OBSERVATIONS 6.1.2019

Financial Markets Review

"Now that people are dismissing the notion of a business cycle, the ability for a country to enter a recession and speculators all but betting the house that volatility will not rise in the near future, we might look back and conclude the "wall of worry" was officially breached in April 2019." – Observations, 5/3/2019

Last month, we touched on how the most recent direction in stock prices has a way of setting market narrative. There was chatter that the business cycle was now a thing of the past and the odds of a Western country ever entering a recession going forward were remote, at best. As the S&P 500 steadily rose through April, it became increasingly evident that complacency was back and many of the concerns that arose over the preceding six months were no longer concerns. And with that, on April 30th the S&P 500 closed out the month at an all-time high.

As we entered the first few days of May, it was evident the script had flipped. The perceived belief that the U.S/China trade spat was concluding was quickly squashed when President Trump issued a deadline to increase the 10% tariffs to 25% on an additional $200 billion worth of goods. And just for good measure, he didn't want to leave Mexico out of the tariff party, so President Trump slapped a 5% tariff on them with specific dates as to when those tariffs would increase. By no means am I an expert on foreign economic policy and I don't pretend to be one. The threat and implementation of tariffs might ultimately be a great tactic for long-term change; however, I can promise you there will be short-term pain.

The pain was certainly felt within U.S. equity markets in May. The S&P 500 declined for the fourth straight week to end the month lower by 6.58%. This was the first monthly decline of the year and the worst May since 2010. Along with declines in the S&P 500, the Nasdaq, Russell 2000 and DJIA also posted losses of 7.93%, 6.64% and 6.69%, respectively. Meanwhile, U.S. Treasury yields continued their march lower and seemingly flew off a cliff in the last two weeks of the month. Over the past four weeks, the 10-year and 30-year Treasury bond fell 37 basis points, while the 5-year Treasury note fell 36 basis points. The 10-year Treasury - the most talked about maturity - yields 2.13%, which is now down 112 basis points over the past six months. That is an absolute stunning move! As the longer end of the Treasury market fell, the shorter end also declined, but not by nearly as much. The 3-month T-bill and 6-month T-bill declined 7 and 10 basis points, respectively. What this boils down to is that the Treasury curve has just inverted by an even greater amount than it already was, which has historically not been a good omen for the U.S. economy. In fact, 1-month T-bills are now inverted out past 10-year Treasury bonds, as the 1-month T-bill yields 2.34% compared to a 2.13% 10-year Treasury.

The recent sharp decline in equity markets, government bond yields and commodities are all signs of slowing growth ahead. And, one thing I'm pretty sure of is the Federal Reserve will be there cutting rates in the very near future. Currently, the market is pricing in a 15% chance of a rate cut at the June meeting, 47% chance at the July meeting and a 75% chance at the September meeting. The 15% chance in the meeting 3 weeks from now actually seems a little low to me. Considering the Fed Funds rate is now higher than all U.S. Treasury maturities, except for the 30-year, which is only 7 basis points higher, I think it's almost a given that the Fed will cut rates in a few weeks. In my mind, it is only a question of how much they will cut. If markets continue to rapidly deteriorate over the next couple of weeks, I think a 25-basis point rate cut would almost be a certainty. And, it would not shock me in the least to see a 50-basis point cut. The question at that point would be how the markets respond to such a move. Over the short-term, I think it would undoubtedly be positive for U.S. stock prices, as we've been groomed to celebrate central bank intervention. In the longer-term, it will be interesting to see if the Fed really has the power to suspend the business cycle, which was being predicted no more than six weeks ago.

Tandem Strategy Update

With two-thirds of the quarter in the books and 98% of S&P 500 constituents having reported their quarterly results, 1st quarter year-over-year sales growth came in at 5.33%, while EPS increased by 1.10%. As the quarter has progressed, estimates for the 2nd quarter have slowly been coming down. On 3/31, estimates for S&P 500 sales and EPS growth stood at 4.69% and 1.57%, respectively. This compares to current estimates for sales growth of 4.19% and a decline of 0.73% in EPS. Relative to the S&P 500, the fundamentals of our core holdings have held up quite well. For the 1st quarter, sales growth was 12.42% with EPS growth of 13.26%. Similar to the 2nd quarter, estimates for our core holdings have come down from the 1st quarter results, but continue to grow. As of today, estimates for 2nd quarter sales growth is 11.77% and EPS growth is 7.24%. By and large, our companies continue to do what is required of them – demonstrate consistent revenue, earnings and cash flow growth.

As volatility picked up in May, there were a few opportunities to put some cash to work. We took new positions in Laboratory Corp of America (LH) and UMB Financial (UMBF). LH was added to our Equity and Mid Cap Core strategies. And, UMBF was added to just our Mid Cap Core strategy. Both companies are beginning to accelerate their top and bottom lines, while trading at attractive valuations. UMBF, along with most other banks and specifically regional banks, were hit particularly hard in May as interest rates got pummeled. As the regional bank sector sold off, we also got the opportunity to round out our existing Signature Bank (SBNY) position in Large Cap Core. An inverted yield curve is not too kind to banks; however, the valuations of UMBF and SBNY, coupled with the growth both banks continue to exhibit, make both banks attractive at current prices.

If uncertainty, fear and volatility continue to gain traction in this market, it is likely we will have additional opportunities to invest our clients' cash. In the meantime, we remain patient. As long as short-term interest rates stay elevated, we will continue with our cash strategy of rolling over 1-month T-bills or investing in money market mutual funds, whichever is available to us at our clients' custodian.

-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

DISCLAIMER: This writing is for informational purposes only. The information contained in this writing should not be construed as financial or investment advice on any subject matter. Tandem Investment Advisors, Inc. does not represent that the securities, products, or services discussed on, or accessible through, this site are suitable for any particular investor. You acknowledge that your requests for information are unsolicited, and the provision of any information through this site shall not constitute or be considered investment advice, or an offer to sell, or a solicitation of an offer to buy any product, service, or security. Past performance is no guarantee of future results. Indices are unmanaged and not available for direct investment. They are shown or referred to for illustrative purposes only and do not represent the performance of any specific investment. No data in this writing should be construed in any way as performance of any Tandem investment product. For complete performance information and disclosures, please contact John Carew at jcarew@tandemadvisors.com

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