OBSERVATIONS 4.3.2018

Financial Markets Review

March was a microcosm of the first quarter. The S&P 500 made its monthly high within the first third of the month. It then traded sharply lower, only to bounce back but not enough to close higher than where it started.

Volatility reigned supreme and never really let up throughout the month. The S&P 500 traded in a 216.64-point range, which is roughly 8%. This sounds like a lot, especially when you compare it to how the market has traded over the past two years. And it is a rather significant monthly trading range, but the daily trading ranges were even more notable. In fact, when comparing the daily trading ranges of the S&P 500 in March to all of 2017, the daily volatility over the past 31 days was utterly staggering. The following table illustrates just how volatile the past month was compared to all of 2017.

	March 2018	2017
Average Daily Range	40.61 pts	12.47 pts
Largest Daily Range	78.66 pts	45.10 pts
Smallest Daily Range	11.88 pts	4.44 pts
Days Over a 30 pt. Range	14 days	5 days
Days Over a 45 pt. Range	10 days	1 day

There were days last year where we would even question why the stock market was even open. In fact, there were 5 days where the S&P 500 traded in less than a 5-point range. This past month we witnessed several times when the market traded in more than a 5-point range in a given minute. Unfortunately, volatility is likely here to stay for the foreseeable future. It may calm down a little bit given the extremes of the past month, but by no means is it going back to the levels seen last year.

Earnings Update

We are certainly not short of reasons to explain volatility's return and the recent decline in the stock market – inflation, rising bond yields, a flattening yield curve, turnover in the White House, a new Fed Chair, weakness in the technology sector and the rumblings of a trade war. However, one potential reason that is not getting a lot of airtime is the idea of peak earnings growth for the S&P 500. I'm not referring to a decline in the absolute earnings number, but rather a deceleration in the growth rate.

According to Factset, the current year-over-year expectation for Q1'2018 is 17.08% EPS growth. This is followed by the expectation of 19.30% EPS growth for Q2'2018, 21.47% EPS growth for Q3'2018 and 17.36% EPS growth for Q4'2018. Regardless of how you measure the growth (i.e. year-over-year, rolling quarters, etc…), earnings growth is expected to peak in the third quarter of this year. None of this should come as a surprise considering the massive corporate tax cuts that were recently passed.

However, this fiscal stimulus will only increase EPS growth rates for the first year after enactment. Once companies begin to comp against the same lowered tax rate, their growth rate will normalize.
Currently, estimates going into 2019 and 2020 are for sales growth in the mid-single digits with EPS growth in the low double-digits. Based on these estimates, the only way to get the numbers to work is to price in margin expansion. Considering the S&P 500 currently sports the highest EBIT margin in history, the continued upside in the operating profit margin becomes increasingly more difficult. After going through countless quarterly earnings calls, one of the big takeaways this past quarter was the effect wage inflation is having on corporate costs. In addition, many corporate executives have begun to come out over the past couple of weeks to express concerns over how a trade war would negatively impact their cost structure. Now, unless the actual sales growth rate can double from the expected mid-single digits to low-double digits, the EPS growth rate will most certainly decelerate from here.

This isn't a prediction, but rather a potential reason to explain the recent volatility and weakness in the stock market. By all measures, corporate fundamentals haven't changed over the past two months. The only thing that has really changed is the valuation and price an investor is willing to pay for future earnings. We are in the midst of multiple contraction after years of multiple expansion. And, just maybe this period of multiple contraction is foreshadowing a deceleration in future profitability. Only time will tell.

Tandem Strategy Update

While an increase in volatility can be frightening for some, we welcome it. Volatility allows us to find opportunities to buy and sell stocks with the overall goal of limiting portfolio volatility and downside returns relative to that of the S&P 500. So far this year, we have been more active on the transaction front than we have in some time. And, we've been able to achieve our stated goal across all our investment strategies. *(For information regarding Tandem's investment strategies, please email a request to Elaine Natoli at* enatoli@tandemadvisors.com*)*

Over the past month, we added to our positions in Hormel (HRL)*, Tractor Supply (TSCO)*, TJX Companies (TJX)**, Dominion Resources (D)*** and Henry Schein (HSIC)****. Since the passage of the tax reform bill, several of these companies have announced dividend increases, debt reduction and reinvestment back into their businesses. In particular, HRL's dividend paid in February represented a 10% increase over the previous quarter. TJX announced a 25% dividend increase. And, D reaffirmed their previously stated guidance of a 10% annual increase through 2020.

In addition to the purchases, we wrapped up our liquidation of Cerner (CERN)***** and Wabtec (WAB)*. As mentioned in previous months, both companies had violated our basic fundamental criteria, but for different reasons. CERN hired a CEO from outside the company. And, WAB no longer passed through our quantitative model due to inconsistent earnings growth. Lastly, the Scripps Networks (SNI) merger with Discovery Communications (DISCK) closed during the first week of March. After waiting for seven months since the merger was first announced, our clients finally received the full offer price of $90/share in cash.
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-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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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.

** HRL and TSCO was bought across all strategies (Tandem Large Cap Core, Equity, and Mid Cap Core). WAB was sold across all strategies.*

*** TJX was bought across Tandem Large Cap Core and Equity.*

**** D was bought across Tandem Large Cap Core.*

***** HSIC was bought across Tandem Mid Cap Core.*

****** CERN was sold across Tandem Equity and Mid Cap Core.*