

"Well, what worries me is how totally lazy investors have gotten, totally dependent on the Federal Reserve and I find this to be a precarious situation."

--Richard Fisher, March 20, 2015, in an interview with CNBC one day following his retirement as President and CEO of the Federal Reserve Bank of Dallas

It is difficult for me to reflect on the month of March and not immediately think of March 2008, when the most devastating financial crises since the Great Depression began to unfold, at least as far as the American public was concerned. I had been working at Tandem for less than two years, and I found myself tasked with the seemingly insurmountable challenge of guarding our clients' investments against rapidly deteriorating American and global economies. At the height of the crisis, I was so consumed with work that I often arrived to the office by 3 a.m. and didn't leave until after 10 p.m. There were many events of monumental significance during that time, but I can clearly recall one of the first dominos to fall: On March 16, 2008, JPMorgan agreed to purchase Bear Stearns for a nominal \$2 per share, a price that infuriated Bear shareholders but was considered far too much by those who were close to the situation. Over the course of its illustrious 85-year run, Bear had become one of the nation's largest investment banks – a member of Wall Street's "Big Five." In one week, however, Bear went from "well-capitalized" to defunct. Of course, the financial crisis started to gain momentum well before Bear failed, but it took the collapse of this giant to really open the public's eyes. The harsh reality of the JPMorgan/Bear deal was that it took a \$30 billion government backing for JPMorgan to even be interested in acquiring Bear. Despite a string of similar unprecedented actions taken by the Federal Reserve to stem the collapse of the global financial system, the S&P 500 hit a low of 666.79 almost exactly one year later. And during that same stretch from March 2008 to 2009, the U.S. lost 5,000,000 jobs, GDP for the 4th quarter of 2008 came in at an annualized rate of -6.2%, and the S&P 500 was down 57.7%, from its peak in October 2007. At this time, few would argue against the emergency measures put in place by the Fed, particularly zero interest rate policy (ZIRP) and quantitative easing (QE). There was no doubt that we were headed down the road toward another Great Depression, which absolutely justified the Fed's use of emergency monetary policies.

Fast forward 2,200 days, and compare current statistics for the same above categories. The U.S. created roughly 3,000,000 jobs in 2014 (the most since 1999), GDP has grown at a 2.84% annualized growth rate since the 4th quarter of 2008, and the S&P 500 is up over 215% since its low, set in March 2009. Look around you. By no means is the economy knocking it out of the park, but we are clearly in the midst of neither a depression nor a recession. So why is the Fed continuing its outdated emergency monetary policies? Undeterred, the Fed furthered this seven-year trend on March 18th, when it downgraded its economic forecasts, implying a continuation of ZIRP for longer than the market anticipated. This decision caused the S&P 500 to close up

1.8% off its intraday low. Instead of suggesting that the market move was justified based on company earnings reports or strong macro data, the financial media was instead obsessed with Janet Yellen's "amazing performance" during her news conference following the FOMC decision. These actions by the Fed and the subsequent reaction by the media underscore the point I have been making for some time (one that my regular readers will no doubt recall): There is a vast disconnect between companies' fundamentals and their respective valuations. More to the point, fundamentals seem to be irrelevant in today's equity markets. Instead, the policies of the Fed are what truly matter most. The Fed continues to state that it is "data dependent." Well, the investing public has been trained to be "Fed dependent," and we are forced to continuously parse through its every last word. For example, over the past few weeks, the financial media debated ad nauseam what it would mean for markets if the Fed drops the word "patient" from the FOMC statement. Clearly, Richard Fisher's warning has substantial merit. Like Fisher, I, too, think this is getting downright ridiculous! Unfortunately, this is the world we continue to live in, even seven years after the Fed's emergency monetary policies were first introduced.

Many pundits and analysts would argue that the Fed is doing the correct thing by not raising interest rates, and I would not necessarily disagree...now that the Fed is sufficiently boxed in by both deteriorating company fundamentals and macro data points. Moreover, it's been over 40 years since the last time we've seen the U.S. dollar appreciate at this speed and magnitude. This rapid appreciation of the U.S. dollar is one reason why oil prices have declined so quickly over the past six months. These two factors – the dollar's appreciation and decline of oil prices – will end up being major contributing factors to the S&P 500 earnings recession, which I anticipate once 1st quarter earnings are reported. The window for the Fed to raise interest rates and remove its emergency policies was a couple of years ago, not today. The Fed missed its opportunity to act, and I believe it is well aware of a growing predicament: an increased amount of speculation as well as risk-taking amongst investors, both with no end in sight. For example, traditional bond investors are being pushed into equity securities in search of yield; there exists a record amount of margin debt, which is used to magnify returns on risky assets because it has never been so cheap to borrow money; and many companies are buying back shares in excess of the cash flow they generate by using cheap debt to make up the difference. Let me clarify that risk-taking is not all bad. In fact, if you ever want to make a return on any of your money, you must invest with a certain level of risk. However, problems arise when you're forced to take unnecessary risks. Does the phrase "where else are you going to put your cash" ring a bell? If you watch television programs or networks that track U.S. and global markets, then you'll likely hear this saying at least three times a day. The Fed's actions over the past several years have forced investors to make decisions they normally would not make, and I can't envision a scenario in which it all ends well.

I would be remiss if I didn't dedicate a portion of this column to volatility, a topic that I have touched on in previous editions and that again has particular significance. Volatility is another unfortunate by-product of the Fed's emergency monetary actions. As I mentioned above, low interest rates have led to an increase in margin borrowing, which magnifies returns on both the upside and downside. So far, we've only really seen upside in the U.S. equity markets. However, anyone who follows or invests in currency, fixed income or commodities markets knows about the pain felt as a result of the swift downdrafts over the past several months. Most recently, the U.S. dollar index fell a little more than 1.5%, a move that began the moment the Fed

downgraded its economic forecast, and the slide hadn't stopped by the time the equity markets closed that same day. And just minutes after the U.S. equity markets closed, the U.S. dollar index fell an additional 1%. These moves don't sound extreme, but in the highly levered currency market, they are astronomical. For example, if a fund is levered 30 to 1, it only takes a 3.4% decline against its positions to wipe out its capital base. Now, you see why such small moves in these markets can be devastating. If you are looking for further proof of the strong correlation between the Fed's emergency monetary policies and current market volatility, go back to October 15, 2014, when arguably the largest and most liquid market in the world, the U.S. treasury market, experienced a flash crash during which all liquidity disappeared in minutes. The 10-year U.S. Treasury was trading around 2.20% in the early morning, but after the retail sales report, the 10-year was trading around 2.00%. Almost immediately after the opening bell signaling the start of the equity trading day, the 10-year plummeted to 1.86%. Again, the magnitude and speed of these moves are astonishing. Some financial pundits dismissed these moves as one-offs and, thus, not interrelated with Fed action. I couldn't disagree more. These moves are a direct result of the continuation of the Fed's emergency monetary policies as well as increased central bank intervention across the globe. I wish I could say that this is all an aberration, but I'm afraid it's just the start. Unfortunately, this volatility will find its way into our equity markets. It's only a matter of time.

Looking back, I can hardly believe that seven years have passed since news broke of JPMorgan purchasing Bear Stearns. And while I don't miss those 19 and 20-hour workdays, I do feel a sense of pride and accomplishment when thinking back on the role our strategy and discipline played in helping to protect those who entrusted Tandem with their assets. It remains a point of pride for us at Tandem to say that we were able to minimize the downside in our clients' portfolios*, which allowed them to recover all losses 28 months before the S&P 500 was able to get back to even. Just as we did during the worst of the financial crisis, we will do our best to navigate the Fed's continued use of emergency monetary policies, not through speculation or unnecessary risk-taking but by making independent decisions based on our own analysis and on our proven quantitative valuation models. Anything less would be, as Richard Fisher put it, "lazy" and certainly not up to the high standards that Tandem places on itself.

--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

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