Financial Markets Review

For most financial markets around the world, the past few weeks have brought a sense of calm and renewed complacency. Domestic and International equity markets ground higher throughout much of July. The VIX fell 20% in the face of a market that quietly marched upward. The S&P 500 shot higher right out of the gates as the index tested its February, March, and June high of 2,800. The market initially struggled to get above its resistance at 2,800 until it finally broke through on July 17th. The NASDAQ continued its impressive run as it set another all-time high towards the end of the month. The Dow is the only one of the major indices to not recapture its post-January 26th high.

Meanwhile, the yield curve continued to flatten at a very quick pace. The spread between the U.S. 10-year Treasury and the U.S. 2-year Treasury collapsed to just a mere 25 basis points halfway through the month before steepening ever so slightly into the back end of July. As we stand on the precipice of inversion, any further Fed rate hikes could potentially invert the curve. Per the CME Group website, as it currently stands, the market is pricing in a 92% probability that the Fed will hike in September and a 65% chance of another hike in December. These two rate hikes in tandem (no pun intended), certainly leaves the strong possibility of inversion by year end.

Finally, by the end of the month, cracks began to form in the FANG trade. Netflix reported weaker than expected subscriber growth, while Facebook projected future slowdown in growth rates on top of a revenue miss. Netflix closed the month 15.7% lower than where they closed prior to earnings. Facebook was down more than 20% following its earnings report. Amazon was able to shore up some of the concern surrounding the FANG trade. However, weakness in the market-leading tech sector could bring back some of the volatility that has been absent in the market over the last month.

Earnings Update

The strength of corporate America has not shown any let up so far this reporting season. Tax reform is still funneling its way through the system, so year-over-year comps continue to accelerate. Through July 27th, 53% of companies in the S&P 500 have reported Q2 results. So far, according to Factset, the reported numbers have been as follows:

- Revenue growth +10.58%
- EBITDA growth +11.18%
- EPS growth +21.27%

It's hard to argue against the strength of the U.S. economy. The first reading of the Q2 GDP report came in at a blazing 4.1%, which is the fastest pace in four years. There are always pundits who will argue for or against any given report. In this case, those who are in the "this is just the start camp" point to the drawdown in inventories being a positive going forward. Eventually, companies will have to produce more to build inventories to meet demand, which will create a further increase to GDP down the road. On the other hand, those who are in the “this is as good as it gets camp” point to the surge in exports ahead of the Chinese tariffs that is unlikely to be sustainable. Either way, this was a good number and reflective of corporate fundamentals.

Regardless of whether or not this GDP report ends up being a cycle high, there is one thing we are sure of – corporate earnings growth is set to dramatically slow from current levels. Once the corporate tax cuts have been in place for a year, the current spread between revenue growth and EPS growth will contract. EPS growth will come closer to in-line with revenue growth. And, there is a strong possibility that EPS growth will be lower than revenue growth. It is hard to imagine margins expanding any more than they already have during this business cycle. In fact, as we continue through this earnings season it is becoming more evident on conference calls that CEOs are increasingly worried about rising input costs. Most recently, Coca-Cola's CEO, James Quincey, announced the company would be taking the unusual step of raising prices in the middle of this year to combat rising costs, which include freight, steel, aluminum, and labor costs. I don't know about anyone else, but this sounds like a little inflation to me!

Tandem Strategy Update

July 2018 marks the third July out of the past four where we did not make a transaction at the composite level. It's not like we shut down the office for the summer. We are still here! Over the past few years, July has seen the VIX trade down near the lowest level for that given year and the S&P 500 trade toward its highest level. This lack of volatility typically doesn't present us with a whole lot of opportunities to buy new positions or add to existing positions. We have stops in place on our core holdings that are ranked a sell. And, we continue to move these stops higher as the stock prices slowly drift higher. As we've seen in the past, I suspect we will be more active – buying and selling – as volatility likely picks up over the next two months.

While we patiently wait to take advantage of opportunities in the stock market, we've been busy combing through the various earnings calls over the past couple of weeks. So far, everything has been pretty good for our core holdings. As of July 27th, 49% of our companies have reported Q2 earnings with the following aggregate results:

- Revenue growth +13.92%
- EBITDA growth +16.75%
- EPS growth +17.93%

Due to the strong results, we've had a few companies increase their quarterly dividend payments.

- SJM* +9.0%
- NNN* +5.3%
- RSG** +8.7%
- SBNY*** – has initiated a $0.56 quarterly dividend for the first time in the company's history

Lastly, the increase in short-term interest rates over the past year has created an opportunity for cash balances to generate a little extra yield. With the 30-day U.S. T-Bill trading around 1.90%, there are several U.S. Treasury or U.S. Government Obligations money market funds that yield anywhere from 1.60% to 1.80%. This is the first time in 10 years that cash can generate a little something. It might not be a lot, but it sure is better than nothing! So, from a portfolio management standpoint it is a bit of a no brainer to put a portion of a client's cash position into a money market fund or 30-day U.S. T-Bill. While we wait for the market and individual companies to present valuable opportunities to deploy cash, clients can preserve capital and earn a relatively decent yield at the same time. Over the past couple of weeks, we have been working with the various custodians of our clients to review our cash equivalent options. If you have any immediate questions, please do not hesitate to contact Billy Little at 843-720-3413 or wlittle@tandemadvisors.com.

-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

** Owned in Tandem Large Cap Core and Mid Cap Core.*

*** Owned in Tandem Large Cap Core, Equity and Mid Cap Core.*

**** Owned in Tandem Equity and Mid Cap Core.*