April 2023 - Tandem Investment Advisors, Inc.

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Financial Markets Review

After years of zero interest rate policy (ZIRP), cracks in the financial system began to emerge in early March. You would never know it by the positive performance seen in the S&P 500 and Nasdaq, as the large-cap indices climbed 3.51% and 6.69%, respectively. However, stress amongst small and mid-size regional banks was apparent within the small-cap index, as the Russell 2000 fell 4.98%. The real excitement though was in the land of interest rates, as yields across the entire Treasury curve declined in response to a brewing banking crisis.

March started out innocently enough as stronger than expected economic data dominated headlines. Over the past year, it has been hotly debated whether the blistering path of interest rate hikes by the Federal Reserve would result in a hard or soft landing for the economy. With inflation slowly coming down at the same time the economy seemed to hold steady amidst strong job growth, the narrative then switched to “no landing”. At this point, it’s hard to envision a scenario where “no landing” is remotely possible.

As Fed Chair Powell hinted at a possible acceleration to the pace of rate hikes, the short end of the Treasury curve lurched ever higher. At one point the 6-month and 1-year Treasury bills had a yield of 5.3%. A month ago, we wrote that the direction and speed of change in rates matters a lot for the equity market. Well, it appears that going from essentially 0% to 5% in just over a year is not all that healthy, particularly, for banks.

In a matter of days, we went from “no landing” to shades of the 2008 Great Financial Crisis. Not to get too deep in the weeds, but the banking crisis in March was very different than the one we experienced in 2008. For starters, the current banking crisis is one of liquidity, whereas in 2008 it centered around solvency. But that is ultimately not the point that I wish to drive home. What we should all take away from the last few weeks is a reminder of what I wrote about in February’s Observations:

“The only thing one can be certain of at this point is to expect the unexpected.”

I would be willing to bet that very few people came into March expecting the collapse of Silicon Valley Bank and Signature Bank, which happened to be the second and third largest bank failures in the history of the United States, respectively. What happened to these banks was unexpected, which is why you should expect more of the same. Remember, we just came out of a period of unprecedented fiscal and monetary stimulus. Two years ago, there was over $18 trillion in negative yielding debt across the globe. In the U.S. alone, nearly $5 trillion was dispersed as fiscal stimulus. These numbers are staggering, and it would be foolhardy to think that absolutely no consequences would stem from the policies enacted over the past several years. So, we now can chalk up soaring inflation and a couple of bank failures as consequences, but what's next?

There are a significant number of conflicting signals in the marketplace today. Broadly speaking, equities are painting the picture that everything may turn out OK. First quarter earnings will come into focus over the next few weeks and expectations are for a year-over-year decline of 7%. However, earnings are expected to resume growing again in the back half of this year. Through the recent upheaval in regional banks and an ensuing corporate earnings recession, equities have remained rather resilient. The Treasury market is saying the complete opposite. The spread between the 3-month and 10-year Treasury yields is pointing to a recession. This part of the curve is the most inverted it has been going back to the late 1970s and it's one that has predicted a recession 100% of the time over the past 50 years. The market's expectations of the Fed Funds rate also shows the likelihood of another rate increase in May followed by cuts as early as July and throughout the remainder of the year, which would be expected if the economy falls into a recession. However, Fed Chair Powell most recently pushed back against market expectations saying that the Fed does not generally expect to be cutting rates this year.

So, one of these signals is going to be correct. However, given the dichotomy between these signals, the likelihood of heightened volatility in all financial assets moving forward is increasingly probable. Most recently, we've seen this volatility play out in the Treasury market, as the 2-year Treasury note hit a high yield of 5.10% and then subsequently dropped to 3.44% in the span of two weeks, and back to 4% as of this writing. It is likely only a matter of time before volatility creeps into equities and other assets, as well.

Tandem Strategy Update

As we outlined above, most of the volatility experienced within financial markets over the past month was seen within the banking sector and Treasury markets. Outside of that, most equities held up rather well given all of the noise, which caused us to remain a little more patient than we would have otherwise expected.

In March, we took an initial position in Akamai Technologies (AKAM) within our Equity strategy. We have owned AKAM in our Mid Cap Core strategy since last year. As a refresher, AKAM is a leading content delivery network and a cybersecurity and cloud service provider.

In addition, we added to our core position in Brown Forman (BF.B) across all strategies, which has been a core holding in our Large Cap Core strategy since 2007. BF.B produces and distributes whiskey, scotch, tequila, vodka and wine under the following brands – Jack Daniel's, Woodford Reserve, Old Forester, Finlandia, Diplomatico, Herradura and Korbel.

Amongst all of our strategies, we own only one bank, which is held in just our Mid Cap Core strategy. UMB Financial (UMBF) is a traditional mid-size regional bank headquartered in Kansas City, MO. Given the nature of the turmoil among regional banks, coupled with the fact that our quantitative model is projecting UMBF to no longer meet our investment criteria in the coming quarters, we felt it was prudent for us to begin reducing our exposure to the company.

You have undoubtedly heard us say and write that volatility breeds opportunity. It is my belief that given the nature of the economy and financial markets, we will have many opportunities to invest cash in the coming quarters. We will also have some great opportunities to reduce our exposure in overvalued companies, as volatility works both ways. But one thing that volatility will do is spark emotion and it tends to make individuals do the wrong thing at the wrong time. It is always our goal to manage a strategy that experiences less volatility than the broader market. By doing so, this allows the investor to stay invested, while keeping their emotions in check. One of the most important aspects to staying emotionally grounded during highly volatile times is to know and understand what it is that you own. Bob Michele, CIO of JPMorgan Asset Management summed it up well in a recent interview with Bloomberg:

"If we've been taught anything this past month, you may see it coming or you may not. You don't know exactly where it's going to hit. But once it hits, whatever you own, you own, and you have to hope that you own the stuff that recovers." – Bob Michele, CIO of JPMorgan Asset Management, March 31st, 2023

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Billy Little is a shareholder, Senior Vice President, and Portfolio Manager for Tandem Investment Advisors, Inc. Mr. Little began his career in the investment industry in 2004, as a Financial Advisor with Ameriprise Financial in Baltimore, Maryland. Mr. Little joined Tandem in 2006. Mr. Little oversees Tandem's corporate financials, including business planning, budgeting, and vendor negotiations. Mr. Little also directs Tandem's quantitative and fundamental research. He is a regular member of the CFA Institute and past President of the CFA Society South Carolina. Mr. Little graduated from the College of Charleston with a Bachelor of Arts in Business Administration with a concentration in Finance.

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