for 2.99% growth, which has come down 3.5% over the past few months. And, sales growth is expected to come in at 7.31%. If the U.S. Dollar Index in Q1 2019 stays in the range it has for the past six months, the U.S. Dollar Index will have appreciated roughly 8% year-over-year. The rate of appreciation will be even greater against most emerging market currencies. Couple the U.S. dollar appreciation with slowing worldwide demand and it's a recipe for significantly lower sales growth than what is currently expected. If Q1 2019 sales estimates come down there is a serious risk to the Q1 2019 earnings estimate actually declining (not just decelerating) year-over-year, which is not consensus thinking right now. Go no further than Apple's most recent pre-announcement of an upcoming revenue miss. I can promise you they will not be the only one to miss estimates or pre-announce a miss to sales and earnings.

Although sales and earnings estimates for the S&P 500 are likely to come down in the future, it doesn't mean there is nothing worth buying. In many individual cases, prices have come down so far that company valuations are already pricing in a slowdown to earnings that analysts have yet to factor into estimates. In these cases, there is a margin of safety that makes it worthwhile to begin accumulating shares. It pays to be very diligent and selective in an environment of decelerating or possibly declining growth.

Tandem Strategy Update

In January, Ray Dalio, who is head of the world's largest hedge fund, had this to say during a CNBC interview:

"If you're holding cash, you're going to feel pretty stupid." – Ray Dalio, Bridgewater Associates

This comment was spot on for about three days, while equities continued to climb higher and short-term interest rates remained relatively subdued. Eleven months after the comment was made, the S&P 500 fell nearly 20% and the return on cash rose by 100 basis points. To be honest, having cash on hand didn't feel all that stupid. As we've written many times before, cash is a byproduct of our investment process. We don't huddle around a table and opine on where we think markets might go and set a cash allocation accordingly. Based on our quantitative model, if more stocks are ranked to sell than to buy, cash will increase, which is what we saw for much of the past couple of years. However, just recently we've seen this script flip and now buy rankings are starting to outnumber sell rankings, which has led us to be opportunistic with our clients' cash.

Over the past month, we've had the opportunity to establish a new position in Comcast (CMCSA) and add to many of our core holdings, some of which ended up being new positions to a specific strategy. These incremental purchases were done in the following stocks:

- Signature Bank (SBNY) – new position in our Large Cap Core strategy
- Euronet Worldwide (EEFT) – new position in our Equity strategy
- Cognizant Technology Solutions (CTSH)
- Dollar General (DG)
- T. Rowe Price (TROW)
- TJX Companies (TJX)
- United Technologies (UTX)
- JM Smucker (SJM)
- Tyler Technologies (TYL)
- ExlService Holdings (EXLS)

On several occasions throughout 2017 and 2018, I used a quote from Seth Klarman who is the founder and CEO of Baupost Group. In those cases, it was used to iterate how the pervasive bull market and lack of volatility presented great risk to investors. Today, we are in a very different environment. Our process and quantitative model have identified that now is the time to selectively start deploying some of our clients' cash as the long-term risk/return profile is much more favorable today than in the past.

"When share prices are low, as they were in the fall of 2008 into early 2009, actual risk is usually quite muted while perception of risk is very high. By contrast, when securities prices are high, as they are today, the perception of risk is

muted, but the risks to investors are quite elevated." – Seth Klarman, Founder, CEO, and Portfolio Manager of Baupost Group

Going Forward

There are all kinds of theories and reasons as to why U.S. equity markets fell so sharply in the 4th quarter. Some of these reasons include the following:

- Uncertainty surrounding global trade and the Chinese tariffs
- "Algos" and high-frequency trading
- Credit tightening – not a single high-yield issuance in December
- Federal Reserve – continued balance sheet run-off and a signaling of future rate hikes
- Global economies slowing – effect on future earnings
- European worries – Brexit and Eurozone banks

I'm sure I could list several more reasons, but at the end of the day most of these are just noise. The day-to-day bemoaning of the Federal Reserve and the direction of their next move is noise. Blaming the decline in equities due to "algos" is noise. And just for the record, "algos" may exacerbate daily moves and increase day-to-day volatility, but they are not the reason for the decline in stocks. The tightening of credit in a world of record corporate leverage is meaningful. Listening to what corporate executives have to say (i.e. Apple's most recent guidance) is meaningful.

None of the reasons listed above are going away any time soon, so there is likely to be increasing volatility going forward. But it is important to sift out what is merely noise and what is truly meaningful to companies and the economy. It is very easy to get caught up in the daily gyrations of the stock market, but this is a time when cooler heads need to prevail. It's times like these where a proven investment process and discipline can guide you through the noise and allow you to take advantage of it rather than permitting it to dictate your portfolio decision making. At the end of the day, you ultimately want your portfolio to be shaped by what is meaningful and have those decisions be implemented during times of noise.

-Billy Little, CFA

"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it." ~ Ralph Waldo Emerson

From time to time Tandem may discuss select purchases and/or sales within this report. All past portfolio purchases and sales are available upon request. Any portfolio transaction discussed here does not constitute advice or a recommendation. Please consult your financial advisor before making any investment decisions. For information regarding past purchases and sales, please contact John Carew at jcarew@tandemadvisors.com