OBSERVATIONS 10.3.2018

TANDEM Investment Advisors

Financial Markets Review

Last month, we highlighted the noticeable divergence across global financial markets. Essentially the only asset class to make it back to its January high, and go on to set all-time highs, has been U.S. equities. Everything else – well, they haven't come even close. International developed markets (EFA) and emerging markets (EEM) are still down 10% and 17% from their January peaks, respectively. This is in stark contrast to U.S. equity markets, where everything from the Dow Jones Industrial Average to the Russell 2000 has set record highs over the past month. At the index level, it all looks great! But pop open the hood for a second and you'll see the divergences spreading through our own domestic markets.

In August, the S&P 500 pierced through its climactic January 26th record high. Then on September 21st, the S&P 500 made an intraday high of 2,940.91, which represented a 2% increase above the January highwater mark and a 9% gain for the year. That's not too shabby, especially when the rest of the world's equity indices are struggling so badly! However, the internals of the S&P 500 have been telling a much different story. When the S&P 500 hit its record high on January 26th, 8 out of the 11 sectors also set all-time highs with 83.33% of all S&P 500 constituents trading above their 200-day moving average. During this most recent run to all-time highs, only 3 out of the 11 sectors have gone on to exceed their January peak with 69.31% of all S&P 500 stocks trading north of their 200-day moving average. Lastly, the table below highlights the number of stocks on the NYSE making 52-week highs and lows on January 26th and September 21st.

	52-Week High	52-Week Low
January 26th, 2018	292	82
September 21st, 2018	103	87

It has become increasingly evident that the record setting rally in U.S. equity markets has come on the back of fewer and fewer stocks. In fact, there have been several days leading up to and right after, the S&P 500's most recent all-time high where 52-week lows outpaced 52-week highs. The bull market is thinning out, which is typically a late-cycle sign. It doesn't mean equities have to fall apart from here, but rather the easy money has already been made. Correlations among individual stocks and sectors are declining, and that is a breath of fresh air for active managers like ourselves. We can finally view the equity market as a "market of stocks" rather than a "stock market", where individual company performance matters.

Tandem Strategy Update

After reading the section above, you're probably eager to find out all the different transactions we made this month within the new "market of stocks". Well, not to disappoint, but there was very little action taken in September. The only transactions we made were within the Equity strategy, where we added to our Celgene (CELG) position and initiated a new position in Dollar Tree (DLTR). Even though correlations are coming down, which ultimately provide more opportunities for active managers to buy and sell, volatility over the past quarter has been uncharacteristically low for this time of year. According to Ryan Detrick with LPL, this past quarter was only the second time in history where in the third quarter of a calendar year the S&P 500 didn't record a daily close, up or down, of at least 1%. However, that script may soon change, as no other month has witnessed more 1% intraday changes for the S&P 500 than October since 1950.

Earnings Update

The recent macro and political headlines dominating the news every day have had little impact on the market. But the upcoming quarterly earnings season has the potential to induce some volatility. As we've mentioned in previous columns, earnings through the fourth quarter of 2018 will be very strong due in part to corporate tax reform. We are now more than half way through the initial growth spurt and as we enter the final quarter of the year, companies will begin to hint at expectations for 2019. And, this is where it could get interesting.

So far this year, earnings growth has been running around 25%. Estimates for the third and fourth quarter are 19.5% and 16.9%, respectively. This earnings growth is coming on the back of sales expectations of roughly 7% growth. As you can see, there is a rather large dispersion between the rate of sales and earnings growth. Once a full year of tax reform is behind us the year-over-year comps will get much more difficult and the dispersion between sales and earnings growth will dramatically narrow. In fact, we believe it is very likely you will see earnings growth mirror sales growth. This means the rate of earnings growth will decline from the mid-20s to the mid-single digits. That is an enormous deceleration and one we may start to hear about over the next few weeks.

End of an Era

During the Fed's most recent meeting on September 26th, Chairman Powell made a statement during his press conference that seemed to get very little attention.

"*So I don't comment on the appropriateness of the level of stock prices. I can say that by some valuation measures they're in the upper range of their historical value ranges. But I wouldn't want to speculate about what consequences of a market correction should be. You know, we would look very carefully at the nature of it, and I mean really. What hurts is if consumers are borrowing heavily and doing so against, for example, an asset that can fall in value. So that's a really serious matter when you have a housing bubble and highly levered consumers and housing values fall, and we know that that's a really bad situation. A simple drop in equity prices is all by itself doesn't really have those features. It could certainly feature - it could certainly affect consumption and have a negative effect on the economy, though."* – Federal Reserve Chairman, Jay Powell

This is a significant sea change from the previous two Fed Chairs. Over the past 10 years, there has been an implied "Fed Put" to the equity markets. Like clockwork, whenever stocks fell a few percent, a member of the Federal Reserve always came out to reassure the markets that the Fed was there to add more stimulus if necessary. The stock market has become conditioned to expect the Fed to always have its back. Well, Chairman Powell might have just turned his back on the equity market. Only time and a little volatility will signal if he really means it.

-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