OBSERVATIONS 9.5.2018

TANDEM Investment Advisors

Financial Markets Review

The S&P 500 managed to climb a global mountain of worry to exceed its prior high set on January 26th. While almost every major asset class around the world seems to be coming unhinged, the domestic markets remain steadfast. And in a world of interconnectedness, it is even more surprising to see the divergence between the U.S. and the rest of the world.

If there were ever a time to use the term - "Goldilocks" - to describe the U.S. economy and its financial markets, this might be it. The economy and corporate America are growing at a pace not seen in several years. Inflation, albeit increasing, remains under control. In the face of the Federal Reserve increasing the Fed Funds rate, long-term interest rates remain subdued. And lastly, due to the carnage among many emerging markets, which is being blamed mostly on the Fed's monetary policy normalization and subsequent U.S. dollar liquidity issues, there are whispers floating around that the Fed could pause its tightening cycle. All these factors together should lend support to the U.S. equity markets.

Unfortunately, so much can't be said for economies and markets around the world, specifically the emerging markets. For most of 2017 and into the first month of this year, the buzzword throughout the financial media was "global synchronized growth". You literally couldn't go two minutes without someone uttering this phrase. It was used to explain rising equity markets across the globe in conjunction with robust global economic growth. However, all good things must come to an end. During the first month of this year, we witnessed a melt-up in global financial markets. And since that time, financial markets around the world haven't fared so well. We touched on this topic a few months back in the May 14th, 2018 edition of ***Notes from the Trading Desk.***

- Emerging Market equities (EEM) - down 17%
- Emerging Market bonds (EMB) - down 9%
- Emerging Market currencies (CEW) - down 10%
- International Market equities – developed countries (EFA) - down 10%
- Bloomberg Commodity Index – down 8%
- DJ-UBS Industrial Metals Index – down 17%

With all this being said, it doesn't mean the U.S. equity markets are headed for an imminent decline. It's just another one of those things to note alongside another topic we've spoken about in great detail – historically high valuations. There is never one reason for a bull market to end. Rather, several issues build up over time leading to the eventual reset of asset prices.

Tandem Strategy Update

At Tandem, we shy away from making big "market" calls or even long-term predictions. I've found that more times than not predictions don't quite pan out. Instead, we exert 100% of our energy on what we can control amid the uncontrollable nature of financial markets. And, the only thing we can really control is adherence to our investment philosophy and discipline. We strive to provide Tandem clients with a consistent, repeatable experience. And that consistent experience should apply to all facets of our business from the Operations Team to the Client Relations Team and the Investment Team.

Regular readers of our bi-weekly piece (***Notes from the Trading Desk)*** and our quarterly newsletter (***The TANDEM Report)*** have probably come to realize that we've been a bit cautious on the market for a while now. Over the past couple of years, depending on the specific strategy, our cash levels have ranged from low-20% to mid-30%. That is a significant amount of cash for an equity manager! However, the one thing we've always said is we don't buy stocks for the sake of buying stocks. We consistently follow our quantitative model and buy what needs to be bought and sell what needs to be sold. Currently, we have more stocks ranked a sell than a buy. And for that reason, we are in an environment where you would be hard pressed to see cash levels drop.

Over the last month, we were net sellers across all our strategies. Our quantitative model signaled us to make valuation sales in ResMed (RMD) and Brown Forman (BF.B). As a reminder, we sell 25% of the position for valuation sales. Both RMD and BF.B have been core positions for several years and continue to meet all the fundamental criteria to remain in our strategies. However, both stocks are beginning to experience deceleration in their sales and earnings growth rates, while they continue to trade at historically high valuation levels. The combination of a deceleration in growth metrics and all-time high valuations will typically cause our quantitative model to issue a sell signal. On the flip side, the reverse is true. A buy signal would typically be generated if a company is experiencing accelerating growth metrics and historically low valuation levels. It's a bit more nuanced than that, but it gives you a little peek into what makes our quantitative model tick.

With everything going on politically, socially and monetarily throughout the world, so much can change in an instant for both better or worse. There are a couple of sayings that will always ring true within financial markets. And, as always, we are prepared for whatever comes our way.

"Risk happens fast."

"Asset prices usually take the escalator up and elevator down."

-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