OBSERVATIONS

Tandem Investment Advisors | William "Billy" Little, Jr., CFA

August | 2020

Financial Markets Review

It was Christmas in July! All major asset classes posted a positive return and they do not appear to be letting up through the first few days of August. Some might even call this the "all gas, no brakes" market. If you own financial assets, your portfolio is undoubtedly higher as global assets climbed the proverbial "wall of worry" last month.

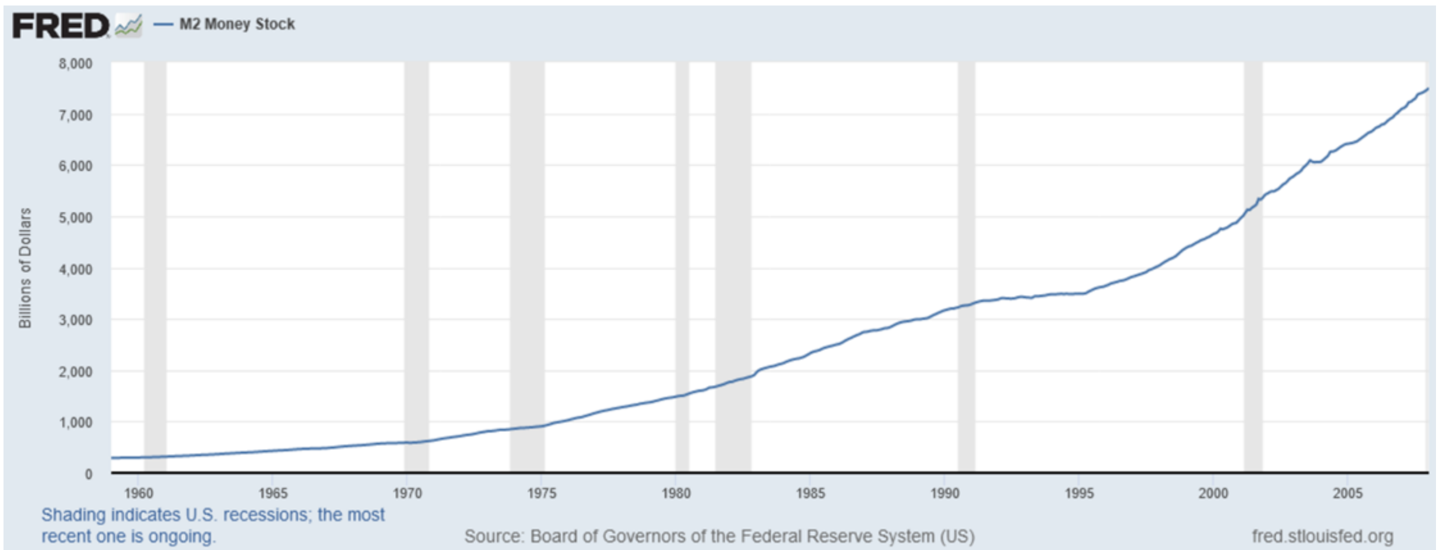
- S&P 500 +5.5%
- NASDAQ +6.8%
- U.S. Small Caps (Russell 2000) +2.7%
- Foreign Developed Equities (MSCI EAFE) +2.3%
- Foreign Emerging Market Equities (MSCI EM) +8.9%
- U.S. 20+ Year Treasury Bonds (TLT) +4.3%
- U.S. Investment Grade Bonds (LQD) +2.9%
- Commodities (Bloomberg Commodity) +5.7%
- U.S. Dollar Index (DXY) -4.2%

The "worries" are countless and span all aspects of our lives. You name it – economic, political, social, health – there is something about every one of those that affect us in one way or another. If you read over the list of assets again, you will see there is one that is unlike the others. It stands out among the rest as one of the only financial assets that did not appreciate in July – the U.S. Dollar Index. Our worries may not be reflected in the prices of stocks, but they are most definitely being captured by the decline in our currency.

A currency's worth or value is dependent upon many factors, but ultimately it comes down to a function of supply and demand. The supply of U.S. dollars can be measured by M2, which includes currency in circulation, savings deposits, and money market deposits. As you can see from the chart below, M2 has steadily grown from 1959 to 2007 (just before the Financial Crisis). Some years, it grows faster than others, but for the most part the trend is consistently higher.

To combat the negative effects of the 2008 Financial Crisis and prevent a global depression, the Federal Reserve and global Central Banks unleashed, at the time, unprecedented expansionary monetary policy. The world was awash in liquidity. By the end of 2019, M2 had doubled since the start of the 2008 Financial Crisis.

Supply has been increasing, but so has demand for U.S. dollars. In fact, since the Financial Crisis, demand has outpaced supply, which lead to the U.S. Dollar Index increasing by roughly 28% between January 2008 and December 2019. Over this time, the United States was looked at as a "safe-haven" relative to the rest of the world. Our economy was recovering, and the Federal Reserve eventually had



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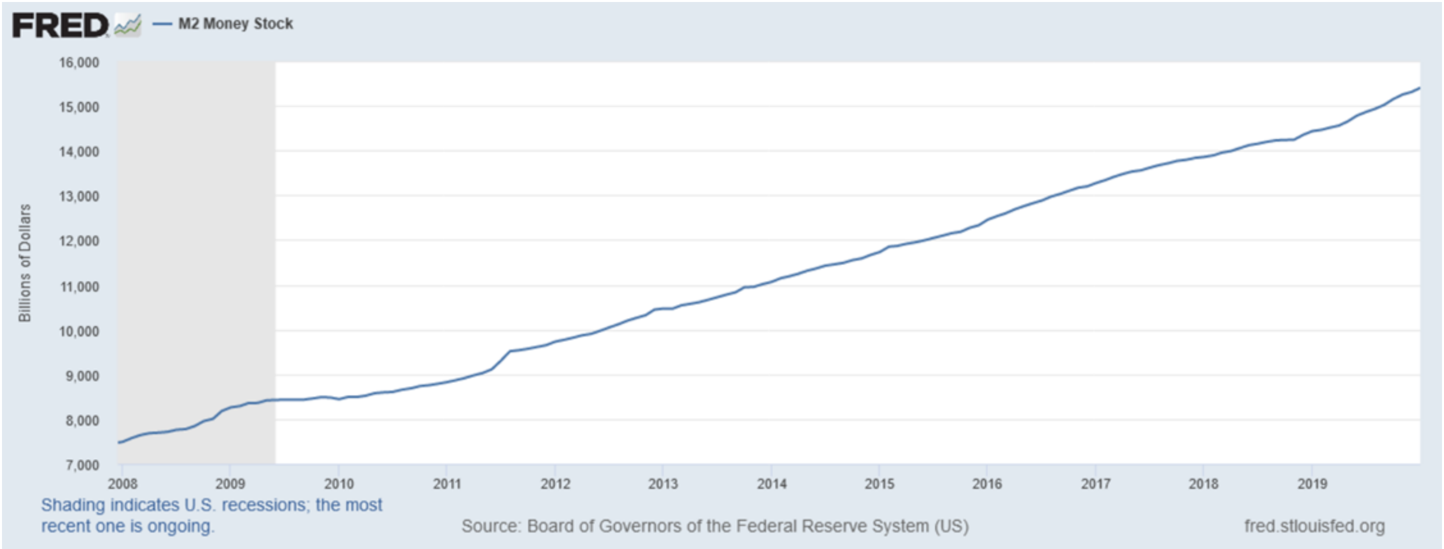
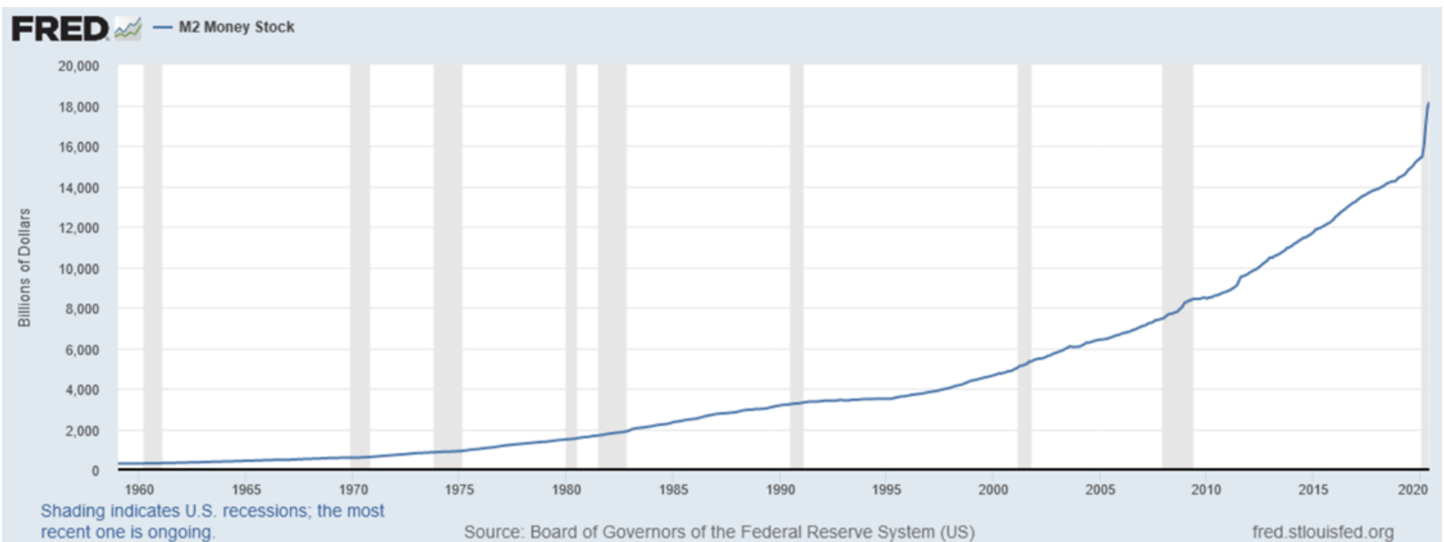


the confidence to wind down QE and ultimately raise rates. In a world of relativity, higher rates and economic stability lead to capital flows and demand for the currency.

Everything was moving along well until the calendar flipped to 2020. The COVID-19 health crisis and global economic shutdown will go down as a life-changer. Some of the lifestyle change and economic disruption we have endured over the past few months will be temporary and some will be permanent. Only time will tell. However, there is no disputing that the now unprecedented monetary and fiscal response will have lasting effects. The Federal Reserve's monetary and the U.S. government's fiscal response to the most recent crisis dwarfs that of the 2008 Financial Crisis. Most recently, it took the Federal Reserve 3 months to expand their balance sheet by $3 Trillion. To put this in perspective, it took them 5 years to increase the balance sheet by $3 Trillion from the onset of the Financial Crisis. So far, Congress has approved over $3 Trillion in relief and are currently debating another multi-trillion-dollar stimulus package. All of this liquidity has caused the supply of U.S. dollars to grow exponentially.

Unfortunately, the surge in M2 has not coincided with an equivalent increase in demand. Therefore, the U.S. Dollar Index has fallen close to 10% since mid-March. As the U.S. Dollar Index declined over 4% in July alone, the speed of the descent has everyone taking notice.

There are several factors one can attribute to the waning demand for U.S. dollars and the subsequent price decline with the most obvious one being a decline in real rates/yields. The real rate is the interest rate you receive after adjusting for inflation. For example, if you purchase a bond yielding a nominal 4% and the inflation rate is 2%, your real yield is a posi-



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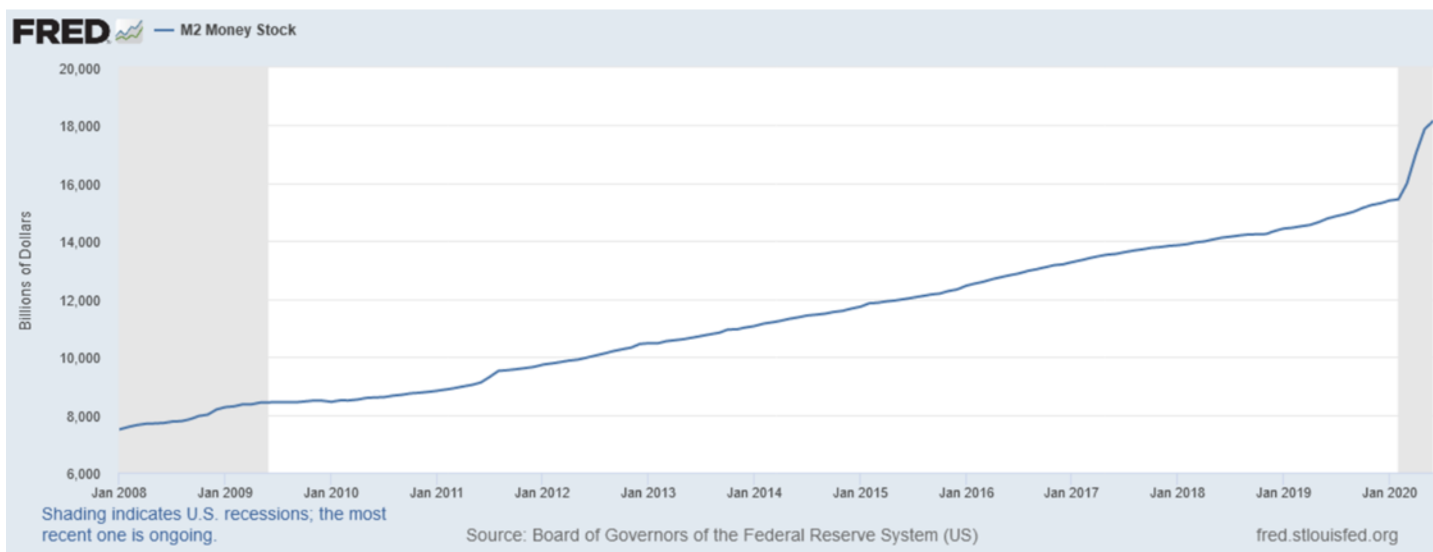
tive 2%. If you purchase a bond yielding a nominal 2% and the inflation rate is 4%, your real yield is a negative 2%. In the latter case, the yield of your investment is not keeping up with the pace of inflation. You did not actually lose money in this scenario, but you lost purchasing power. At the very least, you want your income and investments to grow at the rate of inflation, so your money can buy the same amount of goods today as it did yesterday.

Current inflation expectations, as measured by the 10-Year Breakeven Inflation Rate, have risen considerably over the past few months. This rise in inflation expectations is attributable to the massive monetary and fiscal stimulus, the likelihood for additional fiscal stimulus, the low supply of goods due to economies being shut down and factories still working at reduced capacity and global supply chains being upended. We are currently experiencing a supply shock - broken supply chains lead to higher input costs, which tend to get pushed on to the consumer in the form of higher prices, and fewer goods available for sale without a relative decline in demand also leads to higher prices.



While inflation expectations have picked up, the nominal yield in U.S. Treasuries has not kept pace. In fact, yields across the entire curve are making multi-month lows. The decline in nominal yields can be attributable to the economic recovery slowing in July due to a pick-up in coronavirus cases in many parts of the U.S. and some worry that the pent-up demand is beginning to wane. It is this decline in nominal yields coupled with rising inflation expectations that has pushed real rates negative across the yield curve and subsequently, the U.S. Dollar Index to move lower.

What Does This Mean and How Should I Be Positioned?

This is the question on many investors' minds because it can get a little wonky when discussing currencies, rates, and economic expectations. The United States is a net importer of goods and services and imports roughly 50% more than it exports. When the U.S. dollar depreciates, it takes more dollars to import the same amount of goods and thus, costs of imported goods go higher. If incomes and wages are supported, which are currently being done through fiscal stimulus, companies can pass along the higher costs by raising prices, resulting in inflation. In an inflationary environment, some of the best assets to own are equities, commodities, TIPS, and real estate. However, if economic activity and the recovery stall out, productivity and GDP will languish. Couple meager growth with inflation and you get stagflation. The same assets you want to own in an inflationary environment are what you also want to own in a stagflationary one. However, not all equities are created equal and ownership in certain sectors would be preferred over others. Specifically, companies in the healthcare, consumer staples, and utilities sectors theoretically would perform the best. The reason is that are those companies typically sell products that remain in demand regardless of the economic environment. They are also the type of

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companies that can maintain pricing power since their products have very low price elasticity. Companies that can grow their business regardless of the economic cycle, which give them the ability to pay a dividend and grow that dividend, are ideal businesses to own. Income that can grow at or higher than the rate of inflation and ownership of an asset that can offset the loss of purchasing power is paramount. And, those are exactly the types of businesses we own in the investment strategies that we offer.

Tandem Strategy Update

Real rates on the long end of the curve straddled the zero bound for several months before they finally sustained a move into negative territory on June 17th. This was the last day the real rate on the 30-year Treasury Bond was essentially zero at -0.01%. Today, the real rate on this maturity is -0.45%.

Since mid-June, several of our core holdings have performed very well and significantly outpaced the S&P 500. The companies that have done well are the ones you would expect to do well in a stagflationary environment.

- Becton Dickinson (BDX) - a medical technology company focused on selling medical supplies, devices, laboratory equipment and diagnostic products. Look around the next time you go into your physician's office or a hospital; their products are everywhere.
- NextEra Energy (NEE) – the world's largest utility company. NEE generates, transmits, and distributes electric energy throughout much of Florida. They are also the world's largest generator of renewable energy from wind and solar.
- Abbott Labs (ABT) – a health technology company aimed to discover, develop, and sell diagnostic, cardiovascular and nutritional products. ABT is the number one market leader in stents, continuous glucose monitoring for diabetes care, blood and plasma screening and pediatric and adult nutrition.
- Waste Connections (WCN) – an integrated waste services company that provides waste collection, transfer, disposal, and recycling services. It is a rather simple business; they collect our trash.

The one commonality between these four companies is our dependence on the products and services they provide. Hospitals are not getting rid of syringes, surgical instruments, and hazardous waste disposal. Over the past several years, Florida has ranked as the number one state in attracting new residents. This trend is increasing the consumption of energy in Florida and unless everyone decides to pick up and leave that consumption should not waver too much. In addition, their position of being the number one generator of renewable energy puts them in great position for evolution of clean energy. As the population gets older, the demand for cardiovascular products, such as stents and diabetes care, will only increase and be necessary to extend life expectancies. Lastly, we are consumers of stuff, which creates a lot of trash; there will always be a need for trash collection and recycling. All of these companies will have demand regardless of the economic and pricing environment. And, not to mention, these four companies have grown their dividend by an average of 10.4% annually over the past three years. Now, that is the type of income growth that can offset the negative effects caused by a depreciating U.S. dollar.

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Billy Little is a shareholder, Vice President and the Lead 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 where he directs Tandem's quantitative 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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