TANDEM Investment Advisors

Financial Markets Review

The last market standing finally got knocked off its perch, as the S&P 500 declined 11.44% from peak to trough. Once the closing bell finally rung on Halloween, the S&P 500 logged its worst monthly performance since September 2011 – down nearly 7%.

As we mentioned last month, it was only a matter of time before volatility came back to the market and the S&P 500 would reflect its constituents and other financial markets around the world. Domestic equity markets grinded higher throughout the summer on deteriorating breadth, which was evident in the increasing number of 52-week lows outpacing the number of 52-week highs on the NYSE. Even though the index remained stubbornly high the internals were telling a different story. And that story finally came to fruition in a rather abrupt way.

It's important to put the recent volatility over the past month and earlier this year in a little bit of context. 2017 was an historically calm year and one we may never witness again. In fact, the largest drop was 3% from peak to trough. Coming into this year, investors got too accustomed to equity markets that only went up amidst literally no volatility. Before the correction earlier this year, global equity markets rose for 14 consecutive months, which was the longest uninterrupted monthly streak on record for international equities. It was also the first time on record that the S&P 500 was up all 12 months of the year. In addition, the S&P 500 was higher 20 of the prior 21 months. As great as the stock market rally was for everyone, it was not normal! Many investors were lulled into a false sense of security, because volatility had been absent from the market for so long. According to Ryan Detrick with LPL Advisors, since 1927, there have been 218 instances where the S&P 500 corrected 5+% with an average selloff of 12%. That equates to an average of at least two 5+% corrections every year, which is what the S&P 500 has done so far. 2018 has been the more normal year! Investors just need to reset their expectations to factor in that equities can actually and will go down from time to time.

Economic Review

Many pundits would attribute some of the following reasons as to why equity markets fell in October.

- Extreme complacency among investors
- Rising interest rates
- President Trump's lack of confidence in the Fed and specifically the Fed Chair, Jay Powell
- Upcoming elections
- Trade uncertainty with China

However, one of the leading reasons was rarely discussed or maybe the financial media just didn't want to acknowledge it – slowing growth. The global synchronized recovery, which was the raging buzzword through last year and into January, seemed to hit a brick wall about nine months ago when financial markets around the world all melted up and peaked at the same time.

Ever since then, around the same time as the "trade war" chatter started to pick up, global economies and financial markets began diverging. International economies began decelerating, while the U.S. economy continued humming along. Just as the S&P 500 index level masked some of its internal weakness, the same can be said for the U.S. economy and GDP.

It is looking increasingly likely that GDP peaked in the second quarter of this year. The initial third quarter reading showed continued growth in inventories, which made up all the growth in business investment. Growth in the level of inventories has been increasing ever since the announcement of the Chinese tariffs. Considering the Chinese tariffs are expected to go from 10% to 25% on January 1, 2019, many companies are scrambling to build up their inventories before their costs of good increase significantly. Inventories will likely decrease in future quarters which will be an additional headwind to U.S. GDP.

Last month, we learned that U.S. home sales fell for the sixth straight month in September, which was the largest drop in over two years. Much of this decline is being blamed on rising prices, dwindling supply and higher borrowing costs. All these factors make housing less affordable for individuals. But the real question is whether the weakness in housing will spill over into the rest of the economy. Housing doesn't make up the largest component of GDP, but between residential investment and housing services, it does contribute roughly 15%.

More recently, over the past week we've seen weakness across the globe when it comes to manufacturing PMIs. China reported a number that missed expectations and came in just above the contraction/expansion breakpoint of 50.0. Europe posted their weakest manufacturing PMI report in over two years. And lastly, the ISM manufacturing print for the U.S. also decelerated from the previous month. The U.S. report missed expectations on comments from purchasing managers that included rising prices, tariffs, shortages and declining foreign demand as reasons for the deceleration within the manufacturing sector.

Tandem Strategy Update

It was a much busier month on the transaction front than it had been throughout most of the third quarter. As volatility picked up, we were able to take advantage of opportunities to trim a couple of positions and add to a few others.

Our quantitative model signaled Costco (COST), Becton Dickinson (BDX), TJX Companies (TJX) and Ross Stores (ROST) as valuation sales several weeks ago. All these stocks have had quite a run this year with their price appreciation significantly outpacing their fundamental growth. This divergence between price and fundamentals was one factor that attributed to our quantitative model issuing a sell signal, which called for us to sell 25% of our position.

In addition to the few sell signals we received early on in October, as the month progressed, and volatility increased, we were given the opportunity to add to some of our core holdings – AbbVie (ABBV), Celgene (CELG), Cognizant Technology Solutions (CTSH), Dollar Tree (DLTR) and JM Smucker (SJM).

Even though the S&P 500 fell 11% over the course of a few weeks, one thing we noticed was that we were not receiving a slew of "buy" signals. Part of the reason was because we came into the month overvalued on many metrics. Based on our quantitative model, we saw the drop in equity prices cause significantly more stocks go from being ranked overvalued to fairly valued as opposed to stocks transitioning from being fairly valued to undervalued.

In addition, our quantitative model is picking up on a significant number of stocks beginning to exhibit decelerating growth. This was expected with companies coming up on tougher comps, since we are getting close to the 1-year anniversary of corporate tax reform. However, what is beginning to show up on corporate earnings calls and in the numbers is an increase in their costs. Executives have spoken at length regarding higher labor, raw material and freight costs continuing to go higher. These escalating costs are bound to eat into the record high margins that companies have been reporting, which will ultimately reduce their profitability. As long as trade tensions persist, the U.S. dollar strengthens, and global growth continues to slow, corporate earnings will face significant headwinds in 2019. Unfortunately, it will likely take a deeper correction and/or a reprieve in the escalating costs environment before a significant number of new opportunities show up as being ranked a "buy".

-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